September 2018

Economic tailwinds stronger than political headwinds

Low inflation despite sustained Swedish growth

Nordic Outlook

SEB

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International overview

Above-trend growth despite political risks

Global economic expansion will defy heightened political uncertainty in 2019-2020. Late-cyclical capital spending and optimistic households – helped by loose fiscal policies – will outweigh trade disruptions. Pay hikes will remain moderate despite very low unemployment. This will hold down inflation, although upside risks will rise in case of high resource utilisation. The US dollar will weaken as more countries emulate Fed rate hikes. Stock markets will behave more defensively, with share prices not fully matching earning growth.

The global economy has recently shown mixed tendencies. **The euro zone slowdown lasted longer than anticipated. Chinese indicators have also been unexpectedly weak**. Several other important emerging market (EM) economies have also suffered financial market turbulence, driven by such factors as trade disruptions, falling growth and the negative effects of higher interest rates in the United States. But **US GDP growth speeded up significantly in the second quarter** of 2018. Exclamation marks were also dominant in India, Japan and the United Kingdom. Recent months have also seen a steady succession of political events that have impacted financial markets, such as an escalating trade war, expanded US sanctions against countries including Iran, Russia and Turkey and threats by the new Italian government to violate European Union budget rules.

It is thus increasingly clear that the world faces major challenges related to **US President Donald Trump's** erratic leadership, the economic and political complications of the **Brexit process** and the complex geopolitical situation in the Middle East, including the crises in **Iran** and **Turkey**. This raises the level of economic uncertainty. Trade barriers look set to become bigger than in our earlier main scenario. Meanwhile the resilience of the world economy has confirmed our view that underlying economic forces will mainly determine developments over the next few years. Large capital spending needs, optimistic households and expansionary economic policies are now generating a strong late-cyclical demand surge. We are maintaining our relatively optimistic forecast that **global GDP growth will be 4.0 per cent in 2018 and 3.9 per cent in 2019**. Minor revisions for different regions will thus offset each other. Developments in 2020 are more uncertain, but we see good potential for the global economy to keep growing at a bit above its 3.5 per cent yearly trend. Tight resource situations in countries like the US, Japan and Germany will lead to slowdowns, but we believe that GDP can continue growing by more than 5 per cent in the EM sphere despite financial market tensions related to US Federal Reserve (Fed) key interest rate hikes. Most European economies also have enough slack to allow continued expansion.

If our forecast is correct, **in mid-2019 the US economic upturn will break a post-war record in terms of duration**. We can identify several different explanations as to why the record is now being broken. For example, the Lehman Brothers crisis a decade ago was unusually deep, and the subsequent recovery was lethargic, with relatively subdued growth. The supply side of the economy will be important in determining how long the upturn can continue. Registered US unemployment has now fallen to about the same record-low levels as at the turn of the millennium, but **other indicators suggest that the resource situation today is somewhat less stretched than at that time**. Pay and inflation are slowly rising, but at a moderate pace that gives the Fed a large degree of freedom. In countries like Japan, Germany and the UK, too, unemployment has fallen to levels we have not seen for decades, yet their central banks must still largely continue struggling with uncomfortably low inflation. There are certain upside risks for our generally rather low inflation forecasts. These are connected to the fact that in the prevailing economic situation, we may underestimate the secondary effects of higher energy prices as well as the inflationary effects of extreme drought and trade disruptions.

Global GDP growth
Year-on-year percentage change

	2017	2018	2019	2020
United States	2.2	3.0	2.5	1.9
Japan	1.7	1.1	1.0	0.8
Germany	2.2	2.0	1.9	1.7
China	6.9	6.6	6.3	6.0
United Kingdom	1.6	1.3	1.8	1.9
Euro zone	2.4	2.1	2.1	1.9
Nordic countries	2.3	2.2	2.4	2.2
Baltic countries	4.3	3.6	3.3	2.8
OECD	2.5	2.5	2.3	2.1
Emerging markets	4.8	5.1	5.1	5.1
World, PPP*	**3.8**	**4.0**	**3.9**	**3.8**

Source: OECD, IMF, SEB. * Purchasing power parities

For a long time, the Fed has had to carry out its interest rate hikes in relative isolation. This has opened wide gaps with other advanced economies for various maturities. In this environment, the US dollar has climbed significantly against EM currencies,

while its movements against currencies like the euro and Japanese yen have not been so large. We expect the Fed to continue raising its key rate to 3 per cent by mid-2019. After that, it will carry out another hike to 3.25 per cent by the end of 2020. But today **cautious normalisation of monetary policy also seems to be under way on a broader basis**, despite continued low inflation pressure. The central banks in the UK and Canada recently hiked their rates. Norges Bank in Norway has clearly signalled a hike at its September 20 meeting. We predict that the key rate in both the UK and Norway will reach 1.75 per cent by the end of 2020. At its June meeting, the ECB confirmed it will end bond-buying this year and that the next step will be a rate hike, though probably not until after summer 2019. Sweden's Riksbank will lag behind other central banks with similar economic environments, even in a longer perspective. We predict that like the ECB, it will reach a key rate of 0.75 per cent by late 2020.

In the prevailing environment, financial markets remain torn between economic strength and political turmoil from the trade war or other disruptions, such as the crisis in Turkey. A more fragmented growth outlook, with question marks for Europe but acceleration in the US, is also reflected in the pricing of different assets. On the whole, our main scenario of only minor effects from political risks and gradually normalised central bank interest rates still applies. In this environment, bond yields will slowly climb over the next couple of years but remain low in a historical perspective. In the US, the strong economy, continued Fed rate hikes and a growing budget deficit suggest higher long-term yields. But moderate inflation expectations, the large bond holdings of central banks (due to quantitative easing, QE) and a generally low return environment in other countries will slow the upward trend. We predict that **10-year US Treasuries will be close to 3.50 per cent** by the end of our forecast period, while **equivalent German government bonds will reach only 1.40 per cent**, but the yield spread to the US will shrink somewhat from today's historically high levels of around 2.50 basis points. We expect Swedish 10-year government bond yields to move close to German yields in the short term but to trade at half a percentage point higher, at **1.90 per cent**, by the end of the forecast period.

Recent signs of strength amidst market turmoil suggest that the dollar has regained its defensive qualities. We believe that the EUR/USD exchange rate will bottom out this autumn in an environment of slightly more risk appetite and that the USD will then gradually weaken as other central banks narrow their rate gaps against the Fed. **At the end of 2020, the EUR/USD rate will be 1.28**. Our view is that despite difficulties, the UK will reach agreement with the EU. This promises a strengthening of the pound. In the near future, the Swedish krona will remain under pressure from the Riksbank and from worries about global trade disruptions. **We expect the EUR/SEK rate to remain around 10.50 for the rest of this year**. Uncertainty about the formation of a new Swedish government after the September election may push the EUR/SEK rate somewhat higher, but previous experience suggests that this effect will be minor and short-lived. As the Riksbank hikes its rate, the krona will appreciate to 9.70 per euro by the end of 2020: still weak compared to its long-term equilibrium level.

Stock markets in advanced economies have recently been resilient despite various threats and remain close to historical highs. Still a more **cautious late-cyclical behaviour is discernible and will put some pressure on valuations**. The prospect of continued earnings increases of around 10 per cent yearly implies that the MSCI AC World Index can be expected to provide normal-sized positive returns of some 6-8 per cent during the next 12 months.

Late-cyclical surge or soft landing?

The difficulty of finding credible recession indicators was a main theme of our last *Nordic Outlook*. Metrics for equilibrium GDP or unemployment are usually not stable enough to provide a basis for judgments on how long the recovery can continue. To escape this dilemma, forecasters customarily predict some form of "soft landing", in which GDP growth either "falls asleep" at around its trend level or declines somewhat yet remains at a safe distance from recession. **But history shows that this kind of soft landing rarely occurs**. On the contrary, demand usually shows a strong dynamic late in the economic cycle, among other things because **capital spending takes off** when capacity utilisation has reached levels that urgently require an expansion of production capacity. The rate of increase in capital spending in the Group of 20 (G20) economies has accelerated sharply this past year, indicating that we have entered such a phase.

Household optimism is usually strong late in the economic cycle, when the labour market is hot and wealth is climbing due to rising share and home prices. This pattern is also clear right now, yet because of weak growth in real wages and salaries, consumption has not really taken off. In the US, however, consumption soared in the second quarter of 2018. Although we should be cautious about drawing conclusions from one set of quarterly figures, recently published statistics show that American households have a substantially higher savings ratio than we had previously thought. **As a share of incomes, saving has been revised from 3 to 7 per cent**, which increases the potential for more long-lasting consumption-driven growth.

Pro-cyclical stimulus fuelling late-cyclical strength…

Fiscal stimulus measures are currently also fuelling the tendency towards dynamic demand late in this cycle. Neither Ronald Reagan nor Donald Trump is associated with any great stabilisation policy sophistication. But President Reagan's big tax cuts in the early and mid-1980s were implemented amidst high unemployment. Because monetary policy needed to be tight to push down lingering high inflation expectations, these stimulus measures **arrived at an appropriate time from a policy mix standpoint**. Trump's tax cuts contrast clearly with this, since they have arrived at a time when **unemployment is already record-low**. They consequently risk **pushing up interest rates** due to both rising inflation risks and increasing issuance of government securities due to wider budget deficits.

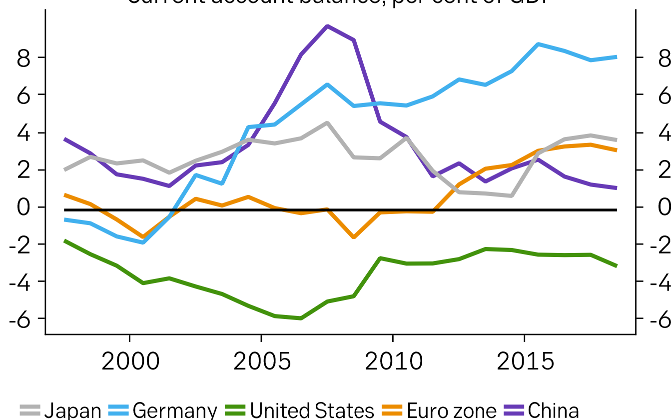
…and making global imbalances worse

German stimulus measures in a hot labour market situation are also contributing to a pro-cyclical shift in OECD fiscal policies. It is difficult to regard this as a major problem, however, considering that for years Germany has been criticised because its excessively tight policy has helped fuel growing imbalances, both internally in the euro zone and at global level. This aspect remains highly topical. The International Monetary Fund (IMF) is now warning that **the surpluses and deficits in various countries' net lending (current account) are dangerously**

large. Countries with unjustifiably high savings ratios are found in northern Europe (for example Germany, the Netherlands and Sweden) and in Asia (China, South Korea and Singapore). The US and the UK are the main examples of economies with worryingly low savings ratios. Due to higher imports and higher budget deficits, President Trump's expansionary fiscal policy will help push up the US current account deficit again to 3-4 per cent of GDP. This will further increase US net external debt (39 per cent of GDP today, above the warning threshold of 35 per cent). Germany's federal budget is now in surplus, and the current account surplus is a record-high 8 per cent of GDP. The country's enormous net external receivables are growing from today's 60 per cent of GDP. These savings imbalances **may worsen trade policy tensions, especially between the US and the EU/Germany**.

German surpluses worsen global imbalances

Current account balance, per cent of GDP



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

How big are imbalances 10 years after Lehman?

Both the IMF and the Bank for International Settlements (BIS) also warn that global imbalances may increase instability in the financial system. On September 15, 2008, Lehman Brothers sought bankruptcy protection. The extent to which new risks to market stability have emerged since then will play a major role in how long today's record-lengthy recovery can continue.

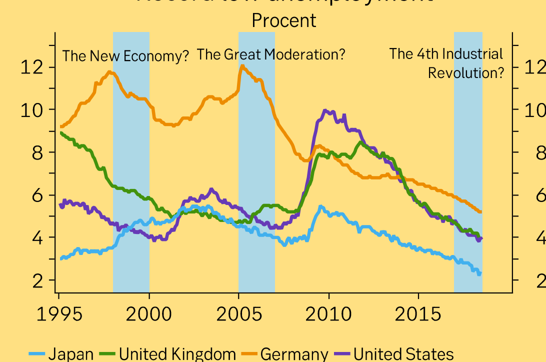
Today the global banking system is more transparent, regulated and well-capitalised. Regulatory authorities work together globally and there are financial market rescue funds (such as the European Stability Mechanism, ESM). Many countries have also implemented various macroprudential tools in order to tame the credit cycle, as a supplement to fiscal and monetary policies. On the other hand, total **world debt is record-high today**: up 40 percentage points to 260 per cent of global GDP. Increased public sector debt is partly due to the acute crisis management measures launched directly after the Lehman Brothers crash, but in such countries as the US, Japan and China, public sector debt has increased further in the past five years because of new fiscal stimulus packages.

Positive or negative spiral dominates risk picture

The lengthy economic upturn, combined with a new political landscape featuring a heightened level of uncertainty, is creating an unusually complicated risk picture. Our main scenario implies that during the next couple of years, we will enter a kind of positive spiral. There are good reasons why a strong demand dynamic will persist. Our relatively positive view of the supply side will allow continued above-trend growth for the global economy. In this environment, most central banks, including the Fed, have plenty of manoeuvring room to sustain the economy. This helps keep stock markets buoyant. The idea that we will soon enter a **Fourth Industrial Revolution, in which digitisation and robotisation** will dramatically reshape the economy, also suggests there may be an upside in our forecast.

Record-low unemployment

Procent

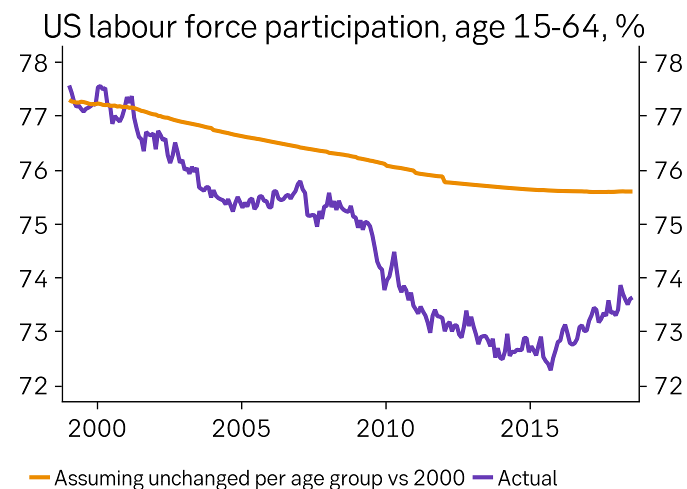


Source: Macrobond, SEB

But it is not difficult to identify several types of threats that may halt this positive spiral. The trade war may escalate to levels that have a far bigger impact. For example, the IMF sketches a scenario in which such an escalation and its indirect effects may lower US economic growth by an accumulated 2 per cent over a 3-year period. The build-up of debt in China is another potential threat, which is difficult to analyse. Mistrust of Italy has also recently increased again, accentuating continued long-term challenges in the euro zone. History also demonstrates the need to be humble about making pie-in-the-sky forecasts. The belief in a New Economy was used in the late 1990s, among other things, to justify bloated stock market valuations. In the years before the Lehman Brothers crash, some theorists spoke of a Great Moderation – claiming that because of globalisation and other underlying changes, in the future the world economy could avoid major cyclical fluctuations. The stock market crash at the turn of the millennium and the Lehman Brothers crisis of 2008 crushed these theories in rather brutal fashion, **reminding us to be cautious about declaring that "things are different this time"**. Overall, downside risks dominate the picture. We are sticking to our moderate bias: a 20 per cent probability of worse economic performance and a 15 per cent probability of improved performance. But there is also a **growing negative bias in the amplitude of our risk scenarios**: upside potential is relatively limited, while a dramatic recession cannot be ruled out.

The long period of very expansionary fiscal policies also led to increased private debt and rising asset prices. Looking ahead, interest rates will remain historically low, making it easier for debtors to make interest payments and justifying higher asset prices. But we view it as risky that the search for returns in recent years has enabled companies to raise funds more easily outside the banking system by issuing bonds. **New investors may behave different from banks, for example**, if various asset classes end up under stress. Financial market factors may undoubtedly help trigger an economic downturn and act as an amplifying mechanism (via credit contraction).

Stock market valuations do not appear alarmingly high, though. For example, compare today's price/earnings(P/E) ratio of about 17 (down from 19 in January) for the S&P 500 companies with the peak P/E ratio of 24 during the stock market boom of the late 1990s. On the other hand, valuations were hardly challenging before the Lehman brothers crisis, culminating at a mere 15. US households, which played a major role during the outbreak of the financial crisis, have also lowered their debts significantly. They also have a healthy savings ratio. In inflation-adjusted (real) terms, US home prices are about 20 per cent below their peak in 2006.



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

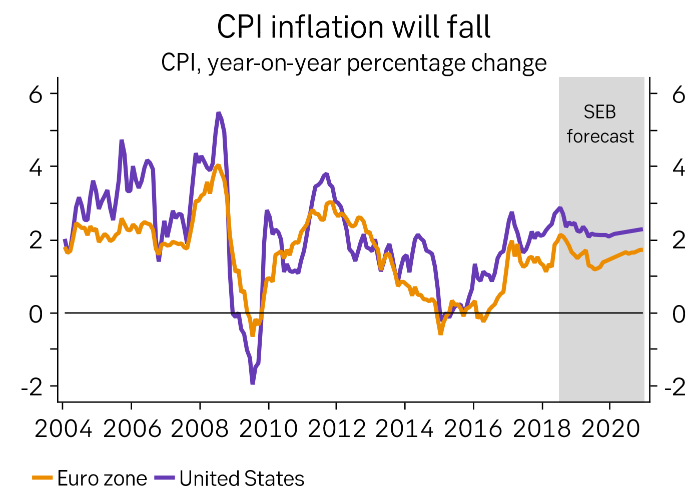
US labour market not as tight as in 2000

Although several leading advanced economies now report historically low unemployment, developments in the US are by far the most important for the medium-term global outlook. Registered US unemployment is down to levels on a par with those around the turn of the millennium. The May reading of 3.8 per cent was the lowest since the 1960s, but slightly broader metrics suggest that **the resource situation is not as tight as it was in 2000**. "Underemployment" (U6) fell to 7 per cent in that year, compared to 7.5 per cent today. Labour force participation is now at 73-74 per cent: about 4 points lower than the peak around 2000. Demographic factors play a large role in this, but adjusting for this and calculating constant labour force participation in every single age group (see chart), it suggests that there is great potential for a continued upturn. Whether this materialises or not will be determined by developments in such disparate fields as drug-related social problems, pension levels, the role of women in the labour market and fee levels in the educational system. Taken together, we see potential for the participation rate to increase a bit from today's level. The overall picture suggests that **registered unemployment may fall to around 3.5 per cent**. This means there are prospects of continued above-trend GDP growth for another while, but in 2020 we foresee both supply- and demand-side reasons for a slowdown in GDP growth to about 2 per cent.

Inflation at a new crossroads

With unemployment at record lows in many countries, the relationship between the labour market and price- and wage formation (the Phillips curve) becomes increasingly important. Our main impression remains that the wage response is relatively weak. The reason may be that structural changes such as **robotisation, automation and globalisation have weakened the negotiating position of employees**. Another reason may be that the quantity of idle resources is larger than previously assumed, for example because more unemployed people are returning to the labour market as job opportunities increase, or because of involuntary part-time work. **We thus may not have reached the critical level (the "knee" of the Phillips curve) where wages and salaries might conceivably take off**.

But this picture is not unequivocal. In Germany, the IG Metall union reached a wage agreement last spring that was higher than expected, and we have recently seen clear signs of higher pay increases in Japan. In the US, we see a stable correlation between a rising participation rate and higher pay. The IMF also points out that the low pace of pay hikes **can largely be explained by a downward trend in productivity increases**. This, in turn, might be due to an increase in the proportion of jobs that are in sectors with low levels of productivity growth. A similar reweighting that slows the average rate of pay hikes occurs when an unusually large percentage of experienced workers leave the labour market. If these explanations are correct, unit labour cost will still remain at the same level. This implies that in the long term, **the rate of pay hikes that is compatible with the inflation target is lower than previously**.



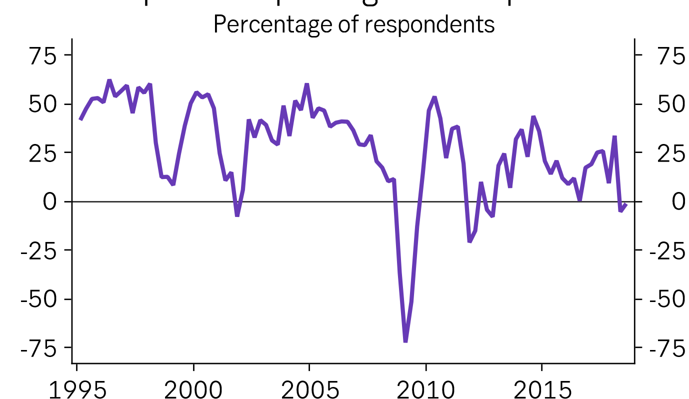
Sources: Eurostat, BLS, SEB

The actual inflation rate has recently been dominated by an energy price-driven upturn. In the US, CPI inflation reached 2.9 per cent. Our main forecast is that CPI inflation will fall in most countries when these price increases disappear from the 12-month figures. In the US, the contribution from rents will probably also fall from today's heightened level. In countries like the UK and Sweden, inflation will also slow as the impact of

currency depreciation fades. For a very long time, the trend of core inflation has been well below 2 per cent. This suggests continued low forecasts and implies that most central banks will have to continue struggling to reach their inflation targets. But the risk picture has meanwhile changed. In the prevailing mature economic expansion, **we cannot rule out larger secondary effects from energy- and currency-driven inflation impulses**. It is also rather unusual for inflation to fall in this cyclical phase, regardless of the drivers. The changing political landscape also implies inflation risks from tariffs and other trade barriers and, further ahead, the effects of decreased international openness.

Worrisome slowdown for EM economies

Growth indicators for EM economies have gradually fallen since December 2017, leading to foreign exchange (FX) and stock market worries. Purchasing managers' indices (PMIs) in manufacturing have trended lower so far this year, which is troubling, especially since this is usually an early sign of fading risk appetite. The slowdown has been clearest in the export sector, and companies in major EM economies are expecting lower deliveries in the near future. The slump in the EU, chiefly Germany, has probably played a part. Many commodity-dependent EM economies have been hurt because commodity prices began to decline late in May due to falling sentiment in the manufacturing sector. Threats of escalating trade war, mainly between the US and China, have probably already affected sentiment, but considering that a very **small percentage of global trade is actually involved, the impact will probably be minor** if/when it materialises. Freight costs (Baltic Dry Index) have already begun to climb, another hopeful indicator since it has often been an early signal of rising production.



Market reactions have been spectacular in the past 4-5 months. SEB's **aggregate EM currency index fell to record-low levels in August** as the Turkish lira crisis infected other high-risk currencies to some extent. The stabilisation of the Turkish lira in recent weeks is largely due to a hidden interest rate hike and reduced futures market liquidity, which will help decrease the current account deficit, but a number of factors that contributed to the decline of the lira remain in place. These include diplomatic tensions with the US including threats of sanctions, high inflation, a weak central bank and the need to refinance Turkey's large short-term foreign debt. The risk of sharp new currency slides thus remains. Countries like South Africa, India, Indonesia, Brazil and Mexico that are sensitive to a downturn in global risk appetite would probably be hurt again. But Turkey's situation is a special case. Because its economy accounts for only 1.7 per cent of global GDP, **there is rather little risk that we are facing something resembling the Asian financial crisis of 1997 or the Russian crisis of 1998**. It is thus also likely that a general downturn in EM currencies would be temporary.

A sharp deceleration in China's growth instead poses a larger risk to the global economy, especially EM economies, but the cool-down in recent months has persuaded Chinese authorities to ease credit policy as well as production restrictions aimed at protecting the environment. Further escalation of the trade conflict between the US and China is a risk that has grown in recent months, but our main scenario is that the two sides will reach some form of negotiated solution, since a broad conflict would harm both the US and Chinese economies. Trump probably also wants to show a successful outcome ahead of the November 2018 mid-term elections, which suggests that we are moving towards an agreement that the president can argue is a result of his tough approach, forcing the Chinese to the negotiating table. We thus expect China to avoid a hard landing; GDP growth will slow gradually from 6.6 per cent this year to 6.3 per cent in 2019 and 6.0 per cent in 2020.

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

	2017	2018	2019	2020
China	6.9	6.6	6.3	6.0
India	6.4	7.5	7.8	7.8
Brazil	1.0	1.5	2.9	3.0
Russia	1.5	1.7	1.7	2.0
Emerging markets, total	**4.8**	**5.1**	**5.1**	**5.1**

Source: OECD, SEB

Overall, this means that despite various risks we maintain a positive view of the EM growth outlook during our forecast period. According to official statistics, GDP growth in the first half of 2018 appears to have held up decently in the EM sphere as a whole. Looking ahead, the gradual deceleration in China may be offset by **acceleration elsewhere, especially in India, Brazil, Indonesia and the Philippines**, and in 2020 also in Russia, South Africa and Mexico. Expansionary fiscal policies will stimulate capital spending. Activity in the construction and service sectors will be an important driver, enabling annual average GDP growth to remain at around 5 per cent in 2018-2020. Assuming such high growth, supply-side restrictions may arise in the EM economies. At present, we foresee inflation generally rising at a slow pace, mainly due to depreciating currencies, but in some countries such as India also driven by increasingly stretched resource utilisation. Central banks in EM economies have responded by tightening monetary policies and hiking key interest rates, sometimes even outside of scheduled monetary policy meetings. Since most economies are nearing full capacity utilisation, we foresee further increases in inflation, though at a slow pace, leading to gradually higher overall EM interest rates.

Above-trend Nordic growth despite uncertainties

The Nordic economies continue to show stable growth. They are benefiting from good international economic conditions and loose economic policies. Generally, trade disruptions represent an especially large threat to small export-dependent economies, but the barriers that the US is in the process of imposing will have only marginal effects. In Sweden, Norway and Denmark, resource restrictions will contribute to slower growth towards the end of our forecast period, while Finland has room to regain some of the ground it lost during the past decade of stagnation.

Swedish GDP surprised on the upside in the second quarter of 2018. Growth remains above trend as rising exports and industrial investments soften the impact of lower home construction. The probability of a soft landing for the housing market has also increased, although a large supply of properties will continue to push down prices. Unemployment will drop below 6 per cent, but inflation pressure will remain low. Great uncertainty ahead of the September election and formation of a new government will have only a short-term impact on financial markets. **Norwegian growth is robust**, but its structure is changing. The oil sector is recovering due to slightly higher prices, while residential construction is decelerating. GDP accelerates from around 1.5 per cent in 2018 to nearly 2.5 per cent in 2019 and 2020. **The Danish economy will cool down temporarily in 2018, with GDP growth reaching only 1.5 per cent**, but a strong labour market and rising real incomes will help GDP growth to accelerate again to 2.5 per cent in 2019 before slowing back to 2.0 per cent in 2020. **Finland has shown resilience** to global uncertainty so far this year, and growth has speeded up. Increased production and business optimism will spill over into the labour market, strengthening household purchasing power after years of low pay increases and public sector austerity. GDP will increase by more than 3 per cent this year and by 2.3 per cent yearly in 2019-2020.

Nordics, GDP growth
Year-on-year percentage change

	2017	2018	2019	2020
Sweden	2.3	2.9	2.4	2.3
Norway	2.0	1.4	2.4	2.4
Denmark	2.3	1.5	2.5	2.0
Finland	2.8	3.1	2.3	2.3

Source: National statistical offices, SEB

Monetary policy normalisation is spreading

After nearly a decade of record-low key interest rates and unconventional stimulus measures, **a cautious normalisation of monetary policy is now under way on a broad basis**. More and more central banks have emulated the Fed's cautious tightening. In July, the Bank of Canada hiked its key rate for the second time this year to 1.50 per cent. Early in August, the Bank of England (BoE) raised its rate again to 0.75 per cent. Next in line is Norges Bank, which has clearly signalled a hike at its next meeting on September 20. In June, the ECB confirmed that it will end bond-buying this year and raise its key rate next year, though probably after the summer. The Bank of Japan (BoJ) will allow larger deviations in 10-year yields, which may open the way for somewhat higher yields ahead, but it will continue asset purchases and efforts to control the yield curve.

