

Swedbank Economic Outlook August 2016

Populism – the Achilles' heel of the global recovery

- Weak global growth – risks mainly related to politics
- Swedish boom fades as structural challenges rises
- Growth in the Baltics should pick up next year



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Executive Summary

Modest improvement in the global economy, growing populism a threat

Weak economic growth, low interest rates, and populist movements are three key themes that dominate the outlook for the world economy. We see the global economy continuing to grow at about 3% per year in the next few years, while the US and the euro area will continue to grow at a moderate pace. In the US, the business cycle is maturing, and we expect growth at around potential, while the euro area is still recovering from the crisis. Growth in emerging markets is diverging, with a continued slowdown in China, somewhat better prospects in India, and a weak re-emergence of growth in Russia and Brazil. Overall, growth is just about high enough for us to see a very gradual normalisation of monetary policy in Western countries. However, it is not strong enough to stave off the growing emergence of populism threatening the long-term prospects of economic growth.

Sweden faces key policy challenges as growth slows

In a situation of low global growth, the Swedish economy continues to be dependent on the strong performance of its domestic sectors. In order to maintain sound growth in Sweden, the housing shortage needs to be tackled and integration into the labour market must be improved. Reforms to increase productivity are also required. The high rate of growth in Sweden in 2015 is providing positive momentum into 2016, but this growth will weaken significantly in 2017 and 2018.

Growth in the Baltics should pick up next year

Growth in the Baltic countries will be lower this year than previously expected, mostly due to weaker investment. However, growth is expected to pick up next year on the back of recovering exports and investments. The labour market remains tight, resulting in strong growth of wages and household consumption. Nevertheless, wage growth is expected to decelerate going forward, while employment growth will be weak or non-existent as a result of ageing societies. Labour costs have been growing faster than productivity and may continue to undermine competitiveness. Inflation will finally pick up due to higher prices of commodities and services.

Solidifying fundamentals in key emerging markets

Financial flows have returned to emerging markets, and economic fundamentals are not deteriorating in the same way as in 2015. Negative or low yields are driving portfolio flows from developed to emerging-market assets, with few questions asked. China fears have settled after the shocking start of the year, when devaluation concerns were high. The Chinese economy is moving towards a slower growth path, with much government support. India is making political progress, as one of the most important tax reforms was passed in the upper house in August. In the near term, the structural shortcomings that India must deal with will restrain growth. We expect the recession in Brazil to end next year. However, we doubt that the new government will be able to push through with the necessary structural reforms. The recession has ended in Russia, but the recovery will be modest.

Macroeconomic indicators, 2015 - 2018

	2015	2016f	2017f	2018f
Real GDP, annual change in %				
Sweden (calendar adjusted)	3.9	3.1	2.5	2.1
Estonia	1.2	1.5	2.5	2.7
Latvia	2.7	2.1	3.0	3.3
Lithuania	1.6	2.5	3.0	2.5
Unemployment rate, % of labour force				
Sweden	7.4	6.8	6.3	6.3
Estonia	6.2	6.2	6.6	6.7
Latvia	9.9	9.5	8.7	8.0
Lithuania	9.1	8.0	7.4	7.2
Consumer price index, annual change in %				
Sweden	0.0	1.1	1.8	2.6
Estonia	-0.5	-0.1	2.5	2.0
Latvia	0.2	0.0	2.5	2.0
Lithuania	-0.9	1.2	3.0	2.5
Current account balance, % of GDP				
Sweden	4.9	4.3	4.0	3.8
Estonia	1.9	1.3	0.1	-0.7
Latvia	-1.2	0.2	-2.1	-3.9
Lithuania	-1.7	-3.3	-0.2	-0.9

Sources: National statistics authorities and Swedbank.

Global Outlook

Weak economic growth, low interest rates, and populist movements are three key themes that dominate the outlook for the world economy. We see the global economy continuing to grow at about 3% per year in the next few years, while the US and the euro area will continue to grow at a moderate pace. In the US, the business cycle is maturing, and we expect growth at around potential, while the euro area is still recovering from the crisis. Growth in emerging markets is diverging, with a continued slowdown in China, somewhat better prospects in India, and a weak re-emergence of growth in Russia and Brazil. Overall, growth is just about high enough for us to see a very gradual normalisation of monetary policy in Western countries. However, it is not strong enough to stave off the growing emergence of populism threatening the long-term prospects of economic growth.

Still reeling from the great recession

The global economy is still suffering from the fallout of the financial crisis in 2008. The past eight years represent the deepest global slowdown since the depression in the 1930s. What started as a financial crisis in the US spread throughout the global economy, with profound consequences for the world economy. Imbalances in the euro area surfaced, and the euro crisis flared up in 2011. Emerging-market vulnerabilities together with the slowdown in China have caused recessions in Brazil and Russia (in addition to sanctions and the conflict in Ukraine). The difference between expected growth before the financial crisis and actual outcomes is startling. There is an increasing amount of data that signals that potential growth is significantly lower than before the crisis. A key concern and underlying reason behind the slow recovery is productivity growth in Western countries, which slowed around 2005 and has been abysmal since the financial crisis.

Populism grows on the back of stagnant wages

These eight years of weak global growth since the financial crisis have severely affected households. Populist movements are growing strong as real wage growth has been stagnant, or even negative, for large groups of the society in many Western countries. In the US, average real wages have been growing at a low pace since the depth of the crisis, while median wages have essentially been developing sideways for more than 15 years. In the UK, average real wages have fallen substantially compared to their pre-crisis levels. The same pattern emerges for the euro area as well.

Swedbank's global GDP forecast^{1/} (annual percentage change)

	2015	2016f	2017f	2018
USA	2.6	1.6 (2.4)	2.2 (2.6)	1.8
EMU countries	1.6	1.6 (1.5)	1.5 (1.6)	1.5
Germany	1.5	1.8 (1.3)	1.2 (1.3)	1.1
France	1.2	1.3 (1.3)	1.3 (1.6)	1.6
Italy	0.6	0.7 (0.9)	1.0 (1.2)	1.1
Spain	3.2	3.0 (3.0)	2.4 (2.4)	2.2
Finland	0.2	0.8 (0.7)	0.7 (0.9)	1.1
UK	2.2	1.6 (1.9)	0.7 (2.1)	1.4
Denmark	1.0	1.3 (1.5)	1.9 (2.1)	2.0
Norway	1.0	0.6 (0.6)	1.5 (1.4)	2.3
Japan	0.6	0.5 (0.7)	0.8 (0.6)	0.6
China	6.9	6.6 (6.6)	6.5 (6.5)	6.5
India	7.2	7.3 (7.2)	7.3 (7.7)	7.7
Brazil	-3.9	-2.9 (-3.5)	0.3 (0.0)	1.6
Russia	-3.7	-0.8 (-1.8)	1.5 (1.5)	2.0
Global GDP in PPP ^{2/}	3.1	3.0 (3.2)	3.3 (3.7)	3.4

1/ April 2016 forecasts in parentheses.

2/ IMF weights (revised 2015).

Sources: IMF and Swedbank.

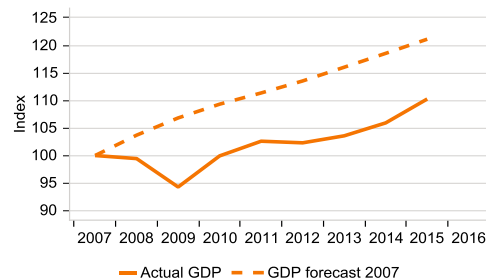
Populist parties' increasing influence

Populist movements influence the political agenda even in countries where they do not directly take part in the government. In the UK, the desire to eliminate the power of UKIP contributed to former PM David Cameron's announcing the Brexit referendum. UKIP's representation in the British parliament is limited, but the UK nevertheless voted to leave the EU. The rise of Donald Trump as the Republican nominee in the US presidential election is another sign of populism growing strong. Both, Trump and Clinton, are advancing protectionism and the reversal of US trade agreements in an attempt to gain voters who have seen traditional jobs in the manufacturing sector moving to Mexico and China. In the euro area, both France and Germany hold elections in 2017. In both countries, populist sentiments are putting pressure on established parties. Also, the constitutional referendum in Italy this autumn is raising tensions.

Populist movements are growing at the same time as central banks have fewer tools available to stimulate economic growth. While more structural reforms and fiscal policy are needed to

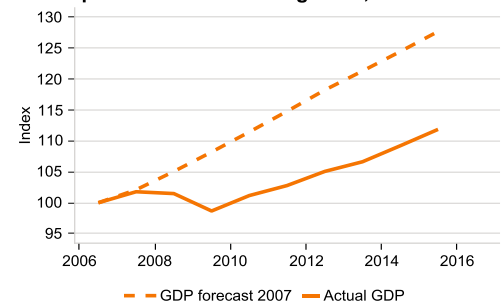
strengthen long-term potential growth, the political system is weak. In this environment, populist movements will have a large impact on economic policy in the coming years. In particular, they contribute to the inability of governments to conduct reforms aimed at increasing productivity growth. As a consequence, it is likely that the world economy will stay in a low-growth environment for the next few years.

Sweden: Expected vs actual GDP-growth, 2007=100



Source: Swedbank Research & Macrobond

US: Expected vs actual GDP-growth, 2006=100



Source: CBO, OECD, Swedbank Research & Macrobond

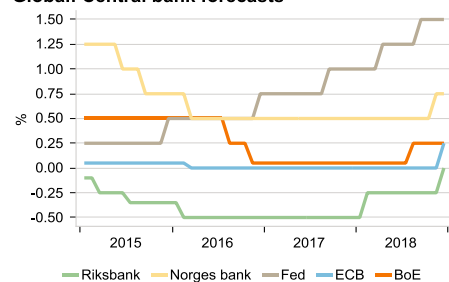
Potential growth lower than previously estimated

Global growth will continue to be weak, at about 3% per year; importantly, this does not imply either a new recession or no growth. Trend growth is weak due to a slowdown in productivity growth and an aging population. US growth will be around potential, or just above, at about 2%. In the euro area, growth is actually above potential, causing lower unemployment, higher consumption, and a very gradual recovery. Our forecast for China is for slowing growth. Structural imbalances remain large, but our main scenario is that China can handle them during the next two-three years. India is overtaking China as a growth engine, with a young population, scope for undertaking reforms, and catching-up to do. A stabilisation of the oil price will contribute to a recovery in both Russia and Brazil, with positive growth numbers in 2017 and 2018, while underlying weaknesses in both countries will put a lid on long-term growth potential.

Only a very gradual normalisation of monetary policy

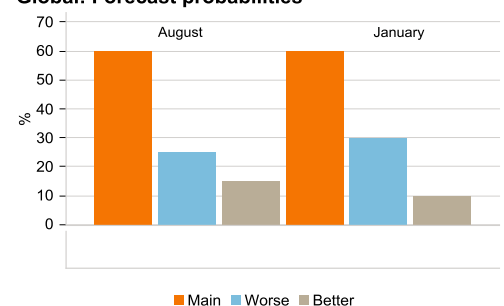
Subdued but positive growth numbers in the US and in the euro area will allow a very slow and gradual normalisation of monetary policy. The fragility of the world economy and the low potential for growth will hinder any ambitious attempt for policy normalisation. We expect one rate hike per year in the US in 2016 and 2017, and two in 2018, but risks remain on the downside. The Fed's policy is affected by the slow recovery in the rest of the world. The ECB will taper its asset purchases in 2017 and make a first rate hike towards the end of 2018.

