Research Reports

Muted global growth
amid extreme yields

Riksbank on hold
despite low inflation

Nordic Outlook

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SEB

Contents

A confused world
Abnormal: the new normal?

Given negative key interest rates and unique record-low yields on long-term and other government bonds, the world feels abnormal in many ways. The future will tell whether this is the "new normal". But we don't have time to wait for answers. Political leaders, central banks, investors and economists are now in unknown territory that requires fresh thinking and creativity.

The global economy is at a crossroads. Will it see an abrupt downturn or continued relatively good growth? Pessimists read recession and deflation scenarios into today's interest rates and yields; they are sceptical of stock market valuations. Optimists see a chance for the public and private sectors to borrow at no real cost for investments in climate solutions and technology, while the interest rate situation props up various asset prices.

Manufacturers worldwide are facing headwinds, though with variations between sectors. But most countries are still showing high service sector activity, thanks to strong employment, good real wage growth and expansionary financial conditions. The question is now: *How immune is the service sector to spill-over effects from a weakened global manufacturing sector*?

At least in part, the global slowdown has been politically self-inflicted, although the economic cycle showed normal "fatigue symptoms" earlier. The positive contributions of monetary policymakers to expansionary financial conditions are being undermined by decisions about import tariffs, Brexit and security policy. Their combined impact is disrupting investment and global production cycles as well as international trade – risking more lasting damage to global growth.

This year's central bank U-turn towards even looser policies was made possible or necessary by below-target inflation rates, falling inflation expectations and downside risks to economic growth. But central banks' manoeuvring room is limited, raising questions about their interactions with – and responsibility for – fiscal policy. Prevailing uncertainty about the factors behind inflation and about the level and changes in neutral key interest rates hardly makes the banks' job easier.

Our task as forecasters is to balance these conflicting forces and present the most likely scenario for the period 2019-2021. We try to see the woods, not just the trees. You will find our final results in this September 2019 issue of *Nordic Outlook*, which also includes five topical, in-depth theme articles:

- Trade war & peace
- Recession risks
- The auto industry
- Brexit
- The Swedish wage round

We hope that the new issue of *Nordic Outlook* will provide you with enjoyable reading and new insights.

Robert Bergqvist
Chief Economist

Håkan Frisén
Head of Economic Forecasting

Uncertain many-faceted conflicts

The world is seeing a noticeably pessimistic bond market and high uncertainty due to trade and geopolitical issues, but political factors alone rarely trigger recessions. A lengthy manufacturing slump and escalating trade wars will cause global growth to slow from nearly 4 per cent in 2018 to just over 3 in the coming years. Downside risks have risen, but our main scenario is still that outright recession will be avoided. Moderate debt lowers the risk of contagion from weak industry to the overall economy. Low inflation gives central banks room for stimulus and Fed rate cuts lower risks of policy mistakes.

Financial markets have been highly dramatic in recent months. This applies, above all, to the radical repricing in the bond market. Since peaking at 3.25 per cent last autumn, 10-year US Treasury yields have more than halved. Their fall has been especially steep since mid-July. German 10-year government bond yields have reached extreme levels far below zero, and their Swedish equivalents have followed this movement into negative territory. For months, stock markets cheered the US Federal Reserve's shift towards more dovish policy– US equity indices set record highs in mid-July – but during the latest phase of plunging yields, worries about a possible recession and escalating trade conflicts have gained a foothold in the stock market too.

Divergence between the real economy and markets. Developments in the real economy have been far less dramatic. Although manufacturing has continued to weaken and global trade growth has stagnated, the domestic economy has been resilient in most countries, reflected by sustained optimism in service sectors. Countries like Germany and China that depend on manufacturing and exports have weakened to a greater degree than the US, for example. Divergent trends in financial markets and the real economy pose challenges to both forecasters and decision makers.

Downside risks have increased. It is not hard to find arguments for a pessimistic interpretation of the situation. Due to declining long-term yields, the slope of the US yield curve indicates a major recession risk, according to earlier historical experience. The length of the US upturn has now broken a post-war record. This may serve as a warning, especially with unemployment at a 50-year low, limiting room for further expansion. Also worrisome are the escalating US-Chinese trade conflict, a traumatic Brexit process and geopolitical trouble spots such as Iran, Hong Kong and Kashmir. Our overall assessment is that this has clearly increased the downside risks. We are thus raising the probability of a recession in the next couple of years to 25 per cent, up from 20 per cent in the May issue of *Nordic Outlook*.

Moderate downward adjustment in main forecast. The manufacturing slump has been more prolonged than expected. Combined with an escalation of the trade war and other events, this has led us to revise our global GDP growth forecast 2 tenths of a percentage point lower for 2019 and 3 tenths for 2020. These downward adjustments mainly apply to EM economies and the euro area. Our global growth forecast of 3.1 per cent and 3.2 per cent, respectively, is well below the updated forecast published by the International Monetary Fund (IMF) in late July.

Global GDP growth
Year-on-year percentage change

	2018	2019	2020	2021
United States	2.9	2.3	1.8	1.7
Japan	0.8	1.2	0.7	0.5
Germany	1.5	0.5	0.7	1.2
China	6.6	6.3	6.1	6.0
United Kingdom	1.4	1.3	1.4	1.5
Euro area	1.9	1.0	1.1	1.3
Nordic countries	1.8	1.7	1.8	1.8
Baltic countries	3.9	3.4	2.3	2.4
OECD	2.3	1.6	1.5	1.5
Emerging markets	4.7	4.2	4.5	4.7
World, PPP*	3.7	3.1	3.2	3.3

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

Global recession will be avoided. We still believe that an actual recession can be avoided in the next couple of years, for various reasons we discuss more thoroughly in several theme articles in this report. The Fed has changed strategy and is expected to follow up its July key interest rate cut with three more cuts in the coming year – lowering the risk that policy mistakes will trigger a recession. In spite of tight labour markets, continued low inflation is giving the Fed and other central banks manoeuvring room to continue supporting the economy. We also see indications that persistently high demand pressure in labour markets may have positive structural effects, in the form of falling equilibrium unemployment and rising participation rates. Moderate private sector debt levels in the US and other countries that underwent major adjustment processes will also lower the risks that the current industrial slump will turn into a global recession. Political uncertainty has recently increased, but historical experience suggests that such factors in themselves rarely cause recessions, as long as they do not interact with serious underlying imbalances. Another reason why forecasters are cautious about predicting outright recessions is that their accuracy when peering ahead several years is rather poor. They need more concrete signals to credibly predict widespread recession. This is especially true of organisations like the IMF and the OECD.

Low-yield environment becoming entrenched. Our forecast of further central bank stimulus – including Fed rate cuts and resumption of asset purchases by the European Central Bank (ECB) in particular – implies that the global low-yield environment will become entrenched. The downward movement will be amplified by various structural and regulatory-related forces. For example, life insurance and pension fund companies need to offset growing liabilities as discount rates fall. US 10-year Treasury yields will continue falling towards 1.30 per cent in mid-2020. Equivalent German yields are expected to be well below zero in the next couple of years, reaching -0.70 per cent late in 2020. The potential for higher yields will mainly be connected to fiscal policy, for example a more expansionary policy focusing on climate change issues in the euro area, especially Germany.

Harmful environment for small currencies. Worries about global economic slowdown and escalating trade conflicts have created a negative environment for small, less liquid currencies, while more defensive currencies have done better. The US dollar has benefited from higher interest rates and is probably somewhat overvalued. Further Fed easing suggests a weaker dollar ahead, but the US currency meanwhile usually benefits from a global slowdown. We thus predict a moderate upturn in the EUR/USD exchange rate to 1.20 by the end of 2020. Because of a probable retreat by Sweden's Riksbank concerning its planned rate hikes, the krona will reach 11.00 per euro by the end of 2019 and then gradually appreciate at a slow pace towards 10.00 per euro at the end of 2021.

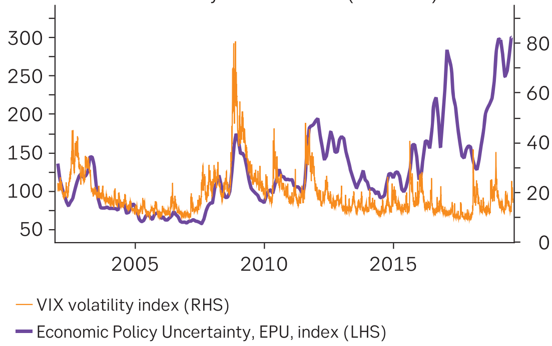
Uncertainty will push down stock markets. Political risks and signs of continued global economic slowdown, together with valuations close to earlier peaks, have caused share prices to fall again. Growth support from central banks and a less threatening trend in trade talks may suffice to improve the stock market mood. If our growth forecasts prove correct, stock markets have room to keep climbing, although relatively high valuations limit their potential.

Bright spots despite escalating trade conflict

Recent months have been dominated by greater political uncertainty on many fronts. The risk of a hard Brexit has soared since Boris Johnson took over as the British prime minister (see theme article, page 32), but financial markets have focused mainly on trade policy. At the G20 summit in late June, the US and China agreed to resume talks, which temporarily eased tensions. But the trade conflict escalated when President Donald Trump announced in early August that the US was prepared to impose new tariffs as early as September 1. China's response – letting the yuan fall and halting government imports of US farm products – represented a further escalation of the conflict and led the US, in turn, to label China a currency manipulator.

High uncertainty but moderate volatility

Uncertainty index and VIX (S&P 500)



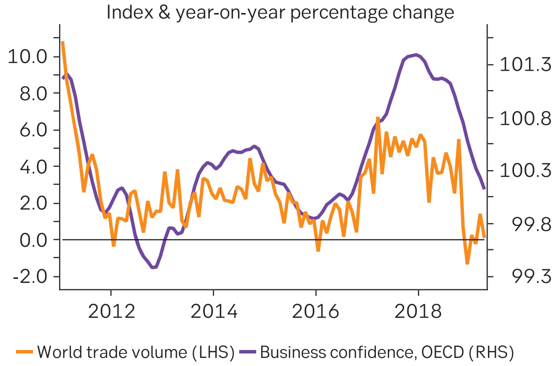
Source: Macrobond, SEB

The negative effects on the global economy appear likely to be clearer than previously expected, but there are also bright spots (see theme article, page 15). After all, trade restrictions cover a relatively small fraction of world trade. During 2019, several new free trade agreements have also been reached, for example tying the European Union closer to Asia and South America and promoting trade with African countries.

Global trade stagnation. The persistent weakening of global manufacturing activity and the escalating US-Chinese trade conflict are partly related, though it is easy to exaggerate the importance of the trade conflict. Since the 2008-2009 financial crisis, global trade growth has been generally weak, trending at about 2 per cent yearly: clearly slower than the 5-6 per cent increases recorded in prior decades. After an upswing in 2017 and 2018, trade growth has now completely stagnated, but this was also true during the slumps in 2012 and 2015-16. Despite a dramatic decline, confidence indicators in the manufacturing sector are now on a par with the levels during these periods.

Global trade has lost momentum

Index & year-on-year percentage change



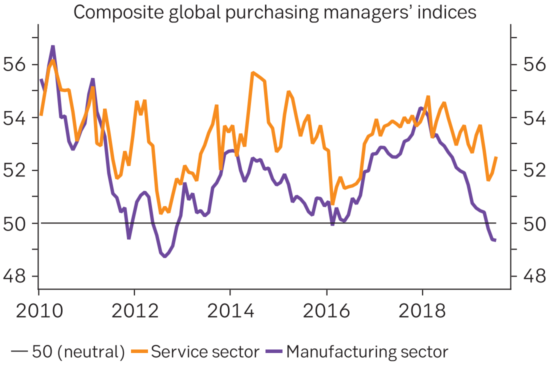
Source: OECD, Macrobond, SEB

Auto and tech sectors deepen the slump. If anything, the service sector and domestic demand have been more resilient this time around. This may be partly because strong labour markets are providing a more stable foundation. Problems in individual sectors such as autos and technology are now also more important, whereas earlier slumps were more broad-based.

Although the auto industry (see theme article, page 28) faces major long-term challenges, this still increases the probability that the slump will be temporary. We expect global trade to revert next year to its "post-Lehman Brothers" trend, with growth of 2 per cent.

Services resilient to manufacturing slump

Composite global purchasing managers' indices



Källa: IHS Markit, Macrobond, SEB

German industrial expansion both a strength and a weakness. The prevailing world economic situation has an especially large impact on Germany, partly because Germany and Europe generally are by far the world's biggest car exporter, but also because manufacturing accounts for a far bigger share of the economy in Germany than in other advanced economies. This difference was intensified by German manufacturing successes in 2017 and 2018, and manufacturing has now climbed to 27 per cent of GDP. This can be compared to 15 per cent in the US, about 17 per cent in the rest of the euro area and only 13 per cent in France.

Manufacturing has climbed to 27 per cent of German GDP, far higher than in most other advanced economies

Now that German manufacturers have suffered a "hangover" after their earlier successes, the effects are noticeable throughout the euro area. The German economy has completely stagnated for a few quarters, and Italy is teetering on the edge of recession – contributing to a downward adjustment in euro area GDP growth to 1.0 per cent in 2019. But despite the great importance of German manufacturing, it is difficult to view this as an early indicator of a broader global downturn. Aside from the general resilience of domestic economies, there are adjustment mechanisms in place that decrease the effect on labour markets. There is also great potential – and increased preparedness – to initiate fiscal stimulus measures if the situation gets worse. Our forecast is therefore that GDP growth will accelerate both in Germany and in the euro area as a whole but reach only a modest 1.1 per cent in 2020 and 1.3 per cent in 2021.

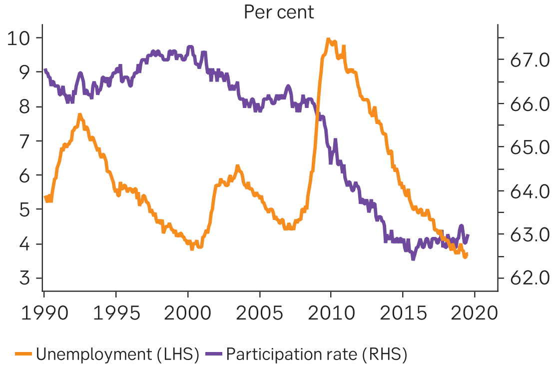
A different US role in the global drama

Although growth has slowed from its 3.5 per cent peak in mid-2018 to an average of just over 2 per cent in the past three quarters, the US economy has remained robust in a weak international environment. Today's risk picture is thus a bit unusual, since global recessions in modern times have generally had their roots in the US. It is rather improbable that the current global industrial slump will cause a recession in the relatively closed American economy, but this does not prevent weak international demand and a strong dollar from affecting both the US growth outlook and the Fed's policy thinking to some extent.

Trade conflict and fiscal policy contributing to slowdown. Both demand- and supply-side aspects will determine future developments. At present, there are few outward signs of the imbalance symptoms – over-investments, mounting debts and financial bubble risks – that have traditionally preceded a US recession. Yet demand will be hampered to some extent by greater uncertainty related to escalation of the trade conflict. Fiscal policy will also be less expansionary after earlier tax cuts, although new stimulus measures are likely in the 2020 "election budget". Overall, our forecast implies a gradual deceleration, with GDP increasing by 2.3 per cent this year and ending up somewhat below trend at 1.8 per cent in 2020 and 1.7 per cent in 2021.

US unemployment approaching record low

Per cent



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

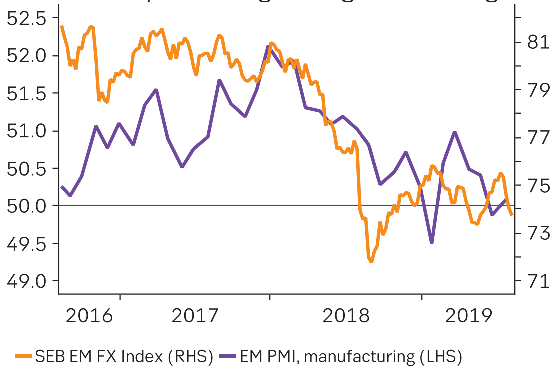
Few signs of labour market overheating. US unemployment has stopped falling, but at 3.7 per cent in July it was half a percentage point below the Fed's latest estimate of equilibrium unemployment: 4.2 per cent. The still moderate rate of yearly pay hikes (3.2 per cent in July) nevertheless suggests that the labour market is not yet overheated. The participation rate has remained low, 63 per cent compared to a peak of 67 per cent in 2000. This partly reflects an ageing population, but even among people aged 25-54 participation is several points below its previous peak, creating room for continued job growth. We are sticking to our forecast that unemployment can fall somewhat lower, to around 3.5 per cent by the end of 2019.

Decent EM growth despite slowdown

The growth rate in emerging market (EM) economies accelerated during the spring after a weak start to 2019. Stimulus measures – especially in China – but also strong private consumption in Eastern and Central

Europe contributed to the recovery. A deceleration in the mainly affluent OECD countries, a renewed decline in China's growth rate and worries about the escalating US-Chinese trade war are now having a negative impact again. We are thus lowering our EM forecast for 2019 to GDP growth of 4.2 per cent, down from 4.6 per cent in our May report. Our 2020 forecast is also more cautious, 4.5 per cent, but we still expect a gradual upturn to average growth of 4.7 per cent in 2021.

Lower EM purchasing managers' index again



Source: IHS Markit, Macrobond, SEB

Broad-based disappointments. The EM slowdown is now occurring on a broad front. One exception is Central Europe, where countries like Poland, the Czech Republic and Hungary have been resilient to Germany's lethargic economy. But in Russia, growth reached only 0.9 per cent in the first half. Otherwise the biggest disappointments have been in South America, with unexpectedly weak growth in Brazil and deepening recession in Argentina despite a record-sized IMF bail-out package. Available Chinese trade, electricity, industrial production and credit growth statistics suggest that GDP is now increasing at about the same pace as during the last slump in 2015-2016. Beijing accepts gradually falling growth, but the latest slowdown has been undesirably dramatic. New stimulus measures are likely, in order to strengthen Chinese private consumption and small and medium-size companies – stabilising growth at about 6 per cent.

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

	2018	2019	2020	2021
China	6.6	6.3	6.1	6.0
India	7.1	6.7	7.0	7.2
Brazil	1.1	0.8	2.0	2.8
Russia	2.3	0.8	1.7	1.9
Emerging markets, total	4.7	4.2	4.5	4.7

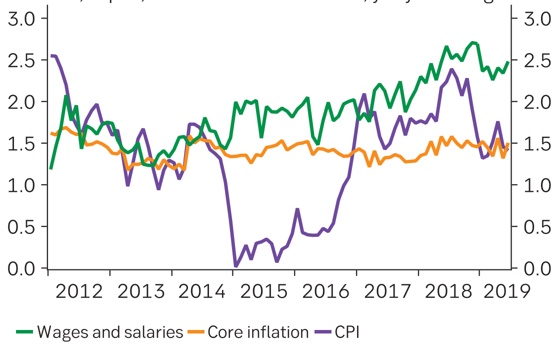
Source: IMF, SEB

Stimulus, but sluggish reform climate in India. GDP growth in India fell to 5.8 per cent in Q1. Although the statistics are hard to interpret, we have seen no rebound so far. After being re-elected in May, Prime Minister Narendra Modi is now promising fiscal stimulus in order to kick-start lending again and boost growth. The central bank also foresees opportunities to cut its key interest rate further. Yet India is unlikely to reach the 8 per cent growth rate that Modi is aiming for, absent reforms in the real estate and labour markets.

Synchronised inflation downturn. Inflation in EM countries has generally fallen, as in the OECD economies. Together with sagging growth and falling global interest rates, this creates room for monetary policy easing. Many large EM economies have already cut their key interest rates faster than expected, but further easing is on the way. Since the EM countries have more monetary policy ammunition available, these stimulus measures are more likely to actually help speed up economic growth in 2020 and 2021.

EM currencies under pressure as risk appetite fades. Emerging market currencies rose gradually in June and July, sustained by increased global risk appetite. A more dovish Fed and signs of willingness to resolve the US-Chinese trade conflict also provided support, but in early August EM currencies plunged after China let the yuan depreciate against the dollar. Falling global yields due to increasing fears of a US recession also contributed. We expect these factors to push down EM currencies and stock markets during the rest of 2019 as well. A more sustainable recovery in these currencies will occur only when GDP growth in the emerging market countries speeds up starting in 2020.

Stable core inflation despite faster pay hikes
US, Japan, the euro zone and the UK, y-o-y % change



Source: Macrobond, SEB

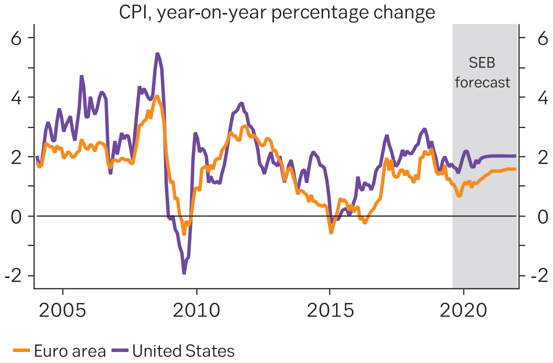
Sluggish CPI response to hot labour markets

Despite slower GDP growth, unemployment has continued to fall and now averages less than 5 per cent in advanced economies: a 40-year low. With near-trend GDP growth in the next couple of years, the jobless rate is close to bottoming out, although we foresee a further decline by a few tenths of a point during the coming year. Since early 2017 there has been a slight upward trend in pay increases in OECD countries, including the US, Japan and Germany. But partly due to a downward shift in Japan, our composite pay metric for large advanced economies (see chart) fell somewhat in early 2019. Since then it has rebounded a bit.

No clear trend for core inflation. Inflation has continued to surprise on the downside. Central bank hopes that inflation would move closer to target have again proved elusive. It is hard to discern any trend at all in core inflation during the past decade, and variations in total consumer price index (CPI) inflation have mainly been driven by energy price fluctuations. Countries where the currency has depreciated sharply, such as the UK and Sweden, have experienced some inflation pressure (see box in Sweden section) via higher import prices, but this seems to be only temporary and without major secondary effects. Higher tariffs and other trade restrictions will marginally boost inflation by a few tenths of a point, but without significantly affecting the inflation environment. We expect core inflation to increase by only a few tenths of a point during the next couple of years. Nor do we expect energy prices to put any major pressure on total CPI. We have adjusted our crude oil price forecast to USD 62.50 per barrel (from USD 70) in 2019, then expect an upturn to an average of USD 70 in 2020. Overall, this implies that central banks will keep struggling with low inflation expectations that reflect scepticism about their ability to achieve their targets.

Low but rising inflation

CPI, year-on-year percentage change



Source: Macrobond, SEB

New price formation pattern decreases likelihood of "ketchup effect". Wages and salaries have responded to some extent to a tighter labour market situation – but not prices. This has been highlighted recently ("The Phillips curve for prices has collapsed, but it is still showing signs of life for wages"). One thesis is that this is because of a lag effect, in which companies will eventually raise their prices in response to rising labour costs. Yet it is unlikely that we will see any major inflation impulse from a pent-up need for price hikes. This is because the acceleration in pay increases in itself is too modest and because in the past year it has been accompanied by a productivity upturn that eases the cost impulse for companies. We can also see a structural change in price formation. A few decades ago, there was a stable association in which wage-driven cost pressure led to price hikes. But this has gradually been weakened as companies have responded to wage pressure by cutting other costs. They have also changed their product range in a way that is recorded as quality improvements instead of price increases.

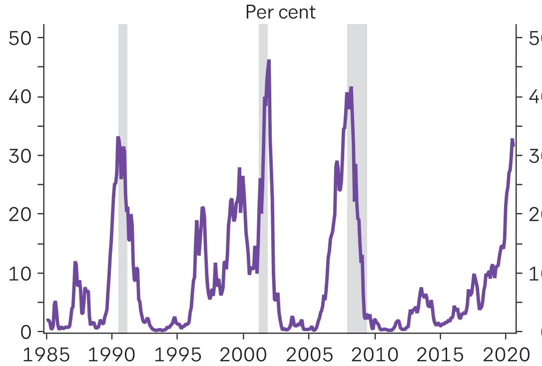
Central banks preparing for new stimulus

The new wave of central bank stimulus measures is not uncontroversial. It risks worsening a number of negative effects of extremely low interest rates and asset purchases that have been discussed in recent years. For example, capital allocation is not optimal in this environment, since zombie-like companies with weak development potential can survive. This reduces pressure for change and hampers long-term improvements in productivity and living standards. Such a policy also contributes to widening economic gaps by pushing up asset prices, for example share and home prices. Aside from negative social consequences, a concentration of incomes and wealth can also hamper consumer demand. The risk of credit bubbles and lending excesses is also in the background, though the situation varies from one country to another. The lack of central bank ammunition for responding to a coming recession is also frequently cited as a problem.

Central banks bear main responsibility, despite more aggressive fiscal policies. There are continuous conferences and evaluations on the monetary policy framework. In June, for example, the Fed held a major conference. In November, Sweden's parliamentary commission of inquiry on the Riksbank will present its report. Yet we are unlikely to see reforms that significantly affect the interest rate environment over the next couple of years. The idea that fiscal policy can do more to ease the burden on central banks is gradually winning support, though. The IMF in particular has become increasingly vocal in its recommendations. There are also many indications that fiscal policy will be loose in most leading economies. In the US, there is likely to be an expansionary 2020 election year budget. In Europe, Brussels is showing greater tolerance for divergences from the EU fiscal framework, while Germany seems to be moving towards easing its strict regulations in some situations. Low interest rates and the need for public funding of urgent climate-related investments may contribute to even more aggressive fiscal initiatives, but during the foreseeable future the main responsibility for stabilisation policy will probably still rest with central banks.

Greater recession risk according to Fed model

Per cent



Souurce: Federal Reserve Bank of New York, Macrobond, SEB

Complex interaction between Fed and market. Cutting the key rate late in an economic cycle, amid robust demand and with unemployment at a 50-year low, is not unobjectionable. This is illustrated by Fed Chairman Jerome Powell's unwillingness, at the time of the July rate cut decision, to signal that a regular rate cutting cycle has just begun. Instead he chose terms like an "insurance" or "mid-cycle" adjustment to justify the decision. Interacting with the market is not easy for the Fed. At the same time as the Fed tries to dampen expectations by underscoring the robust situation in the real economy, the market's aggressive rate cut expectations unavoidably influence its analysis. For example, the main reason why the New York Fed's recession indicator is now above 30 per cent is that the slope of the yield curve is a warning signal. Although the Fed does not pay much direct attention to the president's calls for rate cuts, it is conceivable that his aggressive rhetoric helps fuel market expectations and thus has an indirect influence.

Persistently high demand pressure may lead to structural improvements via lower equilibrium unemployment and higher labour force participation

A prolonged expansion may provide structural benefits. We believe that the Fed will now deliver three more rate cuts, bringing the federal funds rate to 1.25-1.50 per cent by mid-2020: somewhat less aggressive than the market is now pricing in. There are also a few more arguments on behalf of proactive rate cuts. Now that moderate inflation is allowing greater flexibility, it may be worth taking the chance. Although the labour market is tight, experience shows that persistently high demand pressure may lead to structural improvements via lower equilibrium unemployment and higher labour force participation. Historically, we can also draw parallels with 1995 and 1998, when the Fed twice prolonged an expansion successfully by making three rate cuts of 0.25 per cent each. But on these occasions, the economic cycle – at least in the labour market – was not as mature as now. Today's labour market situation is perhaps more reminiscent of January 2011, when the Fed surprised markets with rate cuts that nevertheless did not prevent an eventual recession.