It is worth noting that **these measures are not being justified by citing immediate inflation risks**. Price pressures remain moderate, especially if we exclude temporary energy price surges and exchange rate effects, for example in the UK. Central banks must therefore act without really knowing to what extent the Phillips correlation between unemployment and price and wage formation is actually correct. But with unemployment at historically very low levels, central banks **still seem to be acting pragmatically and paying more attention to the drawbacks of loose monetary policy**. This applies, for example, to risks of unsustainable debt accumulation in an environment where monetary policy has extremely limited room to clean up after new financial bubbles. There is also a risk that persistently low interest rates will lead to inefficient resource allocation and unproductive investments. Nor do such actions pose great risks, since low inflation gives central banks the flexibility to slow their pace if the positive trend in the economy should be interrupted.

Central bank key interest rates
Per cent

	Aug 23	Dec 2018	Dec 2019	Dec 2020
Federal Reserve (Fed)	2.00	2.50	3.00	3.25
ECB (refi rate)	0.00	0.00	0.25	0.75
Bank of England (BoE)	0.75	0.75	1.25	1.75
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10
People's Bank of China (PBoC)	4.35	4.35	4.35	4.35
Riksbank (Sweden)	-0.50	-0.50	0.00	0.75
Norges Bank (Norway)	0.50	0.75	1.25	1.75

Source: Central banks, SEB

Fed moving back towards neutral stance

High second quarter US growth provided further support for our forecast of a total of four rate hikes this year, followed by two more next year, a bit slower than the **Fed's** own forecasts but still faster than market pricing. We believe that the Fed will hike its key rate one more time in 2020 to 3.25 per cent, which would be equivalent to a mildly contractionary interest rate. We expect the **ECB** to move cautiously after ending its bond-buying this year. We believe the ECB will raise its deposit rate for banks to -0.25 per cent after next summer and that the entire corridor will be raised at the end of 2019, resulting in a refi rate of 0.25 per cent. The ECB will continue its hikes in such a way that the refi rate will reach 0.75 per cent by late 2020. Uncertainty about Brexit will continue to cast a shadow over the UK economy. We believe that the **BoE's** next rate hike will not occur until the second half of 2019, when the UK will have officially left the European Union. In **Japan**, the scheduled consumption tax hike in October 2019 is one reason to proceed cautiously with any tightening. We believe that the key interest rate will remain at -0.10 per cent throughout our forecast period. Among EM economies, monetary policy patterns are far more mixed. In **China**, decelerating growth due to earlier credit tightening and

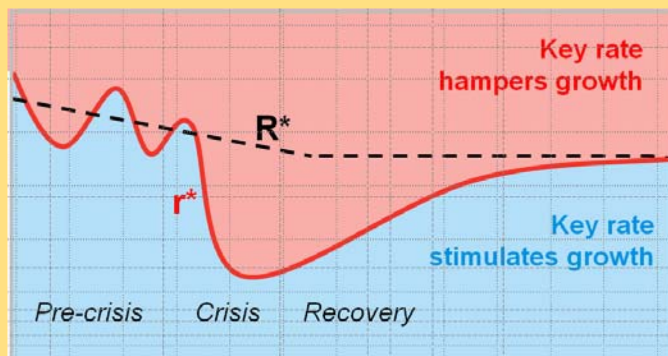
worries about the impact of the trade war with the US have led the central bank to implement various types of easing.

In the Nordic countries there are clear differences in how central banks think about monetary policy and inflation. **Norges Bank** has chosen a forward-looking perspective, focusing on future surges in pay due to rising resource utilisation and partially factoring in the risks of financial imbalances due to home prices and mortgage lending. The central bank also accepts the fact that it takes a long time for inflation to reach its target. The clearly communicated rate hike in September will be followed by two hikes per year in 2019-2020, bringing the key rate to 1.75 per cent. In Sweden, we believe that unexpectedly low underlying inflation will cause the **Riksbank** to postpone its first rate hike until April 2019, but in an environment where other central banks are starting to normalise their policies, we cannot rule out a hike of 10 or 25 basis points as early as December. In 2019 we believe that the Riksbank will hike its key rate twice and in 2020 another three times, bringing it to 0.75 per cent – the same as the ECB – at the end of the period.

The Fed's neutral interest rate

The Fed's key rate hikes will intensify the discussion about the neutral interest rate: the level at which the key rate starts **hampering economic growth**. Conclusions about this level will also determine when it is time for the Fed to **change its communication about monetary policy**: today the Fed believes that "the stance of monetary policy remains accommodative". This statement in its latest Monetary Policy Report may, in turn, influence market assessments of recession risks etc.

The New York Fed's new president, **John Williams**, who now occupies a permanent seat on the Fed's policy-making committee, has focused his **research on the field of "neutral interest rates"**. The neutral rate (**equilibrium interest, R***) indicates when the key interest rate **neither stimulates nor hampers** economic growth. **Williams argues** that this neutral rate is **2.5 per cent**, but a majority of Fed decision-makers believe it is closer to **3 per cent**.



The neutral interest rate is not constant, but **varies over time** (see above conceptual chart). Two types of neutral interest rate are defined: one that is dependent only on structural trends (**R***), and one that is also affected by temporary shocks (**r***). A review of various central bank research papers shows **a consensus about three conclusions**:

1. The structural equilibrium interest rate **R*** has **fallen greatly** in recent decades due to ageing populations that boost household saving, while such factors as weak productivity growth have held back demand for capital; the resulting **savings imbalance** pushes down the neutral interest rate.

2. The **Great Recession of 2008-2009** caused economic shocks that weakened the effectiveness of monetary policy and thereby pushed **r*** further down.

3. A falling neutral interest rate is a **global phenomenon** and **the neutral <u>real</u> interest** rate today is at about the same level in many economies: 0.5 per cent. This implies that for central banks that have a 2 per cent inflation target, the **nominal neutral key interest rate is 2.5 per cent**.

Estimates of the neutral interest rate are important in several ways:

1. The neutral rate provides a picture of **how much room** there is for central banks to cut nominal key rates during a future economic downturn.

2. It influences the outlook for how **long-term yields** will change in the future.

3. Persistently lower short-term rates and long-term yields affect the reasonableness of **record-high global debt** as well as today's valuations of various asset classes.

As previously, **our conclusion** is that the nominal neutral interest rate in the US is now **around 2.5 per cent but that it will climb to about 3 per cent in the future**. This implies that the Fed's final key rate, 3.25 per cent in our forecast, is only marginally above the neutral rate. Despite a reduced balance sheet, the Fed will also still have an **enlarged monetary policy portfolio** due to QE, so the risk that this will abort the economic upturn is rather small. Our forecasts for the bond, FX and stock markets also indicate that total US financial conditions have the potential to remain at expansionary levels, which also makes the Fed's task easier. A key rate of 3.25 per cent by the end of 2020 thus appears rather well-balanced, given the economy's increased sensitivity to interest rates and the need to be able to hike the key rate further if inflation climbs unexpectedly fast.

Central bank balance sheets will swell further

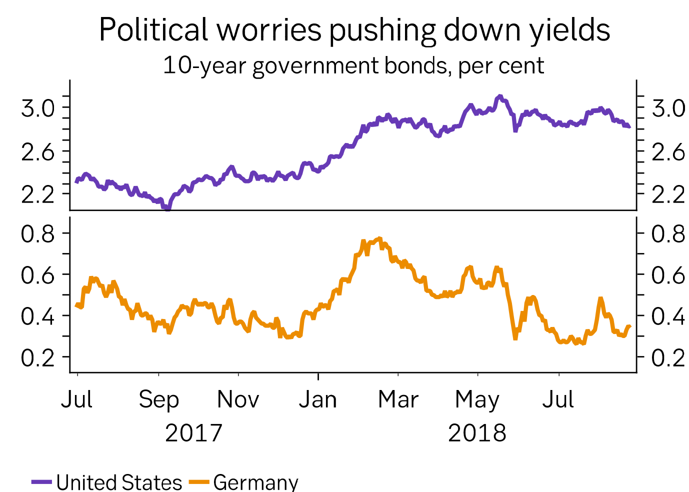
Since the autumn of 2017, the Fed has accelerated its monthly reductions in the monetary policy portfolio in predictable steps (by a total of 8 per cent, to less than USD 4 trillion today). **This autumn the Fed will reach its maximum monthly reduction of USD 50 billion**, i.e. maturing securities that are not reinvested. Our forecast is that the Fed will continue to phase out its portfolio at the same pace. Meanwhile the **ECB will lower its monthly bond purchases from EUR 30 billion to EUR 15 billion**; these purchases will cease at the end at 2018 and the portfolio will be retained during our forecast period. The **Bank of Japan's balance sheet will be allowed to continue growing** at an annual pace of nearly USD 70 billion. Taken together, these three central banks will **increase** their balance sheets (expand their monetary base) by **USD 730 billion this year** (+5 per

cent). **During 2019 their balance sheets will grow by another USD 180 billion**. In the entire global central bank system, over the past 10 years the monetary base has grown by USD 16 trillion, equivalent to about 20 per cent of global GDP.

Bond yields are being pulled by opposing forces

Although various factors have pointed to rising global long-term bond yields, the actual upturn has been modest. While US 10-year Treasury yields have climbed by 40 basis points so far in 2018, they have remained largely flat since late January. The upturn in German 10-year government bond yields early this year has been entirely wiped out, and their level is now about 10 points lower than at the start of 2018. US economic strength and the Fed's determined key rate hiking plans have occasionally impacted US long-term yields. On a couple of occasions, 10-year Treasuries have surged above the symbolically important 3 per cent level. But this has been followed by periods dominated by worries about trade war or other disruptions, such as an escalation of the crisis in Turkey. In the euro zone, disappointing economic data and uncertainty about Italy have caused German yields to fall drastically since mid-May.

The tug-of-war between different drivers is likely to continue. The US economy is expected to show continued signs of strength, and our forecast of Fed rate hikes is somewhat more aggressive than current market pricing. Because of tax cuts and other Trump stimulus measures, this year's federal budget deficit looks set to be the biggest since 2012. This, in turn, is one reason why issue volumes of 10- and 30-year US Treasuries will be the largest ever. Add to this the impact of Fed balance sheet reduction. Another factor that suggests rising yields is related to a tax benefit that expires on September 15. Until that date, US companies can deduct employee pension contributions at the tax rate that applied before last December's reform slashed the corporate tax from 35 to 21 per cent. This has helped to temporarily boost contributions, in turn increasing the demand for long-term government securities and pushing down yields.



It is a little harder to evaluate the forces that are holding back an increase in yields. In the short term, continued worries about escalating trade conflicts are likely to help delay repricing of the Fed outlook. In addition, wage and inflation pressure remains moderate. **Market inflation expectations in a 5-10 year perspective**, measured as the difference between nominal and real yields, **have fallen by 10-20 points since peaking in May**. The market thus seems uncertain whether the customary late-cyclical inflation surge will have time to materialise before a recession breaks out. Weighing together these factors has led to a marginal downward adjustment in our yield forecast compared to May, but we are reiterating our view that 10-year US Treasuries will climb above the 3 per cent level by year-end. After that we foresee **a slow upward movement to around 3.50 per cent towards the end of our forecast period**.

Short-term market rates have climbed due to Fed key rate hikes, and since the first hike in December 2015 the spread between 10-year and 2-year Treasuries has **shrunk from around 120 basis points to the current 25 points**. This spread is expected to narrow as the Fed keeps hiking its key rate, but the yield curve will retain a certain positive slope throughout our forecast period. Since all 10 post-war US recessions were preceded by an inverted yield curve (i.e., short-term yields became higher than long-term yields; see *Nordic Outlook*, May 2018 and November 2017), today's flatter curve is something that both the Fed and financial market players have paid close attention to. Various Fed monetary policymakers interpret the yield curve differently, but their general view is that the curve is only one of many factors that should be weighed in when devising monetary policy. We have also previously argued that the slope of the curve has become a less relevant economic indicator, since long term US yields are pushed down to artificially low levels by QE and by the extremely low yields in other countries.

10-year government bond yields

	Aug 22	Dec 2018	Dec 2019	Dec 2020
United States	2.83	3.05	3.35	3.45
Germany	0.35	0.50	1.10	1.40
Sweden	0.53	0.60	1.50	1.90
Norway	1.66	1.70	2.05	2.30

Although the economic slowdown in Western Europe has been more prolonged than expected, the future outlook justifies a gradual normalisation of ECB monetary policy. However, the ECB's June announcement that a key rate hike will not occur until after the summer of 2019 was somewhat more dovish than anticipated. This is expected to put a lid on short-term European yields until well into next year. The ECB is expected to stick to its plan and end QE in December 2018, which justifies somewhat higher long-term yields, although its continued reinvestments of maturing bonds will dampen this effect. Given the depressed level of German 10-year yields, we see potential for a larger upturn in European long-term yields than in US yields once sentiment shifts. This movement will mainly occur in 2019, with German 10-year yields expected to climb from 0.50 to 1.10 per cent by year-end, then continue upward at a slower pace during 2020. **The yield spread between the US and Germany will shrink slowly towards about 200 points from today's level of somewhat above 250 points**, but we have also adjusted our forecast of German yields a bit lower than in our May forecast.

The spread between Swedish and German 10-year yields has widened since May. This could initially be explained by more hawkish expectations about the Riksbank, but recently it is probably more a consequence of Swedish yields not managing

to keep up with the sizeable downturns we have seen in German yields. According to market pricing, expectations of an initial Swedish rate hike have been pushed back after two months when CPIF excluding energy was below the Riksbank's forecast and a majority of the Executive Board still worried about low service and underlying inflation. Given our forecast that the Riksbank will hold off on a rate hike until 2019 and will also buy more bonds than are issued, we believe that the spread may shrink to around 10 points again before starting to widen early next year. At the end of 2019 it will stand at 40 points. We thus expect Swedish 10-year yields to reach 0.60 per cent by the end of 2018 and 1.50 per cent by the end of 2019 and keep climbing in 2020 as the Riksbank slowly raises its key rate.

Changes in risk appetite increase FX movements

This past summer, the FX market was characterised by low activity and only minor fluctuations among major currencies, but after Turkey's financial crisis escalated these currencies have begun to move. The depreciation of the Turkish lira was previously rather isolated, but **now that the crisis has begun to affect global risk appetite, it has also begun spreading to other EM currencies**. Defensive currencies such as the US dollar and Japanese yen have generally risen, mainly at the expense of small currencies such as the Swedish krona. The FX market will probably continue showing this reaction pattern if the crisis in Turkey or in other major EM countries flares up again. This also implies that those currencies that have lost ground in August have the potential to rebound if the situation in Turkey stabilises.

Exchange rates

	Aug 22	Dec 2018	Dec 2019	Dec 2020
EUR/USD	1.16	1.15	1.20	1.28
USD/JPY	110	110	102	100
EUR/GBP	0.90	0.87	0.82	0.80
EUR/SEK	10.52	10.50	10.00	9.70
EUR/NOK	9.69	9.30	9.00	8.90

Source: Central banks, SEB

Last spring, the US dollar climbed sharply. After a few months of stabilisation, upward movement resumed as the crisis in Turkey escalated. **We interpret USD movements so far this year as a sign of a changed reaction pattern**. Over a long period, the USD has been one of the currencies that have benefited from rising risk appetite, but in 2018 its defensive characteristics have returned. They are likely to persist, though the dollar still seems to be adversely affected because reserve managers continue to reduce their relative dollar exposure. But the pace of this decline in the USD's share of overall global currency reserves slowed early this year compared to 2017. Nor do we believe that the Fed's continued rate hikes will provide much support for the USD. President Trump has also indicated that he dislikes a strong dollar, which may also have some psychological importance even though in practical terms, he has no way of directly influencing the exchange rate. Given our somewhat optimistic view of current international trouble spots, such as Turkey, **we believe the EUR/USD exchange rate may continue to fall a bit but will rebound and reach 1.15 by the end of 2018**. In 2019 and 2020 we foresee further dollar depreciation as other central banks narrow their key rate spread against the Fed. The EUR/USD rate will reach 1.28 at the end of 2020.

Brexit negotiations will continue to be the dominant driver of the British pound. Last spring, the sharply undervalued currency benefited from progress in the talks on British withdrawal from the EU, but during the summer growing political conflicts within the UK government led to renewed weakness. Despite major difficulties related to such issues as future EU-UK trade relations and Irish border arrangements, we are sticking to an optimistic view of the potential to reach an agreement. Along with support from tighter monetary policy, this will eventually result in a stronger pound. In the near future the pound is likely to keep taking a beating until an agreement is in place, and it will probably be a while until the central bank follows up its August key rate hike. Our forecast is that the EUR/GBP exchange rate will climb above 0.90 in the near future and then gradually fall to 0.80 in 2020, assuming that negotiations lead to an agreement that provides a soft, controlled withdrawal. If the negotiations should collapse, or if the agreement is rejected by some EU country or by the UK Parliament – causing the UK to leave the EU without an agreement next year – there is a risk that the pound will depreciate dramatically, especially against the dollar.

The defensive qualities of the Japanese yen have been apparent so far this year. A stock market slide, trade policy tensions and most recently the market turmoil related to Turkey have all helped to push the yen higher. Because the dollar has behaved in a similar way, however, movements in the USD/JPY exchange rate have been limited. Our models indicate that the yen is still undervalued in the long term, yet we find it difficult to foresee a clear yen appreciation in a world of decent economic growth and somewhat tighter monetary policies. Our forecast implies that the USD/JPY rate will remain in the 105-110 range this year and in 2019, moving to 100 further ahead.

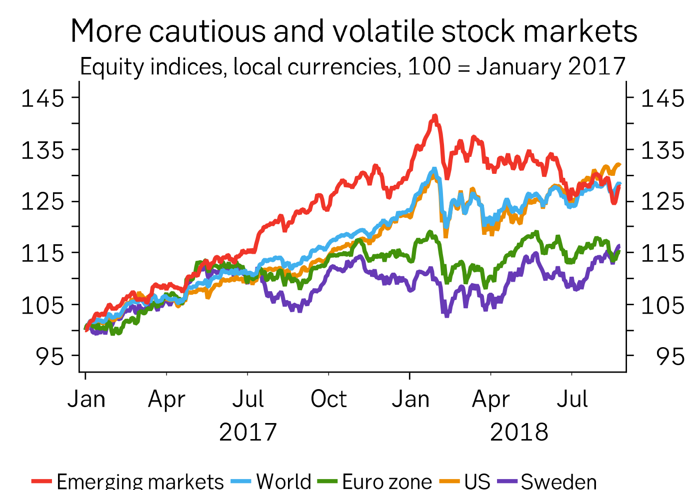
The actions of Sweden's Riksbank have had a negative effect on the krona for a long time. If the Riksbank lowers its rate path at the September meeting, this implies continued uncertainty among market players as to whether enough conditions will be in place for the Riksbank to consider a key interest rate hike justified. Sweden's negative key rate continues to make it unattractive to deposit capital in SEK and thus pushes down the krona. Uncertainty about the upcoming parliamentary election, including alarmist reports about Sweden in international media, may also hurt the krona, although the currency is relatively insensitive to this type of political uncertainty. There is an imminent risk that the EUR/SEK exchange rate will remain weak this autumn. Election worries may push it above 10.50. Although the political situation will clarify somewhat late in 2018, we expect the EUR/SEK rate to remain around 10.50 at year-end and then fall a bit to 10.00 at the end of 2019.

The Norwegian krone has not reacted especially much to the economic stabilisation that followed higher oil prices or the central bank's clear signals that it will hike its key rate as early as the September policy meeting. During the summer, oil prices retreated from nearly USD 80 per barrel towards USD 70. This and lower global risk appetite may help explain why the currency has not attracted buyers, but the prospects for somewhat higher oil prices ahead as well as a key rate hike are expected to help the krone – which is undervalued in the long term – to begin appreciating. This movement will later be

sustained by oil prices that approach USD 85/barrel and by a sizeable yield spread between Norway and the euro zone/Germany. We believe that the EUR/NOK exchange rate will fall to 9.30 during 2018 and that the NOK will then gradually strengthen to 8.90 per euro by the end of 2020.

Stock markets enter defensive phase despite growth

Strong earnings reports helped sustain share prices during the summer. The MSCI AC World Index has moved slightly higher or has remained stable, despite the trade war and worries about Turkey. Last year's pattern of steadily rising share prices amid low volatility has been replaced by more limited upturn phases, with clearly higher volatility. We see two explanations for this trend shift. Increased trade policy worries, recently amplified by risks related to the Turkish crisis and its secondary effects, have given investors tactical reasons to reduce their risk. This new pattern is also characteristic of the late-cyclical phase we are in, where investors gradually begin adjusting to expectations of tougher times during the next phase in the economic cycle. Breaking down the performance of different sectors and asset classes **confirms the picture of more risk-averse late-cyclical behaviour**. US equities, for example, have done substantially better than EM equities. Pharmaceutical companies have attracted capital at the expense of more cyclical shares, and riskier credit exposures are losing ground to government bonds. In some EM stock markets such as China, price slides are already more than 20 per cent, which historically is generally described as a new trend rather than a correction.



A greater focus on stock market valuations is also typical of a more cautious late-cyclical market climate. In recent months, a combination of good earnings performance and flat share prices has pushed price/earnings ratios lower – calculated on the basis of expected earnings 12 months ahead – from stretched levels to more comfortable ones. Globally, P/E ratios have moved from about 17 to just over 15. The US remains at the top, with a P/E ratio that has fallen to just below 17 from previous levels above 18 that we had not seen since the dotcom (IT) bubble. Valuations in Europe and the EM sphere are more cautious, with P/E ratios of around 14 and 12, respectively. But different sectoral structures should be noted here. Corrected for this, the EM sphere's P/E ratio ends up above 13. Considering that earnings forecasts for next year are converging, valuation arguments thus suggest investing in relatively lower-valued markets: Europe and the EM sphere, but a larger proportion of cyclical sectors (especially among EM equities) may create headwinds ahead as the economic cycle enters a calmer phase.

It is reasonable that P/E ratios have fallen from their peak, given expectations of gradually slower future earnings growth. **We thus foresee little prospect of rising valuations ahead**: the most likely development is that over time, P/E ratios will fall a bit further. How investors view the length of the upward cycle will probably determine stock market performance in a longer perspective. **Our relatively optimistic economic forecast**, especially for 2020 when we foresee a very modest slowdown in global GDP growth, **provides support for our fairly positive 12-month stock market outlook**. The lack of attractive alternatives (record-low interest rates and yields, small credit spreads) also fosters resilience during periods of chillier stock market climate.

Cyclical drivers undoubtedly still exist. **We have just witnessed one of the strongest quarterly report periods** for a long time. In the US, the tax reform is contributing to large nonrecurring earnings increases, but underlying earnings are also obviously showing a strong trend. Consensus forecasts point to **global earnings growth of 12-13 per cent in 2018** (with the US close to 20 per cent) and almost as much next year, when US earnings increases will be more in line with the overall average. More recently, though, regional outlooks have begun to show wider gaps. US forecasts have been adjusted sharply higher while Europe has largely remained unchanged. This probably reflects divergences in the macroeconomic outlook, with upward adjustments in US growth forecasts but some downward revisions for Europe.

Late-cyclical market behaviour, with meagre prospects for rising valuations, will limit potential and create a risk of higher volatility – especially over the next few months – given political uncertainty and while awaiting clearer signals from third quarter corporate reports. However, in our main scenario we anticipate only temporary market disruptions from political events. About a year from now, we expect stock markets to have the capacity to climb at nearly the same pace as earnings increases of around 10 per cent; headwinds from somewhat lower valuations will result in a total potential of 6-8 per cent including dividends for the next 12 months.

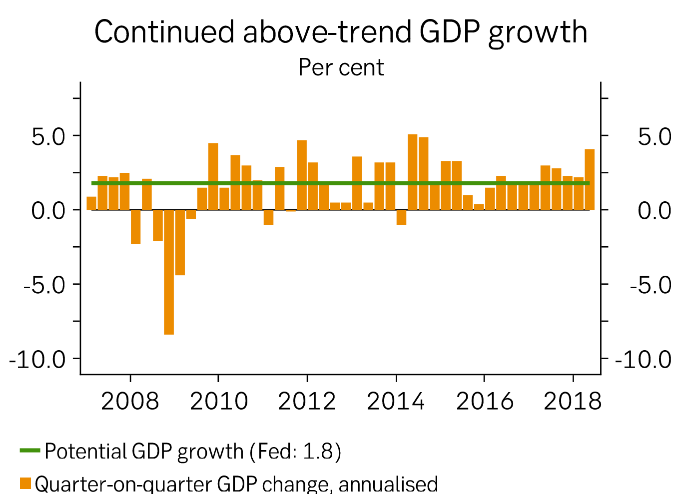
In Sweden, late summer was a strong period on the stock market. Full-year returns are now a few percentage points above the global stock market average. But measured from the beginning of 2017, the OMX Stockholm exchange is still lagging 4-5 percentage points behind global stock markets following a weak period last autumn due to such factors as housing market worries. With earnings increases of just below 10 per cent and a P/E ratio of 15, the Stockholm exchange is in the middle of the European league table. A higher degree of cyclical sectors and help from the weak krona for our export-heavy stock market are providing short-term support. Looking ahead, currency appreciation may become a problem, but in the short term, signs that the krona has bottomed out and is rebounding will spark increased foreign interest given its low starting point.

The United States

Strong demand, offset by trade worries and tight resources

As expected, economic activity soared in the second quarter of 2018 after a slowdown early in the year. The labour market continues to improve and is driving growth, along with tax cuts and a healthy pace of capital spending increases. Inflation pressure is rising moderately, but if US import tariffs expand further this will impact both consumer prices and economic growth. The Fed hiked its key interest rate again in June and is expected to follow up with two more rate hikes this year.

After a deceleration in the first quarter, **economic activity bounced back vigorously in the second quarter**. GDP growth surged from an annualised 2.2 per cent to 4.1 per cent. This acceleration was overwhelmingly driven by private consumption. Sentiment indicators suggest that the third quarter also began strongly. The labour market continues to gain strength. Combined with tax cuts, this is contributing to record-high consumer confidence. Capital spending is expected to keep increasing at a healthy pace. We are now forecasting that **GDP will increase by 3.0 per cent in 2018 and by 2.5 per cent in 2019**. This represents an upward adjustment by 2 tenths in 2018. In **2020**, growth will slow to **1.9 per cent** as resource restrictions make themselves more widely felt, while the effects of the tax cuts fade. As expected, the **US Federal Reserve (Fed)** raised its key interest rate in June. We believe that the central bank will hike the key rate two more times in 2018, followed by **two hikes during 2019** and **one in 2020**.



The largest downside risk is connected to America's escalating **trade tensions** (see theme article, page 17), mainly with China but also with Europe as well as Canada and Mexico. The new tariffs that have already gone into effect will have a limited impact, but an **escalation may interrupt the increase in capital spending** because US companies will postpone planned expansion investments. Our **main scenario** is that the **US will impose tariffs on an additional USD 200 billion worth of imports from China** in addition to the first round that was imposed on USD 50 billion worth of goods. A bit further ahead, there are also risks connected to America's pro-cyclical fiscal policy. Stimulus measures are occurring at a stage when the resources are already tight. In such a situation, driving up public sector debt to about 110 per cent of GDP and boosting the federal budget deficit to above 5 per cent of GDP will decrease fiscal manoeuvring room in case of an economic downturn.

Democrats expected to take control of the House

On November 6 a US congressional election will take place. Although President Donald Trump's popularity has climbed after bottoming out in late 2017, it remains relatively low. Historically, support for a president has been important to his own party's election outcome. Trump's polarising personality and policies will probably help to increase voter turnout, both among his opponents and sympathisers. The Republicans will also benefit from the strong labour market and rising disposable incomes. The most likely outcome is that **the Democrats will take control of the House of Representatives**, where all 435 seats are at stake, while **the Republicans will keep their majority in the Senate**. Although they only have a bare Senate majority, the party will benefit this time around from the election system, in which only a third of seats are in play. In November the Democrats will face the difficult challenge of defending numerous Senate seats in states that Trump won in the 2016 presidential election. A divided Congress will make it harder to push through legislation, decreasing the room for major reforms during the second half of Trump's four-year term.

