Swedbank Economic Outlook

Update – November 2015

Better-safe-than-sorry central banks leave markets in a state of uncertainty

- **Accommodative monetary policy to pre-empt risks**
- **Emerging market economies are the weak link**
- **Sweden and Norway on the extremes; the Baltics pursue the middle road**

The global recovery to regain speed after loss of momentum
Growth performance in developed economies has disappointed in the early autumn, but monetary policy authorities have responded by turning softer to support economic activity. In early December, the ECB is likely to take a more expansive policy, while the Federal Reserve (the Fed) will most likely hike the policy rate for the first time since 2006. With a growing divergence among the main central banks, market volatility is likely to increase. We have revised down global growth forecasts a tad and believe risks to the outlook are still tilted to the negative side. Strong household demand in the US and Germany could raise overall demand more than expected, while the Chinese economic outlook is still uncertain.

The true state of emerging markets is the key source of uncertainty
Concerns about a sharp slowdown of Chinese growth have been a strong preoccupation of market participants and policymakers alike across the world. Market volatility rose early in the autumn, and fear led to a softer stance from both the Fed and ECB. Although Chinese action and reassurances have restored confidence to some degree, vulnerability across emerging markets is widespread. We do not expect this to be resolved in the short term.

Extremes of Sweden and Norway; the Baltics pursue the middle road
Sweden and Norway are facing extreme pressures, but of a varying sort. The Swedish central bank is set to expand monetary policy even further by increasing the asset purchase programme by SEK 65 billion during the first half of 2016. At the same time, the unprecedented inflow of refugees will boost growth by at least an estimated ½-¾ percentage points in both 2016 and 2017, giving annual growth rates in excess of 3% three years in a row; while the monetary policy stance would be suitable for a deep economic crisis. The explanation is the Riksbank's focus on inflation and implicitly using the exchange rate as the primary tool. The cost is growing imbalances and risk taking.

In Norway, unemployment is increasing fast, and household demand is slowing. The main weakness is still concentrated in oil-related manufacturing, which is contracting at a rate of 5%, and the decline is set to continue. Moreover, there are signs that the slowdown is spreading to the rest of the economy. Fortunately, there is room for an expansionary fiscal stance despite lower oil prices. Nonetheless, we expect more rate cuts from Norges Bank, and that the main policy rate will reach zero next year. We see potential for many years of very low interest rates in Norway, and we believe that the rate difference between Norway and its trading partners is too narrow and will fall.

Exports to Russia will continue to contract at least in the short term, but the Baltics have firmly withstood the Russian economic recession and have successfully diversified their exports. Expected improvement of foreign demand in 2016-2017 will give more opportunities for export. This will also have a positive impact on business sector investments. In addition, the Baltics will gradually start using more EU funds, which will also boost investments. Wage growth remains relatively strong and will support robust growth of private consumption, but at the same time keeps outpacing productivity growth thus hindering price competitiveness. Compared to the EU average, public finances remain strong.

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The global economy: The known unknowns

Concerns about the true state of the Chinese business cycle are spooking policymakers around the world and leaving markets confused. This has triggered a bout of dovish moves from central banks, but some are backtracking already. The Fed has clearly hinted of a December hike, while we expect the ECB, Riksbank, and Norges Bank to go softer. With the Peoples' Bank of China also expected to ease, monetary policy action will become unsynchronised. At the same time, the global economy is chugging along, supported not least by growing purchasing power in developed economies and by the expansionary monetary policy. The unwinding of imbalances in emerging markets will, however, act as a drag on global growth. In this global ocean of floating mines, we expect US interest rates to lead the way, pulling up the US dollar, but at any time something could go awry, again plunging the global economy into distress.

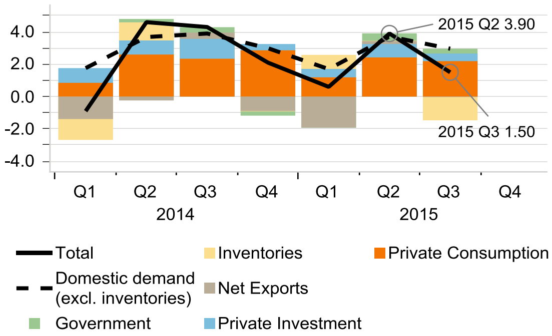
Developed economies fail to take off, but hope springs eternal

Mixed US data …

We had high expectations that the US would lead the developed economies to deliver a continued substantial contribution to global growth this year into next, but developments so far are mildly disappointing. US data are mixed. On the one side, job creation and wage developments weakened in August and September after rebounding sharply in the second quarter. The manufacturing sector is struggling as a consequence of the stronger dollar, with slower production growth, weaker order inflows, and mounting inventory ratios. However, on the other side, domestic demand remains strong, with household spending keeping up. In the third quarter, overall GDP growth is estimated at 1.5%, but 1.4 percentage points were shaved off by a drawdown of inventories. The most recent labour statistic reported a sharp increase in job creation and also in wages. Thus, underlying growth remains healthy. In addition, residential investments are boosted by a recovering housing market, which is making up for sluggish business investments, not least in energy-related sectors.

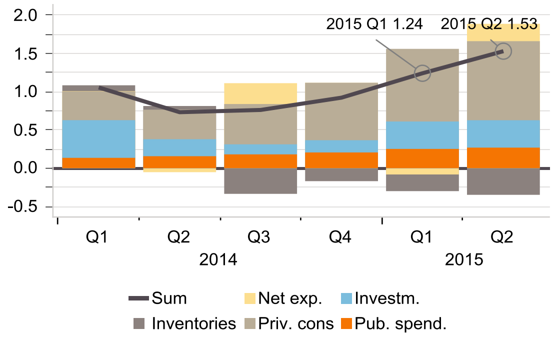
Looking forward, we are revising down our US growth forecast marginally next year, to 3.0%, a level still clearly above potential growth; it will then slow to 2.8% in 2017. We expect activity to continue to be driven by domestic demand on the back of a recovering labour market, a pickup in wages, and lower energy prices. Moreover, the threat of another shutdown of the federal government in late 2015 was averted with the suspension of the debt ceiling until March 2017. The deal also included additional fiscal spending (equivalent to 0.2% of GDP per year). We expect inflation pressures to remain muted (with a still-negative output gap), but the Fed is likely to raise the policy rate at the December meeting. After surprising by not tightening policy at the September meeting, the statement accompanying the most recent meeting (October) was more hawkish. Concerns about external developments were toned down, and the next meeting was explicitly mentioned as a possible liftoff date. In the same statement, however, the Fed downgraded its assessment of the domestic economy, and its communication strategy has become more blurred, mixing data dependency with calendar considerations.

US: Contributions to GDP growth (%points, saar)



Source: Swedbank Research & Macrobond

EMU: Contribution to GDP growth (yoy in %)



Source: Swedbank Research & Macrobond

….and the pressure is on in EMU...

Despite the pressure on Europe and the EMU from the Greek crisis this summer, and from the refugee fallout from the Middle East crisis, the recovery is so far holding up fairly well. Not least in former crisis-struck economies such as Spain--and, to a lesser extent, Italy--activity and sentiments are improving. However, the situation in Greece is still very fragile, and questions of whether the country will be able to stay in the EMU will likely be raised soon, when the Greek government reiterates demands for a nominal debt reduction (which is supported by the IMF but strongly opposed by, among others, Germany). The large migration inflows from Syria will also test political cohesion, both between EU countries and within.

