Swedbank Economic Outlook

The global economy once again shaky – continued stimulus necessary

- Recovery in the US
- Fragility in the euro area
- Political uncertainty in Sweden

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Executive Summary

Uneven global recovery and geopolitical risks

We expect global growth to gradually increase to 3½% in 2014 and to around 4% in both 2015 and 2016. Leading indicators, such as PMIs, are signalling an increase in growth rates, while actual data so far have been mixed. In the US, growth in the second quarter regained some of the lost momentum from the weak first quarter, and the labour market improved consistently throughout the first half of 2014. Geopolitical tensions and Russian sanctions are affecting both sentiments and actual output in the euro area. The slowdown in the growth momentum in the euro area is led by weaker growth in the largest economies: Germany, France, and Italy; meanwhile, Spain and Portugal have managed to sustain positive growth numbers. Growth may have stabilised in China, but the investment/debt cycle represents a major risk, also for the global outlook.

Monetary policy tension

Moving forward, the focus will be on the diverging paths of monetary policy in the US and the UK, on the one hand, and the euro area, on the other hand. A gradual normalisation of monetary policy in the US and the UK stands in contrast to further easing by the ECB. The interest rate differentials between the euro area and the US will weaken the euro and facilitate a return to growth in the euro area. Still, it is a weak, fragile, and uneven recovery in global growth, heavily dominated by downside risks.

Nordic economies are exposed to external forces

Although the Swedish economy is torn between a strong US and a weak EMU; we expect the weaker performance in Europe will dominate. In addition, there is uncertainty regarding the domestic economy, related to the election outcome and the risks in the housing market. We revise down the growth forecast for this year to 2.1% and downgrade the outlook going forward, largely due to the weakening growth in the euro area. The low inflationary pressures and the ECB's expansionary monetary policy also mean that the Riksbank is expected to cut the policy rate further in the autumn. The outlook for the Nordic economies is moderate, with growth forecasts for Finland revised down, following a worse economic outlook for Russia; meanwhile, the outlook for the Norwegian and Danish economies is slightly better.

Baltic growth to suffer from geopolitical tensions and sanctions, but to remain solid

The Baltic countries will be amongst those most hurt by escalating economic sanctions by the EU and Russia, yet the impact is likely to be contained, and they will remain amongst the fastest-growing EU countries. Not only farmers and food manufacturers are susceptible, but, since the Baltic countries, especially Lithuania, serve as a large trade gateway between West and East, the transport sector is also likely to suffer. This year, Estonia is struggling more than previously expected, since it bears the burden not only of a weaker Russia, but also of an ailing Finland. Overall, the impact on economic growth will be due to weaker exports, but investments will also be dampened due to larger geopolitical uncertainties and smaller confidence. A positive side effect of this embargo is lower inflation, which, amongst many other factors, will boost household consumption. As of January 2015, all three Baltic countries, finally, will share the same currency – the euro.

Macroeconomic indicators, 2013 - 2016

	2013	2014f	2015f	2016f
Real GDP, annual change in %				
Sweden (calender adjusted)	1.6	2.1	2.3	2.5
Estonia	0.8	0.8	2.3	3.0
Latvia	4.1	2.5	2.6	3.5
Lithuania	3.3	3.0	3.5	3.8
Unemployment rate, % of labour force				
Sweden	8.0	8.0	7.6	7.0
Estonia	8.6	7.7	7.6	7.2
Latvia	11.9	10.7	9.9	8.8
Lithuania	11.8	10.9	9.7	8.5
Consumer price index, annual change in %				
Sweden	0.0	0.1	1.4	2.1
Estonia	2.8	0.3	2.5	2.7
Latvia	0.0	0.8	2.5	2.5
Lithuania	1.0	0.2	2.0	3.0
Current account balance, % of GDP				
Sweden	6.2	5.4	4.6	4.1
Estonia	-1.0	-1.3	-1.7	-2.0
Latvia	-0.8	-2.0	-2.2	-2.9
Lithuania	1.5	-1.8	-2.0	-2.4

Sources: National statistics authorities and Swedbank.

Global Outlook: Uneven recovery

Global growth is expected to rise moderately, led by decent growth in the US and the UK. Geopolitical tensions, slower-than-expected growth in the euro area, and large imbalances in many emerging markets are holding back growth. Moving forward, the focus will be on the diverging paths of monetary policy - a gradual normalisation in the US and the UK stands in contrast to further easing by the ECB. The interest rate differentials between the euro area and the US will weaken the euro and facilitate a return to growth in the euro area. Still, it is a weak, fragile, and uneven recovery in global growth, heavily dominated by downside risks.

US and UK pull ahead, euro area lags

Our global macroeconomic outlook remains cautious, and we expect global growth to gradually increase to 3½% in 2014 and to around 4% in 2015 and 2016. Leading indicators, such as purchasing managers' indices (PMIs), are signalling an increase in growth rates, while actual data so far have been mixed. In the US, growth in the second quarter regained some of the lost momentum from the weak first quarter, and the labour market improved consistently throughout the first half of 2014. UK developments are similar, with accelerating growth rates and lower unemployment. In the euro area, leading indicators are falling back, following weak output growth in the first half of 2014. Geopolitical tensions and Russian sanctions are affecting both sentiments and actual output in the euro area. The slowdown in the growth momentum in the euro area is led by weaker growth in the largest economies: Germany, France, and Italy; meanwhile, Spain and Portugal have managed to sustain positive growth numbers. Also, the outlook for the Nordic economies is moderate, with growth forecasts for Finland revised down, following a worse economic outlook for Russia, while the outlook for the Norwegian and Danish economies are slightly better. We expect commodity prices to decline, and thus put a downward pressure on inflation.

Swedbank's global GDP forecast [1] (annual percentage change)

	2013	2014f		2015f		2016f
USA	2,2	2,1	(3,0)	3,1	(3,1)	2,6
EMU countries	-0,4	0,8	(1,3)	1,7	(1,9)	2,0
Germany	0,2	1,6	(2,0)	2,0	(2,2)	2,0
France	0,4	0,3	(1,1)	1,4	(1,9)	2,0
Italy	-1,8	-0,2	(0,4)	1,1	(1,4)	1,6
Spain	-1,2	1,3	(1,0)	2,4	(1,8)	2,7
Finland	-1,2	-0,2	(0,2)	0,5	(1,3)	1,3
UK	1,8	3,1	(2,8)	2,6	(2,4)	2,1
Denmark	0,4	1,7	(1,6)	1,8	(2,0)	2,2
Norway	2,0	2,3	(1,8)	1,8	(2,1)	2,2
Japan	1,5	1,2	(1,4)	1,0	(1,0)	0,9
China	7,8	7,3	(6,9)	6,9	(6,5)	6,6
India	4,7	5,5	(5,5)	6,8	(6,8)	6,7
Brazil	2,5	1,7	(2,2)	2,5	(2,5)	2,4
Russia	1,2	-0,1	(0,8)	-0,6	(0,8)	1,0
Global GDP in PPP [2]	3,3	3,4	(3,5)	4,0	(3,8)	3,9

1/ April 2014 forecast in parenthesis.

2/ World Bank weights (revised 2014). Sources: IMF and Swedbank.

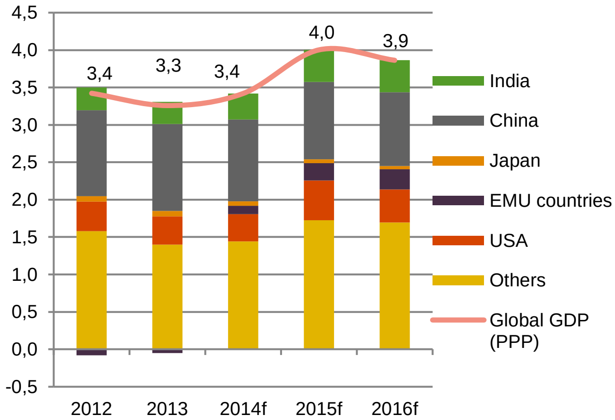
Main growth push still from emerging economies

Emerging economies are still the main contributors to global growth, but developments in individual countries are diverging sharply. The Russian economy is weakened by The Russia-Ukraine conflict. The US, the EU, and other countries have extended the sanctions against Russia into energy, defence, and financial markets. We revise down our growth forecast for Russia and now expect the Russian economy to contract in both 2014 and 2015, while our underlying view on the Russian economy has not changed. The Russian economy is structurally weak, and the conflict with Ukraine is making it worse. Other emerging markets are also struggling, but the outlook has stabilised in India due to a decisive central bank and a growth-friendly new government. Economic growth in China has surprised on the upside, but the housing market imbalances are being corrected and prices are now falling in a majority of larger cities. Countries such as Brazil, Turkey, and South Africa are struggling with high inflation and weaker output growth, while remaining highly vulnerable to global financial capital flows due to large current account deficits. Normalisation of US monetary policy may put additional pressure on these countries.

Timing and scope of further easing from the ECB in focus

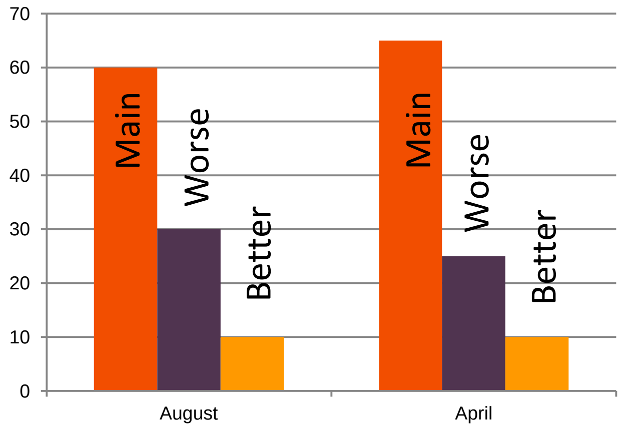
A key theme for global growth and financial markets in the coming years will be the divergence in monetary policy between the US and the euro area. While US inflation is approaching the Federal Reserve (Fed) policy goal of 2 percent and unemployment is declining faster than anticipated, inflation in the euro area keeps falling. At the June monetary policy meeting, the ECB lowered the refi rate to 0.15% and the deposit rate into negative territory at – 0.10%. A new round of long-term refinancing operations (TLTROs), this time targeting lending to the private sector, was announced to be introduced in September. A further fall in inflation and growth coming to a halt have intensified the discussions and demands for further easing from the ECB. The divergence in monetary policy between the ECB and the Fed and its consequences for market interest rates and currencies will therefore be a dominating theme throughout the fall. There remains a high degree of uncertainty about what the ECB can or is willing to do to further stimulate the euro area economy. A programme of quantitative easing would be contentious, but may nevertheless be launched this autumn. The ECB has already signalled a willingness to buy forms of asset-backed securities from banks under the right conditions and is actively supporting regulatory changes that will facilitate the market for these securities to grow. In addition, the results of the asset quality review and stress test of euro area banks will be crucial to ECB policy and the return to health of the euro area banking sector.

Contribution to global growth (pp)



Sources: Ecowin and Swedbank's forecasts.

Forecast risk scenarios (prob. in %)



Source: Swedbank

Geopolitical risks boost a negative scenario

The negative risks to our forecast have increased substantially since April, and we lower the probability of our main scenario from 65% to 60%. The downside risks are dominating, with a 30% probability for a worse outcome, and a mere 10% probability of a better outcome. Downside risks are connected to the increased geopolitical tensions due to the Russia-Ukraine conflict, as well as to the intensified negative developments in the Middle East. The Russia-Ukraine conflict has led to sanctions and lower trade between Russia and the EU. The slowdown in sentiment indicators and in growth in Germany and the euro area may well be related to increased geopolitical tensions. Further escalation in the conflict during the fall and the potential for energy supply disruption as the winter approaches exacerbates the risks to the fragile euro area recovery. In addition, the growth momentum in emerging economies has slowed, and several countries suffer from underlying structural weakness that make them highly sensitive to adverse developments on financial markets. A slowdown in China and tighter US monetary policy could cause a further slowdown in growth and lead to financial instability in many emerging market countries.

A gradual normalisation of markets expected

During the fall of 2014 and early 2015, the development of long-term interest rates will be dominated by the monetary policy in the U.S. The Fed is expected to finish its bonds purchases in October 2014, and, if the U.S. economy does not suffer any major setbacks, we expect the Fed to start increasing the Fed funds rate by the middle of 2015. The increase in long-term market interest rates that would normally be observed due to tighter monetary policy in the US will be counteracted by an easing bias from the ECB. We therefore expect to see a divergence in market interest rates between the US and Europe. Over the whole forecast period, we revise down our interest rate forecasts for German (proxy for euro area) and Swedish bonds, while keeping the forecast mainly intact for US bonds.

Stronger US dollar

Correspondingly, we expect the U.S. dollar to strengthen against the euro over the next 12-18 months, after which the euro will recover somewhat. The sterling also gains compared with the euro. The yen will depreciate, while the Chinese renminbi is expected to gradually strengthen in value.

Interest and exchange rate assumptions, %

	Outcome	Forecast				
	2014	2014	2015	2015	2016	2016
	22-Aug	31 Dec	30 Jun	31 Dec	30 Jun	31 Dec
Policy rates						
Federal Reserve, USA	0,25	0,25	0,50	1,00	1,50	2,00
European Central Bank	0,15	0,15	0,15	0,15	0,15	0,50
Bank of England	0,50	0,50	0,75	1,00	1,25	1,50
Bank of Japan	0,10	0,10	0,10	0,10	0,10	0,10
Government bond rates						
Germany 2y	0,0	0,0	0,0	0,1	0,1	0,1
Germany 10y	1,0	1,1	1,2	1,3	1,3	1,3
US 2y	0,5	1,0	1,5	1,9	1,9	1,9
US 10y	2,4	3,0	3,2	3,4	3,4	3,4
Exchange rates						
EUR/USD	1,33	1,30	1,25	1,23	1,23	1,25
USD/CNY	6,2	6,1	6,0	5,9	5,9	5,8
USD/JPY	104	105	105	107	107	110
EUR/GBP	0,80	0,77	0,76	0,77	0,77	0,79

Sources: Reuters Ecowin and Swedbank.

Euro area: Growth slumped in second quarter

Disappointing lack of growth in Q2

A year after exiting recession, growth fell back almost to zero in the euro area in the second quarter. This was much lower than expected and indicated by business surveys such as the PMIs, usually the best guide to current business developments. The industrial sector showed a marked downturn in production throughout the quarter, suggesting obstacles may have come in the way of growth after a clear upward trend over the past year. The downturn was all the more surprising as important demand factors have been improving, including a close to 2% rate of growth in retail sales and a continued decrease in unemployment in most countries.

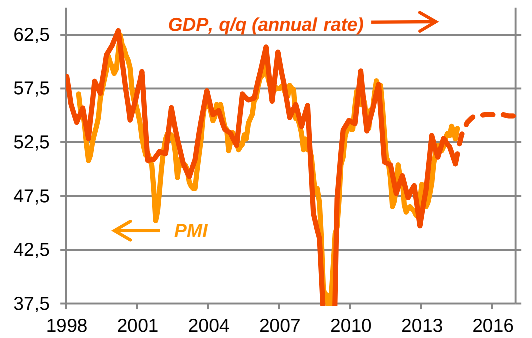
Unequal development

Developments remain unequal across the four main euro area economies. The French economy posted yet another quarter of zero growth, in line with business surveys. The Italian economy contracted by 0.2%; expectations were set higher as PMIs have improved considerably in recent months. Spain reported that growth accelerated to 0.6%, confirming that the upswing is taking hold. The main surprise, however, was a reported 0.2% contraction in the German economy, which has been growing at a decent pace over the past year. Several factors have been invoked to explain why the setback in Germany may only be temporary; all the same, business surveys have faltered somewhat in the past few months, and firms seem increasingly anxious about the outlook. Many are worried that the conflict with Russia may escalate further. While a full-blown trade war seems unlikely, this development may hurt confidence, and thus business investments and household consumption.

Unclear how the ECB will respond

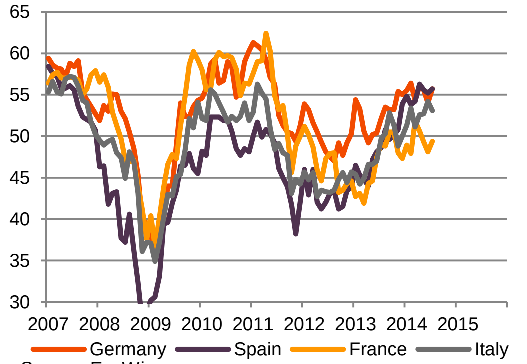
The ECB cut interest rates in June in response to very low inflation and a relatively modest outlook. Over the past months, inflation has stabilised, in particular the core inflation measure, which has stood at about 0.8% for quite some time. On this basis, the threat of deflation seems modest. The ECB will be rolling out its new cheap loan arrangements for banks (called TLTROs) this autumn and would naturally want to see the effects of these programmes before they launch new measures. But slower economic growth, if seen as persistent, will affect the inflation outlook and may prompt further action. Policy rates are already at the zero bound, so the next step would most likely involve asset purchases. The ECB has already signalled a willingness to buy forms of asset-backed securities from banks under the right conditions. Markets are speculating that the bank eventually will be buying government debt as well, in an effort to push rates even lower, depress the euro currency, and boost inflation. Although these options have come under closer scrutiny, it is still far from certain that the ECB's governing council would sanction them. Indeed, Governor Draghi has called for a complementary role for fiscal policy, arguing that mass bond purchases would need to be supported by looser fiscal policy and structural reforms to strengthen the recovery. This autumn, the ECB will more likely focus on the TLTROs, as well as the results from the bank stress tests and their consequences.

EMU: PMI vs. GDP



Sources: EcoWin and Swedbank

EMU: Composite PMI



Source: EcoWin

Continued upswing remains the most likely outcome

Despite the weak growth in the second quarter, we continue to expect that the economies in the euro area are improving and are not set for a new downturn. This view is based on several key observations. Private sector consolidation is already well advanced. Households have saved enough and consumption is growing. Business investments have increased somewhat in the recent quarters but are still low and should continue to grow. The international economic environment should be increasingly benign for the euro area, as growth has picked up both in the UK and the US. Monetary policy is extraordinarily accommodative, and the tightening of fiscal policy has abated. Finally, the euro has weakened somewhat but should slide further in the year ahead, due to diverging economic performance and interest rates relative to the US.