Central bank key interest rates
Per cent

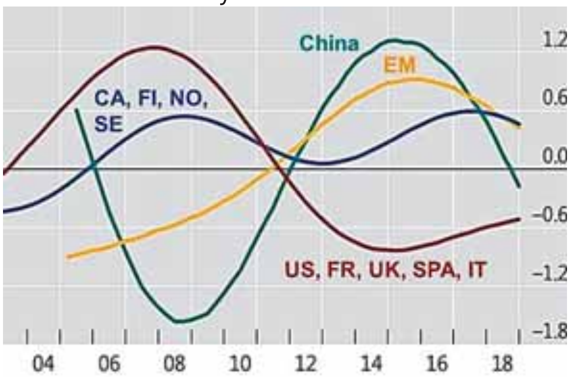
	Aug 21	Dec 2019	Dec 2020	Dec 2021
Federal Reserve (Fed)	2.25	1.75	1.50	1.50
ECB (deposit rate)	-0.40	-0.60	-0.60	-0.60
Bank of England (BoE)	0.75	0.75	0.75	1.00
Bank of Japan (BoJ)	-0.10	-0.10	-0.10	-0.10
Riksbank (Sweden)	-0.25	-0.25	-0.25	0.00
Norges Bank (Norway)	1.25	1.50	1.50	1.50

Source: Central banks, SEB

ECB planning broad-based stimulus. The ECB is now also about to deliver new stimulus measures, due to inflation and growth disappointments as well as the Fed's policy shift. Although the euro area labour market also looks rather strong, the ECB is signalling vigorous action. We expect the ECB's deposit rate for banks to be lowered in two 10 basis point steps in September and December to -0.60 per cent. Other measures will include re-starting the asset purchase programme (APP). As the ECB's new president, Christine Lagarde is likely to continue in the spirit that Mario Draghi created, with his "Whatever it takes" policy for keeping the euro project alive. As a former French finance minister, she may also work towards improving the interaction between fiscal and monetary policies.

Bank of England will go against the current. Other central banks are of course strongly affected by the new winds from the Fed and the ECB, but national peculiarities are naturally important too. In the United Kingdom, a lot of developments revolve around the outcome of the Brexit process. But in our main scenario – where despite all difficulties the UK can avoid a no-deal withdrawal from the EU – economic growth will be decent. In an environment with a tight labour market and upward inflation pressure due to the weak pound, the Bank of England is likely to abstain from cuts and let its key rate remain unchanged for a long time. Late in our forecast period, we expect a cautious rate hike.

The financial cycle in selected countries



Source: Bank for International Settlements

Strained financial cycle in the Nordics. The dilemma facing the Swedish and Norwegian central banks can be partly illustrated by the situation shown in the above financial cycle chart. This trend-adjusted metric – which tries to measure where countries are in such areas as private debt, home prices and credit availability – shows that the group of countries that managed to avoid a major post-financial crisis adjustment is in a more strained situation than the US, for example. Unlike the situation in Sweden and Norway, according to this metric the Fed thus has no great reason now to "lean against the wind" and abstain from rate hikes by citing an overheated financial cycle. Norges Bank's current tightening can be interpreted partly as an attempt to reduce financial market risks. We believe Norway is now nearing the end of its hiking cycle, but we expect a final hike in September. But in Sweden, the Riksbank has focused entirely on pushing up inflation and has not taken similar factors into account. With a labour market that is about to weaken, and with continued problems in reaching its inflation target, most indications are that the Riksbank will abstain from its planned rate hikes. We thus believe that the repo rate will remain at -0.25 per cent until late 2021, when it will be hiked to zero.

GDP growth, the Nordics
Year-on-year percentage change

	2018	2019	2020	2021
Sweden	2.3	1.5	1.3	1.7
Denmark	1.4	1.9	1.7	1.5
Norway	1.4	2.0	2.9	2.1
Finland	1.7	1.5	1.6	1.6

Source: IMF, SEB

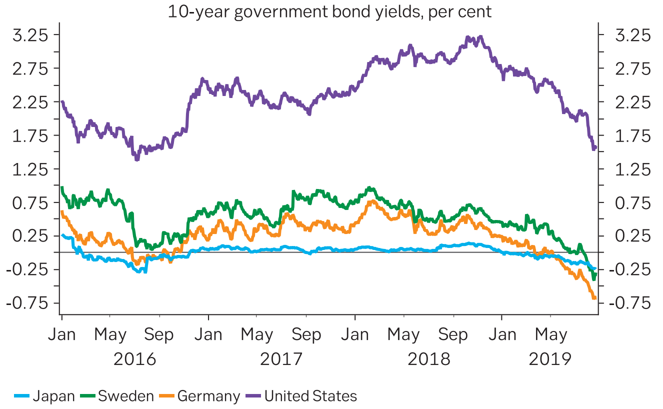
Fixed income

Global collapse in yields

We believe that a combination of cyclical, structural and regulatory-related drivers is behind this year's dramatic plunge in bond yields. Negative yields prevail at most maturities – a completely new landscape for central banks, investors and forecasters. Our assessment is that yields will remain low for the next 12-18 months. The risks are on the downside. More expansionary fiscal policies – especially in Europe and China but also in the US – may cause yields to move upward.

New all-time lows after drastic declines in yields

10-year government bond yields, per cent



Source: Macrobond, SEB

10-year government bond yields

	Aug 21	Dec 2019	Dec 2020	Dec 2021
United States	1.59	1.50	1.30	1.50
Germany	-0.68	-0.70	-0.70	-0.40
Sweden	-0.37	-0.35	-0.20	0.20
Norway	1.13	1.00	1.00	1.20

Source: Central banks, SEB

Collapse in long-term bond yields. The global downturn in yields intensified this summer. US 10-year Treasury yields have more than halved since November 2018. This movement has coincided with a shift in market expectations about the Federal Reserve and in a period of only eight months have expectations shifted from hikes of about 75 basis points (one year ahead) to rate cuts of nearly 100 points. According to market pricing, the Fed will lower its key rate to just 1.0 per cent by the end of 2020. This summer about 15 central banks have followed the Fed's example and cut their key rates.

German government bond yields have hit new record lows and the entire Swedish government bond yield curve has occasionally fallen below zero. The European Central Bank has opened the door for new rate cuts and for re-starting its purchases of bonds. Euro area yields are thus below Japanese counterparts. The Fed stopped reducing its monetary policy portfolio (USD 50 billion per month until July) earlier than planned, while the Bank of Japan continues its purchases. When the ECB resumes bond-buying, overall central bank net purchases will total about USD 100 billion per month.

An inverted yield curve is fuelling recession worries. Because of the plunge in long-term yields, the spread between US 10- and 2-year Treasuries has turned negative for the first time since 2007. This has contributed to further recession worries and downward pressure on yields. The correlation between the yield curve and recessions deserves respect, but there are disagreements as to whether unconventional monetary policy (bond purchases) and falling neutral interest rates have made this recession indicator less accurate. Yet the inversion has had a major impact and thereby risks hurting household and business optimism. A sustained period with a negative yield curve will affect the profitability of banks and their incentives to transform short-term deposits into long-term lending. Looking ahead, there is a risk that this may slow down credit growth. This is primarily a euro area problem.

A combination of cyclical and structural factors may explain the decline in bond yields, both in the short and long term:

1. Heavy demand for safe, liquid assets, reflecting investors' worries for the economic outlook and portfolio returns as well as regulations requiring life and pension insurance companies to take positions in the swap market for lower yields, thus offsetting growing pension liabilities with falling discount rates.
2. Falling inflation expectations and risk premiums, due to the economic outlook, "Japanification" worries and structural disinflationary forces.
3. Continued purchases of bonds by central banks (see above).
4. Expectations of low – and in some cases lower – key interest rates in both advanced and emerging market economies.
5. Expectations of further declines in neutral interest rates, due to demographics and savings surpluses that (absent greater business demand for capital) push down equilibrium interest rates on capital.

No near-term recovery likely. The downturn has been significantly bigger than expected. In late August, US 10-year Treasury yields were only 20-30 bps above earlier lows. We believe that yields will remain largely steady at around 1.50 per cent this autumn and then fall further to 1.30 per cent during 2020. Once the Fed has ended its rate cuts in 2020, we expect long-term yields to move cautiously upward during 2021. We expect German 10-year yields to be pushed down by the ECB's new monetary policy easing and then follow US yields upward in 2021. The potential for higher yields is connected to the fiscal policy outlook. For example, if euro area countries in general – and Germany in particular – should launch more expansionary policies that focus on such issues as climate change, long-term yields may climb more than in our main scenario.

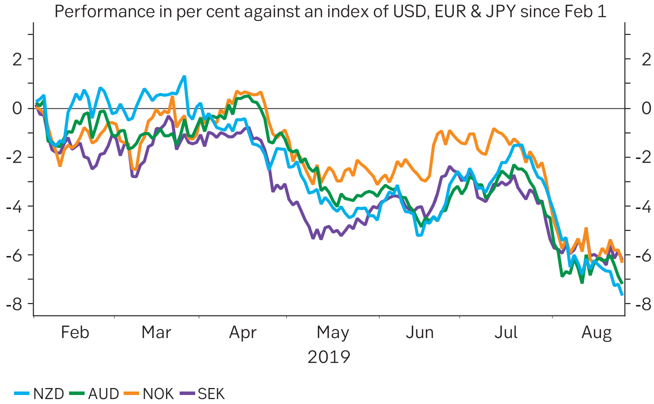
The FX market

Harmful environment for small currencies

Less liquid currencies had a tough first half, while traditionally defensive currencies did better. This suggests that worries about a global economic slowdown and the escalating US-Chinese trade conflict are dominating the FX market. The Swedish krona continues to suffer from negative interest rates. It will be a while before we see a stronger krona. The US dollar has long benefited from higher interest rates, but further Fed rate cuts will likely result in a somewhat weaker dollar ahead.

G10: The krona is not alone in struggling this year

Performance in per cent against an index of USD, EUR & JPY since Feb 1



Source: Macrobond, SEB

Exchange rates

	Aug 21	Dec 2019	Dec 2020	Dec 2021
EUR/USD	1.11	1.13	1.17	1.20
USD/JPY	107	105	100	100
EUR/GBP	0.91	0.93	0.87	0.88
EUR/SEK	10.67	11.00	10.50	10.00
EUR/NOK	9.91	10.30	9.60	9.30

Source: Bloomberg, SEB

Less liquid currencies have had a tough year. They include currencies with widely varying interest rate conditions, growth prospects and monetary policies, suggesting that other factors are behind their problems. A continued global economic slowdown, a general shift towards looser monetary policies and falling global interest rates/yields plus the escalating trade conflict between the United States and China are among the factors that together have created a negative environment for smaller currencies. Note that the traditional connection with general risk appetite, such as stock market climate, has been weaker than normal. Poorer global risk sentiment thus does not seem to be a crucial explanatory factor.

The US dollar is probably somewhat overvalued and has benefited from widening interest rate spreads in recent years as the Fed has hiked its key rate. President Donald Trump has recently been harshly critical of Fed policy, however, and the escalating trade conflict with China has further aggravated tensions in a way that risks spreading to the FX market. We cannot even rule out direct market interventions at a later stage. The Fed is now expected to follow up its July rate cut with three more cuts over the next year. Narrower interest rate spreads suggest a somewhat weaker dollar. We expect the EUR/USD exchange rate to be around 1.20 by end-2021. Other central banks such as the ECB have also shifted towards further easing, which makes a sizeable USD decline less likely. The dollar benefits from the global slowdown, which is another reason not to expect sharp USD depreciation as long as the Fed does not signal substantially more aggressive rate cut plans.

The British pound has taken a beating since it became clear that Theresa May would resign as prime minister. Her successor Boris Johnson's far tougher policy, with a cabinet ready to leave the EU on October 31 with no deal, has worsened relations with Parliament. Right now there is a major risk that the United Kingdom will crash out of the EU. The most likely path to prevent a no-deal withdrawal appears to be a government crisis. None of the alternatives appears especially favourable to the pound, and we expect further depreciation this autumn. In case of an orderly withdrawal and tighter British monetary policy, today's low valuation means the pound has room to regain lost ground ahead.

So far in 2019, the krona has again been the weakest among the G10 currencies. Although other small currencies have also lost value, the Riksbank's policy shift after its December rate hike has helped weaken the krona. The Riksbank is now expected to revise its rate path sharply lower and deliver no rate hike until the second half of 2021, pushing the krona even lower. An uncertain international environment, with risks of worsening trade conflicts, is not helpful to the krona either. We believe the EUR/SEK rate will climb towards 11.00 late in 2019. The krona is undervalued, which suggests some appreciation a bit further ahead. There are many indications, however, that the krona's equilibrium exchange rate has weakened over the past decade and is not especially far below 10.00 per euro. We thus foresee a modest appreciation, with the EUR/SEK rate reaching 10.00 by the end of 2021.

The weakness of the Norwegian krone is puzzling. Strong economic growth and inflation of around the central bank target have led to three rate hikes in the past year. We expect further hikes ahead. Despite a radically different interest rate situation from Sweden, the krone has weakened against traditionally defensive currencies this year. Perhaps SEK weakness has infected the NOK, or this weakness may reflect scepticism that Norges Bank can continue its rate hikes. Another reason may be that the global slowdown has lowered the oil price outlook. Yet it is hard to believe that the NOK's fundamental strengths will not eventually prevail. We predict an EUR/NOK rate of 9.60 by late 2020.

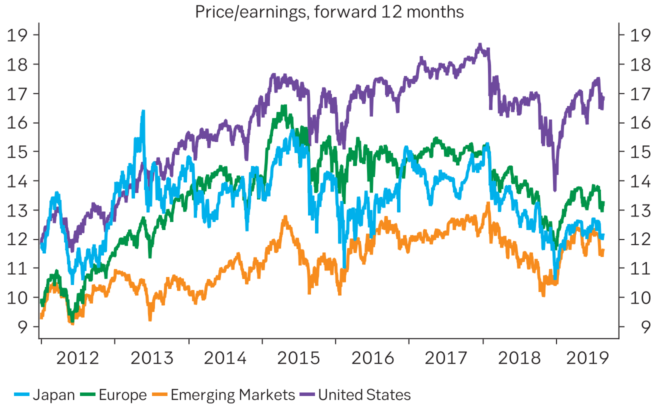
The stock market

Rising nervousness depresses markets

This year's stock market upturn, despite falling growth and earnings forecasts, seems to be over. Low bond yields – normally good for equities – are being interpreted as signals of weaker growth. Triggered by the trade war, worries about growth now dominate stock markets. A milder deceleration than feared, driven by soft central banks and by a more benign trade picture, may well be enough to drive new upturns – but concerns about growth and earnings are likely to predominate this autumn.

Less expensive stock markets, but not cheap

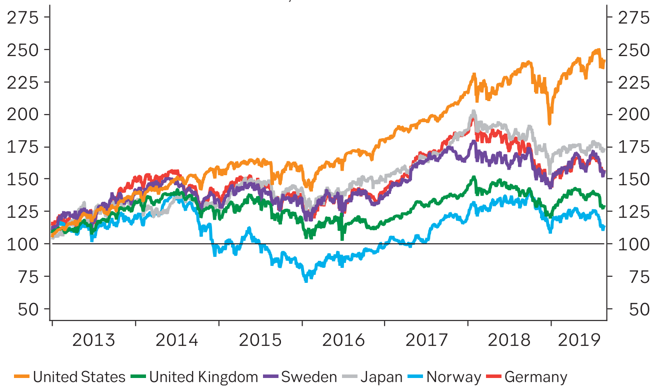
Price/earnings, forward 12 months



Source: Macrobond, MSCI, SEB

US stock market continues to outperform others

Total returns, USD. Index 2012=100



Source: MSCI, Macrobond, SEB

Rising share prices and falling growth not a healthy stock market cocktail. After last May's reversal, optimism returned – mainly driven by the prospect of further central bank stimulus. Meanwhile signals of decelerating growth continued. When tensions then escalated in US-Chinese trade talks and other sources of concern like Brexit, Italy and Hong Kong made themselves felt as valuations approached summer 2018 peaks, stock market turmoil returned.

Mixed messages in reports. Q2 earnings of listed companies turned out better than feared, but cyclical companies as a group signalled a rather clear slowdown in order bookings. This confirms our picture of slowing (industrial) activity, fuelling worries about future profits. The stock market views manufacturers as in or near a recession-like environment. There are rising concerns that this will spread to other sectors, but so far this has had no major impact on earnings forecasts. The consensus view of 2019 is now that although listed companies globally will not deliver any earnings increases, predicted earnings increases next year will be close to 10 per cent. This 2020 scenario is probably too optimistic, given the poorer sales outlook and squeezed margins due to rising wages. On the other hand, the forecast for this year may well be too low.

Double-edged yield situation. Low/falling bond yields support stock markets via valuations, but the question is what long-term growth outlook justifies extremely low and even negative yields on long maturities. Due to low yields, TINA (There Is No Alternative) is increasingly cited to explain this year's stock market upturn. But sooner or later, valuations will seize up. If growth and earnings perform as weakly as yields are signalling, this will deprive share prices of long-term fuel, making the market sensitive to changes in expectations. Our forecast of volatility above the historical trend remains. At the sectoral level, lower yields and flat yield curves are creating headwinds for banks. Both defensive (capital-intensive) sectors and those driven by structural growth will probably benefit, though, as illustrated by the continued good performance reflected in the reports of such recent stock market engines as the FANG companies (Facebook, Apple, Netflix and Google).

Cautious investors minimising potential losses. Surveys show that professional investors have adopted a cautious stance, also reflected in generally higher weighting of US equities despite the view that they are overvalued. EM equities have been down-weighted, taking a beating due to risk aversion and falling profit forecasts. The tug-of-war between trade and cyclical uncertainty and the impact of a dovish Fed on yields and currencies is creating a risk of stock market volatility. In the Nordics generally and Sweden specifically, the relatively large element of cyclical shares is making investors hold off, as reflected in weak relative performance this year – lowering the future potential of Nordic stock markets.

Cautious stock market upturn, with increased downside risks. Today's P/E ratios are a bit above historical averages and presuppose earnings increases of about 5-10 per cent yearly for a long time. This is not unreasonable, given our growth forecasts, but late-cyclical patterns with downside risks are currently pointing towards lower valuations. An immediate reversion to historical averages would lead to a decline in the 10 per cent range. If the adjustment occurs over a number of years, given our growth forecasts, this suggests weakly rising stock markets but at a somewhat slower pace than earnings. A more cautious projection of zero earnings growth and P/E ratios falling just below historical averages implies a larger downside, but this is not our main scenario. Clear growth support from central banks and less threatening trade relations may well suffice to turn the stock market mood optimistic. The increased risks of a more unfavourable stock market scenario are a clear call for caution in the near term.

Theme

Trade war & peace

World trade stagnation but not entirely due to Trump

Despite the "war" headlines, several new free trade pacts have been reached in 2019, for example tying the EU closer to Asia and South America and promoting trade among African countries. But US trade policy is unpredictable – with heightened uncertainty about both existing and expected agreements. White House tactics have helped disrupt the tech sector's global supply chains and portions of the auto industry. The contours of potential currency wars are also visible. There is an increased risk of sustained adverse effects on global GDP growth. US-Chinese talks are difficult but are expected to lead to partial results later this autumn. To summarise, we predict that world trade will recover slightly in 2020-2021 after weakening in 2019, but growth rate will still be far below the average of recent decades.

Global trade seized up late in 2018 and has shown zero volume growth so far this year (see chart below): well below the 2 per cent growth we expect early in 2019. The slowdown is still under way, according to the export component of global purchasing managers' indices. We predict that world trade volume will grow by 1 per cent in 2019, then stabilise at about 2 per cent in 2020-2021; in line with average since the financial crises but far slower than the average during pre-crisis decades.

We have identified five factors behind the slowdown:

1. Higher tariffs as part of the US-Chinese conflict
US and Chinese imports and exports have been hurt by the trade war, yet the total direct effect is marginal. Fed analyses indicate that US imports have fallen by about USD 70 billion, or by 0.5 per cent of total global imports. Countries like Vietnam and Indonesia have instead benefited from the US-Chinese conflict.

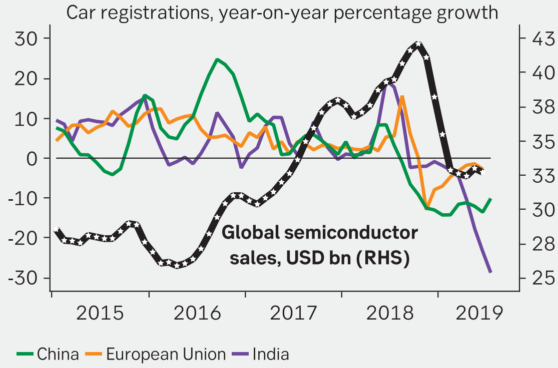
2. Less predictability, weaker investment cycle
Indirect adverse effects, caused by heightened uncertainty and frequent shifts in US trade policy, will increase as optimism decline and global supply chains need adjusting. But it is hard to distinguish what is the result of the tariff war specifically and what is due to a general global deceleration; economic slowdowns usually have a clear impact on global trade because of lower demand for such items as investment goods.

3. A deceleration in the technology sector

The tech cycle has shown a clear deceleration (see chart). This can be linked to lower demand as well as countries' attempts to protect their technology. The latter has made it harder to maintain global/Asian supply chains. Today the demand for mobile devices shows signs of saturation; new relatively high-priced models offer only marginal technical improvements. As a result, consumers are buying mobile services instead of new phones. According to an analysis by the International Monetary Fund[1], the tech sector accounted for about 1/6 of world trade two years ago.

Big declines in the tech and auto sectors

Car registrations, year-on-year percentage growth



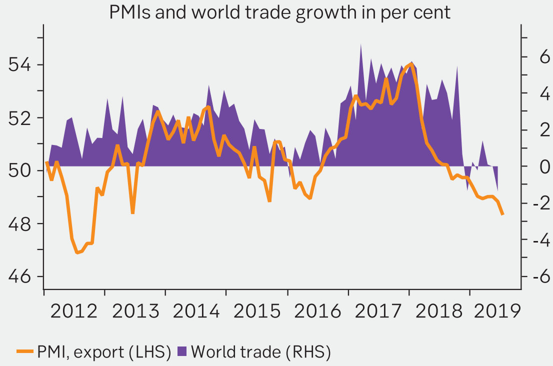
Source: Auto manufacturers' organisations, Macrobond, SEB

4. Weak car sales, mainly in China and India

Demand for cars has declined broadly, affecting other manufacturing sectors. In China, the world's biggest car market, sales fell 14 per cent year-on-year in the first half of 2019. Reasons included adjustments to new emission rules, elimination of tax rebates on car purchases that applied in 2015-2017, increased demand for (dearer) electric cars, tougher borrowing conditions (also in India), mounting concerns about the economy and stock market volatility. Car registrations in the US and Europe have shown good growth in the past 5-6 years, so a future slowdown seems logical.

Challenging outlook for global trade

PMIs and world trade growth in per cent



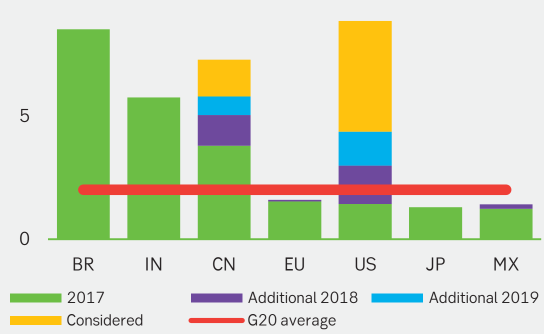
Source: Macrobond, SEB

5. Tighter export financing, due to banking regulation

The Bank for International Settlements[2] perceives a long-term negative association between increased regulation of the financial sector and export financing. This provides no obvious explanations for the global trade deceleration during 2018-2019, it but may affect the potential for a recovery in global trade.

Average tariff in selected G20 countries

Per cent according to the World Bank and SEB



New free trade agreements reached...

If there are problems in the two largest economies (the US and China), which account for 35-40 per cent of the world economy, this also becomes a global issue. Tariffs between advanced economies are generally low, but often high in emerging economies (see chart). In the past 18 months, US tariffs have climbed conspicuously. Yet it is worth noting that the rest of the world has meanwhile taken several major steps, especially in symbolic terms, towards increasing free trade between countries and regions. Some examples:

EU-Japan: A new pact took effect Feb. 1, 2019. The EU and Japan make up 20 per cent of the world economy.
EU-Mercosur: In June the EU reached an agreement in principle with Brazil, Argentina, Uruguay and Paraguay covering 90 per cent of EU-South American trade and about 20 per cent of the world economy.
African Continent Free Trade Agreement (AfCFTA): By July 2019 all 54 African economies had signed the pact. This has great symbolic value, even though Africa only accounts for 5 per cent of the world economy.
US-Japan: Both sides have expressed optimism on the chances of achieving a new trade pact this autumn.

...but new breakdown after Shanghai talks

During the G20 summit in Japan late in June the US and China agreed to resume their talks, which had broken down in May. The White House pledged to hold off on new tariffs on Chinese goods until further notice. This 12th round of talks broke down in late July, causing President Donald Trump to threaten new 10 per cent tariffs on USD 300 billion worth of Chinese goods starting September 1. China responded by halting virtually all imports of US farm goods until further notice and allowing the Chinese yuan to lose value against the dollar. This led the US to label China a currency manipulator (see the box on China's potential to use its currency in the ongoing trade war).

[1] See "*A New Smartphone for Every Fifth Person on Earth: Quantifying the New Tech Cycle*", IMF WP/18/22.

[2] See "*What is behind the recent slowdown?*", speech by Hyun Song Shin, BIS, May 14, 2019.

In August, Trump decided to delay some new duties until December 2019, a step that could be seen as the US wanted to avoid increasing tensions with Beijing. However, ahead of the G7 meeting in France in late August, China announced retaliatory tariffs on USD 75 billion of US imports. President Trump escalated the trade war by announcing a wave of higher tariffs (most tariffs will be raised by 5 percentage points).

The yuan: a new trade war weapon?

After the US announced new tariffs on August 1, China allowed its yuan to depreciate past 7 per dollar for the first time since spring 2008 (see chart). This was a clear signal to the US. A weaker yuan would provide some relief to manufacturers hurt by US tariffs. But for China, the disadvantages outweigh the advantages:

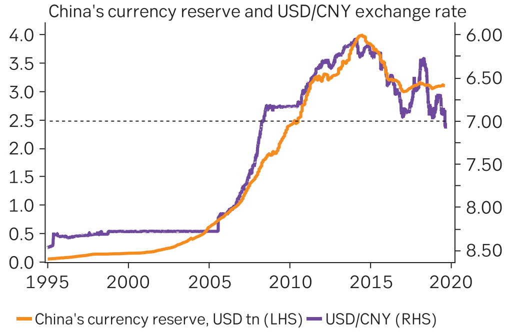
Destabilising capital outflows. Chinese firms can replace USD loans with CNY loans, thus creating large capital flows. China's dollar-denominated debt is estimated at USD 3 trillion. Foreign firms in China can increase their currency hedging level, thus also creating large capital outflows.

Decreased capital inflows. China's currency policy is a key factor in making its stock and fixed income markets more attractive to foreigners and giving the yuan global reserve currency status.

G20 agreement. China wants to project an image as one of the foremost friends of globalisation and trade. An obvious yuan depreciation policy would jeopardise that image and also violate the G20 agreement. The yuan is now being traded at close to its equilibrium exchange rate.

USD/CNY surpasses historic 7.00 level

China's currency reserve and USD/CNY exchange rate



Source: Macrobond, SEB

Large economic assets are at stake for the US and China, but it is also a matter of political tactics and of two countries on a collision course in terms of ideology, security policy and global/regional leadership in the Fourth Industrial Revolution. As for trade, US demands include increased farm exports to China and protection of American technology. China wants removal of tariffs and realistic requirements on how much goods it should import from the US. New talks are still expected to begin in September; we expect some progress later this year, but at a slow pace.

...but there are other sources of conflict

The June G20 summit in Osaka underscored the need to quickly reform the World Trade Organisation (WTO) and aimed at achieving results at the WTO meeting in Kazakhstan in June 2020. By December 2019, though, the WTO Appellate Body will cease to function because the US is blocking the appointment of new members.

But the US also plays a key role in other conflicts – aside from those with China and the WTO:

US-India: Since early 2018 the US has boosted tariffs on 14 per cent of all imports from India. New Delhi has reacted by raising tariffs on 6 per cent of imports from the US. Talks seem to be moving ahead very sluggishly. **US-EU**: The two sides are observing an uneasy truce, with an ongoing dialogue in the shadow of the US-China conflict. Trump decided in May to delay announcing tariffs on car imports from the EU. An agreement must be reached by November 13 or he may impose them. **Japan-South Korea**: Technology sector growth is being hurt by another worsening international conflict, after Japan imposed restrictions on exports of certain high-tech components. This conflict has a history stretching back to Japan's occupation of Korea in 1910-45. The US has been called in as a mediator in the conflict.