Looking ahead, the EMU economy is expected to be driven by an improving labour market, low energy prices, and a loose monetary policy. The weaker euro has also supported exports, and we expect real growth in the neighbourhood of 2% per annum in the next two years. Not spectacular, but still an improvement over recent years. Nonetheless, the ECB is concerned about inflation and inflation expectations, not least from the supressed price pressure coming from the slowing Chinese economy, and has strongly signalled that more monetary policy action is to be expected. We believe that the ECB will expand the asset purchase programme but not, at this stage, lower policy rates.

….and in Japan

In Japan, growth returned to negative territory in the second quarter after a strong rebound in the first. Recent indicators suggest that the soft patch continued in the third, driven by the slowdown in emerging markets and weak domestic demand. Although the Bank of Japan refrained from any additional monetary policy actions at its most recent meeting, there is a clear possibility that more stimulus is forthcoming. However, the room for manoeuvre is constrained by both an already-extended balanced sheet and a large public debt. Instead, focus needs to be directed to structural reforms aiming to raise labour participation.

Headwinds from our Nordic neighbours

Finnish growth is weak, and the economy is suffering from structural as well as cyclical problems. Its government is under severe pressure to implement reforms – which will not be well received by trade unions or the public. Sanctions against its large trading partner, Russia, are not helping the uncertain outlook for exports, and the industrial output decline has deepened. Growth is expected to return to positive, albeit low, levels in 2015 after three consecutive years of negative growth. In Denmark, low interest rates, falling energy prices, and a weaker exchange rate are pushing up demand, and a pickup in demand from Germany and the UK is supportive. However, there is a risk that the house price bubble in Copenhagen will reappear, and of a general overheating of the economy. The new government has indicated that fiscal policy will be tightened in 2016. We expect growth at around 2% in the next two years--slightly lower than in our August forecast.

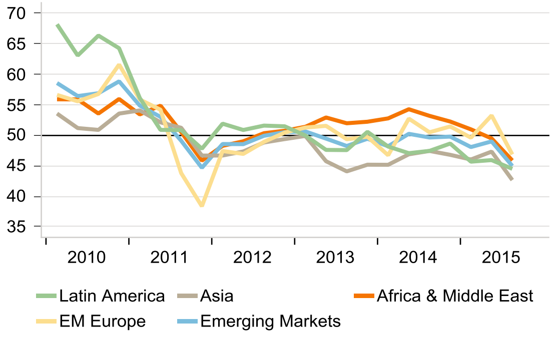
The China syndrome in reverse and other EM woes

A rebalancing felt throughout the world

Instead of a nuclear disaster tunnelling its way to China (if you remember the epic 1970s movie *The China Syndrome*), the predominant concern recently has been that a Chinese economic meltdown would have a disastrous impact on the global economy. However, our view is that the Chinese authorities will be able, through carrots and sticks, to gradually rebalance the growth model. We expect growth to weaken, especially in the old, manufacturing-heavy sector of the economy. Households, on the other hand, are keeping up consumption, and house prices and sales have risen anew, in part bolstered by monetary stimulus. Years of overinvestment have created deflation at the producer level, which continues to exert downward price pressure on manufactured goods around the world. We do not, however, expect any significant further depreciation of the renmimbi; the reason for China's new currency policy is mainly to qualify it for the IMF's currency basket. This would help China internationalise its currency and reduce its dependency on the dollar and on US monetary policy. We expect the renminbi to stabilise in the months ahead and then gradually weaken.

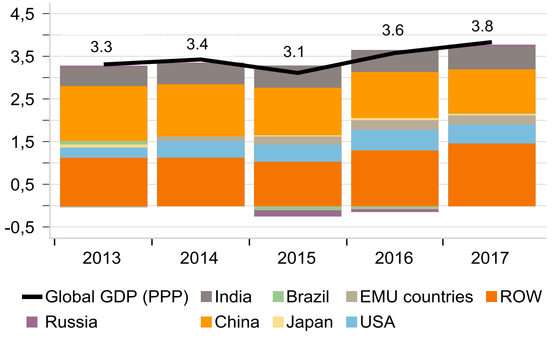
During 2015, overall financial conditions in emerging markets have tightened, with local currency bond yields increasing, equity prices falling, and exchange rates depreciating. In the first quarter, there was a sharp decline in loan demand, and the index reached its lowest level since 2009. Following an improvement in the second quarter, led by Europe, lending conditions again tightened in the third. A worsening is seen across the board, led by lending to real estate and funding conditions in international markets.

Emerging Markets Lending Conditions (Index)



Sources: Institute of International Finance & Swedbank Research

Global: Contribution to growth (p.p.)



Source: Swedbank Research & Macrobond

Emerging-market economies facing several headwinds

Other emerging-market economies are afflicted by large imbalances, declining commodity prices, dependency on Chinese demand, or political turmoil (in some cases, by all). The economic situation in Russia remains a great concern. Economic sanctions are stifling foreign trade, and the weak rouble is keeping inflation high, reducing domestic consumption.

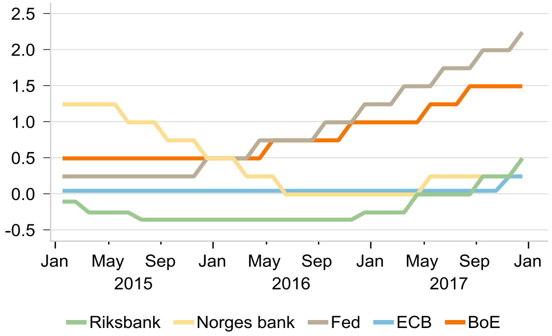
The economy is in need of more rate cuts--not likely with the present weak exchange rate. International reserves have declined, and the situation is even worse than during the financial crisis. Brazil, meanwhile, had its rating cut to junk level by Standard & Poor's in September, and the Brazilian real subsequently fell to a new record low. The central bank has raised its benchmark rate by 225 basis points (bp) to 14.25% in 2015 to combat inflation, and the government is being forced into further savings since the budget deficit is about 10% of GDP. The GDP growth in India of 7% in the second quarter was a disappointment relative to expectations, and, in general, economic activity has been weak in 2015, with exports trending lower. However, falling prices provide some relief, as India is one of the largest commodity importers. We have revised down our oil price forecast for 2016 and 2017 by about 10% to $56 and $63 per barrel, respectively.

Dovish central banks mitigate risks but markets to remain volatile

US yields and currency pull ahead

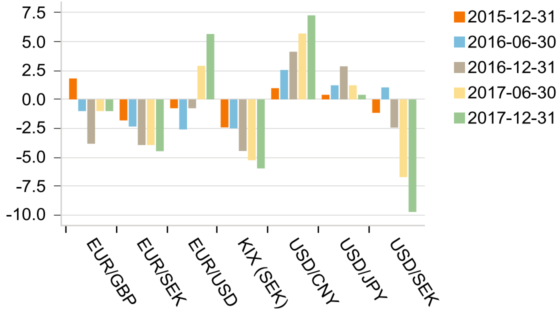
With the recent apparent change in the Fed's stance, divergence among the main central banks is back in focus. We expect the Fed to hike the policy rate in December, based on a fairly upbeat view of the recovery of the US economy, and the market-implied probability of a Fed hike has risen to above 50%. Most economists now predict a hike, regardless of whether they believe it to be the right policy move. US interest rates responded and jumped nearly 15 bp higher. The spread between 10-year US Treasury and Bundesbank rates widened to almost the level back in March 2015. We expect spreads to continue to widen, and the impact to be felt also in the exchange rate markets. The US dollar is set to appreciate against most currencies during 2016, reaching 1.06 by midyear, after which the euro is expected to regain strength.