Global: Central bank forecasts



Sources: Swedbank Research & Macrobond

Global: Forecast probabilities



Sources: Swedbank Research & Macrobond

Risks tilted to the downside

Risks are more balanced than in our previous forecast, but there is scope for both a stronger and a weaker outcome. On the upside, there is room for higher consumption growth in both the US and Europe as household savings are high. Investments have room for improvements if business sentiments improve. In addition, if the political system manages to fend off the rise of populism and substantive economic reforms are enacted, the upside is quite large. On the other hand, there are still large risks that may cause an even bleaker outlook than the one presented here. Risks include a sharp slowdown in China, Donald Trump's winning the US election, geopolitical tensions, the European banking sector weakening, and the rise of populism causing poor economic policies to even further slow economic growth.

The key message is that it is unlikely that growth will return to its pre-crisis level. An aging population and weaker productivity growth imply that potential growth is low for the foreseeable future. While we still see decent global growth and no drastic downfall in the global economy, it still faces significant long-term headwinds.

Lower rates, flatter curves across the board during 2016

Expect a range-trading currency market

No clear direction in the euro-dollar exchange rate

No action in G10 currencies makes investors turn to emerging markets

Undervalued krona held back by the Riksbank

Interest and exchange rate markets

During the first half of the year and the summer months, markets have largely been sentiment driven. The year began with falling equity prices and a general tendency of flight to safety. Although equity prices have stabilised and are currently trading, on average, at levels equivalent to those seen at the start of the year, interest rates have remained depressed. These developments – medium- to long-term interest rates significantly lower, with a marked flattening of interest rate curves as the short end is more or less locked at central banks' policy rates – have been fairly consistent across asset classes, currencies, and countries.

In the foreign exchange market, a lot of attention has been paid to the surprise Brexit vote, which saw the pound sterling depreciate sharply, in particular against well-known safe-haven currencies like the US dollar, the yen, and the Swiss franc. As expected, central banks did their best to support markets with liquidity and by keeping the doors open to a further loosening of monetary policy, if necessary. The Brexit-related market premiums pulled back relatively fast, and problems in the

European banking sector, primarily Italy, were not seen as creating systemic risks. The economic and political impact on the rest of Europe from Brexit is not yet known, but the UK economy will most likely see weaker economic growth and lack of inward investment, given the long future period of uncertainty regarding UK relations with mainland Europe. The Bank of England (BOE) has cut the Bank rate and embarked on quantitative easing (QE) again. Signals from the BOE have been clear that the rate most likely will be cut further later this year, close to 0 %. All in all, this will weigh on the pound sterling, not at least as the UK has a big current account deficit. We expect the pound sterling to continue weaken going forward, potentially towards 0.90 against the euro over the next six months.

Interest and exchange rate forecasts, %

	Outcome	Forecast				
	2016 25-Aug	2016 31 Dec	2017 30 Jun	2017 31 Dec	2018 30 Jun	2018 31 Dec
Policy rates						
Federal Reserve, USA	0.50	0.75	0.75	1.00	1.25	1.50
European Central Bank	0.00	0.00	0.00	0.00	0.00	0.25
Bank of England	0.25	0.05	0.05	0.05	0.05	0.25
Norges Bank	0.50	0.50	0.50	0.50	0.50	0.75
Bank of Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
Government bond rates						
Germany 2y	-0.6	-0.6	-0.4	-0.3	0.5	0.6
Germany 5y	-0.5	-0.5	-0.3	-0.2	0.6	0.8
Germany 10y	-0.1	-0.1	0.1	0.2	0.9	1.0
US 2y	0.8	0.9	0.9	1.2	1.6	2.0
US 5y	1.2	1.3	1.4	1.5	1.9	2.4
US 10y	1.6	1.7	1.7	1.8	2.2	2.6
Exchange rates						
EUR/USD	1.13	1.08	1.06	1.10	1.10	1.12
USD/CNY	6.7	6.8	6.9	6.7	6.8	7.0
EUR/NOK	9.67	9.11	8.91	8.90	8.73	8.73
USD/JPY	100	103	105	108	108	108
EUR/SEK	9.47	9.20	9.00	8.90	8.90	8.90
EUR/GBP	0.86	0.89	0.85	0.85	0.82	0.82
USD/RUB	65	60	59	58	55	52

Sources: Macrobond and Swedbank.

The euro-dollar exchange rate has been trendless since the beginning of last year, even though the ECB has lowered the deposit rate into negative territory and introduced QE. The Fed currently holds a variety of views, but there seem to be a majority that wants to see inflation closing in on the target before hiking again. We expect that the US dollar will see some interest rate support over the next year, but it is clear that longer-term fundamentals and valuation do not make much of a case for a sustained dollar rally from current levels. Our euro-dollar forecast is now bottoming out at around 1.06.

The current situation—with the Fed very cautiously lifting rates over the next few years, together with all the other main (G10) central banks fearing stronger currencies and most of them with little or no room to cut rates further - suggests that the main exchange rates will remain very much in a range-trading market, without clear trends. Also, the G20 has a consensus not to use currencies as a direct policy tool. The Bank of Japan is fighting to avoid an undervalued yen from appreciating, and the cut of the key rate earlier into negative territory did not help. Emerging-market currencies seem, at least for now, to be the name of the game for investors who are searching for carry in this low-yielding world. This is despite geopolitical risks in many emerging markets and lacklustre growth outlooks.

The expected appreciation of the Swedish krona against the euro has again been postponed. The krona is undervalued, measured from a fundamental perspective. The current account surplus and relative strong growth are indicators, among others, that support this view. With Sweden having the most negative short-term real rates in the G10, the Riksbank threatening

currency intervention, and the extensive QE, both investors and speculators buying krona are meeting big headwinds. Looking forward, we expect rising domestic inflation, and inflation expectations will open the door for the Riksbank to tolerate a bit of appreciation, consistent with its own assumption of the outlook for krona. That said, the Riksbank will probably shadow the ECB policy and not dare to stop buying bonds until there is a clear signal of an ECB tapering. Our forecast is for the euro-krona rate to move slowly towards 9.00 over the next 12 months.

Norwegian krone supported by a rising oil price

In Norway, growth seems to have bottomed out this year, and the earlier rate cuts and weakening of the Norwegian krone are starting to help the economy. In particular, the main drop in oil investments should now be behind us, and the oil price has clearly stabilised in the area of USD 40-52 per barrel. This suggests that confidence among Norwegian consumers and corporates can turn a bit more positive. Fiscal policy is also providing support. Looking ahead, Norges Bank will probably keep the door open for one more rate cut, but our base scenario is that it will stay on hold. As we see the oil price move gradually higher, towards USD 55 a barrel towards the end of the year, we see some potential for the euro-krona exchange rate to break below 9.00 over the next 12 months.

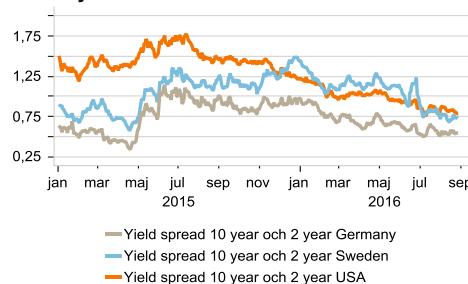
Interest rates forecast to rise in main markets– albeit slowly – while curves remain flat

While we expect central banks to remain the main determinant of market movements, our forecast is that interest rates will reverse the fall of recent months in favour of an upward, though modest, trend to better reflect long-term economic fundamentals. Based on our main scenario and our central bank forecasts, we expect interest rates to begin rising, albeit very slowly, during the forecast horizon, and that dollar rates will take the lead. We foresee that interest rates curves will flatten initially as the short term rates will increase more than the long-term ones. The yield curve will remain relatively depressed even towards the end of the forecast period, due to the persistent low inflation environment as well as other fundamental and technical factors, such as investor's ongoing hunt for yield. This time Fed is not starting a 'normal' hiking cycle per se, but a rather embarking on a normalisation out of an abnormal period. This hiking process will be more moderate than in the past, which will mitigate the effect on bond prices when rates rise. At the same time the divergence in global monetary policy will continue to keep demand for US treasuries high, hence the relatively flat US yield curve through the hiking cycle. As the Federal Reserve will be the only major central bank increasing policy rates before the last quarter of this year the differences in interest rates between the United States and other advanced economies is expected to increase. The spreads between Swedish rates and German will also increase albeit by less.

The question lingers, however, how far long-term interest rates can go

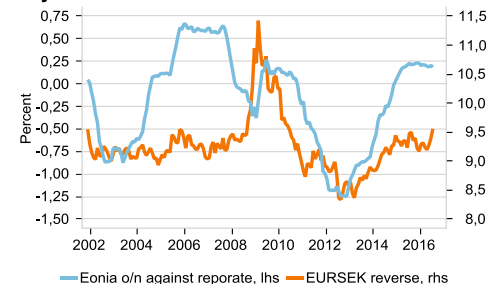
In the longer perspective, it is interesting to discuss how much higher, realistically, longer rates may potentially rise. In other words, what is the new 'normal' to be achieved by "normalisation"? This is especially true for government bonds, which fill so many roles in the financial system in addition to funding public debts. A key feature of government bonds is their role as a store of value. Bernanke's hypothesis of a "global savings glut" and Summers' "secular stagnation" hypothesis are two examples of academics' discussion of there being excess demand for (risk-free) savings products, of which advanced country government bonds is the prime example, pushing down interest rates globally rather than being invested in productive investment. With continued high savings rates across the world, we therefore believe that such excess demand for low risk savings will dampen the potential for long-term rates to increase during the forecast horizon.

Global yield curves



Source: Swedbank Research & Macrobond

Key rate diff and EURSEK



Source: Swedbank Research & Macrobond

Sweden: Average is over

How can Sweden achieve sound economic growth when the world is stagnating? How can Sweden significantly increase housing construction while limiting household debt levels? How can jobs be created for new immigrants without reducing the lowest wages? Swedish data looks fine on average. Yet the underlying data shows growing polarization. In a situation of low global growth, the Swedish economy continues to be dependent on the strong performance of its domestic sectors. In order to maintain sound growth in Sweden, the housing shortage needs to be tackled and integration into the labour market must be improved. Reforms to increase productivity are also required. The high rate of growth in Sweden in 2015 is providing positive momentum into 2016, but this growth will weaken significantly in 2017 and 2018.

High growth largely a result of one-offs

Last year was exceptional, as the Riksbank's interest rate cuts coincided with unexpected fiscal policy stimulus following the migration wave. Public sector consumption increased in parallel with the stimulus of household consumption through the low interest rates. Simultaneously, the Swedish krona weakened, which contributed to higher export growth. The high GDP growth rate at the end of 2015 spilled over into 2016. The driving forces are a strong labour market that helps boost household consumption, an expansive construction sector, and a continued high level of public consumption. This favours primarily the domestic services sectors, while industrial production and exports are seeing only modest growth rates. Strong domestic demand means that the labour market continues to experience strong growth, and the pressure in the construction sector remains high.

Key Economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP (calendar adjusted)	3.9	3.1	2.5	2.1
Industrial production	3.8	3.5	3.0	2.5
CPI index, average	0.0	1.1	1.8	2.6
CPI, end of period	0.1	1.8	2.2	2.7
CPIF, average ^{2/}	0.9	1.5	1.7	1.9
CPIF, end of period	0.9	1.8	1.7	1.9
Labour force (15-74)	0.8	1.2	1.0	0.9
Riksbank policy rate, end of period	-0.35	-0.50	-0.50	0.00
Unemployment rate (15-74), % of labor force	7.4	6.8	6.3	6.3
Employment (15-74)	1.4	1.8	1.5	1.0
Nominal hourly wage whole economy, average	2.5	3.0	3.4	3.5
Savings ratio (households), %	15.7	15.6	15.8	15.6
Real disposable income (households)	2.7	2.6	2.1	1.4
Current account balance, % of GDP	4.9	4.3	4.0	3.8
General government budget balance, % of GDP ^{2/}	-0.1	0.1	-0.2	0.5
General government debt, % of GDP	43.4	41.1	39.6	38.2

^{1/} Annual percentage growth, unless otherwise indicated.