A picture of war & peace in global trade

Despite the various conflicts, the world has taken positive steps in the free trade field over the past year. But unpredictable White House trade policy – including threats to suspend existing agreements (such as with Mexico – has caused persistent uncertainty and varying degrees of damage to global supply chains. The above-listed five reasons for the global trade slowdown include both temporary and more permanent forces.

Oil and other commodities, autos, auto parts and high-tech products are among the biggest elements of global trade. If the growth contributions from these products decline for various reasons, while fossil fuels are phased out, global trade volume is likely to fall despite increased trade in other goods and services. Our forecast of weak growth in world trade during our forecast period – totalling 1-2 per cent yearly – is well below historical growth of 5 per cent and somewhat below the 2.5 per cent yearly average since 2012.

The global economy

The United States

1.5 %

Our forecast of the Federal Reserve's key interest rate by mid-2020. We expect the Fed to deliver three more "insurance cuts" in order to prolong an already historically long expansion.

Page 19

The euro area

-0.60 %

The European Central Bank will ease its already loose monetary policy further, cutting the deposit rate by 0.10 percentage points in September and December 2019 to -0.60 per cent.

Page 25

The United Kingdom

4.4 %

The British household savings ratio remains low.

Page 31

China

7.00

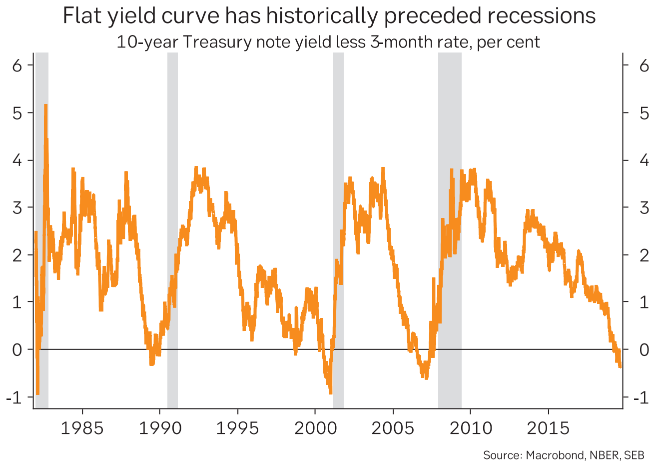
The approximate USD/CNY exchange rate. China is accepting a decline in the value of the yuan against the US dollar.

Page 34

The United States

The Fed's rate cuts will prolong the upturn

The escalating trade conflict with China and its interaction with nervous and pessimistic financial markets are creating clear downside risks for the US economy after a lengthy upturn phase, but the Fed's partial reversal of its earlier rate hikes will increase resilience. We expect the central bank to deliver three more "insurance" cuts, bringing the key interest rate to 1.50 per cent by mid-2020. Our main scenario is that the economy will gradually decelerate to below trend but avoid a recession.



Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	2.9	2.3	1.8	1.7
Unemployment*	3.9	3.6	3.5	3.7
Wages and salaries	3.0	3.3	3.4	3.3
Consumer Price Index (CPI)	2.5	1.7	1.9	2.0
Core PCE (the Fed's target variable)	1.9	1.6	1.8	1.8
Federal budget balance**	-5.3	-4.9	-4.6	-4.6
Federal debt held by public**	106.8	108	109	110
Fed funds rate***	2.50	1.75	1.50	1.50

* Per cent **Per cent of GDP ***At year-end. Source: Macrobond, SEB

Gradual deceleration, with increased downside risks

The US economy has remained robust amid a weak international environment but growth has slowed clearly, from a peak of 3.5 per cent in mid-2018 to an average of just above 2 per cent during the past three quarters. Meanwhile we are seeing few of the imbalance symptoms – over-investments, mounting debts and financial bubble risks – that have traditionally preceded a recession. Our forecast is a gradual US deceleration from 2.3 per cent this year to growth somewhat below trend during 2020 and 2021, when we expect GDP to increase by 1.8 and 1.7 per cent, respectively.

Uncertainty in trade and financial markets. In a theme article on page 22, we discuss the tricky balancing act that forecasters face in the current late-cyclical phase, while noting that the US economy is surrounded by greater uncertainty than usual. One classic warning signal – the gap between 10-year Treasury and three-month yields – has fallen to levels that have normally been followed, after a lag, by a recession. Yet the Federal Reserve has responded faster than has often been the case, which has lowered the risk of a policy mistake. Inflation has remained moderate, increasing the Fed's manoeuvring room. We expect the Fed to take advantage of this in an effort to further prolong an already historically lengthy upturn phase and counter the negative sentiment effects of the trade war.

Diminishing support from fiscal stimulus. The tight labour market is setting limits on the expansion, and slower job growth will hamper consumption growth. Meanwhile fiscal stimulus will fade. After a stimulus effect equivalent to about 0.5 per cent of GDP in 2019, we expect more neutral fiscal policy in 2020 and 2021. This summer's bipartisan budget agreement has removed the threat of disruptive new budget battles in the near term and has reduced the danger of major fiscal tightening next year. The US will not risk bumping up against its debt ceiling until mid-2021, well past next year's elections. Now that the spending framework for 2020 and 2021 has been enlarged, there will also be greater room for reforms when negotiations about next year's budget begin. Because President Donald Trump needs the votes of congressional Democrats, who want to match higher defence appropriations with higher spending in other fields, another expansionary budget is likely in the election year 2020. Federal deficits will thus remain at historically high levels, nearly 5 per cent of GDP, at the end of our forecast period.

Weakness concentrated in manufacturing. The ISM purchasing managers' index (PMI) for manufacturing has fallen in line with its counterparts elsewhere and as world trade has shrunk. It now remains at only weakly expansive levels. Both exports and business investments were down in the second quarter. The domestic economy has been more resilient and will benefit from lower interest rates. The downturn in the construction sector is showing signs of levelling off. Household and small business confidence indicators are still at high levels, the labour market has remained strong and the deceleration in private consumption early in 2019 was followed by an upswing in the second quarter. The ISM non-manufacturing PMI has recently fallen, indicating a risk that the slump in manufacturing may spread to the rest of the economy, but overall data do not yet indicate that the US is on a path to recession.

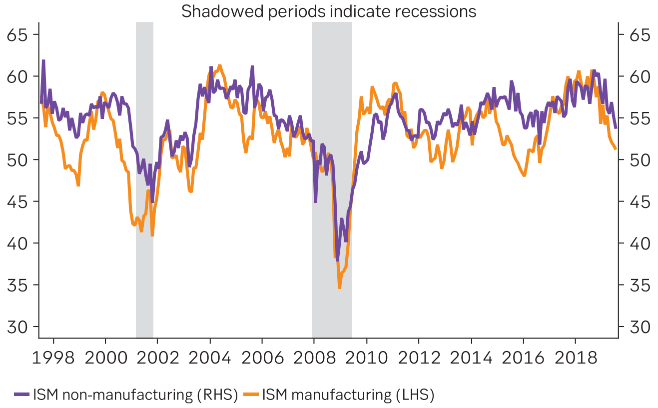
Trade war is escalating; few signs of quick solutions. In May's *Nordic Outlook*, our main scenario was that the US and China will reach a trade agreement. The G20 summit in late June brought temporary relief, with both countries deciding to resume negotiations. Since then, the conflict has escalated again. On August 1, Trump unexpectedly announced that the US will impose 10 per cent tariffs on the remaining USD 300 billion worth of imports from

China on September 1 and that a further increase to 25 per cent is conceivable. China responded by letting the yuan depreciate and by halting government imports of US farm products. After that, the US officially labelled China a currency manipulator – a step that is mainly symbolic in a situation where the US has already imposed higher tariffs. Plans for continued negotiations remain and the two sides have taken steps to calm the situation (such as the US decision to postpone the recent tariffs hike for certain consumer products) but lately the conflict has escalated once again with new tariffs from both sides. The trade conflict thus looks set to become deeper and more prolonged than we previously assumed, with growing economic damage as a consequence.

We should instead draw a comparison with the mid-1990s, when the Fed cut its key rate in three steps despite a continued downward unemployment trend

Declining sentiment in services is also a downside risk

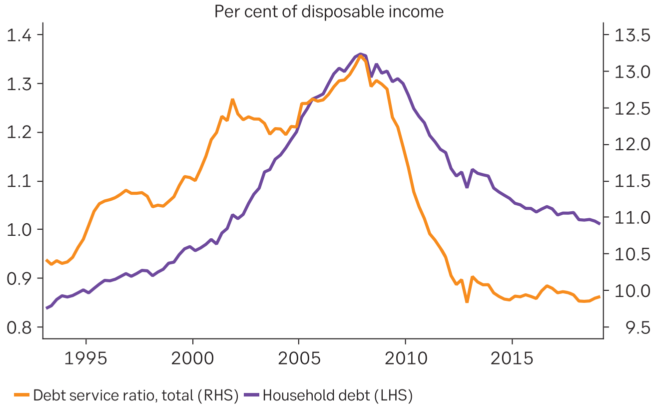
Shadowed periods indicate recessions



Source: Institute for Supply Management (ISM), Macrobond, NBER, SEB

Modest household debt and debt service costs

Per cent of disposable income



Source: Federal Reserve, Macrobond, SEB

The threat to the economy does not come mainly from direct effects on trade and import prices, but above all from uncertainty and disrupted global supply chains. Read more about US trade conflicts in the theme article on page 15.

International uncertainty slows investment, exports

During the first half of 2018, capital spending showed clear signs of speeding up but activity has dwindled since then. Last year's US tax cuts thus do not appear to have triggered the upswing that many had hoped for. In the second quarter of 2019, capital spending even fell for the first time since 2015. This is probably due in part to increased uncertainty about trade policy, which is expected to continue holding back investment activity. Residential construction has retreated for six consecutive quarters, but looser monetary policy has caused sentiment to climb. Meanwhile home sales have recovered somewhat this year, and construction is expected to show positive growth again. Cyclical sectors (construction, machinery and equipment investments and purchases of consumer durables) have generally remained at low levels as a share of GDP: a few percentage points below their peaks prior to earlier economic slowdowns. This lowers the risk that such fluctuations will lead to a recession in the entire economy. If we also include investments in intangible assets (software plus research and development), business investments (excluding homes) as a share of GDP is more in line with the latest peak in mid-2008 and about one percentage point below the level in 2000. Overall, business investments will slow from last year's growth of nearly 5 per cent to just above 2 per cent this year and a bit over 1.5 per cent in 2020 and 2021.

The high dollar and weak external demand are likely to hurt US exports, which fell in the second quarter after a strong start to the year. We forecast largely unchanged exports this year, followed by increases of 1.5 per cent in 2020 and 2 per cent in 2021. Since domestic demand is decent, foreign trade is expected to make a continued negative contribution to growth. As long as the US is growing faster than other economies it will be difficult for Trump to bring down the size of trade deficits, despite new trade barriers.

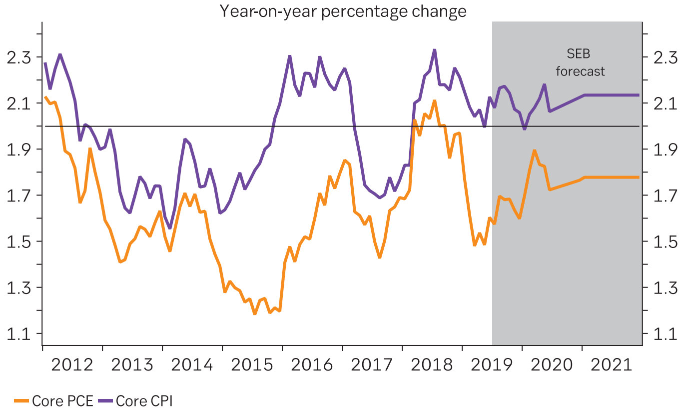
Good household resilience. A combination of falling share prices late in 2018, a partial shutdown of federal government operations and the Fed's key rate hikes had a clear negative impact on private consumption in late 2018 and early 2019, but a clear recovery was evident during the second quarter. A near 150 basis point decline in 30-year mortgage rates since November triggered a resurgence in refinancing applications, enabling households to lower their mortgage payments. Households are in good financial shape. Since the crisis a decade ago, their debt burden has continued to shrink as a percentage of income. Mortgage interest and repayment costs remain at historically low levels. The household savings ratio has climbed to around 8 per cent during the past 2-3 years, thereby also creating room for consumption in a situation where consumer confidence is still at high levels. However, the pace of consumption growth is slowing and will reach around 2.5 per cent in 2020 and 2 per cent in 2021.

Moderate pay hikes decrease overheating risks

Various labour market indicators have levelled off at high readings. Non-farm payroll growth slowed from an average of more than 230,000 new jobs per month in the last quarter of 2018 to a monthly rate of 140,000 in the past three months. The downturn in unemployment has stopped, but the July jobless rate of 3.7 per cent is half a percentage point below the Fed's latest estimate of equilibrium unemployment, 4.2 per cent. Labour market participation has remained low, at 63 per cent compared to a peak of 67 per cent in 2000. This partly reflects an ageing population, but even among people in prime ages, 25-54 years, the participation rate is several points below the previous peak. This means there is room for continued job growth. We are sticking to our forecast that unemployment can fall somewhat lower, to around 3.5 per cent by year-end. The still moderate rate of pay increases suggests that the labour market is not yet overheated. Despite some acceleration in recent months, the 3.2 per cent July rate of increase in hourly wages is still somewhat below the levels of early 2019. We believe that pay hikes may speed up a bit further as the labour market continues to tighten, but that they will stay at historically moderate levels: around 3.4 per cent in 2020 and 3.3 per cent in 2021.

Fed's favourite measure will remain below target

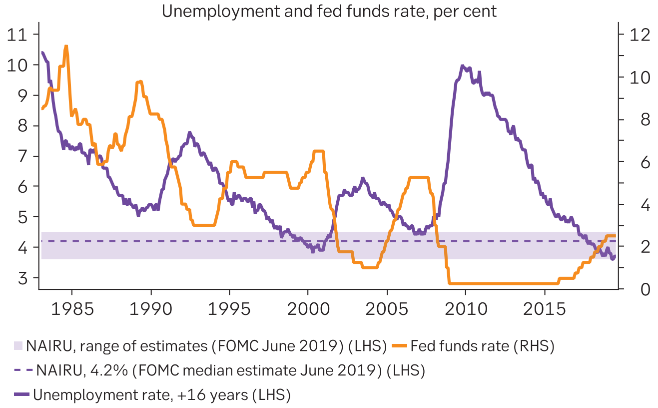
Year-on-year percentage change



Source: Macrobond, SEB

Fed took a chance with the labour market in the 90s

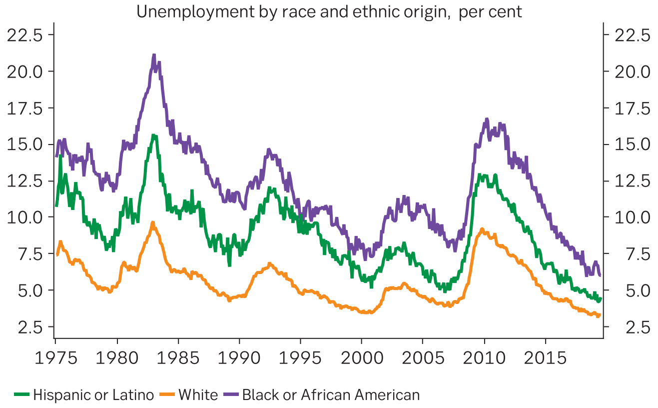
Unemployment and fed funds rate, per cent



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

Weak groups have seen large declines in unemployment

Unemployment by race and ethnic origin, per cent



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

Inflation is uncomfortably low for the Fed. Both total inflation and core inflation (excluding food and energy prices) have cooled somewhat since last year. The Fed's target variable, core PCE (using the personal consumption expenditures deflator), stood at 1.6 per cent in June – well below its 2 per cent target – while inflation expectations based on market pricing have again fallen. Gradually accelerating wage inflation can be expected to exert some upward pressure on the figures during the next couple of years, but continued downward pressure on world market prices for consumer goods will have the opposite effect. Higher tariffs do not seem to have had any significant impact, but the most recently announced US tariff hikes will affect consumer goods to a greater extent, increasing the upside risk. One restraining factor, however, is that certain imports from China are expected to shift to other countries. Meanwhile the strong US dollar will hold down import prices generally. Tough competition in the retail trade also makes it hard for retailers to pass on their cost increases to consumers. Overall, our forecast is that underlying inflation will be largely unchanged at around 1.8 per cent for core PCE during 2020 and 2021.

More "insurance" cuts by the Fed can be expected

Last year's Fed rate hikes appear to have started affecting the economy, for example by cooling the housing market. Plunging share prices late in 2018 also challenged the strategy of letting the tight labour market steer monetary policy. The Fed's strategy shift in early 2019, when it shelved further rate hikes, as well as this summer's rate cut and the end of the Fed balance sheet reduction (two months early) have changed the situation, however. The Fed described its July cut, which brought its key rate from 2.50 to 2.25 per cent, as a mid-cycle adjustment rather than as the beginning of a series of rate cuts. By easing monetary policy despite the prevailing strong labour market situation, the Fed is going against the pattern of its most recent rate cutting phases. We should instead draw a comparison with the mid-1990s, when the Fed cut its key rate in three steps despite a continued downward unemployment trend. The downside risks from trade conflicts appear likely to continue, which suggests that the Fed will carry out additional "insurance cuts". We now believe that the next one may occur as early as September, followed by further rate cuts in December 2019 and the first quarter of next year. This would bring the federal funds rate to 1.50 per cent by mid-2020.

Several arguments for cuts despite record-low unemployment. In its market communication, the Fed has highlighted several arguments for a looser monetary policy. 1) A low neutral interest rate, which increases the risk of again hitting the zero lower bound. In June the Fed again revised its estimate of the neutral interest rate downward from 2.8 per cent in March to 2.5 per cent. 2) A greater need to factor in global developments, as well as the impact of the Fed's own monetary policy on other countries and on financial markets. The trade war is intensifying these risks. 3) A greater willingness to test the limits of the labour market in order to boost labour market participation among weaker groups as well. Last spring the Fed held meetings around the country, and one message for the Fed was that the long upturn phase in the labour market has improved the job chances of low and middle income earners in a way that had not happened for several decades. The merit of not prematurely cooling down the labour market is also supported by new IMF research that points to the occurrence of positive "hysteresis effects". In other words, an upturn in labour force participation late in an economic expansion may lead to a lasting increase in the participation level.

Theme

Recession risks

Recessions are hard both to define and to predict

The global economy is at a crossroads. Its current healthy performance will either continue or – as some observers fear – abruptly end. This theme article discusses various definitions related to the “recession” concept and the potential for predicting outbreaks of recession. Economic forecasts often include various forms of soft landings. Although history shows that soft landings as such rarely occur, they may still serve as a reasonable scenario, considering that long-term forecasts are often inaccurate. This is even truer after the Federal Reserve’s recent shift in a more pragmatic and dovish direction, which lowered the risk that policy mistakes will trigger a recession.

Weak predictive power

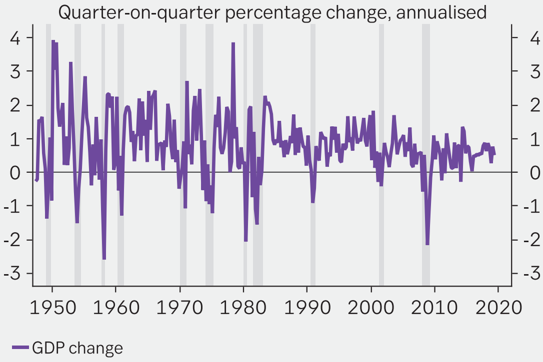
The US expansion has now lasted for over 10 years, breaking a modern-day record. This is one reason why current discussions of the economy focus on the risks and probability of a coming new recession. We have now expanded our forecast horizon to the end of 2021, further highlighting the question of how long the economic upturn can actually last. It is important to note that the predictive power of forecasters diminishes the further they peer into the future. Evaluations by Sweden’s National Institute of Economic Research (NIER), the Riksbank and the Swedish government show that forecasting errors for the year t+2 (now 2021) are often very large. Using such a time horizon, forecasters have difficulty even surpassing a “naïve” projection of historical average GDP growth. Despite this lack of predictive power, it is still valuable if forecasters try to determine where we are in the economic cycle, and whether the economy is likely to grow more slowly or rapidly than its underlying trend. Without such estimates, it is difficult to draw any financial market conclusions from a macro forecast.

Different definitions a headache

Worth noting is that there is no unambiguous definition of the “recession” concept. One simple and often-used definition is two successive quarters of falling GDP. The US National Bureau of Economic Research (NBER) has a broader definition that includes other variables besides GDP, such as employment, industrial production, incomes and retail sales. The important thing is to look at the whole economy, not just subsectors. But there is no quantitatively clear definition. In practice various definitions have fortunately coincided.

United States: GDP changes and recessions

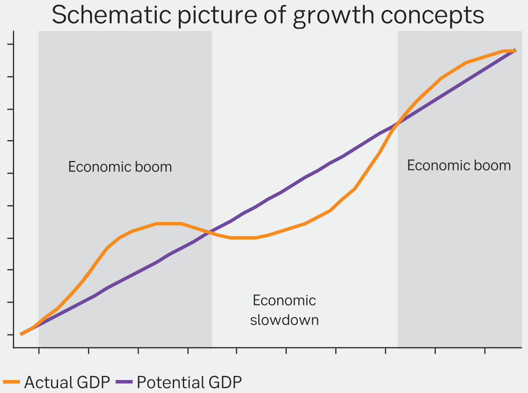
Quarter-on-quarter percentage change, annualised



Source: OECD, Macrobond, SEB

Focusing on change or level? The above recession concepts focus mainly on changes in variables such as GDP growth and unemployment. From a stabilisation policy standpoint, it is often more important to determine where, in terms of levels, we are in the cycle. In that case, GDP gaps – or output gaps – and equilibrium unemployment are important concepts. Sometimes the concept of an economic boom is defined (for example by the NIER) as a situation where GDP growth is actually above the level considered sustainable in the long term. If so, decision makers should consider enacting austerity measures, whereas they should consider stimulus measures during an economic slump or slowdown – when there are idle resources in the economy and actual GDP growth falls short of potential growth. One advantage of level concepts is that they can be decoupled from actual GDP growth. Recession concepts defined only on the basis of a given growth rate – such as two straight quarters of negative GDP changes – may be misleading when examining long periods during which underlying productivity and labour supply trends vary sharply. Of course, negative GDP growth has a more serious impact on unemployment in an environment with rapid rises in productivity and in the underlying labour supply.

Schematic picture of growth concepts



Källa: Macrobond, CBO, SEB

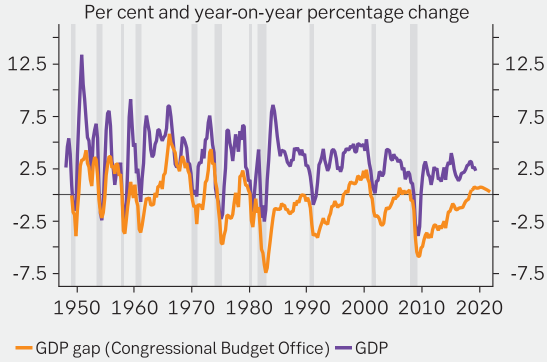
Definition and reporting problems with GDP gaps. But there are important problems with level-based metrics that decrease their relevance. For example, they are not directly observable and can be defined in a number of competing ways. Because wages and prices have reacted so little to the historically low unemployment of recent years, this creates extra big interpretation problems, enabling different definitions of resource utilisation to result in totally different results. These metrics also undergo rather dramatic revisions, and something which initially seemed to be a normal economic situation may later look like obvious overheating. Later assessments of the economic policies that were employed may thus be unfair. This is one reason why decision makers hesitate to tie economic policy reaction functions too strictly to gap metrics.

Soft landings: Unusual, but reasonable

The usual historical pattern has been that an economic downturn has begun with a recession, when GDP has normally fallen. In recent decades, US recessions have been fairly clear, with financial market drama and surging unemployment. This was especially true of the recessions that occurred in the wake of the real estate crash of the early 1990s and the Lehman Brothers crash of 2008, while the downturn following the IT (dotcom) crash around the turn of the millennium was milder. Once recession has broken out, it has been amplified by underlying financial imbalances. These recessions have then been followed by long periods of growth recovery, but where the economy has still been dominated for a rather long time by lower-than-normal resource utilisation and has thus been in a slump, as defined above. Booms – periods of GDP growth above what is potentially sustainable – have been relatively short. According to NBER's current estimates, slumps were far shorter during the period 1950-80; boom periods were instead longer (see chart).

US: Output gaps and recessions

Per cent and year-on-year percentage change



Source: OECD, CBO

Will history repeat itself? One fundamental methodological question for a forecaster is to what extent they should take historical patterns into account and try to re-create them in forward-looking forecasts. This applies to timing – when it is reasonable to expect a recession to occur – as well as amplitude, that is, how deep it will be. The ongoing expansion phase has already broken the post-war record of 120 months, set in the 1990s. Meanwhile estimates from NBER, the IMF and other organisations suggest a slight overheating – equivalent to about 1 per cent of GDP. During the past three months, actual unemployment has averaged 3.7 per cent, which is well below the Fed's estimate that equilibrium unemployment is 4.2 per cent. The flat and sometimes negative slope of the yield curve, which has historically been a good recession indicator, is also signalling that a recession may be close at hand.

Deceleration towards a normal economic situation. Although it is thus not difficult to find arguments pointing to a US downturn during the next 2-3 years, most observers abstain from including a genuine recession in their forecasts. One common method when looking ahead a few years is instead to let the economy shift slowly towards normal resource utilisation. Such a "soft landing" is often designed (for example by the IMF) by forecasting that for a few years, growth will be a bit below its potential rate. Potential GDP growth in the US is estimated at around 2 per cent in the next couple of years. There are many indications that actual GDP growth in 2019 will be higher than this and that the "overheating gap" this year will thus increase further. Based on CBO and IMF projections, the US economic boom will culminate in late 2019, with a positive GDP gap of around 1½-2 per cent. Given our forecast of GDP growth, 1.8 per cent in 2020 and 1.7 per cent in 2021, the gap would shrink slightly to just over 1 per cent in 2021. Because it would not close, the US would thus experience a boom throughout our forecast period, even though our forecast is below the consensus (average) among economists. Both the IMF and the Fed forecasts are also higher than ours.

Methodological and economic arguments for caution. Looking ahead, we can certainly expect a debate on whether economists are too cautious or cowardly in their forecasts. Aside from the record-long upturn and overheating tendencies, there are also geopolitical threats such as trade wars and uncertainties about the EU project, especially related to the increasingly convulsive Brexit process. History also shows that soft landings rarely materialise, but the fact that predictions a few years ahead are so inaccurate is an important argument for avoiding spectacular recession forecasts.

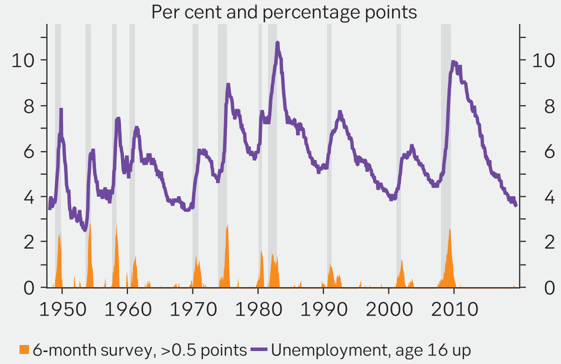
Moderate debt. But there are also underlying arguments against a forecast in which the expansion merely "dies of old age". The current debt level in the US private sector, especially households, is relatively moderate: one reason why the "financial cycle" is not at all as mature as the traditional economic cycle, in which the labour market plays a major role. This reduces the disadvantages of continued expansionary monetary policies, while lowering the risk that the private sector's need to repair its balance sheets will initiate or amplify an economic downturn.