Continued favourable climate for consumption

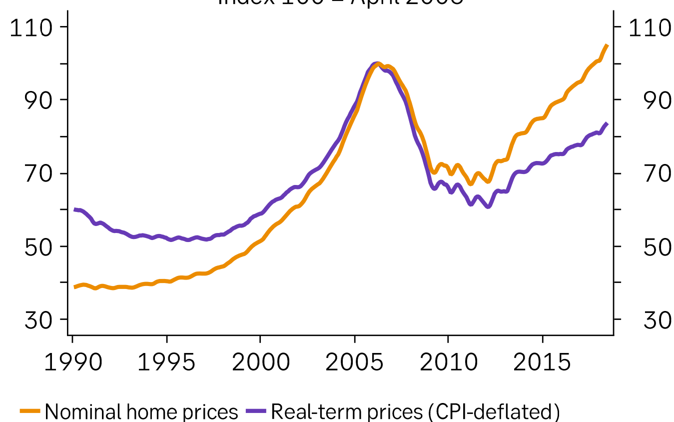
Consumption rose by 4.0 per cent in the second quarter, thereby contributing a full 2.7 percentage points to GDP growth. Even though the rate of increase was driven higher by an expected rebound after a weak first quarter, **private consumption remains the most important driver of economic growth**. Rising employment, somewhat faster pay increases and tax cuts will lead to rising disposable incomes, although more expensive petrol (gasoline) due to higher oil prices will slow the upturn.

Sharply revised figures also show that household saving is significantly higher than earlier statistics had indicated. The **savings ratio** is now **close to 7 per cent**, more than twice as high as before the financial crisis. We previously regarded the low savings ratio as a downside risk to private consumption, but the revised figures instead imply that households have ample room for consumption. Their balance sheets are also strong,

since their debt ratio has gradually been pushed down while rising share and home prices have increased their wealth. In nominal terms, home prices are now at record levels, but in real terms they still have nearly 20 per cent to go before reaching pre-crisis peaks. Our forecast is that **consumption will rise by 3.0 per cent in 2018 and 2.8 per cent in 2019**. In **2020** the rate of increase will slow to **2.1 per cent** as employment levels out and the impact of the tax cuts diminishes.

Real home prices still far below pre-crisis peak

Index 100 = April 2006



Source: Core Logic, Macrobond, SEB

Strong capital spending, uncertainty about exports

Although capital spending growth decelerated somewhat during the second quarter, this was from a high level. It contributed nearly one percentage point to GDP. **Several factors suggest that business investments will continue to increase at a healthy pace**. Capacity utilisation has crept higher during 2018, although it is a bit below the 80 per cent level at which capital spending normally takes off in earnest. Meanwhile higher oil prices are stimulating investments in the mining and oil industries, where capacity utilisation is already very high. This indicates that the need for investments in these sectors will persist. The recent tax cuts are generating incentives for companies to bring investments forward, which will provide a little extra stimulus in 2018 and 2019. Meanwhile an increasingly tight labour market and mounting difficulties in recruiting employees are creating stronger reasons for companies to increase their investments. We are forecasting that capital spending will increase by 5.0 per cent in 2018 and 3.0 per cent in 2019, before slowing further to 2.5 per cent in 2020, but there is a **risk that uncertainty about trade policy and tariffs will persuade companies to hold off on investments**. So far there are no such tendencies in the hard data, but it is not difficult to find anecdotal information about companies that are hesitating for this reason, as the Fed has also pointed out.

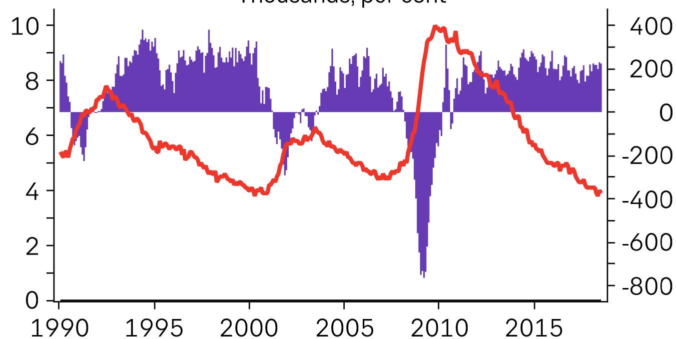
Trade conflicts are creating **uncertainty about US exports**. Q2 export figures surged as exporters tried to make delivery before China started levying new import tariffs on food, mainly soya beans and maize (corn). Net exports made a sizeable contribution to GDP growth: one percentage point. However, because the US dollar has regained lost ground in recent months, the export upturn will be more muted ahead. During the third quarter, we expect food exports to fall dramatically compared to Q2. Meanwhile healthy domestic demand, fuelled by tax cuts, will keep import demand strong. **The major contribution of foreign trade to GDP growth during the second quarter** thus appears to have been temporary. Net exports are not expected to remain a major US economic driver.

Labour market is increasingly being tested

Unemployment is now at its lowest level since 2000. The May reading of 3.8 per cent has not persisted for long periods since the 1960s. In spite of this, job creation during this late-cyclical economic expansion remains impressive. During the first half of 2018 the number of jobs rose by a monthly average of 224,000. In recent months, the increase has been especially large in the mining and manufacturing sectors. August unemployment stood at 3.9 per cent, which is well below the Fed's 4.5 per cent estimate of long-term equilibrium unemployment.

More job creation despite low unemployment

Thousands, per cent



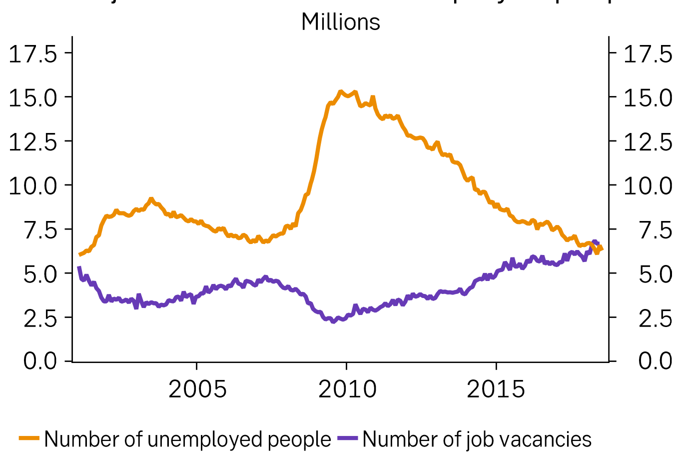
Unemployment, per cent (LHS)

Change in employment, thousands, 3-month moving averages (RHS)

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

We believe that the labour market will continue to improve for another while. In June the percentage of companies reporting recruitment difficulties was close to the record high that was set in 1983. This suggests that unemployment will continue to fall further. Another sign that the labour market will keep on tightening is that **the number of job vacancies now exceeds the number of unemployed people** – a further example of strength. Our forecast is that unemployment will fall slowly during the rest of 2018, levelling out at around 3.5 per cent in 2019-2020. Earlier historical patterns show that once unemployment has started to climb, this increase tends to persist for a long period. Experience from the recessions of the early 1990s and 2000s and the aftermath of the 2008 financial crisis shows that unemployment rose for a period of 2-2½ years.

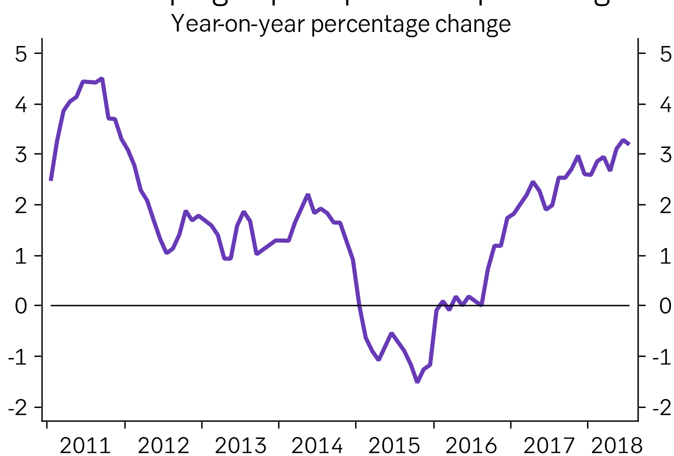
There are signs that the **bottleneck problems** that have been apparent in the labour market for a while are starting to grow. The Fed's regional economic report – the Beige Book – points to ever-increasing difficulties for companies to recruit qualified employees. These signs are clearest in the construction sector but also include professions like truck drivers, manufacturing plant workers and IT staff. Increasing bottleneck problems in the labour market will be among factors that cause GDP growth to begin decelerating around the end of 2019 and during 2020.



Despite low unemployment, **pay increases remain moderate**, although some income metrics point to stronger growth. Pay increases in July were 2.7 per cent year-on-year (BLS data), a bit faster than in 2016 and 2017 but a slower increase than expected at the current point in the economic cycle. But we are sticking to our view that job creation will slow and instead be replaced by accelerating wage and salary growth.

Increased inflation pressure from several directions

Inflation pressure continues to rise slowly. CPI inflation has crept higher since early 2018 and stood at 2.9 per cent in July, although base effects explain a large part of the latest upturn. Core inflation has rebounded too. But as long as pay increases remain moderate, it is unlikely that we will see any surge in inflation. **Measured as full-year averages, we expect CPI inflation to end up at 2.5 per cent in 2018, and 2.2 per cent in 2019 and in 2020.** Inflation using the personal consumption expenditures (PCE) deflator amounted to 2.2 per cent in June. The Fed's favourite metric, core PCE, stood at 1.9 per cent: just below its 2 per cent target. The differences with CPI are largely explained by health care prices. Our forecast is that **core PCE** measured as annual averages will increase by **1.9 per cent in 2018** and by **2.2 per cent in 2019 and 2020**. The Fed expects inflation to remain close to its target and forecasts core PCI of 2.1 per cent in both 2019 and 2020.



The **tariffs** that have already been imposed have not affected CPI inflation. Import tariffs on steel and aluminium do not impact consumers directly, and US tariffs on imports from China have been designed to avoid consumer products as much as possible and thereby protect households from price increases. However, this will not be possible when tariffs are expanded. **Producer prices have accelerated noticeably since early 2018** and rose during July by 3.2 per cent year-on-year. The main drivers were probably increasing commodity prices in the world market combined with some dollar depreciation, but the steel and aluminium tariffs have also helped to drive price increases for input goods used by companies. Business sentiment survey data also show rising inflation expectations at the producer level, although this is partly driven by the petrol price upturn.

Fed weighing strong economy against trade worries

As expected, the **Fed hiked its key interest rate to 2 per cent at the June policy meeting**. Meanwhile the individual rate path forecasts of Federal Open Market Committee members ("dot plots") rose, so that they now indicate two further rate hikes this year and three hikes in 2019. The Fed's official forecast for the rest of 2018 is thus in line with our own. After seven hikes since December 2015, the key rate is now beginning to approach the Fed's own estimated neutral rate of 2.9 per cent, which makes future forecasts more uncertain.

Although the central bank's own forecasts indicate that its rate hikes will continue in 2019 and 2020, and the **Fed** has an optimistic view of growth, it has also **communicated that escalating trade conflicts are a downside risk**. Fed Chairman Jerome Powell warned in July that escalating tariffs would drive up the rate of inflation, while hampering economic growth. In our main scenario, where a severe trade war is avoided, we nevertheless believe that the Fed's rate hikes will continue and we predict two hikes in 2019 and one in 2020. This would bring the **key rate** to **3.25 per cent at the end of 2020**.

The **Fed's balance sheet** has attracted attention after **criticism** to the effect that the reduction process has caused volatility in the financial markets of emerging economies. The argument is that the combination of balance sheet reduction and a sharp increase in the supply of Treasury bonds, driven by the swelling US budget deficit, is helping push dollar liquidity lower. The Fed would thus need to slow or completely halt its balance sheet reduction. This is unlikely, though, since the central bank's clear ambition has been to ensure that the decrease in its balance sheet is based on predictability. The Fed has communicated that the balance sheet will be decreased to the USD 2.4-3.5 trillion range. If the Fed follows its existing plan, it will not reach the upper part of this range until the end of 2019, but after nearly one year of balance sheet reduction we are approaching the point where the Fed needs to more exactly specify a reasonable long-term size for its balance sheet. However, we do not expect such a specification to be published until early 2019.

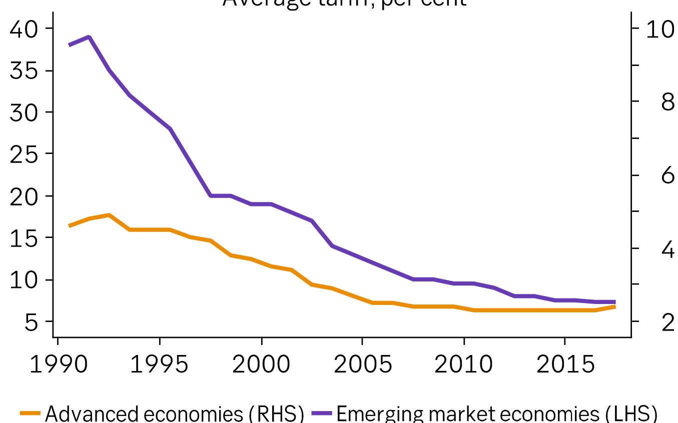
In June, the Fed also decided that starting in January it will organise **press conferences** after every monetary policy meeting, instead of after every second meeting. Such a change could be interpreted as hawkish, since in practice every such meeting will be "live" although revised forecasts will only be presented every other meeting. The Fed denies this hawkish interpretation, however. One consequence of the change is that it may become more difficult to predict the timing of Fed rate hikes during the next couple of years.

Theme: Trump's trade war

Many-faceted, regrettable but manageable in terms of growth

Global import tariffs have trended downward for the past 30 years. But increased populism is fuelling protectionism. The trade war will intensify this autumn. Today the US and the rest of the world are choosing different trade policy strategies. The effect on global economic growth remains manageable, even assuming new tariffs – with the US as the biggest loser – but will worsen if risk appetite hurts asset prices, for example. Central banks may face the dilemma of managing both higher inflation and downside risks to growth and asset prices.

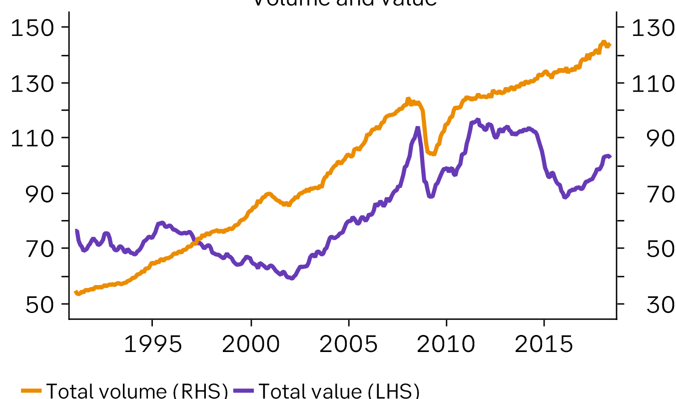
President Donald Trump has boosted import tariffs in 2018, citing "national security" reasons, thus **drawing the US into a trade war with the rest of the world: mainly China, the EU, Canada, Mexico and Japan**. Affected countries have responded to this aggressive new US trade policy by boosting **tariffs on US goods** (see box, page 18) and trying to **expand and intensify**, not worsen, **international trade cooperation**. The 2018 trade war is thus bilateral, not multilateral as in the 1930s.



So far, the world has prioritised lowering tariffs...

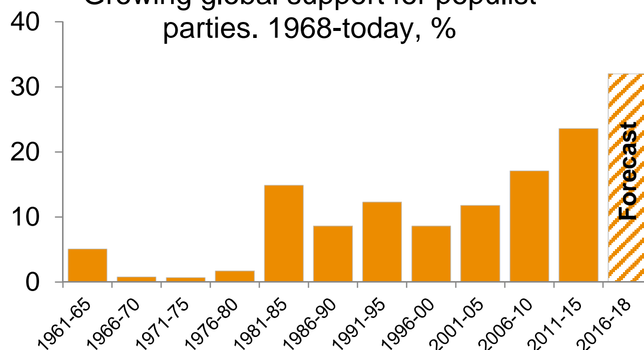
In the past 30 years, most economies have perceived greater advantages than disadvantages in lowering tariffs and thereby stimulating world trade, despite facing the worst economic crisis since the 1930s in 2008-09. According to World Bank statistics (see above), **tariffs in emerging markets averaged 40 per cent in the early 1990s; they average 5 per cent today. In advanced economies, tariffs have fallen from 5 to just over 2 per cent**. Global trade has thus boosted economic growth, living standards and incomes for many people in developing countries. It has also helped squeeze prices, allowed low interest rates and raised real incomes in many advanced economies.

Yet tariffs are **not the only tool** countries can use to gain trade advantages. For example, they can let their **currency** depreciate or impose trade-related **administrative procedures** that are unnecessarily slow and complex. There are many indications that China, despite its denials, has allowed its currency to fall by 8 per cent against the US dollar in recent months to stress its displeasure with US trade policy and make it easier for Chinese exporters to cope with tariffs that make them less competitive.



Populism and protectionism are flourishing

EU and US elections and referendums in recent years indicate that **anti-establishment forces are enjoying tailwinds**. This means that populism is growing (see chart below), which will drive future protectionism and isolationism. Increased **economic inequality**, especially within countries, and migration flows will increase tensions further. Meanwhile we are on the verge of major technological changes (sometimes called the **4th industrial revolution**), which are creating great opportunities but also political tensions as labour markets, social welfare and educational systems must adapt themselves to a new world.



Is there any logic to Trump's trade war?

History shows that the **erecting trade barriers has been a losing strategy for the US**. For example, when George W. Bush imposed steel tariffs in 2002, they hurt growth and jobs and were abolished within 21 months. Yet Trump seems to have several incentives to continue his trade war for another while:

1. To keep election promises. Trump won election on promises to bring back US industrial jobs by re-negotiating such pacts as the North American Free Trade Agreement (NAFTA) and imposing tariffs on goods made in China and Mexico. With mid-term elections due November 6, the president must deliver.

2. To decrease import leakage. Because Trump cut taxes by about USD 1.7 trillion over a two year period, imports will increase. But tariffs will make imports more expensive, and demand can be redirected towards American-made goods.

3. To slow the growth of external debt. After many years of large trade deficits, net US debt to other countries is USD 7.9 trillion (41 per cent of GDP). Such large debts make the US vulnerable, even though it enjoys reserve currency status.

4. To shake up the system. By threatening tariffs, the US forces countries to the negotiating table, enabling barriers to be made visible and be resolved in ways that will lead to increased trade.

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

Trade war affects growth, inflation and share prices

A trade war including import tariff hikes affects the real economy via two main channels – directly and indirectly.

- **Directly**: Decreased trade, disruptions in global supply chains and higher costs for imported goods (i.e. inflation);
- **Indirectly**: Uncertainty lowers willingness to invest and consume and adversely impacts asset prices, such as shares.

Both the IMF and the Bank of England (BoE) have estimated[1] the effects of tariffs on growth and inflation. They make somewhat different assumptions about how future tariffs may be adjusted.

The IMF includes both **adopted** tariffs and others **announced** by July 16, including new US-Chinese tariffs and car tariffs). It also adds an indirect effect (**confidence shock**). This worst-case scenario would lower global GDP by about 1.3 per cent through 2021. The **US figure would be about -2.0 per cent**.

The BoE assumes that the US will **triple import tariffs on all** trade partners, i.e. raise them by 10 percentage points. The estimated direct effect would be a **1.2 per cent lower global GDP through 2021**. The **effect on the US would be -2.5 per cent**. Adding indirect effects would double the adverse impact. The BoE also concludes that the world and the US would see accumulated price hikes of 1.1 and 0.8 per cent, respectively, by 2021. This illustrates the policy dilemma for central banks.

Trade war: US, China & the EU – various stages

The trade war has escalated gradually (see below). Note that the BoE's estimates indicate that China's trade barriers against the US are far bigger than equivalent US and EU barriers. Measures now on their way would also increase this gap further.

Average bilateral import tariffs. Per cent

Tariffs imposed by **...on imports from**	**US** **China**	**China** **US**	**US** **EU**	**EU** **US**
Current	2.6	9.1	3.3	3.0
Announced (July 5) incl Trump's car tariffs	4.5	14.9	6.2	7.2

Jan: US imposes tariffs on solar panels, washing machines
Apr 2: China imposes tariffs on US goods (USD 3 bn)
Jun 1: US imposes tariffs on steel and aluminium
Jun 25: EU imposes tariffs on US goods (USD 3 bn)
Jul 6: USA/China impose tariffs on each other (USD 34 bn)
Jul 10: US may impose tariffs on China (USD 200 bn)
Jul 25l: USA and EU agree to continue negotiating
Aug 3: China may impose tariffs on US goods (USD 60 bn)
Aug 23: US/China impose tariffs on each other (USD 16 bn)

Regrettable but manageable in terms of growth

The new US trade policy unavoidably entails downside risks, for example to economic growth, but we believe that the IMF and BoE tend to exaggerate these effects if various other moderating factors are also taken into account:

1. The tariffs adopted so far will have **little impact on global growth** unless the world is suddenly hit by major risk aversion. This is also true if tariffs rise further (as assumed by the IMF).
2. The trade war is still bilateral (between the US and the rest of the world) – **not multilateral**. The EU and Japan have now put a free trade agreement in place that covers one third of the world economy, confirming the widespread desire for more free trade.
3. The **US** is the country whose growth will be hardest hit, which should influence American public opinion.
4. Tariffs help **redirect trade flows**, which will also **benefit growth in various countries**, but **high resource utilisation** in many countries could make it harder to shift global production.
5. Economy policy may again be shifted in a more **expansionary direction** to support growth, for example in China.

Our overall conclusion from the above estimates and arguments is that absent a surge in risk aversion, **global growth will remain resilient** to disruptions even if the trade war escalates further.

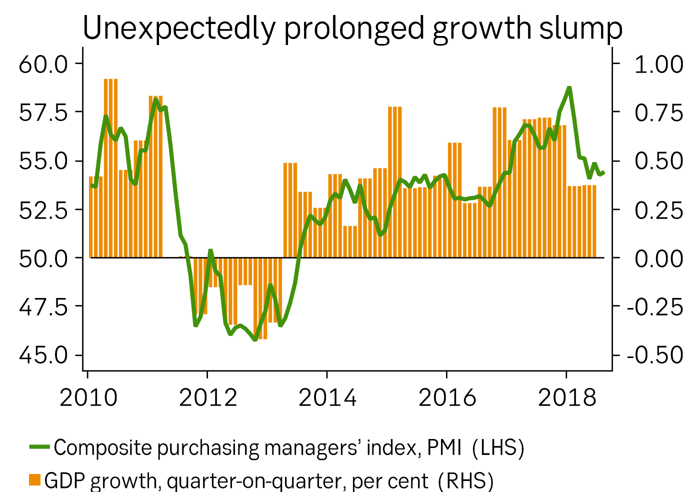
[1] *"G-20 Surveillance Note"*, IMF, July 18, 2018, and "*From Protectionism to Prosperity"*, Mark Carney, Bank of England, July 5, 2018.

The euro zone

Prolonged deceleration, but continued healthy outlook

The weak start to 2018 has lasted longer than expected, but we still have a positive view of the outlook. Despite declines, business sentiment is at levels that signal above-trend growth, though trade concerns pose downside risks. Rising employment shows that businesses foresee continued expansion. Strong labour markets and fiscal stimulus will help households. GDP will grow by some 2 per cent yearly in 2018-2020. Inflation and wage hikes will increase but are low. ECB rate hikes will start only in summer 2019.

Disappointing growth dominated the first half of 2018 and the slowdown has lasted longer than expected. Meanwhile various risks are hanging over the euro zone. Trade war and Brexit are hampering exports and capital spending, but their impact will probably be limited. Italy's government is challenging EU budget rules, with higher bond yields as a result. **Meanwhile there are signs of strength**. We still have a positive view of the euro zone growth outlook. Labour markets are moving in the right direction and public deficits are at their lowest in 10 years, opening the way to stimulus measures. Despite declines, business sentiment indicators signal above-trend growth. Although we foresee a rebound this autumn, due to the weak first half **we are revising our growth forecast a few tenths lower to 2.1 per cent in 2018 and 2019**. In 2020, GDP growth will slow due to such factors as an ever-tighter German labour market.



Source: Eurostat, Macrobond, SEB

Political uncertainty a part of daily life

Not unexpectedly, efforts to intensify European Union economic policy integration have lost momentum in an environment **where the focus is on Brexit and trade war and where euro-sceptical forces have scored successes in various national elections**. The ambitious plan unveiled by Brussels in 2017 has now been replaced by a more realistic path forward, emphasising **issues related to a banking union, defence and migration**. Integration efforts will continue to face headwinds as completion of Brexit negotiations, management of trade conflicts with the US and preparations for the new EU budget generate friction between Brussels and individual member countries. In such an environment, officials will probably focus on solving the most acute issues in order to keep EU cooperation on course, putting aside visionary aspirations. Next spring's European Parliament elections will also make officials less willing to raise sensitive issues related to expanding the role of the EU. We believe Brexit negotiations will be completed but that a proposed EU-UK agreement will fall into place only at the last minute. Italy's political situation will remain uncertain due to the threat of reforms that would violate euro zone budget rules, but we believe that – deterred by the example of other countries that were forced into major austerity programmes – the Italian government will try to find a compromise enabling it to keep its election promises but spread them over a more extended time period, in order to avoid a sharp rise in yields.

GDP forecasts
Year-on-year percentage change

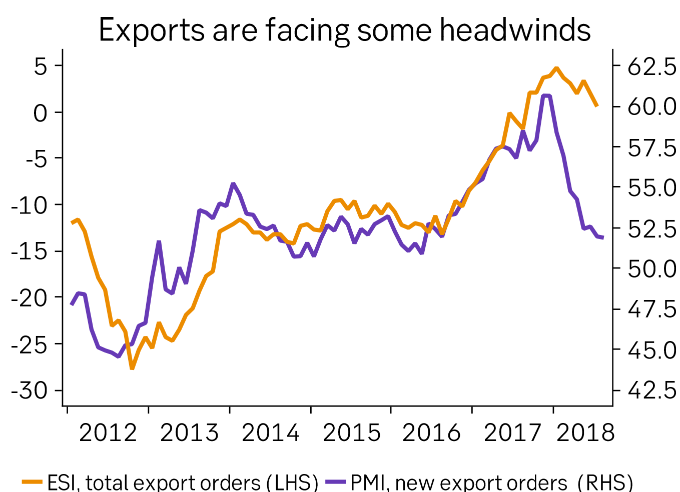
	2017	2018	2019	2020
Germany	2.2	2.0	1.9	1.7
France	2.2	1.7	1.9	2.1
Italy	1.5	1.2	1.4	1.5
Spain	3.1	2.8	2.6	2.2
Euro zone	**2.4**	**2.1**	**2.1**	**1.9**

Source: Eurostat, SEB

Stabilisation after prolonged weakness

The period of **negative surprises in economic data was more long-lasting than expected**. Q2 was also disappointing. The decline in business sentiment indicators is broad-based, but the deceleration has occurred from pumped-up levels that peaked around the end of 2017. In recent months we have seen a stabilisation at levels that support **our forecast of GDP growth a bit above trend in 2018-2019**. Growth profiles will diverge a bit as Germany, with its record-low unemployment, experiences supply-side problems and decelerates despite looser fiscal policy, while reforms in France begin to bear fruit. Euro zone **exports have faced headwinds** due to a stronger currency and weaker global demand and fell for the first time in five years in Q1. So far this year, industrial production and order bookings have been hurt by temporary negative factors, but business

indicators show that order books remain strong. Exports, capital spending and **industrial production will be hampered by future uncertainty about trade war and Brexit**, although these effects are difficult to measure. The crisis in Turkey will have an impact, mainly via connections to European banks. Exports will be only marginally affected, since only 1.5 per cent of euro zone exports go to Turkey. Exports to Iran are even smaller, totalling a mere 0.2 per cent, so that the side effects of the new US sanctions on total euro zone exports will be negligible. Because world trade will continue growing despite trade disruptions, exports will increase by about 4 per cent yearly in 2018-2020. Imports will climb somewhat faster, and the euro zone's **current account surplus will shrink to 3 per cent of GDP in 2020**.