^{2/} CPI with fixed interest rates.

Sources: Statistics Sweden and Swedbank

Global weakness and structural imbalances

Sweden has good prospects for achieving high growth in the long term. Government finances are sound, the labour market is strong, and Swedish companies are competitive. However, global demand will continue to remain subdued in the next few years at the same time as the Swedish krona will be strengthening. Exports are therefore increasing at a modest rate, while imports remain high due to strong domestic demand. We expect negative contributions from net exports in both 2017 and 2018. The pressure on the domestic sectors to maintain a high rate of growth is, therefore, high. This brings two issues into focus – the housing market and the labour market, and the two are linked.

Housing market a key determinant for growth

Demand for housing is high, and we will see a continued large volume of new housing construction in the coming years. This high level of housing construction is a prerequisite for positive developments in the labour market. A major housing shortage in the metropolitan regions and university towns affects, first and foremost, young people and new immigrants looking for jobs and education. Around 60% of new housing in Sweden is for owner occupation; this figure is 70% for the Stockholm region. This means that a high level of construction will fuel a continued rise in household debt. Measures to curb household debt will affect consumption and construction, which, in turn, will dampen employment and growth (see In-depth 1).

Polarised labour market characterised by matching problems

The labour market is the second key issue for economic development. The polarisation of the labour market between those born in Sweden and those of foreign origin has increased. Furthermore, matching problems are increasing. The Swedish government and the labour market parties are facing a difficult problem. To maintain a positive increase in employment, integration has to be improved. Around half of the new immigrants who participate in the labour market programmes have no secondary-level educational qualifications. If integration is not improved and the polarisation continues to increase, new immigrants with a low level of education will require public support, and there is a risk that social divisions will increase. (see In-depth 4 on populism and the economy).

Riksbank on hold

The contrast between a strong domestic economy and weak global growth is creating a major challenge for the Riksbank. Domestic demand leads to increased price pressure for domestic goods and services, while imported inflation remains weak. Our forecast is that the CPIF will remain under the Riksbank's target of 2% during the forecast period. The Riksbank will find itself in a situation with one foot on hot coals and the other in freezing water. The average may seem fine, but the distribution is problematic. We believe that the Riksbank will be forced to adapt to internationally low rates of interest where, not least, the ECB will dominate. As a consequence, the repo rate will remain at -0.50% until the beginning of 2018 and then be raised to zero toward the end of 2018.

Sluggish exports so far in 2016

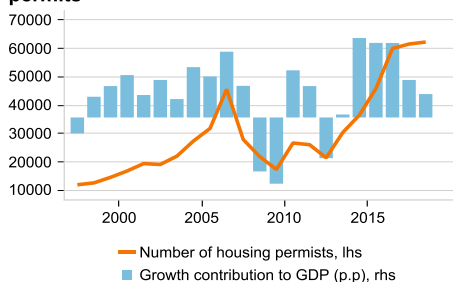
Slow export growth

Swedish exports expanded only moderately during the first half of the year, depending on significantly lower exports of services after the exceptional increase of last year. Goods export, on the other hand, recovered only weakly, driven primarily by an increase in vehicle exports. However, export volumes are increasing at the expense of falling export prices, which means that exports of goods are falling in nominal terms. The sluggish export growth resulted in a negative contribution to GDP during the first two quarters of 2016.

Weak export market and increased cost pressures

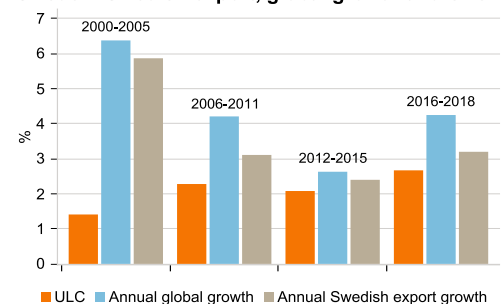
The global market for Swedish exports is expected to improve in 2016-2017, but at a slower rate. The downward revision comes mainly from the US and the euro area – important markets for Swedish exports. The slowdown in the UK is also expected to have repercussions for Swedish exporters, while the Nordic markets are expected to pick up. In connection with a gradual deterioration of competitiveness due to the expected strengthening of the Swedish krona and higher unit labour costs, we expect that Swedish exports will lose market shares.

Sweden: Investment in housing and number of permits



Source: Swedbank Research & Macrobond

Sweden: Swedish export, global growth and ULC



Source: Swedbank Research & Macrobond

In sum, we expect the total export volume to increase by just under 3% this year before rising next year with the help of stronger services exports. The uncertainty related to services exports has, however, increased due to the UK's decision to leave the EU. In 2018, we expect exports to lose momentum as competitiveness worsens and global demand remains sluggish.

Swedish exporters are under continued pressure from the weak level of global investment activity. Although commodities prices appear to have bottomed out and a weak recovery is predicted, this is not expected to generate new investments in the short term. We also expect that transport-related exports will grow at a lower rate after their strong growth in 2015-2016.

Investment activity dampening from high levels

Investments continued to increase across the board at the start of 2016. Investments rose in the first and second quarters by an annualised rate of 7.3% and 6.4%, respectively. Not surprisingly, the largest contribution came from investment in housing, which rose significantly. This is a higher increase than predicted and means that we raise our expectations for the coming years. We expect, however, to see a progressive slowdown in investment—just over 55,000 new housing units per year for the 2016-2018 period. This is significantly lower than the Housing Board's estimate that around 88,000 new housing units per year are needed until 2020 in order to tackle the housing shortage in the long term.

Public investments to rise

Public investments surprised negatively during the first half of the year, which leads us to reduce our investment forecast for the full 2016 year. However, we maintain our view that public investments are set to increase, and that the weak start so far this year represents a deferment of investment until later. This concerns primarily central government investments in infrastructure. We also expect to see higher investments at the municipal and regional levels, where there are great needs in schools and health care, e.g., and for the modernisation of municipal properties. The reduction in asylum immigration will, however, slow down local government investment. Business investment, excluding housing, is expected to grow at a slower rate, which is in line with Statistics Sweden's latest investment survey.

Households benefit from low interest rates and low inflation

Household consumption is central to growth

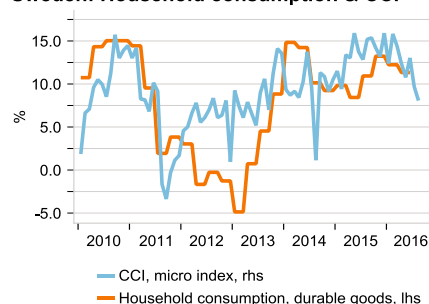
Household spending has accounted in recent years for a significant part of Swedish growth. In addition to the increase in consumption—not least of durable goods, including vehicles—the housing shortage, in combination with a strong rise in jobs in urban areas, has boosted housing investment. Private consumption, along with housing investment, contributed in 2014 and 2015 around two-thirds of the total increase in growth. Consumption is underpinned by the positive growth in employment and large increases in real wages. This means that households as a whole have not taken any excessive risks, and, even if debt levels continue to rise, savings are also rising. However, indebtedness varies greatly among households, as young households in metropolitan areas take on significantly more debt than older households.

Consumption growth to slow

We expect continued positive growth in consumption in the coming years, although at a declining rate. Nonetheless, the amortisation requirement and uncertainty in the housing market appears to be having a dampening effect. In addition, households' view of their own economy seems to have peaked at the same time as the risk of unemployment is still considered to be relatively high. Vehicle sales appear to be having another record year after last year's all-time high, and a subsequent slowing is likely. Consumption of other durables and parts of services consumption will also have difficulty in maintaining the current rate of growth.

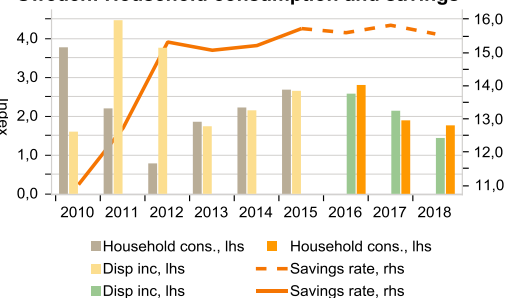
As a whole, households' situations will continue to be strong in the next two years, with good increases in disposable income and relatively low inflation. However, given the caution we see in households, we expect that savings will remain at very high levels. Households' significance for growth will, in any case, remain high and thereby constitute a risk for the economy.

Sweden: Household consumption & CCI



Source: Swedbank Research & Macrobond

Sweden: Household consumption and savings



Source: Swedbank Research & Macrobond

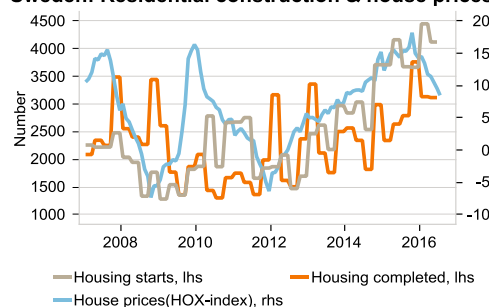
In-depth 1: Increased construction and falling debt - an impossible equation

According to the Swedish National Board of Housing, Building and Planning's latest forecast from June this year, 440,000 new homes need to be built before the end of 2020. According to the June forecast of the Swedish Construction Federation, construction on 56,500 new homes was begun this year, which means that around 88,000 new homes need to be completed per year in the period 2017-2020. In the slightly longer term, the Swedish National Board of Housing, Building and Planning predicts in its June forecast that 710,000 new homes are needed in the next 10 years. The Riksbank and the Swedish Financial Supervisory Authority stated at the same time that household debt must be moderated. What will happen with debt if housing construction increases in line with needs?

In order to measure the effect of increased housing construction on household debt, we adopt the Swedish National Board of Housing, Building and Planning's forecast of the need for new homes as our starting point. Our calculations show that household debt is increasing by just over SEK 90 billion per year just in order to meet the need for new homes. We further assume that construction will follow the current patterns in regard to ownership trends and regional differences. We are also assuming an average loan-to-value of 75%. Our calculations are also based on the gradual reduction in the size of new homes and the reduction in the size of apartments by 2% per year. In addition, we have assumed that land costs will remain unchanged during the forecast period but that construction costs will increase by 5% per year, which reflects wage drift and rising material costs. If the loan-to-value is increased to 85%, which is likely for new construction, household debt will increase by somewhere between SEK 105 billion and SEK 120 billion per year, which means that new production alone will raise household debt in relation to disposable income by around 1.6% per year. This, in turn, should contribute to household debt continuing to rise in line with the current rate of growth. In other words, increased construction in line with the increase in population will mean that household debt will continue to rise from already-high levels.

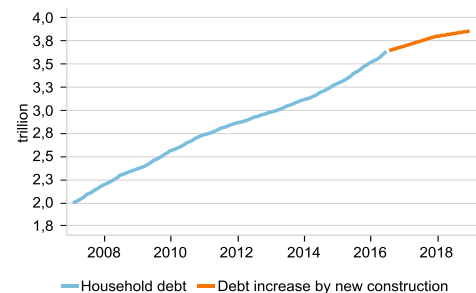
Reforms in the housing market could counteract this development. Higher mobility in the housing market and/or an increase in rental apartments' share of the housing market would dampen the need to continue to increase household debt. Greater mobility could contribute to a better utilisation of the existing housing stock and reduce the need for new housing construction. More rental apartments would reduce the debt burden in the household sector.