In our view, a significant part of the setback in euro area industrial production in the second quarter seems likely to be temporary, in particular in Germany, where performance has been strong for quite some time. With a tight labour market, Germany may well see increased wage growth over the coming year, which would boost private demand. Indeed, both German households, firms and the public sector have the capacity to increase spending; weaker

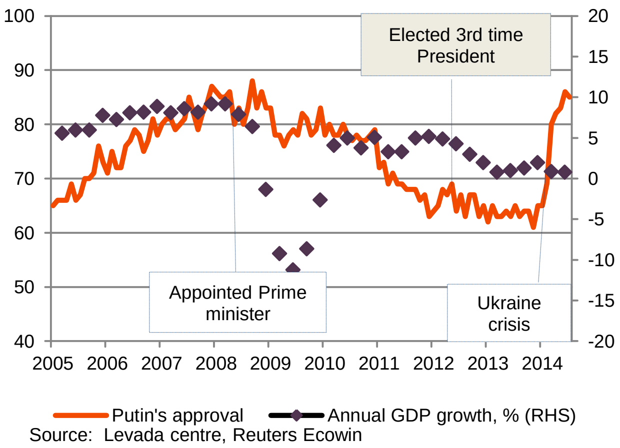
EMU economies would benefit from stronger German demand. Herein lies the main risk factor ahead, as the German economy remains vulnerable to a Chinese slowdown, and to a further escalation of the conflict with Russia.

In-depth 1: Russia is turning its back on the West

We see no quick solution to the Russia-Ukraine crisis, which means continued uncertainty and economic cost. The crisis escalated again after the downing of Flight MH17, leading to sanctions against Russia being extended further into defence and energy industries, and financial markets. Until then, Russia had refrained from imposing sanctions, but now has retaliated with a year-long embargo of selected food items from the EU and other countries that had introduced sanctions against it. Russia's actions seem to have been hot headed – just two weeks into its embargo, it has been softened as shops are running short of goods and prices are rising. Both sides have plans for more sanctions if needed.

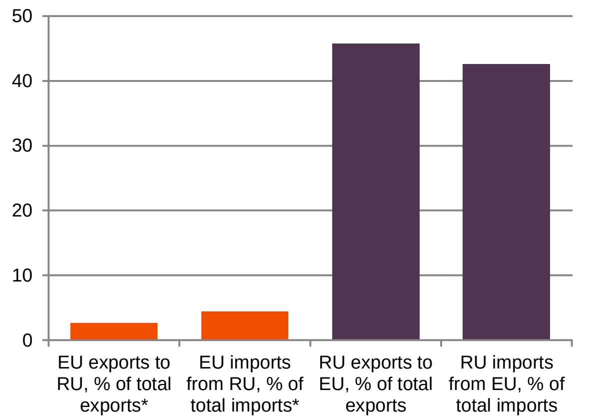
Who is likely to suffer more from a potentially escalating stand-off? Russian growth forecasts have received most of the beating. Judging by foreign trade, Russia is way more vulnerable – nearly half of Russian foreign trade in goods is with the EU, whereas less than 5% of the EU's trade is with Russia. European exposure varies widely across countries, but even the most exposed EU member is less exposed to Russia than Russia is to the EU as a group. Financial linkages are more difficult to quantify, there are considerable banking sector exposures for countries such as France and Austria, but overall Russia is more vulnerable again. Confidence has been hit, and foreign investors have been withdrawing their funding. Russia has no problems meeting its short-term funding needs (e.g., external assets larger than debt, and a trade balance surplus), but the current sanctions against the three major Russian banks damage their medium- and long-term financing ability, eating into corporate sector investment. Evidence indicates that it has already hit real estate development.

Putin's approval rating and GDP growth



Source: Levada centre, Reuters Ecowin

EU and Russia's foreign trade, % of total



Source: UN Comtrade database

* Excluding Austria

The economic frame is not all the story. The approval ratings of Mr. Putin show that political gains (e.g., national pride and perception of correcting for historical injustice) can compensate for economic weakness. This means that there is no easy way for Mr. Putin to back off – political wins or face-saving deals will be needed, and wearing out the opponent by continuously destabilising the situation may improve Russia's bargaining power.

Focussing so much on the economic frame is the problem for Europe. First, historically, economic sanctions have shown to have poor efficacy per se. Second, it is not how painful sanctions are for the recipient, but how much pain the one imposing those sanctions can take. The cost of sanctions is unevenly spread across the EU, which makes it difficult to find consensus. Third, public mood – as for the labour market, Russia comes from a point of strength (i.e., historically low unemployment and strong real income growth until recently), whereas the EU comes from a point of weakness (i.e., high unemployment and poor income growth) and thus is less willing to take on economic cost. Fourth, Russia is rich in natural resources, and the West has an interest in participating in future explorations; aggravating the political dispute would erode such prospects. To sum up, the conflict would really need to escalate for the EU to agree on new major sanctions. The US is more likely to move more abruptly as it has a stronger economic standing and is less integrated with Russia.

Who holds the momentum? The pendulum is swinging. So far Ukraine has been quick to narrow down separatist activities. Failing to stop the war soon will raise political and economic cost; it will be more difficult to run general elections this autumn. Instability plays in favour of Russia, as does the approaching winter and seasonal sensitivity to natural gas supplies for Europe, as well as the lack of a gas deal between Russia and Ukraine. With its current reserves of natural gas,

(Continued on the next page)

Ukraine will make it till the end of the year. Ukraine is likely to be most vulnerable in winter, which may provoke Russia to flex its muscles and open avenues for the conflict to escalate. When the winter has passed, the conflict could find a more permanent balance as the importance of gas dependency for Ukraine will fall and Russia will feel more pain from its economy sliding. This would mean less economic and political uncertainty, and the risk of an escalation of sanctions fading away.

What are the likely scenarios for the current crisis to unfold?

- Positive (20%): sanctions are perceived as a dead end. A political compromise is formed, and sanctions are eased or imposed only loosely. There is no further negative impact on the EU, and recession in Russia is smaller or evaded. The recent easing of the Russian embargo could be a sign of such a development, but it would require face-saving for Mr. Putin (e.g., increased autonomy of Ukraine regions), which might be not that quickly/ easily acceptable for Ukraine.

- Baseline (60%): muddling through. Possible extensions of, and closing loopholes in, the existing sanctions, but without a major rise in economic cost from what is seen now, i.e., Russia in shallow recession and a tad slower EU growth than before sanctions. Natural gas supply interruptions to the EU could perhaps be part of this scenario. If these happen, they would be temporary and for the routes via Ukraine (e.g., claims of Ukraine tapping supplies to Europe or just “accidents”) without affecting other pipelines. Such a negative impact (say, in the order of 0.1-0.2 percentage point of GDP) would be less damaging than in 2006 and 2009 since the EU now has more diversified supply routes and stocks more reserves. The Russia-Ukraine conflict will remain a long-term issue, but when winter passes a balance point (but not yet a solution) will be found, confidence will improve, and economic damage will be limited thereafter.

- Negative (20%): continued escalation; harsher sanctions on both sides but lasting gas supply interruptions unlikely as Russia needs exports to prop up its economy. There will be a deeper recession in Russia, and a significant negative impact on major EU economies. Capital controls are possible and asset ownership could be put at risk. With recession deepening, Russia may change its macro policies, e.g., give up inflation targeting.

Where is Russia heading? Whichever of the above scenarios plays out, Russia is no longer pretending to become a Western style economy with more transparency, better rule of law, etc. Russia is turning its back on the West, strengthening self-sufficiency, and forging alliances with countries such as China, Iran, and Turkey. Russia is by no means the basket case of the late 1990s – is has a much stronger state, a stronger economy, larger reserves, and less debt – but it is structurally too weak to generate reasonable growth.

In the short run, the recent events mean no or very weak growth as (i) import substitution for an economy close to full capacity will not only take time, but also push up prices, hitting consumption and even more so when there is a shortage of capital to set up new capacity, and (ii) it takes time to redirect trade flows to and from new partner countries. Import substitution cannot perform a miracle (at least not quickly), and thus Russia will be careful with imposing further sanctions, favouring bans of goods where there are substitutes readily available domestically or from the new partners. Many things can go wrong, but risk of social unrest any time soon is low, given the strong support for Mr. Putin. With new import routes established, the Ukraine conflict fading, and oil/gas exports to China expanding, growth will return over the next few years. If growth fails to return, risks of further regional conflicts may rise, as the elite may rally its support to hold onto to power by offering political wins as a substitute for economic weakness. This would lead to economic disruptions and the risk of the wider turmoil of a leadership change.

There is no good news for long run growth either. The recent developments are very likely to strengthen the grip of the “Dutch disease”, i.e., dominance of oil sector, which serves as a solid lid for growth for the rest of the economy. With its extractive institutions, rent seeking and lack of rule of law unlikely to change any time soon, growth in Russia will remain weak and it will be close to impossible for it to avoid middle income trap as it has been so illustriously pictured in Acemoglu and Robinson’s book *Why Nations Fail*. For the West this would mean political and economic risks going forward.

With the current Russia-Ukraine conflict gradually deescalating and the search for yield globally ongoing, investors are likely to return with a vengeance to Russian markets. Yet, one should keep in mind that different values mean a different business environment, and different risks for investors. If you do not like the risk of a different political system, this is not a market for you.

US: A growth rebound likely to fade

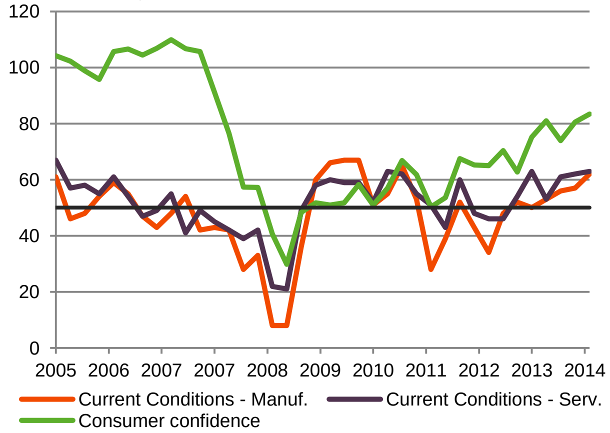
A break in the recovery in the first half of 2014

US growth has slowed significantly so far in 2014, and it was not only due to the unseasonably harsh winter weather. The housing sector lost momentum with fewer housing starts and subdued residential investment, mainly due to tightening credit conditions and higher mortgage rates. Private sector investment has been on a downward sloping trend over the last couple of years and failed to pick up. This downswing ultimately depends on firms' cautious assessment of future demand. In addition, inventory buildup was strong at the end of 2013, which affected growth in the first quarter of 2014. Finally, external demand faltered, resulting in a negative drag from net exports on growth.

Upswing expected in the short term

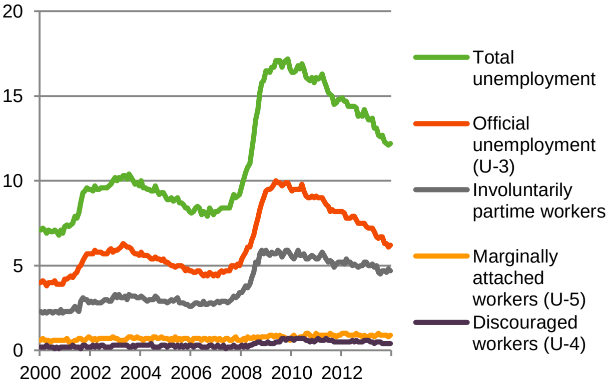
However, there are also signs that economic activity will pick up in the remainder of 2014 and well into 2015. Labour market developments have been strong, with more than 200,000 jobs created per month since February this year. Together with a positive outlook for the housing market, and recovering prices, this should support household demand and consumption. Household confidence indicators are on an upward path. Furthermore, corporations can be expected to take advantage of low financing costs and large cash holdings to upgrade their aging capital stocks, in particular as capacity utilisation rates are rising. Also, private sector confidence has been climbing, albeit at a slower pace. The policy mix is likely to remain expansionary, with less fiscal drag and continued monetary stimulus well into next year. Thus, all in all, we expect annualised real growth of around 3% for the next four quarters, in line with past trend growth.

US economy sentiments



Source: Conference Board

US: Measures of labor underutilisation



Source: Reuters Ecowin

Policy normalisation – amidst intensive discussions

With growth resuming, the Federal Reserve will continue to tighten monetary policy, primarily by ending bond purchases during the autumn and then by starting to raise—by mid-2015--the Fed funds rate. We expect an intensified debate on the trade-off between the risk of financial bubbles if tightening too slowly and the risk of interrupting the labour market improvement if tightening too quickly. There are also concerns of the impact on the interest and exchange rate markets of US monetary policy normalisation and on the rest of the world (see box on next page).

Focus on the labour market

At the recent Federal Reserve rate-setting meeting, more attention was given to the apparent improvement of the labour market and the risk of wage-induced inflation. We believe that there is still a significant slack in the labour market that will have to be worked through before serious pressures on wages appear. The labour market participation rate declined by 3-4 percentage points after the crisis, and various studies suggest that about half of the decline is due to the economic slowdown (the rest is due to effects of an aging population, earlier retirement, etc., which naturally lower the participation rate). This means that the official unemployment rate underestimates the real unemployment. As the economy recovers, many will resume job seeking, thus delaying the decline in the unemployment rate and lowering wage pressures.

Medium-term growth capped without reforms

Although we expect growth rates to go up in the short term, there are significant challenges to the US economy in the medium term. Some fundamental factors are at play. An aging population will slow the expansion of the labour force, thus lowering the potential growth rate. Domestic demand will also be limited by households' already high leverage ratios and a lack of competition in the business sector, which will reduce corporations' need to invest. This, in turn, reduces capital deepening and labour productivity. There are, however, factors that can be affected by policy. Public infrastructure investment would address a long-term deterioration; it would also enhance efficiency in the private sector as well as raise labour productivity. Also, active labour market policies and educational reforms aimed at increasing employability would increase the labour force as well as productivity, while tax reforms could enhance efficiency. Trade agreements and liberalisations would also increase competition and raise long-term growth. Without these reforms, real growth in the US economy will approach 2% in the medium term rather than the 3% that was the case prior to the crisis.

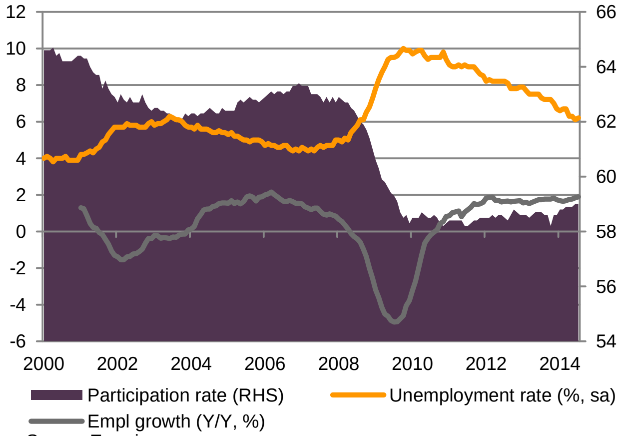
In-depth 2: US - Rates will rise, markets most likely not too vulnerable

Interest rates will rise in the US as economic conditions improve and the end of ultra-loose monetary policy affects investors around the world. The Federal Reserve (Fed) has begun to reduce the largest monetary stimulus the world has ever seen. Since the financial crisis, the Fed funds rate has been virtually zero in nominal terms, implying negative real rates. Moreover, various bond-purchasing programmes (quantitative easing) have contributed to very low longer-term interest rates. But as a result of much sharper decline in unemployment than expected recent quarters, the Fed is gradually changing tack; bond purchases are expected to end this autumn, and the Fed funds rate is expected to rise about ½ percentage point next year, and another percentage point in 2016.

The Fed's dual mandate to promote full employment while keeping inflation low and stable at around 2% frames the monetary policy considerations:

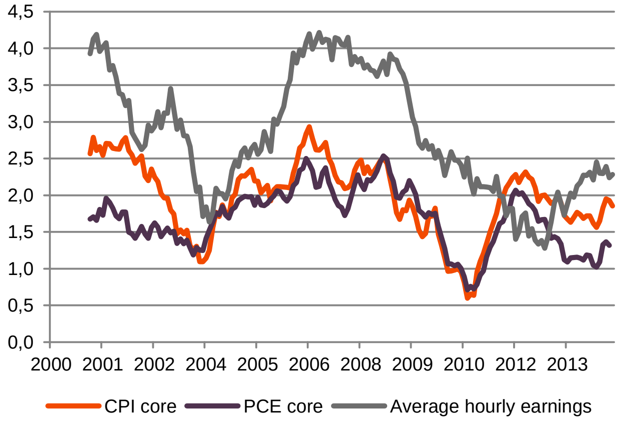
- Inflation remains moderate in the US; though there has been a slight increase over the past months, annual growth in the core personal consumption price deflator is 1.5% (June), below the inflation target of 2%. Moreover, the Fed's projections suggest inflation is expected to remain moderate in the years ahead. The US economy does not have an inflation problem at present.
- Unemployment has fallen to a level close to what is considered normal. At the same time, labour market participation has yet to pick up following the sharp fall during the financial crisis, suggesting there may still be considerable room for growth in employment. The ultimate test of spare capacity in the labour market is wage growth: when the market tightens, wages should start to rise. Thus far, nominal wage growth is at 2-2½% and does not show any signs of increasing.

US: Labor market data



Source:Ecowin

US: Core inflation measures and wages



Source: Reuters Ecowin

Ultimately, only persistently higher wage growth can generate higher inflation over time. Depending on developments in productivity and business margins, wage growth feeds through, first, to business costs and, eventually, to product prices. To what extent and how fast such cost push happens is highly uncertain, however. Developments in these variables will be key inputs to monetary policy in the time ahead. Decisions will also crucially depend on how the members of the Federal Open Market Committee (FOMC) interpret these data and their views of the economy. So far, the FMOC seems to be willing to err on the expansionary side, to ensure that spare capasity in the labour market will be utilised.

The most important driver of rate hikes is likely to be overall economic performance. If growth picks up as expected, financial market consequences are likely to be mostly benign:

- Higher stock prices. Although higher interest rates are negative for stock prices in isolation, corporate earnings and growth prospects will be boosted by better economic performance. This will likely affect all firms geared towards the global economy – including many Nordic companies.
- Higher bond yields. Higher growth and inflation signal higher rates, to the benefit of new savers but at a cost to current bondholders.
- Stronger US dollar. The negative interest rate differential between the US and the rest of the world will be reversed. In particular, US rates will be higher than in the euro area. Capital flows could return to the US and strengthen the dollar, which today appears to be weak relative to the euro.

Alternative scenarios with less benign outcomes include the following:

- Cost-push inflation due to faltering productivity growth. In this scenario, rates would have to be raised to contain increasing inflationary pressures, while growth expectations would diminish, prompting falling stock prices.
- Reversal of speculative capital flows. Over the past years, capital has flowed into emerging and credit markets in searchof higher yield; a rapid reversal would prompt higher borrowing costs and possibly disruptions in areas with high leverage.

While we believe the adverse scenarios to be less likely, they cannot be ruled out. In the face of high uncertainty regarding monetary policy, considerable market volatility seems likely to remain.