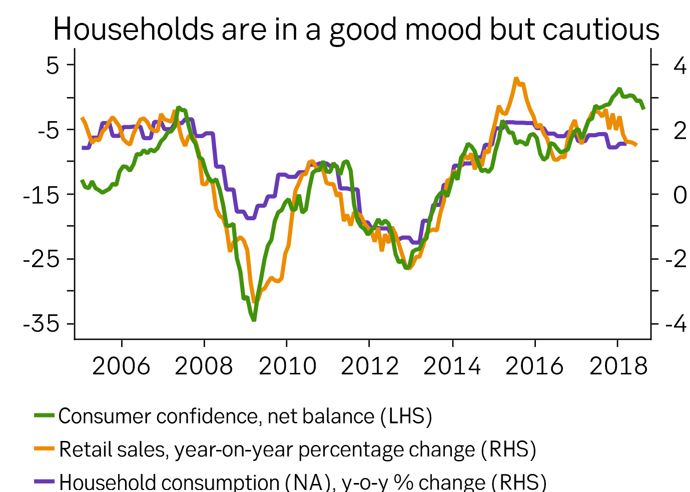
Moving towards more aggressive fiscal policies

The outlook for euro zone public finances has improved, and in 2017 public sector deficits fell for the eighth consecutive year. At below 1 per cent of GDP, they are the lowest in 10 years. Only at the peak of earlier expansions, in 2000 and 2007, has the budget situation been better since today's regulations were introduced in the mid-1990s. The improvement is partly due to stronger general economic conditions but also shows that austerity programmes in various countries have borne fruit. Germany has noted four years of consecutive budget surpluses, and public debt is expected to fall below 60 per cent of GDP. It is mainly other large countries such as France, Italy and Spain that stand out negatively, with deficits of about 2-3 per cent of GDP.

Stronger government finances are now opening the way for more expansionary fiscal policies in various countries. On the other hand, some countries have persistent problems with high debt that would justify continued consolidation, especially Italy. We believe that major dissatisfaction with austerity policies will contribute to a general shift towards **slightly expansionary fiscal policies that will help sustain the recovery**. In Germany, stimulus measures equivalent to about 0.5 per cent of GDP have been announced, despite the tight resource situation. We expect deficits to fall somewhat further, reaching 0.5 per cent of euro zone GDP in 2019. Along with continued decent GDP growth, this will help bring the debt ratio close to 80 per cent of GDP.

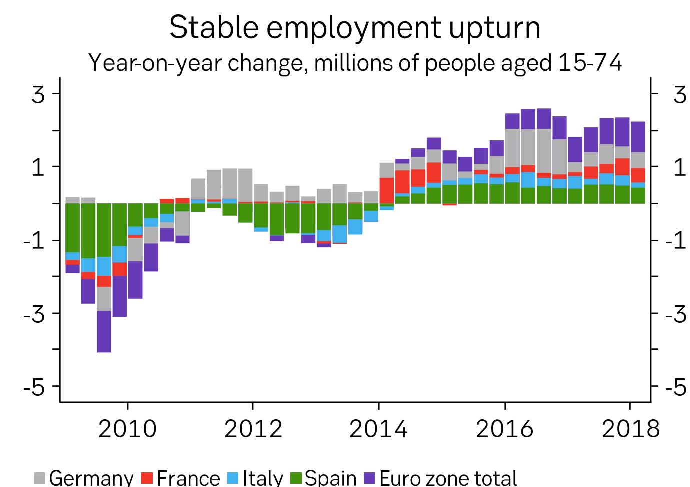
Strong labour market but households are hesitant

The situation of households is improving, in an environment with ever-stronger labour markets, low interest rates and bond yields and fiscal policies that are shifting in an expansionary direction. Stock market performance also remains strong, while housing prices are stabilising or rising. **Consumption will thus remain an important growth driver**. But despite all these positive factors and even though household optimism stood at historically high levels this past spring, consumption and retail sales have primarily remained flat. This may reflect an underlying healthy caution about the future. The economic crisis – with its major cutbacks in the public sector – remains a vivid memory. This may cause concern about the social contract and thereby accentuate the need for personal financial buffers. Household savings ratios are also already depressed below pre-crisis levels and continue to fall. We expect the increase in real incomes to average only 1 to 1.5 per cent in 2018-2020 in an environment of subdued pay increases and somewhat higher inflation. **Consumption will increase by about 2 per cent annually in 2018-2020**.



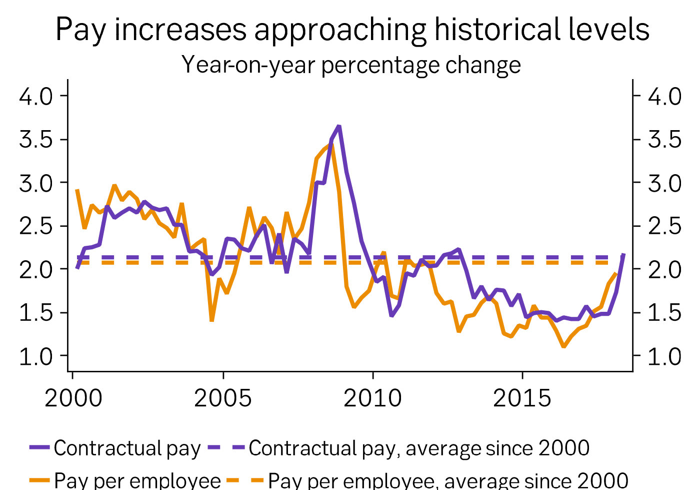
Employment rising without much acceleration in pay

Despite hesitant growth, **labour markets are showing continued strength**. Unemployment fell to 8.3 per cent in May/June and is now only one percentage point above its low in 2007 and nearly 4 points below its peak during the crisis. The downturn is broad-based, but jobless levels diverge within the region. German unemployment is at its lowest in several decades, while in Spain the level exceeds 15 per cent (down from 27 per cent in five years). The downturn is not as notice-able in France and Italy, but there is a clear downward trend.



Unemployment has fallen by 5.5 million people in the past five years, and the downturn is being driven by job creation. In the **past year, employment has risen by more than 2 million**. Since the German labour market has been ever-tighter, other large euro zone countries have increasingly driven this trend. Business sentiment indicators show that **companies continue to have positive hiring plans** despite generally falling indicators, but job creation is likely to slow – mainly due to mounting recruitment problems. Despite relatively high unemployment levels in various countries, businesses are finding it hard to find personnel, according to sentiment surveys. Measured as annual averages, **unemployment will fall from 8.3 per cent to 7.5 per cent in 2020** and labour markets will thus be close to equilibrium unemployment by the end of our forecast period.

Despite rising employment the rate of wage and salary increases is subdued, but the trend has pointed upward for a couple of years. Pay hikes have accelerated to nearly 2 per cent yearly: the highest figure since late 2011. Low unemployment in Germany has begun to have some impact on wage formation. The IG Metall labour union concluded a collective agreement of around 3½ per cent annual pay increases. Although the secondary effects will be limited, we expect average pay hikes of around 3.0-3.5 per cent in 2020. In France and Spain, wage and salary increases are speeding up to 1.5-2.0 per cent, while in Italy they are only around 1 per cent. **Euro zone pay increases will accelerate to 2.5 per cent in 2019** but will not reach much higher than this during the following year.



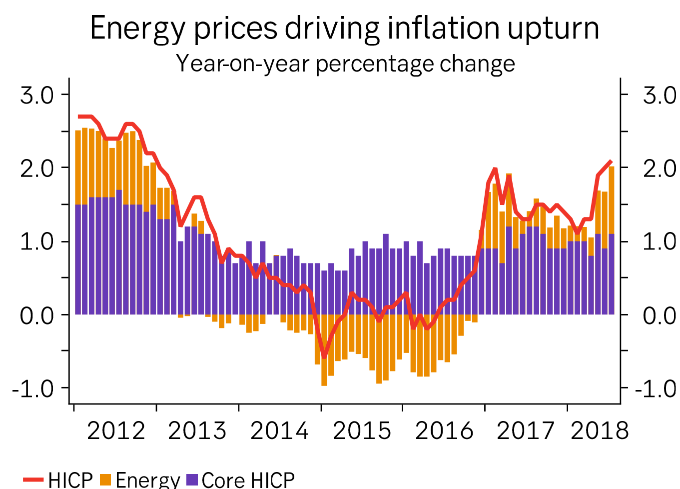
Source: ECB (European Central Bank), Macrobond, SEB

Low inflation pressure, despite above-trend growth

Rising energy prices have again pushed up inflation, which has remained around 2 per cent during the past three months. In July, inflation according to the EU's harmonised index of consumer prices (HICP) reached 2.1 per cent. Of the four large economies, only Italy showed HICP inflation below 2 per cent. We believe that the **upturn is temporary** and that base effects from earlier energy price upturns will help push inflation down towards 1.5 per cent this autumn and winter. Assuming continued relatively low pay increases, HICP **inflation will remain below 2 per cent throughout our forecast period**. Core inflation is sluggish and has been about 1 per cent since 2013; we expect it to stay around 1 per cent until the end of 2019 and then climb slowly to roughly 1.5 per cent. A food price surge due to this summer's drought is a short-term upside risk. It also remains uncertain how core inflation will be influenced by secondary effects from earlier energy price increases.

ECB: QE drawing to a close, long wait for a first hike

At its June policy meeting, the European Central Bank (ECB) finally unveiled its exit strategy. Bond purchases of EUR 30 billion per month (quantitative easing, QE) will continue until the end of September and will be reduced to EUR 15 billion per month in October-December, then end. Re-investments of coupons and maturing bonds will continue until further notice. In June, the ECB stated that its **key interest rates will remain at current levels** "**at least through the summer of 2019**". Although this plan is conditional on incoming economic data, we believe relatively major new developments would be required in order to change it. The ECB's message was again a combination of give-and-take aimed at satisfying both doves and hawks. The hawks gained an end to the QE programme and the doves a three-month extension and a clear signal that key rate hikes will be postponed for another while. If anything, the signal on the timing of the first repo rate hike was somewhat dovish; the ECB's formulation indicates that the hike will occur only after the summer of 2019, or nine months after the end of QE.



Source: Eurostat, Macrobond, SEB

This announcement means that the monetary policy map for the coming year will largely remain in place, and the likelihood of a near-term ECB surprise is limited. The focus will now be on signalling about what "at least through the summer" means, and whether marginally good or bad data may speed up or slow down the first hike, what will happen later on and how fast the ECB's rate hikes will be. We expect the **ECB to hike its deposit rate 15 points in September 2019**, making the interest rate corridor symmetrical. **The first refi rate hike will then occur in Decmeber 2019**, followed by two further hikes during 2020 to 0.5 per cent. Worth noting is that ECB President Draghi's term of office expires in October 2019, and since the ECB with Draghi at the helm has so far never hiked its key rate, our forecast implies that he will round off his term with at least a deposit rate hike. As for the question of his successor, Deutsche Bundesbank President Jens Weidmann tops most surveys conducted among economists, but it is still too early to draw any strong conclusions from this. The allocation of top positions in the EU and the ECB is often like a jigsaw puzzle, with countries giving and taking in different areas. This means that appointments to other high-level positions may provide indications as to whether or not a German will become ECB president for the first time.

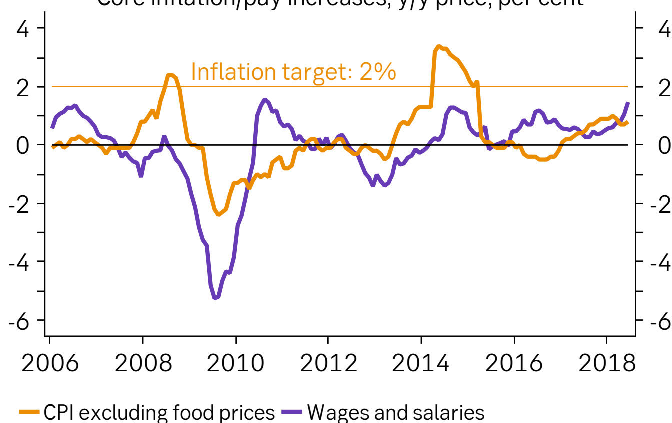
Japan

Difficult policy dilemmas for government and central bank

Despite rising cyclical and structural headwinds, Japan's GDP growth will remain above trend in 2018-2020. An output gap that signals overheating and unemployment at a 40-year low will not be enough to achieve the 2 per cent Bank of Japan (BoJ) inflation target by 2020. The impact of the BoJ's extreme monetary policy on growth and inflation are not apparent. In 2019 we expect the BoJ to continue asset purchases aimed at controlling the yield curve for government bonds.

Japan's quarterly GDP figures show continued high volatility. After unexpected weakness early in 2018 for such components as capital spending and private consumption, activity has rebounded. But **uncertainty** about underlying **economic strength** and the **inflation trend** is creating policy challenges for both the government and BoJ. **Growth is in a falling trend. GDP will expand by 1.1 per cent this year** and then decelerate to **1.0 per cent in 2019 and 0.8 per cent in 2020**. This is still above trend level (0.5 per cent according to the OECD). Growth will slow as fiscal stimulus continues to fade, the previously postponed consumption tax hike from 8 to 10 per cent occurs in October 2019, investments related to the 2020 Tokyo Olympics dwindle and monetary exit strategy is debated more intensively.

Downside risks to growth have increased and are connected to heightened geopolitical uncertainty, escalating trade wars – even though Japan and the EU have now signed a free trade agreement – and rapid deceleration in China. Increased global risk aversion would strengthen the yen, squeeze exports and thereby decrease the already weak desire among companies to invest and to raise wages and salaries. This scenario may be worsened by an excessively rapid end to Abenomics – the prime minister's stimulus and structural reform package – which would open the door for resumption of deflationary forces.



Source: Japanese Ministry of Health, Labour & Welfare, Japanese Statistics Bureau, SEB

Unemployment is expected to fall from today's 2.4 per cent to below **2 per cent, reaching 1.8 per cent by the end of 2020: the lowest level in 40 years**. Labour force participation today is nearly 70 per cent (the highest in 50 years), reflecting reforms that have gradually boosted participation among women and foreign-born residents. These are positive signals for Japan's major long-term demographic challenge. Yet larger labour supply, along with digitisation and robotisation, are helping hold down pay hikes, making it harder to meet the inflation target.

Prime Minister Shinzo **Abe is expected to be re-elected** in September as leader of the ruling Liberal Democratic Party. Meanwhile observers remain **concerned about government finances**. In July, Abe was forced to postpone his target for achieving a primary budget balance from 2020 to 2025. Yet a less expansionary fiscal policy is **too risky** for an economy struggling with demographic headwinds and still permeated by deflationary thinking. We expect **deficits to be 2.5-3.5 per cent of GDP in 2018-2020**, or around 1-1.5 percentage points lower than in 2017. Public debt remains at a high 235 per cent of GDP.

The output gap is closed; overheating is equivalent to 1-1.5 per cent of GDP. **Pay hikes are accelerating** (see chart), boosting the BoJ's chances of achieving its inflation target of a **"steady 2 per cent"**. Meanwhile the government is encouraging companies to boost pay by 3 per cent. But many households and businesses are not convinced that the BoJ will meet its target, and the BoJ itself shows flashes of doubt. Long-term (5-10 year) inflation expectations among households, businesses and economists have been troublingly stable at about 1.2 per cent in the past 2-3 years. **CPI inflation** (excl. food prices) will be **0.7 per cent in 2018, 1.1 per cent in 2019 and 1.5 per cent in 2020**.

Monetary policymakers face a **dilemma**. Deflation seems to have faded, but downside growth and inflation risks still dominate the 2018-2020 outlook. Meanwhile fiscal policy manoeuvring room is increasingly limited by high public debt and demographic challenges, suggesting that the BoJ will adhere to its current policy for another while, keeping government bond yields close to zero and expanding its balance sheet.

Yet some observers question the effectiveness of this policy – its impact on growth, inflation and inflation expectations – and the BoJ's prospects for managing the next recession. We are sticking to our forecast that the BoJ will try to keep 10-year yields "around 0 per cent" at least during 2019 and that yearly growth in the monetary base will remain at 5-10 per cent. We believe the BoJ wants to avoid yen appreciation, which may dampen the desire to increase pay and may lower inflation pressure. **At the end of 2018, the USD/JPY exchange rate will be 110, closing 2019 at 102 and 2020 at 100**.

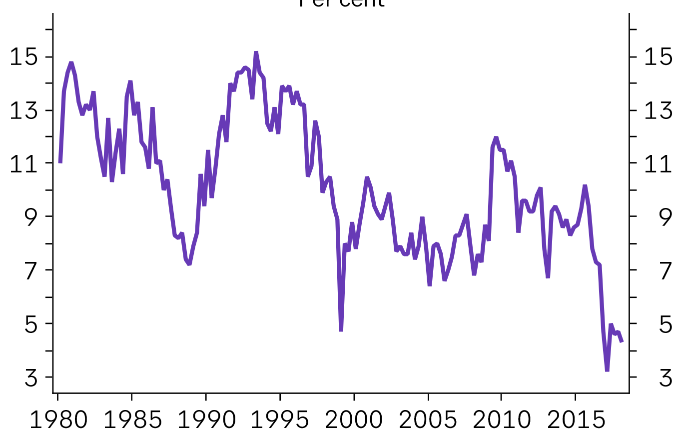
The United Kingdom

Outcome of Brexit talks will determine UK's economic future

Brexit negotiations are entering their final round during the second half of 2018. The outcome will determine the UK's economic performance during our forecast period. If the talks fail, there is a clear risk that the country will end up in a new recession. Our main scenario is still that EU and UK officials will reach an agreement that enables growth to accelerate during 2019-2020. The main risks to the British economy are a low household savings ratio and increased international trade deficits.

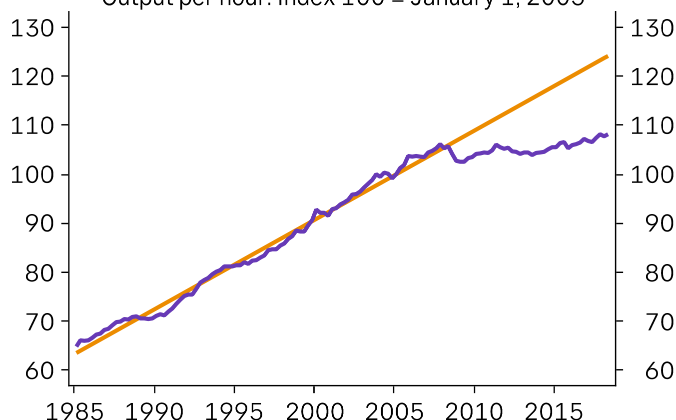
The British economy decelerated sharply during Q1 2018, with quarter-on-quarter growth reaching a mere 0.2 per cent. One reason was that an unusually cold winter hurt construction activity. Growth recovered in the second quarter and GDP grew by 0.4 per cent, partly due to rebounding consumption and capital spending, but the **recovery risks being short-lived** if talks on British withdrawal from the EU ("Brexit") should fail this autumn. Estimates from the IMF and others indicate that a "hard" Brexit, with no trade agreement and thus full withdrawal from the EU single market, could **drive the UK economy into recession**.

But Brexit is not the only risk. The household savings ratio remains historically low, and real wage growth is close to zero. The need for consolidation and more saving should reasonably curb household demand during our forecast period, posing a risk to growth since consumption makes up over 60 per cent of GDP.



Uncertainty about Brexit seems to have slowed UK capital spending in recent quarters. Although surveys show that businesses plan larger investments, they are probably waiting for the outcome of the withdrawal talks before placing their orders. Assuming that the negotiations lead to a new agreement, which is our main scenario, capital spending should grow faster in 2019 and 2020. **We thus expect overall GDP growth to improve to 1.3 per cent in 2018 and then to accelerate to 1.8 per cent in 2019 and 1.9 per cent in 2020**, provided that there is an orderly withdrawal from the EU with an agreement in place. Ours is a more optimistic scenario than the consensus forecast.

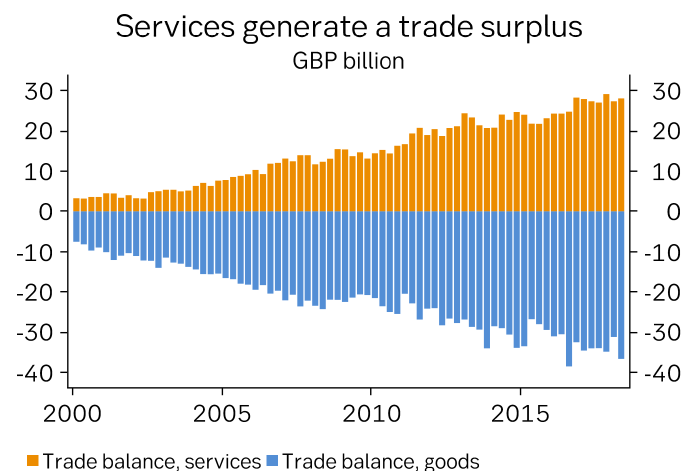
The British labour market remains strong. In the past year, employment has increased by an average of about 100,000 people per month. Unemployment has fallen to 4.0 per cent, which is historically low. Such a tight labour market normally accelerates pay increases, but in recent months **nominal growth in wages and salaries has levelled out**. In June they fell to 2.4 per cent year-on-year. There are clearly many reasons for these restrained pay increases – such as tough competition – but the UK's nearly non-existent productivity growth is one factor helping to hold back the ability of companies to offer higher pay.



UK productivity growth has been close to zero since the financial crisis 10 years ago. Yet there are reasons to expect stronger productivity growth ahead. Historically, higher productivity growth usually goes hand in hand with stronger economic expansion, although causality is debated. Furthermore, the UK still seems to be aiming at limiting free movement of labour after its withdrawal from the EU. **This would risk causing labour shortages in some sectors, suggesting that low unemployment will persist** during our forecast period. Recent statistics show that migration from other EU countries has already fallen sharply. One way of offsetting labour shortages is to increase business investments that boost productivity.

Withdrawal from the EU may thus very well lead to a surge in productivity over the next few years. There are some signs of such a trend.

A weak pound has benefited the British export sector. The UK's trade deficit has shrunk by half in recent years to around 1 per cent of GDP. This is mainly due to a growing trade surplus in services, while the merchandise trade deficit potentially may have stabilised, but there are question marks about this trend related to EU withdrawal. All indications are that a free trade agreement between the UK and the EU will primarily focus on merchandise trade, while trade in services will be hurt by various restrictions. **Brexit may thus have a negative impact on the current account balance**, although the size is hard to quantify. According to the statistics 69 per cent of the goods trade deficit is related to EU. Trade in services lack a similar breakdown. We also assume that the pound will appreciate if negotiations with the EU succeed, which should also dampen exports somewhat.



Source: U.K. Office for National Statistics (ONS), Macrobond, SEB

The Bank of England (BoE) seems to taking EU withdrawal in stride. After a November 2017 reversal of its summer 2016 key interest rate cut directly after the Brexit referendum, the UK central bank hiked the key rate to 0.75 per cent in August. But we believe that inflation will fall faster than the BoE expects in its forecasts. As early as July, core inflation fell below target. Our forecast is that the exchange rate-driven inflation upturn will continue to slow this autumn. By the end of 2018, we thus expect CPI inflation to end up below 2.0 per cent, and we reckon that inflation will remain below the BoE target during 2019 and 2020. This will decrease the need for further key rate hikes, enabling the central bank to calmly await the consequences of British withdrawal from the EU. Assuming a "soft" Brexit, we believe that **two further rate hikes to 1.25 per cent will occur during the second half of 2019**. After that, the BoE will probably follow the same path as other central banks, with a slow tightening that includes two hikes to 1.75 per cent in 2020.

The value of the pound will be determined almost entirely by the status of ongoing withdrawal negotiations and the political situation in the UK. During the spring, there was a slight recovery due to progress in the Brexit talks and expectations of tighter monetary policy, but political turbulence during the summer triggered renewed downward pressure on the pound. Because of continued uncertainty about Brexit, a risk premium on the pound is justified. We expect the currency to keep trading at a rather weak level against the euro for as long as uncertainty about Brexit and the domestic political situation persists. If an agreement is achieved and is approved by both the EU and the UK Parliament, resulting in an orderly withdrawal, we believe that the pound will appreciate as early as the final months of 2018. The EUR/GBP exchange rate will be 0.87 at the end of 2018, 0.82 at the close of 2019 and 0.80 at the end of 2020.

Brexit negotiations move towards a crescendo

Brexit negotiations on the future UK-EU relationship are entering their final stage. So far the two sides have managed to agree on withdrawal terms and a transitional solution that, in practice, postpones British withdrawal until December 31, 2020. A free trade pact and a manageable solution regarding the border between Northern Ireland and the Republic of Ireland are important elements of the remaining talks about the future relationship. According to the original plan, an agreement was supposed to be reached before the EU summit in October, but this appears increasingly unrealistic.

So far, disagreements about what type of future relationship the UK should have with the EU have mainly existed on the British side. The EU has repeatedly asked the UK to formulate a common position in the negotiations. The split between a more EU-friendly faction and a faction made up of "hard Brexiteers" – who want a more far-reaching break with the EU – has existed since the 2016 referendum, but it has widened in recent months. It became more visible when Prime Minister Theresa May gained Cabinet approval of her Brexit plan in early July. Some political leaders regarded her plan as too soft, keeping the UK dependent on the EU in various fields without having any real influence. This led both the UK's chief Brexit negotiator and the foreign secretary to resign in protest at what they viewed as excessive concessions to the EU that would deprive the UK of its independence after Brexit.

It still appears as if the prime minister can manage the situation in her party, but the risk of a government crisis has increased this summer. If May is forced out as PM, there is an overwhelming risk that the UK will crash out of the EU without any agreement in March 2019. The outcome of EU-UK negotiations will also depend on the EU's ability to make certain concessions, for example related to restrictions on free movement for EU citizens. Unfortunately the likelihood of a breakdown in negotiations increased during the summer. What remains to be solved is how to manage an open border between Ireland and Northern Ireland, the influence of the EU Court of Justice on compatibility with EU legislation and the UK's ability to conclude its own trade agreements with third countries while in practice remaining in the EU customs union.

We still believe that the two sides will bridge their differences this autumn on the terms of a new agreement on their future relationship, but based on general experience of political negotiations as well as last autumn's EU-UK talks on the withdrawal agreement, such talks rarely achieve a successful conclusion until the absolute last minute – in order to be politically defensible. This suggests that over the next few months, the negotiations may very well give the impression that there are growing conflicts between the two sides and that the possibility of a solution is receding. Yet the sizeable costs of failure for the EU, and especially for the UK, should nevertheless pressure the two sides to reach agreement in October or November.

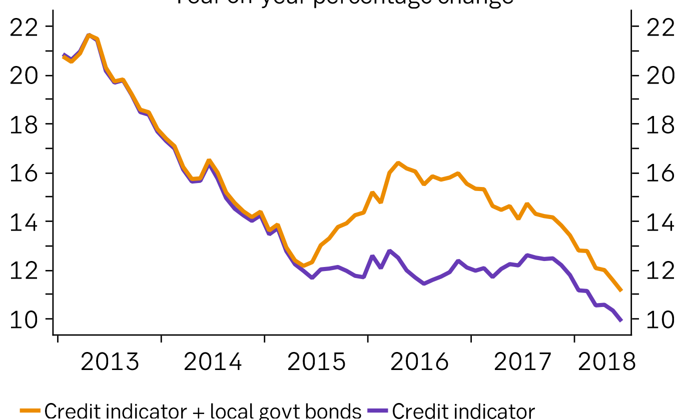
China

Temporary pause in deleveraging, in order to support growth

The trade war with the US has forced China to reassess its credit policy and loosen monetary and fiscal policies, in order to support domestic economic growth. In 2019 China will resume more neutral monetary and credit policies unless the trade war takes a severe turn for the worse. The central bank will try to prevent a destabilising yuan depreciation, which would make deleveraging of large USD loans harder. The yuan will gain 10 per cent against the dollar by the end of 2020, easing tensions between Beijing and Washington.

China's GDP growth was **6.7 per cent in the second quarter of 2018** after remaining stable at 6.8 per cent in the preceding three quarters. Although 6.7 per cent is still above Beijing's target of "about 6.5 per cent", various indicators suggest somewhat lower growth ahead. Domestic demand will slow, mainly due to lower infrastructure investments: an effect of the tighter credit policy that was launched to reduce risks to financial stability. Net exports will also contribute more moderately to GDP growth, but 2019-2020 activity will be sustained by rising real wages, falling unemployment and the resulting solid private consumption. The ongoing trade war with the US is squeezing the export sector and poses downside risks to growth. **This year GDP growth will be 6.6 per cent**, then slowly **fall to 6.3 per cent next year and 6.0 per cent in 2020**.