Sweden: Residential construction & house prices



Source: Swedbank Research & Macrobond

Sweden: Household debt



Source: Swedbank Research & Macrobond

Both the Riksbank and the Swedish Financial Supervisory Authority have made statements in favour of introducing binding legal limitations on the debt-to-income ratio of borrowers. One proposal that has featured often in the debate is a borrowing restriction of six times disposable income. According to our calculations, this would work out on a national basis, but with far-reaching regional effects. A debt-to-income restriction in accordance with the proposal would impact the metropolitan regions considerably; primarily Stockholm, where the tenant-owned apartment market in particular would be affected. In the first quarter of 2016, tenant owners had just over SEK 600,000 in disposable annual income, which means that a debt-to-income restriction would limit the loan sum to SEK 3.6 million. The average price of a 90 m² apartment in Stockholm was SEK 4.96 million in the first quarter, a difference of around SEK 1.4 million. In the Gothenburg region, the current price level largely equates to a debt-to-income ratio of six times disposable income.

Any introduction of a binding legal debt-to-income restriction would put significant pressure on prices, primarily on tenant-owner apartments in the Stockholm region, a factor that would at the same time mean a restriction for continued production of new homes. One alternative is that new production moves further away from the heart of the region to a greater degree with increased strain on infrastructure as a result.

Falling unemployment but bottlenecks worsening**Recruitment problems increasing but slow rise in wage growth**

The labour market continues to strengthen with good employment growth and falling unemployment—a development that is largely expected to continue during the next few years. Unemployment will fall to a low of 6.3% in 2017 and then rise towards the end of 2018. This is clearly lower than the equilibrium level of 6.7%, as estimated by the Swedish National Institute of Economic Research (NIER). Recruitment problems have begun to emerge, and signs of bottlenecks are spreading. While there are likely several explanations, there are clear signs that a growing proportion of the available labour supply does not have the skills to match employers' needs. There is also reason to believe that the increasingly difficult housing situation in the country's large and medium-sized urban areas is hampering recruitment.

Upcoming wage negotiations expected to be fraught with tension

The continued high demand for labour increases the risks for another difficult bargaining process this winter, with growing tensions between different sectors. The industry, which tends to set the norm, is being met by continued tough international competition, while the more sheltered domestic sectors are enjoying strong demand. All in all, the labour market situation points towards wage increases in the coming years. The relationship between resource utilisation and wage growth has, however, weakened in the wake of increased internationalisation, as ample spare capacity in Europe is holding back wage growth. We expect a gradual rise in wages over the next few years, especially in the form of wage drift, from just under 2.5% in 2015 to around 3.5% in 2018.

Labour costs rising faster than wages

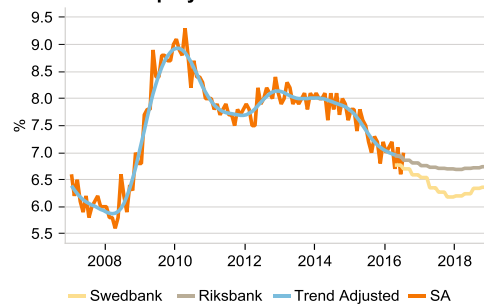
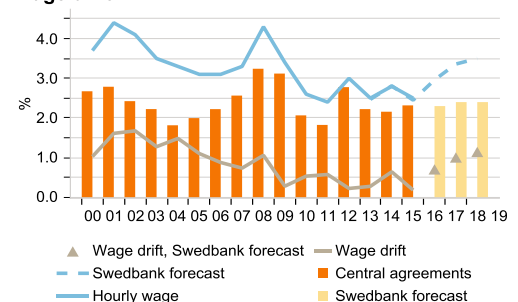
Labour costs are anticipated to increase more than that. The removal of the tax subsidy for youth employees is a factor, but there is also a greater element of increased provisions for pensions, shorter working hours, and higher overtime payment in the latest collective bargaining agreements. Productivity during the forecast period will end on an average of around 1%—a historically low figure. Overall, this means that unit labour costs will rise to just over 2.5% per year during the forecast period, which is about 1 percentage point higher than the average in 2013-2015. From a Riksbank perspective, higher cost pressure is an important prerequisite for a more permanent rise in domestic inflationary pressure.

Rising unemployment in 2018

While employment growth is gradually slowing, the workforce continues to grow (about 1% per year); this will be reflected in rising unemployment in 2018. The large number of asylum seekers in recent years are now obtaining residence permits and being transferred to the labour market programmes. The number of asylum seekers has decreased significantly this year, and the planning assumption has now been reduced to 34,500 people this year and to 51,200 next year, according to the Swedish Migration Agency's July forecast.

Large differences between Swedish and foreign born

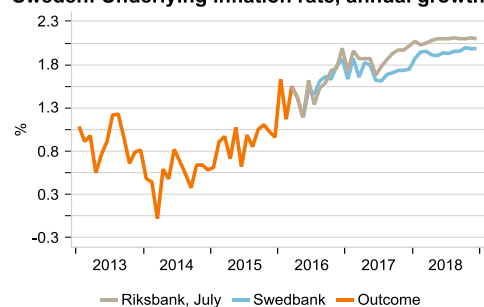
The polarisation of the labour market, which is already considerable, will become even more evident in the next few years. Even at present, unemployment is increasing among people born outside Europe, and these represent more than 40% of the registered unemployed. Nearly half of the participants in labour market programmes for immigrants do not have upper-secondary degrees, while the unemployment rate for native Swedes aged 25-54 is now falling rapidly and nearing 2.5%. One positive sign is that the youth unemployment rate is dropping sharply, both for native Swedes and foreign borns, even if the difference is still significant—16% and 32%, respectively. Foreign borns will in the coming years account for virtually the entire increase in the labour force, while the labour supply of Swedish born persons will decline.

Sweden: Unemployment**Sweden: Central agreement, hourly wage and wage drift**

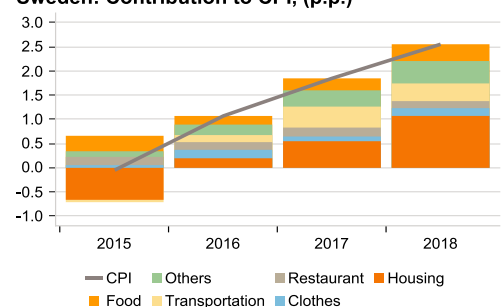
Imported inflation to fall**Underlying inflation remains subdued****Slow rise in inflation**

Inflation has continued to rise in 2016, albeit at a slower pace than expected, and the rate is still below the Riksbank's target of 2%. Inflation has been driven by the rising price of services in the domestic market, while imported inflation has fallen. The previous restraining effect of housing costs on the CPI has decreased during the year in connection with the beginning of a slow rise in interest costs, which had been falling since the end of 2013.

Global inflationary pressures are expected to remain weak throughout the forecast period, although supported by gradually rising commodity prices. Imported inflation is limited by an expected appreciation of the Swedish krona. Rising unit labour costs are expected, however, to push up inflation, particularly in the services sector. At the same time, though, fierce international competition will limit the ability of companies to raise prices. The contribution of housing costs to inflation is expected to rise, given higher energy prices and slightly higher interest rates. We expect the annual rate in terms of CPI to reach 2% during autumn next year and rise to 2.7% by the end of 2018. Excluding for higher interest rates, the CPIF is also expected to increase, although at a slower pace, and we do not expect that CPIF inflation will reach 2% during the forecast period.

Sweden: Underlying inflation rate, annual growth

Source: Swedbank Research & Macrobond

Sweden: Contribution to CPI, (p.p.)

Source: Swedbank Research & Macrobond

In-depth 2: The Riksbank is in the process of changing target variable

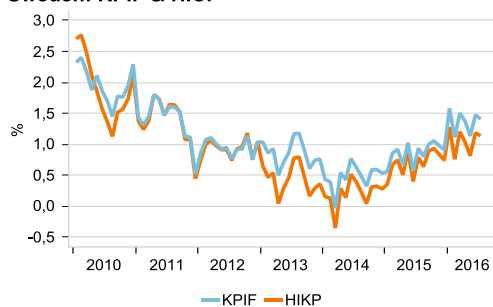
The Riksbank appears to be close to a decision on changing the target variable for monetary policy, and we expect that this will be presented in the autumn. The Riksbank's Executive Board probably prefers the HICP instead of the CPIF, in order to facilitate international comparison. A transition to the HICP would signal a somewhat softer monetary policy than a transition to the CPIF, as the HICP is expected to be below the CPIF by 0.2-0.3 percentage point for the foreseeable future. Judging by a speech by First Deputy Governor Kerstin af Jochnick, a discussion is also under way about the reintroduction of a tolerance interval around the 2% target. We believe it is more uncertain if this is really the right time to re-introduce an interval. It would risk damaging the credibility of the inflation target and the credibility of the Riksbank in pushing over the past years to bring inflation back to precisely this 2% target. We believe that the introduction of a range would increase uncertainty and be perceived as a signal of a tighter monetary policy.

The difference between CPIF and HICP

The crucial difference between the CPI and the HICP is the application of mortgage interest costs. In the CPI, the interest rate index is set as a constant, but the capital stock index of the CPI calculation includes the full weight of the interest component. As house prices have risen since 2000, housing costs have a greater impact on CPIF inflation going forward, especially when the effects of the low house prices in the mid-1990s fade away.

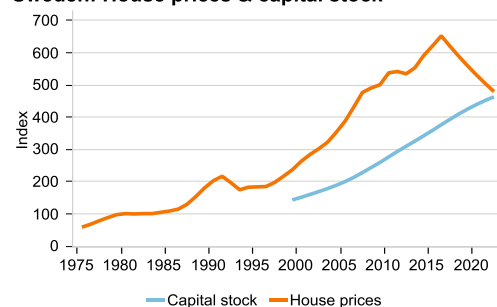
The HICP excludes both interest rates and the house price component. Historical wealth effects that are included in the CPIF are, therefore, not included in the HICP, and the latter might thus be a better indicator for measuring the underlying inflation rate. The consumption basket of the HICP consists of about 85-90% of the total CPI basket, from which property taxes, depreciation, and homeowners' insurance are excluded. In total, housing costs account for 14% in the HICP, compared with 25% in the CPI and CPIF. The calculations in the HICP are not affected to the same degree as the CPIF by shifts in consumption patterns.

Sweden: KPIF & HICP



Source: Swedbank Research & Macrobond

Sweden: House prices & capital stock



Source: Swedbank Research & Macrobond

The correlation between the CPI and HICP has historically been high (0.94% in 2005-2016), but we believe that this will decrease in the future. Since 1999, HICP inflation has averaged between 0.1 and 0.2 percentage point higher than CPIF inflation, but the difference has disappeared over the last two years. If the house price component is excluded from the CPI (an approximation of the HICP), the inflation rate is reduced by 0.3 percentage point for the coming years. It is the strong rise in housing prices that is leading the CPIF to increase faster than the HICP. The decision to adjust for the tax deductibility of the interest in the CPI and CPIF beginning in 017, however, reduces the difference somewhat. Meanwhile, Statistics Sweden aims to introduce a new calculation method for tenant-owner properties; this would mean that tenant-owners' interest costs are included in the CPI and CPIF. The effect is expected to be of the same magnitude as the change of the interest deduction, but with the opposite sign.