Higher US market rates will undoubtedly also affect financing conditions in the Nordic economies; however, these markets are more closely linked to the euro area, where rates are expected to stay low for a long time yet.

UK: Wage growth key to the inflation outlook

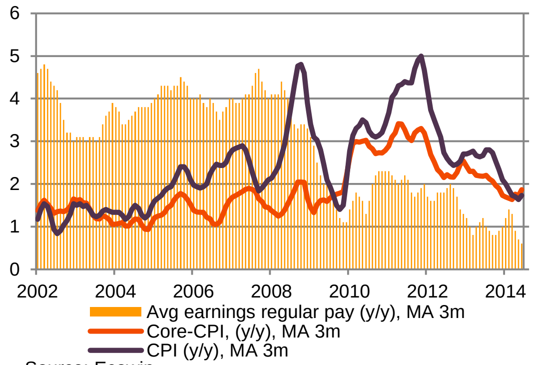
Solid economic recovery

The economic recovery in the UK has benefitted from growing exports and investments. Household spending and business investments have been robust, supported by high confidence and favourable credit conditions. The prospects for the UK economy are bright, with upward revisions of GDP growth for this year and 2015. The improved sentiment and the overall strong momentum in the housing market will continue to be important for this year's growth. Housing remains a risk, and the Financial Policy Committee has recommended that an interest rate stress test should be applied to mortgage lenders and that a limit should be set on the share of high loan-to-income mortgage lenders. The outlook for the housing market will partly depend on wage developments. This year, wage developments are expected to be modest before picking up in 2015 and 2016.

Bank of England one of the first to hike

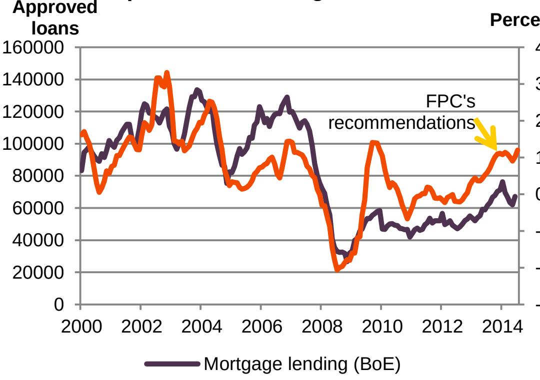
Wage growth is expected to be increasingly important in the Bank rate decisions. The Bank of England is expected to raise the Bank rate from today's 0.5 percent to 0.75 percent in the first half of next year. The hikes will be gradual, and at the end of the forecast horizon, the interest rate will be 1.50%. Being one of the first of the major central banks that tightens monetary policy a Sterling appreciation is foreseen. This, in combination with weak external demand from the biggest export market, Europe, indicates a moderate export growth. For the UK to achieve a sustained economic expansion, the rebalancing of demand must continue and productivity growth must recover.

UK: Inflation and wage growth



Source: Ecowin

UK: House prices and lending



Source: Ecowin

Japan: On a bumpy road

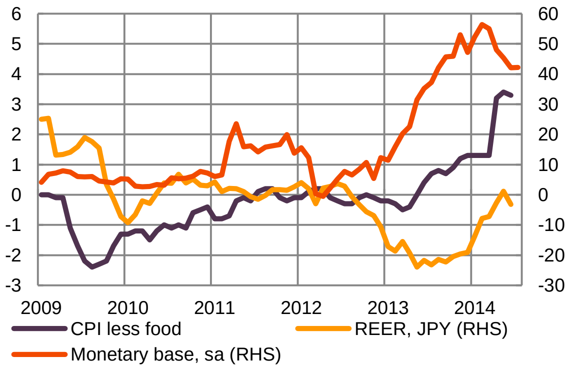
Returning to moderate growth in second half of 2014

The Japanese economy is showing some positive signs. The contraction of economic output in the second quarter was short-lived, resulting from lower private consumption and investment following a VAT increase in April. The economy is expected to return to modest but above-potential growth in the second half of the year. Inflation is accelerating, nominal wages are growing, and inflation expectations are on the rise. However, the sustainability of the recovery is still a big question mark. Economic growth has relied too much on government spending and on people rushing to shops before the sales tax hike. The weaker yen has pushed up inflation but has not translated into strong export growth. Imports are still lifted by domestic energy needs. A gradual switch to domestic nuclear energy is expected only from 2015 onwards.

Fiscal tightening lowers growth in 2015-2016

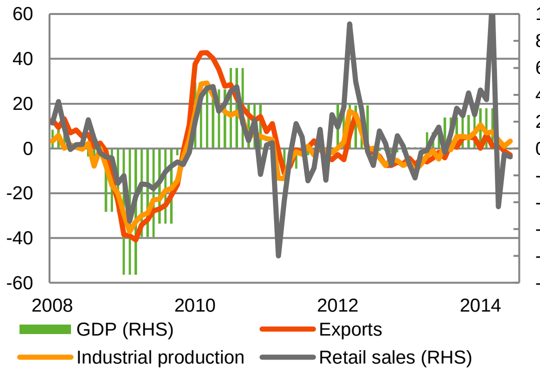
We expect GDP growth to slow in 2015 and 2016 because of fiscal consolidation. The Bank of Japan's two percent inflation target might still need additional stimulus at the end of 2014 or during 2015, pushing the yen further down. The country's fiscal consolidation needs are some of the biggest in the world, even after raising the VAT to 10% in October 202015. Therefore, the im plementation of structural reforms is of key importance.

Japan: Prices (Y/Y)



Sources: Ecowin, Swedbank

Japan: Main economic indicators (Y/Y)



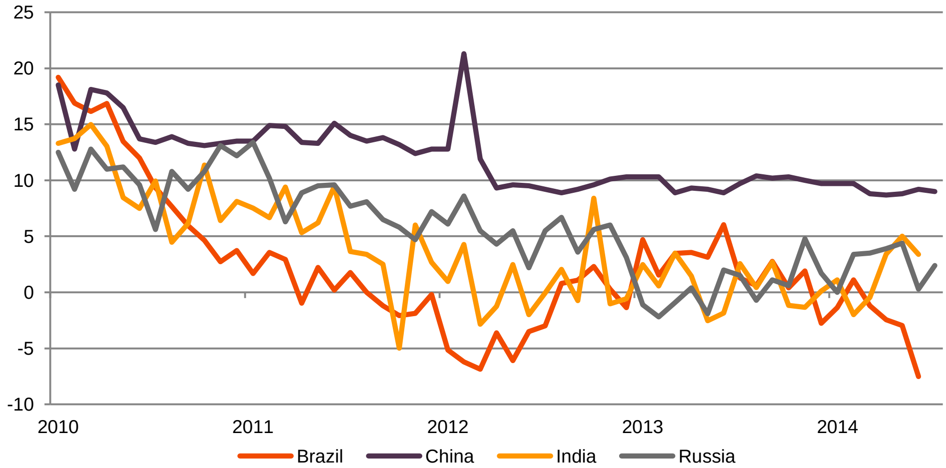
Source: Ecowin

Emerging markets: Focus on politics

Economic developments are mixed

Economic developments are mixed within emerging markets. Growth has been surprisingly strong in China, with help from stronger fiscal spending and higher credit growth. The government has stimulated the economy to mitigate declining house prices. This means that reforms for long-term growth have been postponed. In India, a new government and higher confidence in its monetary policy, has raised business confidence. The conditions for a more growth-friendly policy are the best in a long time. Brazil, on the other hand, is on the brink of moving into recession after many years of unbalanced growth. The economic growth is poor and inflation is high. The Brazilian economy is in great need of reforms to improve the business climate and lift potential growth. In Russia, the situation has worsened, with the Russia-Ukraine conflict far from abating. The West has extended sanctions against Russia into energy, defence, and financial markets, and Russia has retaliated by imposing bans on imported food products. Our underlying view on the Russian economy has not changed, i.e., it is structurally too weak to generate growth, and the conflict with Ukraine is making it worse.

BRIC: Industrial Production y/y (%)



Source: Ecowin

China: Rebalancing postponed

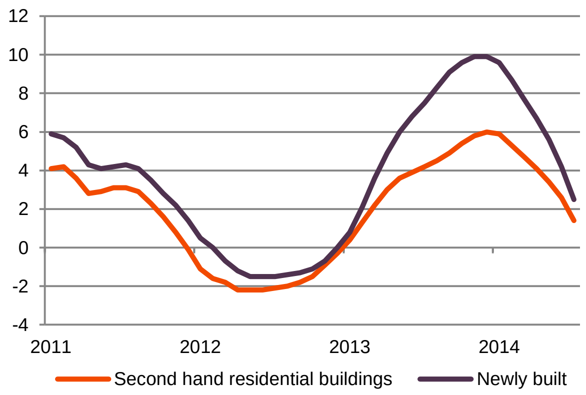
The property market is weak

The overheated property market in China is in a rapid price correction. The housing weakness has spread beyond a small number of coastal cities and has become broad based. In July, house prices fell in 64 out of 70 large cities in China. The property market has become so weak that the government has responded with fiscal stimulus and monetary easing measures. In addition, a number of cities have started to ease policies to support their property markets through adjustments of home purchase restrictions. The economy has responded positively, with a GDP growth of 7.5% year on year during the second quarter compared with 7.4% in the first quarter of this year. Exports turned higher in the second quarter and rose by 14.5% at an annual rate in July. Other economic data have in general been on the downside this year. Investment growth is the weakest since the end of 2001, and falling steel prices indicate that investment demand currently remains low. Steel prices have dropped about 8.5% this year alone. Industrial production activity was slow in the beginning of this year—in May, the slowest growth was registered since the financial crisis in 2008-2009. However, the latest industry surveys show that the sentiment has increased, and we therefore expect that the slowdown in industrial activity has levelled off.

Policy will support growth

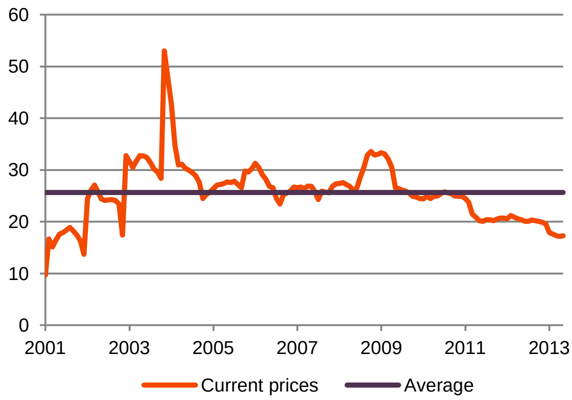
We doubt that the government will meet its target of 7.5% GDP growth for 2014. However, we believe that policy will continue to focus on stabilising the economy with further economic stimulus in order to keep the correction in the property market under control. Implementation of structural reforms that restrain growth will, therefore, be postponed. Accordingly, we revise our forecast for the Chinese economy upwards and now expect GDP to increase by 7.3% this year, compared with our earlier forecast of 6.9%. Policy support is positive for growth in the short term but comes at the expense of long-term growth, as the government is postponing necessary economic reforms. Total credit growth is on the rise again, which means that concerns will remain of a disorderly adjustment in the financial system later on. We believe that the government will tighten credit growth in a controlled manner once the property market stabilises. The overall message is that the government is not yet ready to sacrifice short-term economic pain for long-term gains.

China: House Prices



Source: Ecowin

China: Investment in Fixed Assets



Source: Ecowin

India: Policy change lifting sentiment

New government lifts confidence

India's nearly six-week-long election concluded with a major victory for the Hindu nationalist party, BJP, and its leader Narendra Modi. The party has secured its own majority in the lower house of parliament and is beginning the painstaking process of instituting growth-oriented reforms. Expectations of a more business-friendly policy have lifted business confidence from last year's depressed levels. The challenges are great, and we don't expect any rapid changes. Having said that, we expect the government to take small steps forward with its new policy and reforms to bring down inflation and implement infrastructure projects. The latest proposals for greater openness, predictability, and an improved business climate are important steps on the road to increasing investor confidence. The trade balance has steadily improved over the last year, largely thanks to weak imports, but lately through increased support from stronger export growth. In the process, the current account balance has rapidly improved from a year ago. The deficit has shrunk from around 5% to about 1.7% of GDP. Although the manufacturing growth rate has fluctuated around zero since late 2011, it accelerated in the second quarter of this year, rising by 3.4% on an annual basis in June. Signals from purchasing managers point to a continued modest improvement in industrial production. However, economic growth is still low. GDP grew by 4.6% at an annual rate in the first quarter, which is the average growth rate since mid-2012. In the years before the financial crisis, growth used to average around 9.5%.

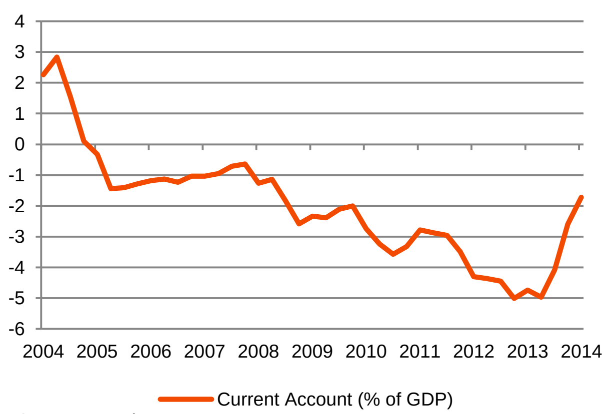
Inflation has come down

The potential for a higher growth path is great, given implementation of the right economic policies by the new government. India has long been plagued by a high inflation rate. But the central bank's hard-line policies quickly reduced the inflation rate from double digits in 2013 to 8.0% in July. The central bank is aiming for consumer price inflation of 8% this year and 6% by the start of 2016. The rupee has performed strongly since hitting bottom last autumn, but is still low measured in terms of the real effective exchange rate; this will provide support for the export sector. Political conditions in India are the best in some time. Because of this, as well as a smaller current account deficit and a more credible monetary policy, we maintain our positive growth outlook for India.

India: GDP (constant prices)

Source: Ecowin

India: Current Account (% of GDP)



Source: Ecowin

Brazil: Heading into recession

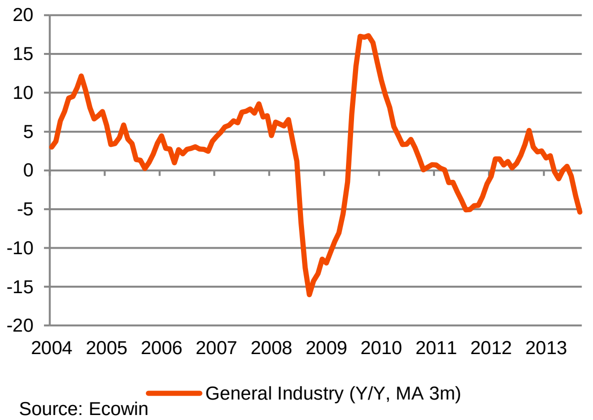
Growth has continued to disappoint.

The Brazilian economy is in danger of moving into recession. The fundamentals have worsened and growth has continued to disappoint. The economy grew by only 1.9% on an annual basis in the first quarter. Exports have continued to decline, registering negative growth rates for most of this year on the back of weaker Chinese demand for industrial metals. The terms of trade are also deteriorating. As a result, the current account deficit has not improved, leaving the financial sector vulnerable if global risk sentiment deteriorates. Manufacturing production shrunk by 6.9% at an annual rate in June, and the outlook is gloomy, based on the latest signals from the recent purchasing managers' surveys. Inflation is stuck at high levels despite rate hikes by the central bank totalling 375 basis points in the last 12 months. We expect the tight monetary policy to continue, since consumer price inflation is at the central bank's upper tolerance limit of 6.5%. Lending rates have risen from 34% at the beginning of 2013 to 43%, causing credit growth to deteriorate quickly.

Big political challenges ahead

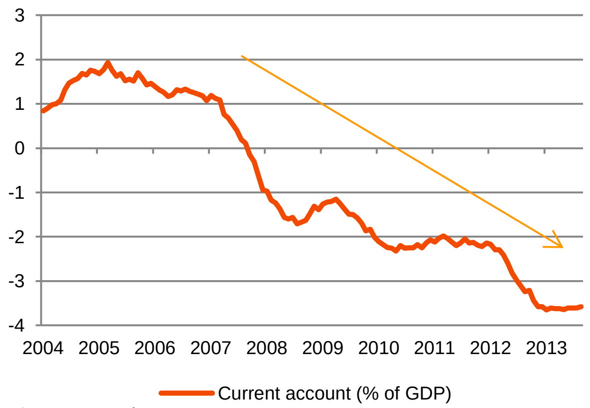
The high inflation rate and high interest rates are a challenge for already-strained households. The situation in the labour market is weak, with real wages and employment falling. Consumer confidence has dropped precipitously to levels last seen during the financial crisis in 2009. Expectations are that incumbent President Dilma Rousseff will be re-elected in the October presidential election. The Brazilian economy is unbalanced after years of heavy government interventions, and the need for reforms and deregulation is huge.

Brazil: Production, (%)



Source: Ecowin

Brazil: Current account (% of GDP)



Source: Ecowin

Russia: Sanctions bite into future growth

The conflict is not abating; the sanctions stand-off has escalated

The Russia-Ukraine conflict is far from abating. After the downing of Flight MH17, the US, EU, and other countries have extended sanctions against Russia into energy, defence, and financial markets; however, the overall sanctions are still quite narrow, mainly targeting Russian long-term growth and the military industry rather than immediate economic activity. On August 7, Russia retaliated by implementing a selected food product embargo on the countries that had introduced sanctions against it. If a political solution to the conflict is not found soon, the sanctions stand-off is very likely to escalate further, and this will damage growth.

Surprisingly good second-quarter GDP data…

Our underlying view on the Russian economy has not changed, i.e., it is structurally weak to generate growth, and the conflict with Ukraine is making it worse. Russia reported surprisingly strong second-quarter data, with annual GDP growth at 0.8%, which by our estimate (full data will be published only in September) implies about 0.5% seasonally adjusted quarterly growth, i.e., no recession. Given the current environment, this seems too good to be true. Our take is that consumption continued to grow and there was some expansion in exports (both expected), but the major impact must have come from a surprisingly sharp contraction in imports due to the rouble weakness and deliberate import substitution policy.