In the wake of credit tightening, **company bankruptcies have soared**, which has decreased investor appetite for corporate bonds with low credit ratings. To ensure a good capital supply – and thereby decrease risks to growth – the People's Bank of China (PBoC) has started to use a new **Medium-Term Lending Facility** aimed at stimulating bank lending and investments in securities with low credit ratings. The authorities are also urging major lenders to drive developments by both boosting credit supply and cutting borrowing costs, mainly to small businesses. Beijing has thus temporarily **deviated, probably for only a short period, from its long-term tightening strategy**: a pattern that is rather common among Chinese economic policymakers.



Source: SEB

Although the PBoC uses the terms "prudent and neutral" to describe its policy, Chinese **monetary policy has now shifted in a more expansionary direction**, especially since late spring. In April the central bank lowered its reserve requirement ratios (RRRs) by one percentage point for most banks. In June, it followed up this decision with a further 0.5 point cut while keeping its short-term repo rate stable despite the US Federal Reserve's key rate hike in June. The 7-day repo rate, a good indicator of China short-term interest rates, has also gradually moved lower in 2018, indicating a more expansionary policy.

In the third quarter, we expect the PBoC to **lower the reserve requirement once again (by 0.5 points)**, while leaving deposit and lending rates unchanged to avoid weakening the yuan. A weak yuan risks triggering larger capital outflows, jeopardising financial stability and decreasing international willingness to invest in Chinese equities and debt securities. While we expect the PBoC to keep lending/deposit rates unchanged at 4.35/1.50 per cent respectively through 2020, **hikes in the 7-day reverse repo rate** are still in the cards. We expect another 5bps hike in Q4 followed by a cumulative 20bps rise in 2019 to reach 2.80 per cent by end-2019. This maintains rate differentials at the short end of the curve, capping upside risks to the USD/CNY rate.

During the rest of this year the government will pursue a more **expansionary and "proactive"** fiscal policy, including tax cuts. China's 2018 target is to lower taxes and fees by CNY 1.1 trillion (1.3 per cent of GDP). This amount is now being expanded by CNY 65 billion to help support economic growth. Beijing also intends to issue special bonds to fund infrastructure projects at local and regional levels.

So far in 2018 the yuan has depreciated by about 5 per cent against the dollar (mainly during the summer), reaching nearly CNY 6.90 per USD in August. In order to prevent the yuan from reaching the psychologically important level of 7 per dollar and risk generating further tensions with Washington, in August the PBoC imposed 20 per cent reserve requirements on foreign exchange (FX) forward contracts, thus making it more expensive to fund short yuan positions. The PBoC is also prepared to take further steps to stabilise the FX market. **We expect a USD/CNY exchange rate of 6.80 at the end of 2018**. Assuming a shift in monetary policy during 2019 and Beijing's goal of encouraging a larger influx of foreign capital, **the yuan will appreciate against the dollar, reaching 6.50 by the end of 2019 and 6.40 at the end of 2020**. We expect the PBoC to resist too large a yuan appreciation as long as the trade war with the US continues.

India

Tighter monetary policy and strong growth will stabilise rupee

Economic activity continued to accelerate in the first quarter of 2018. Data indicate continued healthy growth. The central bank acted to offset rising inflation by hiking its key interest rate in June and August. The rupee has weakened sharply, but tighter monetary policy and continued good growth mean that room for further depreciation will be limited. If the Modi government emerges stronger from next spring's election, strategic reforms in areas like the labour market and land purchases are more likely.

In the first quarter of 2018, India's GDP growth accelerated again and reached 7.7 per cent year-on-year. Private and public sector consumption, which has benefited from the shift towards more expansionary government fiscal policy ahead of the spring 2019 election, was probably the main driver. Economic data indicate continued strength during Q2, although GDP growth likely cooled slightly (published August 31). The purchasing managers' index for the manufacturing sector remains well above the growth threshold of 50, reaching a six-month high in June. Meanwhile business confidence indicators rose. Hard data such as industrial production and car sales also point to good economic performance. Our forecast is that **GDP will increase by 7.5 per cent in 2018 and by 7.8 per cent in both 2019 and 2020**. This represents an upward adjustment of 0.2 points for 2018 and 0.3 points for 2019 compared to our May forecast.

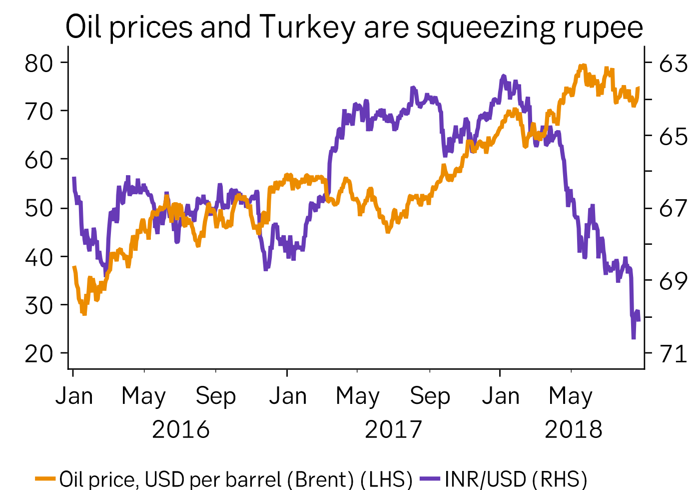
For a long time, India benefited from a downward trend in energy prices, when **now that oil prices have climbed again, the economy is under pressure on several fronts**. The country's trade deficit has widened and the government has cut fuel taxes in order to ease the impact on the private sector. Because of this, the government has also lowered its deficit-cutting ambitions, causing some financial market turmoil and helping weaken the rupee. With future oil prices expected to be around USD 70-80/barrel, however, the negative impact on the government budget and economic growth will be limited.

CPI inflation fell from 4.9 per cent in June to 4.2 per cent in July, just above the 4 per cent official target. The decline was unexpectedly large and was driven by falling food prices, yet core inflation remains high after having risen due to increasing capacity utilisation. Inflation expectations rose markedly in Q2. Combined with healthy growth and expansionary fiscal policy, this suggests continued substantial price pressure. **Measured as full-year averages, we expect inflation to end up at 4.6 per cent in 2018 and 4.8 per cent in both 2019 and 2020**.

The Reserve Bank of India (RBI) has already acted to offset inflation by **raising its key interest rate in June and August** to the current 6.5 per cent: the first rate hikes since early 2014. The RBI has communicated that inflation is the main factor behind these rate hikes. Although CPI inflation fell unexpectedly fast in June, the statistics are volatile and various factors will contribute to continued price pressure. Our forecast is that **the RBI will hike its key rate twice in 2019 and once in 2020 to 7.25 per cent**.

An election to the lower house (Lok Sabha) will take place in **April-May 2019**. The success of Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) in recent state elections indicates that voters still have confidence in the government's reform policies, even though the results of this past term of office have not really lived up to high expectations. Although **various reforms have been enacted**, contributing to slightly higher long-term growth (an inflation target, bankruptcy legislation, currency reform, a national goods and services tax etc.), **implementation** of the reforms has been **poorly managed in several cases**. These include the currency ("demonetisation") reform and a failed attempt to privatise Air India. Also worth noting is the **absence of reforms in important areas** such as the labour market and land purchase legislation. If the BJP manages to improve its position further in the spring election, this will create better potential for progress in these other politically sensitive reform areas as well.

Oil prices and Turkey are squeezing rupee



Source: Macrobond, SEB

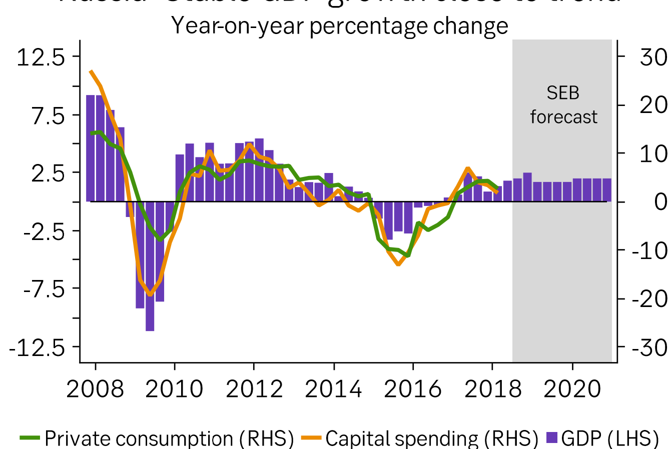
The rupee has fallen to **historical lows against the US dollar**, losing around 9 per cent so far in 2018. The currency is being hurt by higher oil prices, worries about central government finances and the trade deficit. Recently the rupee has also been pulled down by market turmoil related to Turkey, but the risk of further depreciation is limited due to India's tighter monetary policy and favourable economic growth outlook. Our forecast is a **USD/INR rate of 70.0 at the end of 2018, 68.5 at the end of 2019 and 68.0 at the end of 2020**.

Russia

VAT hike and sanctions will slow economic growth

GDP growth will accelerate somewhat in 2018 due to higher oil output and stronger consumption, driven by higher pay and historically low inflation, but tight fiscal and monetary policies – including a value-added tax (VAT) increase in 2019 – will keep the expansion below trend. Initiatives will be taken to meet the goals unveiled by President Vladimir Putin in May, but we do not expect far-reaching reforms. The rouble has weakened and will be depressed as long as the threat of further US sanctions persists.

The economy grew by a preliminary 1.6 per cent year-on-year in the first half of 2018, but GDP growth will probably be adjusted a bit higher due to revised industrial production. This pace of expansion is far below the roughly 4.5 per cent that President Putin needs in order to fulfil his election promise to turn Russia into one of the world's five largest economies and close the gap with other developed countries. The agricultural sector has grown somewhat less strongly than expected, but industrial production and retail sales, stimulated a bit by the football World Cup, have performed better. We expect the economy to accelerate somewhat during the second half, thanks to higher world market prices for agricultural products and rising oil output, with growth averaging 1.7 per cent in 2018. Budget tightening, including a VAT increase from 18 to 20 per cent, will constrain **GDP growth, keeping it at 1.7 per cent next year. In 2020 we expect the economy to grow at close to its potential of about 2 per cent**. Further sanctions will probably be imposed by the United States this autumn, and if they are tougher than expected they pose a clear downside risk to our forecast.



Inflation bottomed out at 2.2 per cent year-on-year in February and stood at 2.5 per cent in July. It will climb gradually this autumn due to increasing consumption driven by robust pay hikes. Over the past year, the rouble has depreciated by 10-15 per cent against the US dollar, which along with base effects will also help boost inflation to the 4 per cent official target by year-end. The VAT hike will raise inflation further to just above target in 2019, but the continued relatively tight monetary policy we have forecasted will cause inflation to drop back to the 4 per cent target in 2020. We believe that during the rest of 2018, the central bank will abstain from key interest rate cuts and leave its key rate at 7.25 per cent to avoid further rouble depreciation. The central bank's view is that a neutral interest rate is 6-7 per cent. We believe that next year it can start lowering the key rate towards this neutral level without jeopardising the inflation target. We expect a key rate of 7.0 per cent at the end of 2019 and 6.5 per cent at the end of 2020, once inflation expectations have stabilised around the target. **We expect a rouble exchange rate of 67 per dollar at the end of 2018, gradually weakening to 71 by the end of 2020**, but this forecast is dominated by risks that may weaken the rouble even more.

Government finances have improved sharply, and the federal budget showed a small surplus in the second quarter. The new three-year budget establishes ambitious goals, such as lowering the oil price level that is compatible with a balanced budget to USD 50 per barrel and boosting the government's reserve funds to 13 per cent of GDP. Meanwhile the goals unveiled by Putin in May at his inauguration for a new term will require increased spending. The government must improve the demographic situation, health care, the educational system, housing, the environment, infrastructure, scientific development and the digital economy. Funding will come from a VAT hike, streamlined tax collection, higher profit requirements for state-owned companies and higher oil revenues. Since spending will be largely off-budget, transparency will be poorer as will the possibility of analysing outcomes. The decision to raise the retirement age has triggered strong protests and may be modified a bit but will not be withdrawn, since the pension system could not manage without it. Putin has enough political capital to stick to the decision. Based on recent developments, we expect the budget to achieve balance in 2019-2020 and the reserve funds to be filled again. Government debt will thus stabilise at around 16 per cent of GDP.

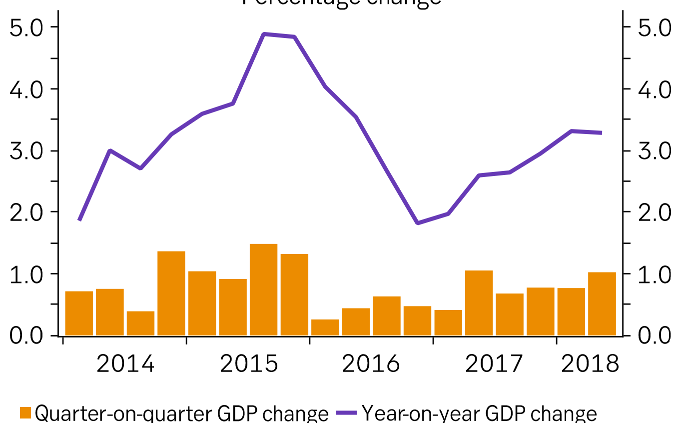
The increase in Russia's international reserves has ceased, which is a sign that capital inflows fell after the imposition of new American sanctions. Volatility will increase further, since we expect further sanctions, but we do not believe that the US will go so far as to prohibit trading in Russia government securities, which might raise yields by about one percentage point.

Sweden

Above-trend growth, but low inflation delays Riksbank action

GDP growth will stay above trend as rising exports and higher industrial and public sector investments offset falling home construction. The probability of a soft landing in the housing market has risen, although large supply will cause a continued price squeeze. Unemployment will fall below 6 per cent by late 2018, but underlying price and wage pressures will remain subdued. The Riksbank will postpone a rate hike until April 2019, keeping the krona weak. Forming a government after the election will be complex, but market turmoil can be avoided.

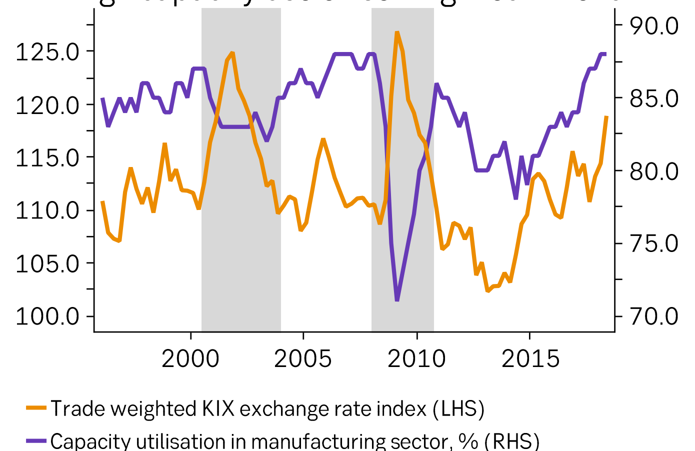
The prospects of relatively good GDP growth have improved in recent months, though production and labour market indicators have been a little mixed. Partly due to a strong second quarter, **we are revising our 2018 GDP growth forecast upward from 2.6 to 2.9 per cent and our 2019 forecast from 2.2 and 2.4 per cent**. In the past year exports and manufacturing have become increasingly important growth engines, softening the GDP consequences of the sharp slowdown in home construction. Expansionary economic policy will help GDP **continue to increase somewhat above trend in 2020**, when we foresee **2.3 per cent growth**, but capacity restrictions both in the export industry and in the labour market in general will gradually make themselves felt. In such a situation, the stimulus effects of the weak krona will be limited. Imbalances in the housing market will continue to be the main downside risk, but both home price and construction volume indicators signal a stabilisation. The probability of a soft landing in the sector has thus increased, though **rising supply will test the housing market this autumn**.



Source: Statistics Sweden

The labour market continues to perform strongly, although job growth is slowing somewhat after its surge in 2017. We still expect unemployment to fall below 6 per cent by the end of 2018 and then level out. Despite high resource utilisation, price and wage pressure remain weak, especially if we exclude rising energy prices. Inflation measured as CPIF (CPI excluding interest rate changes) exceeded 2 per cent last spring, but **once the effects of the energy price fade, CPIF will again drop below the 2 per cent inflation target**. Wage and salary increases will gradually accelerate over the next couple of years, though. CPIF will be close to target by the end of our forecast period. Because of low underlying inflation, we are sticking to our forecast that **the Riksbank will postpone its first key interest rate hike until April 2019**. Yet because of divisions in the central bank's Executive Board, we cannot rule out a hike as early as December, in line with the latest Riksbank rate path. **By the end of 2020 we foresee a repo rate of 0.75 per cent**.

The ongoing parliamentary election campaign has not made it clearer what kind of government will take office this autumn. We are sticking to our assessment that **the most likely outcome will be an Alliance government led by the Moderate Party**, but because of the different attitudes of the parties towards their relationship with the right-wing populist Sweden Democrats, there will be a major risk of government reshuffles and extra elections over the next couple of years. Yet a Swedish political risk premium in financial markets is a rather distant prospect, among other things because of the country's strong government finances and its tradition of being able to reach broad agreements in crisis situations. (See theme article, page 33.)

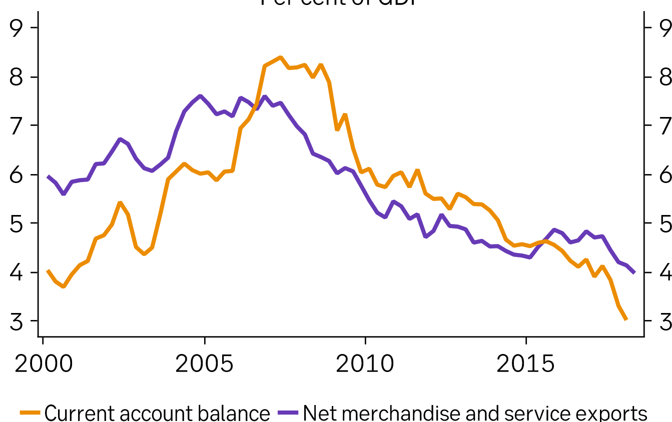


Source: National Institute of Economic Research (NIER), Riksbank, SEB

Shrinking trade surplus, despite strong exports

Over the past year, merchandise exports have climbed nearly 6 per cent: the fastest increase since the rebound after the 2010-11 financial crisis. A slight cooling is discernible since last spring, but sentiment indicators moved higher again during the summer. This supports our forecast that, as in other countries, the slump

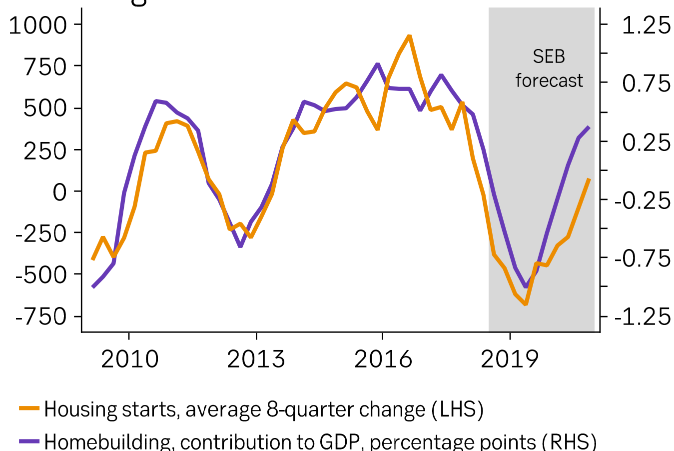
is temporary and exports will continue to increase at a rather healthy pace. However, **we believe that the rate of expansion culminated early in 2018**, since high capacity utilisation in the Swedish manufacturing sector limits the volume effect of last spring's sizeable krona depreciation. **In recent years, service exports have been largely unchanged** after a rapid upturn in 2014 and 2015. This is surprising, since they are often closely correlated with merchandise exports. Temporary fluctuations in exports of banking services seem to have played a large role in this odd pattern, but we believe that service exports will now start to resume their upturn. **Overall, we believe goods exports will increase by 6.7 per cent this year and then decelerate to 5.4 per cent growth in 2019 and 4.8 per cent in 2020**. Global trade policy tensions pose a general risk to a small open economy like Sweden, but the US trade barriers proposed to date will probably have only a marginal impact on the Swedish economy as a whole. The government's calculations indicate that the US car and metal tariffs that have been announced threaten about 5,000 jobs in Sweden, or 0.1 per cent of the total.



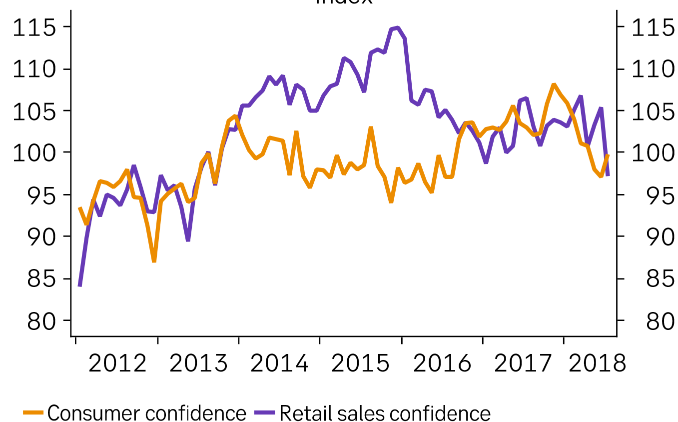
Sweden's current account surplus is about 3 per cent of GDP but has shrunk significant over the past 10 years, a process that has also accelerated this past year. This downward trend is mainly due to larger import growth, driven by strong domestic demand, capital spending and consumption. The accelerating decline of the past year is explained by weak service exports, which we believe are temporary. Stronger exports and weaker capital spending and consumption growth suggest that **the current account surplus as a percentage of GDP will level recover slightly during 2019 and 2020**.

Higher capital spending despite decline in housing

Rising home construction has been an important GDP growth driver during the past 3-4 years. Residential investments are now slowing and will probably fall during the next 12-18 months. Our forecast is that housing starts will fall to 55,000 this year from 65,000 during 2017 (15,000 single family homes, 25,000 rental units and 25,000 tenant-owner cooperative units). Housing starts fell slightly to just below 15,000 in the second quarter. We now expect a steeper downturn during the next 2-3 quarters to about 10,000 during the first half of 2019, after which a cautious recovery will begin. **Our forecast assumes that the downturn will be limited to tenant-owner units**, which will fall by more than 50 per cent, **while the number of rental units and single-family homes started will remain roughly the same as in 2017**. Construction industry sentiment indicators recovered this summer, which supports our view that overall construction will continue to climb even though home construction will fall.



Manufacturing and the public sector are now increasing their capital spending, which will soften the overall slowdown. Manufacturing investments have remained flat for a long time, but signs of an upturn were discernible in the first half. According to Statistics Sweden's survey, companies remain hesitant, but capacity utilisation has climbed to cyclical peaks. **This suggests that companies must now boost their capital spending in order to increase production**. Public sector investments have already begun a clear expansion. Rapid population growth will mean continued pressure on public services and thus major investment needs. **The overall increase in capital spending will slow to 4.5 per cent in 2018 and is expected to be 3.0 per cent in 2019 and 2.8 per cent in 2020**.

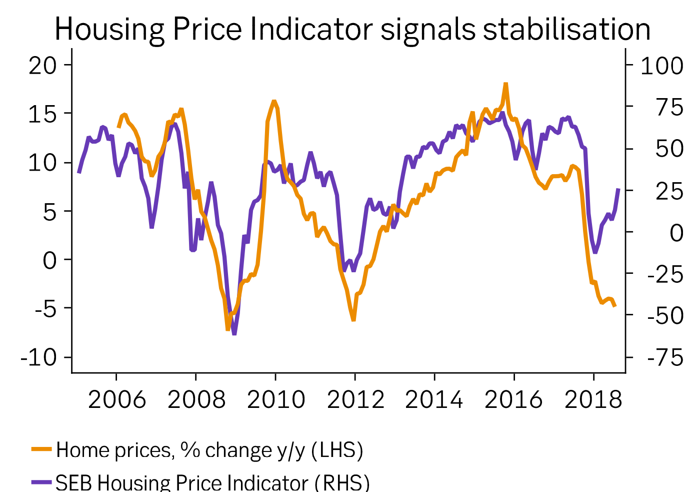


Households are still hesitant

Despite a strong upturn in Q2, uncertainty about consumption has increased. The retail sector's confidence indicator has fallen below its historical average. Among other things, this reflects a structural shift towards more internet-based shopping (e-commerce) as well as depressed profit margins, since higher import prices caused by the weak krona cannot be fully passed on to consumers. Although household incomes will continue to rise, mainly due to increasing employment, slightly higher inflation will cause a significant deceleration in purchasing power

growth during 2018 and 2019. In addition, households continue to save an ever-larger share of their income, which may be due to **lower confidence in public social welfare systems and a greater need to save money for home purchases**. The recent tightening of mortgage principal repayment ("amortisation") requirements also plays a marginal role. The decline in consumer confidence below its historical average suggests that saving will remain high. **Household consumption will grow by less than 2 per cent in both 2018 and 2019**, but due to Sweden's rapid population increase, per capita consumption will not even grow by 1 per cent yearly.

Home prices have been largely unchanged so far in 2018, after falling more than 5 per cent in the second half of 2017. The SEB Housing Price Indicator continued to climb this summer and is now at levels that indicate a year-on-year increase of 5 per cent. On the other hand, the market will be severely tested this autumn due to a large supply, especially of newly constructed tenant-owner flats. We are thus sticking to our forecast of **a total home price decline of about 10 per cent from the summer 2017 peak**.



Economic boom will give new government flexibility

Despite an expansionary election year budget, good economic conditions will create a **strong fiscal situation** for the new government. Tax revenues have continued to surprise on the upside; the government's budget surplus over the past 12 months is now slightly above SEK 100 billion and the full-year 2018 figure is expected to end up close that that level. **Fiscal stimulus measures will total some 0.8 per cent of GDP this year**. Regardless of what parties form a government after the September 9 election, such measures will total more than 0.5 per cent of GDP yearly. Net lending will remain around 1 per cent of GDP during 2018-2020, while public sector debt is the lowest for many years (see chart, p. 36). The official budget surplus target that will take effect in 2019 (0.33 per cent of GDP, down from the previous 1 per cent) will give the new government decent manoeuvring room that may ease the tensions it will face (see *Theme: Sweden's election*, page 33).

Public sector consumption growth has continued to slow after the very rapid increases triggered by the 2015-2016 refugee crisis. So far in 2018 it has increased by around 0,5 per cent year-on-year and it is expected to remain at that level in 2019-2020. Sweden's growing and ageing population suggests continued pressure on public services such as education, health care and elder care, **but employee shortages and strained local government finances will prevent faster expansion**. However, public sector employment is expected to increase by more than 1 per cent yearly, which is above the historical trend.

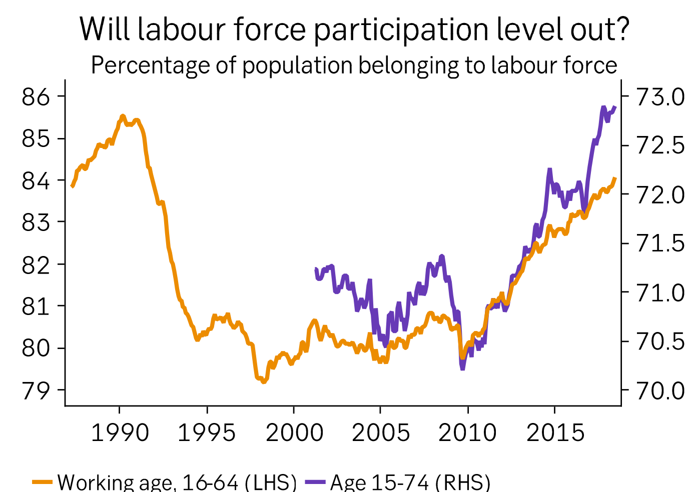
Public finances
Per cent of GDP

	2017	2018	2019	2020
Net lending	1.3	1.0	0.8	0.8
Borrowing requirement (SEK bn)	62	92	60	40
General government gross debt	40.6	36.9	34.5	32.4

Source: Statistics Sweden, SEB

Unemployment will fall below 6 per cent

Job growth slowed in the first half of 2018 after very strong performance during 2017. This pattern is clearest in construction and the public sector but is also visible in the retail sector. **Unemployment has nevertheless continued to fall**, since the increase in labour supply has also slowed as participation has levelled out after the upturn of recent years.