Continued low inflation is the weightiest argument against a recession forecast. The Fed's shift from its rather solid rate-hiking plan of late 2018 to openness to considering follow-ups after its "preventive insurance" rate cut in July 2019 has also changed the playing field. The risk that the Fed might trigger a recession due to policy mistakes – dogmatic rate hikes – has largely been eliminated. Although we cannot rule out the possibility that the tight labour market will finally push up pay and prices, our main scenario is that inflation will be modest, giving the Fed great flexibility in continuing to support the economic upturn. In such a situation, it is not very costly for the central bank to try to prolong the upturn and test how low unemployment can fall and whether it is possible to stimulate more demand.

A mild recession is not very likely in the US. A path midway between a forecast that the "overheating gap" will merely close and a genuine recession of the type we have seen in recent decades is also conceivable. Such "light recessions" have been relatively common in Japan during the past few decades. Western Europe also experienced one around 2015. They have not occurred in the US, probably partly because so-called automatic stabilisers there are so weak. Once job growth decreases and unemployment begins to climb, both public sector and private consumption will be severely affected. At the state level, direct cuts in operations will become necessary as tax revenues shrink, since federal subsidies are generally not forthcoming. Meanwhile unemployment compensation and other forms of income support to households are far weaker than in Europe. Once unemployment has risen by about 0.5 percentage points, the US economy has generally entered a downward spiral in which fiscal and real economic forces amplify each other. Federal Reserve rate cuts have only helped ease the process and have not been enough to stop it, so forecasters have history against them if their main scenario is a very mild forecast. This is especially true of major institutions such as the IMF and the World Bank, which have the potential to influence the expectations of markets and other actors.

Unemployment and recessions

Per cent and percentage points



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

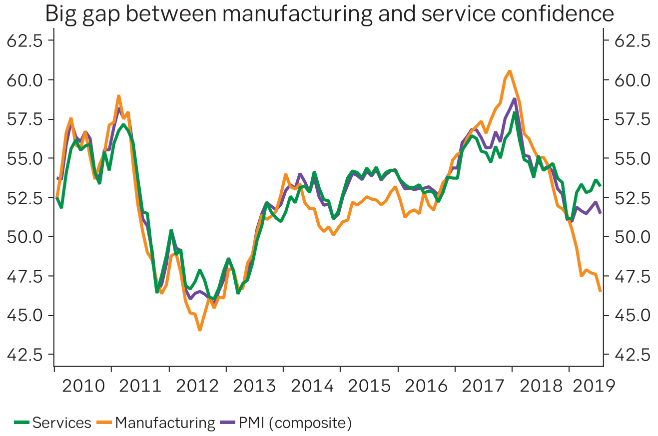
To summarise, weak long-term predictive power, moderate US private sector debt and the prospect of continued low inflation will lead mainstream forecasters to be cautious about making a US recession their main scenario. They will instead probably continue to warn of risks related to both the mature economic cycle and various political sources of concern. There is likely to be a continued discussion as to whether this should be described as a result of exaggerated caution or of a realistic humility about their ability to predict the future.

The euro area

Resilient to German industrial weakness

The euro area economic picture remains divided. Manufacturing – led by Germany – continues to weaken, but sectors more dependent on domestic demand are showing resilience. This will support a slight recovery over the next couple of years. The ECB will contribute to this process by supplying more stimulus; we expect a deposit rate of -0.60 per cent. Fiscal policy will also help drive growth, which will accelerate from 1.0 per cent this year to 1.1 per cent in 2020 and 1.3 per cent in 2021.

Big gap between manufacturing and service confidence



Source: IHS Markit, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.9	1.0	1.1	1.3
Unemployment*	8.2	7.6	7.2	7.1
Wages and salaries	2.2	2.4	2.5	2.5
CPI	1.8	1.2	1.2	1.5
Public sector balance**	-0.5	-0.8	-0.8	-0.8
Public sector debt**	85.1	84.4	82.7	82.7
Deposit rate***	-0.40	-0.60	-0.60	-0.60
EUR/USD***	1.14	1.13	1.17	1.20

* Per cent **Per cent of GDP ***At year-end. Source: Eurostat, SEB

Gaps between sentiment indicators lead to questions

Composite purchasing managers' indices (PMIs) for the region as a whole have stabilised at a bit above 50 in recent months, pointing to quarter-on-quarter growth of around 0.2 per cent. Service sector sentiment has improved in the past six months, while manufacturing has continued downward to its lowest PMI level since the 2012 euro crisis. The gap has been equally wide only twice before in recent decades (in 1998 and 2008-2009). The divergence between sectors and countries is making the outlook less clear. Due to Italy's budget problems and political uncertainty, its growth is stagnating. New short recessions may occur. Stimulus measures will help France to grow faster than Germany in the next couple of years. Spain, the growth pacesetter (among the Big Four economies) in recent years, is decelerating. Germany's problems are slowly fading, but its anaemic GDP trend is holding down overall growth in the region. Euro area weaknesses have been more stubborn than we expected. We are revising our GDP growth forecast slightly lower to 1.0 per cent. Industrial weakness, Brexit and trade worries will continue to hamper growth, but absent further major disruptions, this is not enough to push the region into recession. Instead we foresee a slight recovery to 1.1 per cent growth next year and 1.3 per cent in 2021.

Hangover for German manufacturers after a long period of success. Germany's export machinery is sputtering, causing concern both there and in the region as a whole (the role of the vehicle industry is analysed in a theme article on 28). Quarter-on-quarter GDP growth in Germany is currently around zero. German manufacturing weakness can also be viewed in a longer perspective. Over the past 20 years, German industry has shown impressive development. It has gained ground internationally and, unlike in other countries, has also expanded its share of the economy (see chart on next page). Its success culminated in 2016-2017, when the global economy reached a German-friendly peak. The recent weakening can be viewed partly as a natural reaction to this long expansion. Order levels and capacity utilisation nevertheless remain at levels that indicate growth, not a crisis or recession.

Increased exports, despite a varying international outlook. Unexpectedly strong demand from the US and China this past spring contributed to a minor surge in exports, but the outlook ahead appears mixed. Generally rising global activity in 2020 and 2021 will provide support, even if US and Chinese GDP growth gradually decelerates, while the Brexit process will create unclear conditions. Unexpectedly weak imports have helped to keep the region's current account surplus strong. In 2018 it was the second-highest ever. We expect some decline ahead, but the surplus will remain above 2 per cent of GDP throughout our forecast period.

Household consumption reflecting some caution. As international demand has weakened, domestic demand has held up relatively well. Households have benefited from job growth, and low inflation has led to increased real purchasing power despite subdued pay increases. Meanwhile home prices are climbing in most euro area countries, with Italy as a major exception. Consumer confidence has fallen from its peak of just over one year ago but is at a level that suggests some upward potential for consumption. We nevertheless believe that households will step up their saving a bit in response to greater uncertainty, which will slow the upturn in consumption.

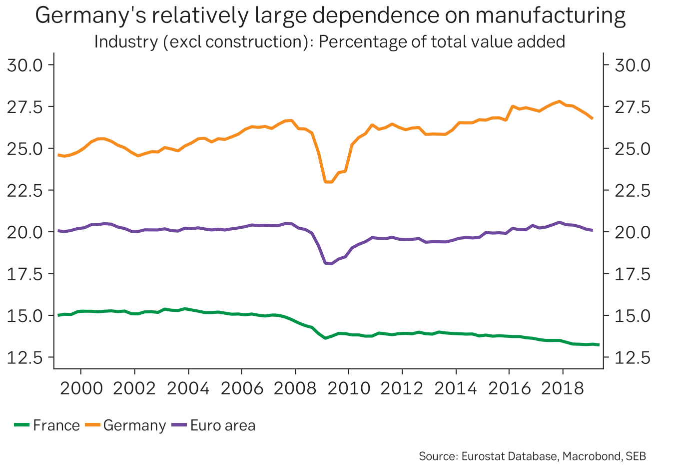
Downside risks predominate. Although resilient domestic demand will prevent a recession, according to our main scenario, the risk picture is predominantly negative. Aside from falling sentiment in the manufacturing sector and the effects of threatened escalation of the US-Chinese trade conflict, the euro area is struggling with constant political uncertainty at many levels. These include problems in forming a Spanish government, an aggressively EU-sceptic government in Italy and budget-related quarrels between member countries and Brussels. The impact of a hard Brexit could be significant, especially for the already hard-pressed German and French auto industry. Many countries are also plagued by high unemployment and government debt, which would make them vulnerable once a downward spiral begins. Positive potential surprises are far more limited, especially since unemployment has now fallen to the same level as before the financial crisis. Supply side restrictions are thus no longer as remote a possibility as before.

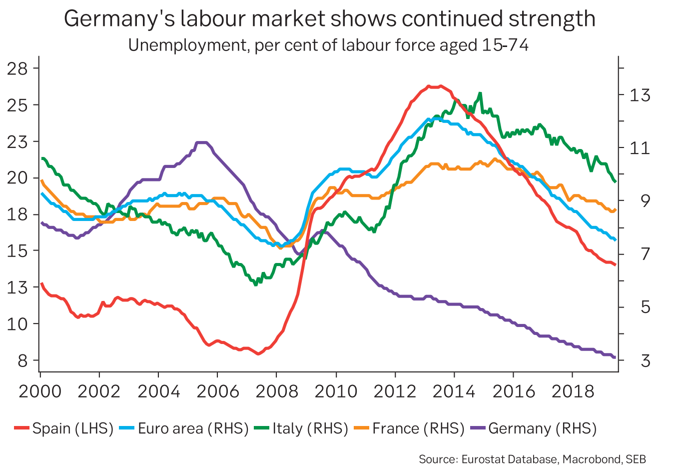
GDP growth forecasts

Year-on-year percentage change

	2018	2019	2020	2021
Germany	1.5	0.5	0.7	1.2
France	1.7	1.2	1.3	1.4
Italy	0.9	0.1	0.6	0.8
Spain	2.6	2.3	2.0	1.8
Euro area	1.9	1.0	1.1	1.3

Source: Eurostat, SEB





Loose fiscal policies will not change the playing field

Public finances have continued to improve, despite criticism of some countries for a lack of fiscal discipline. All euro area countries now have deficits below 3 per cent of GDP. Last year the overall deficit fell to 0.5 per cent of GDP: about the same as the earlier best level in 2000, but there are sizeable variations. In 2018 Germany's budget surplus reached a new record, 1.7 per cent of GDP, while the fiscal deficits in France, Italy and Spain were 2-3 per cent of GDP.

Willing but not able. And vice versa... Although euro area monetary policy is now becoming even more expansionary, fiscal policymakers will play a key role in supporting growth. But no major shift towards looser fiscal policy is apparent. The countries that run surpluses are traditionally fiscally conservative, especially Germany. They also have cyclical reasons not to spend their surpluses, as long as the slowdown is not severe. Other large euro area economies (France, Italy and Spain) are struggling with deficits, which also limits their room for extra spending. Yet there are signs of a shift. Brussels has adopted a more relaxed attitude, for example abstaining from escalating its budget conflict with Rome. The pattern now seems to be that breaches of EU budget rules will trigger tough rhetoric but not then lead to actual sanctions. Germany is also making some concessions to international calls for fiscal stimulus measures. For example, there is speculation that the Germans are moving towards easing their regulations and accepting increased government debt if this is connected to climate change-related investments. Overall stimulus measures in the region will be equivalent to one quarter per cent of GDP yearly in 2019-2021.

A new leadership team, but limited potential for innovation. EU-sceptical, populist parties were less successful than feared in May's European Parliament elections. The conservatives (EPP) ended up as the largest party bloc, although the liberal, green and populist blocs gained seats. Because of the election results, none of these party blocs was able to win enough parliamentary support for its first choice candidate for president of the European Commission. As often happens in EU politics, the Commission presidency became one piece of a puzzle with major countries taking the initiative in choosing candidates for key EU positions. France (Christine Lagarde) is taking over the ECB presidency, and Germany's Ursula von der Leyen finally won the Commission presidency. EU member countries are now nominating their candidates for commissioners. Ultimately, however, national governments will have a decisive influence on the future of the EU. As usual, Germany and France are sharing the driver's seat. but there are likely to be major challenges ahead. Opinion polls suggest that Matteo Salvini's populist League will receive an enlarged mandate in a coming Italian snap election to pursue a hard line against the EU. Meanwhile the EU must deal with all the ins and outs of the Brexit process as well as an increasingly complex global trade and security policy situation.

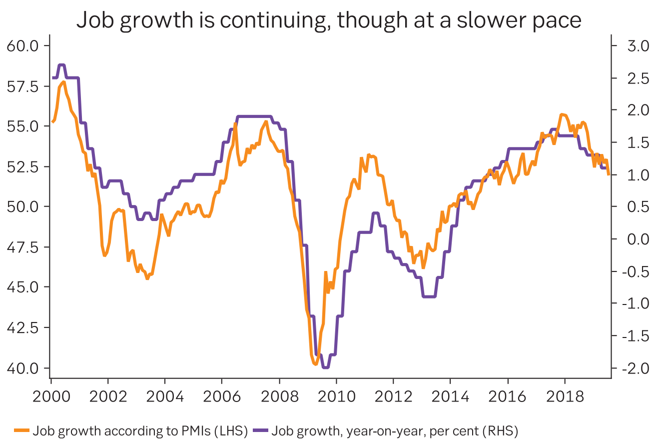
Resilient labour markets

Despite slower growth, companies are continuing to hire and euro area employment has reached new peaks, although job growth has slowed somewhat. Hiring plans have become more cautious, especially in manufacturing, but they remain at decent levels. Unemployment has continued to fall at 0.1 percentage point roughly every second month. In June it was 7.5 per cent for the region as a whole, only 2/10 above its low before the financial crisis.

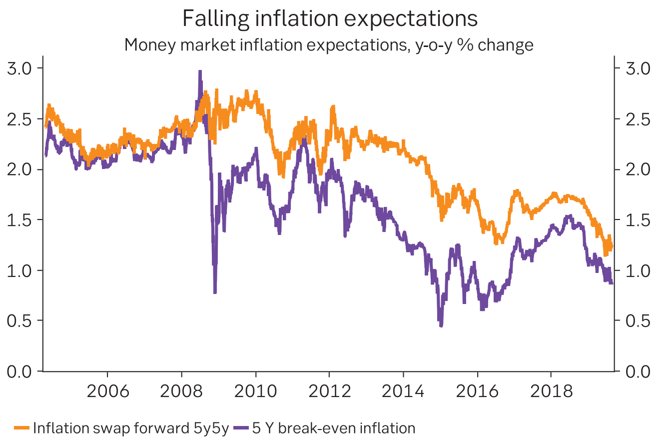
Supply-side restrictions a minor problem. Despite this low unemployment, the supply side is unlikely to hamper growth in the foreseeable future. Unemployment remains high in Italy, Spain and France. The rate of pay increases is still subdued. In the region as a whole, pay increases – depending on the metric – are 2-2.5 per cent yearly. We expect this rate to climb slightly over the next couple of years to around 2-5-3.0 per cent late in our forecast period. Cyclical differences between countries are discernible, but not even in Germany is the rate higher than about 3 per cent. The picture is not unequivocal, however; worth noting is that the percentage of companies that list staff shortages as an obstacle to increased production is higher than at earlier cyclical peaks in the past 30 years. This is one reason why we believe that future growth will be a little productivity-driven as companies' problems in finding labour become more prominent. Despite slightly stronger growth, the rate of downturn in unemployment will slow, leaving a jobless rate of just above 7 per cent at the end of our forecast period.

-0.60 %

The European Central Bank (ECB) is being forced to retreat and once again embrace stimulus measures; it will cut the deposit rate in two steps and then leave it unchanged for the rest of our forecast period.



Source: Eurostat, IHS Markit, Macrobond, SEB



Source: Bloomberg, Macrobond, SEB

Continued low inflation pressure

Inflation has again surprised on the downside. In July, inflation according to the Harmonised Index of Consumer Prices (HICP) fell to 1.1 per cent. The trend has been downward for nearly a year. Slowing food and energy inflation is dampening price increases. Core inflation is being pushed downward and has been around 1.2 per cent for the past two years. Inflation expectations have also fallen to multi-year lows, leading to increased scepticism that the ECB can achieve its target of just below 2 per cent. Rising labour costs have not yet resulted in higher inflation, a problem that the ECB shares with other central banks. The Bank for International Settlements (BIS) and others point out that the connection between the labour market and pay growth remains strong, but transmission from pay to inflation is not the same as before. This is usually explained by various structural changes such as globalisation, how automation has altered the demand for labour and lower service sector profitability. Although the euro area as a whole still has some idle resources, these changes will lead to slower future inflation. But worth noting is that economies like Italy and Finland with more idle resources left to use have relatively lower inflation rates than economies with more strained resource situations. Both HICP and the core measure is expected to reach around 1.5 per cent by the end of our forecast period.

ECB is being forced to retreat

Disappointing inflation, weak economic data and a dramatic repricing of Fed expectations forced the ECB into a policy retreat in July. The wait-and-see situation that we described in the May issue of *Nordic Outlook* has been replaced by preparations for monetary easing. ECB President Mario Draghi highlighted disappointing outcomes in terms of inflation and the real economy. Meanwhile he described the euro area labour market as resilient and said further improvements are expected to result in continued acceleration in pay increases. To avoid further setbacks, the ECB thus needs to act. Unlike the Fed, however, its manoeuvring room is limited. We thus expect a mix of measures: 1) the ECB will lower its deposit rate by 10 basis points both in September and December (from -0.40 per cent to -0.60 per cent); 2) it will explore whether to introduce a system of tiered deposit rates in order to avoid the adverse effects of negative interest rates (also allowing further rate cuts); 3) the ECB will restart its Asset Purchasing Programme (APP) by purchases of EUR 20-30 bn per month, mainly in government bonds. In addition, the ECB has already approved TLTRO III, a programme of unlimited lending to the banking system at a low fixed interest rate for onward lending to the rest of the economy.

Lagarde will continue in the spirit of Draghi. Now that Mario Draghi is stepping down after eight years, the ECB will enter a new phase with Christine Lagarde as its fourth (and second French) president. Since Lagarde is a former politician, we believe this will help perpetuate Draghi's policy of doing "whatever it takes" to keep the euro project alive. This will help minimise regional bond yield and interest rate gaps, thereby providing indirect support to countries that want to spend more. The departing ECB president again emphasised that politicians must do their part by enacting reforms that will increase long-term growth and reduce vulnerabilities. Lagarde is likely to continue in that spirit and may perhaps make even further progress towards improving the interaction between fiscal and monetary policies. In our assessment, fiscal stimulus measures in the euro area will be very modest over the next couple of years, which means that the main responsibility for supporting the economy will ultimately fall on the ECB. We thus believe that after this year's cuts, the ECB will leave its deposit rate unchanged at -0.60 per cent during the rest of our forecast period.

Theme

The auto industry

Structural changes lead to many-faceted challenges

Compared to the rest of the euro area, manufacturing – especially the auto industry – is especially important to Germany. After several good years, when German manufacturing was an engine for the region, today's slowdown is raising many questions nationally but also about risks of contagion to the rest of Europe. The auto industry now faces a number of structural and cyclical challenges, such as tougher emission requirements, electrification, market saturation, trade wars and Brexit. Overall it is hard to foresee a near-term acceleration in the auto industry; these developments will hamper both sales and profitability.

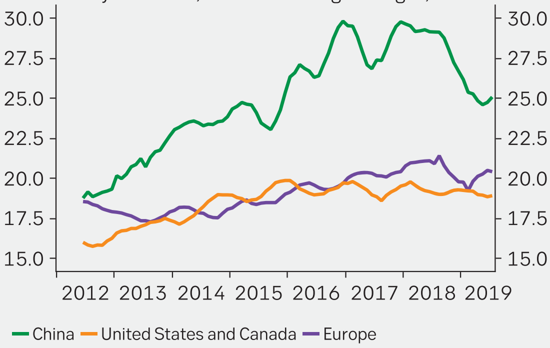
Manufacturing represents a big chunk of Germany's economy. After several successful years this share has expanded, whereas the service sector has gained ground at the expense of manufacturing elsewhere in Europe. Manufacturers produce 27 per cent of German value-added, compared to 13 per cent in France and 20 per cent in the euro area. The cyclically sensitive German economy benefited from the strong global economy in 2016-2017, but we are now seeing a clear negative trend. The recent downturn raises questions about possible contagion to the entire European economy. The German auto industry plays a large role in these developments, so there is reason to discuss its specific driving forces in a global perspective.

Auto industry important to the euro area

Global sales of light vehicles (<3.5 tonnes) total around 90 million. China is the biggest market (about 25 million new cars) followed by Europe (about 20 million) and the US (about 17 million). Europe, especially Germany, dominates global auto exports, making it particularly sensitive to fluctuations and structural changes. Sales have been good since 2012 but are now falling, especially in China (which peaked at 30 million) and the US, but also Europe. Car purchases are viewed as similar to other capital goods investments, which traditionally occur early in an economic cycle when lower interest rates make financing cheaper. Yet cars seem to have a cycle of their own in some ways. This may be attributable to the service life of passenger cars, but also to major model trends and – in the future – probably adaptation to climate change.

Saturated market for new cars?

Yearly unit sales, 6-month moving averages, millions



Source: Macrobond, LMC Atomotive, SEB

Many-faceted problems in the industry

The rapid growth of the auto industry in recent years increases the risks of setbacks. In the autumn of 2018, the auto industry, along with pharmaceuticals, was behind much of the euro area manufacturing downturn. The vehicle industry accounts for nearly one fifth of German exports, or just below 5 per cent of value added (direct effect only). The secondary effects to the rest of the German economy and to other EU countries are relatively large, due to rather extensive supply chains in the EU. Last spring the European Commission showed that an 8 per cent downturn in German car production lowered German GDP by more than 0.6 percentage points, but also shaved nearly 0.2 points off GDP in countries like the Czech Republic, Hungary and Slovakia. Despite a recovery in 2019, there are clear structural reasons behind this weakness, which will probably limit the vehicle industry's contribution to European growth in the next couple of years.

Many forces are affecting the auto industry. The January issue of *Nordic Outlook* discussed the many-faceted problems of the German auto industry. They can be divided into four areas:

1) New EU emission rules imposed last autumn initially led to a surge in sales, followed by a sharp decline. Since then, sales have recovered most of the decline.

2) Weak global demand**,** mainly from China and the US, has hampered sales. The US decline was for passenger cars, while pickup models benefited from lower fuel prices and low interest rates.

3) A structural transformation of the auto market is putting pressure on both producers and consumers. Electric cars are a major focus of attention, which will mean high costs to carmakers; meanwhile prices are higher than for traditional models. Changed ownership patterns are probably another factor.

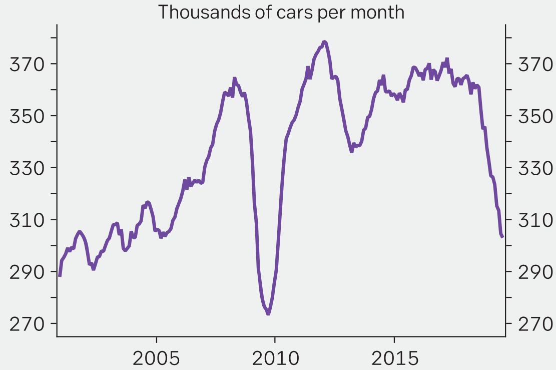
4) National feelings dominate the auto industry, since production is concentrated in a few countries, making the industry vulnerable to trade disruptions and political events like Brexit. There are many indications that carmakers will face continued market pressures.

Other country-specific factors are depressing sales. The demand for cars in China has been driven for years by structural changes such as higher living standards and more widespread lending. The current decline in Chinese new car registrations may be connected to such factors as falling stock markets, changing emission requirements and subsidies plus the introduction of electric car sales targets. Increased domestic Chinese production of components and vehicles is also making imports less important. The same thing is actually true in the US. There it is worth recalling that car sales have been robust for many years, and the risk of reaching the saturation point is imminent. Increased worries about where the economy is headed can also make consumers more cautious. But over time, job growth is one of the better predictors of car registrations in a number of countries. In the US and the EU, auto sales over the past decade have reacted to job growth with a lag of 1-1.5 years. Although the strength of the US labour market has surprised on the upside, job growth has slowed. The same is true in the EU. This means that regardless of any structural changes, acceleration in auto sales growth seems rather unreasonable.

Germany's industrial engine is sputtering, after a 19 per cent decline in car exports in the past 2 years. How much of this decline can be recovered will depend on how well car companies can cope with structural changes in the auto industry. The US and China are trending towards less import dependence, putting a brake on the German carmakers' potential to shift back into higher gear.

Plunging German auto industry exports

Thousands of cars per month



Source: German Association of the Automotive Industry (VDA), Macrobond, SEB

The auto industry faces major challenges. Assuming a rising – but varying – ambition to shift the vehicle fleet in a climate-friendly direction, the industry will undergo fundamental changes. It is reasonable for consumers to hesitate about buying cars, considering today's environmental, energy source and ownership issues. Electric cars are often expensive and there is a limited choice of models, while there is much debate about whether they are good for the environment or not. Europe's earlier fondness for diesel cars provides an example of how quickly conditions can change. But if the lofty ambitions of political leaders to increase the percentage of electric cars become a reality, supply chains will change. Electric cars are characterised by high purchase prices, few moving parts and more focus on operability. To the extent that electricity is not generated from fossil fuels, global trade will decrease as fewer car-related products are transported between countries (except for copper and other metals used in batteries).

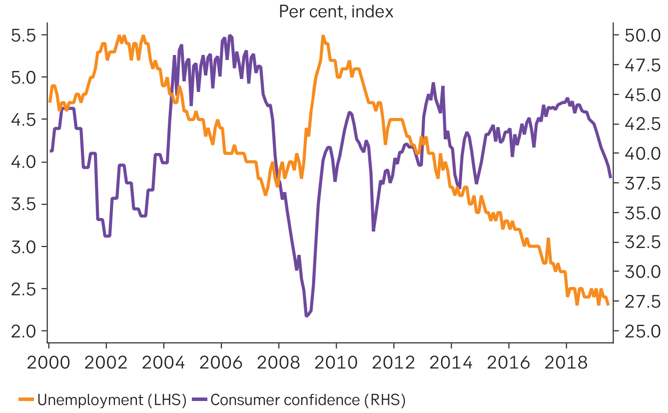
Japan

Low inflation pressure: a never-ending story

Temporary effects boosted GDP growth, but it will now revert to 0.5 per cent. Private consumption – totalling 60 per cent of GDP – will hold up, largely due to the strong labour market. But this autumn's consumption tax hike and export uncertainties pose downside risks. Demographics and low inflation expectations have Japan in an iron grip. The country will fall short of the inflation target. Despite doubts about its monetary policy, the Bank of Japan (BoJ) keeps expanding its balance sheet.

Japanese households hesitant, despite low unemployment

Per cent, index



Source: Japanese Cabinet Office (CaO), Japanese Statistics Bureau, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	0.8	1.2	0.7	0.5
Unemployment*	2.4	2.3	2.3	2.2
CPI excluding food prices	1.0	0.7	1.4	0.8
Public sector financial balance**	-3.2	-2.8	-2.1	-1.9
Public sector debt**	237	238	237	237
Repo rate***	-0.10	-0.10	-0.10	-0.10
USD/JPY exchange rate***	110	105	100	100

*Per cent **Per cent of GDP ***At year-end Source: IMF. SEB.

Japan's GDP grew by 0.4 per cent quarter-on-quarter in Q2 2019 (a 1.8 per cent annualised rate), well above its estimated 0.5-1.0 per cent year-on-year trend. The installation of Emperor Naruhito in early May gave many Japanese a 10-day break, triggering a strong but unfortunately temporary surge in consumption. Although we expect GDP growth in 2020 and 2021 to benefit from continued support from favourable household conditions, thanks to a strong labour market, the overall picture is still dominated by downside risks due to October's consumption tax hike from 8 to 10 per cent and the international economic slowdown. Exports and capital spending will also show a relatively weak trend. GDP growth will reach 1.2 per cent in 2019, falling to 0.7 per cent in 2020 and 0.5 per cent in 2021. Growth effects from the 2020 Tokyo Olympics have largely faded and do not affect our 2020-2021 GDP forecast.