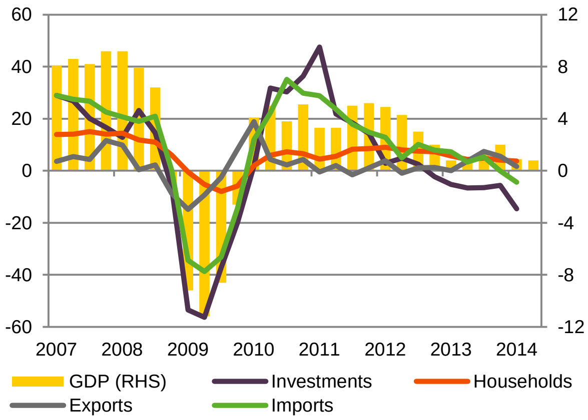
… but imports substitution can take it only so far

The Russian economy is close to full capacity, and import substitution, while it is widely supported by the society and thus likely to have a stronger positive impact on GDP growth, can take it only so far. The labour market is beyond its peak – unemployment is very low and pushing it lower would at some point raise inflation; wage growth has slid into single digits from double digits a year ago. Annual credit growth is still above 20% but is swiftly coming down. Russia is actively looking for alternative suppliers, but this will take time and they are likely to be more expensive; this means that the food product embargo is set to push inflation up from an already-high annual rate of 7.5% in July. Overall, we see consumption growing in the low single digits; however, with inflation picking up, wage growth easing, and a lack of new jobs, real incomes may contract. To create jobs, investments are needed. Yet, gross fixed capital formation fell by 7% in the first quarter compared with a year before, and we see no key factor to break this negative trend any time soon – the central bank has raised its benchmark rate to 8% (from 5.5% earlier in the year), western capital is being withdrawn, the state bank funding squeeze is tightening (some have already asked for state support), and the stimulus programmes are small. Tight capacity and import substitution are likely to bid up prices, which then hits consumption.

We expect Russia to slide into recession, with weak recovery in late 2015

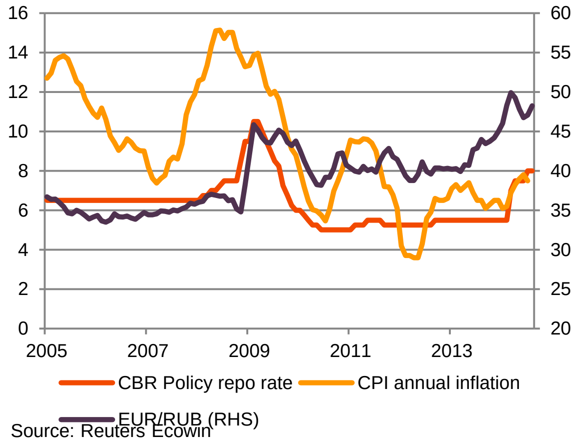
As for capital flows, Russia is turning inwards. The first two quarters show foreign capital inflows falling and residents shrinking their outflows. Net capital outflows in the first half of the year amounted to about USD 70 billion, compared with about USD 56 billion for the whole of 2013. The trade balance is set to remain strong, and, with reduced outflows, the Russian financial situation may remain quite robust. Yet, with financial constraints locking, the funding squeeze tightening, credit becoming more expensive, and inflation biting into consumer purchasing power, we still expect Russia to slide into recession. We cut its 2014 GDP growth to -0.1% (from 0.8%) and to -0.6% (0.8%) for 2015. The 2015 revision seems particularly large due to the base effect, i.e., we see Russian economy contracting later this year and early next year, and the recovery in the second half of 2015 to be weak. The weakening of the rouble will continue. We expect the Russia-Ukraine conflict and the sanc-tions stand-off to find its balance later in 2015 and, thus, GDP to expand by 1% in 2016.

Russia: Annual growth of GDP components, %



Source: Reuters Ecowin

Russia: Financial market indicators and inflation (%)



Source: Reuters Ecowin

Nordic area: Exposed to external forces

Norway: A 2% economy, for the time being

A downward shift of the growth path

Economic growth in Mainland Norway was higher than expected in the second quarter but the overall picture is still that growth has settled on a 2% path, well below the 3 - 3.5% growth trajectory the country experienced until 2013. Still, the unemployment rate is just marginally up from the trough and may even be declining. The main uncertainty for 2015 and 2016 is by how much oil investments will decline, after having contributed significantly to the Mainland growth over-performance in recent years. We expect oil investments to decline by 5-10%, and Mainland growth to remain close to 2%, Norges Bank's policy rate to stay at 1.5%, and the krone to trade in a 8.10 – 8.40 band. Household demand, net exports, and a more expansionary fiscal policy will eventually compensate for the shortfall in oil investments.

The domestic economy is weak

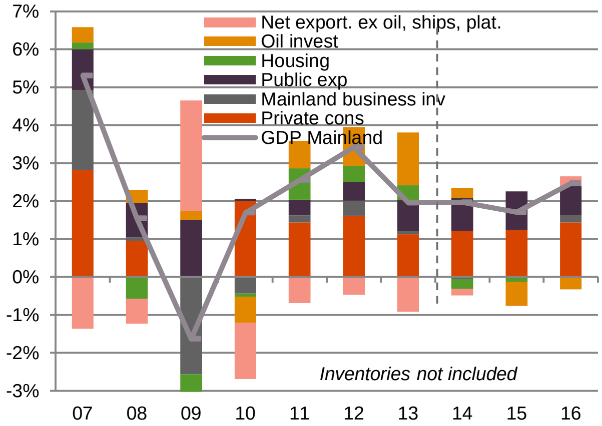
Thus far, the slowdown in mainland GDP has been due to weaker Mainland demand, not reduced oil investments. Household consumption slowed, housing investment declined, and existing home prices declined, as banks tightened their credit policies in order to meet new, tougher capital requirements. Now, banks have changed tack, house prices are rising again, and new housing starts are up. Mainland businesses have remained cautious ever since the financial crisis and their investments are lacklustre, especially in new machinery and equipment. The budget, although moderately expansionary, is still running a 2% of GDP surplus vs. the long-term budget rule, which implies that transfers from the Government Pension Fund Global (the "Petroleum Fund") should over time equal 4% of the Fund. The sharp Norwegian krone depreciation since early 2013 only marginally changed trade patterns, export volumes are just marginally up.

Inflation has moved up towards the 2.5% target almost entirely due to the direct impact of the NOK depreciation and higher prices on imported goods. The minor increase in the unemployment rate has been sufficient to pull wage inflation down, and domestic cost pressures are muted even if productivity growth remains below par.

Rising likelihood of monetary policy easing

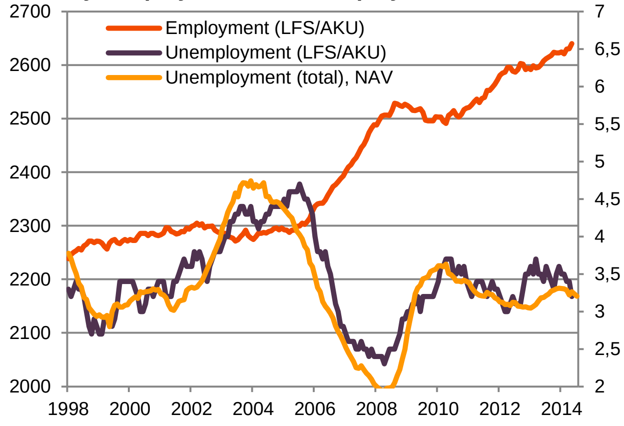
Although Norges Bank has kept its key policy rate unchanged at 1.5% since March 2012, the bank signalled just before the summer that it might cut it in the face of a significant fall in oil investments. This risk has been a main element in our forecast since early 2013, based on an analysis of the outlook for the global and Norwegian oil industry. The jury is still out on how severe and how long the downturn in oil investments will turn out to be. However, all business surveys, investment surveys, order inflows, and anecdotal evidence confirm a sharp change, from rapid growth to zero growth, and most likely a decline next year, which we continue to factor into our GDP forecasts.

Norway: Contributions to GDP



Source: Statistics Norway and Swedbank

Norway: Employment and unemployment



Sources: Ecowin and Swedbank

Sound household economy faces risks

At the same time as the change in the oil industry finally hit the front pages during the first half of the year, the housing market and household demand recovered, following the 2013 slowdown. High household savings, continued real income growth (albeit at a lower speed than before), a low unemployment rate, and very low interest rates, as well as "willing" banks, are good arguments for households to keep demand up. There is still a risk that the oil investment "shock" could affect the Norwegian economy in a broad manner, including the household sector. House prices are at an unusually high level (compared with anything), and the household debt-to-income ratio is high as well. If needed, more expansionary monetary and fiscal policies should be sufficient to stabilise the overall economy.

We do not expect oil investments to pick up in 2016, and mainland GDP growth will remain below old trend paths. Unemployment will increase marginally, wage inflation remains subdued, and inflation stay well below the 2.5% target. As the global economy gradually recovers and the cost level becomes more competitive, net exports should contribute to growth, as will a continued expansionary (and still-sustainable) fiscal policy.

Denmark: Recovery threatened by euro area weakness and domestic imbalances

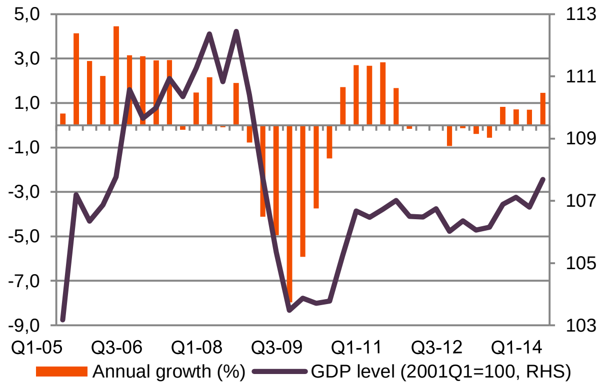
Output loss from crisis made up

The Danish economy is gradually recovering, and, with the 1.5% annual growth in the first quarter, real GDP has reached pre-crisis levels, if the structurally declining energy extraction sector is excluded. In particular, backed by strengthened confidence and growing real income, household consumption is up. The private sector investments are also gaining pace albeit from low levels. Also, overall exports have been growing, especially services sector related, while goods exports have declined.

Continued expansion, but external weakness looms

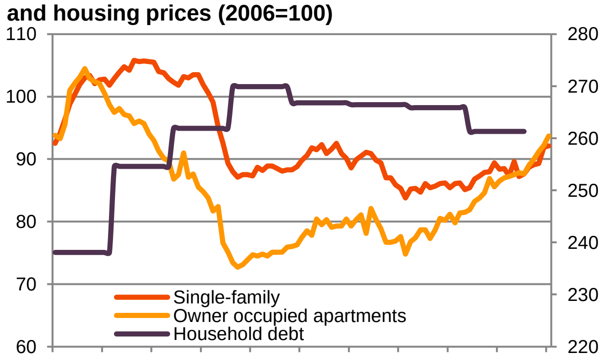
Looking forward, the financial conditions of households are benefitting from an improving labour market and from rising real estate prices. Thus, household consumption will likely be driven by both increasing real incomes and a growing sense of increasing net wealth. The manufacturing sector's investment intentions are rising. However, the positive domestic conditions are counterweight by a more fragile external environment, and by the potential threat from large domestic imbalances. Danish exports are predominately destined for the struggling euro area, and Danish households are amongst the most indebted in Western Europe. Thus, a rapid turnaround in sentiments cannot be ruled out. Overall, we expect the economy to grow by 1.7 % this year, followed by about 2% growth in 2015 and 2016.

Denmark: GDP



Source: Ecowin

Denmark: Household debt to income (%) and housing prices (2006=100)



Sources: Statistics Denmark and OECD

Finland: Only modest growth potential

Russia's struggles will affect the Finnish economy

The slightly improved export sales have slowed the decline in manufacturing output in Finland this year. However, the escalation of geopolitical tensions in the region and the trade embargo imposed by Russia can aggravate the export performance. The substantial weakening of Russia's economic growth and the rouble depreciation are already having a negative spill-over effect on Finland.

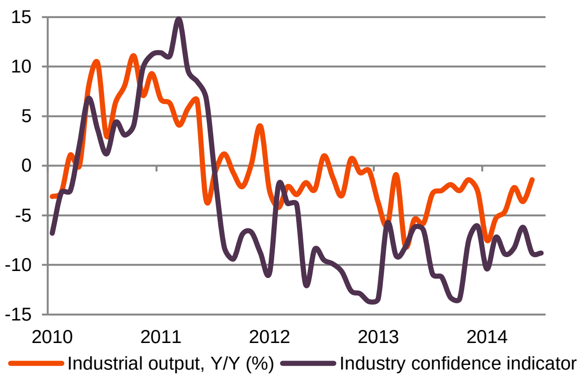
Domestic economy remains weak

Insufficient demand, low confidence, and low capacity utilisation are inhibiting private investments. These investments should, however, gradually pick up as the demand for Finnish goods and services improves. At the same time, due to the government budget consolidation, public investments will not increase. The unemployment rate is higher than the long-term average, and enterprises' ambitions to raise their profitability and improve competitiveness are unlikely to change this. In addition, moderate wage growth, tax hikes, and cuts to income transfers are limiting growth in households' income and private consumption.

Recession in its third year

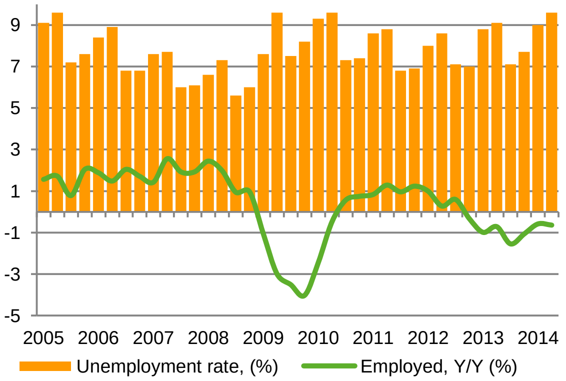
Finland's economic growth is held back by a number of factors: the ongoing economic restructuring, weak domestic demand, and shrinking working-age population, as well as less government contribution due to the need for further austerity. Finland's economy is staying in recession this year for the third year in a row, as GDP falls by 0.2%. The improving global economic outlook in 2015-2016 will contribute to a modest growth of exports from Finland, and economic growth will recover to 0.5% and 1.3% in 2016.

Finland: Industrial output and confidence



Source: Statistics Finland, DG ECFIN

Finland: Labour market indicators



Source: Statistics Finland

Sweden: A world divided, uncertainty at home

The Swedish economy is torn between a strong USA and a weak EMU. Then there is uncertainty in the domestic economy because of the outlook of fiscal policy and the risks in the housing market. We are lowering the growth forecast for this year to 2.1% and are making a downward adjustment to our outlook, very much because of weaker developments in the Eurozone. The low inflationary pressure and ECB's expansive monetary policy means the Riksbank will further cut the policy rate this autumn.

Weak first six months of 2014

Economic developments during the first half of 2014 were far weaker than expected. Weak growth internationally – both in the USA and in the European area – had a negative impact on Swedish exports. Despite relatively good short-term indicators such as the PMI (Purchasing Managers' Index) and the NIER economic tendency survey, Swedish industry has stood still. Together with the increased anxiety as a result of the conflict between Russia and Ukraine, this has led to stagnating production and reduced investment. Only investments in housing gathered pace, driven by the acute shortage of housing. Private consumption and positive developments in the labour market have supported domestic demand. The other side of the coin is a continued growing imbalance in the form of increased household debt. The low inflation, which can be explained both by low imported inflation and by increased domestic price pressure – in part through digitalisation – caused the Riksbank to lower the repo rate by a surprising 50 basis points and also to lower the future repo rate path.

Key Economic indicators, 2013-2016 1/

	2013	2014f	2015f	2016f
Real GDP (calendar adjusted)	1,6	2,1	2,3	2,5
Industrial production	-1,3	0,5	4,2	5,0
CPI index, average	0,0	0,1	1,4	2,1
CPI, end of period	0,1	0,4	1,7	2,5
CPIF, average 2/	0,9	0,7	1,6	1,8
CPIF, end of period	0,8	1,1	1,6	1,8
Labour force (15-74)	1,1	1,1	0,7	0,4
Unemployment rate (15-74), % of labor force	8,0	8,0	7,6	7,0
Employment (15-74)	1,1	1,1	1,2	1,0
Nominal hourly w age w hole economy, average	2,6	3,0	3,1	3,4
Savings ratio (households), %	12,2	12,1	11,1	11,1
Real disposable income (households)	2,5	2,7	1,5	2,1
Current account balance, % of GDP	6,2	5,4	4,6	4,1
General government budget balance, % of GDP 3/	-1,3	-1,7	-1,1	-0,9
General government debt, % of GDP 4/	40,9	41,4	40,7	39,7

1/ Annual percentage growth, unless otherwise indicated. 2/ CPI with fixed interest rates.
3/ As measured by general government net lending. 4/ According to the Maastricht criterion.
Sources: Statistics Sweden and Swedbank

The state of the Swedish economy has become more uncertain since our April forecast. The low growth in the Eurozone is slowing down external demand, and it is doubtful whether Swedish competitiveness is sufficient to exploit the US recovery. The household economy continues to be solid, but risks have increased. Regardless of the election outcome we expecting reduced fiscal policy constraints, and measures that limit household indebtedness. This will put pressure on the household economy, without the private sector appearing to be ready to raise investments. Unemployment is decreasing, but only slowly due to a growing labour force. Overall, a weakened Swedish economy and an aggressive monetary policy by ECB mean that the Riksbank is lowering the repo rate to 0.1% in the autumn.

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2013	2014f		2015f		2016f
Households' consumption expenditure	2,0	2,8	(2,8)	2,4	(2,3)	2,1
Government consumption expenditure	2,0	0,9	(0,9)	2,0	(1,6)	1,6
Gross fixed capital formation	-1,1	3,9	(5,3)	6,0	(7,4)	6,0
private, excl. housing	-2,5	-1,8	(4,6)	4,9	(8,4)	6,4
public	-3,2	5,7	(1,3)	3,8	(3,7)	3,8
housing	6,3	22,3	(11,6)	10,6	(6,8)	6,4
Change in inventories 1/	0,1	0,2	(0,3)	0,1	(-0,0)	0,0
Exports, goods and services	-0,4	2,3	(3,9)	4,4	(6,5)	5,9
Imports, goods and services	-0,8	4,1	(4,7)	5,7	(7,3)	6,2
GDP	1,5	1,9	(2,8)	2,6	(2,9)	2,7
GDP, calendar adjusted	1,6	2,1	(2,9)	2,3	(2,7)	2,5
Domestic demand 1/	1,3	2,3	(2,6)	2,8	(2,9)	2,6
Net exports 1/	0,1	-0,6	(-0,1)	-0,3	(0,0)	0,1

1/ Contribution to GDP growth. Sources: Statistics Sweden and Swedbank

Weak competitiveness and risk of rising interest rates

The krona will depreciate initially, but mainly reducing the risk of an appreciation of the krona against the euro. In the medium term we expect the krona to strengthen against the euro but weaken against the dollar. Together with relatively high increases in unit labour costs this means Swedish competitiveness is coming under pressure. The market interest rates remain low, but rising American interest rates could also push up Swedish interest rates, with a negative effect on household consumption and investments.