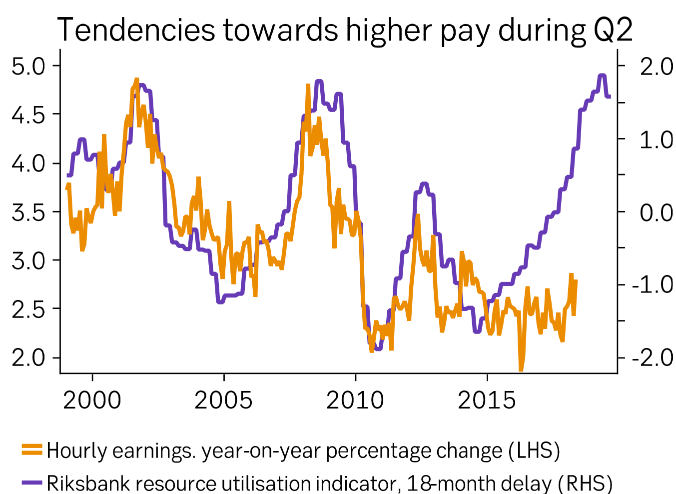


After their previous decline, employment indicators have now stabilised at levels that indicate a decent rate of increase over the next six months. We thus continue to believe that unemployment will fall below 6 per cent this autumn, but job growth will slow in 2019 and 2020. Unemployment will thus remain flat during the rest of our forecast period. In an international perspective, the Swedish labour market is characterised by a very high participation rate, while joblessness is stuck well above the northern European average. **In this context, integration of foreign-born residents into the labour market remains a key issue**. The jobless rate among the foreign-born residents is 15 per cent, compared to 3.5 per cent for Swedish-born individuals. Although labour force participation among the foreign-born (aged 16-64) has climbed from below 75 per cent to nearly 80 per cent in recent years, it remains 6-7 points lower than for those who were born in Sweden.

Pay increases will finally accelerate a bit

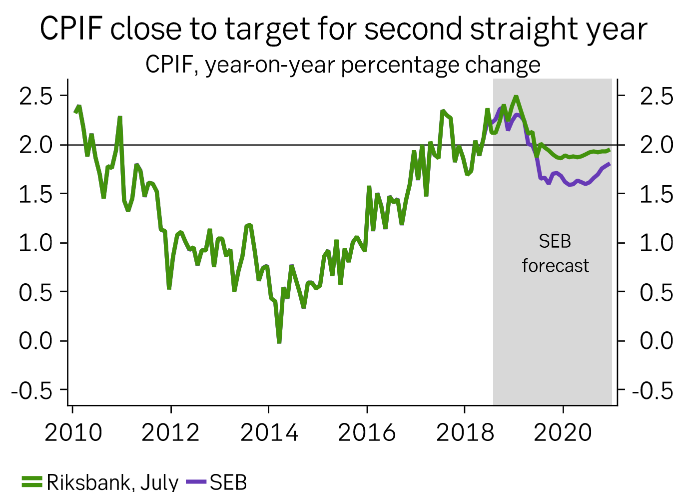
Because of slower job growth, the Riksbank's resource utilisation (RU) indicator fell slightly during the first half of 2018, but the indicator is close to historical highs. Given our

forecast that employment will increase by about 1.5 per cent both in 2018 and 2019, resource utilisation is likely to remain high over the next couple of years. During the second quarter, there were some signs that the tight resource situation was **beginning to result in a slight acceleration in the rate of pay increases**. Although it is a little early to draw any sure conclusions, this supports our forecast of a gradual speed-up in the rate of pay increases. But as long as the low collective bargaining contracts signed in the spring of 2017 dominate wage formation in Sweden, the rate of these increases will remain rather low. Not until 2020 do we expect pay increases to reach **3.5 per cent, which under normal conditions is compatible with the 2 per cent Riksbank inflation target**.

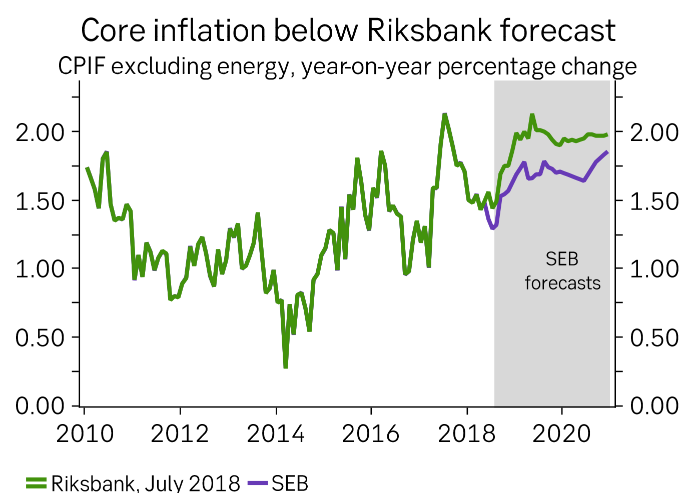


Service prices are slowing inflation

Last spring CPIF inflation exceeded 2 per cent, and 2018 looks set to be the **second straight year of inflation in line with the Riksbank target**. The most important driver is higher oil prices, along with electricity prices that rose mainly due to the dry summer. According to Nord Pool forward prices, electricity prices will remain high until spring 2019 and then fall. Overall, energy prices will make a slightly negative contribution to CPIF in the second half of 2019 and early 2020.



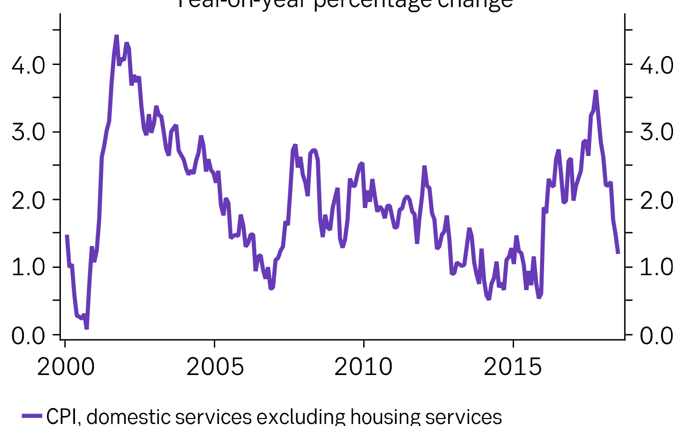
Excluding energy effects, this picture changes. Core inflation (CPIF excluding energy) was only 1.3 per cent in July. If food, alcoholic beverages and tobacco products are also excluded, inflation was a mere 1.1 per cent: about the same as the corresponding metric in the euro zone. The weak krona exchange rate and price hikes due to the summer drought will contribute to an increase in CPIF excluding energy to 1.6 per cent at the end of 2018. **But if we exclude these probably temporary effects, underlying inflation pressure continues to look weak**. Domestic service inflation has fallen every month since October 2017 and was down to 1.2 per cent in July. In line with our forecasts, temporary price increases for banking, health care, domestic travel and other services were not repeated this year. Other service prices have also decelerated, helping push inflation lower than expected. We continue to believe that in the long term, the combination of stronger economic conditions and higher international prices will cause inflation to move closer to the Riksbank's target, but the unexpectedly weak underlying trend this year has led to a downward adjustment in our 2019 forecast as well. CPIF will stay above 2 per cent in the coming six months, but then quickly move closer to core inflation. **During the second half of 2019 and in 2020, the two inflation metrics will be close together**.



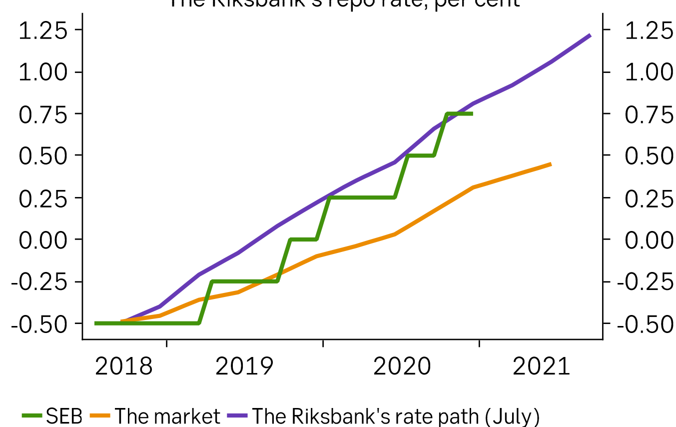
No rate hike until next spring

The minutes of the Riksbank's Executive Board meeting in July showed that the views of Martin Flodén have moved closer to those of Henry Ohlsson, who has been calling for a key interest rate hike since early 2018. Flodén argues that inflation and inflation expectations are now close enough to target to justify a cautious normalisation of Sweden's exceptional monetary policy starting soon, even if inflation should surprise a bit on the downside. Because of growing divisions on the Board, combined with a consensus among members that a rate hike is not far away, **a fourth quarter 2018 hike in line with the Riksbank's own rate path cannot be ruled out**. A possible compromise might also be a small 10 basis point hike in December this year.

However, we foresee a bigger risk that the rate hike will be postponed further. Board member Per Jansson clearly states that he wants underlying inflation to be close to or on target before a rate hike should be considered. Riksbank Governor Stefan Ingves also emphasised in the minutes that he supports Jansson's and Kerstin af Jochnik's analysis. These three Board members underscore that it is important for service inflation to be high, which suggests there will be no rate hike this year. Our forecast is thus that the first rate hike will occur only in April next year, which is unchanged since our May issue. We then expect an additional rate hike in 2019 and then three more during 2020, bringing the **repo rate to 0.75 per cent by year-end**.



Given our inflation forecast, the first rate hike might be delayed further, but we believe the risks of an earlier hike are bigger. It is not unusual for energy price hikes late in an economic cycle to have secondary effects, and the Riksbank might take these into account in its forecasts. Although we now believe that the September 2018 meeting will revise the Riksbank's rate path in a more dovish direction, there is **certainly a pain threshold for how many times the Executive Board is willing to repeat that procedure**. More and more central banks elsewhere are beginning to normalise their monetary policies, which will also make the Riksbank's first step easier. The Executive Board was also noticeably worried about the dramatic exchange rate reaction that followed its dovish statements at the April meeting. We thus cannot assume that the Board is unaffected by international discussion about the dilemma of facing the next recession with a largely empty monetary policy toolkit.



Continued downward pressure on bond yields

The yield spread between Swedish and German 10-year government bonds has widened since May. This could initially be explained by more hawkish expectations about the Riksbank, but more recently it is probably more a consequence of the inability of Swedish yields to follow the big downturns reported for Germany yields. According to market pricing, expectations of an initial Riksbank rate hike were postponed after CPIF excluding energy fell below the Riksbank's forecast for two months. A majority of the Executive Board remains worried about excessively low underlying inflation. Given our forecast that the Riksbank will wait until 2019 to raise its key rate and will also buy more bonds than are issued, we believe the spread will shrink to around 15 basis points before starting to widen early next year. At the end of 2019, it will reach 40 points. We expect Swedish 10-year yields of **0.75 per cent at the end of 2018 and 1.50 per cent at end-2019**, with a continued upturn to 1.90 in 2020 as the Riksbank slowly hikes its key rate.

Riksbank and trade worries will keep krona weak

The Riksbank is expected to lower its rate path at the September meeting. This implies continued uncertainty among market players as to whether enough conditions will be in place for the Riksbank to regard a key interest rate hike as justified. The negative key rate continues to make it unattractive to deposit capital in SEK and thus pushes down the krona. Uncertainty about the parliamentary election, including alarmist reports about Sweden in international media, may also hurt the krona. Experience from earlier periods, such as late in 2014 when a government crisis led to threats of an extra election, shows that **the krona is relatively insensitive to this type of political uncertainty**. Yet we have seen the krona take a beating from heightened geopolitical uncertainty, with escalating trade conflicts and worries about Turkey and other EM countries leading to falling risk appetite. There is little indication that these worries will fade in the near future. Combined with our forecast that the first key rate hike will occur only in April 2019, this creates a negative environment for the krona. There is thus a risk that the EUR/SEK exchange rate will remain weak. Election worries may push it above 10.50. Once the political situation clarifies **we expect the EUR/SEK rate to remain at 10.50 when 2018 draws to a close, then reach 10.00 at year-end 2019** and fall somewhat further during 2020. The weak krona is also impacting our forecast of SEK exchange rates against the dollar. Meanwhile we anticipate a weaker dollar ahead. **We thus expect the USD/SEK rate to peak at 9.30 this autumn before again falling sharply during 2019-2020 and reaching 7.60 at the end of 2020.**

Theme: Sweden's election

Sweden's election – strong, decisive government still unlikely

The inability of the parties to deal with the new political landscape will hinder the formation of a strong government. In the prevailing public opinion situation an Alliance government will probably take power, although tensions regarding its relationship to the Sweden Democrats may threaten its stability. Financial markets are likely to pay more attention than usual to Swedish politics, but due to strong government finances, a high degree of consensus on economic policy matters and a history of cross-bloc cooperation, there is little risk of turmoil.

By all indications, Sweden's September 9 parliamentary election will not result in any clear government alternatives. For a long time, the two traditional political party blocs – red-green and Alliance – have each enjoyed 37-40 per cent support in public opinion polls: far from a majority of their own. Yet there are no clear plans for cross-bloc collaboration or openings to the right-wing populist Sweden Democrats. Nor is it likely that the current election campaign will throw much light on the issue of how to form a government. Outside observers, especially financial markets, will probably show more interest than usual and try to understand the background of the deadlock that makes forming a Swedish government so hard. This article aims at providing a background description of the political situation in Sweden.

Even match between blocs ahead of the Sep 2018 election
2014 election outcome and public opinion situation, %

	Election 2014	Aug 2018	Min	Max
Social Democrats (S)	31.0	25.8	21.1	25.9
Green Party (MP)	6.9	5.6	3.8	6.5
Left Party (V)	5.7	9.2	8.7	12.6
S+MP+V (= "red-green bloc")	**43.6**	**40.6**	**33.6**	**45.0**
Moderates (M)	23.3	20.3	15.9	20.4
Centre Party (C)	6.1	10.3	6.9	11.1
Liberals (L)	5.4	6.0	4.4	6.0
Christian Democrats (KD)	4.6	3.3	2.4	4.8
M+C+L+KD ("Alliance bloc")	**39.4**	**39.9**	**29.6**	**42.3**
Sweden Democrats (SD)	12.9	16.8	16.8	25.7

Source: Compilation based on Kantar Sifo and Pollofpolls.se surveys

Government deadlock is partly explained by history

There are several special reasons behind the current deadlock in Swedish politics and in the formation of governments.

1) The decades-long dominance of the Social Democrats in Swedish politics (between 1932 and 2006, the party led governments during 65 of 74 years) is usually explained in part by divisions and mistrust among the non-socialist parties. The more formalised Alliance collaboration these parties created in 2004, which laid the groundwork for the accession to power of a government headed by Moderate leader Fredrik Reinfeldt in 2006, seemed to change this situation. Joining inter-bloc coalition governments and thereby breaking up the Alliance is thus a sensitive topic for individual non-socialist parties.

2) Unlike Germany, France and the UK, minority governments have been relatively common in Sweden. This has not previously been viewed as a sign of political weakness. **A grand coalition of large parties from both blocs is normally viewed as an emergency solution** reserved for severe crises. So far it has only been tried once, during the Second World War.

3) Mainly by accepting refugees, Sweden has experienced by far the largest per capita immigration in Europe over the past few decades, which makes migrant-related issues **especially divisive**. Although a large majority of both the general public and Members of Parliament now believe that the tightening of refugee policy implemented late in 2015 should be made permanent, many difficult questions remain. These include immigration of relatives and procedures for deporting those whose applications for refugee status have been rejected. There are also political tensions connected to strains on the schools, health care, social services system and housing supply.

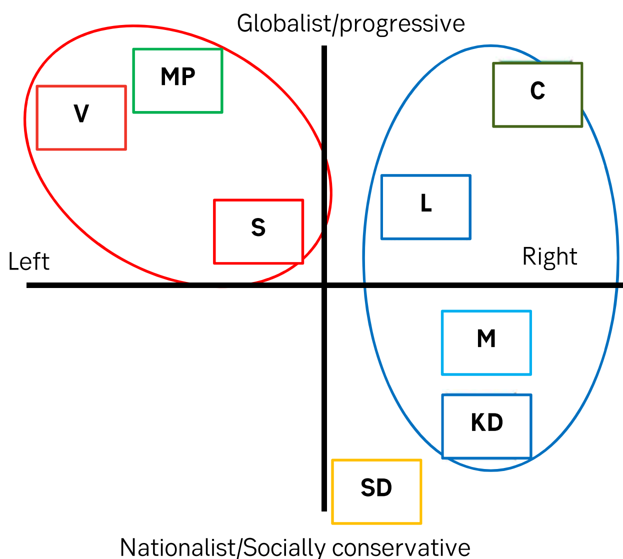
4) Compared to sister populist and immigration-sceptical parties in other Nordic countries, the Sweden Democrats have their roots in more extreme nationalist environments dating from the early 1990s. **Although SD has devoted a lot of energy to polishing its image and distancing itself from these roots, at national level it is still not regarded as a possible political partner by the other parties**. But can experiences in other Nordic countries can be applied to Sweden in the future?.

Political tensions in two dimensions

The above four topics have largely set the tone of political discourse and the ongoing election campaign. Due to dramatic events in the migration field, conflicts in dimensions other than the traditional left-right scale (see below) have played a larger role than in other countries. Dual conflict dimensions increase the tensions within the political blocs. For the Alliance, this is primarily visible in the widening gap between C and M on the migration issue. Similar tensions between the currently govern-ing S and MP have gradually gained strength. Such tensions are also powerful within individual parties, especially the Social Democrats, where segments of the party find it difficult to accept the policy shift by the party leadership. But there may be

tactical reasons for the political blocs to exaggerate the widening of these gaps, in order to reach the broadest possible range of voters. Within the Alliance, for example, this implies that M is focusing (in competition with S) on winning back voters from SD by emphasising its views on "tough issues". The task of C and to some extent L is, instead, to retain voters who left MP due to disappointment with the government's new refugee policy. In the battle for this voter category, it is important to both C and L to keep the door to SD closed.

Positioning of Swedish parties in two dimensions



"Chicken race" closes doors in the election campaign

The current positions of the parties block virtually all governing alternatives. C and L reject both a cross-bloc government led by S and an Alliance government dependent in any way on SD. In the event of a parliamentary deadlock situation, they instead prefer a grand coalition across the dividing line between blocs, but neither S nor M (which dominate their respective blocs) show much interest. For its part, M is trying to find a way to gain SD's acceptance of an Alliance government that is not repulsive to C and L. In the current chicken race, both M and S are thus trying to manoeuvre themselves into a leading position in the next government, while the "middle parties", C and L, are frantically trying to avoid having to choose between the devil and the deep blue sea: either splitting the Alliance or breaking their promise to have no relationship at all with SD.

The parties are likely to continue this chicken race throughout the election campaign. Once the election is over and the process of forming a government reaches a critical juncture, things may change. The parties will then be forced to adopt more pragmatic positions, and along the way things may happen that make the parties feel it is legitimate to end earlier deadlocks. The formal process of forming a government (see box) is one important piece of the puzzle in determining how long blockages will last.

Regardless of outcome, tricky to form a government

If the Alliance (M+C+L+KD) wins more seats in Parliament than the red-green bloc (S+MP+V), **our main scenario is that an M-led coalition including all Alliance parties represented in Parliament will take office**. Based on today's party positions, this government will be exposed to major strains, with SD announcing that it will make clear political demands in exchange for tolerating such a government while L and C are not prepared for any form of dialogue with SD. But given such an election outcome, all Alliance parties have declared that they are prepared to form a government. One important element of such a calculation is certainly that they believe that SD and the red-green bloc will not be inclined to join forces in various attacks against an Alliance government, at least in the near future. If tensions inside the government should become too great when it comes to relations with SD, it is possible that after a while C and L will leave the government and that M will form an even narrower minority government, possibly in coalition with KD.

At present, however, opinion polls instead suggest that the red-green bloc will win somewhat more seats than the Alliance. This would lead to an even thornier parliamentary situation, among other things because C and L have declared that in such a case there is no basis for an Alliance government. **Yet we end up concluding that an Alliance government is still the "least unlikely" outcome, even in such a situation**. One can imagine a process in which C and L initially demand that the Social Democrats should join a grand coalition. But we do not believe that the time is ripe for such a coalition, and it is unlikely that S would be interested in being part of an Alliance-dominated government. After S rejects a grand coalition, C and L may very well argue that they are being forced to reassess their election campaign views. A pure M government (possibly joined by KD) would have a greater degree of freedom to seek parliamentary support from different directions, yet in a crunch we still believe that C and L will conclude that they will be more useful as part of a government, instead of forcing M to move even closer to SD. A cross-bloc government made up of S, C and L (and perhaps MP) will also be discussed at this stage. Yet it is not very likely that C and L are already prepared to kill the Alliance. In addition, there will be economic policy tensions in view of C's far-reaching deregulation proposals, especially in the labour market.

Some aspects of the election outcome will have the potential to change this picture. **One is if SD becomes the largest party**. According to traditional public opinion surveys (see table), SD is quite far behind S, but it is worth noting that betting firms give about the same odds for S and SD to become the biggest party. The background is that in recent elections, public opinion surveys have underestimated SD's support, which may be due to a lingering disinclination among some voters to reveal their SD sympathies. If SD should become the largest party, this would have major symbolic value and might marginally increase the likelihood of a grand coalition. But in itself, this would not be of such great importance to the party's role in Swedish politics.

Of course it remains uncertain which way the election winds will blow during the final weeks of the campaign. Extreme weather and drought appear to have helped MP gain a firmer foothold, but the recent large number of car fires in problem suburbs has again shifted the focus of attention towards integration of immigrants as well as law and order issues. This benefits SD and to some extent M. For a long time, public support for several parties (L, MP and KD) has been just above the 4 per cent threshold needed to stay in Parliament. Whether or not they make it into Parliament will be instrumental in determining which bloc will end up being the largest. Aside from MP, L has also moved up to levels of support that provide a certain safety margin above the threshold. KD has also picked up public support, but its situation is still precarious. Our main scenario is that the party will manage to get enough votes to pass the 4 per cent threshold.

How is a new government chosen?

The formation of governments often has special national features. This box describes some important aspects of the Swedish system.

Who proposes a government? The task of appointing someone to form a government rests with the Speaker of Parliament. This makes Sweden different from most other parliamentary democracies, where the head of state often assumes this role. The speaker consults with the parties that have seats in Parliament, playing a non-political role in the sense of not being allowed to favour his/her own party. A new speaker (plus three deputy speakers) is elected as soon as Parliament convenes after an election and may not be dismissed until after a new election. Historically, the largest party in the largest political bloc has held this position, but this is not established by law, and the largest parties in particular have differing views. For example, S has formally adopted the view that the speaker should come from the largest party. In the prevailing unclear political situation, the speaker's role in appointing someone to form a government is an increasingly important issue.

How is a new government formed? The speaker is responsible for dismissing a government. When a government resigns, which does not automatically occur after an election, the speaker asks it to remain in office as a caretaker government. Such a government handles current business but takes no new political initiatives and cannot call an extra election. Directly after the election, the change in speaker involves some complications. During the period until a new speaker is elected (September 10-25 this year), the departing speaker holds preparatory talks with the parties, but only the new speaker can formally propose a new prime minister. The speaker may assign one or more party leaders the task of seeking support in Parliament for a government, then propose a prime minister (as well as proposing which parties should be in the government). The prime minister is elected by Parliament under a system of "negative parliamentarism": the candidate does not need the support of a majority, but may take office as long as a majority (at least 175 out of 349 members) does not vote against the proposal. If the speaker's proposal is not approved by Parliament, the speaker can make three more attempts (i.e. a total of four) before an extra election is called. In that case, a new election occurs within three months, provided that a regularly scheduled election does not occur during that period. To date, proposals by a speaker have never been voted down by Parliament.

Important dates after the Swedish election

Sep 9	Parliamentary election
Sep 10-25	The government normally resigns if it does not enjoy sufficient support in the new Parliament
Sep 10-25	The departing Speaker holds preliminary talks with the parties
Sep 14	Final election results are announced
Sep 24	Parliament elects a new Speaker
Sep 25	Parliament convenes and can vote on a new prime minister

What happens right after the September 9 election? In concrete terms, several issues of a formal nature will become acute right after the election. One is whether Prime Minister Stefan Löfven will resign at his own initiative. After the fact, Fredrik Reinfeldt was criticised because on election night 2014 he resigned both as prime minister and leader of the Moderate Party. In practice, his decision meant that the entire government resigned and that even before the "December agreement" was reached later that year, he was following its principle that the biggest bloc should govern. It is unclear what lessons Löfven will draw from this, but the Social Democratic prime minister has indicated that he intends to force the Alliance and SD to join forces in a vote of no confidence to dismiss him when the new Parliament convenes: something that has never happened before. Such a strategy poses risks, but we believe that Löfven will follow this plan if the red-green bloc wins more seats than the Alliance, but that he will resign on election night if the outcome is the opposite.
The departing speaker, Urban Ahlin (S), will probably explore the possibility of cross-bloc governments, but only after the election of the new speaker on September 24 will we see concrete steps towards forming a government. It is not self-evident who will become the new speaker, but the most likely outcome is that Parliament will continue to apply the principle of choosing the speaker from the largest party in the largest bloc.

Different perspectives on DA will affect behaviour

The "December Agreement" (DA), which was concluded in 2014 to enable the largest bloc to rule even in the absence of a majority of its own, formally collapsed in 2015. But in practice it has been in effect throughout the 2014-2018 parliament. Most political parties agree that the DA has major flaws, since it reinforces the bloc system in a dysfunctional way and has also probably helped to fuel SD's continued rise in voter support. Although most political leaders now formally disavow the DA, its mechanisms will remain in the background for as long as resistance to both cross-bloc cooperation and contacts with SD persists. But in practice, the desire to act in the "spirit of the DA" can be interpreted in different ways. After the Alliance accepted four years of S-led rule, while also pushing the S-MP government a bit left by forcing its budget cooperation with V, patience with continued passivity about the absence of decisive government is wearing very thin. To a Social Democratic Party that appears headed for its worst election performance, a period when it can lick its wounds in opposition is probably much less distasteful. Much as the Alliance has done during this past Parliament, S can sit in the audience and hope that the Alliance will be damaged and possibly torn apart while in government, where it will be forced to deal with all types of practical difficulties, not the least being its relationship with SD. These different perspectives on the DA thus also contribute to our belief that an Alliance government is now the most likely election outcome.

Different from Denmark and Norway, but also similar

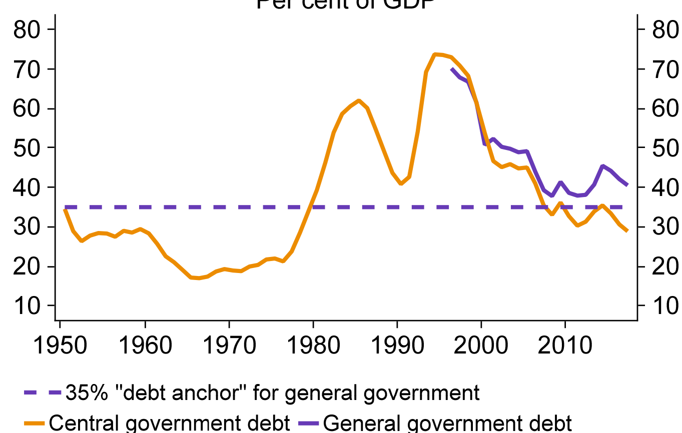
Although there are major differences between Sweden and its neighbours, the experiences of these countries are worth bearing in mind. After **Norway's** 2013 election, the leading non-socialist party – the Conservatives – formed a coalition with the

immigration-sceptical, populist Progress Party (FrP). Several parties in the middle of the spectrum chose to remain outside the coalition, but both the Liberals and Christian Democrats were part of the government's parliamentary base. After the 2017 election, the Liberals also joined the government. FrP has mainly acted pragmatically within the government, although it has retained its aggressive rhetoric mainly on migration-related matters. FrP also seems to accept its declining support in public opinion as a consequence of its participation in government. FrP's voter support has now fallen to about 12-13 per cent. In **Denmark** the largest traditional non-socialist party, Venstre (conservative), formed a one-party government after a Social Democratic-led government lost the 2015 election and resigned. Unlike Norway, the populist and immigration-sceptical Danish People's Party (DfP) chose to remain outside the government, even though it actually had more MPs than Venstre. Instead DfP is guaranteed an influence on policy matters through extensive negotiations with Venstre. As one might expect, DfP has found it easier than Norway's FrP to retain high public opinion figures, since it completely avoids taking responsibility for government policies.