Japanese business optimism fell this summer to a 3-year low, according to the BoJ's Tankan survey, which plays a key role in assessing the state of the economy. This decline reflects the global deceleration in general and the problems of the technology sector in particular. This summer, relations with Seoul deteriorated after Japan restricted certain high-tech exports to South Korea, citing the need to "protect" Japanese technology. This conflict is deep, has a historical dimension and may prove lengthy. A trade agreement with the US has better potential for success: about 20 per cent of Japan's exports go to the US, less than 10 per cent to South Korea.

Unemployment is low and is expected to remain at 2-2.5 per cent during our forecast period, among other things due to Japan's demography; an ageing population is shrinking the labour supply. Yet the strength of the labour market is having little impact on wages and salaries, which are rising at 0.5-1.0 per cent yearly. Household real wage increases may thus fail to materialise. There are major concerns that this autumn's tax hike will hurt consumption, but Shinzo Abe's government has taken various steps to ease the impact on growth, for example with temporary tax concessions on interest expenses and auto purchases.

Japan will not achieve its 2 per cent inflation target during our forecast period, despite a positive output gap for the past 2-3 years (currently about 1 per cent of GDP). Yet an optimist can point out that average inflation, using the metric followed by the BoJ, has been 0.5 per cent in the past 5 years compared to a deflation of 0.25 per cent over the preceding 10-15 years.

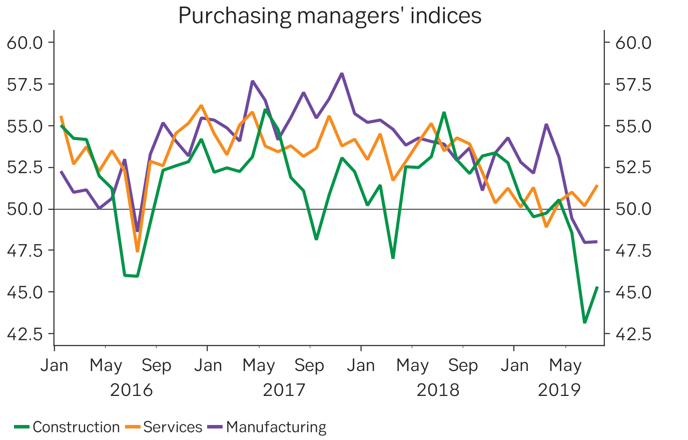
The impact of the BoJ's unconventional monetary policy is increasingly being questioned, since the inflation target is not being met. For example, some observers maintain that inflation pressure is low for structural reasons, not due to weak demand. Households should thus be allowed to enjoy low price increases, which the BoJ should not try to boost. Others believe BoJ policy is intended to keep the yen weak. This decreases reform pressure on the manufacturing sector and benefits the emergence of capital-guzzling Japanese zombie firms.

Low inflation expectations – about 0.5 per cent – are deeply rooted in the consciousness of households and businesses. Limited fiscal manoeuvring room – the national budget deficit is expected to be about 2 per cent of GDP – imposes heavy policy responsibility on the BoJ. This is why its key interest rate remains at -0.1 per cent, while the central bank tries to keep 10-year government bond yields at close to zero: quantitative easing (QE) by means of bond-buying keeps Japan's monetary base growing by 5-10 per cent yearly. Monetary policy is depressing the value of the yen, but the trend of the dollar will nevertheless cause the USD/JPY exchange rate to move to 100 during 2020-2021.

The United Kingdom

Struggling with the complications of Brexit

The Brexit process makes it difficult to assess the underlying strength of the economy. The latest quarters have been dominated by abrupt shifts, but it appears as if the global slowdown is also adversely affecting the British economy. A tight labour market is benefiting households, but low savings will make them sensitive to any disruptions. The central bank is continuing to focus on the labour market and we expect an unchanged key interest rate both this year and next.



Source: IHS Markit, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.4	1.3	1.4	1.5
Unemployment*	4.1	3.9	3.9	4.0
Wages and salaries	2.9	3.5	3.0	2.5
CPI	1.8	1.9	1.8	1.7
Public sector balance**	-1.5	-1.3	-1.2	-1.1
Public sector debt**	86.8	85.7	84.4	83.6
Key interest rate***	0.75	0.75	0.75	1.00
EUR/GBP***	0.90	0.93	0.87	0.88

* % of labour force ** % of GDP ***End of period. Source: Macrobond, SEB

Conflicts between the United Kingdom and the European Union have intensified since Boris Johnson took over as prime minister, and the change of leadership has greatly increased the risk of a hard Brexit (see theme article). Brexit-related disruptions make it difficult to assess the growth outlook, now that the period of uncertainty has been extended. This includes postponements of capital spending as firms await the outcome, but also such temporary disruptions as major stock building when companies prepare for a hard Brexit. This was very clear prior to the original March 30 withdrawal date, contributing to surprisingly strong first quarter growth, which then reversed during Q2. Our main scenario is still a controlled withdrawal from the EU, but a no-deal withdrawal would likely cool off the economy sharply during the next couple of years, with an increased risk of recession.

Consumption is holding up. but low savings pose a downside risk. Aside from uncertainty about Brexit, the British economy seems to be following the global slowdown, which has affected the euro area, Asian countries and other regions. Sentiment indicators have fallen dramatically. especially in the construction sector. Manufacturers are also gloomier, while the service sector has been resilient. With record-low unemployment of 3.9 per cent and yearly pay increases of more than 3.5 per cent, households remain in a stable situation. Household demand has long been the main driver of growth. As long as the labour market remains firm, we expect the current rate of consumption growth to persist. Yet households are vulnerable to disruptions, since their savings are record-low while home prices are unchanged. This implies limited buffers, and if the labour market should weaken, households would quickly be forced to cut back their spending.

Investment uncertainty, but a weak pound is benefiting exports. Uncertainty about Brexit contributed to a slight decline in capital spending during 2018, and businesses are likely to be restrictive with investments as long as this uncertainty persists. The British export sector is benefiting from the weak pound, yet the UK's merchandise trade deficit was record-high in Q1. In our main scenario, we anticipate some improvement in the trade balance. Overall, we thus expect GDP to grow by 1.3 per cent in 2019, 1.4 per cent during 2020 and 1.5 per cent in 2021.

BoE actions are in the hands of Boris. The pound depreciation of recent years is the main reason why British inflation has exceeded the Bank of England's target for some time, but this currency effect has slowly faded. We expect inflation to stabilise just below the BoE's 2 per cent target during our forecast period. For a long time the BoE has focused its attention on the tight labour market, and it is still signalling a future one-off rate hike, but its actions will be determined by British EU withdrawal. In case of a controlled withdrawal, we expect the tight labour market to persist, leading to one rate hike late in our forecast period and a key interest rate of 1.00 per cent in December 2021. In case of a hard Brexit, the central bank is instead likely to cut its key rate in order to support the British economy. Brexit continues to determine the direction of the pound. As the probability of a hard Brexit has increased during the summer, the pound has weakened. In our main scenario of a controlled withdrawal, we expect the pound to recover and appreciate during 2020.

Theme

Brexit

The risk of a hard Brexit has greatly increased

The new British government, consisting of EU sceptics and Brexiteers led by Boris Johnson, has greatly increased the risk of a hard Brexit. By means of confrontation, the government wants to force the EU to the negotiating table to adjust the withdrawal agreement. Its next battle will be with Parliament, which voted earlier this year by clear majorities against a hard Brexit. There is a major risk that the government will fall and that Parliament will try to enact a law postponing withdrawal again. Although the government has time on its side and the risk of a hard Brexit has risen, we are sticking to our main scenario that the UK will leave the EU in an orderly process.

Increased divisions. In late July, Boris Johnson took over as the new Conservative (Tory) leader and prime minister of the United Kingdom. On his very first day in office, he made dramatic changes in Theresa May's cabinet, bringing in EU sceptics and Brexiteers. Not unexpectedly, his government has adopted a confrontational stance towards the EU, trying to force changes in the UK's existing withdrawal agreement. It is uncertain if this strategy will be successful. Although there have been some positive signs the EU's response does not indicate that it is prepared to yield to British pressure, despite the threat of a no-deal withdrawal. When the UK Parliament reconvenes on September 3, less than two months will be left before the October 31 withdrawal date.

Given the government's clearly EU-sceptical tone and the prime minister's unyielding position that the country will leave the EU at the end of October, with or without a deal, not only has the UK's confrontation with the EU hardened, but the divide between Parliament and the new government has also widened significantly. In addition, the level of conflict inside the governing Conservative Party has escalated, now that many ex-ministers have lost their jobs in the government, voluntarily or not. Today there are very few indications that the new PM and his EU-sceptical government will be able to persuade Parliament to approve the existing withdrawal agreement, after May failed multiple times despite her willingness to make some compromises.

Two alternatives for avoiding a hard Brexit. Earlier, a second referendum seemed like a reasonable way forward, but the events of recent months make this appear less likely. We actually see only two possible ways to resolve the Brexit issue. One alternative is for the EU to retreat, accepting certain adjustments in the withdrawal agreement that will finally enable the UK Parliament to approve the document. The UK can then leave the EU in an orderly process on October 31. The second alternative is for Parliament to try to take over the process from the government. In the first alternative, the UK would enter a transition period which – according to the existing agreement – will run until December 31, 2020. However, the EU has earlier been open to an extension of the transition period, if the British should request it. During the transition period, in practice the UK would behave like an EU member country without influence in the EU. This would include remaining in the customs union. Only when the transition period ends would the British leave the EU in practice. Unfortunately there is very little indication that such a more positive outcome will occur.

Headed for a confrontation with Parliament. The new government's strategy of a hard Brexit on October 31 represents a total confrontation with Parliament, where a majority has repeatedly rejected a no-deal withdrawal. The government's majority is extremely fragile. At present, the Conservative government plus its partner, Northern Ireland's Democratic Unionist Party, only have a one-vote majority in the House of Commons. This means that if a new vote of no-confidence is held, the outcome is extremely uncertain. Conservative MPs would then suddenly face an unpleasant choice between defending a Conservative government and probably risking a hard Brexit or defeating their own government and triggering a new election, in which the Conservatives risk losing power.

Increased support under Boris. This summer, opinion polls showed essentially a dead heat between the governing party and the biggest opposition party, Labour. Meanwhile the newly established Brexit Party and the EU-friendly Liberal Democrats have made strong gains in public support. But it appears as if the Conservatives recently managed to win back some voters at the expense of the Brexit Party after Boris Johnson took over as party leader, given his tougher rhetoric towards the EU. Even though the Conservatives are once again the biggest party in the opinion polls, the outcome of a snap election that was held before EU withdrawal would be very uncertain. The Tories continuously risk losing votes to the Brexit Party, as long as the UK is still in the European Union. Although the election system makes it hard for small parties to gain any major influence in Parliament, this is still a threat to the governing party since it is likely to benefit Labour, the dominant opposition party.

Snap election no earlier than October 25. If the government should lose a no-confidence vote, a formal parliamentary process begins. During an initial period of 14 days, the prime minister or another MP is given a chance to find a constellation that commands a majority in the House of Commons. If this fails, a snap election can be called, taking place no earlier than after 5 weeks. Given the October 31 EU withdrawal date, time is therefore short. A snap election could not be held any earlier than October 25: less than one week before the withdrawal date. The government can also influence the date of a snap election, and there has been speculation that it would try to delay the election until after the withdrawal date, thereby forcing the UK into a no-deal withdrawal. In other words, it is not certain that the country can avoid a hard Brexit even if the current government loses a no-confidence vote.

Important events during autumn 2019

Sep 3	Parliament convenes after its summer break
Sep 5-13	The opposition can call a no-confidence vote
Sep 21-25	The annual Labour Party conference
29 sep-2 okt	The annual Conservative Party conference
Mid-Oct	Parliament reconvenes
Oct 25	Earliest possible day for any snap election
Oct 31	The UK leaves the EU according to current law

What other possibilities are there to avoid a hard Brexit? A majority of MPs oppose a hard Brexit. But the British parliamentary system still gives the government various ways to delay or block the influence of Parliament. The government controls the legislative agenda in Parliament and also has the executive role in relations with the EU. Under current law, it suffices to let time run out without any new legislation for the UK to leave the EU on October 31. This makes it difficult for Parliament to take its own law-making initiatives, such as forcing a postponement of the withdrawal date via new legislation in order to avoid a hard Brexit. Parliament previously took advantage of amendments to other legislation to influence the withdrawal process, but if the government abstains from legislation before October 31 that path is also closed.

If Parliament still wants to change the law in order to stop or postpone EU withdrawal, the surest path is probably to defeat the government in a no-confidence vote and then – parallel with preparations for a snap election – gather all MPs from different parties who want to avoid a no-deal withdrawal. In that way, they could influence the agenda and initiate new legislation. Nothing like this has happened since the Second World War, and it would probably lead to irreparable splits, within the Conservative Party in particular, that would have consequences extending far into the future. Because the EU referendum in 2016 was held for the specific purpose of removing EU withdrawal from the agenda in order to save a divided Conservative Party, this would mean that reality finally caught up with the party. Given the new government and the limited time until the withdrawal date, the risk of a hard Brexit has greatly increased. In spite of this, our main scenario is still that a hard Brexit can be avoided and that the United Kingdom will leave the EU with a transition agreement.

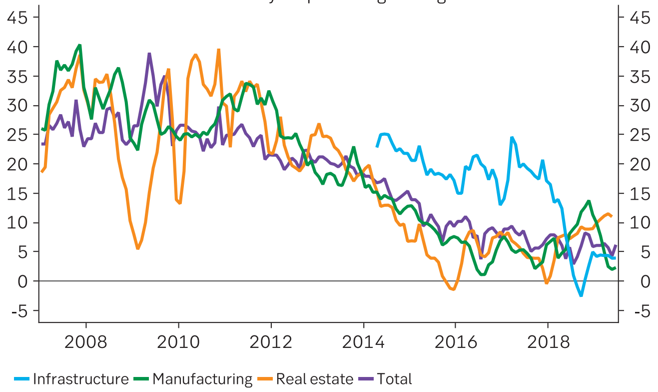
China

Slow recovery in domestic demand

China's economic growth is slowing gradually, but risks of a sharper decline are increasing. The challenge for policymakers is to maintain strong domestic demand and employment, and to support manufacturers squeezed by a global deceleration, tariff worries and shifting tech sector supply chains. Beijing will lower bank reserve require-ments, but avoid reviving rapid, uncontrolled credit growth. The trade conflict with the US will likely drag on over the next couple of years.

Total upturn of about 5 per cent in fixed asset investment

Year-on-year percentage change



Source: CEIC, Bloomberg

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	6.6	6.3	6.1	6.0
CPI	2.1	2.1	1.5	1.8
Public sector debt*	50.5	55.4	59.5	63.2
Bank reserve requirement**	14.5	12.5	12.5	12.5
Lending rate**	4.35	4.35	4.35	4.35
Deposit rate**	1.50	1.50	1.50	1.50
7-day reverse repo rate**	2.55	2.50	2.50	2.50
USD/CNY***	6.88	7.15	7.05	6.90

* Per cent of GDP ** Per cent *** At year-end. Source: IMF, SEB

Our 2019 growth forecast of 6.3 per cent remains unchanged. Year-on-year GDP growth slowed to 6.3 per cent during the first half, in line with expectations, but weakness in domestic demand is a source of concern. There is reason to carefully watch the trend of employment and investment indicators in the coming months, in case a downward revision of the full-year forecast is warranted.

Beijing's 2019 growth target is "6.0-6.5 per cent" but it will be challenging to policymakers (see below) to maintain growth as demographic headwinds accelerate. Future success will hinge on their ability to generate persistently high GDP growth in this environment, while managing risks associated with already high debt levels. The takeover of Baoshang Bank by regulators in May, borrowing limits on local authorities and Beijing's abstention so far from massive new infrastructure projects indicate a departure from earlier policy based on rapid, uncontrolled credit growth. We expect China's growth to edge towards 6 per cent in 2020 and 2021.

China's tense relations with the US are increasingly evident, for example in monthly export figures and purchasing managers' indices for both manufacturing and services. As recently as May, the US raised tariffs on USD 200 billion worth of Chinese goods to 25 per cent (from 10). After US-Chinese trade talks resumed following the G20 summit in late June, they ran aground again in early August, when the White House announced new 10 per cent tariffs on USD 300 billion worth of goods (see the theme article "Trade war & peace", page 15). China's response included allowing the yuan to depreciate past CNY 7 per USD (see below), which in turn led to US to label China a currency manipulator.

US actions are mainly affecting China's small and medium-sized enterprises, which tend to be disproportionately exposed to external risks. Tighter US technology export regulations may also curtail portions of China's product development. The deceleration has, in turn, led to challenges for employment and bigger downside risks for private consumption, which makes up 40 per cent of China's GDP. Imports have slowed, indicating weaker domestic demand, although investment growth seems to have stabilised.

Inflation rose in the first half but remains below target. Vegetable shortages and higher pork prices have helped push average inflation to 2.2 per cent so far in 2019; Beijing's full-year target is "about 3 per cent". Productivity growth is an estimated 6-7 per cent, leading to generally deflationary tendencies. We expect CPI inflation to remain close to 1.5 per cent during 2020 and 2021.

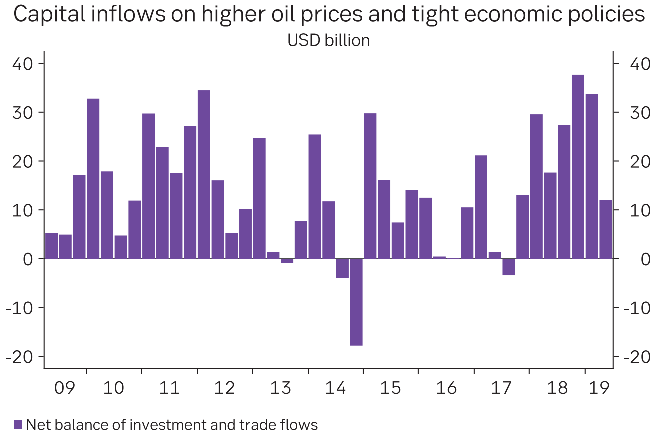
Chinese policymakers are well prepared and have manoeuvring room to respond to downside economic risks. They have cut taxes on households and businesses in order to boost consumption and capital spending. Beijing's fiscal strategy now relies mainly on targeted measures rather than large general stimulus packages like those launched in response to the recession of 2008-09. Monetary policy is also more expansionary. Aside from expecting another cut in the bank reserve requirement by another percentage point to 12.5 per cent by end-2019, we expect authorities to also lower the 7-day reverse repo rate. More dovish US monetary policy will enable China to follow suit by easing its key rates. The central bank announced in mid-August a long-awaited reform to the interest rate market by mandating banks to use the new loan prime rates (LPR) as the benchmark for loans with tenors of 1Y and above 5Y. We believe the Chinese will try to avoid too large a decline in yuan exchange rates, for both trade and debt policy reasons. If the world believes that China will pursue a policy of yuan depreciation, this increases the risk of destabilising capital outflows. We expect the USD/CNY exchange rate to be 7.15 at the end of 2019, 7.05 at the end of 2020 and 6.90 at the end of 2021.

Russia

Weak growth leads to increased political risk

The Russian economy has slowed down noticeably as global growth has fallen. Meanwhile federal budget and monetary policies have been tight, leading to a decline in living standards. Dissatisfaction because opposition politicians have been blocked from participating in Moscow local elections, along with an unpopular pension reform, has led to major protests. The likely result is that continued economic reforms will be postponed and that potential growth will stagnate.

Capital inflows on higher oil prices and tight economic policies



Source: Central Bank of the Russian Federation (CBRF), Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	2.3	0.8	1.7	1.9
CPI	2.9	4.7	4.0	4.1
Key interest rate*	7.75	6.50	6.75	7.00
Government debt**	14.0	13.8	13.9	14.1
Current account surplus**	4.6	4.5	3.0	2.0
Wages and salaries	10.1	6.5	6.0	7.0
USD/RUB exchange rate***	69.4	67.9	67.0	69.0

*Per cent at year-end ** Per cent of GDP ***At year-end..
Source: IMF, Rosstat, Central Bank of the Russian Federation, SEB

Broad-based slowdown in growth. GDP rose by a healthy 2.3 per cent in 2018 but decelerated sharply this year, reaching only an annualised 0.7 per cent rate during the first half. The slowdown has been broad-based but is no worse than expected in light of global deceleration. Russia's agreement with OPEC to limit oil production has had a moderating effect, but the slowdown is based on weaker export growth and capital spending plus a tight budget policy. Bank lending to households increased in May by a high 23.5 per cent year-on-year rate. The central bank's efforts to limit this growth, which might eventually threaten the stability of the banking system, will hold back private consumption in the second half of 2019. Yet we foresee some acceleration in GDP growth, thanks to increased government investments plus an upturn in oil and gas exports.

Fiscal stimulus measures, but no structural reforms. During the first half, Russia's federal budget showed a surplus of 1.6 per cent of GDP after a record-large 2.6 per cent surplus in 2018. Meanwhile the Finance Ministry has increased its borrowing in the domestic bond market. The Kremlin will probably use these resources to boost growth, while taking steps to ease growing dissatisfaction with its economic reforms, especially the pension reform. Overall we believe that GDP will grow by 0.8 per cent this year, 1.7 per cent in 2020 and 1.9 per cent in 2021, but we are unlikely to see any major structural reforms. Areas that urgently need attention include state-owned enterprises and the courts, where reforms could strengthen ownership rights and reduce corruption, thereby boosting potential economic growth in the long term.

Falling inflation rate will allow room for interest rate cuts. Inflation rose during the second half of 2018 and at the beginning of 2019, due to base effects and a value-added tax increase on January 1. Because of tight central bank monetary policy and weak growth in demand, inflation has fallen faster than expected since then, reaching 4.6 per cent in July. Inflation will probably end the year at, or just below, the central bank's 4.0 per cent target, remain at target in 2020 and then climb somewhat during 2021. Capital inflows, falling inflation and lower international interest rates have created room for monetary policy easing. The first interest rate cut occurred at the central bank's June policy meeting, followed by another in July. We expect the central bank to continue cutting its key rate from the current 7.25 per cent to 6.50 per cent by the end of 2019. At the end of 2020 it will hike the key rate again, and we foresee a key rate of 7.00 per cent at the end of 2021.

More stable conditions for the rouble. The rouble has been relatively stable during the past year thanks to a persistent current account surplus, relatively high real interest rates and strong government finances. A budget rule also decreases the sensitivity of the exchange rate to oil price fluctuations. We expect the rouble to weaken to 67.9 per dollar in 2019 due to slowing global growth and weak risk appetite. It should recover slightly to 67.0 by the end of 2020, before sliding to 69.0 at the end of 2021, on the back of relatively high inflation in Russia compared to other countries.

Demonstrations and sanctions are recurrent risk factors. Large protests against the authorities for blocking various opposition candidates from running for office in the Moscow local election on September 8 this year have mainly shaken Moscow but also affected other cities. Although the number of protesters has approached 60,000, the demonstrations are too small to threaten Russia's existing power structure. President Vladimir Putin's popularity is close to record lows but still remains at about 60 per cent. American sanctions against purchases of newly issued bonds were imposed on August 2, but we believe that the risk of Iran-like sanctions is unlikely, since their market impact might also harm US companies and banks.

The Nordics

Sweden's growth is starting to slow despite fiscal and monetary stimulus. The Riksbank is turning more dovish and will leave its key rate unchanged in 2019-2020. Positive impulses from the oil sector continue to drive Norway's economy, while households are supporting growth. Norges Bank will hike its key rate this autumn. Denmark is in good shape; household incomes are rising, home prices seem to have bottomed out and companies are investing. Finland's manufacturers are gloomy, but exports are growing and domestic demand is up with support from falling unemployment.

Sweden

4.5 %

Despite global manufacturing weaknesses, exports rose by 4.5 per cent year-on-year. The contrast with Germany is raising questions, but we expect a deceleration as international demand cools.

Page 37

Norway

2.9 %

Total GDP growth will accelerate in 2020 to 2.9 per cent. Norway's economic expansion will be the fastest in the Nordic region during the 2019-2021 period.

Page 46

Denmark

0.5 %

Record-low home mortgage rates of 0.5 per cent on 30-year loans – and below zero on shorter loans – are supporting home prices, which have recovered after bottoming out.

Page 45

Finland

6.6 %

At 6.6 per cent, unemployment is the lowest for more than 10 years. Continued robust demand for labour suggests a sustained but slower decline in Finland's jobless rate, in spite of decelerating economic growth.

Page 48

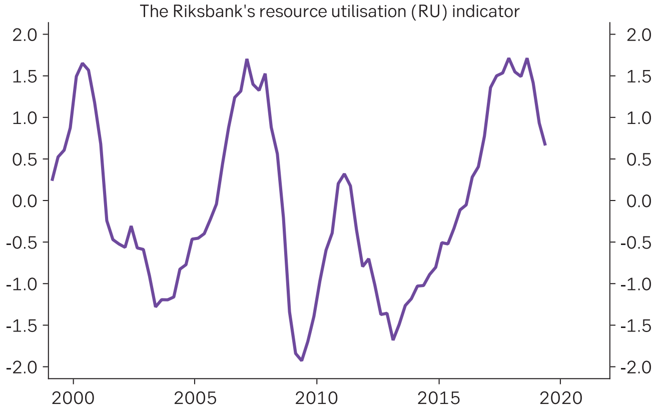
Sweden

Higher joblessness due to below-trend growth

The economy is entering a phase of slower GDP growth, despite support from both monetary and fiscal policy. Manufacturers are resilient, helped by a weak krona, but export growth is slowing due to weak international demand. In spite of a decent purchasing power trend, households will remain cautious. Unemployment will climb. Despite slightly higher contractual pay hikes, inflation will be below target in 2020 and 2021. The Riksbank will keep its key interest rate unchanged until mid-2021.

A weakening economic trend

The Riksbank's resource utilisation (RU) indicator



Source: The Riksbank, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	2.4	1.5	1.3	1.7
Unemployment*	6.3	6.5	6.8	7.0
Wages and salaries	2.5	2.6	2.7	3.1
CPIF (CPI less interest rate changes)	2.1	1.7	1.6	1.7
Net lending**	0.9	0.3	0.2	0.0
General government debt**	38.8	34.6	34.0	32.5
Repo rate***	-0.25	-0.25	-0.25	0.00
EUR/SEK***	10.15	11.00	10.50	10.00

*Per cent ** Per cent of GDP ***At year-end. Source: Eurostat, SEB

GDP growth will bottom out in 2020

GDP fell unexpectedly in the second quarter. A minor rebound is likely during Q3 – falling sentiment indicators suggest that growth has entered a calmer phase. But due to a strong Q1, the downward revision in our full-year GDP forecast is only 0.1 of a percentage point: we now foresee a 1.5 per cent increase. However, we are lowering our GDP growth forecast for next year by 0.4 points to 1.3 per cent. In 2021 the economy will accelerate to 1.7 per cent growth, in line with somewhat stronger international conditions.

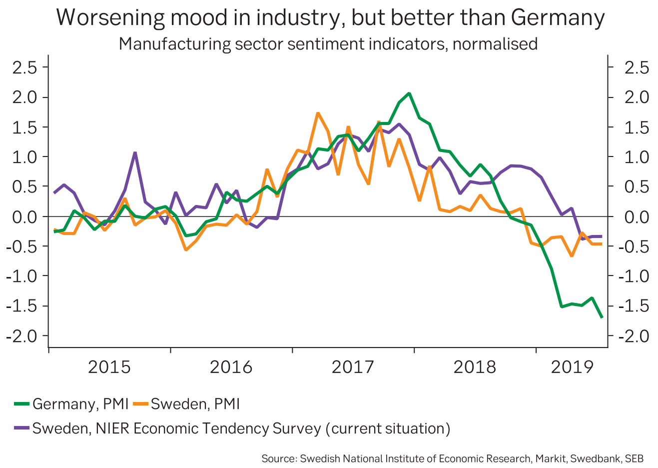
A cooler labour market, due to muted growth. The slowdown is being confirmed by signs of rising unemployment. For the first time in years, this upturn is driven by weak job growth and not by rising labour force participation. We expect joblessness to climb from an average of 6.3 per cent in the first half of 2019 to 7.0 per cent by the end of 2020. Next winter's national wage round will thus take place in an environment of falling resource utilisation, but due to somewhat higher inflation expectations and rising international wages, contractual pay hikes will probably speed up a bit. We foresee 3-year contracts with 2.5-2.6 per cent yearly pay hikes. Yet because wage drift will remain subdued and international prices will be low, inflation will fall below the Riksbank's 2 per cent target throughout our forecast period. Lower contributions from energy prices explain the near-term decline, but in 2020 underlying inflation will also slow as krona depreciation effects fade.