Sluggish export recovery

Development in exports poorer than expected

Swedish exports exhibited weaker development during the second quarter than what we predicted in the April forecast. The slowdown came about as a result of lower exports of goods, which in seasonally adjusted terms dropped by 0.9 percent after having increased for two quarters in succession – though at a modest pace. It is above all reduced exports to the EMU countries, which represent approximately 40 percent of Sweden's exports that contributed to the decline, whilst export deliveries to the USA and the UK increased. Service exports continued to expand – something that can largely be attributed to increased merchanting. The growth in imports accelerated during the first half of the year in the wake of increased domestic demand, thus net exports' contribution to the growth in GDP of -0.7 percentage points explains much of the weak growth in GDP during the first six months.

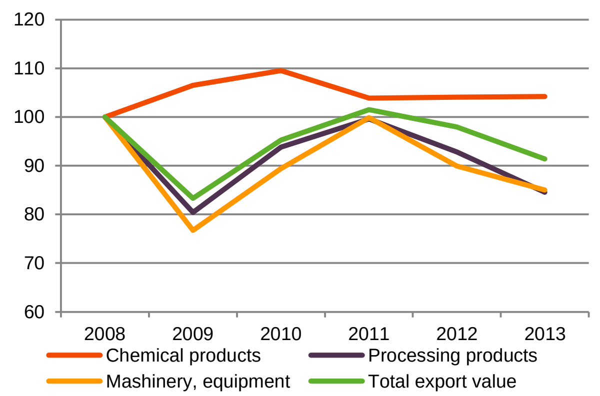
Recovery, but big risks

Following the weak first six months we have revised the year's export growth down to just over 2 percent from the 3.9 percent of the April forecast, though this implies a minor recovery during the course of the second half of the year. We are in part basing this on the fact that more companies in the PMI and in the NIER MCI survey (KI barometer) are reporting increased export orders. However, the recovery is fragile, not least considering the summer's weak growth figures from the Eurozone and the risks of the EU countries' sanctions against Russia. Global market growth for Swedish export companies is expected to increase during the forecast period in conjunction with a continued economic recovery. An estimated market growth of 6-6.5 percent during the period 2015-2016 is predicted, but at the same time we are reckoning on slower Swedish export growth than has been the case with previous economic upturns.

Swedish competitiveness under pressure

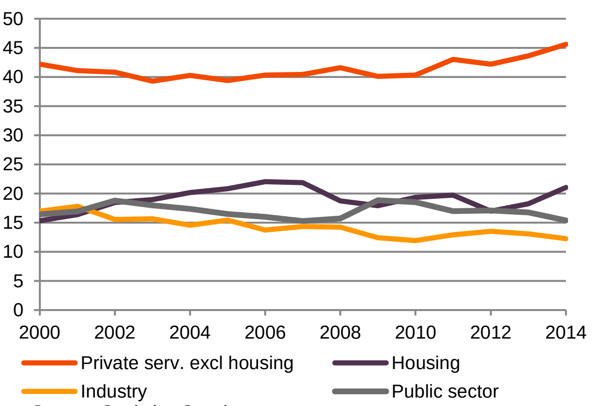
We are expecting exports to increasing by around 4.5 percent next year and just below 6 percent in 2016, which means Sweden will continue to lose market shares. The main explanation is the weak investments in the Eurozone. The level of investment in the Eurozone is 20 percentage points lower than before the 2008 crisis. Since 2011 it is above all Swedish investment goods that have lost out relative to other groups of goods. At the same time, as regards Swedish competitiveness we are predicting less advantageous developments during the period of the forecast, when we are reckoning on a gradually stronger krona, mainly against the euro, and higher increases in unit-labour costs, above all in 2016, when new wage agreements are expected to lead to higher salaries. Increased domestic demand and growing imports – for both goods and services – in the wake of specialisation and increased internet trade indicate that the contribution from net exports will restrain growth in GDP, above all during the period 2014-2015.

Sweden: Export value, year 2008 = 100



Source: Statistics Sweden

Sweden: Investment share , % of total investments



Source: Statistics Sweden

Increased service sector investments - industry weighs down

Lower investment growth, but housing gathering pace

Growth in investment slowed down during the second quarter of the year, and annual growth in investment dropped to 2.1 percent from 7.7 percent in the previous quarter. It was above all lower investments in machinery that contributed to the decrease, whilst housing investments continued to increase at a fast rate (annual growth rate of 20 percent) and were responsible for the greater part of the growth in investment during the first half of the year together with increased municipal investments.

Continued subdued outlook for investments in industry

Compared with our April forecast we are making a downward adjustment to the total investment growth in the Swedish economy – to 4 percent this year and 6 percent next year, in part because of the more sluggish developments in terms of exports. This is primarily inhibiting the industrial sector, but also parts of the private service sector. In Statistics Sweden's May investment survey, investment plans were showing a downward tendency in industry, tying in with the low capacity utilisation, pressure on profit margins and sluggish production developments. The level of investment in industry has fallen by 10 percent since 2008, and count for around 13 percent of total private business investments. It is instead the private service sector's investments that are growing as the Swedish economy is servicified, and we are expect business investments to increasing by just over 5 percent next year and by 6.4 percent in 2016, when industry's investments are expected to gather pace. Overall, total investment, including housing and public investments, will increase by 6 percent during 2016 as housing investments is expected to level off.

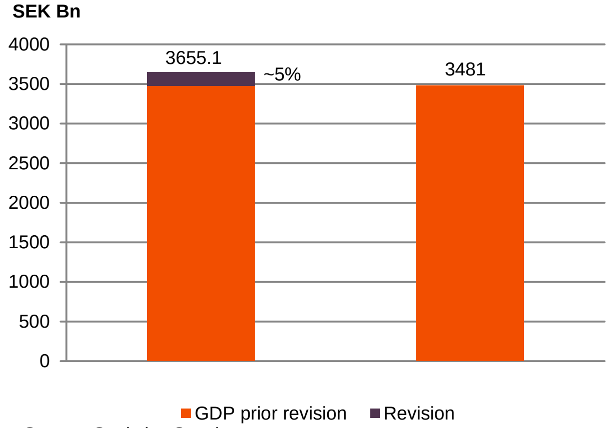
New housing encountering more and more supply obstacles

Investments in housing makes the biggest contribution to the increase in investments this and next year, but are expected to level off during 2016, in part because of a higher overall investment level, but also on account of growing supply obstacles such as access to land ready for building and a shortage of labour. In the long term higher rates of mortgage interest and probably more measures that make domestic loans more expensive may also reduce construction activity. The nature of economic policy after the general election in September will play a crucial role as regards public investment – especially state investment, where investment in infrastructure is key. We expect public and housing investments to be prioritized over the coming years.

In-depth 3: Higher Swedish GDP – in statistical terms

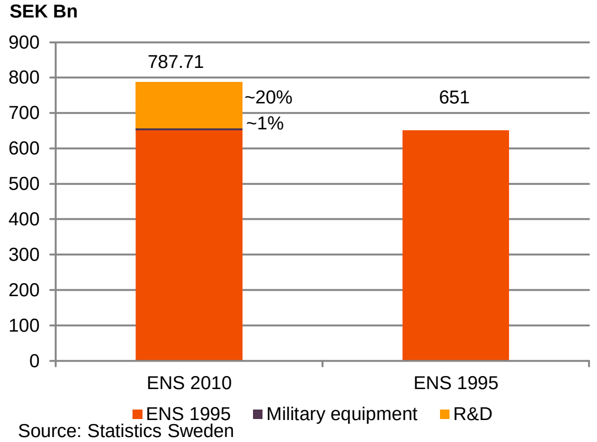
In September, the Swedish national accounts will be revised in accordance with the European System of National and Regional Accounts (ESA 2010), whilst simultaneously reviewing current calculation models and sources. What is unequivocally the biggest change being carried out is expansion of the concept of investment to include all costs for research and development (R&D) – an area that used to be recorded as a cost item. Sweden, which is a research-intensive country, will thus see significant changes. Other important changes include keeping accounts of tripartite trade – trade in goods that do not cross Sweden's national borders – where the value of the whole product will be included as export and import, and accountancy in connection with the state pension debt. Regarding foreign trade, export and import of goods will increase whilst commercial services, where registration currently takes place, will decrease. After the statistical revision *all* of an employee's pension undertakings, which are recorded as a liability on the employer's balance sheet, will be included as a liability in the national accounts (but not in the Maastricht debt). In practice this means that state expenditure in accordance with the national accounts will increase, and public saving will decrease to an equivalent degree.

Sweden: Revision of GDP, current price 2011



Source: Statistics Sweden

Sweden: Revision of investments, year 2011



Source: Statistics Sweden

Higher GDP level but unchanged paces of growth

According to preliminary figures from Statistics Sweden, the change means that the GDP level for the 12-month period 2011 increases by 5 percent at current prices. Of this increase, the ESA revision explains 4 percentage points and the remainder is attributable to a general overhaul of the methods of calculation. These figures can be compared with a revision in GDP of about 2-3% for other EU countries in accordance with a previous questionnaire. A change in level means a change in the measures and quotas in which GDP is included. The investment quota is expected to increase, whilst public-sector saving will probably decrease slightly. The state's fixed gross investments will change as military weapons systems (submarines, military aircraft etc.) are classified as an investment instead of a cost. This will have the second biggest effect on the level of GDP. According to the SCB's preliminary figures, the reclassification should supplement growth by a tenth of a percentage point or so.

The effect on the paces of growth, however, is less certain, but it will probably be relatively small, as the series of time is adjusted upwards. Statistics Sweden's preliminary estimate is that over time the rate of growth will go up or down by one to three tenths of a percentage point. The Swedish National Institute of Economic Research also assesses that the rate of GDP growth will change marginally. What is more problematic, according to the Swedish National Institute of Economic Research, is how R&D is measured. R&D surveys are only carried out every other year, thus estimates are necessary. The consequence may be that investments, and thus GDP, will be revised more in future.

New view of the Swedish economy?

Since the financial crisis, the development of productivity in Sweden has been modest, the average being around 1% per year. The beginning of 2014 was no exception, with a negative annual rate of 0.5% for the first quarter and 1.0% for the second quarter. When the national accounts in the autumn are changed, there will be an upward revision of productivity as a consequence of the higher GDP level. There will thus be a change in the somewhat negative view of Swedish productivity in recent years.

The Swedish economy is dependent on households

Consumption is carrying the Swedish economy

Households have been the key to the Swedish economy's recovery in recent years. Last year household consumption increased by 2.1 percent, and in the first half of this year it rose to 2.5 percent. Not least the consumption of durable goods is very strong, and this is a sign of confidence. The strong increase during the first half of this year is largely explained by markedly increased car sales, which have recorded an upturn of 18.1 percent. Consumption of other durable goods is also strong, with an increase of nearly 10 percent so far this year.

Several factors are interacting, and providing support for the current healthy level of consumption. The employment situation is favourable, and together with a low rate of inflation it has resulted in a rapid increase in real disposable income. The low level of interest rates – not least the consumption of durable goods – is also benefiting household consumption, and according to the NIER CCI survey households have had a positive view of the purchase of capital goods since the beginning of 2013.

Continued favourable terms for households ...

The factors that have supported household consumption will remain during the period of the forecast, though their strength will gradually flatten out. Developments on the labour market remain good, but an increasing rate of inflation means that the increase in real disposable income will gradually decrease – chiefly next year. During 2016 disposable income will rise again, as we foresee a higher rate of pay increase. The interest rates will remain low throughout the period of the forecast; though a weak upward trend is to be expected as from the second half of 2015 and during 2016.

... but reduced contribution

Overall we are seeing that household consumption continues to be an important driving force in the Swedish economy, even though the contribution to the growth is decreasing. This year we expect an increase in consumption of nearly 3 percent, in part supported by strong developments during the first six months. Over the coming two years the growth in consumption will decrease. In this context we are reckoning on a decline in the strong development in consumer durables, partly because of a saturation effect and partly because of a slower increase in real disposable income. Households' savings ratio will drop to just over 11 percent over the coming two years.

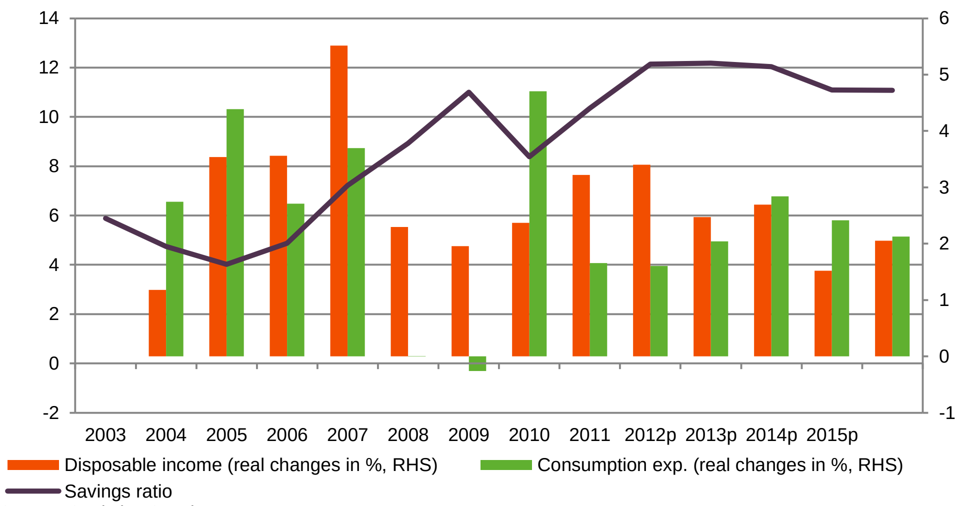
Risks significant: compulsory amortisation ...

Whilst consumption in our main scenario remains as a strong growth engine, there is great vulnerability. Levels of debt are high, and whatever the next government we are reckoning on targeted measures to curb the increase in debt. One measure is compulsory amortisation, though despite everything we are reckoning on a relatively limited impact, as the basis is that it principally applies to new credits. If compulsory amortisation were also to apply to existing loans the effect on consumption would be far-reaching, even in the short term. At the same time other measures are also being considered, e.g. restricting the proportion of variable loans. Depending on where the limit is set, this could have more or less far-reaching effects on consumption. At the same time it is worth noting that at approx. 0.6 p.p. the difference in interest between variable and 5-year mortgages is currently relatively small.

... and a tighter financial policy

The nature of the financial policy is also uncertain. Whatever government comes into power after the autumn election, the period of tax cuts is behind us, and the trend is rather the opposite for the period of the forecast. As regards household consumption we see significant risks in excessively large-scale tax increases, which would curb the increase in disposable income and may have an adverse effect on household confidence. This measure would curb households' willingness to consume, and thus Swedish growth.

Sweden: Household consumption



Source: Statistics Sweden

More jobs needed in order to push unemployment down

Unemployment takes a grip at 8%

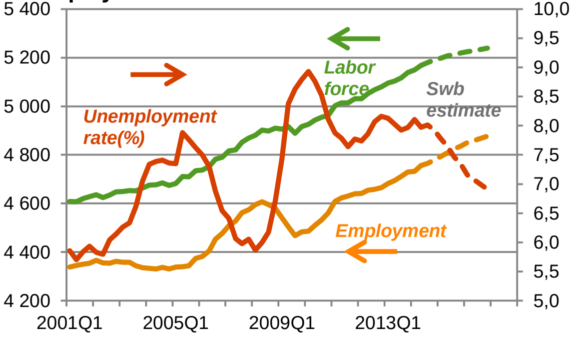
Developments on the labour market have shown continued positive preliminary signs during 2014, but there is a fly in the ointment in the form of unemployment, which is stubbornly taking a grip at around 8%. Employment is increasing at an annual rate of between 50,000 and 60,000, redundancies have decreased and forward-looking indicators show that the improvement will continue during the autumn.

According to statistics from the Swedish Public Employment Service (SPES), recently registered vacancies have increased during the spring and summer, which bodes well, and according to the Swedish National Institute of Economic Research barometer and PMI, employment plans are positive. But the impact on the level of unemployment is conspicuous by its absence. Unemployment, according to the Swedish workforce survey AKU, stubbornly remains at approx. 8% – the same level as in 2012 and 2013. This is linked to the fact that the workforce is increasing at about the same rate as employment, which has surprised both authorities and forecasters.

The age make-up of the workforce (with an upward shift) has led to a slowing-down of the rate of increase. The number of people of a working age is, however, increasing at an unexpectedly fast rate, chiefly because of increased net immigration, not least in the wake of the catastrophic developments in Syria. Sweden's population increased by 89,000 last year, and during the first five months of this year by 40,000. This has prompted Statistics Sweden to make an upward revision of its forecasts of the number of people of a working age. The participation of the workforce has furthermore increased, not least amongst people born abroad. Government reforms in the field of tax and social insurance as well as attempts to more quickly get newcomers to Sweden onto the labour market have had an effect in this regard – though maybe over a more extended period of time than was envisaged. It takes time for people to adjust to new circumstances and regulatory frameworks.

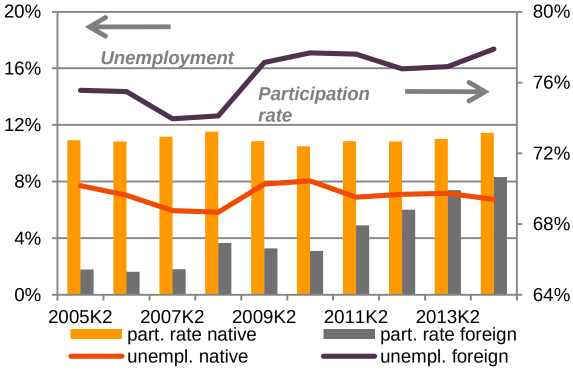
Apart from an increase in the number of people born abroad on the labour market, a continuing increase in the participation of elderly people (55-74 years) on the labour market is also evident. The percentage participation of those aged 55-64 has increased to 79%, from 72% in 2006. During the same period – the second quarter of this year – the proportion of people aged 65-74 in work increased from approx. 10% to 17%.

Sweden: Employment, labor force and unemployment rate



Source: Statistics Sweden and Swedbank

Sweden: Unemployment and participant rate (%), by native- and foreign born



Sources: Statistics Sweden and Swedbank

Slow improvement predicted

The labour market is expected to continue to improve over the coming years, and with some delay a slow drop in unemployment is expected. With and increased proportion of older people in the workforce, we are reckoning on the demographics having an increased impact, and on net immigration beginning to normalise, though there is admittedly great uncertainty about this assumption.

Other uncertainty factors are whether the government's earlier supply reforms are still exerting an effect, as well as the tenor of labour-market policy during the next mandate period. The red/green parties have announced increased investment in education and trainee jobs, but on the other hand voices have been raised regarding removal of the tax rebate on jobs for young people and the halved restaurant VAT.

Regardless of the political colour of the next government, there are significant challenges in the field of the labour market. According to estimates by (SPES), an increasing proportion of the unemployed are in a weak position on the labour market, in various ways. To sum up, Swedbank predicts that unemployment will drop to 7.6% next year and 7.0% in 2016. Over the coming years employment is expected to continue to increase by at least 1% a year.