Centralbank forecasts (in %)



Source: Swedbank Research & Macrobond

Exchange rate movements from Nov 5 (Swedbank forecasts)



Source: Swedbank Research & Macrobond

Lower growth with less negative risk

In August, we raised our global growth forecast but, at the same time, assessed risk on the downside to exceed the positive risks (with a probability of 30 to 10). Now, some of those negative risks have materialised--namely, increased uncertainty about Chinese growth and a not-so-strong US recovery. Subsequently, we have lowered growth forecasts over the next couple of years. At the same time, the Chinese authorities have demonstrated that they are willing to act aggressively to contain the risks of a sharp slowdown, and we thus reduced the risks for the overall global economy. Negative risks still exist, however. The initiation of a Fed tightening cycle, however protracted, could put pressure on emerging markets with large imbalances and that are heavily indebted in foreign currencies. In Europe, risks are predominantly political, stemming from circumstances in Syria, Turkey, and Greece. Developments here will put to the test leading European political leaders' ability to preserve the EU cohesion. There are, however, also positive risks. The financial strength of, in particular, US and German households, on the back of improving labour markets and lower energy prices, could translate into stronger-than-expected domestic demand and, thus, growth. All in all, we consider the risks to be somewhat less negative, with a probability of a negative scenario at 25% and a positive scenario at 15% (and the probability of the main scenario still at 60%).

Sweden: Crisis policy in boom times

The Swedish economy is increasingly characterised by strong growth and a monetary policy suited for a severe economic crisis. The divergence can be explained by a fear of deflation and of an excessively strong Swedish krona that will erode Swedish competitiveness, while the domestic economy is benefiting from robust household finances. This bipolarity will grow in the years ahead as the huge wave of refugees leads to a fiscal stimulus at the same time that monetary policy fuels further government bond buying. We are revising Swedish growth upwards to over 3% for the period 2015-2017. The cost, however, is rising imbalances and growing risks, not least in the housing market. But what cannot continue forever will inevitably come to an end, and we expect the Riksbank to begin tightening earlier than it is itself predicting. The question is whether it will be in time.

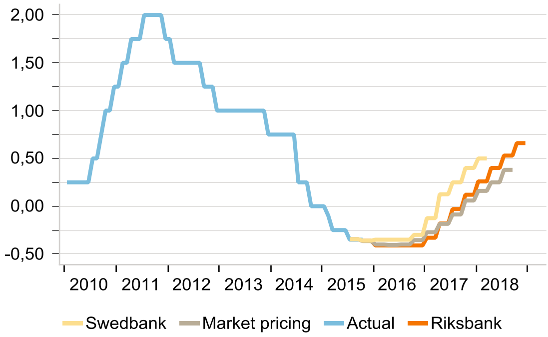
Solid growth in the Swedish economy in 2015

Economic growth in Sweden has slowed somewhat in the early fall after very positive development in the second quarter with a growth rate of just over 4% on an annualised basis. Household consumption was slightly weaker at the end of summer, but it turned higher again in September. Foreign trade in the first nine months generated a surplus and surpassed an admittedly weak 2014. Exports to Germany and the US were especially good, although sales to China increased as well. Moreover, the weaker krona undoubtedly contributed. From a production perspective, manufacturing has been especially positive, not least the intermediate goods industry. The service sector, on the other hand, has slowed slightly, though the purchasing managers' index (PMI) indicates continued expansion. The manufacturing PMI also points to growth. Sentiment in the Swedish economy is strong, especially in manufacturing and construction, while households have become somewhat more cautious. As a whole, we estimate growth for the full-year 2015 at 3.2% after slowing slightly in the second half (3% on a revised annualised basis).

Migration is leading to a significant boost of growth

The big increase in refugees will dominate the Swedish economy and politics for years to come, and in the next two years we expect migration to directly and indirectly raise Swedish economic growth by ½ to ¾ of a percentage point more than it otherwise would have been (see Swedbank Macro Focus: "Wave of Refugees Propels Growth," 10 November 2015). Increased consumption, both private and public, will significantly boost domestic demand, and thus growth. This is expected to be financed mainly through government funding (to some extent by a redistribution of the aid budget and savings), and the rising budget deficit will thereby lead to an increased fiscal stimulus. This means lower unemployment, higher wages, and slightly higher inflation. Monetary policy will get a break (something we previously called for but did not predict in this form), and we expect the Riksbank not to offer any more monetary stimulus during the forecast period. Instead, we expect it to raise the benchmark rate as early as the late fall of 2016, which is earlier than its own repo rate path shows.

Riksbank reporate forecasts (%)



Sources: Swedbank Research & Macrobond

Table 1. Economic impact from refugee inflow

	2016	2017
Household consumption 1/	0.37	0.28
Public consumption 1/	0.42	0.29
Housing investments 1/	0.05	0.02
Public investments 1/	0.03	0.03
Imports 1/	-0.17	-0.13
GDP	0.70	0.49
Employment	35000	50000
Unemployment	-1.1	-0.9
Wages	0.2	0.2
Inflation	0.2	0.2
Budget balance (net lending; % of GDP)	-0.9	-1.5
Reporate (bp)	25	25

1/ Contr. to GDP Sources: SCB and Swedbank

Less contribution to growth from foreign trade

Conditions in the global economy are sluggish from a Swedish perspective, with risks overwhelmingly on the negative side. We have revised our global growth projection slightly downwards but, most important, the growth outlook for key trade partners such as Norway, the EMU, and China is uncertain. While continuing to recover, Swedish exports are expected to grow at a slower rate than we predicted in our August forecast. A lower growth rate in emerging markets and less global trade growth affect Sweden's large-volume markets, not least the Nordics, and we are revising downwards total demand for Swedish exporters. The drop in commodity prices and production cutbacks in global commodity industries are reducing Swedish exports, both directly and indirectly. Less favorable competitive conditions are expected in 2016-2017 through a stronger krona and higher unit labour costs compared with the last two years. As a whole, we expect total exports to rise by 3.9% this year, and then slightly above 4.5% in 2016 and 2017.

Consumption on the rise

Domestic demand is expected to be solid even without the contribution from the large increase in migration. The housing shortage is sparking investment, and investment projections for 2015-2017 have been revised higher compared with August. Business investment excluding housing is being driven by more investment in the services sector, while investment in industry is lower in the wake of a more uncertain global economy and modest export growth. The labour market has been stronger than expected, and major indicators such as job openings and hiring plans, according to the Economic Tendency Indicator and PMI, are positive and point to a solid increase in employment in coming quarters. This strengthens household income growth and, together with the effects of the migration increase, has convinced us to revise significantly higher our projection for consumer spending in 2016-2017, from around 2.5% in the August forecast to over 3% per year. Savings are declining, but only marginally, and remain at high levels. This indicates continued cautiousness among households. The biggest risks are the housing market and declining sentiment due to unforeseen changes in taxes, borrowing conditions, and political stability.