Riksbank on hold in near future**The Riksbank to stay on alert in a weak environment**

Inflation surprised on the upside in July and is just over 0.1 percentage point above the Riksbank's latest forecast. This, combined with a continued strong performance of the domestic economy and the labour market, and the Swedish currency being slightly on the weak side, suggests that the Riksbank will refrain from taking further monetary measures in the near future. The pressure on the Riksbank, however, remains high, and it will remain ready to take further measures for a long time to come.

Other central banks will remain soft

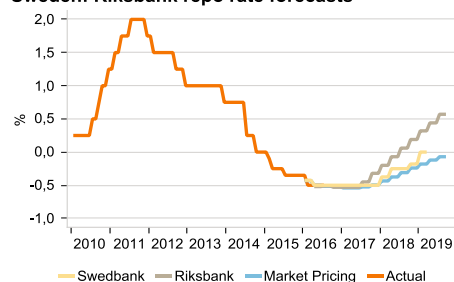
There is considerable uncertainty about the international economic and inflation situation, and this has increased after the British decision to leave the EU. Globally, central banks remain soft. The long-expected interest rate hike in the US has been long in coming. The Bank of England has cut interest rates and restarted the bond purchase and loan programmes in the wake of the UK EU referendum. We do not anticipate any further action from the ECB in the near future. However, it is likely that the ECB will extend its bond purchase programme until the autumn of next year, albeit with a gradual scaledown.

Asset purchases likely extended into 2017

The Riksbank's asset purchase programme runs until the end of the year. We believe that it is likely that the Riksbank will also extend its programme, at least until mid-2017, and that this will be announced in October or December. The major sticking point is whether the Riksbank will continue with only government bonds, nominal and real, or if it will broaden the programme to include municipal and/or covered bonds. Liquidity in the nominal government bond market is gradually deteriorating, a development that is likely to be accentuated in line with the Riksbank's holding an increasing share of the government bond portfolio. The Swedish National Debt Office's decision to cut bond issuance further reduces the supply of bonds. During the second half of this year, the Riksbank plans to buy a total of SEK 30 billion of nominal government bonds; this, together with the Riksbank's reinvestment of maturing loans and coupons, would mean that the Riksbank at the end of the year will hold about 42% of the outstanding bond portfolio (if the short-bond SGB 1051 maturing in August 2017 is excluded).

No move on policy rate until 2018

Swedbank's main scenario is that the Riksbank maintains the repo rate at negative 0.5% throughout 2017. While there is certainly a willingness to try to get away from negative interest rates as soon as the opportunity arises, we believe that this will be difficult, given the soft approach that the leading central banks around the world are adopting. Although Swedish inflation is now moving upwards, this rise is fragile and volatile and, in our opinion, not sufficient to get the Riksbank to take action during the second half of 2017, which currently is their own forecast. It is estimated that there will be scope in 2018 for a few cautious repo rate increases, and the repo rate is expected at 0% at the end of 2018.

Sweden: Riksbank repo rate forecasts

Sources: Swedbank Research & Macrobond

Interest and exchange rate forecasts (%)

	Outcome		Forecast					
	2016	2016	2017	2017	2018	2018		
	24.Aug	31 Dec	30 Jun	31 Dec	30 Jun	31 Dec		
Interest rates								
Swedish repo rate	-0.50	-0.50	-0.50	-0.50	-0.25	0.00		
10y government bond rate	0.1	0.2	0.2	0.4	0.7	1.0		
Exchange rates								
EUR/SEK	9.47	9.20	9.00	8.90	8.90	8.90		
USD/SEK	8.40	8.47	8.49	8.09	8.09	7.95		
NOK/SEK	0.98	1.01	1.01	1.00	1.02	1.02		
KIX (SEK)	111.5	109.1	107.5	107.8	107.7	107.4		

Sources: Macrobond and Swedbank

Public finances to show surplus**Fiscal policy recharge leading up to the 2018 election**

The monetary policy toolbox is becoming increasingly empty, and the impact of further easing is limited. This has led to calls for a more expansionary fiscal policy. We believe that the government will listen only half-heartedly to these demands. This spring, the government, together with the Left Party, presented a mildly expansionary budget without substantial structural reforms. The government also abandoned its principle of "fully financed" new expenditure. Since then, all parties in parliament except the Sweden Democrats have agreed on a fiscal policy framework, including a new surplus target. The new target means that public sector financial savings over the business cycle should be about 0.33% of GDP (compared with 1% of GDP today). Growth in the Swedish economy has also been strong, with higher tax revenues as a result. This, together with temporary factors, is expected to generate a surplus in the state budget this year. In addition, the lower numbers of refugee arrivals is expected to lower migration costs below the previous forecast.

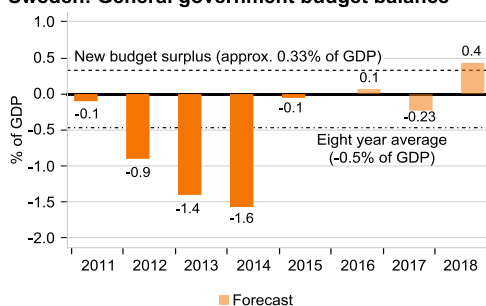
Tight budget expected ahead of 2018 elections

This year's surplus will turn into a deficit in 2017, as the higher tax revenues, part of which have been of a nonrecurring nature, level out while the integration costs remain high. In the autumn budget, we expect a number of structural reforms to improve the integration of new immigrants into the labour market. Some educational sector investments and larger subsidies to households are also in the cards. These are expected to be implemented in the main in 2018.

The pressure will increase, ahead of the parliamentary elections in 2018, to meet the demands of the coalition partners and to show decisiveness. Tax subsidies for “green” companies are likely. The government is also likely to want to show a budget surplus close to the new surplus target. Therefore, we believe a slowdown in public consumption and welfare investments at the municipal level (schools, housing, and infrastructure) will be justified through the strengthening of sustained growth.

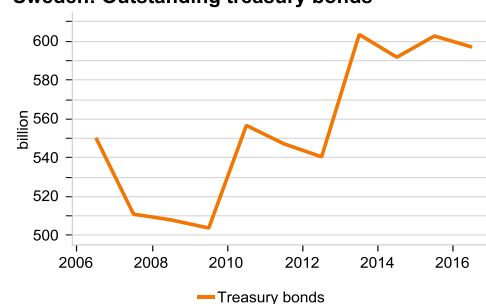
Looking ahead, we anticipate bond issue volumes at municipal and regional level rising at a somewhat slower pace, at least in the short term. Permanently larger government subsidies and favourable tax revenue in the short term will reduce borrowing needs. Government net borrowing needs have decreased significantly this year, and our forecast of the public sector's financial savings includes the risk that the Swedish National Debt Office makes further downward adjustments to bond issuance for 2017-2018 (the Swedish National Debt Office's latest forecast is that SEK 77 billion in nominal government bonds will be issued).

Sweden: General government budget balance



Source: Swedbank Research & Macrobond

Sweden: Outstanding treasury bonds



Source: Swedbank Research & Macrobond

Advanced economies: Still in need of support

Advanced economies continue to be suffering from only a weak recovery, with reoccurring negative events. The UK decision to leave the EU was a negative surprise that will weigh on growth there for a significant time, but the immediate effects on markets has so far proved transitory. Growth in the euro area is uneven, and in the US slower than anticipated. The weak recovery since the financial crisis, together with slow productivity growth, increases political strains and puts the focus on the political outlook. All major economies will still be in need of economic stimulus over the forecast period.

Euro area: Slow growth continues

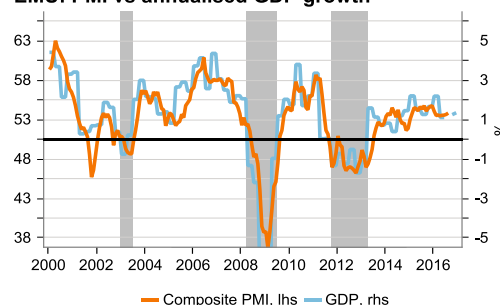
GDP in the euro area grew by 1.1% in second quarter (annualised rate). Growth continues to be uneven across the main economies. Growth remains strong in Spain, at close to 3%, and fair in Germany, at about 1½%, much in line with the purchasing managers' index (PMI) and other surveys. But despite clear improvements over the past year, both the French and Italian economies reported zero growth in the second quarter, and business barometers are providing less precise indications of future developments.

Overall, most surveys indicate continued 1-1½% growth in the euro area. Our forecast is in the upper end of this range. Nevertheless, we see little scope for growth to accelerate substantially. Growth in manufacturing production has softened in recent months and new orders have been weak, suggesting there is little more for European manufacturing to gain from a weakening of the euro. Consumer confidence has fallen through the year. Even if it remains above average in all the largest euro area economies, this fall suggests slower growth in private consumption ahead, and retail sales were indeed close to unchanged in the second quarter.

On a more upbeat note, real investments have been rising continuously for two years and will most likely continue to grow in the years ahead; however, the rise so far has been relatively slow. Investments still seem to be dampened by access to credit. The banking sector has largely passed the stress tests, and credit is expanding both to businesses and to households, but serious concerns remain in some countries about its capitalisation and profitability. Banking shares have had a horrible year, reflecting investors' increasing concerns about these issues; however, share prices have stabilised recently, and both funding spreads and corporate credit spreads have narrowed.

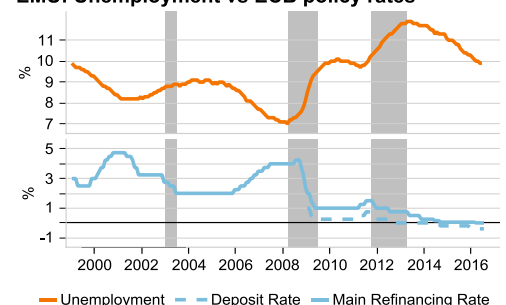
Despite slow growth, unemployment is falling in almost all countries in the euro area. Importantly, this is due to expanding employment, which is boosting households' incomes even if wage growth remains low. The level of unemployment is still high, however, and there are no signs of wage or price pressures anywhere. Consequently, it remains legitimate for the European Central Bank to pursue an exceptionally expansionary monetary policy for quite some time yet. The scope for further easing in monetary policy is limited at this point, and we expect any adjustments made would have little impact on the economy. Although fiscal policy could turn slightly more expansionary, it will remain constrained by high debt levels in many countries and by political resistance in others.

EMU: PMI vs annualised GDP growth



Sources: Swedbank Research & Macrobond

EMU: Unemployment vs ECB policy rates



Source: Swedbank Research & Macrobond

Uneven growth in main economies

Limited upside to our growth forecasts

Weak banks a threat to investments

In-depth 3: Brexit – UK dealings and the impact on the euro area

Summer came and the Brexit drama subsided. The transition to a new government was surprisingly smooth. David Cameron was replaced as Prime Minister with Theresa May, who is described as goal oriented and pragmatic. In July, she announced her new cabinet, with two new portfolios led by prominent Brexit proponents: the Department for International Trade under Liam Fox, and the Department for Exiting the European Union, headed by David Davis. The last of the “Three Brexit Musketeers,” Boris Johnson, was appointed Foreign Minister.

The “wait-and-see” phase

The UK government is not yet ready to invoke Article 50, which initiates a two-year negotiation period for exiting the EU. Furthermore, key ‘Brexiters’ disagree on what relationship the UK and the EU should have. PM May has repeatedly said that she will not invoke Article 50 before early 2017, but an unprepared Whitehall could cause a delay of the formal exit process.