Real salary increases a threat to competitiveness

The nominal salary increases are reduced in the wake of the low centralised three-year pay agreements concluded last year (the centralised agreements led to an average salary increase of approx. 2.3% per year). But against the background of the low inflation Sweden has seen relatively high real increases in salary, and the unit labour cost is increasing faster than in the rest of the world. This is contributing to pressure on competitiveness. According to KI's barometer, the shortage figures continue to be low. As the available resources on the labour market are gradually taken up, wage drift is expected to increase. Furthermore, it is predicted that wage negotiations during 2016 will be held under more normal economic conditions, which should ensure somewhat higher centralised pay agreements (at least a good 2.5%). Overall salary increases are expected to be a good 3% next year, and just under 3.5% in 2016, but salary negotiations and Swedish competitiveness depend on the Riksbank succeeding in getting inflation up and meeting the long-term inflation expectations around the target inflation.

The rest of the world and technological development curb prices

Low inflation puts pressure on Riksbank

The rate of Swedish inflation has long been low, and so far this year CPI with a fixed interest rate has increased by just under 0.5% per year, with a weak pressure on prices in both the goods and service sectors contributing to the low inflation. Concerns about excessively low inflation caused the Riksbank to surprisingly lower the base rate by 50 points in July.

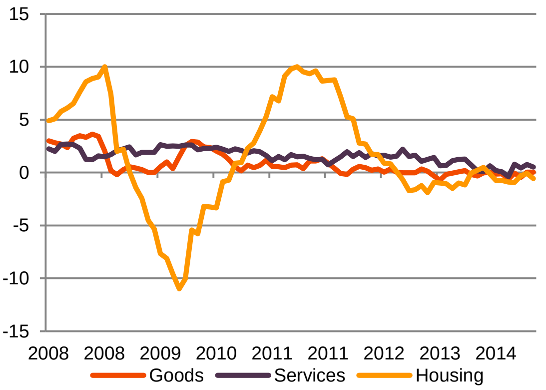
External factors behind low pressure on prices

But it is to a large extent factors beyond the Riksbank's control that have affected Swedish inflationary pressure. A slow recovery in the global economy together with lower growth in the major raw-material-consuming economies means we are reckoning on a reduced development in prices for raw materials this year, followed by a clearer, though moderate, upturn in 2015 and 2016. This, together with low international utilisation of capacity and a slight strengthening of the krona, will result in much reduced import price inflation this year and next. As the international economy strengthens world market prices will rise, and this will have an impact towards the end of next year – a development that will gradually be accentuated during 2016. Digitalisation also means that more and more intermediaries in the sales process are disappearing and distribution costs are decreasing. This, too, is having a restraining effect on prices.

Slowly increasing inflation in the coming years

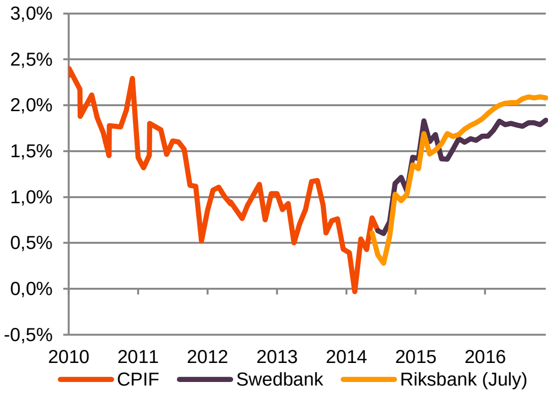
During the course of next year and 2016 inflationary pressure will slowly increase in both the service and the goods sectors. Prices of goods will increase as a result of a stronger global economy and slowly rising prices for raw materials. Within the service sector higher salary costs together with a greater willingness to pay on the back of a stronger labour market will contribute to rising prices. Overall we are expecting that consumer prices, measured as CPI with a fixed interest rate, will rise by 1.6% in 2015, followed by an upturn of 1.8% in 2016. CPI inflation is expected to rise by 1.4% next year, when interest rates will continue to have a restraining effect on CPI. We forecast that CPI will increase by 2.1% in 2016.

Sweden: Inflation development per sector



Source: Statistics Sweden

Sweden: Inflation development



Sources: SCB, Riksbanken and Swedbank

Riksbank now putting all its eggs in one basket

Inflation target first of all

The Riksbank lowered the repo rate by a surprising 50 points to 0.25% in July, in the wake of the continued low inflation recorded this year. The previous strengthening of the krona and the ECB's easing of monetary policy in June were considered when coming to a decision. A weaker krona is necessary in order to push up inflation more substantially within a reasonable period of time. The Riksbank's concern about household debt has in no way decreased – rather on the contrary. But the longer inflation greatly deviates from the inflation

Interest and exchange rate assumptions

	Outcome	Forecast				
	2014	2014	2015	2015	2016	2016
	25 Aug	31 Dec	30 Jun	31 Dec	30 Jun	31 Dec
Interest rates (%)						
Policy rate	0,25	0,10	0,10	0,10	0,50	1,00
10-yr. gvt bond	1,53	1,60	1,90	2,20	2,30	2,40
Exchange rates						
EUR/SEK	9,2	9,2	9,1	9,0	8,9	8,8
USD/SEK	6,9	7,1	7,2	7,3	7,2	6,9
KIX (SEK) 1/	108,2	109,2	108,1	107,0	106,0	104,5

1/ Total competitiveness weights. Trade-weighted exchange rate index for SEK.

Sources: Reuters Ecowin and Swedbank

target the harder it will be for the Riksbank to take financial stability risks into consideration.

There is in any case a tendency for a drop in the medium-term inflation expectations, and this has contributed to the Riksbank's increased efforts to ensure credibility around the inflation target. With the establishment of the Financial Stability Council and with the Swedish Financial Supervisory Authority now having direct responsibility for macroprudential measures, the Riksbank can now increasingly point to the fact that in policy areas other than monetary policy measures are now being taken to curb the expansion of loans – not least as such measures need to focus on pushing up inflation.

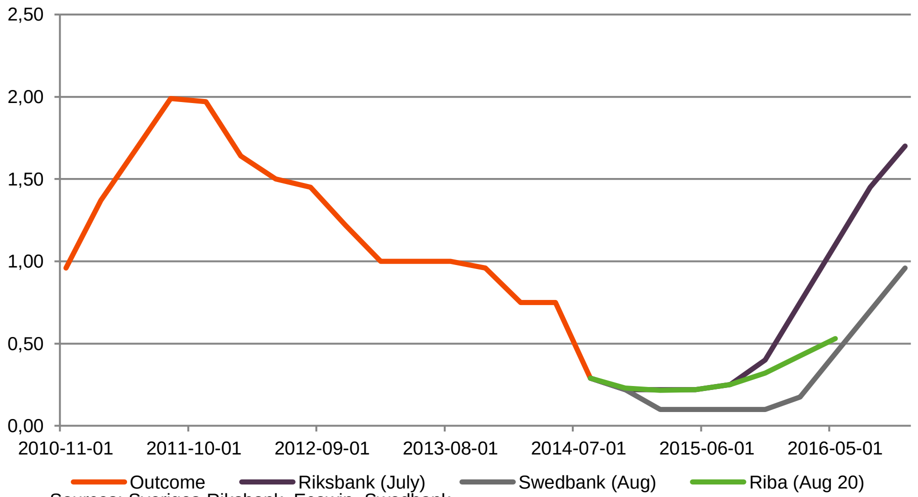
Further measures cannot be excluded

In its new forecast the Riksbank is forecasting that the first interest-rate increase taking place at the end of 2015. But to judge by the latest protocol, members are not averse to further relaxing the monetary policy if so required. The repo rate can be lowered to near zero and the interest-rate forecast can be further postponed. The Riksbank also has an arsenal of other measures up its sleeve; for example, it now has an infrastructure for handling the purchase of bonds on the interest-rate market so as to put force behind signals of low interest rates for a prolonged period.

No increase in repo rate until 2016

Swedbank is predicting that inflation is now gradually increasing, but it will be some time before the underlying inflation more permanently reaches 2%. There is a risk of inflation expectations remaining below 2% for some time to come. In the short term the risk is rather that the very low inflation will continue and that the ECB will undertake further monetary-policy easing, which we think would bring about a further drop in the interest rate and a postponement of the Riksbank's repo-rate forecast. *Swedbank's main scenario is thus that the Riksbank will lower the repo rate to 0.10% in December and that it will be early 2016 before we see a first increase in the interest rate. We predict that by the end of 2016 the repo rate will have risen to 1.0%.*

Sweden: Repo rate path



Sources: Sveriges Riksbank, Ecowin, Swedbank

In-depth 4: Digitalisation's effects on Swedish inflation

Digitalisation is a structural change that affects the Swedish economy more than other comparable countries. Physical goods become digital services, intermediaries disappear and the marginal costs of production, copying and distribution approach zero. The price mechanism will consequently be affected in future when the supply within certain industries becomes practically unlimited. Swedbank's calculations show that 30% of the Swedish CPI basket is directly or indirectly affected by digitalisation. We have also drawn up an example that indicates that the price of music consumption has dropped by 33% since 2008.

The low inflation is not just a Swedish phenomenon. Inflation is below the inflation target in a number of developed economies, but Sweden is further from its inflation target than Switzerland, the euro area and Canada, for example. The reasons for the decreasing inflation that has been recorded in most developed economies can be divided into several factors: a global downturn in food and energy prices; low resource utilisation on the labour market, thereby holding salaries back; a low credit supply as a result of stricter credit provision in the wake of the financial crisis. These factors are cyclical, and when demand in the economy strengthens, inflation is expected to increase. But the development of inflation can also be attributed to structural changes that digitalisation contributes to:

- E-commerce across Sweden's borders is increasing, and Sweden is one of the countries where e-commerce is biggest.[1] Swedish inflation is thus experiencing relatively high exposure to digitalisation through increased competition, which is contributing to downward pressure on prices.
- More and more small and medium-sized companies are so-called 'born globals' – through digitalisation they reach the entire international market as soon as they are formed. Digitalisation has meant that producers of both goods and services are increasingly being exposed to international competition. One example is film rentals. Netflix is now competing with local video shops. Streaming films on the net leads to falling marginal costs. This increases competition and pushes prices for services down.
- The marginal costs for producing, copying and distributing digital services are approaching zero. This is increasing the supply of digital services, and we could liken this to a supply shock within certain sectors. Intermediaries are also obviated when supply and demand meet directly, thereby creating further downward pressure on prices. Niche producers gain access to customers they would not otherwise have had access to.
- Low pressure on salaries as a result of unemployment in the field of technology.[2] It is above all routine jobs in the field of commerce and administration, but also certain highly qualified jobs, that may be replaced. Having initially replaced muscles, the new technology is now also replacing the human brain.

So as to somehow facilitate quantification of the effect of digitalisation on inflation, we divided up the CPI basket into three different categories. We allocated to the first category goods and services that we estimate have been directly affected by digitalisation. In our opinion they are often both purchased and consumed digitally (e.g. streamed music). To the second category we allocated goods and services we consider to have been indirectly affected by digitalisation. In our opinion it is relatively common for households to do price comparisons and to buy these goods and services on the net (e.g. computers). The final category includes goods and services that we deem not to have been greatly affected by digitalisation. We allocated the remaining product groups (e.g. nursery charges) to this category. By adding up the weightings in the category in question, we estimate that around 30% of the goods and services in the CPI basket have thus far been directly or indirectly affected by digitalisation. With the same CPI basket we then attempted to estimate whether the goods and services will be noticeably affected by digitalisation over the coming 10-year period. Our assessment on the basis of this exercise is that in future a further 7% of the CPI basket will be noticeably affected by digitalisation, be it directly or indirectly.[3]

The industry that have perhaps been most affected by digitalisation is the music industry – a sector in which a physical product has become a digital service. We have made assumptions regarding the pressure on prices over the past six years, given that we listen to 10 or 20 new tracks a month. According to our assumptions the price of each newly listened-to track would have decreased by 33% during this period.[4] Given that 20 new tracks are listened to every month, the price has dropped by 67%. This big decrease reflects the fact that the marginal price of each new 'streamed' track is zero.

Whilst the value of digitalized goods and services moves toward zero, the value of non-digital goods and services increases. This can be seen in the music industry, where artists no longer earn money on sales of CD's or music downloads as they used to, but on concerts and advertising activities etc. We do not pay anything to see an artist on Youtube, but are prepared to pay a great deal for a concert. The price of theatre tickets has, for example, increased by 7.6 percent over the last year, and concert earnings by 22 percent.

Music consumption forms a very small part of the total CPI basket, but our calculations can give an indication of what digitalisation means in terms of pressure on prices when more and more industries are affected.

It can be hard to capture the full pressure on prices in public statistics. Statistics Sweden measures price trends for digitally consumed music by quality-adjusting the subscription charges. Furthermore, free digital consumption is totally excluded from the official measure of price trends.

Riksbanken's ability to affect Swedish inflation is on the decrease. This is because the repo rate is already, and is the result of more globalised capital markets on which the Riksbank's measures cannot deviate too much from those of the ECB, and, as we have attempted to describe in this focus box, technological developments.

[1] HUI
[2] Research shows that 53% of Swedish professions risk being replaced by digital technology within 20 years. The equivalent figure for the USA is 47%.
[3] The CPI basket we used as our starting point comprised 360 different goods and services. Of these, three were deemed directly affected, 113 indirectly affected and 244 unaffected. In our estimates for the next 10 years we have subdivided the goods and services into 10 directly affected, 148 indirectly affected and 202 unaffected.
[4] We are assuming a period of six years, with reference to the IFPI's statistics.

Fiscal policy expansion damped

Growing deficit

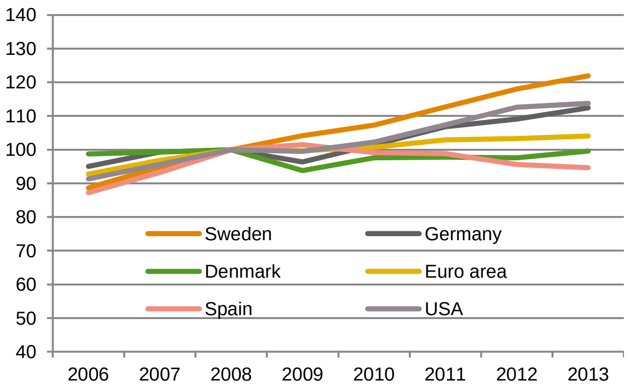
An expansive fiscal policy has contributed to a good recovery in the Swedish economy since the financial crisis. Significant decreases in income tax through tax credits comprise an important factor regarding the positive development of disposable income in Sweden compared with many other countries since the crisis (see figure). The result of the income-tax decreases, however, is decreasing financial saving during 2014. Financial saving in Sweden has not been positive since 2008 (see figure).

Increased pressure on expenditure, regardless of the election results

Public finances will be affected by the outcome of the national election on 14 September. Swedbank is not making any probability assessment of the outcome of the election; its forecast is instead based on an assumption that strong public finances and full financing of new measures are a priority, regardless of the election outcome.

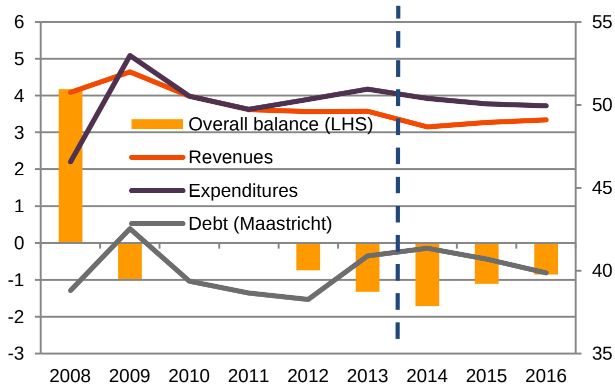
Public consumption, however, will increase as a result of requirements in the fields of healthcare, care services, schools and promised investments – chiefly in the area of education. The deficit in the state finances will decrease during 2015 and 2016, but financial saving will continue to be negative throughout the period of the forecast. The risk, however, is of a move towards a bigger increase in public expenditure, as an unclear parliamentary situation may put pressure on new expenditure in order to satisfy all parties in any coalition government (see In-depth 3).

Sweden: Disposable income, current prices (2008 = 100)



Source: EcoWin

Sweden: Public finances (% of GDP)



Sources: Statistics Sweden and Swedbank

Rising taxes, but the surplus objective will not yet be achieved

A number of measures affecting state finances and macroeconomic developments have been announced by both the alliance and the opposition. They involve higher tax on alcohol, tobacco and vehicles, abolition of the right to tax deductions for private pension saving and higher expenditure, particularly in the field of education. These reforms will lead to higher taxes, and redistribution from private consumption to public consumption during 2015 and 2016. As regards growth, the expected measures are largely neutral. As a result of an ageing population and an increased need, e.g. within healthcare and care for elderly people, municipal taxes will also be increased in many municipalities and county councils, which will also contribute to a somewhat higher taxes during the period of the forecast. Fiscal policy will thus range from expansive to neutral, and then a tightening-up towards to end of the period of the forecast. Despite this, financial saving will be negative during the period of the forecast. It appears less and less probable that the surplus objective will be met (i.e. government net savings of 1% over the business economic cycle). We assess that the surplus objective will be investigated during the next mandate period and will in the long term be reformed.

In-depth 5: Restricted macro and market effects in the event of a weak government

If on 14 September the Swedish people were to vote as indicated by the opinion polls at the end of August, the red/green parties will be far bigger than the alliance parties, but by a small margin they would not achieve an absolute majority after the national election.

There is thus great uncertainty, and much may be decided during the final weeks, but tricky and drawn-out government negotiations are on the cards right now. It is also possible that nine parties will be represented in the Riksdag (including the Feminist Initiative). There is a risk of the resultant government being weak and uncertain. The influence of the Riksdag and the committees on economic policy would increase. This would not be anything new: in the 1970s Sweden had to live with a lottery Riksdag and failing conservative wing governments. In the following decade the social-democrat government was gradually weakened by internal conflicts during the so-called Wars of the Roses, and during the period 1991-94 the conservative government did not hold an absolute majority, as the New Democracy party entered the fray in the Riksdag.

After several relatively strong governments, the current mandate period has been characterised by increased uncertainty, as the alliance does not hold an absolute majority in the Riksdag. In the attached table we have attempted to catalogue the government's strength and stability since the 1971 election.