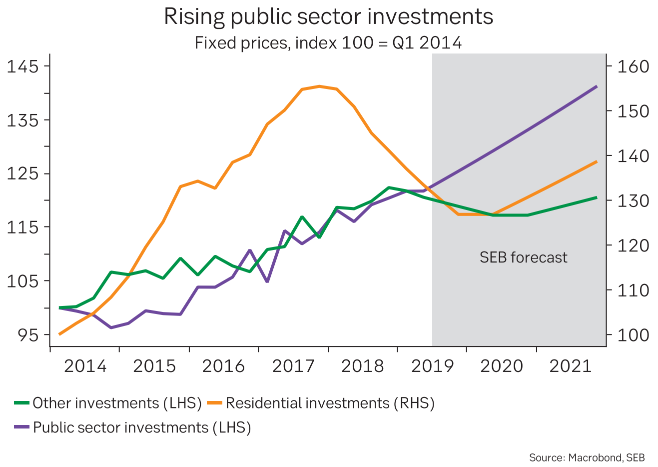
Rate hikes shelved. Due to weak growth, low inflation and looser ECB and Fed policies, the Riksbank will abstain from its planned key rate hikes. Market pricing indicates that the main question instead is whether the key rate will be cut or not, but we believe it would take a more dramatic economic downturn to persuade the Executive Board to cut the repo rate. We thus expect it to remain unchanged for a rather long time. Not until late 2021 will it be hiked to zero.

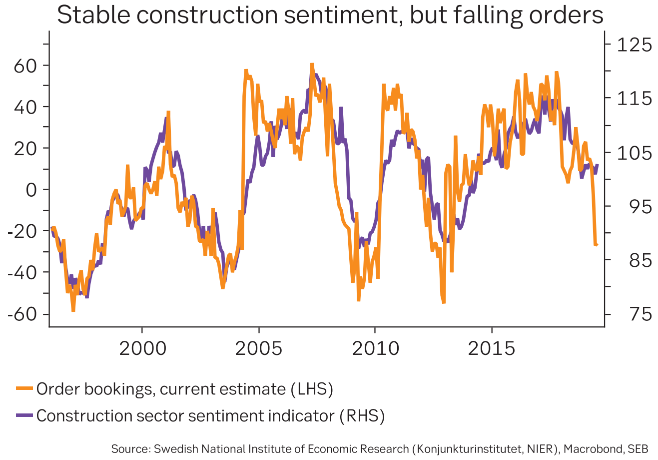
Struggling manufacturers helped by weak krona

Manufacturing activity has remained strong, diverging from the gloomy trend elsewhere, but a slight cooling was discernible late in Q2. Merchandise exports rose 4.5 per cent year-on-year in the first half. Pharmaceuticals were the fastest-growing export category but the upturn was broad-based, including good growth in vehicle exports (despite the weak global market; see theme article, p. 28). Service exports also accelerated after a period of weaker growth. Manufacturing sentiment have fallen this summer, but their levels are significantly above those in Germany and are still signalling growth. The downturn in manufacturing sentiment is broad-based, although the electronics and vehicle industries are bucking the trend. The krona exchange rate will continue to provide support, but future exports will probably be hampered by weak demand from the European markets that buy 70 per cent of Swedish merchandise exports. Service exports are normally less cyclically sensitive and are expected to continue increasing by nearly five per cent year-on-year throughout our forecast period. Total exports will increase by 3.2 per cent in 2019, 1.4 per cent in 2020 and 2.6 per cent in 2021.

Residential investments are about to bottom out. Although exports have held up, manufacturers have been cautious about capital spending. Machinery investments fell by five per cent in the first half. Because of falling capacity utilisation in manufacturing, another downturn of about 10 per cent is likely in the coming year. Residential investments are also falling – they are down nearly 15 per cent in all since their peak early in 2018. The number of housing starts has dropped by about 30 per cent since 2017, but the down-turn has slowed in the past 3-4 quarters. After another minor down-turn in the second half of 2019, we expect housing starts to recover slightly. Because of lags, residential investments will keep falling during most of 2020, but we expect a rebound of about 5 per cent in 2021. According to the Economic Tendency Survey of the National Institute of Economic Research (NIER), the decline in the construction sector's order bookings poses a downside risk in its forecast. We predict that construction will begin on 47,000 housing units in 2020 and 50,000 in 2021. The 2021 level will be nearly 50 per cent above housing starts before the construction boom began in 2014. Needs-based calculations by the National Board of Housing, Building and Planning – using population growth – nevertheless show that housing starts would have to increase by at least 50 per cent above the 2021 level.







Rising public sector investments are contributing to the high total. Despite falling capital spending for homes and manufacturing, total investments have been unchanged in the past year. This is mainly because public sector investments have increased rapidly. Heavy demand for services due to growing population suggests that the upturn will continue. The downturn in total investments will thus be only one per cent in 2020. When economic conditions improve in 2021, we expect an upturn. Capital spending rose to more than 25 per cent of GDP in late 2018, the highest level since the 1980s. Its share of GDP will fall by two percentage points during the next couple of years but is still very high in an international perspective.

Cautious households are reluctant to spend money

Despite rising incomes, household consumption growth has been very weak, almost completely stagnating so far this year. An increase in purchasing power suggests that consumption will recover this autumn, but due to shaky economic conditions and rising unemployment, households will remain cautious. Looking ahead, the purchasing power upturn will slow as job growth slows, but lower inflation and a slightly higher wages will provide support. In addition, income taxes will probably be cut in 2020 due to elimination of a 25-year-old "temporary" surtax on high incomes and lower taxes on pensions. Also supporting consumption will be a partial recovery in the housing market from its 2017 price decline. The home price upturn has accelerated this summer, and the SEB Housing Price Indicator suggests continued near-term increases. The weaker labour market poses a downside risk, but a decline in mortgage rates from already low levels will probably be more important. We expect slightly rising home prices throughout our forecast period. Overall, we expect consumption to increase by around 1½ per cent yearly in 2020-2021. This is modest, given rapid population growth. The savings ratio will keep climbing from an already high level.

New statistical source boosts consumption

When Statistics Sweden (SCB) publishes its final second quarter GDP figures (September 13), it will also revise historical data as part of a review carried out every five years based on instructions from Eurostat. Preliminary SCB estimates suggest that the 2015 GDP level will end up about 1 per cent higher. Private consumption in 2015 will be revised a full 3 per cent higher, mainly because consumption abroad was previously underestimated. One consequence will be that the household savings ratio will be reduced by 2.5 percentage points. To some extent, this will decrease the room for higher future consumption, but the ratio will remain very high in an international comparison and its upward trend in recent years will probably persist. Household bank deposits can serve as a metric for the size of available financial buffers. These have increased significantly faster than incomes for many years and are now equivalent to almost one year's income (chart on next page).

Continued loose fiscal policy

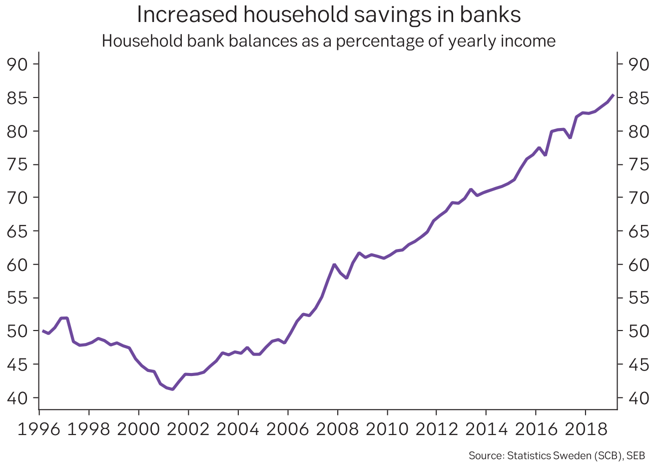
In an international perspective, Swedish public finances show continued strength, though surpluses will fall in the next couple of years. A strong labour market and high construction activity have helped fill the public purse. Despite loose fiscal policy the central government has shown surpluses, and debt has shrunk. The positive forces that have benefited public finances will weaken somewhat, but if the economy worsens the starting point is still good, with government debt as a share of GDP at its lowest in 40 years.

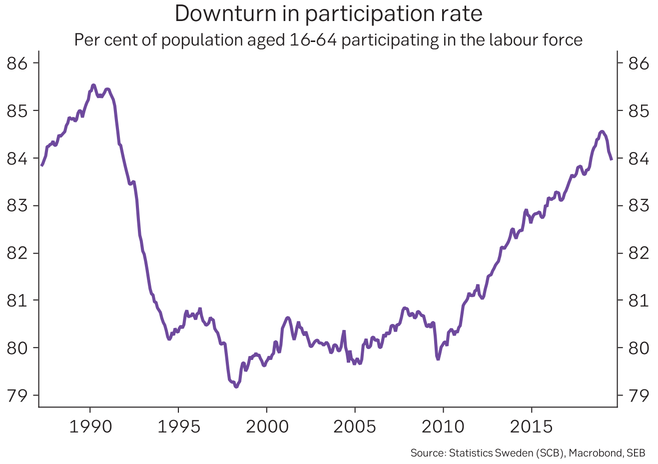
Political and regulatory conflict. While the public sector surplus is expected to shrink towards zero in 2021, the debt ratio will already fall below its "anchor", 35 per cent of GDP, this year, creating a goal conflict in the fiscal policy framework. In deciding between cutting government debt further or letting the debt ratio rise, we are likely to see more reforms than would be compatible with the surplus target (1/3 per cent of GDP). Meanwhile the parliamentary political situation may reduce this expansiveness. The January Agreement with the Centre and Liberals guarantees the red-green government of Social Democrats and Greens a majority for its budget, but there are still tensions. The Agreement, largely a list of Centre and Liberal demands, absorbs a lot of the funding that is available for reforms. When the economy slows, it will be harder for the government to find room for its own political agenda. The Centre and especially the Liberals – whose new leadership has shown no great enthusiasm for budget collaboration – will react negatively if government reforms are too ambitious. Overall we believe stimulus measures will total about 0.5 per cent of GDP in 2020 and 2021.

Household incomes and saving
Year-on-year percentage change

	2018	2019	2020	2021
Real disposable income	1.8	2.3	2.2	1.5
Private consumption	1.2	0.7	1.3	1.7
Savings ratio, per cent of income	16.4	17.3	17.8	17.5

Source: Statistics Sweden (SCB), SEB





Heavy pressure on local governments not fully reflected in GDP. This autumn's budget will probably include new funding for local governments. Although tax revenues have risen, local government debt has increased due to pressure from demographics, refugee resettlement, construction and demands for higher-quality public services. The public sector will continue to expand faster than its historical trend, although the upturn in public employment will slow a bit. As previously pointed out, new SCB measuring methods report most public consumption increases as rising prices and falling productivity, rather than volume increases, which pulls down real GDP growth. Public sector productivity has fallen 10 per cent in the past 6 years. SCB seems quite alone in applying these new methods, which cause Sweden's yearly GDP growth to be reported at 0.2-0.4 percentage points lower than would be the case in other countries. We expect public employment to rise by 1 per cent yearly in 2020 and 2021, while consumption volume will largely be unchanged.

The labour market is about to weaken

Slower growth is now having an impact on the labour market. After falling since early 2014, unemployment has now started to rise. Weaker demand for labour is also affecting the labour supply. By the end of 2018 the labour force participation rate was close to its peaks from the early 1990s, which are very high in an international comparison. This upward trend has now come to a halt, and unexpectedly high unemployment is explained primarily by weaker job growth, while the participation rate has fallen.

Resource utilisation culminated in late 2018. Business hiring plans have gradually become less expansive but they still suggest yearly job growth exceeding one per cent. As weaker growth affects the labour market with a lag, we expect job growth to decelerate to 0.4 per cent in 2020, well below recent years, with unemployment climbing more than 0.5 percentage points to 7 per cent next year and remaining around this level during 2021. The weaker labour market is reflected in lower resource utilisation (RU), and the Riksbank's RU indicator has fallen in the last three quarters. The resource situation is tighter than normal, but we expect the RU downturn to continue, falling below its historical average early next year. Despite weaker economic conditions, we foresee collective labour contracts including yearly pay increases of 2.5-2.6 per cent, 0.3-0.4 per cent higher than the agreements signed in 2017. Total pay is expected to rise by 2.6, 2.7 and 3.1 per cent in 2019-2021.

Below-target inflation as energy prices fall

Since the spring of 2017, average CPIF inflation (CPI less interest rate changes) has been in line with the Riksbank's target. But this summer, CPIF plunged. In July it stood at 1.5 per cent: one percentage point below its September 2018 peak. The main factors behind this were falling energy prices and base effects as last year's energy price surge fades from the 12-month figures. We expect energy prices to keep pushing inflation lower in the next few months. We estimate that CPIF will fall to 1.3 per cent in September, then rebound somewhat. CPIF excluding energy prices has shown a rising trend and reached 1.7 per cent in July. We should also factor in SCB's change in metrics for package tours and dental care charges, which pushes down inflation by 0.2-0.3 percentage points.

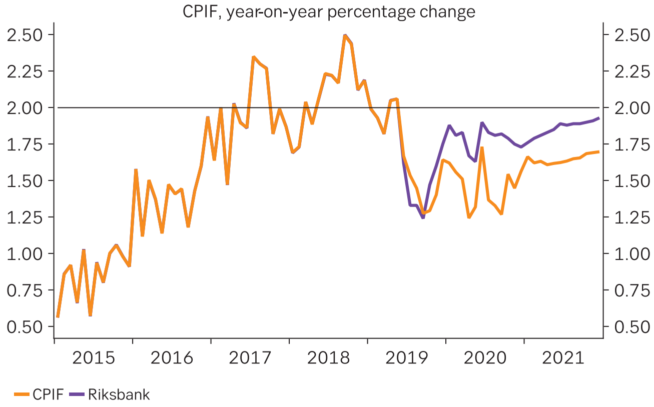
Inflationary impact of weak krona fading. In recent years, the weak krona has helped push inflation higher. Short-term indicators suggest that this upward pressure will persist for the rest of 2019, but assuming that the krona will not continue to fall significantly, historical experience indicates that this effect will gradually fade in 2020. We thus expect inflation to fall. Faster pay hikes will partly offset this, and we expect indirect taxes to provide slightly larger inflation contributions than in the past year. But low international inflation suggests that CPIF will remain below target throughout our forecast period. As annual averages, we estimate that CPIF will increase by 1.6 per cent in 2020 and 1.7 per cent during 2021.

-0.25 %

The Riksbank will remain on hold for a long time. Its repo rate will be unchanged in 2019 and 2020.

Inflation below Riksbank target

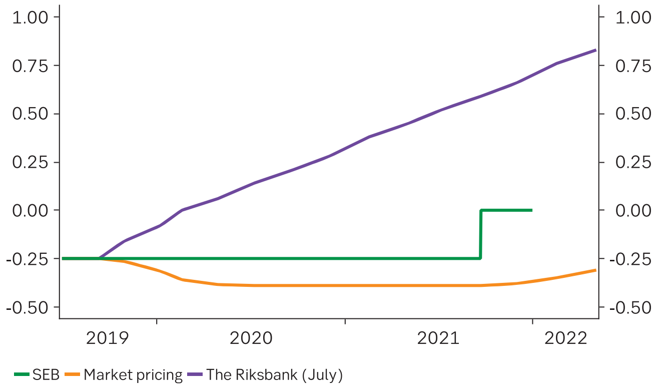
CPIF, year-on-year percentage change



Source: Central Bank of Sweden (Riksbanken), Macrobond, SEB

Markets clearly doubt the Riksbank will hike

Procent



Source: Macrobond, SEB

Key interest rate hikes will be postponed

Weaker growth, below-target inflation and new ECB and Fed stimulus measures suggest that the Riksbank will shelve its planned rate hikes. In July it signalled a large (17 basis point) probability of a rate hike this year, followed by gradual hikes to nearly 1 per cent by the end of 2022. The market has been sceptical of this rate path and is now pricing in a 65 per cent probability that the repo rate will instead be cut. We believe that in September the Executive Board will take a big step backward, revise the rate path downward and leave hikes of only 2-3 basis points by the end of 2019. The end-point of the rate path will probably be lowered by about 40-50 points. Although lower inflation expectations are likely to cause concern, we believe that the Board is highly reluctant to reverse its December 2018 rate hike, unless there is a severe economic downturn or a sharper decline in inflation. A majority of the Board will probably stick to the view that the inflation outlook is significantly better than a few years ago. There are also signs that more members would like to avoid contributing to further krona depreciation. We cannot rule out that during the coming year, the Riksbank may still end up in a rate-cutting situation, but our main scenario is that the repo rate will be left unchanged at -0.25 per cent throughout 2020. When the economy improves, we expect the Riksbank to hike its key rate by 25 basis points to zero late in 2021.

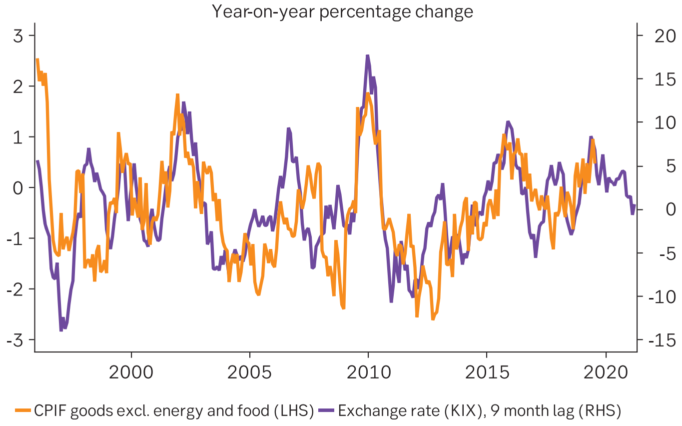
Riksbank will keep about 50 per cent of government bonds. We believe the Riksbank will extend its bond purchases when the current programme expires at the end of 2020, announcing that it will buy about half the bonds maturing in June 2022. This forecast implies that the central bank will continue buying bonds at about the same pace as today: SEK 15 billion worth per six-month period. Although purchases at that pace would cause its balance sheet to decrease by an average of about SEK 25 billion, the bank would continue to hold about 50 per cent of all outstanding bonds.

Wider yield spread due to ECB stimulus measures. During the summer, Swedish 10-year government bonds plummeted to well below zero (-0.37 per cent). The yield spread against German 10-year bonds widened from about 10 basis points to 35 at the end of 2018 after the Riksbank hiked its repo rate. Since then the spread has lacked a clear trend. Like their German counterparts, Swedish 10-year yields have fallen by 100 points since the beginning of 2019. Rate cuts and expanded quantitative easing by the ECB, combined with Riksbank inaction, suggest that the spread against Germany will widen during the coming year, but due to the low bond supply and continued Riksbank purchases the upturn will be modest. We expect the 10-year spread to widen from about 30 points at present to 50 points at the end of 2020. Assuming that the Riksbank hikes its key rate and the ECB does not, we expect the spread to widen by another 10 points during 2021.

So far in 2019, the krona has again been the weakest of the G10 currencies. Although other small currencies have also lost ground, the Riksbank's policy shift after its December 2018 rate hike has contributed. Our expected sharply lower rate path and no rate hike until the second half of 2021 should further push down the krona. An uncertain international environment, including risks of worsening trade conflicts, is not helping the krona either. We believe that the EUR/SEK exchange rate will move towards 11.00 by late 2019. The krona is undervalued, which suggests some appreciation further ahead, yet there are many indications that its equilibrium exchange rate has weakened in the past decade and is now not much stronger than 10.00 per euro. We thus predict a modest appreciation, with the EUR/SEK rate reaching 10.00 by the end of 2021.

Goods prices are in line with historical pattern

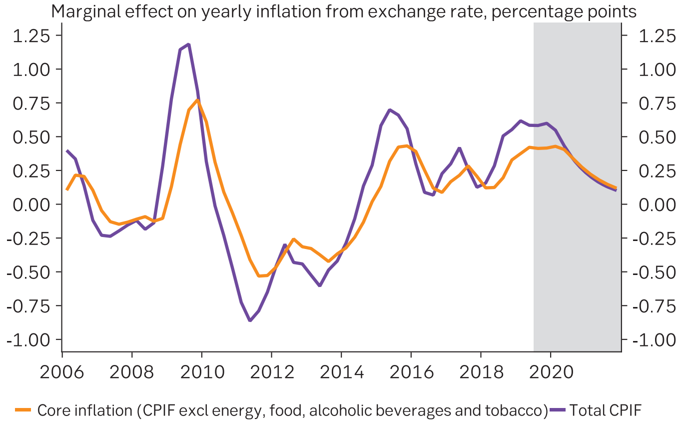
Year-on-year percentage change



Source: Riksbank, Statistics Sweden, SEB

Moderate but prolonged inflation pressure in Sweden

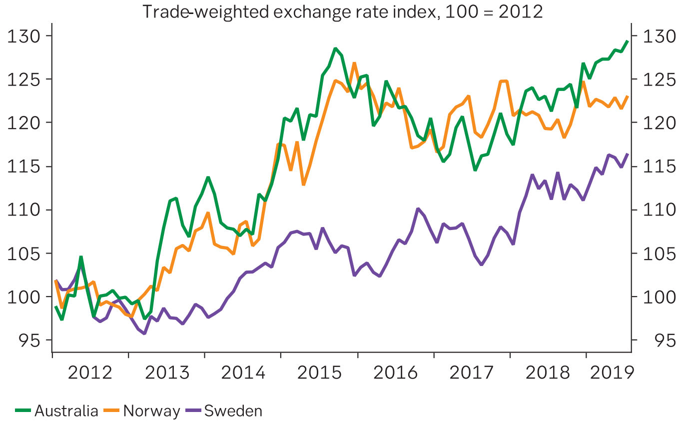
Marginal effect on yearly inflation from exchange rate, percentage points



Source: SEB

Bigger exchange rate depreciation in other countries

Trade-weighted exchange rate index, 100 = 2012



Source: National central banks

Moderate inflation pressure from exchange rate

The long period of krona depreciation is the biggest upside risk in our inflation forecast. A weak exchange rate has historically had clear, albeit moderate effects on inflation. Our estimates suggest that a 10 per cent depreciation raises prices by nearly 1 per cent after a year and another 0.6-0.7 per cent long-term. The model is structured in a way that allows varying degrees of delay for different components in the CPI basket. The effect on energy prices is largely immediate, while the impact on other goods and services is delayed. The effect on core inflation (CPIF excluding energy, food, alcoholic beverages and tobacco) is just over half a percentage point after a year and another half point after a few more years. The maximum effect on the inflation rate occurs after about 9-12 months. The top-left graph suggests that the inflation effects of recent krona depreciation have been in line with the historical pattern.

Inflation pressure in line with the historical pattern. Our model indicates that the krona effect will continue to push up inflation for the next 6-12 months, but this pressure will then gradually dwindle. One uncertainty factor is that these estimates were made during a period when krona depreciation was temporary. During both the IT (dotcom) crash and the Lehman Brothers crisis, the krona fell even more sharply than it has done recently, but rebounded relatively quickly. But it is conceivable that a more lasting decline in the exchange rate will have a bigger impact, since companies in such a situation may be more inclined to raise prices. In such a case, risks of contagion to wages and other prices could rise.

Inflation impulse from exchange rate around 0.20-0.25 per cent. Despite the weak krona, once volatile energy prices are excluded, inflation only exceeded the 2 per cent target for one month. But since the krona began to weaken in 2014-2015, CPIF excluding energy has been a bit more than one tenth of a point above its long-term trend. It is even clearer that the exchange rate has boosted inflation if we exclude food prices, which have periodically climbed steeply due to international price shocks. Since 2015, this metric has averaged 0.2 percentage points above its historical average. According to our model, the contribution from the exchange rate in the same period averages about 0.25 per cent yearly, or marginally above the deviation of core inflation from its historical average.

Temporary inflation effects in other countries. A comparison with other countries also suggests that the effect of exchange rate changes on inflation is moderate and temporary. Since 2012, the krona's trade-weighted exchange rate has fallen by 15 per cent. During the same period, the Norwegian krone fell by nearly 25 per cent and the Australian dollar by nearly 30 per cent. Due to the larger depreciations in these currencies, core inflation has climbed and remained above target longer than in Sweden, but inflation has then dropped below target. The reason Norway's inflation has recently been above target is that the target itself was lowered from 2.5 per cent to 2.0 per cent in 2018. Not even the United Kingdom experienced any lasting inflation pressure even though the pound lost 30-40 per cent after the financial crisis. Inflation was above target for 2-3 years, but this was just as much due to VAT being hiked by 5 percentage points as to a weaker exchange rate.

Theme

The wage round

Somewhat higher pay hikes despite cyclical headwinds

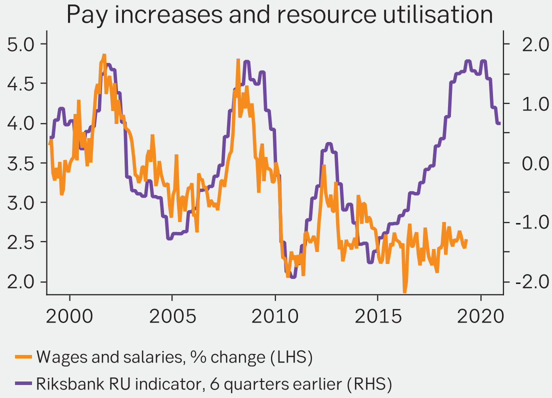
Sweden's next national wage round will take place during a cyclical slowdown. Meanwhile pay increases in other countries have speeded up a bit. The leading role of industry in wage formation has again been questioned. Due to heated debate about the reasons for the weak krona, employers and employees will probably be forced to more clearly express their views about their interaction with the Riksbank and its policy framework. Yet we are unlikely to see a major break with the patterns of recent decades. Our forecast is that the two sides will reach 3-year agreements with annual pay hikes of 2.5-2.6 per cent. This represents a slight acceleration from the previous wage round, but the Riksbank is likely to have continued problems achieving its inflation target.

Within a few months, Sweden's 2020 national wage round will take off in earnest. Coordination among employee unions will occur this autumn, and the results of this are usually very important to the entire wage round. Actual negotiations with employer associations begin after New Year, with the aim at putting collective agreements in place before the agreements signed in 2017 begin to expire in late March. Recent decades have been characterised by low conflict levels and relatively small variations in contractual pay hikes. The gaps between different economic sectors have also narrowed. In 2017 virtually all sectors followed the benchmark set by the industrial sector, with yearly pay increases of 2.2 per cent in 2018-2020. The upcoming wage round is unlikely to diverge from this pattern in any dramatic way, but there are new factors for the negotiators to take into account. The leading role of industry in wage-setting has again been questioned recently. Heated discussion about reasons for the weak krona may also play a role in the wage round.

Underlying conditions are pulling in different directions. The economic environment in Sweden and elsewhere is of course important for the wage round. The picture is rather mixed. The labour market is now about to cool off, weakening the position of unions. Resource utilisation according to the Riksbank's RU indicator has fallen but remains well above normal. The indicator will probably fall a bit further before the wage round is over, however. Productivity growth has also

been weak in recent years, limiting the room for pay hikes. But there are factors that suggest higher contractual pay increases than in the last round. Inflation expectations have risen. Labour and employer organisations have regained some of their confidence in the Riksbank's ability to reach its 2 per cent target. Tight labour markets have also helped accelerate the pay hikes in various competitor countries. For example the rate in Germany – normally considered the most important – has speeded up since Sweden's last wage round and is around 3 per cent yearly. Overall, the economic environment is unlikely to justify any major departure from 2017 contractual hikes.