PM May has been clear that “Brexit means Brexit” and this remains our baseline. There are, however, some factors that could alter the situation. First, Scotland and Northern Ireland overwhelmingly voted to remain in the EU. The risk of a UK break-up could change the dynamics. Second, the main opposition party, Labour, is in upheaval. On September 24, Labour’s leadership election will be held. Labour leader Jeremy Corbyn’s rival, Owen Smith, has suggested the possibility of a new EU referendum. Thus, the political situation in the UK remains very fluid at the moment.

Meanwhile, the preparations in the EU are continuing. On September 16, the EU’s 27 leaders will meet for an informal meeting to discuss further reforms and the development of the ‘new’ EU27. Furthermore, the union has appointed the French politician and Brussels insider Michel Barnier as chief Brexit negotiator.

Not a walk in the park

Aside from the question of UK membership or access to the single market, there are numerous additional issues that must be agreed upon. Deals on European security and defence are a few, but also accession to a full WTO membership on its own must be negotiated. All negotiations are likely to exceed the two-year window after the Article 50 trigger, and they will likely be flavoured by much creativity. In sum, the general uncertainty looms large.

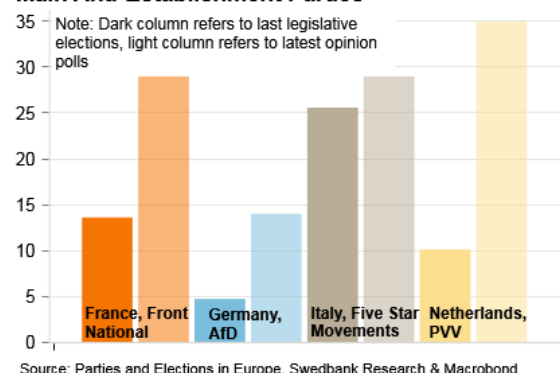
Economic consequences for the euro area are likely small...

On balance, weaker developments in the UK will of course have a negative impact on the euro area economy – but the impact is likely to be limited. Private consumption is the main driver for growth in the euro area, and there is no good reason to believe that ordinary Europeans will cut their spending because the Britons have voted to exit the EU. Consumer confidence remains above average, unemployment is falling, and inflation is low. That is what matters to households. A weaker UK economy will likely demand fewer imports from the euro area, but this amounts to no more than 2.5% of euro area GDP, and, as long as the UK economy does not collapse entirely, the impact will not be large. Business investment is more at risk; however, given that exports to the UK are such a small part of their market, there is little to suggest that companies will cut investments massively unless they see serious indications that the entire European project is at risk.

...but political risks have risen

The political consequences for the euro area are harder to predict. The worst-case scenario is a full break-up of the EU, and, with it, the euro. This scenario would presumably come about as populists receive support for EU referendums in several countries, including the Netherlands, France, and Italy. Should a ‘core’ EMU member choose to leave, the whole European project would be at risk, as faith in European institutions such as the ECB would fade. This would not only create economic uncertainty but also fomenting discontent, stirring up nationalist sentiments, and weakening political cohesion. But Brexit could also result in long-needed EU reforms and changes that could boost public support over time.

Main Anti-Establishment Parties



Indeed, the chaos and upheaval in the weeks following the British referendum seem to have made people see leaving the EU as a big gamble. In our view, what we have witnessed was most likely only a Brexit, not the end of the EU. Even so, the upcoming referendum on badly needed constitutional reform in Italy, which PM Renzi has chosen to interpret also as a vote of confidence, may create uncertainty during the autumn. A “no,” which is not unlikely, will be another challenge for the whole European project.

Referendum outcome to dampen growth going forward

Forceful BOE response and fiscal policy will manage to prevent recession

Brexit uncertainty still major risk factor ahead

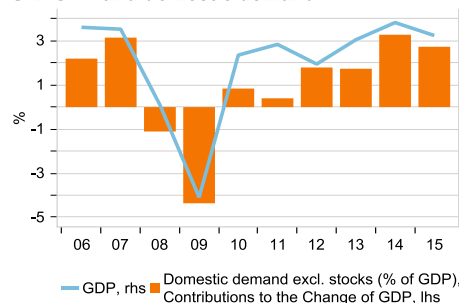
UK: Brexit woes weigh heavy

Growth in the first half of 2016 was surprisingly solid despite referendum uncertainties. However, the surprising outcome will affect growth ahead. We expect that domestic demand will weaken significantly, with business surveys signalling a slowdown and consumer confidence materially lower. Hiring intentions have continued their downward trend and are expected to translate into weaker demand for labour. House prices have started to fall and the commercial property markets are slowing. Some of the economic slowdown, however, is expected to be offset by an improving trade balance, but policy stimulus will also play a role.

In August, the Bank of England (BOE) considerably loosened its monetary policy. Going forward the BOE will face a trade-off between weaker growth and rising inflation due to the weaker pound. We expect another rate cut and, thus, a period of above-target inflation, tolerated by the BOE. The bank rate is forecast to be cut already in November to 0.05% and will stay there until 2018. Add to that a more supportive fiscal policy, and the UK is expected to avoid recession.

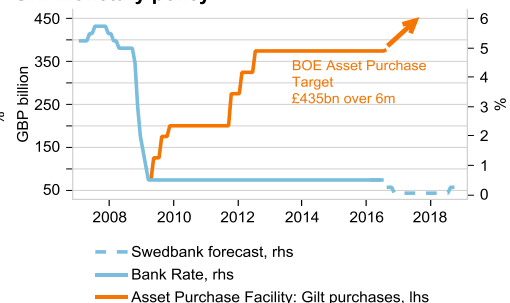
The uncertainty associated with the GDP forecasts is high and the risks, relating to Brexit and the housing market, are significant. The new PM Theresa May has signalled that the UK will invoke Art. 50 in early 2017, but this could be postponed, causing further investment, trade, and recruitment uncertainties. (For an extended analysis, see In-depth 3).

UK: GDP and domestic demand



Source: AMECO, Swedbank Research & Macrobond

UK: Monetary policy



Source: BOE, Bloomberg, Swedbank Research & Macrobond

Economic growth and inflation to remain modest

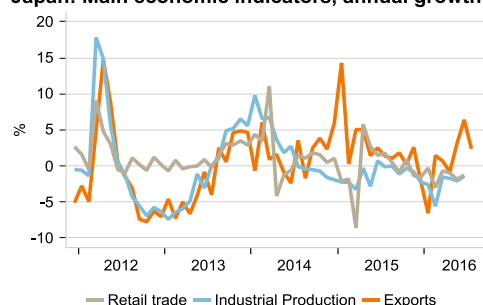
Current efforts by the government might not be enough

Japan: Challenging times ahead

More than three years have passed since the launch of Mr Abe's ambitious macroeconomic programme. But economic growth remains fragile and inflation far from the target. Preliminary GDP data show that the economy barely grew in the second quarter. The Japanese economy felt the impact of Brexit mainly via heightened volatility in the financial markets, which added upward pressure on the yen. The yen strengthened substantially, hurting Japanese exporters and putting downward pressure on import prices, and thus holding down inflation. We expect growth to pick up slightly next year. A tightening labour market will gradually lift real wages and push up consumer confidence. Another supplementary budget, to be adopted this fall, and the postponement of the value-added tax hike will support domestic demand.

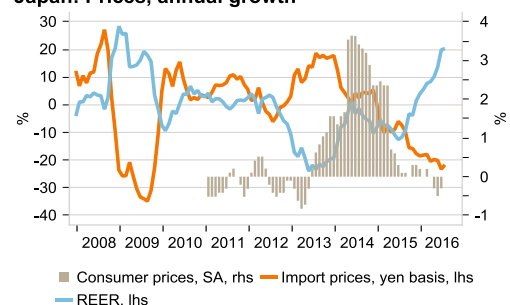
The Bank of Japan (BoJ) decided to double its exchange-traded fund purchases at its latest meeting in July but more needs to be done to meet its current inflation target of 2.0%. Unfortunately, the range of possible monetary instruments for the bank to use is narrowing. The BoJ might run out of bonds to buy (it already owns more than one-third of all the government bonds outstanding). Lowering the already negative interest rate on banks' excessive deposits with the BoJ will not encourage lending. The effectiveness of the current monetary policy is to be assessed in September. Expanding current instruments much further would not have a meaningful impact on achieving the price target; however, something needs to be done, when prices fail to increase.

Japan: Main economic indicators, annual growth



Source: Swedbank Research & Macrobond

Japan: Prices, annual growth



Source: Swedbank Research & Macrobond

US economy chugs along, thanks to domestic demand

Households the important engine for growth

Turnaround in inventories expected

Increasingly less slack available in the labour market

Inflation continues to trend higher, energy prices upside risk

The cycle is maturing and weak productivity gains will limit growth, going forward

Low global interest environment constrains Fed to normalise interest rates slower than they would prefer

US: The cycle is maturing and the Fed is constrained

The US economy sent mixed messages during the first half of this year. Growth disappointed, indicating that the slowdown from late 2015 continued into 2016. Job creation also slowed somewhat, though not dramatically. However, underlying growth appears to be stronger. In particular, household spending has been solid. Sentiment indicators suggest that this will prevail going forward.

Household consumption, two-thirds of US GDP, is an important contributor to economic growth, and spending picked up in the second quarter, in line with our earlier forecast. Wage increases have stayed above 2% since mid-2015, with disposable incomes also growing at a healthy pace, albeit slowing somewhat during the spring and summer. Buoyant consumer credit, low energy costs, and the housing market are also providing support. We expect these factors to remain in place, with households contributing sizably to economic growth. Nevertheless, rising inflation and tighter monetary conditions will slow household spending towards the end of our forecast.

Inventory drawdowns reduced headline growth in the second quarter by a whopping 1.3 percentage points—these drawdowns have been weighing on growth for five consecutive quarters now. As always, this component can be ambiguous. Strong retail sales suggest, however, that the drawdowns are due mainly to companies' underestimation of demand, rather than expectations of weaker sales ahead. Inventories are thus expected to normalise as production is realigned with demand.

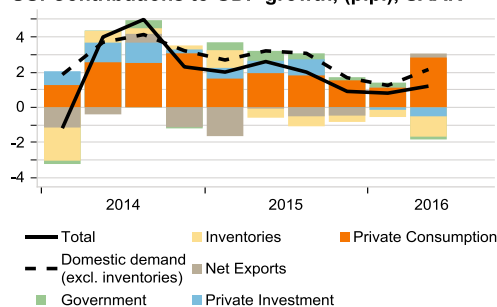
The US labour market is increasingly showing signs of firming up, despite somewhat slower job creation recently. With official unemployment holding steady at just below 5.0%, the labour force participation rate appears to have reversed its falling trend as reentrants to the labour force increase. Despite this, underemployment is also developing sideways. Vacancies are increasing, while new claims for unemployment insurance are at low levels. Hence, we posit there will be increasingly less spare capacity available, leading to wage inflation at current or higher levels going forward. This will boost household spending and drive inflation, as higher wages are passed through to consumer prices.

Since mid-2015, inflation has been trending higher. Core consumer prices (CPI) have exceeded 2% for some time, while prices for core personal consumption expenditures (PCE) are growing at about 1.5% currently. Supported by wage growth and increasing energy costs, and in line with our forecast, inflation is expected to continue rise over the horizon, albeit slowly.