Period	Strenght	Comment
1971-74	Pretty strong	S government w ith support from VPK
1974-76	Weak	"Lottery Riksdag"
1976-79	Pretty w eak	Bourgeois government -- became w eak, Ullsten alone 1978
1979-82	Weak	Bourgeois government w ith slim majority
1982-85	Strong	Palme strong
1985-88	Pretty strong	Palme w eaker
1988-91	Pretty w eak	Weaker. MP enter. "War of the Roses" escalates
1991-94	Pretty w eak	Bourgeois government but w ith NYD
1994-98	Strong	Strong RG w ith pretty strong S
1998-02	Pretty strong	Strong RG but w eaker S
2002-06	Strong	Strong RG and better S
2006-10	Strong	Bourgeois government w ith ow n majority
2010-14	Pretty strong	Bourgeois government but w eakaned w ith SD

The political climate can affect economic developments. Uncertain and sluggish developments in economic policy can create uncertainty in companies and households. Our review of government strength and growth since 1971 does not show any clear link between a weak government and poor growth – and this is in line with the research literature. The Swedish experience, however, is that regularly recurring weak governments such as the ones we experienced during parts of the 1970s and 1980s ultimately also have an adverse effect on stabilisation policy in a broad sense and thus on public finances (the beginning of the 1990s).

History indicates that the market can observe these differences in the strengths of governments. The difference between long-term Swedish and German government-bond rates tends to be bigger during periods of relatively weaker governments. Sweden is currently AAA-rated, the state debt is relatively low (approx. 40% of GDP) and there is great confidence in the stability of economic policy.

Thus the effects of a weak government over the coming years must not be exaggerated, but our assessment is that increased uncertainty about the direction of economic policy may slightly inhibit growth over the coming years. We also believe that on the margins public finances may this time to some extent be adversely affected. An improvement in state finances over the coming years is on the cards in the wake of the improvement in the economy, but some increases in expenditure may trickle through.

All things being equal, we are reckoning on a relatively limited impact on pricing of the Swedish currency and interest rates, bearing in mind the very strong starting point. However, we are reckoning on an outcome in accordance with our main scenario, i.e. a red/green victory, but one in which an absolute majority is not held, leading to slightly higher risk premiums and slightly increased volatility in Swedish interest rates and the development of the krona.

Estonia: Uphill struggle continues

Export opportunities have worsened as the economic outlook for Estonia's main export markets has deteriorated. In 2014, economic growth relies primarily on private consumption, while investments and exports will start contributing more in 2015. Increased labour costs and slowness in improving productivity limit further the reduction of unemployment. Geopolitical tensions pose downside risks to the recovery.

Key economic indicators, 2013-2016 1/

	2013	2014f		2015f		2016f
Real GDP growth, %	0,8	0,8	(1,8)	2,3	(3,0)	3,0
Consumer price growth, %	2,8	0,3	(1,3)	2,5	(2,5)	2,7
Unemployment rate, % 2/	8,6	7,7	(8,4)	7,6	(7,9)	7,2
Real gross monthly wage growth, %	4,9	5,9	(4,9)	3,4	(3,5)	3,5
Current and capital account balance, % of GDP	1,7	1,6	(1,4)	1,3	(1,0)	1,2
General government budget balance, % of GDP 3/	-0,2	-0,5	-(0,4)	-0,4	-(0,3)	-0,2

1/ April 2014 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: Statistics Estonia, Bank of Estonia, Swedbank.

Economic growth in Estonia's main export markets has deteriorated

Economic growth in Estonia's main export markets has deteriorated. Geopolitical tensions have further worsened the growth outlook in the region and will continue to impair export opportunities in the coming quarters. Besides agricultural producers and the food industry, the embargo by Russia is hitting companies in the transport sector and wholesale, where the items under embargo have a considerable share in the product structure. As Russia continues to develop its cargo ports on the Baltic Sea, the tightening competition reduces the service of transit trade and hinders the growth of the transport sector. Export growth will decelerate this year and will have only a sluggish recovery in 2015. A better economic outlook for Estonia's main trading partners in 2016 will improve external demand and help to accelerate export growth. However, because demand for imports is stronger than for exports, a negative contribution of net exports will inhibit GDP growth in 2014-2016.

Primarily due to the worsened economic outlook and weakened external demand amongst most of Estonia's main trading partners, we have revised GDP growth in Estonia downwards to 0.8% in this year (from 1.8% in our April outlook). The recovery of growth will be sluggish, and we expect the economy to grow by 2.3% in 2015 and 3% in 2016.[1]

The recovery of import prices will be faster than those of exports

In 2013, the terms of trade improved considerably: import prices became cheaper than export prices, which contributed to the cost reductions for exporting companies. However, the spread between export and import prices has considerably narrowed, and we expect that the recovery of import prices, although very sluggish, will be faster than that of export prices towards the end of the forecast period, mainly due to euro depreciation.

Investments will not grow growth is decelerating this year, but will pick up in 2015

Due to the weak demand and uncertainty amongst corporations, their investments have been quite modest. Owing to reinvested earnings, a considerable share of investments is financed by own funds. The necessity to increase productivity, as labour costs are increasing and corporations are hiring fewer new workers, requires more investments in machinery and equipment. At the same time, the heightened geopolitical tensions have increased uncertainty amongst economic agents and have worsened their sentiment. This will inhibit growth in investment activity amongst corporations in the coming quarters. Corporations' investments are growing only modestly this year, but growth will pick up in 2015 and 2016 as demand improves. Household investments in dwellings have been robust, as the demand in real estate is high. As with corporations, households have increasingly financed their investments from their own funds. However, the deceleration in growth of real wages will limit households' investment activity. Public investments depend considerably on the availability of EU funds. As this source of funding will not pick up strongly until the second half of 2015, government investments will continue to decrease this year and will remain weak during 2015 and 2016 as well. The modest amount of government orders and investments is having a negative impact on the construction of infrastructure. However, the demand for dwellings is supporting private investments. All in all, total investments will not grow this year, but will pick up in 2015.

Employment decreases during the forecast period

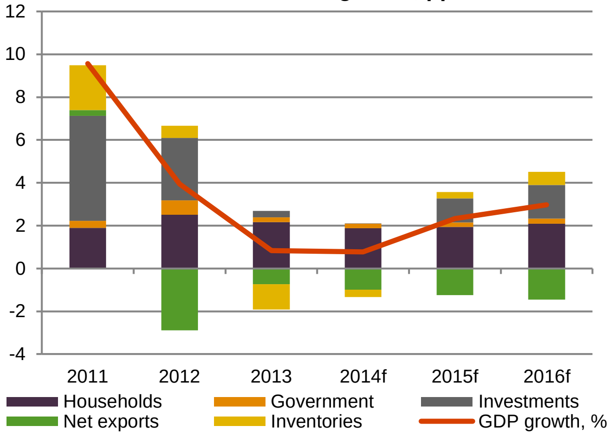
Employment has decreased this year. We expect employment to continue falling during the forecast period, although the decline will slow somewhat in 2015-2016. Employment is decreasing due to the shrinking Estonian population and negative net migration. Although emigration will slow slightly in the medium term, the continuing natural decrease of the popu-

[1] Statistics Estonia will release revised GDP time series according to the fully new methodology (ESA2010) at the beginning of September this year. This will effect changes in levels as well as growth rates of GDP and its transactions

lation will have a stronger effect. Fewer people will enter the labour market, while the population is aging.

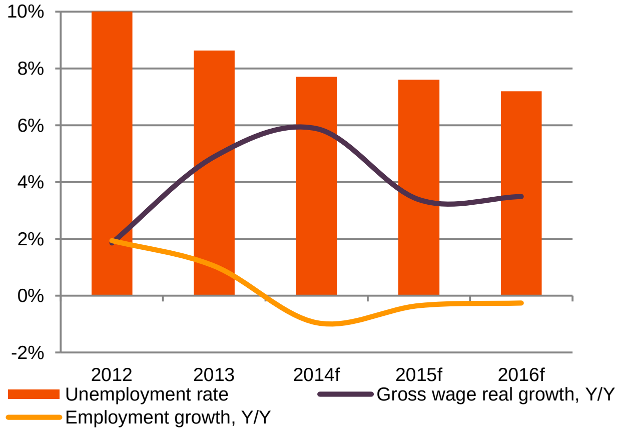
The unemployment rate has decreased gradually and has reached 7.7% in the first half of this year. The worsening outlook for the economic recovery, including increased uncertainty amongst corporations due to geopolitical tensions in the region, could inhibit the decline in unemployment in the second half of 2014 and the first half of 2015. However, we do not expect a considerable impact from this worsening, and the unemployment rate is expected to decrease to 7.7% this year on average. The fast decline in the unemployment rate will halt in 2015-2016 due to the shrinking labour force and skills' mismatch, as well as because corporations are hiring fewer workers, with the aim of curbing the increase in labour costs and making production more efficient.

Estonia: Contributions to GDP growth, pp



Source: Statistics Estonia, Swedbank

Estonia: Labour market indicators



Source: Statistics Estonia, Swedbank

The growth of real wages will decelerate in 2015-2016

The actual unemployment rate has been considerably lower than its natural rate already since last year, thus exerting upward pressure on nominal wages. Due to the shortage of qualified labour, employers have had to increase wages faster than labour productivity, which has accelerated the growth of unit labour costs. However, decreased prices of imported inputs have kept producer and export prices low. Although nominal wage growth will remain robust, we expect it to slow moderately, as the profitability of corporations has fallen; reducing the number of employees would be the last chance in an environment of labour shortage. As inflation is very low, the growth of real wages will accelerate this year and contribute to an increase in retail trade and private consumption. Besides nominal wages, the growth of real wages will also decelerate in 2015-2016, as inflation will pick up.

Private consumption maintains solid growth

The decrease in personal income tax of 1 percentage point (from 21% to 20%) and increase in income tax exemption in 2015 will have a relatively modest effect on private consumption, compared with the negative effect of the deceleration of real wages and decrease in employment. Under these conditions, private consumption still maintains relatively fast growth and contributes the most to economic growth.

The year 2014's inflation has been affected by several one-off measures that will lose their relevance in 2015. A warm winter and early spring pushed down energy and food prices. The Estlink2 electricity cable and a decline in network fees have made electricity cheaper. The new government-operated train system and free train transport within Tallinn has increased competition and lowered prices of public transport. The impact of free higher education since last autumn will also diminish from September 2014 onwards.

Inflation will pick up in 2015 and 2016

The euro will weaken against the US dollar in 2015 and 2016, lifting prices of several imported goods and services. Food prices will increase globally in the following two years as demand will increase more than supply. In Europe and in Estonia, the prices of selected food products will probably decline during the second half of 2014 and the first half of 2015, due to excess supply after the introduction of Russia's export restrictions. The prices of services will continue their upward trend due to the fast growth of wages. An increase in excise taxes of alcohol, tobacco, natural gas, and heating oil will lift consumer prices by around half a percentage point in both 2015 and 2016.

The main risk is related to the possible escalation and protraction of geopolitical tensions

The main risk to the current forecast is related to the possible escalation and protraction of geopolitical tensions between Russia and the EU; this could have an adverse effect on the economic recovery of both Estonia's trading partners and itself. The risk related to the possible overheating of the labour market, as wages were increasing very quickly (as we previously noted with concern), seems to abating gradually due to slower-than-expected growth.

Latvia: Adjusting to a new normal

Geopolitical tensions between Russia and Europe will slow Latvian growth in 2014-2015. The financial situation of companies in those few exposed sectors will worsen; however, these will be liquidity rather than solvency problems. We expect export and investment growth to weaken temporarily, while household consumption growth should remain quite robust. In 2016, economic growth will again pick up.

Key economic indicators, 2013-2016 [1/]

	2013	2014f		2015f		2016f
Real GDP growth, %	4,1	2,5	(3,0)	2,6	(3,5)	3,5
Consumer price growth, %	0,0	0,8	(1,5)	2,5	(3,2)	2,5
Unemployment rate, % [2/]	11,9	10,7	(10,7)	9,9	(9,6)	8,8
Real net monthly wage growth, %	5,7	7,4	(4,7)	2,9	(2,7)	3,9
Current account balance, % of GDP	-0,8	-2,0	(-1,7)	-2,2	(-1,7)	-2,9
General government budget balance, % of GDP [3/]	-0,9	-1,3	(-1,2)	-1,5	(-1,1)	-0,8

1/ April 2014 forecast in parenthesis.
2/ According to Labour force survey.
3/ According to Maastricht criterion.

Sources: CSBL and Swedbank.

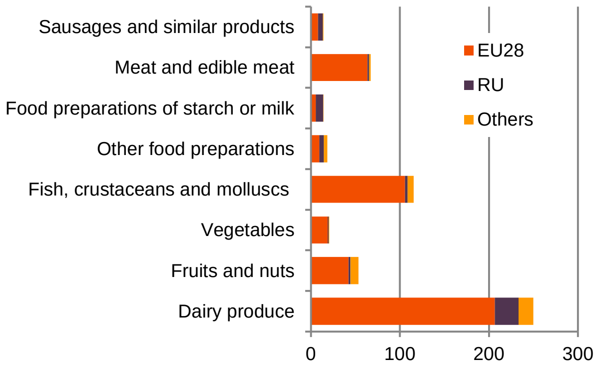
Slower growth in 2014-2015

Increased geopolitical uncertainty, a direct and indirect impact from food products embargo by Russia, and weaker-than-expected household consumption so far this year, imply slower growth in Latvia in 2014-2015. We are revising downwards GDP growth forecast to 2.5% in 2014 and 2.6% in 2015 (3% and 3.5%, respectively in April outlook). We expect economic growth to pick up in 2016 to 3.5%, as the Russia-Ukraine conflict normalises and companies adjust to a new normal. The risks are skewed to the downside, and we could see even slower growth, if the August 7 embargo is the last round of sanctions to/from Russia.

Exports to be hit by Russian embargo, but still growing

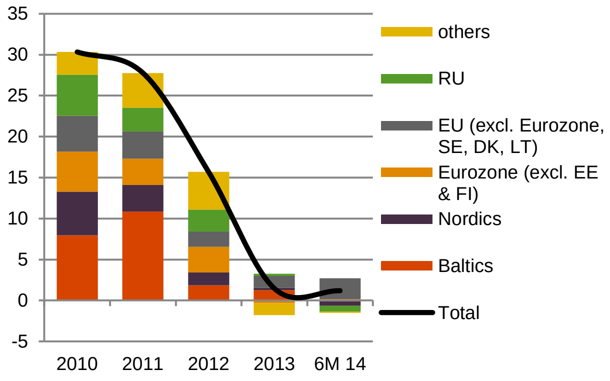
Despite increased trade barriers from Russia, stronger competition within the EU, and a very weak Russian economy, external demand from Latvian trade partners is set to continue picking up in 2014-2016. This implies opportunities for exporters to find new markets or benefit from stronger growth in already penetrated ones. For instance, in the first half of this year, goods exports to Russia declined by 7%, but this fall was more than outweighed by export growth to the UK, Poland, and Sweden. The Russian embargo affects a relatively small share of Latvian companies: farmers (mostly dairy), some food manufacturers, and carriers (mainly road transportation). Direct exports of embargo products to Russia are only 0.5% of total goods exports; these are unlikely to disappear completely, as companies will search for other ways to sell their produce to Russia. The embargo indirectly influences additional 4.6% of Latvian goods exports that go to the EU28, where competition will rise and push prices downwards. The impact on volumes is expected to be relatively limited, and we forecast exports to grow in 2014-2016, although notably slower than forecast before.

Latvia's exports of embargo products by destination in 2013, EUR m



Source: UN Comtrade database

Latvia: Contribution of main trading partners to annual goods' export growth, pp



Source: CSBL

Increased uncertainty to weigh down on investments

With export sales decreasing in the sectors that are exposed to the embargo, companies' cash flows and liquidity will deteriorate; yet, we do not expect wide-scale solvency problems. However, increased uncertainty is likely to slow investment growth. Investment activity in the first half of this year still looks quite good, but we expect private sector investments to weaken in the second half of this and the beginning of next year with some postponement of new projects (especially in those sectors exposed to the Russian market). At the same time, public infrastructure projects will continue, such as road maintenance (with EU funds for the new period starting to come, it is hoped, in 2015) and railway (the remainder from previous EU budget period to be spent until the end of 2015). In late 2015 and 2016, EU structural funds will again be the key driver of investment growth in both the public and private sectors.

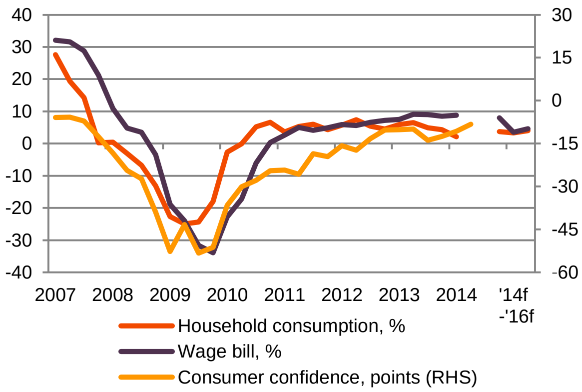
Household consumption to remain the major driver of growth...

Household consumption is forecast to remain the major driver of economic growth in the coming years, owing to a robust increase in real disposable incomes. In the first half of this year, households' income growth exceeded their spending growth, pointing to higher saving rates. However, an increase in deposits at the end of 2013 and cautious household spending early this year can at least partly be attributed to the euro changeover. It looks like household spending growth picked up somewhat in the second quarter.

... boosted by strong wage increase...

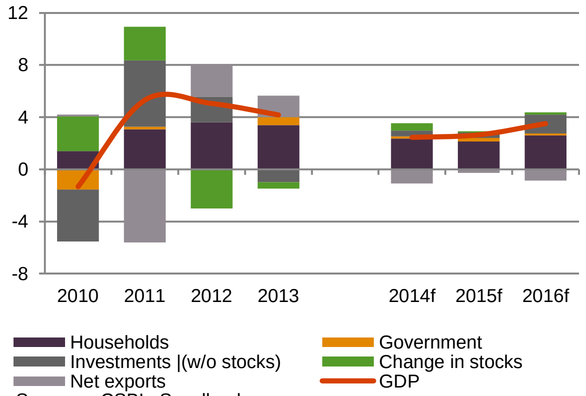
Wage growth in the first quarter was stronger than expected and most likely remained strong also in the second quarter. This is partly driven by a minimum wage hike at the beginning of the year (adding at least 1 percentage point to annual growth). This hike, does not add much to consumption, though, as it is in fact largely income legalisation. Net wages have additionally benefitted from a smaller labour tax burden. Although we expect companies to be much more careful in revising wages in the second half of the year, we forecast average net wage to grow by over 8% this year, owing to the wage revisions already made. In 2015, net wage growth will decelerate to 5.5% (with the base effect of the minimum wage hike disappearing), picking up to 6.5% in 2016. This forecast takes into account the currently approved 1 percentage point easing in the labour tax burden both in 2015 and 2016.