Higher inflation and stronger krona

Better-than-expected growth in the Swedish economy means higher inflation pressure, and that the Swedish krona will appreciate slightly more than we had predicted in August. Stronger domestic demand, revised wage projections, and higher resource utilisation are the underlying factors that are producing slightly higher inflation pressure, and we expect inflation, excluding interest costs, to reach the targeted level in the second half of 2016. The Riksbank would begin normalising monetary policy at that point. After that, we expect a slightly more aggressive rate hike cycle than the Riksbank's own forecast, and a repo-rate of 0.50% by the end of 2017. This means that the Swedish krona will also be slightly stronger than the Riksbank's forecast.

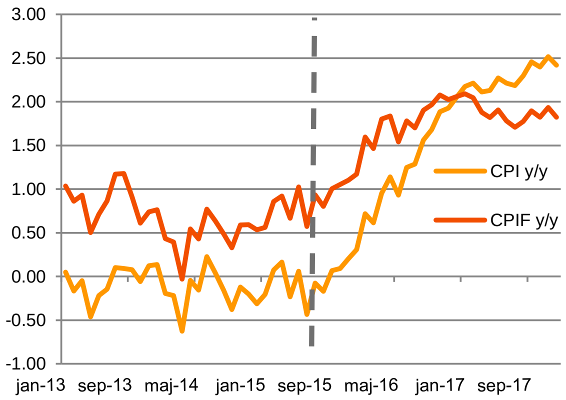
Rising budget deficit and increased political risk in Sweden

Fiscal policy and political conditions will receive greater attention in Sweden in coming years. A more expansionary fiscal policy eases pressure on the Riksbank slightly through the direct effect on domestic demand. The budget deficit is expected to rise significantly in coming years without being a threat to Sweden's public finances. Government debt is still expected to decline as a share of GDP. The refugee situation will, however, put pressure on both the government and the opposition, and a government crisis and new election ca not totally be ruled out. Weak governments have usually led to less fiscal discipline, and political risk in Sweden has increased.

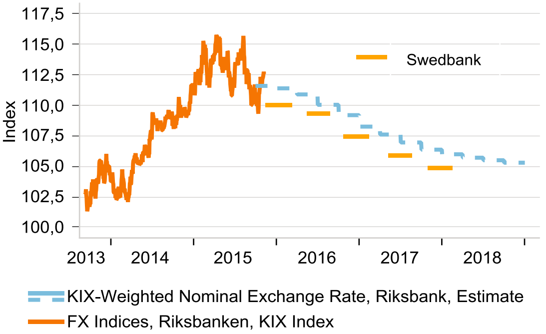
Cross-currents have made it harder to navigate the asset seas

Growing political instability and strong economic stimulus, coupled with uncertain global development, make the market very difficult to predict. The Riksbank has announced additional bond buying for the equivalent of SEK 65 billion, which means that the Riksbank will this summer hold about 35% of the outstanding stock. The purpose is to keep downward pressure on rates in Sweden, but, if liquidity is seen as threatened the willingness of many bondholders to let go of government bonds will decline. This could put additional pressure on yields. The risk for liquidity shortage may be alleviated, however, by the National Debt Office, which will probably have to revise its government borrowing forecast higher and, thus, issuance volumes. This in itself would put upward pressure on long-term yields. We do not expect the Riksbank to do more than it has already announced. Pricing of mortgage bonds and other asset classes may, therefore, have to be revised, with upward pressure on yields here as well. Add to this the uncertainty surrounding international rates, with the US Federal Reserve raising its benchmark rate fairly soon. US yields have already risen and dragged Swedish and European yields with them. In an environment with opposing forces, asset pricing is highly uncertain, but our basic assumption is that rates will increase between nearly 100 to 150 bp in the next two years. This will put pressure on both the equity and the housing market.

Inflation - Swedbank forecast



KIX - Trade weighted index and Riksbank forecast



Source: Swedbank Research & Macrobond

Norway: Slowdown continues

Growth in the Norwegian mainland economy continues to slow, in line with our expectations. According to Norges Bank's regional network, growth has declined to a rate of only 0.2%, as confirmed by actual growth in the second quarter, and is expected to be close to zero in the coming months. The main weakness is still concentrated in oil-related manufacturing, which is contracting at a rate of 5%, and the decline is set to continue. However, there are signs that the slowdown is spreading to the rest of the economy, and we expect to see more of it over the coming year.

Unemployment is increasing faster, and household demand is slowing down

The labor market has been deteriorating for some time. Unemployment keeps climbing rapidly, according to AKU (the Labour Force Survey), and the rate has already passed Norges Bank's projected peak of 4.5% for 2016. Registered unemployment has risen by less overall, but markedly faster over the past two months. Thus far, the increase remains concentrated in oil-related regions and professions. In other parts of the country, the unemployment rate remains flat. However, all indicators point to weak labour demand, including few vacancies, weak employment survey results, and slow wage growth.

More signs of a slowdown in household demand are appearing. Retail sales have fallen for two consecutive months, and house price growth is slowing. Even though monthly data are too volatile to draw a firm conclusion, we believe household demand is on a weaker trend. The outlook remains poor, as consumer confidence has fallen sharply to low levels and real wage growth has stopped, indicating that consumption growth could slow significantly. The major macro risk is now a slowdown in household demand, which is the main driver of domestic demand.

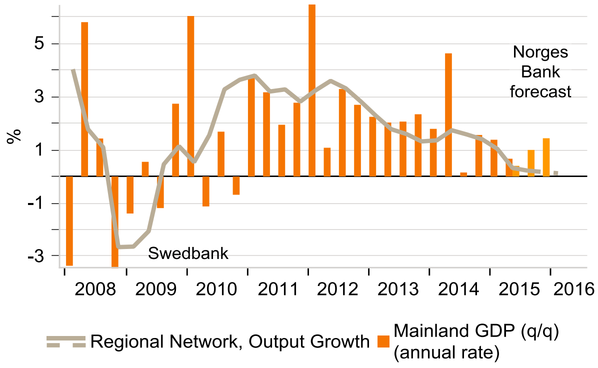
Expansionary fiscal stance, and increasing monetary stimulus

Fortunately, the government can afford an expansionary fiscal stance despite lower oil prices, thanks to a plentiful petroleum fund. The fiscal impulse (increase in the non-oil deficit) of 0.7% of Mainland GDP in 2016 is considerable and appropriate given the state of the economy, but it will not be enough to prevent a recession if households decide to tighten their belts.

In response to the economic slowdown, Norges Bank has lowered the main policy rate from 1.5% last autumn to 0.75% now. The bank's projections indicate that a further rate cut to 0.5% in 2016 is likely, and this has been priced in financial markets. Relative to these projections, we believe most risks are on the downside, not only due to a slowdown in household demand but also because it may take longer than previously assumed for businesses to respond to the weaker krone. We therefore expect more rate cuts from Norges Bank, and we expect to see the main policy rate at zero next year. We see potential for many years of very low interest rates in Norway, and we believe that the rate difference between Norway and its trading partners is too high and will fall.