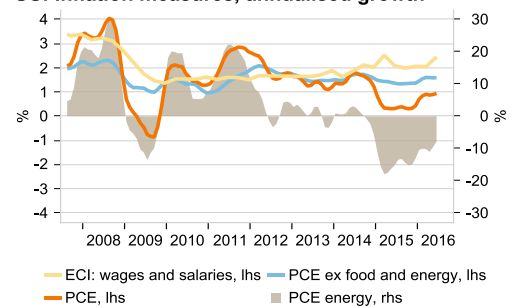
Meanwhile, the economic cycle is increasingly showing signs of maturing. Corporate profit levels are slowing despite buoyant consumer spending. Investments are, similarly, abnormally weak and contributing negatively to growth. Therefore, the US business cycle is likely maturing, with growth expected to slow during 2018. However, a pickup in investments is an upside risk to our forecast. The US, like many economies, has seen productivity growth fall in recent years -- to a dismal 0.5% annual pace. Growth in hours worked is unlikely to continue to support growth as the labour market firms. Thus, trend growth will fall, in line with the slowdown in our forecast for 2018.

After one hike of 25 basis points later this year, we expect that comparatively strong domestic fundamentals will support the Federal Reserve's (Fed's) intentions to continue normalising interest rates. We expect the Fed to be torn between wanting to hike, in order to contain domestic inflation impulses, and needing to maintain interest rate differentials with dovish central banks to prevent the dollar from strengthening excessively. Overshooting the 2% target will be tolerated to a certain extent. The Fed will, instead, balance demands by hiking the policy rate by 25 basis points once in 2017 and twice in 2018. With a forecast policy rate of 1.50% at the end of 2018, our assessment of the federal funds rate is a full percentage point lower than the Fed's own estimate, yet notably above current market pricing.

US: Contributions to GDP growth, (p.p.), SAAR



US: Inflation measures, annualised growth



In-depth 4: The Economics of Populism

Populism is to promise simple solutions to complicated problems. The Brexit vote can be seen as the first major casualty of populism in Europe since the financial crisis. The UK election was fraught by divisive rhetoric. The cost of EU membership was misrepresented and migrants were blamed for taking jobs and lowering wages. In the US, Bernie Sanders and Donald Trump condemn the “Establishment” and the free trade consensus for weak growth, while providing unrealistic economic promises. Populist parties are advancing in polls across Europe. Next year, both France and Germany will hold elections. A better understanding of populism and its ties to the economic dynamics will be important in coming years.

Is the rise of populism an effect of weak economic growth, or is it a consequence of changing social values and high immigration? How will economic policy be affected by the rise of populism in Western countries? Populism is by no means a new phenomenon. Yet, the economic foundations for the rise of populism in recent years have not been widely studied or understood. Very little academic research in economics is available on the connection between populism and the economic development. In the media, and among political and economic commentators, several explanations for the rise in populism are being discussed. High immigration and changing social values (in the US, gun control, same sex marriages and abortion are such divisive social issues) as well as stagnant wage growth, austerity measures and high unemployment are often put forward as explanations.

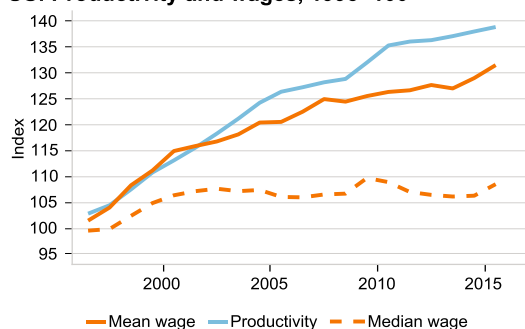
We have three key messages on the topic of the ‘Economics of Populism’. First, we caution against attempting to find simplistic explanations for the rise in populism. It is reasonable to assume that social values, and immigration as well as economic explanations, are all playing a role in fuelling populist movements. These factors will affect different countries to varying degrees. In addition, they also interact. For example, high migration is partly a consequence of differences in economic development across countries. In times of economic weakness, people may turn to traditional social values and long for a return to past, more prosperous times in order to find comfort in a turbulent world.

Second, economic factors are important. The global economic downturn following the financial crisis has been the worst since the 1930s, an era that was also characterised by populist movements. Absolute, relative and expected economic developments affect individuals’ sentiment. Negative economic shocks such as lower real wages and high unemployment matter greatly. In addition, behavioural economics tells us that individuals also care about their economic position relative to others in society as well as to their prior expectations. The economic outcome since the financial crisis has been much worse than anticipated and has been characterised by growing inequalities in society. (See graph). Many groups have been falling behind in both relative and absolute terms. In the US, real wage growth has been stagnant since the crisis and median real wages since long before the crisis. In the UK, real wages have been falling (see graph). One’s feeling of relative loss may be exacerbated by the perception that one’s economic misfortune, relative to expectations, has been coupled with the perceived economic rise of ‘the others’ (read immigrants).

Third, populism is affecting economic policy and will continue to do so. Populism influences the economic agenda even in countries where they do not directly take part in the government. The influence of UKIP in the UK is an example. Its rise was an important factor in making Cameron announce the Brexit referendum and the party heavily influenced the campaign. Another example is Clinton’s protectionist rhetoric in the US, which would likely not have played as important a role had Sanders and Trump not risen to prominence. In Europe, we see that the rise of populism makes it difficult to implement unpopular structural reforms. As such reforms are needed to strengthen long-term potential growth, populism is affecting growth prospects.

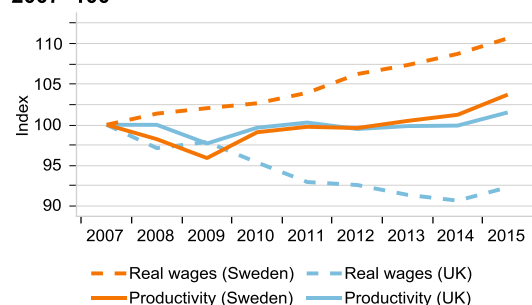
There are few, if any, simple solutions to the complicated challenges facing Western economies today. Low growth is partly a consequence of the financial crisis. But weak growth is also a result of underlying structural challenges related to a slowdown in productivity growth and aging populations. Without higher productivity growth, it is unlikely that real wages will rise very much. The rise of populism is reminder that it is imperative for policy makers to take these issues seriously. We therefore need ambitious reform agendas and brave economic policy makers to improve long-term prospects. Populism is not making it easier.

US: Productivity and wages, 1995=100



Källor: BLS, OECD, Swedbank Research & Macrobond

UK/Sweden: Real wages and productivity, 2007=100

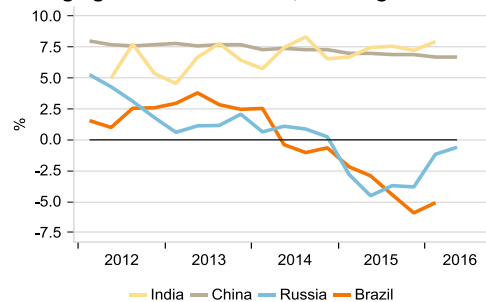


Source: OECD, Swedbank Research & Macrobond

Emerging markets: Hunt for yield

Financial flows have returned to emerging markets and economic fundamentals are not deteriorating in the same way as in 2015. Negative or low yields are driving portfolio flows from developed to emerging-market assets with few questions asked. China fears have settled after the shocking start of the year, when devaluation concerns were high. The Chinese economy is moving towards a slower growth path, with much government support. India is making political progress, as one of the most important reforms was passed in the upper house in August. In the near term, the structural shortcomings that India must deal with will restrain growth. We expect the recession in Brazil to end next year. However, we doubt that the new government will be able to push through with the necessary structural reforms. The recession has ended in Russia but the recovery will be modest.

Emerging markets: Real GDP, annual growth



Source: Swedbank Research & Macrobond

Emerging Markets: Economic Surprise Index (Citigroup)



Source: Swedbank Research, Macrobond and Citigroup

Monetary conditions and economic policy supportive for growth

China: Economic policy supportive for growth

This year started with elevated fears of the situation in China, with equities in free fall and heavy pressure on the renminbi with large capital outflows. The situation has calmed down considerably since then, even though the economic momentum has moderated. External factors, such as a softer US dollar and tighter capital controls, have played a big role. The Chinese economy continues to adjust to a lower, and, it is hoped, more sustainable, growth rate. GDP grew by 6.7% annually in the second quarter this year-- the same growth rate as in the first quarter. Growth has mainly been driven by the property market, with strong support from the government. Economic policy is still supportive of growth. The trade-weighted currency has depreciated by almost 10% in real terms since one year ago. Bond yields have fallen close to levels last seen during the financial crisis in 2009. However, we expect GDP growth to slow to 6.5% in 2017 as China continues to rebalance its economy, tilting towards more services.

Higher commodity prices have eased deflation pressures in industry

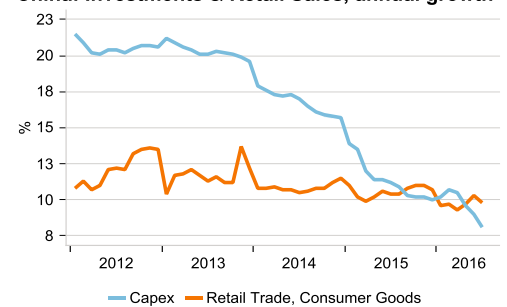
Other economic indicators have recently slowed sharply. Fixed-asset investments (nominal) are growing at the lowest rate since the beginning of 2000. Industrial production has been growing at around 6%, which is less than half the rate of five years ago. The old, commodity producing industrial sector has long been plagued by overcapacity. This will continue to be a drag on manufacturing investments but may ease in magnitude going forward. Producer prices have been falling since 2012 but have recovered sharply this year, partly because of higher commodity prices. Foreign trade is sluggish. Both export and import growth have been negative since May 2015. Meanwhile, retail sales are growing steadily, by around 10% in annual terms. We expect the Chinese economy to gradually moderate and economic policy to remain supportive.

China: Monetary Conditions Index, 2007=100



Source: Swedbank Research, Macrobond and Bloomberg

China: Investments & Retail Sales, annual growth



Source: Swedbank Research & Macrobond

Finally, some political progress, which, it is hoped, will offset monetary uncertainty

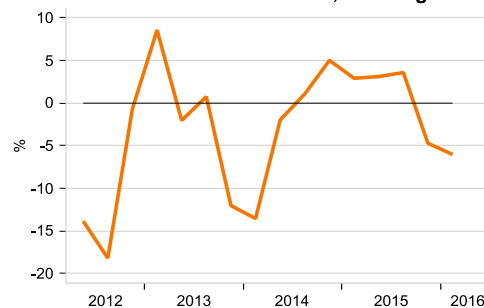
Credit growth has not picked up as banks are still burdened with bad loans

India: A major political breakthrough

India is the fastest-growing economy in the world. GDP expanded by 7.2% last year, and we expect somewhat higher growth in 2016. Long term, we believe that growth will be even higher as we expect more structural reforms to be decided and implemented. On that note, it is very positive that the nationwide goods and sales tax (GST) was passed in the upper house on August 2. The GST is a unified tax that will broaden the tax base, make it easier to transport goods between states, and reduce disputes and corruption, thereby raising potential growth. Growth is estimated to increase by an additional 1-2% once implemented. There are still details to be formalised and decided, such as exemptions, thresholds, and the rate for the tax. The plan is to implement the GST on April 1, 2017, which may be too optimistic, as there are technical and staffing issues to sort out. The legislation also needs to be approved by a GST council and at least half of India's 29 states. Nevertheless, approval of GST is a significant achievement for President Modi, as the reform process so far has been slow. It is also important for international confidence, as the well-respected central bank governor, Mr Rajan, will step down when his term ends in September, making future monetary policy somewhat more uncertain.