It would be strange if Sweden's Moderates did not study what has happened in Norway and Denmark. If they can somehow include the seats of immigration-sceptical parties in their parliamentary base, traditional conservative parties are suddenly guaranteed a place at the focal point of the political spectrum. The change in the political playing field is so dramatic because immigration-sceptical parties enjoy a rather high degree of support from working-class voters who left the Social Democrats, especially in Denmark and Sweden. In a Western European perspective, the Swedish Social Democrats stood out for decades because of their ability to broaden their voter base to the middle class. Now that S is instead being challenged by SD as the dominant party among its previous core voters, for example in the blue-collar unions belonging to the Swedish Trade Union Confederation (LO), it is understandable that the party is facing an identity crisis. **On the other hand, the Moderates will also take big risks** if and when they try to move closer to SD. Because of its ultra-nationalist roots, SD's position in Sweden is different from that of its sister parties in neighbouring countries. It did not win seats in Parliament until 2010. Its Norwegian and Danish sister parties have been represented in Parliament largely without interruption since 1973, and support for them was mainly fuelled by non-socialist dissatisfaction with high taxes and an increasingly bloated public sector.

A political risk premium for Sweden is still distant

Even though Sweden is entering a period of uncertainty about how to achieve decisive political governance, **other factors must also be included** when assessing the likelihood that financial markets will begin pricing in a political risk premium. Compared to the lengthy political crises in various other European countries, the problems of forming a Swedish government appear relatively minor. **Strong government finances also represent an important protective buffer**. The public sector is showing surpluses, and general government debt is now below 30 per cent of GDP, very low compared to other countries. There is also a broad political consensus on the value of strong government finances. We also believe that there is solid support for European Union membership in Swedish public opinion. There is thus rather little risk that V and SD could successfully pursue the "Svexit" issue: Swedish withdrawal from the EU.



In the ongoing election campaign, parties are trying to conjure up a picture of major ideological economic policy differences. The Social Democrats contrast the proposed investments in their national development plan with the Alliance's tax cuts. The Alliance responds, in turn, by accusing S of being a "dole party". Although the parties differ on their priorities, such rhetoric includes a **tendency to want to stoke the left-right conflict** in order to shift the focus from issues that benefit SD. In fact, **the differences in how parties view economic policy are narrower than for a long time**, especially between S and M. The differences in their proposals for the tax system and government spending are far from systemically important. Instead, both parties are making it their highest priority to try to guarantee the continued quality of the schools, health care and social services and other core public sector activities, thereby calming fears of breaches in the social contract. The two parties are not alone in promising more money for local governments and for public safety, defence and the judiciary system.

Aside from a relatively high degree of consensus in many fields, there is also **a tradition of pragmatic cooperation in Swedish politics**. During the 2014-2018 term of Parliament, important cross-bloc agreements were achieved in such areas as energy and defence policies. But **there have been major blockages in labour market, tax and housing policies**. In emergency situations such as the krona crisis of the early 1990s, the Lehman Brothers crash of 2008 and the refugee crisis of 2015, Swedish political parties have also managed to join forces and conclude far-reaching agreements in sensitive areas. The big tax reform of the early 1990s, which included big cuts in marginal income taxes, is one example of how a breakthrough could be reached in an important area without pressure from an acute economic crisis situation. Although things are quiet on this front ahead of the September 9 election, there are signs of behind-the-scenes collaboration and dialogue between parties that provide hope for cross-bloc agreements on taxation and housing policies.

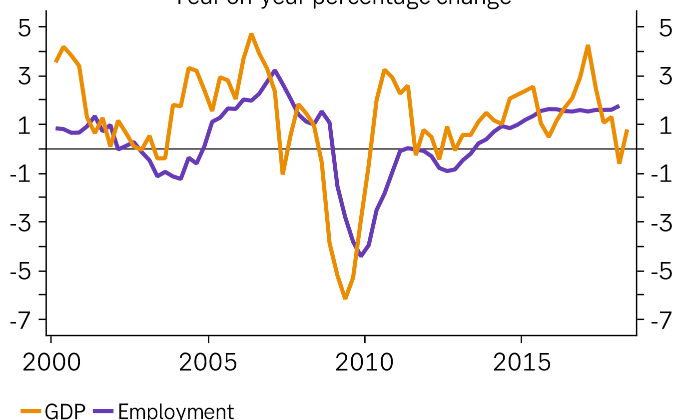
Sweden's position compared to other countries – especially in Western Europe – combined with its earlier experience of a pragmatic working climate suggest that financial markets need not demand any significant risk premium for Sweden. Although we cannot be certain that the Swedish political system will be able to come together in ways that result in stronger, more decisive government action in important and neglected areas, it will at least have substantial lead-time before these problems grow so severe that they lead to major financial market turmoil.

Denmark

Temporary slowdown

The summer drought, soft first half exports and a technical overhang from 2017 have led us to revise our 2018 growth forecast from 2.2 to 1.5 per cent. Yet key underlying drivers such as employment, real income and confidence support growth. European export markets will also recover. We thus still expect sustained above-trend GDP growth around 2 per cent through 2020. Wage inflation is edging towards 3 per cent, but there is room for several years of expansion yet before overheating becomes a serious concern.

The upswing in the economy continues, largely driven by private consumption supported by solid income growth. Concerns about tighter credit conditions holding back spending have been reduced, as bank lending standards stopped tightening during the spring. A combination of weaker growth in Europe, a one-off patent payment raising GDP by 0.4 percent in 2017 and an unusually hot summer, which has resulted in a fall in energy production, has led us to revise our GDP forecast for **2018** downward from **2.2** per cent to **1.5** per cent, while we have raised it for **2019** from **2.3 to 2.5** per cent. Looking beyond annual volatility, our forecast reflects a stable expansion with above-trend growth, averaging 2 per cent from 2016 to 2020.



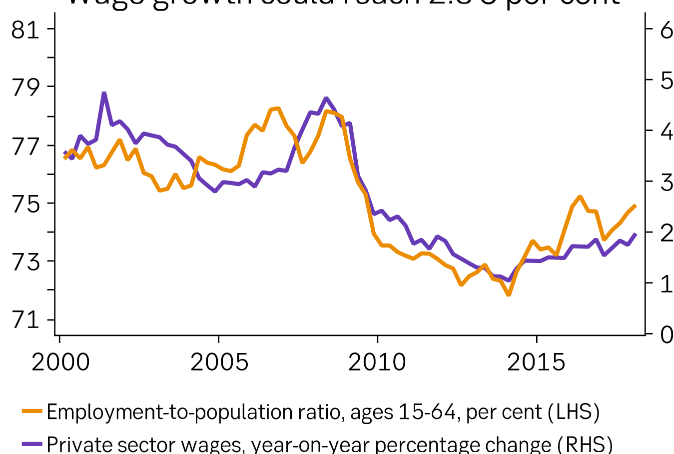
Source: Statistics Denmark, Macrobond, SEB

Rebound in consumption, strong capital spending

Private consumption continued to grow quite strongly in the first quarter, even after car sales reverted to normal after a tax change. Credit tightening introduced by the Financial Supervisory Authority in Q1 had a short-lived impact on consumption patterns, which faded during the spring, while underlying drivers in the shape of employment, disposable income, wealth and confidence continue to dominate. Macro-prudential policy continues to stabilise the housing market, with prices increasing at a stable 5 per cent year-on-year rate and debt climbing in line with income. Rising incomes and low mortgage rates would normally point to faster price increases, but access to loans remains constrained, preventing a repeat of the 00s credit boom. Business investment continues to rise strongly, even though capacity utilisation has stabilised around its long-term average. Construction activity continues to increase, driven by rising property prices. Export growth looks weak in 2018, partly due to one-off factors in Q1 2017. It lost momentum during the first half of 2018 in line with disappointing growth in euro zone markets, which we expect to pick up during the second half.

At least 2-3 more years of growth above trend

Continued economic growth has pushed unemployment down to 5 per cent, close to the median in the decade before the global financial crisis, prompting overheating concerns. But wage inflation has only reached 2 per cent in 2018. This reflects a hidden labour market reserve, as the participation rate in key age groups is still considerably below pre-crisis levels. Taking this into account, low wage inflation makes sense and Denmark still appears to have room for 2-3 years of above-trend growth just to reach equilibrium. **We forecast normalisation of HICP inflation at 2 per cent, with wage inflation above 3 per cent and unemployment below 4 per cent in 2020.**



Source: Statistics Denmark, Macrobond, SEB

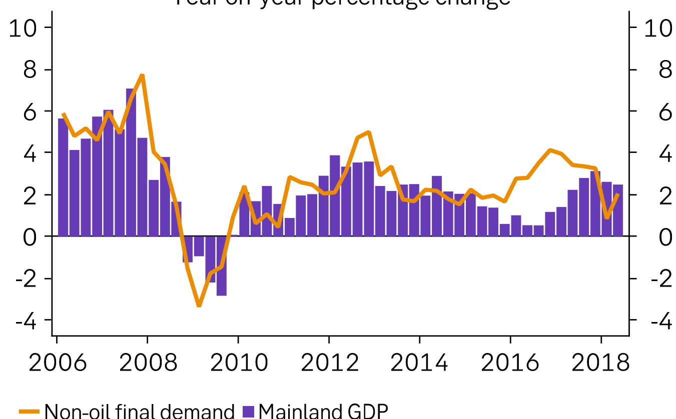
Fiscal policy remains largely neutral. Although the government appears to be planning a relatively expansionary budget for the election year 2019, the election is unlikely to alter the broad economic policy consensus. The Danish krone is back in the National Bank's sweet spot of between 7.45 and 7.46 per euro and has not appreciated as much due to recent political uncertainty in Europe as in the past.

Norway

Norges Bank on steady course towards policy normalisation

Economic expansion is robust, though the composition of growth is slowly changing. The upswing in the petroleum and broader business sectors is becoming increasingly important as housing investment shrinks considerably and Norges Bank starts normalising monetary policy. A subdued inflation rate will not prevent this, but the high interest rate sensitivity of households points to a slow rate hiking trajectory. We are maintaining our forecast of above-trend growth in mainland GDP, though global trade frictions constitute a downside risk.

The recovery in mainland GDP has been robust, with sequential growth running above trend since early 2017. The marginal slowdown in the first half of 2018 is not due to a weaker trend. In spring, it was driven by a weather-related plunge in electricity output. The composition of second quarter growth was indeed reassuring as final domestic demand rebounded strongly.



The upswing in the petroleum and business cycles will provide major contributions to GDP growth, countering the negative impact of a further contraction in housing investment and less expansionary monetary policy. Heightened uncertainty related to global trade tensions remains a downside risk. So far indicators from the real economy remain strong, and upbeat sentiment indicators suggest that underlying growth momentum remains intact. **We expect mainland GDP (excluding oil, gas and shipping) to grow by 2.5 per cent in 2018 and by 2.4 per cent in 2019, before slowing to 2.1 per cent in 2020.** Reviving capital spending in the petroleum sector will lift overall GDP growth from 1.4 per cent in 2018 to 2.4 per cent in both 2019 and 2020.

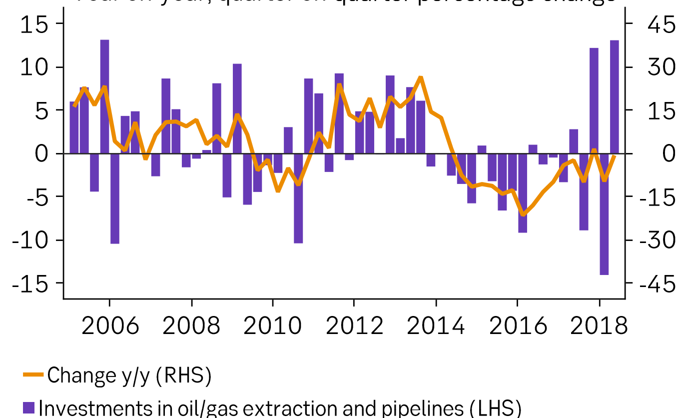
Business optimism despite trade conflicts

Norway is not unaffected by US trade conflicts. The tariff on aluminium impacts an important part of Norwegian exports since it compromises 6 to 8 per cent of total shipments. However, 97 per cent of aluminium exports are shipped to EU while less than 1 per cent goes to the US. Since Norway is part of the EEA, it will be exempt from countermeasures imposed by the EU. The overall impact on Norway from these tariffs will thus be negligible. Potential US tariffs on car manufacturers in the EU are a bigger threat. If the two sides fail to reach an agreement, the appetite for Norwegian aluminium in Europe will fall and Norwegian exports will suffer.

Norway is still less sensitive to an escalation of trade conflicts than other Nordic countries. The recovery in the global petroleum industry will underpin demand for the products of Norwegian oil service companies. The business sector remains in an expansionary mood, export orders are high and competitiveness has improved. **We forecast growth in traditional goods shipments of 4.3 per cent in 2018 and 2.6 per cent in 2019.** Net foreign trade will make a fairly neutral contribution to mainland GDP in 2019 and 2020.

Positive growth in gross fixed capital formation

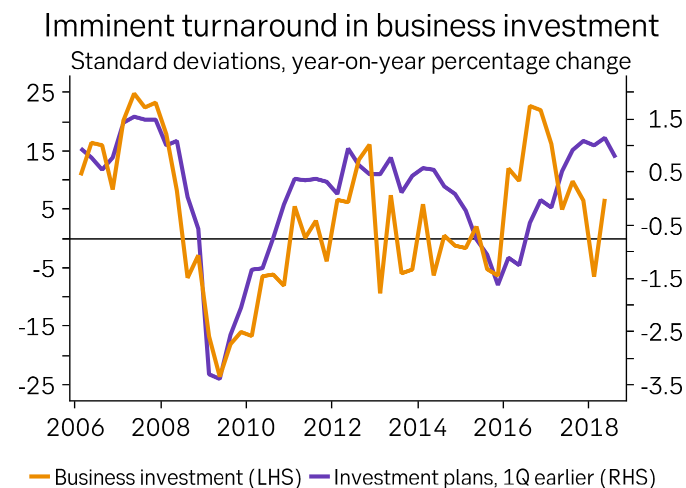
Activity in the petroleum industry is picking up, but capital spending growth has been volatile on a quarterly basis. Investment rose 13.1 per cent in Q2, but due to a sharp drop early this year we have lowered our 2018 forecast to 2.5 per cent (previously 6.5 per cent).



The outlook nonetheless remains positive, and investment growth is bound to accelerate in coming years. The firmer oil price outlook, improved profitability in the sector and limited opportunities for significant additional cost reductions will lead to more new projects being developed. This was confirmed in

Statistics Norway's oil investment survey for the third quarter as oil companies revised their investment estimates for 2019 markedly higher. **We expect petroleum investment to climb by 9.5 and 4.5 per cent in 2019 and 2020, respectively.**

The turnaround in business capital spending has proven slower and weaker than expected. However, a broad-based revival was noted in the spring, with non-oil investment rising 7.2 per cent. There are clear indications of a lasting upturn. Capacity utilisation in manufacturing has rebounded to more normal levels, corporate credit growth has accelerated and manufacturers' investment expectations are positive. **We believe that business investments will increase by 3.9 per cent in 2018, followed by a more modest 3.6 and 2.1 per cent in 2019 and 2020, respectively.**



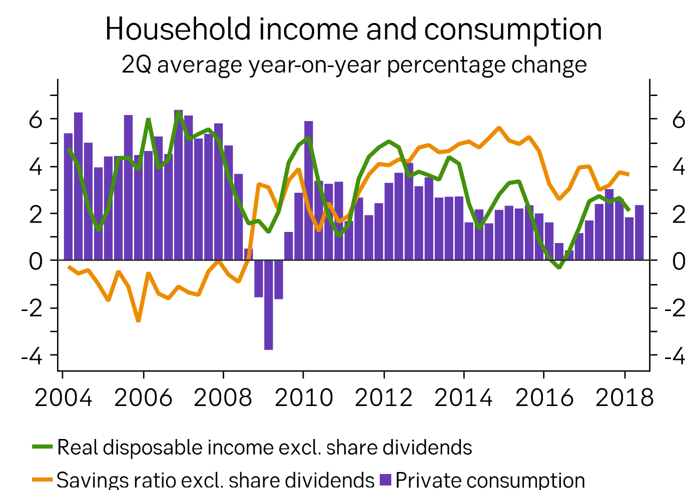
The slowdown in private mainland investment growth is primarily due to sharply lower residential investments. Such spending has declined by an aggregated 12 per cent over the past three quarters. A correction was in the cards following strong investment activity over the past three years and lower home prices. The decline has nonetheless been more pronounced than expected. The negative trend in housing starts, combined with prospects for slower population growth, supports the notion that residential investments will continue to weigh down aggregate growth. **We have lowered our forecast to -9.0 per cent in residential investments in 2018, before stabilising in 2019.** Gross fixed capital formation will still contribute positively to growth.

Boom, bust, recovery in home prices

The correction in existing home prices proved short-lived. From their peak in March 2017, prices declined by an aggregated 2.9 per cent. Strong monthly gains since the start of 2018 have pushed existing home prices back to peak-levels. The stock of homes for sales has normalised, underpinned by rising turnover and shorter transaction times. **We now forecast that existing home prices will rise 1.1 per cent in 2018.** The long-term outlook remains cautiously optimistic, despite solid economic growth. The strong gains in housing starts in earlier years will continue fuelling housing completions, and prospects of higher mortgage lending rates will dampen housing demand. We expect annual price gains of 3 per cent in 2019 and 2.5 per cent in 2020.

A moderate rise in private consumption

Private consumption of goods revived solidly in the second quarter, mirroring rebounding home prices. Momentum should nonetheless slow in the coming quarter. Higher electricity prices will accelerate inflation, squeezing household real disposable income. The impact will be transitory, and in the longer term we expect both pay increases and solid job growth to contribute to stronger household incomes. Prospects of higher interest rates will pull in the opposite direction. **We expect private consumption to grow by 2.6 per cent in 2018 and 2.5 per cent in 2019.** Due to high household debt levels and a trend towards floating rates, households' interest rate sensitivity is high. The central bank is well aware of this strong transmission mechanism and indicates that interest rates will rise broadly in line with household real income. A more hefty increase in mortgage rates would certainly boost savings and remains a downside risk to the outlook for private consumption.



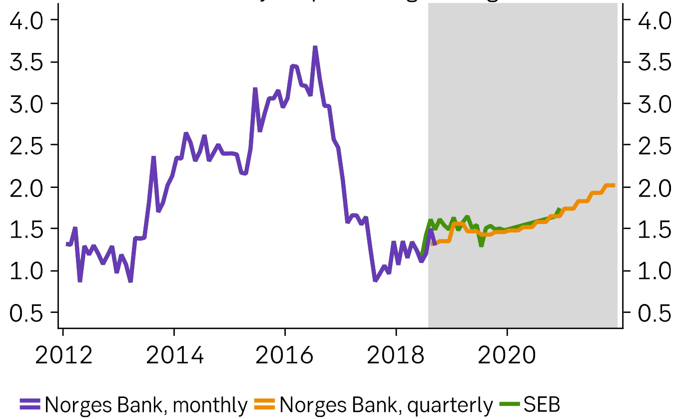
Unemployment has fallen steadily since 2016, but there are signs that the downturn is losing momentum. This slowdown reflects a sharp rebound in labour force participation, which is now more in line with historical levels. Job growth has also accelerated. According to the national accounts, employment rose by 1.6 per cent in Q2 from a year earlier. Labour demand should remain solid. Surveys show that businesses' hiring expectations remain positive, and unfilled vacancies are trending higher. **Measured by the Labour Force Survey metric, we forecast a moderate decline in unemployment to 3.5 and 3.4 per cent in 2019 and 2020, respectively.**

Inflation stuck below the target

After falling below 1 per cent in August 2017, the underlying inflation rate measured by CPI-ATE has gradually recovered. The year-on-year rate was 1.4 per cent in July. Slight upward pressures from weaker krone exchange rates and a rebound in temporarily low inflation on food have driven the acceleration. Adjusted for the tax increase on sugar at the beginning of 2018, food prices remain depressed. A continued acceleration will thus contribute to a further increase in inflation this autumn.

The stabilisation in exchange rates makes the driving forces for inflation less clear compared to the past few years. Domestic inflationary pressures have been weak, but **unemployment is now at levels pointing towards higher capacity utilisation and rising wage pressure**. Pay hikes are nevertheless likely to remain at a moderate level to maintain cost competitiveness.

We expect annual wage growth to rise from 2.9 per cent in 2018 to 3.4 per cent in 2020. The upswing is probably insufficient to bring underlying inflation back to target, especially in light of moderate price gains globally. In 2019, goods inflation will slow as the effects of the weaker krone fades. Higher service inflation will nevertheless stabilise the inflation rate. We forecast marginally higher CPI-ATE inflation than anticipated by Norges Bank for the remainder of this year.

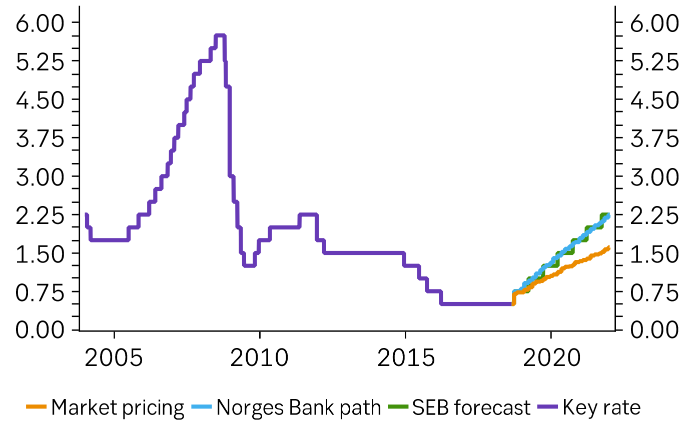


Rising energy prices (primarily electricity) boosted CPI inflation to 3.0 per cent in July. Electricity prices are partly driven by the dry weather, and the futures market indicates that prices will remain high until falling significantly after next spring. **We expect CPI-ATE to increase by 1.4 per cent this year and by 1.5 and 1.6 per cent in 2019 and 2020, respectively.** Corresponding figures for headline inflation are 2.6, 1.4 and 1.6 per cent.

Norges Bank ready to start normalising policy

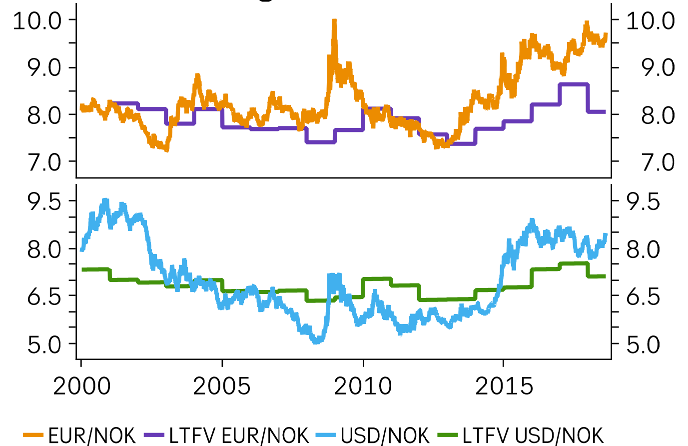
Norges Bank is on course to start normalising monetary policy in September. Above-trend growth, a positive output gap and rebounding home prices are indications that today's policy is too expansionary. Inflation remains subdued, but rising capacity utilisation suggests that domestic inflation pressures should start to rise. Unlike Sweden's Riksbank, Norges Bank is making use of a flexible inflation target that allows for a longer period with inflation below target. Waiting for underlying inflation to accelerate before starting to raise interest rates would increase the risk of ending up behind the curve, with a need to respond forcefully. The central bank is thus planning to hike its key interest rate to 0.75 per cent in September.

The pace of rate hikes thereafter will be slow. Norges Bank wants to assess the effects of its first rate hike before raising the key rate further. Highly indebted households and uncertainty regarding the level of the neutral rate also suggest a gradual hiking cycle. **We expect an average of two hikes yearly, with a key rate of 1.75 per cent by the end of 2020.**



NOK and NGBs remain historically cheap

The Norwegian krone has recovered in 2018 on the back of solid fundamentals and a hawkish shift by Norges Bank, but the krone has proven vulnerable in the context of escalating global trade frictions. The krone's often poor liquidity has amplified its recent depreciation against the euro. Solid fundamentals nonetheless remain intact. A repricing of market's cautious expectations for Norges Bank should result in a wider interest rate spread against the euro zone. The long-term valuation of the NOK remains favourable. **We expect the EUR/NOK exchange rate to fall from 9.30 by the end of 2018 to 8.90 in 2020.**



Norwegian government bonds (NGBs) offer an attractive yield pick-up against their German equivalents. Though Norwegian yields tend to follow international developments, the impact on German yields from the ECB's phase-out of its bond purchasing programme should influence Norwegian bonds to a lesser extent. On the other hand, Norges Bank's upcoming rate hikes will keep the 10-year yield spread against Germany at a historically high level. **We forecast a spread of 120 and 95 basis points by the end of 2018 and 2019, respectively.**

Finland

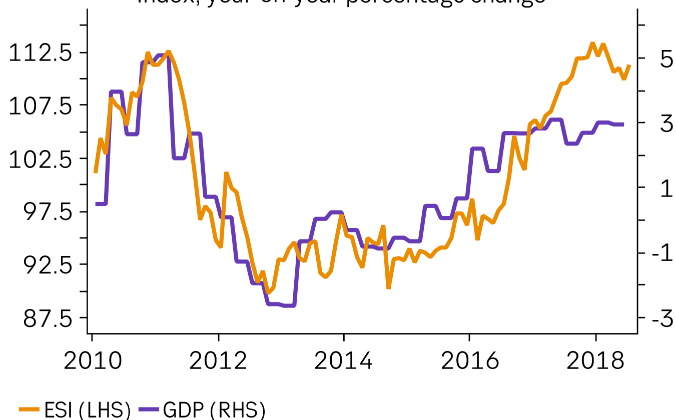
Resilient growth and rapid job creation

After nearly a decade of setbacks, the economy has reawakened. So far in 2018, the recovery has been resilient; as the global economy has hesitated, Finnish growth has accelerated. Higher production and optimism are spilling over more clearly into the labour market. Employment is rapidly rising – strengthening households squeezed earlier by low pay hikes and public austerity. We are revising our 2018 growth forecast upward to 3.1 per cent; GDP will gain nearly 2.5 per cent yearly in 2019-2020.

The recovery is continuing, and Finland appears to have **escaped the slowdown that dominated much of the euro zone during the first half** of 2018. Despite export headwinds, Finland instead noted its **fastest growth in several years during the first quarter**. The first half also looks very strong. Although Finland is still a long way from full recovery after its prolonged slump, this year will mark a milestone as GDP surpasses its previous peak from before the global financial crisis. Sentiment indicators remain strong and are also showing resilience to international hesitation. The European Commission's Economic Sentiment Indicator (ESI), for example, is close to historical peaks. In sectoral terms, the picture is somewhat divided: the manufacturing sector is leading the way, while the service and construction sectors are somewhat more hesitant. Growth will probably not accelerate further but will remain well above trend throughout our forecast period.

Continued strong indicators

Index, year-on-year percentage change



Source: Statistics Finland, European Commission (DG ECFIN), Macrobond, SEB

Manufacturing output continues to increase by 4-5 per cent: largely in line with what we saw in 2017. The order situation improved sharply during 2017 and remains at a high level. The influx of new orders is pointing higher after a weak patch early in 2018. As domestic demand and exports grow, imports will also rise, though somewhat more slowly than exports. The 2016 Competitiveness Pact between government, employers and unions – which ensured low contractual pay hikes – will continue to have a positive impact on exports but will meanwhile hamper household purchasing power. In 2017 Finland's current account balance showed its first surplus since 2010. This year it will widen to 1 per cent of GDP. Inventory drawdowns have held back recent growth figures, but the inventory cycle is now shifting in an expansionary direction. Capacity utilisation in manufacturing is above the long-term average, but it has some way to go before reaching earlier peaks. Aside from high capacity utilisation, a bright economic outlook and good profitability will help drive a **5 per cent upturn in capital spending this year**, which will slow somewhat in 2019-2020. Home prices are stagnant but are expected to climb weakly. Housing construction is increasing, especially in major cities, but a falling number of building permits signal a slight deceleration.