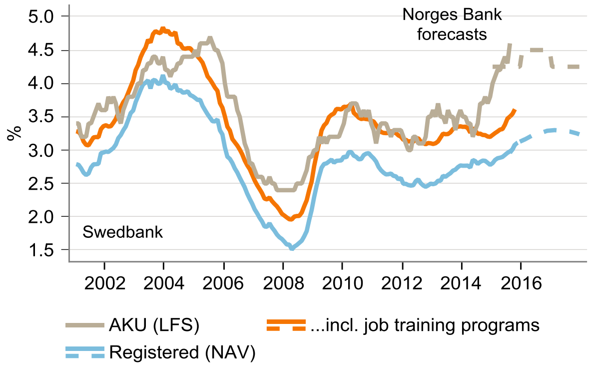
Even though Norges Bank has cut interest rates several times, it remains concerned about financial imbalances in the household sector and, increasingly, in commercial real estate. If the financial stability concerns were not present, the key policy rate would most likely be at zero already, according to the bank's own calculations. Growth in house prices is about to decline, but household credit growth has been maintained. Banks recently reported that, this summer, they tightened credit conditions for households, partly as a result of the government's new mortgage regulations. However, it may take some time before we see the full effects of the tightening on household borrowing. Banks now plan to tighten credit standards for firms as well, due to the weaker outlook and the higher capital requirements.

Norway: Norges Bank's network vs. GDP



Sources: Swedbank Research & Macrobond

Norway: Unemployment



Sources: Swedbank Research & Macrobond

Estonia: Better-balanced economy ahead

We have revised Estonian GDP growth downwards to 1.6% for this year, primarily due to the more-than-expected decrease in exports and investments in 2015. Private consumption continues to contribute the most to the growth. Stimulated by the expected improvement of foreign demand, GDP growth will accelerate to 2.6% in 2016 and to 2.8% in 2017.

Recovery of export growth remains modest

Export growth, which started to slow already in the beginning of the year, contracted further in the third quarter. The decrease in the exports of, in addition to electronic products, electricity, refined shale oil products, and ferrous metals has had the largest negative impact. The decline of exports to Russia appears to have bottomed out. Whereas the Russian market contributed the most to the decline in the first half of this year, exports of goods to the Latvian and the US markets have recently worsened even more. At the same time, exports to several European markets, especially to Norway, the UK, the Netherlands, and Germany, have either increased or sustained their moderate growth. Despite the expected easing of the recession in Russia next year, the rouble is expected to depreciate, and sanctions will remain in force. This is expected to continue squeezing import demand on this market next year. Meanwhile, the higher base level effect of electronics from the second half of 2014 will fade in the beginning of next year, creating a positive effect on total exports. Although the expected improvement of economic conditions for Estonia's main export partners in 2016 should increase foreign demand, the recovery of export growth is expected to remain relatively modest.

The expected improvement of foreign demand will increase the need for more investments

Due to the worsened situation in exports, the contraction of production volume and turnover of the Estonian industrial sector have deepened. In addition, business sector investments have decreased already four quarters in a row and their share in GDP has dropped to the lowest level of the last 20 years (excluding 2009-2010). At the same time, it's a positive that the shares of machinery and equipment and R&D have increased. Still, this has not yet contributed to productivity growth. The increase in imported capital goods in the first half of this year refers—with a delay time--to the improvement of capital investments. The expected improvement of foreign demand in 2016 will increase the need for more investments in the business sector (its credit portfolio is growing).

Labour market might loosen up a bit

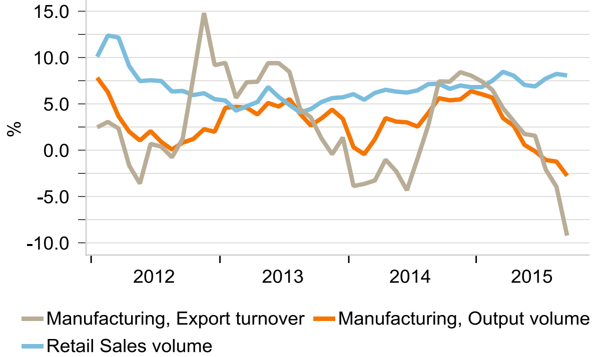
In 2016-2017, employment is expected to fall because of a lower supply and demand of labour. Employment is expected to decline in a few export-related sectors, which have been struggling with low demand. A state reform will reduce labour in the public sector. A reduction in the number of public workers and the reorganisation of the social benefits system of the disabled (forcing them to find jobs) will lift the number of the unemployed, at least temporarily. Registered unemployment figures started to increase in the third quarter of this year.

Wage growth will remain fast as the lack of suitable labour remains a concern. An agreed 10% increase in the minimum wage in 2016 and again in 2017 will also have an impact. The growth of wages in real terms will slow in 2016 compared with 2015 as prices will start growing and labour taxes will be lowered less than this year. A rise in pensions, children's allowances, and other social benefits will further support private consumption.

Prices will increase again in 2016

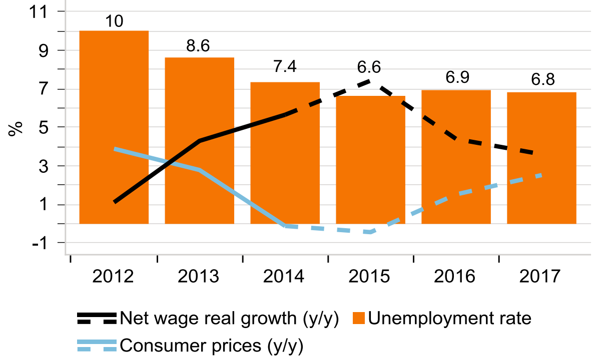
Consumer price growth is expected to accelerate in 2016 and 2017. Inflation will be pushed higher by a modest increase in commodity prices globally, which will lift motor fuels and heating prices in Estonia. A cheaper euro against the US dollar will gradually raise import prices next year. An increase in excise taxes in 2016-2017 and a higher value-added tax for hotels in 2017 will also have a positive effect on prices. Strong wage growth will lift the prices of services.

Estonia: Manufacturing and Retail Sales Growth



Source: Swedbank Research & Macrobond

Estonia: Labour market indicators & inflation



Sources: Swedbank Research & Macrobond

Latvia: Exporters need to gear up

GDP growth will be mostly consumption driven this year, owing to continued wage growth and weak inflation. Export growth has slowed due to fragile external demand, while investment growth seems to be starting to pick up despite geopolitical uncertainty and still-delayed EU funds inflows. In 2016-2017, a swifter investment and export growth is expected, as external demand gradually speeds up.

There have been quite a few revisions in historical GDP data series, some of which have also changed the base effects for this year. Although the story for 2014 and the first half of 2015 remains the same (2.4% and 2.3% growth, respectively), there have been some twists here and there. Annual GDP growth accelerated in the second quarter of 2015 to 2.7% from 1.8% in the first one, owing to robust consumption and a pickup in investments. The flash estimate suggests that growth again slowed to 2.5% in the third quarter. We forecast 2.4% growth this year, picking up to 3.3% in 2016 and 3% in 2017.

Exports continue to grow…

Data revisions suggest that export volume growth did slow in the second quarter to 0.8% in annual terms after a very strong beginning of the year. The third quarter might have been even weaker; however, overall export performance is holding up relatively well. Exports to Russia continue to fall big time, but risks of reducing the freight transit through Latvian railway and ports have diminished. The fall in Russian exports is compensated for by exports to the EU, China, the US, and some African and CIS countries. We expect a somewhat weaker second half of the year for exports than the first one, but still growth. In the autumn growth will be supported by exceptional grain crops. With the global outlook improving, a more swift export growth is forecast for 2016-2017.

… but competitiveness risks rise, and exporters need to change gears

One of the worries, though, is that the Latvian export market shares that had been rising rapidly in Europe during 2010-2012 were flat for the last couple of years and have even started inching down this year. This hints that competitiveness problems – about which we have repeatedly warned – might start building up again.[1] Unit labour costs are rising, since wage growth keeps outpacing productivity. In order to boost exports and market shares, exporters need to change gears, i.e., develop new products with higher value added. Meanwhile, strong wage growth and no inflation (due to cheaper commodities) are supporting robust household consumption growth, which nevertheless remains rather cautious, i.e., somewhat slower than income growth.