Pay increases and resource utilisation



Source: National Mediation Office (Medlingsinstitutet), Macrobond, SEB

Timetable for the 2020 wage round

Oct-Nov: Union coordination discussions

Jan-Feb: Labour and employer organisations begin their negotiations

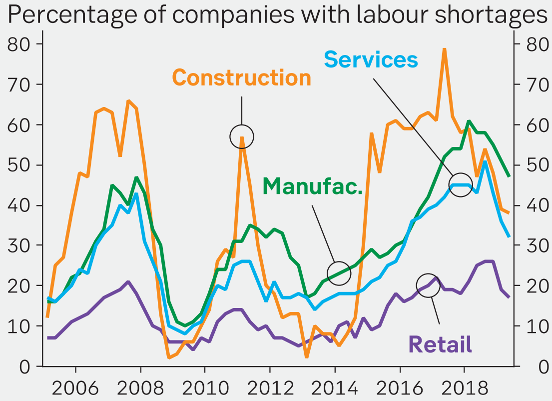
Mar 31: Agreements expire for 1.3 million employees in industry and other sectors

Apr 30: Agreements expire for about 0.5 million employees in construction and other sectors

Focusing on both the inflation target and international conditions. The leading role of the industrial sector in Swedish wage formation has recently been questioned with varying intensity. The main criticism is that the system is actually rigged for a fixed exchange rate regime. In such a regime, industrial companies exposed to international competition will be the main ones that suffer the consequences if high pay increases undermine their competitiveness. In a regime with floating exchange rates and inflation targets, domestically oriented sectors are hurt just as much if the Riksbank is forced to hike its key interest rate in response to pay agreements that threaten to drive up inflation. Since the current monetary policy framework took shape in the mid-1990s, labour and employer organisations have tried to balance these two perspectives and take into account restrictions posed by both the inflation target and pay increases abroad. There have thus also been reasons to preserve the system of letting the industrial sector lead the way, setting a "benchmark" for the rest of the Swedish labour market. The word "benchmark" is also carefully chosen; it need not be a norm that everyone must follow, if there are good reasons for diverging. In practice, however, valid reasons for divergences have had to meet ever-rising standards.

Harsh attacks against the industrial sector norm. The unions in the "6F" group, including the Building Workers and Building Maintenance Workers, have again challenged the industrial sector and proposed a system in which the Negotiations Secretary of the mainly blue-collar Swedish Trade Union Confederation (LO) plus a delegation of 3-4 unions would represent the labour side. The unions in the delegation would change from one wage round to another. In partnership with its think tank, Katalys, the 6F group recently presented a report entitled "Wage Formation for a New Era", which argues that the current collective bargaining mechanism must be reformed. The report was based on source material from economists with varying degrees of affiliation with the union movement. Independent professors such as Lars Calmfors and Nils Gottfries contributed chapters respectively entitled "The Role of Industry as a Wage-setting Norm Can and Should be Reformed" and "Europe as a Norm Lacks Relevance – On the Association Between Wage Formation, Monetary Policy, Exchange Rate and Competitiveness" (our translations). Several other chapters by union-affiliated economists argued that pay demands should be higher than in 2017 and be set at a level that fully accepts the Riksbank inflation target as an "anchor".

Percentage of companies with labour shortages

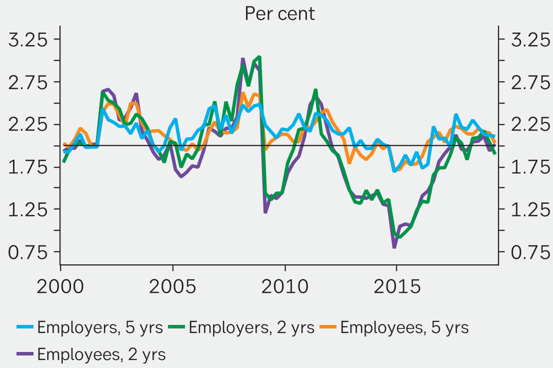


Source: NIER, Macrobond, SEB

Several actors have a strong interest in preserving the status quo. Despite this offensive, the collective bargaining mechanism is unlikely to be reformed. The dominant industrial union, IF Metall, has declared that it wants to keep the current system. The employer side has hardly any reasons to open the way for reform. If the matter is to be seriously considered, it will be necessary for LO's national leadership to firmly support the 6F group's strategy. But the question is whether LO really wants to engage in divisive conflicts about wage round mechanisms, in a situation where it must devote a lot of energy to public advocacy in other areas where it fears that union interests are being threatened by budget collaboration between the Social Democratic-led government and the Centre and Liberal parties.

Some acceleration in contractual pay hikes compared to 2017. Although the prevailing system of negotiations will formally continue, the unions are likely to demand slightly higher pay increases than in 2017. This is partly related to their interaction with the Riksbank and its monetary policy. The drawbacks of the weak krona have recently been debated intensively. Because of high capacity utilisation in Sweden's export sector, the weak krona's positive effects on production volume and employment are much smaller than normal, while domestic sectors like retail find it hard to pass on rising import prices to consumers. This increases pressure to reach agreements that will help ease the Riksbank's difficulties in meeting its inflation target and thus also ease the downward pressure on the krona from the bank's extremely low key rate. Unions are probably also willing to give the Riksbank credit for its efforts to reach its target, as evidenced by the inflation expectations of the two sides.

Inflation expectations close to Riksbank target



Source: TNS Prospera, Macrobond, SEB

Business community ambivalent about the weak krona. The employer side naturally has a greater need for proof that the Riksbank can actually push inflation higher. The focus on the consumer price index (CPI) is sometimes also singled out as a problem, since the price trend for companies' products – not consumer prices – is what determines their wage-paying capacity. But the wide gap between producer and value added prices in different sectors, driven largely by exchange rate movements, is a dilemma. In principle, this should lead to sectoral differentials in pay agreements, but after the discouraging experiences of the mid-1990s, wage formation has again been centralised. Recently, employers have been the firmest opponents of divergences from the industrial benchmark. Business leaders have also pointed out the drawbacks of a weak krona: for example the risk that Swedish assets will be sold off at a discount. Although the connection is not self-evident, the period after the krona exchange rate plunged in 1992 saw big ownership changes in Swedish business, with a wave of head office out-migrations as a consequence.

Higher trend of price increases is depressing the krona. Recently the discussion of Sweden's industrial competitiveness has been a bit confused. Some people argue that the weak krona gives Swedish industry such a strong competitive position that it is impeding pressure for reform in the economy and thus also productivity improvements. Meanwhile the employer side has published several reports arguing that Swedish business is being squeezed hard by cost pressures, compared to other countries. Our own analysis also indicates that due to wage and productivity trends over the past 10-15 years, unit labour costs in Sweden have risen faster than in other countries. This is one reason behind our view that the krona's equilibrium exchange rate against the euro has weakened. The question is what role this will play in the wage round. The two sides have agreed earlier that short-term exchange rate fluctuations should not affect the available room for pay hikes. In addition, they have agreed that even given floating exchange rates, it is valuable for Sweden to adhere closely to international cost trends. For example, the unions are unlikely to use the krona's current weakness as an argument that there is greater room to raise wages and salaries.

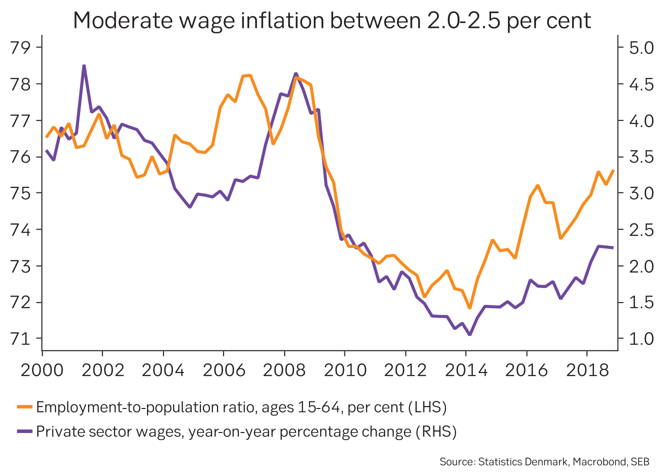
Is the employer side sceptical about the inflation target? During the past decade, both the Riksbank and the European Central Bank (ECB) have had problems reaching their inflation targets, due to strong disinflationary forces. It is not so unusual that these forces were even stronger in the euro area during its existential crisis. A slight underlying depreciation in the krona's nominal exchange rate – a response to slightly higher inflation in order to keeps real competitiveness in balance – is also a natural result, both in theory and practice. Demanding that Swedish unit labour costs must now rise more slowly than in the euro area, in order to offset the earlier trend, implies a significantly greater departure from the ground rules of floating exchange rates than we have seen so far. This would undoubtedly introduce strongly disinflationary forces into the economy. If the employer side should actually pursue such a strategy, we should certainly interpret this as meaning they can no longer accept the inflation target as an anchor of Swedish monetary policy. In that case it is no longer a matter of criticising how the Riksbank applies its policy, but instead of seeking some form of peg to major currencies, especially the euro – and later on, once public opinion is ready, perhaps aiming at Swedish euro area membership.

Contractual pay increases of 2.5-2.6 per cent are not enough for the Riksbank. Despite all the big macroeconomic issues now being debated so heatedly, it is still likely that the pragmatic negotiating machinery will finally end up with contracts that are not especially different from those signed in 2017. We believe that because of higher inflation expectations and a degree of weariness with currency volatility and extreme monetary policy, we will get 3-year collective agreements containing yearly pay hikes of 2.5-2.6 per cent. Weak productivity growth and profitability problems in several domestically oriented sectors will help keep contractual pay hikes down. Slightly higher pay agreements will allow the Riksbank some relief, but given a cooler labour market situation, wage drift above the contractual increases will probably be quite modest. The total pay hikes that we foresee – around 3 per cent yearly in 2020 and 2021 – imply that the Riksbank will continue to have problems reaching its inflation target. Because contracts will once again probably end up at about the same level in different sectors, regardless of the labour market situation, the wage formation process will not promote mobility and structural reform either. But perhaps this is a price worth paying for stability and labour peace.

Denmark

Still on a steady course

Denmark's GDP indicator points to a rebound in growth in Q2 2019 after a weak Q1. Full-year growth still looks likely to end up close to 2 per cent despite weaker euro area growth, and employment shows signs of returning to a less buoyant pace. We still expect growth to slow modestly over the forecast period, but barring a broader international setback, domestic drivers remain strong enough to extend the expansion at least a couple of years.



Key data

Yearly change in per cent

	2018	2019	2020	2021
GDP	1.5	1.9	1.7	1.5
CPI	0.8	0.9	1.1	1.6
Wages and salaries	2.2	1.7	2.5	2.8
Public sector financial balance*	0.5	0.5	0.5	0.5
Public sector debt*	36.0	35.0	34.0	34.0
Current account*	8.0	7.0	7.0	7.0
Key interest rate (CD rate)	-0.65	-0.85	-0.85	-0.85
EUR/DKK	7.46	7.46	7.46	7.46

*Percent of GDP. Source: Statistics Denmark, DØRS

The Danish economy remains fundamentally strong. Falling interest rates and modest fiscal stimulus are likely to support domestic demand and keep growth above the euro area average.

Q2 shows rebound in GDP growth to above 2 per cent. The preliminary GDP indicator suggests that growth picked up in Q2 after a weak first quarter. With quarter-on-quarter growth snapping back to 0.8 per cent in Q2 after a disappointing 0.1 per cent increase in Q1, the year-on-year growth rate is back above 2 per cent, well above the euro area rate of just above 1 per cent. We have marginally reduced our GDP forecast for 2019 to 1.9 per cent. Our forecast for 2020 and 2021 points to a further gradual slowdown to around 1.5 per cent, mainly due to lower international growth expectations, but the overall picture remains robust.

Consumption drivers remain healthy, with real disposable income growth above 2 per cent and employment posting healthy growth, albeit at a slower pace in Q2. The household saving ratio continues to increase and consumer confidence has weakened during the summer, suggesting that consumption growth may have peaked for now. On the other hand, home prices appear to have bottomed out, supported by record-low mortgage rates, and credit conditions have stopped tightening. A surge in mortgage refinancing on the back of the decline in bond yields in recent months is likely to support spending in the second half of the year. Meanwhile, rising capacity utilisation is likely to support business investment.

The housing market appears to have bottomed out for now. Home prices recovered in recent months as lower mortgage rates added support, and a surge in mortgage refinancing is likely to support prices going forward. Falling yields have allowed a shift to 0.5 per cent coupons on 30-year fixed-rate mortgage loans and for shorter loans, rates are moving into negative territory. The result is a significant increase in refinancing activity in the past two refinancing terms. The decline in monthly payments is likely to add further support to prices and provide liquidity support for consumer spending. However, with successful macroprudential policy continuing to cap leverage, credit quality is likely to remain strong.

Job creation has slowed and the risk of an overheating labour market remains distant. Wage inflation is back below 2 per cent and there are no signs of labour shortages, with the employment-to-population rate levelling off well below the peak in the last cycle. We still expect the wage inflation rate to move higher, but low inflation will limit the pressure on nominal wages. HICP inflation has slowed to 0.4 per cent, led by weaker service sector inflation, and the gap to euro area inflation has started widening again.

Over the forecast period, we foresee little sign of overheating.. Danish competitiveness is strong. The main risk to exports is weaker demand. Wage inflation remains below the euro area average and the current account surplus has stabilised at 6 per cent of GDP. A faster slowdown in euro area demand could have domestic implications, but this is not our base case.

Stronger DKK eases pressure on DNB. The krone has moved back inside the DNB (central bank) target range, falling below 7.46 per euro as expectations of further ECB easing have gained momentum. From a structural perspective, fundamentals still suggest the DKK peg is more likely to face upward than downward pressure. Money market rates remain below euro area levels.

Modest fiscal support likely. June's elections paved the way for a minority Social Democratic government. This is likely to lead to a modest fiscal expansion. In light of low public debt and the recent easing of inflation risks, this seems like a reasonable policy stance.

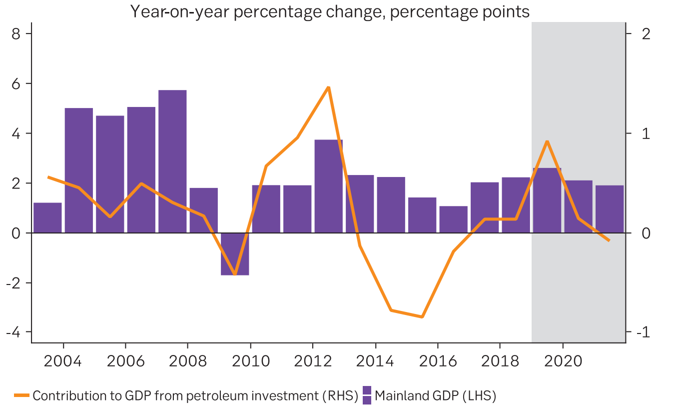
Norway

Weak krone despite domestic strength

The economy continues to expand, driven by positive impulses from sharply higher petroleum investment. Global events add downside risks, but domestic growth drivers should remain intact. Labour market conditions are favourable, supporting private consumption via higher wage growth. The weaker krone adds to inflation pressures and Norges Bank is expected to deliver a final rate hike this autumn.

Growth lifted by sharply higher oil capital spending

Year-on-year percentage change, percentage points



Source: Statistics Norway, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.4	2.0	2.9	2.1
Mainland GDP	2.2	2.6	2.1	1.9
LFS unemployment*	3.9	3.5	3.6	3.6
Annual wage and salary increases	2.8	3.3	3.5	3.5
CPI-ATE inflation	1.5	2.3	1.9	1.9
Key interest rate*	0.75	1.50	1.50	1.50
EUR/NOK***	9.90	10.30	9.60	9.30

*Per cent ** Year-end. Source: Macrobond, SEB

Growth is slowing but remains above trend

The Norwegian economy continues to expand, driven by positive impulses from sharply higher capital spending in the petroleum sector. Headwinds from rising protectionism and weaker growth abroad have yet to make a notable impact on the domestic outlook. Growth in mainland GDP slowed somewhat at the start of the year, but the dip should prove temporary (Q2 national accounts will be published on August 29). The government surprisingly boosted fiscal policy stimulus in the spring budget to 0.5 percentage points of mainland GDP in 2019, lifting growth in the second half. The broad contours from the May issue of *Nordic Outlook* remain intact. We are maintaining our forecast that mainland GDP will accelerate from 2.2 per cent in 2018 to 2.6 per cent in 2019. Waning petroleum sector demand will slow growth to 2.1 and 1.9 per cent in 2020 and 2021, respectively. Total GDP should grow by 2.9 per cent in 2020 and 2.1 per cent in 2021. We assume no contribution from fiscal policy in 2020-2021.

Industrial activity boosted by petroleum investment

The capital spending cycle in oil and gas extraction has turned markedly stronger. Measured in volume terms, such investment is up 26 per cent from its cyclical trough in early 2018. Development of new fields on the Norwegian continental shelf will boost investment activity further in the second half, and capital spending is expected to accelerate by 16.0 per cent in 2019. The direct contribution to annual GDP growth is estimated at 1.0 percentage points and will provide the rest of the economy with important demand impulses. A thinner pipeline of new projects will slow investment growth to 2.5 in 2020 and -1.5 per cent in 2021.

External risks have not had a notable impact on industrial activity. Although business sentiment has trended lower, it remained above its long-term average in the second quarter, indicating trend-like growth in production. Details are showing a growing split within manufacturing, where output growth in petroleum-related sectors is running well-ahead of others. Production of export-oriented intermediate goods has nonetheless been surprisingly resilient, and companies reported rising foreign orders in the most recent Business Tendency Survey. The sharp depreciation of the krone has improved competitiveness and kept foreign demand intact. Looking ahead, manufacturing output is likely to slow when the demand impulses from the petroleum sector ease. We expect exports of traditional goods to grow by 2.2 and 1.6 per cent in 2020 and 2021, respectively. Substantial investment growth over the past three years and increasing uncertainty related to the global industrial cycle are likely to slow growth in business investment in the next couple of years. We expect a slowdown from 4.0 per cent in 2019 to 1.9 per cent in 2021.

A cautiously optimistic housing market outlook

Existing home prices have trended higher during the spring and recent increases put prices in July 1.5 per cent above the previous peak in March 2017. Momentum is expected to moderate in the second half. The stock of unsold homes will remain high as a large number of new dwellings are nearing completion. Although demand has been solid, the inventory-to-sales ratio has trended higher and points to a broadly balanced housing market ahead. We are maintaining our forecast implying yearly price gains of nearly 2.5 per cent in the coming years. Moderate price increases, a pick-up in housing starts and stable developments in new home sales point to a slight increase in residential investment and we expect growth of 1.0 per cent in 2019 and near 2.0 per cent yearly in 2020-2021.

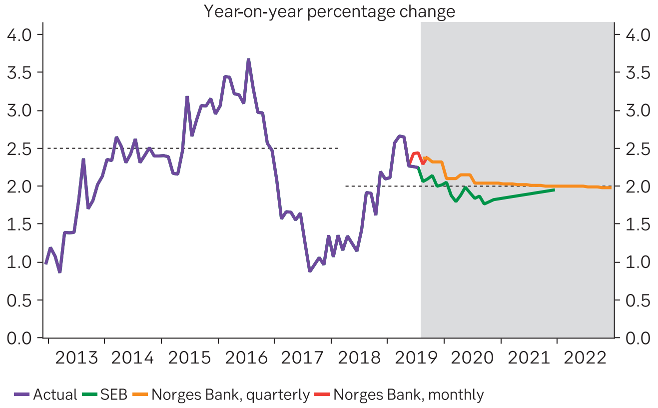
Tight labour market supporting consumption

Unemployment has been trending lower since early 2017, but momentum in the downturn has slowed this year, suggesting that the fall in unemployment appears to be largely over. The registered jobless rate has stabilised around 2.3 per cent, which is compatible with the level Norges Bank assumes to be consistent with price stability. Employment has grown at a brisk pace, rising 1.6 per cent in the first quarter from a year earlier. Job expectations according to various business surveys remain robust, but a slower inflow of new vacancies suggests job growth will moderate. We expect the Labour Force Survey unemployment rate to be relatively stable near 3.5 per cent in the years ahead. This implies that labour market conditions will remain tight. Trend-like job growth, a rebound in real wages and expansionary fiscal policy will support household income. The quarterly survey of consumer confidence has improved over the summer to a level consistent with trend-like growth in consumption. We expect private consumption to grow by 2.3 per cent in 2019 and 2.6 per cent in 2020.

We expect Norges Bank to deliver a final rate hike at the meeting in September, implying that the key rate will peak at 1.50 per cent

CPI-ATE near target in coming years

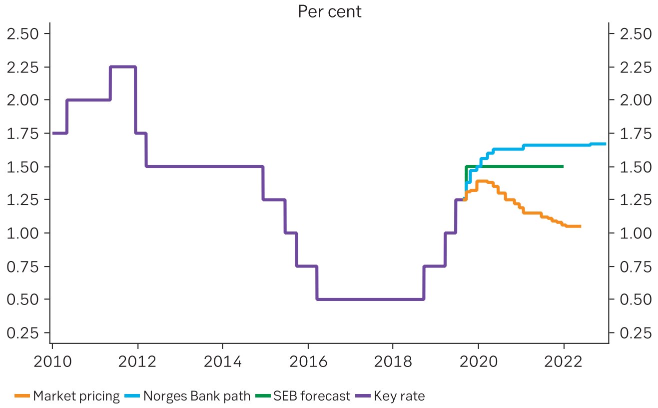
Year-on-year percentage change



Source: Bank of Norway (Norges Bank), Statistics Norway, Macrobond, SEB

Expectations for Norges Bank

Per cent



Source: Bank of Norway (Norges Bank), Macrobond, SEB

Inflation stabilising at target, Norges Bank pauses

After rising to 2.7 per cent in March, inflation has eased. In July CPI-ATE inflation (excluding taxes and energy) was 2.2 per cent. The decline is mainly due to slower food inflation, but prices of other goods and services have also fallen somewhat. The near-term inflation outlook is a bit mixed, but we believe CPI-ATE will fall to 2 per cent by year-end. Food inflation has room to fall further, and service prices will decline due to base effects from high price increases at the end of last year. Yet accelerating wage growth suggests that the underlying trend in service prices is rising. Higher goods prices were the most important driver behind the inflation upturn in mid-2018. Renewed krone depreciation means that goods prices will continue to rise firmly over the next 6-12 months. Exchange rate effects will diminish thereafter, causing CPI-ATE to fall below target. We forecast CPI-ATE inflation averaging 1.9 per cent in 2020. In 2021, gradually rising wage pressures mean inflation will approach 2 per cent. Slightly lower prices for both electricity and oil, but above all the base effects from high energy prices last summer, have caused CPI inflation to fall to just below 2 per cent in July. The difference between CPI and CPI-ATE inflation is expected to be small during our forecast period.

Norges Bank is approaching its rate peak. Norges Bank defied dovishness abroad and raised the key rate to 1.25 per cent in June, while signalling one more hike later in 2019. The hikes have been motivated by strong domestic growth that has boosted the risk of accelerating price and wage inflation. Meanwhile, external risks have intensified, suggesting a more cautious approach ahead. We expect a final hike at the upcoming September meeting, implying that the key rate will peak at 1.50 per cent. Above-trend growth in the mainland economy, near-target inflation and financial stability worries will persuade the central bank to leave the key rate unchanged at 1.50 per cent throughout 2020 and 2021.

NOK to remain weak. Price action in the krone has been poor this summer, leading to new multi-year lows against both the euro and dollar. The anticipated support to the krone from solid fundamentals such as strong economic growth and Norges Bank rate hikes has been lacklustre. We expect one final rate hike in September, but this is unlikely to have any material impact on the krone trend. The current environment is negative for small currencies in general, and we believe risk sentiment will remain a decisive driver in the FX market. We thus expect external risks to keep the krone weak for the rest of 2019. We believe the EUR/NOK exchange rate will fall from 10.30 by year-end to 9.60 and 9.30 by the end of 2020 and 2021, respectively. Our expectation of the krone remaining historically weak suggests currency-related demand for Norwegian government bonds (NGBs) will be lower. Interest rates have fallen substantially in line with international trends, but the relatively high key rate results in positive yields across the curve. NGBs thus still offer attractive yields compared to German equivalents. We forecast a 10-year yield spread against Germany of 170 and 160 basis points by the end of 2020 and 2021, respectively.

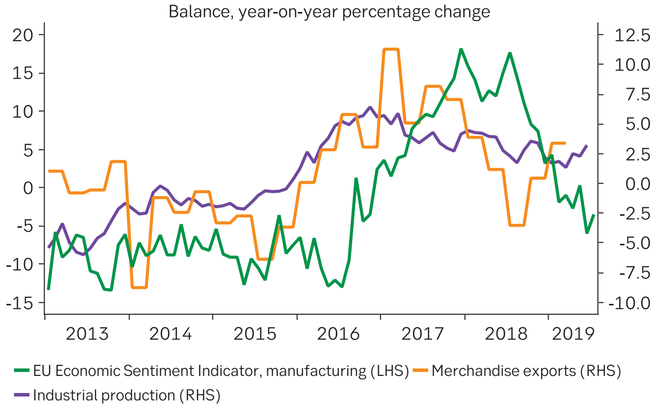
Finland

Strong start to 2019, in spite of lower optimism

Despite falling sentiment, industrial production and exports held up well in the first half. Looking ahead, we expect euro area weakness to hamper Finnish industry. The domestic economy has been resilient, and rising employment – combined with somewhat faster pay hikes – will enable GDP growth to stay at around 1.5 per cent yearly in 2019-2021. The new government will focus on social welfare reforms, but public sector debt, which fell below 60 per cent of GDP in 2018, will slowly continue downward.

Increasing production and exports despite falling sentiment

Balance, year-on-year percentage change



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

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	1.7	1.5	1.6	1.6
Unemployment*	7.4	6.5	6.2	6.1
Wages and salaries	1.1	1.5	2.0	2.2
HICP inflation	1.2	1.3	1.5	1.6
Public sector financial balance**	-0.7	-0.8	-0.7	-0.5
Public sector debt**	58.9	58.5	58.0	57.0

* Per cent ** Per cent of GDP. Source: Eurostat, SEB

Rebound after 2018 slump, despite flagging business sentiment. As in other parts of the euro area, sentiment indicators have gradually fallen in Finland. Manufacturers are gloomier while more domestically oriented sectors are in a somewhat better mood, which also fits the pattern. As the mood in the manufacturing and construction sectors has continued to worsen, service sector sentiment has actually improved slightly. Despite falling sentiment among manufacturers, economic growth accelerated during the first half of 2019 after a slump that lasted during much of 2018. GDP statistics are a little hard to interpret, however, including major fluctuations in consumption, inventories and imports.

Exports have accelerated. During the past six months, Finnish exports grew by about 3 per cent quarter-on-quarter, while imports were weak. Meanwhile the order situation has gradually deteriorated. Given the general weakness in the euro area, we predict that exports will increase at a slower pace ahead. Capacity utilisation has fallen slightly, and manufacturing sector investments will decelerate over the next couple of years. Meanwhile building permits are indicating weaker residential investment activity as well. Although we expect industrial production and investments to slow somewhat, Finland's GDP growth will end up at above the euro area average throughout our forecast period.

Job growth will decelerate. Since the end of 2017 employment has surged, increasing much faster than the country's moderate GDP growth would normally indicate. In June, unemployment stood at 6.5 per cent. This was nearly 1 percentage point lower than a year earlier and only a few tenths above the low in 2008. We see good prospects for a continued decline in unemployment and do not believe that growth will be curtailed to any great extent by supply-side factors during our forecast period. Looking ahead, we expect employment to increase at a slower pace as companies try to boost their productivity, which fell last year. Despite the positive labour market trend, pay increases are modest: around 1.5 per cent yearly. Because of weak productivity and relatively low wage pressure in competitor countries, the upturn in pay increases will be moderate, reaching 2.5 per cent by the end of our forecast period.

Limited manoeuvring room for households. Finnish households have been squeezed by a long period of recessions and fiscal austerity measures. Consumption has risen but despite job growth, household incomes are rising relatively slowly. The pay increases that we are predicting will be somewhat higher than inflation, which we expect to remain slightly below 1.5 per cent in the coming year. Meanwhile the household savings ratio is already around zero. Home prices are largely unchanged, although there are regional differences. Consumption will increase by about 1.5 per cent yearly in 2019-2021.