The labour market continues to improve. Unemployment fell in June to 7.3 per cent: just over one percentage higher than its lowest pre-crisis level and 2 per cent below its 2015 peak. **Job creation has shifted into high gear**, with the number of jobs growing by over 2 per cent year-on-year since late 2017. The number of job vacancies is record-high. Along with positive sentiment and production data, this suggests that the employment upturn will persist. As unemployment falls, recruitment problems will become larger and contribute to slower employment expansion further ahead. **Measured as an annual average, the jobless rate will fall to 6.2 per cent in 2020**, which is about the same level as just before the financial crisis hit.

Pay increases have been held back by the Competitiveness Pact and are now in line with inflation: about 1 per cent year-on-year, which means unchanged real wages. However, total household incomes are favourably affected by the upturn in employment, which will contribute to a **consumption increase averaging about 2 per cent yearly in 2018-2020**. But weak income growth implies that consumption will partly be funded by declining savings and increased debt.

In 2017 Finland's public sector deficit fell to 0.6 per cent of GDP, its lowest level since 2008. Behind this improvement are both austerity measures and the effects of stronger economic conditions. After many tough years we expect the government to begin easing its fiscal policy, though slightly. Towards the end of our forecast period, **the budget deficit will drop to zero while government debt will fall below 60 per cent of GDP**.

Estonia

Higher labour costs will require faster growth in productivity

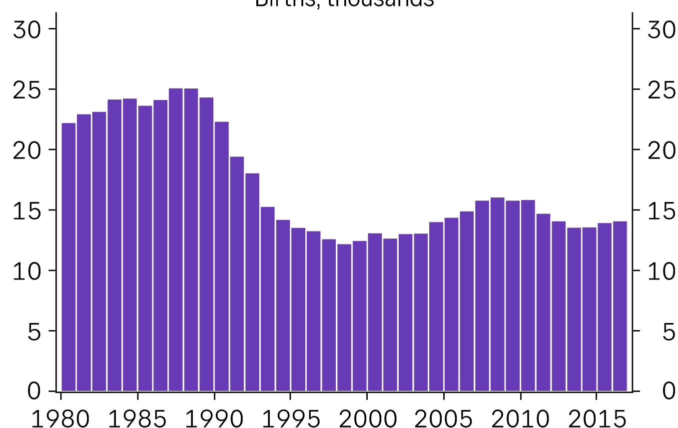
Estonia's economy is still in good health. After an almost 5 per cent GDP increase in 2017, growth has slowed somewhat but remains well-balanced at around 3.4 per cent. The outlook for the export-oriented Estonian economy depends on the future of world trade, but also on how companies adapt to higher labour costs. We expect economic growth to hover around its long-term potential: a 3.5 per cent GDP increase in 2019 followed by 2.8 per cent in 2020.

With foreign trade making up most of total value-added, it is somewhat concerning that exports increased by only 0.9 per cent in Q1 2018. However, weak export statistics were accompanied by a large expansion in inventories, which may explain at least part of it. Export figures continue to be influenced by factors such as unusually large oil sales and severely reduced exports of electronics, but in most sectors trade is showing healthy growth. We forecast that export growth will stay at around 4 per cent this year. Looking ahead, the future of the export sector depends on the ability of export companies to move up the value chain. Many of the largest exporters are subsidiaries of large Nordic companies that once established production in Estonia to take advantage of cheaper labour costs. Now many of them are considering moving labour-intensive processes elsewhere. Assuming favourable economic conditions in Estonia's main export markets, we still expect **export growth to remain above 4 per cent in 2019 and 2020**.

In 2018 significant changes in personal income tax took effect. A progressive element was introduced into the previous flat tax: a variable tax-exempt minimum that reaches zero for incomes above EUR 2,100 a month. Since the reform greatly lowers the effective tax rate on low incomes, many assumed it would have a large impact on private consumption. In February's *Nordic Outlook* we warned that such hopes may have been set too high. People who are unsure of their future incomes would rather pay taxes in full and reap the benefits of the reform only next year, when overpaid taxes are refunded. This scenario seems to have materialised on a larger scale than anticipated. Retail sales show solid growth but are far below expectations. Household consumption may also have been influenced by increased cross-border shopping. Higher excise duties have driven many people to shop in neighbouring Latvia – especially poorer households outside the capital and close to the border, who are also the biggest gainers from the tax reform. We have revised our **household consumption growth forecast to 3.8 per cent in 2018** and have shifted some of the reform's impact to 2019, when we expect 4.4 per cent growth.

Private consumption continues to be influenced by high inflation. In addition to the large hikes in excise duties for alcoholic beverages and fuel, surging electricity and oil prices are putting pressure on consumers. The rapid upturn in food prices that dominated 2017 has eased, but due to unfavourable weather conditions the situation may soon reverse. We have thus **raised our inflation forecast and now expect 3.5 per growth in HICP**. In 2019 and 2020, inflation will stabilise at slightly above 2 per cent.

The unemployment rate stood as low as 5.1 per cent in Q2 2018. Although the number of vacancies seems to have stabilised, **labour shortages are increasingly seen as a major constraint on business**. The problem seems to be more pronounced in sectors with lower productivity, suggesting that companies have shortages of cheap rather than qualified labour. Mounting labour costs **are pushing companies to seek greater efficiency but are also making many of them rethink their business models**. Average gross salary will reach around EUR 1,300 this year, still far below Nordic levels but much higher than in the other Baltic countries. Due to the tight labour market, there are few reasons to expect slower wage growth. A further problem for employers is the demographic situation. While births per year exceeded 25,000 in the late 1980s, by the mid-1990s they had dropped to only 13,000. This means that in younger cohorts the number of potential employees has almost been halved, severely affecting the service sector. In the long run this will have a much wider impact on the economy.



With **parliamentary elections** due in March, the first election promises are starting to emerge. Since the recent tax reform and hikes in excise duties have caused controversy, **tax issues are expected to be at the core of the discussions**. The financing of generous campaign promises may require a more relaxed stance in regard to balancing the government budget.

Latvia

Good growth momentum, but labour cost pressure poses risks

Economic growth has surpassed expectations in 2018. GDP climbed by 5.1 percent year-on-year in the second quarter, with the construction sector as the main driver. The economic impact of the uncertainties surrounding ABLV Bank early in 2018 has been marginal. Rising real incomes will provide the basis for sustained consumption, but the tight labour market also risks creating cost problems. Exports are showing stable expansion despite a slowdown in manufacturing growth. We expect growth to be close to its potential level in 2019-2020.

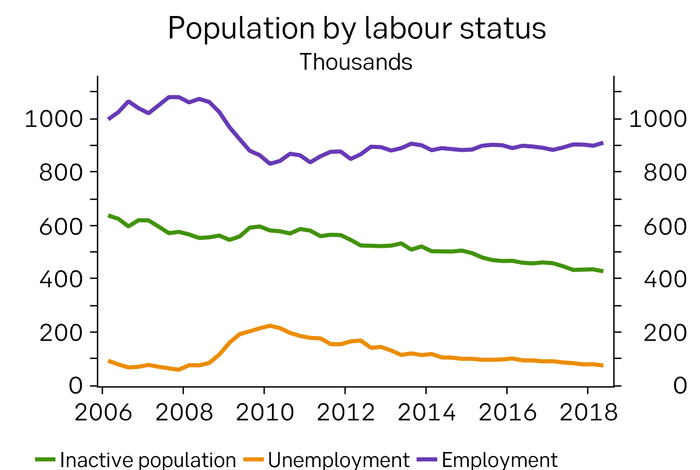
Latvia's year-on-year GDP growth accelerated from 4 per cent in the first quarter of 2018 to **more than 5 per cent in Q2**. Construction contributed about 35 per cent of this growth, thereby offsetting negative effects connected to the problems surrounding ABLV Bank (see *Nordic Outlook*, May 2018). The key role of the construction sector in GDP growth, Latvia's increasingly strained labour market and expected reductions in capital inflows from EU structural funds raise questions about future growth. We still believe that activity will be sustained with the help of private consumption, capital spending and exports. **GDP growth will be 4.2 per cent this year** (compared to 4.5 per cent in 2017). **We expect GDP to grow by 3.7 per cent in 2019 and 3.2 per cent in 2020**, that is, close to trend.

During 2017, capital spending rose by 16 per cent. This expansion looks set to persist. In the near future and until 2020, EU money will foster both private and public sector investments: **capital spending will grow by 14 per cent this year, 8 per cent in 2019 and 6.5 per cent in 2020**. Profitability remains solid in the export-oriented sector.

The overall **outlook is positive** for Latvia's economy and financial situation, but there are **downside risks**. Excessively pro-cyclical fiscal policy, along with cost problems in industry (see below), may lead to an overheated economy with growing imbalances and lower growth. On the other hand, **structural reforms** may boost mobility and supply in the labour and housing markets. Higher productivity growth would awaken greater interest in capital spending and help lower the risks posed by mounting cost problems. Overall, this would increase the likelihood that Latvia can enjoy more resilient growth.

Unemployment is 7.7 per cent, the lowest level in 10 years. It will fall in the next couple of years, reaching 6.5 per cent in 2020. The participation rate for people aged 15-74 is record-high: 64.4 per cent, forcing employers to search intensively for employees. The labour market is thus becoming tighter and tighter. This situation risks becoming a serious obstacle to future growth and is made worse by such factors as growing **skills shortages and low mobility**. The labour supply is also adversely affected by demographics and the ageing population: the number of people available to the labour market is falling by about 1 per cent a year, while any labour reserves are already essentially exhausted.

Pay increases are high. Over the next three years, wages and salaries are expected to climb by **6.5-8 per cent annually**. Because productivity growth is weak – as in many other economies – cost pressure is rising. This is jeopardises Latvia's competitiveness. We predict that **inflation will be 2.5 per cent this year, 2.8 and 2.4 per cent in 2019 and 2020**. Pay increases and higher energy prices are clear inflation risks. .



Source: Central Statistical Bureau of Latvia

A strong labour market and solid increases in real wages during our forecast period will provide good conditions for **both higher consumption and increased saving**. Retail sales are currently rising by about 6 per cent year-on-year, sustained by strong trends in service sectors. Expected rapid growth in real incomes will increase consumption and saving (the household savings ratio is about 3 per cent today).

Home prices are rising; in the Riga area, prices of flats have climbed more than 3 per cent so far during 2018. On the other hand, housing sales are down 19.5 per cent this year. This picture thus points to a stable housing price trend ahead, with supply being limited and demand being constrained by the unwillingness of households to increase their long-term debt.

The financial sector is moving towards solving the problems related to **ABLV Bank** revealed early this year. The IMF's latest analysis of Latvia's financial situation (July 2018) concluded that the banking system is *"stable, liquid and well-capitalised".* Financial uncertainty has had little impact on economic activity.

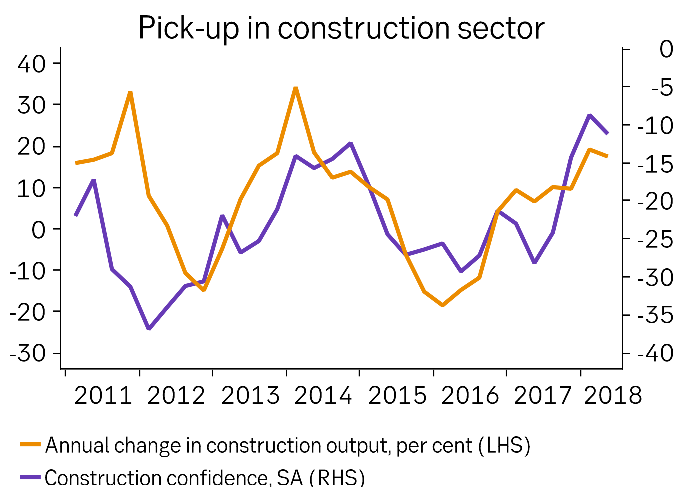
With **government debt at 40 per cent of GDP**, which is expected to fall to 37.6 per cent in 2020, Latvia has the fiscal policy flexibility needed to respond to a new downturn. But today's budget deficit, 0.7 per cent of GDP, will grow to 1.0 per cent in 2020, which risks creating imbalance problems.

Lithuania

Comfortable deceleration in economic growth ahead

The economy expanded by 3.7 per cent year-on-year in the second quarter of 2018, slightly more than we had expected. We are sticking to a scenario of gradual deceleration in GDP growth towards its potential rate: 3.0 per cent in 2019 and 2.6 per cent in 2020. Looking ahead, a sharp increase in labour costs – exceeding the pace of productivity growth – will be a major challenge to the economy and a primary driver for increasing business investment. A reform approved by Parliament will reduce the future tax burden on labour.

After a stronger-than-predicted start to the year, we are raising our GDP forecast for 2018 from 3.2 to 3.4 per cent. Net foreign trade has given a larger boost to growth than expected. **Nevertheless, capital spending will remain the main growth driver in the second half**, also contributing to a surge in construction work output. There are several drivers for the increase in both private and public sector investments. First, since capital spending is pro-cyclical, recent positive years for manufacturers encouraged them to finally start expanding their production capacity more aggressively. Second, sharply rising labour costs are pushing companies to invest in more equipment. Third, there is a positive impetus from the accelerating distribution of EU structural funds.



Source: Macrobond, SEB

Although growth in exports slowed down this year, the main reason is not weaker external demand, but high base effect and supply-side problems. The effects of the trade war are manageable but an escalation is a downside risk as trade disturbances can be especially harmful to small open economies like Lithuania's, where exports are equivalent to 81 per cent of GDP.

Unemployment has fallen further, forcing businesses to search more intensively for employees from other countries. In the first half of 2018 the number of national visas issued to the citizens of non-EU countries jumped by 93 per cent year-on-year and the number of temporary residency permits that were issued increased by 29 per cent. The pace of emigration from Lithuania has slowed this year, improving the balance of net external migration.

A tighter labour market is clearly positive for employees. Average net pay will climb by more than 8 per cent in 2018 as the result of a shortage of both skilled and unskilled staff, as well as a higher minimum wage and more generous rules on social security contributions to part-time workers. **However, Lithuania's wide income inequality has not decreased**, since more skilled employees saw higher pay increases in absolute numbers. The process of upgrading the skills of labour market participants is lengthy and difficult, but some progress in such spheres as education is taking place.

Annual inflation has dropped below 3 per cent. Although the price of fuel jumped in the first half of 2018, other prices for consumer goods, such as food, did not change much. Even the prices of services that largely correlate with changes in labour costs demonstrated slower annual growth. Slower inflation and continued rapid growth in wages do not necessarily have to translate into stronger private consumption growth, since the household savings ratio is close to zero and it should preferably be higher. However, in 2019 we forecast a 3.4 per cent upturn in private consumption due to a recently approved tax reform that will significantly increase the income of employees earning up to twice an average monthly salary. In 2020, private consumption will increase by 3.0 per cent.

Historically high household optimism has not yet translated into excessive borrowing. Household debt keeps rising at 7 per cent annually, close to the rate of disposable income growth. The residential real estate market has cooled off in the past few quarters, and the average price of apartments at the end of first half was just 3.2 per cent higher than a year earlier.

The second quarter of 2018 brought **great news to Lithuania – the country has finally joined the OECD.** It is the last of the Baltic countries to do so. Parliament approved tax and pension reforms in late June. The tax reform will reduce the tax burden on labour, but we fear that it will have a negative effect on the ratio of tax revenue to GDP, which is already one of the lowest among EU countries, and lead to relatively low social spending. We are sticking to our forecast, which is rather conservative compared to others, that the budget will show a consolidated surplus of 0.2 per cent in 2019 and 0.0 per cent in 2020. Upcoming elections will increase the risk of higher expenditures and pork-barrel projects.

Global key indicators

Yearly change in per cent

	2017	2018	2019	2020
GDP OECD	2.5	2.5	2.3	2.1
GDP world (PPP)	3.8	4.0	3.9	3.8
CPI OECD	2.3	2.6	2.1	2.2
Oil price, Brent (USD/barrel)	54.8	73	85	85

US

Yearly change in per cent

	2017 level, USD bn	2017	2018	2019	2020
Gross domestic product	19,754	2.2	3.0	2.5	1.9
Private consumption	13,654	2.5	3.0	2.8	2.1
Public consumption	3,407	-0.1	1.2	0.9	1.0
Gross fixed investment	3,295	4.9	5.0	3.0	2.5
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	2,420	3.0	4.5	2.9	2.9
Imports	3,022	4.6	4.1	2.9	2.8
Unemployment (%)		4.4	3.9	3.5	3.6
Consumer prices		2.1	2.5	2.2	2.2
Household savings ratio (%)		6.7	7.1	6.9	6.9
Public sector financial balance, % of GDP		-3.8	-4.2	-4.4	-4.6
Public sector debt, % of GDP		108.1	108.4	108.8	109.2

Euro zone

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	10,527	2.4	2.1	2.1	1.9
Private consumption	5,742	1.6	1.8	2.0	2.0
Public consumption	2,172	1.1	1.4	1.5	1.5
Gross fixed investment	2,108	2.7	4.0	3.5	3.0
Stock building (change as % of GDP)		0.0	0.0	0.0	0.0
Exports	4,863	5.2	4.1	4.0	3.5
Imports	4,388	4.0	4.5	4.5	4.0
Unemployment (%)		9.1	8.3	7.8	7.5
Consumer prices		1.5	1.7	1.4	1.6
Household savings ratio (%)		6.3	6.2	6.0	6.0
Public sector financial balance, % of GDP		-0.9	-0.7	-0.6	-0.6
Public sector debt, % of GDP		86.7	85.7	83.4	83.4

Other large countries

Yearly change in per cent

	2017	2018	2019	2020
GDP				
United Kingdom	1.6	1.3	1.8	1.9
Japan	1.7	1.1	1.0	0.8
Germany	2.2	2.0	1.9	1.7
France	2.2	1.7	1.9	2.1
Italy	1.5	1.2	1.4	1.5
China	6.9	6.6	6.3	6.0
India	6.4	7.5	7.8	7.8
Brazil	1.0	1.5	2.9	3.0
Russia	1.5	1.7	1.7	2.0
Poland	4.6	4.6	3.4	3.2
Inflation				
United Kingdom	2.6	2.4	1.9	1.7
Japan	0.5	0.7	1.1	1.5
Germany	1.6	1.6	1.7	1.8
France	1.2	1.3	1.4	1.6
Italy	1.3	1.3	1.2	1.4
China	1.6	2.2	2.4	2.5
India	3.3	4.6	4.8	4.8
Brazil	3.5	3.3	4.2	4.4
Russia	3.7	2.8	4.0	4.5
Poland	2.0	2.0	2.7	2.5
Unemployment (%)				
United Kingdom	4.4	4.1	4.1	4.1
Japan	2.8	2.3	2.0	1.8
Germany	3.8	3.6	3.6	3.8
France	9.0	8.7	8.4	8.1
Italy	11.3	10.9	10.5	10.0

Financial forecasts

Official interest rates		22-Aug	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
US	Fed funds	2.00	2.50	3.00	3.00	3.25	3.25
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	0.25	0.50	0.75
United Kingdom	Repo rate	0.75	0.75	0.75	1.25	1.50	1.75
Bond yields							
US	10 years	2.83	3.05	3.20	3.35	3.40	3.45
Japan	10 years	0.09	0.10	0.10	0.15	0.15	0.20
Germany	10 years	0.35	0.50	0.70	1.10	1.25	1.40
United Kingdom	10 years	1.42	1.50	1.70	2.10	2.25	2.40
Exchange rate							
USD/JPY		110	110	106	102	101	100
EUR/USD		1.16	1.15	1.18	1.20	1.24	1.28
EUR/JPY		128	127	125	120	125	128
EUR/GBP		0.90	0.87	0.84	0.82	0.81	0.80
GBP/USD		1.29	1.32	1.40	1.46	1.53	1.60

Sweden

Yearly change in per cent

	2017 level, SEK bn	2017	2018	2019	2020
Gross domestic product	4,600	2.3	2.9	2.4	2.3
Gross domestic product, working day adjustment		2.5	3.0	2.4	2.1
Private consumption	2,027	2.2	2.3	1.8	1.8
Public consumption	1,198	0.4	0.5	0.5	0.5
Gross fixed investment	1,146	5.9	4.5	3.0	2.8
Stock building (change as % of GDP)	35	0.1	0.1	0.0	0.0
Exports	2,085	3.6	4.9	5.1	4.7
Imports	1,891	4.8	4.1	4.0	3.8
Unemployment, (%)		6.7	6.2	5.9	6.2
Employment		2.3	1.7	1.2	0.9
Industrial production		4.5	5.7	5.5	4.5
CPI		1.8	2.0	1.8	2.0
CPIF		2.0	2.1	1.9	1.7
Hourly wage increases		2.4	2.7	3.0	3.5
Household savings ratio (%)		16.0	16.4	16.4	16.4
Real disposable income		2.3	2.6	1.9	1.7
Current account, % of GDP		3.5	2.8	3.2	3.5
Central government borrowing, SEK bn		-62	-92	-60	-40
Public sector financial balance, % of GDP		1.3	1.0	0.8	0.8
Public sector debt, % of GDP		40.6	36.9	34.4	32.4

Financial forecasts	22-Aug	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
Repo rate	-0.50	-0.50	-0.25	0.00	0.25	0.75
3-month interest rate, STIBOR	-0.36	-0.52	-0.15	-0.02	0.35	0.73
10-year bond yield	0.53	0.60	1.00	1.50	1.70	1.90
10-year spread to Germany, bp	18	10	30	40	45	50
USD/SEK	9.07	9.13	8.64	8.33	7.98	7.58
EUR/SEK	10.52	10.50	10.20	10.00	9.90	9.70
KIX	120.3	121.0	117.9	115.9	114.3	111.6

Finland

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	220	2.8	3.1	2.3	2.3
Private consumption	119	1.3	2.1	1.8	1.9
Public consumption	52	-0.5	1.0	0.5	0.5
Gross fixed investment	47	4.0	5.0	3.5	3.2
Stock building (change as % of GDP)		-0.2	0.2	0.1	0.0
Exports	78	7.5	5.1	4.2	4.5
Imports	80	3.5	4.0	3.5	3.8
Unemployment, OECD harmonised (%)		8.6	7.4	6.6	6.2
CPI, harmonised		0.8	1.1	1.2	1.5
Hourly wage increases		-1.2	1.0	1.5	2.0
Current account, % of GDP		0.7	1.0	1.0	1.0
Public sector financial balance, % of GDP		-0.6	-0.4	-0.2	0.0
Public sector debt, % of GDP		61.4	60.0	58.0	56.0

Norway

Yearly change in per cent

	2017 level, NOK bn	2017	2018	2019	2020
Gross domestic product	3,181	2.0	1.4	2.4	2.4
Gross domestic product (Mainland)	2,768	2.0	2.5	2.4	2.1
Private consumption	1,443	2.2	2.6	2.5	2.4
Public consumption	778	2.5	1.8	1.4	1.3
Gross fixed investment	819	3.6	1.0	3.8	2.4
Stock building (change as % of GDP)		0.1	0.0	0.0	0.0
Exports	1,096	-0.2	2.2	2.8	3.3
Imports	1,064	1.6	3.6	3.0	2.3
Unemployment (%)		4.2	3.7	3.5	3.4
CPI		1.9	2.6	1.4	1.6
CPI-ATE		1.4	1.4	1.5	1.6
Annual wage increases		2.3	2.9	3.2	3.4

Financial forecasts	22-Aug	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
Deposit rate	0.50	0.75	1.00	1.25	1.50	1.75
10-year bond yield	1.66	1.70	1.85	2.05	2.15	2.30
10-year spread to Germany, bp	131	120	115	95	90	90
USD/NOK	8.35	8.09	7.71	7.50	7.22	6.95
EUR/NOK	9.69	9.30	9.10	9.00	8.95	8.90

Denmark

Yearly change in per cent

	2017 level, DKK bn	2017	2018	2019	2020
Gross domestic product	2,150	2.3	1.5	2.5	2.0
Private consumption	985	1.6	2.3	2.6	2.2
Public consumption	537	0.6	1.6	1.4	0.9
Gross fixed investment	441	4.5	4.5	4.6	4.4
Stock building (change as % of GDP)		0.1	-0.1	-0.4	0.0
Exports	1,184	4.5	1.0	4.1	3.8
Imports	1,035	4.3	4.2	4.0	4.3
Unemployment, OECD harmonised (%)		5.4	4.7	4.3	3.9
CPI, harmonised		1.1	0.8	1.8	2.0
Hourly wage increases		1.7	2.0	2.4	2.9
Current account, % of GDP		9.0	8.0	7.0	6.0
Public sector financial balance, % of GDP		0.0	0.5	1.0	1.0
Public sector debt, % of GDP		37.0	36.0	35.0	34.0

Financial forecasts	22-Aug	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
Lending rate	0.05	0.05	0.05	0.30	0.55	0.80
10-year bond yield	0.41	0.54	0.74	1.14	1.29	1.44
10-year spread to Germany, bp	6	4	4	4	4	4
USD/DKK	6.43	6.48	6.31	6.21	6.01	5.82
EUR/DKK	7.46	7.45	7.45	7.45	7.45	7.45

Lithuania

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	42	3.9	3.4	3.0	2.6
Private consumption	27	3.8	3.3	3.4	3.0
Public consumption	7	1.0	1.0	1.2	1.2
Gross fixed investment	8	7.3	9.0	7.0	6.0
Exports	34	13.6	6.7	3.7	2.5
Imports	33	12.8	6.2	4.7	3.4
Unemployment (%)		7.1	6.5	6.2	6.0
Consumer prices		3.7	2.8	2.5	2.5
Public sector financial balance, % of GDP		0.5	0.3	0.2	0.0
Public sector debt, % of GDP		39.7	36.0	38.0	36.5

Latvia

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	25	4.5	4.2	3.5	3.2
Private consumption	15	5.1	4.9	4.1	3.3
Public consumption	4	4.1	3.9	3.1	2.5
Gross fixed investment	5	16.0	14.0	8.0	6.5
Exports	15	4.4	3.5	3.2	3.0
Imports	14	9.2	7.8	6.0	5.5
Unemployment (%)		8.9	7.7	7.0	6.5
Consumer prices		2.9	2.5	2.8	2.4
Public sector financial balance, % of GDP		-0.5	-0.7	-1.0	-1.0
Public sector debt, % of GDP		40.1	39.6	38.3	37.6

Estonia

Yearly change in per cent

	2017 level, EUR bn	2017	2018	2019	2020
Gross domestic product	23	4.9	3.4	3.5	2.8
Private consumption	12	2.2	3.8	4.4	3.4
Public consumption	5	0.8	2.2	2.5	1.8
Gross fixed investment	5	13.1	2.8	4.8	1.8
Exports	18	3.5	4.1	4.4	4.2
Imports	17	3.9	4.4	4.2	4.0
Unemployment (%)		5.8	6.0	6.2	6.4
Consumer prices		3.7	3.5	2.5	2.5
Public sector financial balance, % of GDP		-0.1	-0.4	-0.7	-0.7
Public sector debt, % of GDP		9.3	8.8	8.3	8.0

Research contacts

Robert Bergqvist
Chief Economist
Japan
+ 46 8 506 230 16

Håkan Frisén
Head of Economic Forecasting
+ 46 8 763 80 67

Daniel Bergvall
The euro zone,
Finland
+46 8 506 23118

Erica Blomgren
SEB Oslo
Norway
+47 2282 7277

Ann Enshagen Lavebrink
+ 46 8 763 80 77

Richard Falkenhäll
United Kingdom
Foreign exchange markets
+46 8 506 23133

Lina Fransson
Government bond markets
+46 8 506 232 02

Dainis Gaspuitis
SEB Riga
Latvia
+371 67779994

Johan Hagbarth
Stock markets
+46 8 763 69 58

Per Hammarlund
Russia
+46 8 506 231 77

Olle Holmgren
Sweden
+46 8 763 80 79

Melody Jiang
SEB Singapore
China
+65 6505 0584

Andreas Johnson
US, India
+46 73 523 77 25

Elisabet Kopelman
+ 46 8 506 23091

Elizabeth Mathiesen
SEB Copenhagen
Denmark
+45 2855 1747

Mihkel Nestor
SEB Tallinn
Estonia
+372 6655172

Tadas Povilauskas
SEB Vilnius
Lithuania
+370 68646476

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