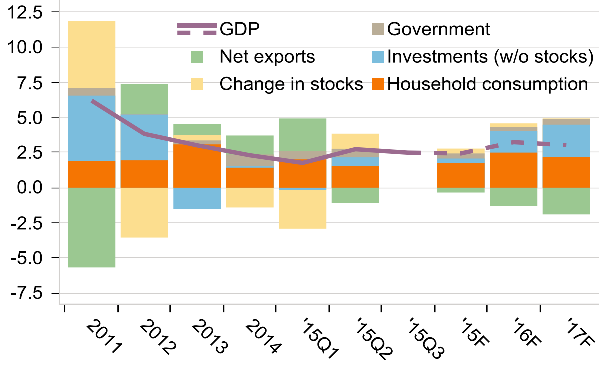
Will the recent pickup in investment activity be long-lasting?

The slow productivity growth calls for more investment. It seems that investment activity has started to recover; credit demand and new lending have also been growing this year. Yet, it might well be a temporary hike. Businesses are still cautious and would like to see more stable demand growth before investing in capacity expansion. So far, they are mostly focussing on increasing effectiveness, investing mostly in new machinery and equipment, which is also seen in the import figures. Many businesses are looking forward to the EU funds from the current planning period. However, even though nearly two years have passed since the beginning of the period, none of the programs for entrepreneurs have been announced so far (with the exception of agriculture and road maintenance) – the administrative framework is still being developed by the authorities.

As the current plan stands, budget deficit in 2016 is set to be higher than planned

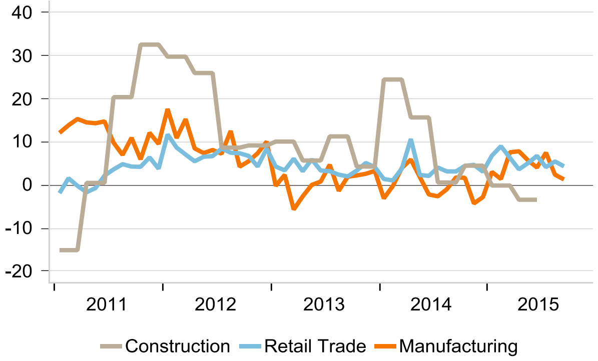
The 2016 government budget should be passed in parliament by the end of November. While its macro assumptions are largely realistic, the announced tax revenue-boosting measures are, unfortunately, patchy and insufficient to sustainably keep raising the share of tax revenues in GDP to be able to increase spending on such priorities as defence, healthcare and education. Hence, without further adjustments, the budget deficit next year is likely to be higher than the planned 1% of GDP.

Contribution to GDP growth, pp



Source: Swedbank Research & Macrobond

Annual growth in selected industries (%)



Source: Swedbank Research & Macrobond

[1] See our recent newsletter here for more details.

Lithuania: Widening trade and current account deficits

As expected, economic growth strengthened in the third quarter on the back of strong household consumption growth. Despite weak exports, the labour market remained almost unscathed, and accelerating wage growth should support further domestic demand growth. However, the foreign trade deficit next year and in 2017 will farther widen despite recovering export growth. Wage growth will continue outpacing productivity growth, and competitiveness challenges will have to be addressed.

Economic growth dragged down by weak exports, but domestic demand remained strong

As expected, economic growth bottomed out in the first half of this year and accelerated in the third quarter – annual GDP growth increased to 1.8%. Exports were still dragging the economy down due to rapidly shrinking exports to Russia and falling exports of refined petroleum products. Exports of Lithuanian-origin goods, except for exports to Russia and exports of refined petroleum products, were higher by 9.3% in the third quarter than a year ago. However, domestic demand, especially household consumption, remained strong due to the rapidly rising real wage bill. Annual retail trade growth accelerated to 6.0% in the third quarter. Investment growth probably weakened in the third quarter, but it increased rapidly in the first half of this year. Therefore, we keep our GDP forecast unchanged – the economy will expand by 1.8% this year before accelerating to 3.3% in 2016 and coming back to its potential growth of around 3% in 2017.

Negative impact from Russia will fade away and domestic demand should remain strong

We expect economic growth to continue strengthening, due to recovering export growth, as the negative impact from Russia will fade away; also, many companies have diversified towards more stable markets in the EU. Higher absorption of EU structural support should contribute to investment growth, as companies have both sufficient reason and means for higher investments. Household consumption should remain strong as problems in the Eastern export markets did not reverse the positive development in the labour market.

Labour market remains resilient, structural unemployment will drive wage growth

Employment growth remained rapid in the first half of this year, and job vacancies continued increasing in the third quarter as well. However, due to the high skills mismatch in the labour market, the fall in unemployment rate will slow. In October, registered unemployment increased in a month by 0.2 percentage points to 8.3% and was at the same level as a year ago. Nevertheless, wage pressures most likely will continue building up due to high structural unemployment. Consumption will be supported by the government's plans to further increase the minimum wage and nontaxable income threshold.

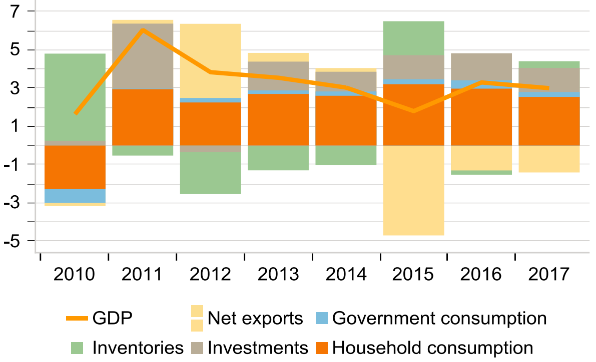
Shrinking shadow economy increases budget revenues

The rather strong domestic demand and labour market contributed to the better-than-expected public sector balance. During the first nine months of this year, national budget revenues exceeded the plan by 2.0% and were 7.6% higher than a year ago – this was also a clear sign that the shadow economy has shrunk somewhat. This is also indicated in the number of smuggled cigarettes – their share fell from 29% last year to 20% in 2015 (the Nielsen "empty "pack survey).

Widening foreign trade deficit and possible competitiveness challenges ahead

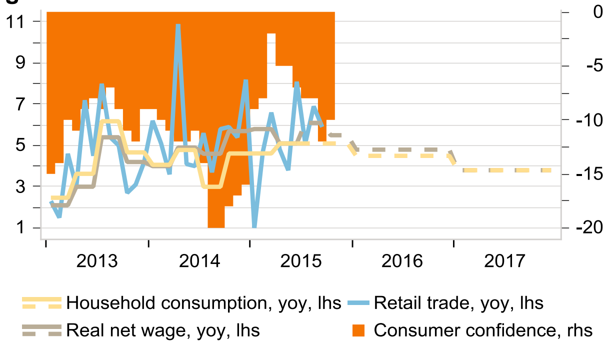
Rising domestic demand and weak exports will push the foreign trade balance into negative territory this year after three years of foreign trade surplus. The current account balance is expected to continue worsening throughout the forecast period; this mainly reflects an excess of imports over exports. Rapidly rising wages are posing challenges to the competitiveness of Lithuanian exporters, as wages have been rising faster than productivity for a few years now and companies have seemed to underinvest during the post-crisis period. When wage growth started outpacing productivity, Lithuania started losing its markets shares in the EU – its main export market. This trend will not be reversed unless companies invest in efficiency and the development of their brands; meanwhile, the government should continue implementing essential structural reforms, not least in education and labour market regulation.