Latvia: Annual growth of household consumption and wage bill, consumer confidence



Source: CSBL, DG ECFIN, Swedbank

Latvia: Contribution to GDP growth, pp



Sources: CSBL, Swedbank

... while employment growth will be very modest

Employment growth nearly stopped in the first half of 2014, and we expect only minor job creation this year and the next, as companies will remain cautious in hiring. For instance, investments in manufacturing mainly entail raising efficiency rather that raising production volumes, which would need more labour input. The unemployment rate will continue falling, mostly due to emigration, but in 2016 also due to a bit more vigorous job creation.

Inflation to remain very moderate

Inflation has been very low this year, as in the euro area, and we expect even stronger downward pressure on food prices in the autumn due to an increased supply of product deliveries from European countries hit by the Russian embargo. As a result, we forecast average consumer price inflation to be just 0.8% this year and 2.5% in 2015-2016. A gradually weakening euro exchange rate will exert upward pressure on imported products in the coming years – e.g., it will largely outweigh an expected gradual fall in global oil prices. At the beginning of next year, the liberalisation of the electricity market for households will result in a tariff hike, yielding about a 0.6 percentage point rise in annual inflation.

Credit-less recovery very likely to drag on

The credit-less recovery continues. Deleveraging will carry on in the coming years, with both private and public debt ratios falling. New loans to residents in the first half of this year were about one-third smaller than a year ago, owing to feeble credit demand and cautious banks. From a macro perspective more lending is welcome to support investments, but given the current uncertainty and negative effects of the geopolitical turmoil on companies' financial situations, it is unlikely that new lending will become more active in the short term. Small current account deficits will be financed by EU fund inflows and foreign direct investments (FDI). FDI inflows disappointed in the first half of 2014, though, and are expected to be smaller in the coming years than the last 10- year average (as a percent of GDP).

Labour tax burden set to continue easing

Slower economic growth also means slowing tax revenues. We forecast somewhat larger general government budget deficits in the coming years, but they will not pose a threat to fiscal sustainability. We expect the labour tax burden to continue easing, yet it can very well be manifested as a rise in tax allowances rather than a fall in the personal income tax rate, as currently set in law. Given the parliamentary elections in October and the EU presidency in the first half of 2015, we do not expect any major reform breakthrough or significant changes in tax policy this year or next. Discussion on how to raise tax revenues will still be in place, and combating the grey economy seems the most convenient approach. Larger tax shifts involving residential real estate are unlikely. Hence, Latvia is set to remain a country with a relatively small tax revenue share in GDP (implying also a quite small welfare state).

Lithuania: A chilly drizzle, not yet a storm

In the first half of 2014, the economy expanded in line with our expectations, by 3.2%, in annual terms. The second half of this year and 2015, however, are shaping up to be less favourable – economic dynamics are going to reverberate around the Russian-Ukrainian crisis. Although current sanctions will probably have only a limited effect on the economy, a further escalation of geopolitical tension is not unlikely, and fears can hurt confidence and investments.

Key economic indicators, 2013-2016 [1/]

	2013	2014f		2015f		2016f
Real GDP growth, %	3,3	3,0	(3.3)	3,5	(4.0)	3,8
Consumer price growth, %	1,0	0,2	(0.8)	2,0	(2.5)	3,0
Unemployment rate, % [2/]	11,8	10,9	(10.4)	9,7	(9.4)	8,5
Real net monthly wage growth, %	3,8	4,7	(4.5)	3,5	(3.5)	4,1
Current account balance, % of GDP	1,5	-1,8	(-1.8)	-2,0	(-3.0)	-2,4
General government budget balance, % of GDP [3/]	-2,2	-2,1	(-2.1)	-1,2	(-1.1)	-0,5

1/ April 2014 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

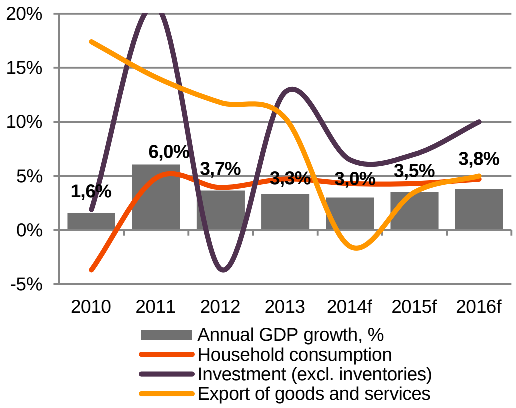
Growth, as expected, remained stable but will be dragged down by geopolitical factors

As expected, in the first half of this year growth was driven by domestic demand, whereas exports contracted. Both household consumption and investments surprised on the upside. Annual retail trade growth accelerated from 5.0% in the first quarter to 6.0% in the second quarter of this year. This was faster than last year's 4.4% growth. The improving situation in the labour market, feeble inflation, and accelerating growth of the loan portfolio will support household consumption, but further acceleration of growth is unlikely. We expect annual growth of household consumption to remain close to 4.5% during the forecast.

Both household consumption and investments surprised on the upside

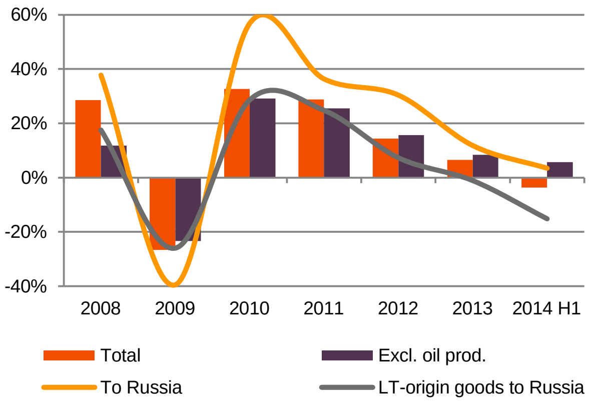
In the first quarter, gross fixed capital formation increased by 12.1% compared with the same period last year and probably remained buoyant in the second quarter. All three sectors – households, government, and, especially, business – increased their investments. Investments in fixed tangible assets in the first quarter rose by 23.4% annually – the fastest pace in three years. They are likely to grow somewhat slower due to worsening business confidence, although a new wave of EU structural funds, as well as improving credit conditions, will support growth. There is a clear turnaround in bank lending this year – in June, the stock of loans to nonfinancial corporations was 5.4% larger than a year ago, whereas it was still contracting throughout most of 2013. Household investments in real estate are already cooling down – the number of transactions in Vilnius in the second quarter increased by only 5.9% annually after a whopping 53% growth in the first quarter.

Annual real GDP growth



Source: Statistics Lithuania

Exports of goods, annual growth (nominal)



Source: Statistics Lithuania

Exports will shrink this year but will recover somewhat in 2015 and 2016

Already at the beginning of this year we expected a worsening foreign trade balance due to a general weakness in some key export markets and the likelihood of Russian sanctions against some producers. However, we did not anticipate a broad embargo of food products imposed on the whole EU and most other Western countries. This means that not only will exports to Russia be smaller than we expected (although during the first half of this year their value was 3.4% larger than a year ago), but the competition in other markets will also be more intense, since more unsold food products will be competing for buyers.

Exposure to Russia: theoretically – quite big, practically – limited

Lithuanian exporters' exposure to Russia is relative large – in 2013, exports of now-embargoed goods amounted to more than EUR 900 million, or 2.6% of GDP. However, most of these goods are not produced or grown in Lithuania, but are re-exported from other countries; thus the direct impact on the Lithuanian economy is quite small. Furthermore, it does not mean that none of these goods will be re-exported – a big fraction of fruits and vegetables are imported from third countries (not affected by the Russian sanctions) via the port of Rotterdam. Finally, Lithuanian producers and farmers, whose theoretical direct exposure amounts to about EUR 220 million, or 0.6% of GDP, may find ways to sell their goods in Russia via other CIS countries. This year's export numbers will be negatively affected not just by the trade bans to Russia, but also by the declining exports of refined oil products produced by the Lithuanian oil refinery that is still facing serious competitiveness problems. The record grain harvest that is expected this year will contribute positively to higher export growth at the end of the year, but mostly next year. We forecast that the value of exports will shrink by 1.5% this year, before recovering somewhat next year; however, the return to a more healthy growth rate of 5.0% is expected only in 2016.

A pleasant side effect of Russian embargo – cheaper food

A consumer-friendly side effect of the Russian embargo will be lower-than-expected inflation. We have cut this year's forecast to 0.2%, mainly due to cheaper food products, up to 22% lower natural gas prices for Lithuanian consumers as of July 1, and somewhat lower than previously expected growth of labour costs. This will still be felt in 2015; thus, we have cut next year's inflation forecast by 0.5 percentage points to 2.0%. The euro introduction will create some additional inflation in accommodation, catering, and leisure services, and the weakening euro will push up the prices of imported goods; otherwise, there will be few sources of inflation. In 2016, we expect inflation to accelerate to 3.0%, mainly due to more rapidly increasing labour costs, but also due to more expensive food products.

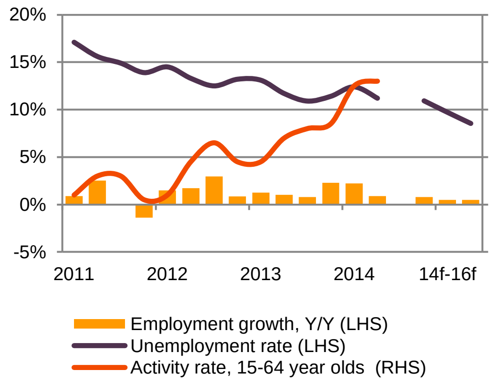
Employment will peak in 2016; unemployment will drop due to shrinking labour force

Some jobs will be lost due to the sanctions and a slightly smaller number of jobs will be created due to larger uncertainties and risks associated with geopolitical developments. Thus, we have increased our unemployment forecast for 2014 and 2015 to 10.9% and 9.7%, respectively. However, the losses will be small and employment will still increase by 0.8% this year and by 0.5% in both 2015 and 2016. In 2016, employment will peak at 1.315 million and unemployment will drop to 8.5%. The main reason behind the dropping unemployment rate will not be growing employment, but rather an unpleasant demographic factor – the shrinking working-age population and labour force.

Many factors behind real net wage growth

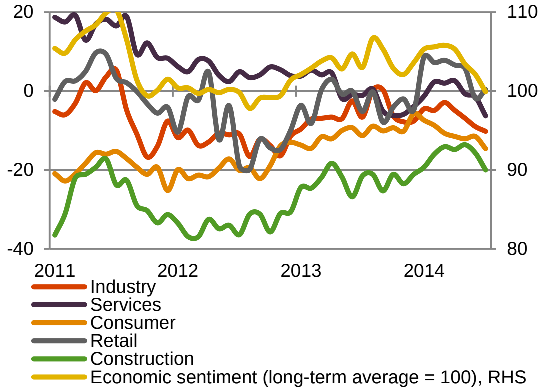
In general, households are well positioned to drive overall economic growth. Although consumer confidence has been declining throughout this year (probably mainly due to the Russian-Ukrainian crisis), loan stock to households has been growing at an accelerating pace – annual growth in May and June reached 1.2%, the fastest in the post-crisis period. Increasing employment and an ever-more-visible lack of skilled labour will be accompanied by a more rapid wage growth. Although we have adjusted our forecast of nominal wage growth downwards, to 4.5% and 5.5% this year and the next, respectively, real net wage growth will be faster due to lower inflation and a higher non-taxable income threshold, which we forecast to increase by about 10% in both years - 2015 and 2016. Nominal wage growth in 2016 will accelerate to 7.0%, not least because of the rising minimum monthly wage. We forecast that, at the beginning of 2015, the minimum monthly wage will be increased to EUR 300 (currently EUR 289.6) and will most probably reach EUR 350 by the end of 2016. Parliamentary elections will take place in the autumn of 2016.

Lithuania: Labour market



Source: Statistics Lithuania

Lithuania: Consumer confidence (SA)



Source: DG ECFIN

Public finances are stable, as long as global storms stay beyond horizon

During the first seven months of this year, national budget revenues increased by 4.2% compared with the same period a year ago and were 1.2% above the plan. Despite this we forecast that budget deficit as a share of GDP will be somewhat larger than expected by Ministry of Finance. However, the sustainability of public finances is not at risk – this also seems to be the consensus in financial markets, as long-term government bond yields (Eurostat benchmarks) dropped to 2.9% in July, the lowest on record. Part of this drop in borrowing costs is, of course, due to Lithuania's upcoming accession to EMU. However, growing budget revenues and curtailed expenditures (but not the expectations of, and promises to, increase expenditures) indicate that the sustainability of public finances is not at risk – at least as long as global geopolitical and economic storms stay beyond the horizon.

Statistical Appendix

ESTONIA: Key economic indicators, 2013-2016 [1/]

	2013	2014f		2015f		2016f
Real GDP growth, %	0,8	0,8	(1,8)	2,3	(3,0)	3,0
Household consumption	4,2	3,5	(3,9)	3,5	(3,6)	3,8
Government consumption	1,3	1,2	(1,4)	1,2	(1,4)	1,4
Gross fixed capital formation	1,1	0,0	(2,0)	4,0	(5,0)	5,5
Exports of goods and services	1,8	1,0	(2,0)	2,5	(5,0)	4,0
Imports of goods and services	2,6	2,0	(3,0)	3,7	(6,0)	5,3
Consumer price growth, %	2,8	0,3	(1,3)	2,5	(2,5)	2,7
Unemployment rate, % [2/]	8,6	7,7	(8,4)	7,6	(7,9)	7,2
Real gross monthly wage growth, %	4,9	5,9	(4,9)	3,4	(3,5)	3,5
Nominal GDP, billion euro	18,4	19,1	(19,3)	20,2	(20,6)	21,5
Exports of goods and services (nominal), % growth	2,8	1,8	(2,9)	3,6	(6,7)	5,5
Imports of goods and services (nominal), % growth	2,2	1,7	(3,2)	4,7	(7,5)	6,8
Balance of goods and services, % of GDP	2,0	1,8	(1,8)	1,7	(1,4)	1,5
Current account balance, % of GDP	-1,0	-1,3	-(1,4)	-1,7	-(2,0)	-2,0
Current and capital account balance, % of GDP	1,7	1,6	(1,4)	1,3	(1,0)	1,2
FDI inflow, % of GDP	3,9	2,1	(2,1)	2,5	(2,4)	2,3
Gross external debt, % of GDP	87,4	85,5	(84,9)	82,5	(81,5)	79,6
General government budget balance, % of GDP [3/]	-0,2	-0,5	-(0,4)	-0,4	-(0,3)	-0,2
General government debt, % of GDP	10,0	10,0	(10,0)	9,8	(10,0)	9,5

1/ April 2014 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Estonia, Bank of Estonia and Swedbank.

LATVIA: Key economic indicators, 2013-2016 [1/]

	2013	2014f		2015f		2016f
Real GDP growth, %	4,1	2,5	(3,0)	2,6	(3,5)	3,5
Household consumption	5,4	3,7	(4,4)	3,3	(3,7)	4,0
Government consumption	3,6	1,0	(1,0)	1,6	(0,6)	0,8
Gross fixed capital formation	-4,3	2,0	(2,0)	2,0	(5,0)	7,0
Exports of goods and services	1,0	0,5	(1,5)	3,0	(5,5)	4,5
Imports of goods and services	-1,7	2,3	(3,0)	3,3	(5,3)	5,7
Consumer price growth, %	0,0	0,8	(1,5)	2,5	(3,2)	2,5
Unemployment rate, % [2/]	11,9	10,7	(10,7)	9,9	(9,6)	8,8
Real net monthly wage growth, %	5,7	7,4	(4,7)	2,9	(2,7)	3,9
Nominal GDP, billion euro	23,3	24,3	(24,7)	25,7	(26,5)	27,5
Exports of goods and services (nominal), % growth	2,3	1,0	(2,9)	5,4	(8,8)	7,1
Imports of goods and services (nominal), % growth	-0,3	2,7	(4,2)	5,7	(8,5)	8,3
Balance of goods and services, % of GDP	-1,9	-2,8	(-2,5)	-2,9	(-2,4)	-3,6
Current account balance, % of GDP	-0,8	-2,0	(-1,7)	-2,2	(-1,7)	-2,9
Current and capital account balance, % of GDP	1,6	0,6	(0,9)	0,9	(1,3)	-1,8
FDI inflow, % of GDP	2,6	1,6	(2,4)	2,3	(3,4)	2,9
Gross external debt, % of GDP	130,5	130,3	(128,2)	124,6	(120,2)	119,8
General government budget balance, % of GDP [3/]	-0,9	-1,3	(-1,2)	-1,5	(-1,1)	-0,8
General government debt, % of GDP	38,1	39,1	(39,4)	34,3	(33,5)	33,7

[1/] April 2014 forecast in parenthesis.
[2/] According to Labour force survey.
[3/] According to Maastricht criterion.

Sources: CSBL and Swedbank.

LITHUANIA: Key economic indicators, 2013-2016 [1/]

	2013	2014f		2015f		2016f
Real GDP growth, %	3,3	3,0	(3.3)	3,5	(4.0)	3,8
Household consumption	4,7	4,3	(4.3)	4,3	(4.5)	4,7
Government consumption	1,9	2,0	(2.0)	2,5	(2.5)	2,7
Gross fixed capital formation	12,8	6,5	(7.0)	7,0	(9.0)	10,0
Exports of goods and services	10,3	-1,5	(3.0)	3,5	(6.0)	5,0
Imports of goods and services	10,3	1,6	(6.0)	5,2	(7.8)	7,1
Consumer price growth, %	1,0	0,2	(0.8)	2,0	(2.5)	3,0
Unemployment rate, % [2/]	11,8	10,9	(10.4)	9,7	(9.4)	8,5
Real net monthly wage growth, %	3,8	4,7	(4.5)	3,5	(3.5)	4,1
Nominal GDP, billion euro	34,6	35,7	(36.3)	37,6	(38.7)	40,0
Exports of goods and services (nominal), % growth	8,8	-4,0	(2.5)	4,5	(7.0)	8,0
Imports of goods and services (nominal), % growth	8,7	0,0	(5.5)	5,5	(8.5)	9,0
Balance of goods and services, % of GDP	1,1	-2,3	(-1.4)	-3,1	(-2.6)	-3,9
Current account balance, % of GDP	1,5	-1,8	(-1.8)	-2,0	(-3.0)	-2,4
Current and capital account balance, % of GDP	3,7	0,5	(0.5)	0,3	(-0.7)	-0,1
FDI inflow, % of GDP	1,2	2,5	(2.5)	3,0	(3.5)	4,0
Gross external debt, % of GDP	67,1	67,1	(66.0)	65,3	(63.4)	62,6
General government budget balance, % of GDP [3/]	-2,2	-2,1	(-2.1)	-1,2	(-1.1)	-0,5
General government debt, % of GDP	39,4	42,7	(42.5)	42,5	(41.0)	37,5

1/ April 2014 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

Sources: Statistics Lithuania, Bank of Lithuania and Swedbank.

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