Improved government finances, but continued deficits. Earlier cost-cutting programmes and employment-intensive growth pushed the public sector deficit below 1 per cent of GDP. Last April's election results were fragmented, and for the first time no party received more than 20 per cent of the vote. The new government, led by the Centre Party, is now negotiating its first budget and among other things is expected to focus on social welfare reforms such as helping pensioners and low-income households. Ahead of the negotiations, the finance minister clearly signalled that the government's resources are limited. We expect a slightly expansionary fiscal policy that will leave budget deficits largely at their current levels throughout our forecast period. Last year Finland's public sector debt fell below the EU's benchmark – 60 per cent of GDP – for the first time in five years. We expect it to continue falling slowly to 57 per cent of GDP in 2021.

The Baltics

So far, the Baltic economies have been resilient to the global economic slowdown and have shown comparatively healthy growth. This autumn and next year, however, their expansion will cool significantly as exports weaken and capital spending appetite fades amid uncertainty about the future. Despite a rate of pay increases substantially higher than in many other EU countries, inflation in the Baltics will be stable at or a bit above 2 per cent, although inflation may become a challenge in the future.

Estonia

7.8 %

The lowest public sector debt in the EU, as a percentage of GDP. Despite slower economic growth, this debt ratio will continue to fall.

Page 50

Latvia

2.4 %

Our GDP growth forecast for 2019. Because of changing international conditions, we have lowered our forecasts for both 2019 and 2020 by more than 1 percentage point.

Page 51

Lithuania

8.2 %

This projected rate of wage and salary increases during 2019 is the highest among the Baltic countries.

Page 52

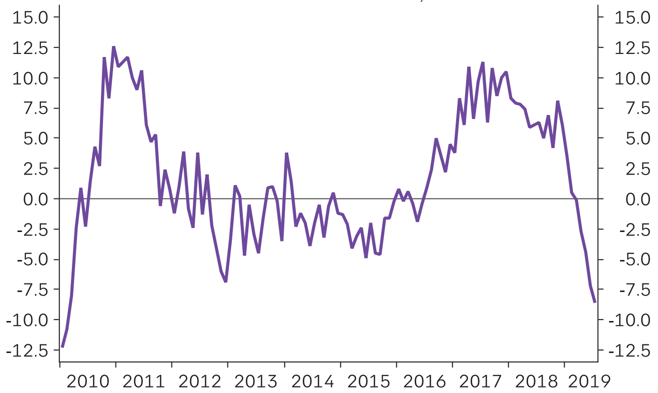
Estonia

Good luck is about to turn

While economic headwinds have forced many countries to lower their growth forecasts, Estonia has stood out as a rare exception. We now expect GDP to expand by 3.0 per cent in 2019, mainly due to a strong start in Q1, but the second half of 2019 – as well as 2020 and 2021 – will see much lower growth figures as the economy faces decelerating demand, both in export markets and domestically.

Industry has lost its confidence

Industrial Confidence Index, SA



Source: European Commission (DG ECFIN)

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	3.9	3.0	2.3	2.0
Private consumption	4.8	3.5	2.6	2.3
Exports	4.6	2.2	2.4	2.8
Consumer price index (CPI)	3.4	2.3	2.2	2.0
Unemployment*	5.4	5.4	6.0	6.4
Wages and salaries	7.3	7.6	6.2	5.4
Public sector financial balance**	-0.5	-0.2	-0.3	-0.3
Public sector debt**	7.9	7.8	7.5	7.5

* Per cent ** Per cent of GDP. Source: Statistics Estonia, SEB

Strong first half in Estonia despite bleak European data. In Q1, GDP growth accelerated to 4.5 per cent due to a surge in capital spending and strong exports. The risks highlighted in our previous forecasts, such as slowing trade and shrinking demand for real estate, have not yet materialised or their impact has been more muted. But Estonia's luck is about to turn in the second half of the year. Exports, which had previously shown strong growth, dropped 10 per cent in June. Further troubles lie ahead, and industrial confidence has quickly dropped to its lowest level since 2010. A tripling of the price of CO_2 quotas has been a serious hit to the Estonian energy sector, which relies on oil shale. The large wood production sector is experiencing headwinds due to shrinking demand and oversupply. However, problems in manufacturing are not only cyclical and confined to few sectors, but also stem from the very high wage growth of recent years, which is forcing manufacturers to reduce their labour dependency and aim for higher value-added products. These factors will keep Estonia's yearly export growth below 3 per cent during our forecast period.

Construction has been a key driver, thanks to strong demand for new homes. Yet due to the sharp drop in the birth rate in the early 1990s, the potential customer base is shrinking. Construction volume has already started to come down, but the decline in new building permits has been more moderate than previously expected. Another concern is the future level of public sector investments. The current budget period for the European Union's structural funds is ending in 2020. In the next round, Estonia will receive significantly less EU money. This will definitely depress public investments, which have thus far been mostly financed using EU funds. In addition, because of worsening business sentiment, the outlook for stronger growth in other capital spending looks grim.

Significant rise in living standards due to strong labour market. Private consumption growth will again exceed 3 per cent in 2019. This year, consumers are also benefiting from slower inflation. While CPI grew by 3.4 per cent both in 2017 and in 2018, this year it will average just a little over 2 per cent. Lower energy prices have been one of the key factors behind this, but the new government's decision to lower excise duties on alcohol has also had an impact. The cooling economic climate will nevertheless put a limit on the increases in household spending, and in 2020 and 2021 private consumption will grow by only around 2.5 per cent yearly.

First cracks are appearing in previously solid labour market. While Labour Force Survey data for Q2 were good, with an employment rate of 68.1 per cent and joblessness at 5.1 per cent, registered unemployment as recorded by the Unemployment Insurance Fund in July was the highest since 2013. Layoffs in the energy sector and manufacturing have had an impact and are expected to continue in the second half of 2019. Consumer polls also show higher unemployment expectations. The upturn will nevertheless be limited, and the unemployment rate should average 5.4 per cent in 2019 and only rise to 6.4 per cent in 2021.

Reversing previous reforms is the new government's top priority. In June, excise duties on alcohol were reduced by 25 per cent. The previous government had significantly raised them. Another major government undertaking is a reform of the 2nd pension pillar, aimed at allowing people to stop saving for their retirement and also take out their accumulated funds. In the short term this could have a positive effect on private consumption, but similar reforms in other countries have shown that most people continue saving.

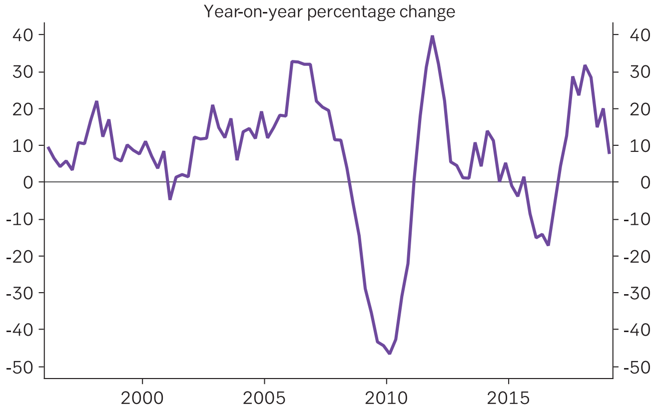
Latvia

Economy drops out of the fast lane

The Latvian economy saw an unexpectedly sharp slowdown in the second quarter. Uncertainty about world developments will continue to affect sentiment and growth negatively, and we have adjusted our GDP forecast more than 1 percentage point lower for both 2019 and 2020. Due to slower economic growth of around 2-2.5 per cent, the labour market will cool off. We expect the rate of pay increases to slow from 7 per cent in 2019 to 4.5 per cent in 2021.

Sharp fall in construction, but there are encouraging signs

Year-on-year percentage change



Source: Latvian Central Statistical Bureau, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	4.8	2.4	2.0	2.5
Private consumption	4.6	2.9	2.6	3.2
Exports	1.8	-0.3	2.8	3.5
Consumer price index (CPI)	2.5	2.8	2.2	2.2
Unemployment*	7.4	6.5	6.1	6.2
Wages and salaries	8.4	7.0	6.0	4.5
Public sector financial balance**	-1.0	-0.9	-0.9	-0.9
Public sector debt**	35.9	33.5	32.0	31.5

*Per cent **Per cent of GDP. Source: Latvia CSB, SEB

Sharp deceleration in growth. The growth rate dropped from 3 per cent in the first quarter of 2019 to 2.1 per cent in Q2. While lower momentum was inevitable, the pace of this change was unexpected. Going forward, private consumption will be a key driver, while external trade will provide a negative contribution to GDP. EU structural fund inflows will serve as a stabiliser, but increased uncertainty will constrain business investment plans. The risk of recession has increased, but our main forecast is that the economy will keep growing, though more slowly. We have adjusted our GDP forecast more than 1 percentage point lower for both 2019 and 2020. We now predict GDP growth of 2.4 per cent in 2019 and 2.3 per cent in 2020. In 2021 we expect growth to climb to 2.5 per cent.

Record-strong sentiment, but modest spending. According to the Latvian Barometer survey, the overall sentiment of the country's residents rose in June to its highest level on record. However, retail growth is subdued after some spikes early in the year. In June retail sales grew by just 2.1 per cent. Household spending will remain modest despite strong real wage growth and a tight labour market. We forecast that private consumption will climb by 2.9 per cent this year, slow to 2.6 per cent growth next year and rebound to 3.2 per cent in 2021.

Rapid expansion phase in construction is over. After surging by 22 per cent in 2018, construction growth slowed to just 1 per cent in Q2. Completion of large-scale private projects, capacity constraints and peaking EU fund inflows suggest that growth in coming years will be very limited but volatile. Yet an increase in issuance of building permits, especially for the construction of private homes, industrial and other specialised construction projects provides encouraging signals for the sector's outlook.

Global headwinds are hurting exports and manufacturing. In June, exports of goods dropped by 8.2 per cent. During the first half of the year, export growth stayed just above zero, at 0.3 per cent. Current export performance is very disappointing, indicating that goods exports will continue to be a major drag on GDP growth. With no clear indication of a long-term solution to ongoing trade disputes, goods exports could fall by as much as 3-4 per cent this year. However, service exports might keep expanding, especially in the ICT sector. In the first half of this year, service exports rose by 5.6 per cent and could offset part of the negative contribution from goods exports. Manufacturing growth is likely to remain subdued in the second half but will reach 1.5 per cent this year and then pick up to 3-3.5 per cent in the next two years.

Cooler economy will mean slower pay increases. Because of weaker economic growth, unemployment will now level off somewhat above 6 per cent after a long period of falling. We expect wage and salary growth to decline from an average of 7.0 per cent this year to 4.5 per cent in 2021. Despite being high compared to other euro area countries, this would be the weakest increase rate since 2012.

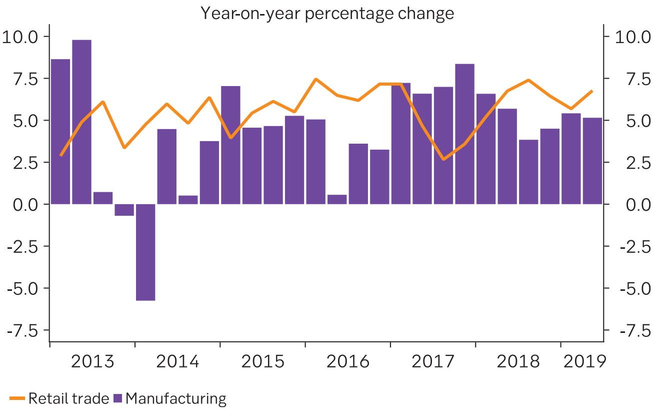
Inflation will fall. In July, inflation slowed to 2.9 per cent. Due to weakening cost pressure and lower energy prices, inflation will decelerate to 2 per cent this autumn, although higher food prices and utility tariff hikes will prevent it from heading even lower. Slower wage and salary increases and falling inflation expectations will relieve pressure on service prices, helping keep the annual average inflation rate at only 2.2 per cent in both 2020 and 2021.

Lithuania

Growth keeps on surprising

GDP growth was stronger than we expected in the first half of 2019 on surprisingly strong net exports. We are conservative about manufacturing output and exports for the remainder of 2019 and 2020. Private consumption growth will slightly decelerate as increases in employment and real wages slow. Unemployment will stay at close to six per cent. Pressure to increase public sector salaries will continue.

Still solid results from retail and manufacturing sectors



Source: Statistics Lithuania, Macrobond, SEB

Key data

Year-on-year percentage change

	2018	2019	2020	2021
GDP	3.5	3.6	2.4	2.6
Private consumption	3.9	3.7	3.2	3.2
Exports	5.1	4.6	2.7	3.0
HICP inflation	2.5	2.4	2.3	2.4
Wages and salaries	9.9	8.2	6.5	5.8
Public sector financial balance*	0.7	0.3	0.1	0.0
Public sector debt*	34.2	36.5	35.5	34.5
Current account*	1.6	1.5	0.4	0.6

* Per cent of GDP. Source: Statistics Lithuania, SEB

The Lithuanian economy expanded by 4.2 per cent in the first half of 2019. Stronger-than-expected net exports contributed the most to GDP growth, which exceeded market consensus. The manufacturing sector managed to withstand deteriorating demand in markets such as Germany early this year. However, manufacturing output is likely to stagnate or even drop in the second half of 2019 and grow only at a marginal rate in 2020. Private consumption drivers remain healthy, but the growth rate will be lower in 2020 and 2021. Taking into account Lithuania's solid economic growth in the first half of 2019, we have raised our GDP forecast for 2019 from 3.2 to 3.6 per cent but have left our 2020 forecast unchanged at 2.4 per cent. In 2021 GDP should increase by 2.6 per cent, which is close to the medium-term potential growth rate.

Investments important growth driver. Continued satisfactory growth in private and public investments is also playing a major role in the GDP growth rate. However, we see a clear risk that global trade tensions and a cautious outlook on economic growth will have a negative effect on capital spending by export companies in the next couple of years. This year, machinery and equipment investments are already growing at a slower pace than investments in real estate. The latter investments benefit from a strong trend in demand for commercial and residential properties, but rapidly increasing supply will lead to higher vacancy rates in the office market and unsold residential properties in 2020.

Private consumption will decelerate. Private consumption growth is expected to decelerate from 3.7 per cent to 3.2 per cent in 2020 and 2021. Slower increases in employment and real wages will reduce the growth rate of household spending. The employment rate (ages 15-64) is already at 73 per cent and above the EU average, leaving less and less room for further growth. Employment of workers from outside the EU will remain an attractive option for employers, but the government will have to put more effort into attracting economically inactive people back into the labour market and upskilling the entire labour force.

Tight labour market also ahead. Slower growth will marginally reduce the tightness of the labour market. We forecast that unemployment will remain close to its current level of 6 per cent over the next two years. This would contribute to slower growth in average wages and salaries, which will increase by 8.2 per cent this year, 6.5 per cent in 2020 and 5.8 in 2021. The government has already approved a 9.4 per cent increase in the minimum monthly wage in 2020. There will be great pressure to raise the salaries of public sector employees in 2020, but we forecast that they will have to be satisfied with slower salary growth next year. The ruling coalition has also agreed to hike the universal monthly child benefit from 50 to 70 euros in 2020. However, there is more uncertainty how much the lower threshold for income taxation will rise next year.

We have marginally reduced our inflation forecast but still expect average headline inflation to remain close to 2.5 per cent during our forecast period. The economy will keep on converging to the average EU level, and this will lead to increasing wages and prices of services accordingly. This year, inflation is being partly driven by a jump in prices of vegetables, due to a hot, dry summer that has reduced harvests.

The newly elected President, Gitanas Nausėda, is seeking to increase tax revenues from 30 to 35 per cent of GDP and boost spending by as much over the next five years, but this will be hard to achieve if Parliament remains afraid of raising property and green taxes. In 2019 fiscal policy is procyclical, with a smaller budget surplus despite higher growth in GDP. The 2020 and 2021 budgets are expected to be close to balance.

Key indicators

Global key indicators

Yearly change in per cent

	2018	2019	2020	2021
GDP OECD	2.3	1.6	1.5	1.5
GDP world (PPP)	3.7	3.1	3.2	3.3
CPI OECD	2.6	1.9	1.9	2.0
Oil price, Brent (USD/barrel)	72	62.5	70	70

US

Yearly change in per cent

	2018 level, USD bn	2018	2019	2020	2021
Gross domestic product	20,580	2.9	2.3	1.8	1.7
Private consumption	13,999	3.0	2.5	2.4	1.9
Public consumption	2,904	1.7	1.7	1.2	1.0
Gross fixed investment	4,316	4.4	2.5	1.8	1.6
Stock building (change as % of GDP)		0.1	0.2	-0.1	0.0
Exports	2,510	3.0	0.2	1.5	1.9
Imports	3,149	4.4	2.1	3.0	2.3
Unemployment (%)		3.9	3.6	3.5	3.7
Consumer prices		2.5	1.7	1.9	2.0
Core CPI		2.1	2.1	2.1	2.1
Household savings ratio (%)		7.7	8.2	8.2	8.4
Public sector financial balance, % of GDP		-5.3	-4.9	-4.6	-4.6
Public sector debt, % of GDP		106.8	108.0	109.0	110.0

Euro area

Yearly change in per cent

	2018 level, EUR bn	2018	2019	2020	2021
Gross domestic product	11,586	1.9	1.0	1.1	1.3
Private consumption	6,230	1.3	1.2	1.3	1.3
Public consumption	2,353	1.0	1.0	1.0	1.0
Gross fixed investment	2,422	2.1	2.0	2.0	2.0
Stock building (change as % of GDP)	0	0.1	0.0	0.0	0.0
Exports	5,565	3.4	2.2	2.8	3.1
Imports	5,051	2.7	3.0	3.5	3.5
Unemployment (%)		8.2	7.6	7.2	7.1
Consumer prices		1.8	1.2	1.2	1.5
Core CPI		1.0	1.1	1.3	1.5
Household savings ratio (%)		6.2	6.0	6.0	0.0
Public sector financial balance, % of GDP		-0.5	-0.8	-0.8	-0.8
Public sector debt, % of GDP		85.1	84.4	82.7	82.7

Other large countries

Yearly change in per cent

	2018	2019	2020	2021
GDP				
United Kingdom	1.4	1.3	1.4	1.5
Japan	0.8	1.2	0.7	0.5
Germany	1.5	0.5	0.7	1.2
France	1.7	1.2	1.3	1.4
Italy	0.9	0.1	0.6	0.8
China	6.6	6.3	6.1	6.0
India	7.4	6.7	7.0	7.2
Brazil	1.1	0.8	2.0	2.8
Russia	2.3	0.8	1.7	1.9
Poland	5.1	4.2	3.1	3.0
Inflation				
United Kingdom	2.5	1.9	1.8	1.7
Japan	1.0	0.7	1.4	0.8
Germany	1.7	1.5	1.5	1.6
France	1.9	1.3	1.4	1.5
Italy	1.3	1.1	1.2	1.3
China	2.1	2.1	1.5	1.8
India	4.0	3.5	3.5	4.1
Brazil	3.7	4.0	4.2	4.2
Russia	2.9	4.7	4.0	4.1
Poland	1.7	2.0	2.5	3.0
Unemployment (%)				
United Kingdom	4.1	3.9	3.9	4.0
Japan	2.4	2.3	2.3	2.2
Germany	3.4	3.4	3.6	3.8
France	8.9	8.6	8.4	8.4
Italy	10.6	9.9	9.7	9.5

Financial forecasts

Official interest rates		21-Aug	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21
US	Fed funds	2.25	1.75	1.50	1.50	1.50	1.50
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Euro area	Refi rate	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	Repo rate	0.75	0.75	0.75	0.75	0.75	1.00
Bond yields							
US	10 years	1.59	1.40	1.30	1.30	1.50	1.50
Japan	10 years	-0.25	-0.20	-0.20	-0.20	-0.10	-0.05
Germany	10 years	-0.68	-0.70	-0.70	-0.70	-0.50	-0.40
United Kingdom	10 years	0.48	0.40	0.40	0.50	0.80	0.90
Exchange rate							
USD/JPY		106	105	103	100	100	100
EUR/USD		1.11	1.13	1.15	1.17	1.19	1.20
EUR/JPY		118	119	118	117	119	120
EUR/GBP		0.91	0.93	0.85	0.87	0.88	0.88
GBP/USD		1.21	1.22	1.35	1.34	1.35	1.36

Sweden

Yearly change in per cent

	2018 level, SEK bn	2018	2019	2020	2021
Gross domestic product	4,790	2.4	1.5	1.3	1.7
Gross domestic product, working day adjustment		2.5	1.5	1.1	1.6
Private consumption	2,115	1.2	0.7	1.3	1.7
Public consumption	1,253	0.9	0.2	0.2	0.2
Gross fixed investment	1,223	4.0	0.0	-0.7	2.2
Stock building (change as % of GDP)	48	0.3	0.0	0.0	0.0
Exports	2,253	3.9	3.2	1.4	2.6
Imports	2,102	3.8	0.9	-0.4	2.0

Unemployment, (%)	6.3	6.5	6.8	7.0
Employment	1.8	0.4	0.4	0.5
Industrial production	3.4	1.5	0.0	2.0
CPI	2.0	1.7	1.4	1.6
CPIF	2.1	1.7	1.6	1.7
Hourly wage increases	2.5	2.6	2.7	3.1
Household savings ratio (%)	16.4	17.3	17.8	17.5
Real disposable income	1.8	2.3	2.2	1.5
Current account, % of GDP	2.0	2.9	3.2	3.5
Central government borrowing, SEK bn	-80	-130	-5	-30
Public sector financial balance, % of GDP	0.9	0.3	0.2	0.0
Public sector debt, % of GDP	38.8	34.6	34.0	32.5

Financial forecasts	21-Aug	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21
Repo rate	-0.25	-0.25	-0.25	-0.25	-0.25	0.00
3-month interest rate, STIBOR	-0.02	-0.05	-0.05	-0.05	-0.05	0.20
10-year bond yield	-0.37	-0.35	-0.30	-0.20	0.05	0.20
10-year spread to Germany, bps	31	35	40	50	55	60
USD/SEK	9.62	9.73	9.39	8.97	8.65	8.33
EUR/SEK	10.67	11.00	10.80	10.50	10.25	10.00
KIX	123.4	126.4	125.4	121.7	118.5	115.4

Finland

Yearly change in per cent

	2018 level, EUR bn	2018	2019	2020	2021
Gross domestic product	241	1.7	1.5	1.6	1.6
Private consumption	125	2.0	1.6	1.7	1.7
Public consumption	53	1.4	1.5	1.0	1.0
Gross fixed investment	53	3.1	2.0	2.5	2.5
Stock building (change as % of GDP)	0	0.9	-0.7	0.0	0.0
Exports	91	1.1	1.5	2.2	2.5
Imports	92	4.1	0.3	2.5	2.7

Unemployment, OECD harmonised (%)	7.4	6.5	6.2	6.1
CPI, harmonised	1.2	1.3	1.5	1.6
Hourly wage increases	1.1	1.5	2.0	2.2
Current account, % of GDP	-1.6	-1.2	-1.0	-1.0
Public sector financial balance, % of GDP	-0.7	-0.8	-0.7	-0.5
Public sector debt, % of GDP	58.9	58.5	58.0	57.0

Norway

Yearly change in per cent

	2018 level, NOK bn	2018	2019	2020	2021
Gross domestic product	3,227	1.4	2.0	2.9	2.1
Gross domestic product (Mainland)	2,829	2.2	2.6	2.1	1.9
Private consumption	1,473	2.0	2.3	2.6	2.3
Public consumption	788	1.2	1.8	1.5	1.4
Gross fixed investment	827	1.0	5.1	2.3	1.0
Stock building (change as % of GDP)		0.4	-0.4	0.0	0.0
Exports	1,089	-0.7	2.5	4.5	2.9
Imports	1,071	0.6	3.9	2.2	1.7
Unemployment (%)		3.9	3.5	3.6	3.6
CPI		2.8	2.3	2.1	1.9
CPI-ATE		1.5	2.3	1.9	1.9
Annual wage increases		2.8	3.3	3.5	3.5

Financial forecasts	21-Aug	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21
Deposit rate	1.25	1.50	1.50	1.50	1.50	1.50
10-year bond yield	1.13	1.00	1.00	1.00	1.10	1.20
10-year spread to Germany, bps	181	170	170	170	160	160
USD/NOK	8.96	9.12	8.61	8.21	7.97	7.75
EUR/NOK	9.94	10.30	9.90	9.60	9.45	9.30

Denmark

Yearly change in per cent

	2018 level, DKK bn	2018	2019	2020	2021
Gross domestic product	2,223	1.5	1.9	1.7	1.5
Private consumption	1,058	2.2	2.3	2.1	1.6
Public consumption	546	0.9	0.9	1.1	0.8
Gross fixed investment	499	6.6	1.6	4.1	3.0
Stock building (change as % of GDP)		0.1	-0.2	0.0	0.0
Exports	1,212	0.4	2.1	2.9	2.6
Imports	1,101	3.3	1.2	4.1	3.9
Unemployment, OECD harmonised (%)		5.2	4.5	4.2	4.2
CPI, harmonised		0.8	0.9	1.1	1.6
Hourly wage increases		2.2	1.7	2.5	2.8
Current account, % of GDP		8.0	7.0	7.0	7.0
Public sector financial balance, % of GDP		0.5	0.5	0.5	0.5
Public sector debt, % of GDP		36.0	35.0	34.0	34.0

Financial forecasts	21-Aug	Dec-19	Jun-20	Dec-20	Jun-21	Dec-21
Lending rate	-0.65	-0.85	-0.85	-0.85	-0.85	-0.85
10-year bond yield	-0.66	-0.65	-0.65	-0.65	-0.45	-0.35
10-year spread to Germany, bps	2	5	5	5	5	5
USD/DKK	6.72	6.60	6.49	6.38	6.30	6.22
EUR/DKK	7.46	7.46	7.46	7.46	7.46	7.46

Lithuania

Yearly change in per cent

	2018 level, EUR bn	2018	2019	2020	2021
Gross domestic product	45	3.5	3.6	2.4	2.6
Private consumption	28	3.9	3.7	3.2	3.2
Public consumption	7	0.8	1.0	0.8	0.6
Gross fixed investment	9	6.5	6.4	5.2	4.1
Exports	37	5.1	4.6	2.7	3.0
Imports	36	4.3	4.4	3.7	3.5
Unemployment (%)		6.2	6.0	6.0	5.9
Consumer prices		2.5	2.4	2.3	2.4
Public sector financial balance, % of GDP		0.7	0.3	0.1	0.0
Public sector debt, % of GDP		34.2	36.5	35.5	34.5

Latvia

Yearly change in per cent

	2018 level, EUR bn	2018	2019	2020	2021
Gross domestic product	30	4.8	2.4	2.0	2.5
Private consumption	17	4.6	2.9	2.6	3.2
Public consumption	5	4.0	2.0	1.7	2.3
Gross fixed investment	7	16.4	7.5	3.2	3.5
Exports	17	1.8	-0.3	2.8	3.5
Imports	18	5.1	2.3	3.3	4.2
Unemployment (%)		7.4	6.5	6.1	6.2
Consumer prices		2.5	2.8	2.2	2.2
Public sector financial balance, % of GDP		-1.0	-0.9	-0.9	-0.9
Public sector debt, % of GDP		35.9	33.5	32.0	31.5

Estonia

Yearly change in per cent

	2018 level, EUR bn	2018	2019	2020	2021
Gross domestic product	26	3.9	3.0	2.3	2.0
Private consumption	13	4.8	3.5	2.6	2.3
Public consumption	5	0.3	3.1	2.0	1.6
Gross fixed investment	6	3.3	6.8	2.8	1.5
Exports	19	4.6	2.2	2.4	2.8
Imports	18	6.2	3.5	3.0	3.5
Unemployment (%)		5.4	5.4	6.0	6.4
Consumer prices		3.4	2.3	2.2	2.0
Public sector financial balance, % of GDP		-0.5	-0.2	-0.3	-0.3
Public sector debt, % of GDP		7.9	7.8	7.5	7.5

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