Contribution to annual GDP growth



Source: Swedbank Research & Macrobond

Consumption, consumer confidence and wage growth



Source: Swedbank Research & Macrobond

Forecast tables

I. Global Outlook

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

	2014	2015f		2016f		2017f	
USA	2.4	2.5	(2.5)	3.0	(3.1)	2.8	(2.6)
EMU countries	0.9	1.5	(1.3)	1.9	(1.9)	1.8	(1.8)
Germany	1.6	1.6	(1.7)	1.8	(1.9)	1.6	(1.6)
France	0.2	1.1	(1.1)	1.9	(1.9)	1.7	(1.7)
Italy	-0.4	0.7	(0.6)	1.4	(1.4)	1.4	(1.4)
Spain	1.4	3.2	(3.2)	3.0	(2.9)	2.4	(2.4)
Finland	-0.4	0.1	(-0.3)	0.5	(0.5)	1.0	(1.0)
UK	2.9	2.4	(2.6)	2.3	(2.5)	2.1	(2.1)
Denmark	1.1	1.9	(2.0)	2.2	(2.3)	1.9	(2.0)
Norway	2.3	1.1	(1.3)	1.1	(1.4)	2.2	(2.3)
Japan	-0.1	0.6	(0.7)	1.1	(1.1)	0.7	(0.8)
China	7.5	6.8	(6.9)	6.6	(6.6)	6.3	(6.3)
India	7.1	7.6	(7.3)	7.5	(7.4)	7.7	(7.3)
Brazil	0.2	-3.1	(-1.8)	-2.3	(-0.6)	0.4	(0.3)
Russia	0.6	-4.5	(-4.8)	-2.0	(-2.0)	1.5	(1.5)
Global GDP in PPP [2/]	3.4	3.1	(3.2)	3.6	(3.8)	3.8	(3.9)

1/ August 2015 forecasts in parenthesis.
2/ World Bank weights (revised 2014).
Sources: IMF and Swedbank.

Interest and exchange rate assumptions, %

	Outcome	Forecast				
	2015	2015	2016	2016	2017	2017
	6-Nov	31 Dec	30 Jun	31 Dec	30 Jun	31 Dec
Policy rates						
Federal Reserve, USA	0.25	0.50	0.75	1.25	1.75	2.25
European Central Bank	0.05	0.05	0.05	0.05	0.05	0.25
Bank of England	0.50	0.50	0.75	1.00	1.25	1.50
Norges Bank	0.75	0.50	0.00	0.00	0.25	0.50
Bank of Japan	0.10	0.10	0.10	0.10	0.10	0.10
Government bond rates						
Germany 2y	-0.3	-0.3	-0.1	0.1	0.3	0.7
Germany 10y	0.7	0.6	0.8	1.0	1.4	1.9
US 5y	1.7	1.7	2.0	2.4	3.0	3.3
US 10y	2.3	2.3	2.6	3.0	3.5	3.8
Exchange rates						
EUR/USD	1.09	1.08	1.06	1.08	1.12	1.15
USD/CNY	6.3	6.4	6.5	6.6	6.7	6.8
EUR/NOK	9.53	9.39	9.34	8.91	8.74	8.61
USD/JPY	122	122	123	125	123	122
EUR/GBP	0.72	0.72	0.70	0.68	0.70	0.70
USD/RUB	65	67	75	80	75	70

Sources: Reuters Ecowin and Swedbank.

II. The Swedish Outlook

Key Economic indicators, 2014-2017 1/

	2014	2015f	2016f	2017f
Real GDP (calendar adjusted)	2.5	3.2	3.3	3.6
Industrial production	-0.8	2.5	3.5	4.0
CPI index, average	-0.2	0.0	1.3	2.3
CPI, end of period	-0.3	0.3	2.1	2.4
CPIF, average 2/	0.5	0.9	1.8	1.9
CPIF, end of period	0.5	1.2	2.1	1.8
Labour force (15-74)	1.3	0.7	0.8	1.3
Unemployment rate (15-74), % of labor force	7.9	7.3	6.5	6.4
Employment (15-74)	1.4	1.3	1.7	1.5
Nominal hourly w age w hole economy, average	2.9	2.5	3.2	3.3
Savings ratio (households), %	15.3	15.7	15.9	16.5
Real disposable income (households)	2.2	3.2	3.4	3.6
Current account balance, % of GDP	6.0	6.1	5.6	5.3
General government budget balance, % of GDP 2/	-1.7	-1.1	-1.3	-1.4
General government debt, % of GDP	40.6	39.2	38.6	38.1

1/ Annual percentage growth, unless otherwise indicated.
2/ As measured by general government net lending.

Sources: Statistics Sweden and Swedbank

Swedbank's GDP Forecast - Sweden

Changes in volume, %	2014	2015f		2016f		2017f	
Households' consumption expenditure	2.2	2.5	(2.5)	3.2	(2.4)	2.9	(2.3)
Government consumption expenditure	1.6	2.2	(2.3)	3.9	(2.4)	3.4	(2.3)
Gross fixed capital formation	7.6	4.9	(3.9)	5.5	(5.7)	5.6	(5.5)
private, excl. housing	6.1	3.6	(2.3)	4.4	(5.2)	5.4	(5.5)
public	2.4	2.8	(1.8)	5.7	(4.9)	4.5	(3.9)
housing	19.8	12.4	(11.9)	9.4	(8.2)	7.2	(6.7)
Change in inventories 1/	0.1	-0.1	(-0.1)	0.0	(-0.0)	0.0	(0.0)
Exports, goods and services	3.5	3.9	(4.0)	4.8	(5.0)	4.6	(4.6)
Imports, goods and services	6.3	2.6	(3.2)	6.2	(5.7)	5.4	(5.0)
GDP	2.3	3.4	(3.1)	3.5	(2.9)	3.4	(3.0)
GDP, calendar adjusted	2.5	3.2	(2.8)	3.3	(2.7)	3.6	(3.2)
Domestic demand 1/	3.1	2.9	(2.7)	3.8	(3.0)	3.6	(3.0)
Net exports 1/	-0.9	0.7	(0.5)	-0.4	(-0.1)	-0.2	(-0.0)

1/ Contribution to GDP growth.
August 2015 forecast in parenthesis.

Sources: Statistics Sweden and Swedbank

Interest and exchange rate assumptions

	Outcome	Forecast				
	2015	2015	2016	2016	2017	2017
	06-nov	31 Dec	30 Jun	31 Dec	30 Jun	31 Dec
Interest rates (%)						
Policy rate	-0.35	-0.35	-0.35	-0.25	0.00	0.50
10-yr. gvt bond	0.85	0.75	1.00	1.30	1.70	2.25
Exchange rates						
EUR/SEK	9.40	9.20	9.15	9.00	9.00	8.95
USD/SEK	8.64	8.52	8.71	8.41	8.04	7.78
KIX (SEK) 1/	112.8	109.8	109.7	107.5	106.6	105.8

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

Sources: Reuters Ecowin and Swedbank

III. The Estonian Outlook

ESTONIA: Key economic indicators, 2014-2017 [1/]

	2014	2015f		2016f		2017f	
Real GDP growth, %	2.9	1.6	(1.9)	2.6	(2.8)	2.8	(2.8)
Household consumption	3.5	5.2	(3.9)	4.0	(3.4)	3.5	(3.3)
Government consumption	3.0	1.5	(1.5)	1.5	(2.0)	2.5	(2.5)
Gross fixed capital formation	-1.8	-3.5	(-0.5)	3.0	(4.0)	5.0	(5.5)
Exports of goods and services	1.8	-1.5	(0.0)	2.5	(3.5)	4.0	(4.0)
Imports of goods and services	1.4	-2.0	(-0.5)	3.5	(4.0)	5.0	(5.0)
Consumer price growth, %	-0.1	-0.4	(-0.2)	1.6	(1.9)	2.5	(2.5)
Unemployment rate, % [2/]	7.4	6.6	(6.6)	6.9	(6.7)	6.8	(6.8)
Real net monthly wage growth, %	5.7	7.4	(6.7)	4.3	(4.6)	3.7	(3.7)
Nominal GDP, billion euro	20.0	20.6	(20.4)	21.6	(21.5)	22.9	(22.7)
Exports of goods and services (nominal), % growth	1.4	-3.0	(-0.8)	1.9	(3.3)	4.4	(4.5)
Imports of goods and services (nominal), % growth	0.0	-3.4	(-1.5)	3.0	(3.5)	5.5	(5.5)
Balance of goods and services, % of GDP	3.4	3.4	(3.0)	2.5	(2.9)	1.7	(2.1)
Current account balance, % of GDP	1.0	2.2	(0.4)	0.7	(0.1)	-0.2	(-0.8)
Current and capital account balance, % of GDP	3.1	5.6	(2.0)	2.8	(1.6)	0.9	(-0.2)
FDI inflow, % of GDP	5.9	-1.9	(3.9)	4.6	(4.7)	4.4	(4.4)
Gross external debt, % of GDP	94.7	89.7	(92.4)	84.5	(87.4)	80.1	(83.4)
General government budget balance, % of GDP [3/]	0.7	0.3	(-0.5)	-0.2	(-0.2)	0.0	(-0.1)
General government debt, % of GDP	10.4	10.0	(10.2)	9.7	(10.0)	9.4	(9.7)

1/ August 2015 forecast in parenthesis

2/ According to Labour force survey

3/ According to Maastricht criterion

IV. The Latvian Outlook

LATVIA: Key economic indicators, 2014-2017 1/

	2014	2015f		2016f		2017f	
Real GDP growth, %	2.4	2.4	(2.1)	3.3	(3.3)	3.0	(3.0)
Household consumption	2.3	2.8	(3.0)	4.0	(4.0)	3.5	(3.5)
Government consumption	4.9	2.1	(1.7)	1.6	(1.5)	2.3	(2.3)
Gross fixed capital formation	0.5	1.5	(0.0)	7.0	(9.0)	10.0	(10.0)
Exports of goods and services	3.1	1.8	(2.3)	4.0	(4.0)	4.0	(4.0)
Imports of goods and services	0.8	2.3	(2.1)	6.0	(6.7)	6.8	(6.8)
Consumer price growth, %	0.6	0.3	(0.5)	1.5	(2.0)	2.3	(2.3)
Unemployment rate, % 2/	10.8	9.9	(9.9)	9.2	(9.2)	8.3	(8.3)
Real net monthly wage growth, %	7.9	6.7	(5.5)	4.1	(3.6)	3.6	(3.6)
Nominal GDP, billion euro	23.6	24.5	(24.9)	25.8	(26.3)	27.3	(27.8)
Exports of goods and services (nominal), % growth	2.3	2.5	(2.1)	5.7	(5.7)	5.0	(5.0)
Imports of goods and services (nominal), % growth	0.6	2.3	(2.1)	7.6	(8.3)	7.9	(7.9)
Balance of goods and services, % of GDP	-2.2	-2.1	(-2.8)	-3.2	(-4.3)	-4.9	(-5.9)
Current account balance, % of GDP	-2.0	-1.4	(-2.2)	-2.7	(-3.8)	-4.1	(-5.2)
Current and capital account balance, % of GDP	1.2	1.7	(0.8)	-0.1	(-1.3)	-1.4	(-2.6)
FDI inflow, % of GDP	1.9	2.9	(2.6)	3.1	(3.0)	3.1	(3.1)
Gross external debt, % of GDP	141.5	139.1	(142.2)	135.3	(138.9)	132.4	(137.1)
General government budget balance, % of GDP 3/	-1.6	-1.6	(-1.6)	-1.2	(-1.1)	-0.9	(-1.0)
General government debt, % of GDP	40.8	37.5	(37.0)	37.1	(36.1)	36.4	(35.2)

1/ August 2015 forecast in parenthesis
2/ According to Labour force survey
3/ According to Maastricht criterion

V. The Lithuanian Outlook

LITHUANIA: Key economic indicators, 2014-2017 [1/]

	2014	2015f		2016f		2017f	
Real GDP growth, %	3.0	1.8	(1.8)	3.3	(3.3)	3.0	(3.0)
Household consumption	4.2	5.0	(4.3)	4.5	(4.5)	3.8	(3.8)
Government consumption	0.4	1.5	(1.5)	2.5	(2.0)	1.5	(1.5)
Gross fixed capital formation	7.0	6.5	(2.0)	7.0	(7.0)	6.0	(6.0)
Exports of goods and services	3.3	0.0	(-1.0)	4.0	(6.0)	5.0	(5.0)
Imports of goods and services	3.2	6.0	(3.0)	5.5	(7.0)	6.5	(6.5)
Consumer price growth, %	0.1	-0.8	(-0.8)	2.5	(2.5)	3.0	(3.0)
Unemployment rate, % [2/]	10.7	9.3	(9.3)	8.1	(8.3)	7.5	(7.8)
Real net monthly wage growth, %	5.1	5.5	(5.5)	4.3	(4.0)	2.8	(2.8)
Nominal GDP, billion euro	36.4	37.0	(36.9)	39.1	(39.0)	41.5	(41.4)
Exports of goods and services (nominal), % growth	0.7	-3.0	(-3.0)	7.0	(7.5)	8.0	(8.5)
Imports of goods and services (nominal), % growth	-0.2	1.0	(0.5)	8.0	(8.5)	9.0	(9.0)
Balance of goods and services, % of GDP	1.9	-1.3	(-2.7)	-2.0	(-3.5)	-2.8	(-4.0)
Current account balance, % of GDP	3.6	-2.6	(-3.5)	-2.8	(-4.3)	-3.5	(-4.7)
Current and capital account balance, % of GDP	6.3	-0.2	(-0.7)	-0.3	(-1.3)	-0.8	(-1.9)
FDI inflow, % of GDP	0.7	1.0	(1.5)	1.5	(2.0)	2.0	(2.0)
Gross external debt, % of GDP	70.6	71.3	(68.2)	68.7	(65.8)	66.0	(66.0)
General government budget balance, % of GDP [3/]	-0.7	-1.0	(-1.4)	-1.5	(-1.1)	-0.2	(-0.2)
General government debt, % of GDP	40.7	43.0	(43.0)	40.7	(38.1)	42.0	(40.0)

1/ August 2015 forecast in parenthesis
2/ According to Labour force survey.
3/ According to Maastricht criterion.

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