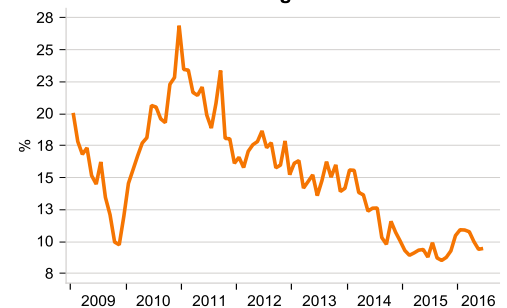
Policy rates have been cut by 150 basis points to 6.5% since 2014, but these cuts have failed to revive credit growth. Public sector banks still have a lot of bad loans on their books, which make them reluctant to pass on lower funding costs to their borrowers. It will be an important task for the new governor to continue Mr Rajan's work on improving the monetary transmission. Growth in fixed-asset investments has been in negative territory since the end of 2015; this is partly explained by high borrowing rates. But the main reason is that investments in infrastructure are hindered by bureaucracy, corruption, and project delays. Almost one-third of all construction and infrastructure projects are still delayed. Infrastructure companies are also burdened by weak balance sheets, which make them very vulnerable to time and cost overruns. So, we are structurally becoming more positive on India but see many policy challenges in the next couple of years.

India: Investment in Fixed Assets, annual growth



Source: Swedbank Research & Macrobond

India: Banks' annual credit growth



Source: Swedbank Research & Macrobond

The economy may have hit bottom but structural shortcomings will prevent a meaningful recovery

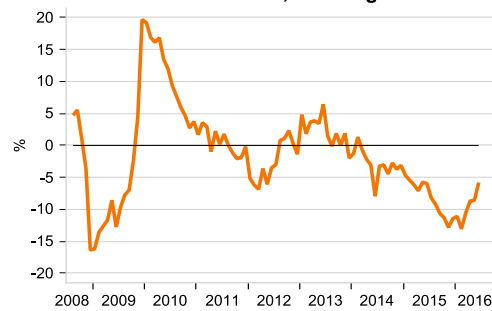
A peak in inflation opens a path for rate cuts

Brazil: Bottom in sight, but structural issues remain

Brazilian financial assets have been the star performer this year. However, this has more to do with friendly external factors, such as a weaker US dollar and higher commodity prices, than improved fundamentals. President Rousseff was forced to hand over the country's leadership to Vice President Temer while she faces an impeachment trial. Financial markets have high expectations for the new, temporary government. We are, however, doubtful regarding the new government's ability to push through with the necessary structural reforms. Brazil has been in recession since the second quarter in 2014. However, there are now some indications that the economy may have hit bottom. Recent data show that the contraction is lessening. Sentiment indicators have improved, albeit from very depressed levels, and are still very low.

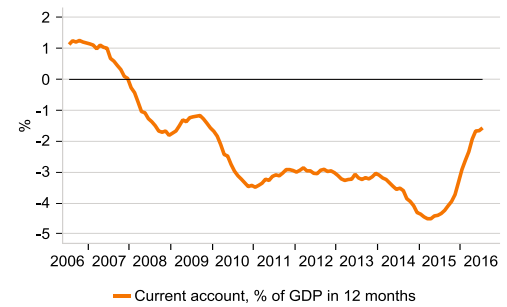
The central bank has kept its policy rate unchanged, at a 10-year high of 14.25%, since 2015, as inflation has been trending higher despite negative economic growth. A sharp depreciation of the real and hikes in administered prices kept inflation high, but these factors are now having less impact on prices. Inflation probably peaked at 10.5% in the beginning of 2016 and has since fallen below 9%. This opens up room for some monetary policy stimulus going forward. Our growth forecast for 2016 is revised upwards on the back of the recent uptick in industrial production, but the Brazilian economy is a long way from returning to a more robust expansion: economic policy will continue to be tight, and it will take years to improve the business climate. However, the Brazilian economy has probably become less vulnerable to financial shocks. The current account deficit has declined from 4.5% in 2015 to less than 2%, and currency reserves cover almost two years of imports.

Brazil: Industrial Production, annual growth



Source: Swedbank Research & Macrobond

Brazil: Current Account



Source: Swedbank Research & Macrobond

**Recession has ended;
recovery led by industry**

**Renewed slump in
construction**

**Bank of Russia to cut rates
to 9.5% by end of 2016**

**Limited diversification,
while sanctions are lifted
gradually**

**GDP will fall 0.8% in 2016,
followed by a modest 1.5-
2% recovery in 2017-2018**

Russia: End of recession, but recovery will be modest

The recession is turning out to be shallower than feared. After falling by 3.7% in 2015, in the first two quarters of 2016 Russian GDP fell annually by only 1.2% and 0.6%, respectively. On a quarterly basis we estimate the GDP expanded in the second quarter. If so, the recession ended about two quarters earlier than we had forecast. The recovery is led by the industry sector, which is benefiting from the weak rouble and import substitution. Following five consecutive quarters of contraction, manufacturing has had timid positive annual growth every month of the second quarter. Mining and quarrying is up 2.6% against the first half of 2015.

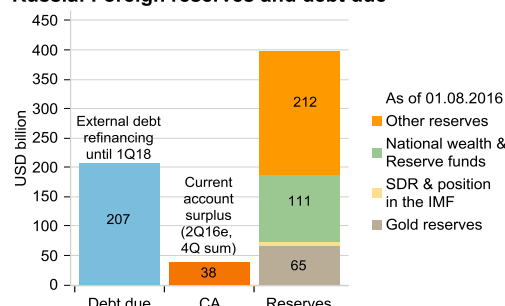
Most other sectors continue to struggle. Retail sales in the first half of 2016 were 6% lower than a year ago. This contrasts with labour market improvements – the unemployment rate is retreating (5.4% in June), and real wages are inching up. There are two main reasons for this mismatch. First, the unemployment rate masks increased part-time employment and a sharp fall in immigrant jobs; real disposable income so far this year is down 4.9%. Second, households deleverage. The credit contraction is slowing, but retail is unlikely to expand next year. The key worry is construction, which shrunk 8.2% annually in the second quarter. The renewed slump is due to the sector's financial woes (nonperforming loans have risen to 25%) and the fiscal squeeze on public investment (public investments are cut 9% this year).

Investment activity is bottoming out and should get more traction next year as the Bank of Russia continues its rate cuts (from the current 10.5% to 9.5% by end-2016). The budget deficit is aggressively financed from the Reserve Fund, but this may dry up in 2017. Despite the dwindling current account surplus (USD 16 billion in the first half of 2016; only one-third of last year's surplus), reserves are stable at nearly USD 400 billion. Unless there is a renewed capital flight (e.g., due to political risks), Russia's ability to service its debt remains good.

Economic policy – e.g., the floating exchange rate, reasonable fiscal discipline and banking system support – has mitigated the recession, but not boosted growth potential. Dependence on hydrocarbons remains high and the diversification drive is uncertain. The ongoing government reshuffle is strengthening Putin's grip on power rather than laying a foundation for a vibrant recovery. The EU is likely to ease its sanctions early next year, but only those against individuals—and lifting these does little for growth. The US sanctions are the most material, and they will not be eased in 2017. Russia has extended its sanctions against EU imports until end-2017. With the EU easing its sanctions, Russia could ease its sanctions against a smaller set of items for which imports substitution has been least successful.

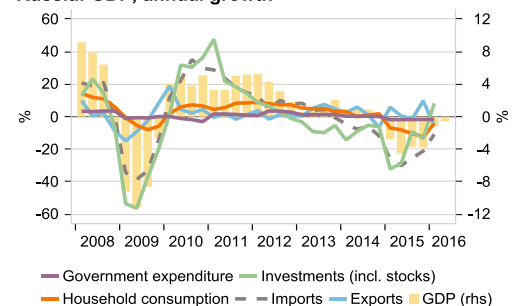
All in all, we expect Russian GDP to fall by 0.8% this year, followed by 1.5% growth in 2017 and 2% in 2018, which is about its potential given the current policies. The rouble exchange rate will fluctuate around 60-65 per US dollar in the second half of 2016, driven by the oil price and political risk. The rouble will gradually strengthen towards 58 and 52 roubles per US dollar by end-2017 and end-2018, respectively.

Russia: Foreign reserves and debt due



Source: Swedbank Research & Macrobond

Russia: GDP, annual growth



Source: Swedbank Research & Macrobond

In-depth 5: Political risks at the core of negative scenarios

The rooting-in of inequality of incomes and opportunities, weaker-than-expected economic recovery, recent refugee crisis, and terrorist attacks have provided a perfect setting for the further rise of populism, protectionism, and nationalistic sentiment in the Western world. The combination of a less united Europe, strengthening protectionist sentiments and challenges to NATO's integrity are rocking the fundamentals of the Western world and posing challenges to security, free trade, welfare, and stable and forward-looking policymaking. This creates an unfavourable environment for investment and productivity-enhancing reforms, and is at the core of the negative risk scenarios in our macroeconomic outlook.

The strengthening of nationalistic and populist political powers increases the risk of weaker ties within Europe and restricted freedom of movement and immigration. A lot is at stake, and the focus now falls on political developments in the biggest economies in Europe and euro area.

The constitutional referendum in Italy in October this year, which is considered to be a confidence vote for the current Prime Minister Matteo Renzi, could benefit the anti-establishment Five Star movement, which supports a referendum on Italy's euro membership. An impaired government may reduce Italy's ability to deal with its banking sector recapitalisation and spur yet another investor scare, driving down growth expectations and killing recovery. The French presidential election will take place in April-May next year, where the far-right, anti-EU, anti-immigration National Front leader, Marine Le Pen, is expected to reach the final round. German Chancellor Angela Merkel, Europe's most powerful leader and the anchor of EU integration, will face parliamentary elections in September 2017. Her approval ratings have suffered from the refugee crisis and terrorist attacks, while the populist Alternative for Germany party has gained support. Keeping the EU and euro area together will require more effort after the Brexit vote, as some politicians claim that their countries should now follow the suit. If Italy or France were to decide to leave the euro area or the EU, this would be the end of the common currency and the end of the 70-year-long economic integration of Europe. This would be a huge economic and political loss. It is not the most likely scenario, but it is a low-probability, high-impact event.

Russian President Vladimir Putin still enjoys an extremely high approval rating of about 80%; he will retain his support in parliament after the elections in September this year, which precede the presidential election in 2018. However, public support for the Duma has fallen. Putin's ratings are also lower than his record highs (about 90%) reached after the annexation of Crimea; that manoeuvre enabled him to increase his popularity even while the economy was nose-diving. We believe that, given Putin's current high approval ratings and the improving economy, Russia is unlikely to engage in open military conflicts. Because the European view on this issue is divided, sanctions against Russia are very likely to be eased in early 2017, but the sanctions eased will be those against individuals, which will give Russia political satisfaction, rather than economic gain. Access to financial markets could be gradually eased only in 2018. The greater the support given to populists in the US, French, and German elections, the less united the West will be, and the quicker Russia will see an easing of sanctions.

The US faces a presidential election in November this year that will be a close call between Democratic candidate Hillary Clinton and the Republican nominee Donald Trump. A Donald Trump victory, which is not in our main scenario, could raise doubts about the resolve of NATO. Most recently, NATO has been challenged by Turkey's response to the failed military coup. Turkey's change of tone with Russia poses the question, Is Turkey the Achilles' heel of NATO's existence? Turkey is housing 3 million refugees, and if it is unable to control migration flows or if it uses such flows to push the EU to gain benefits, this escalation of the refugee crisis would again serve well for the popularity of populist and nationalists.

The chances of implementing the Trans-Pacific Partnership (TPP) free trade deal and the Transatlantic Trade and Investment Partnership (TTIP) now look slim, irrespective of the outcome of the US presidential election, as Clinton has changed her stance on free trade deals during the presidential debate. China is pushing its own version of TPP, which would increase its influence in the region. Both US presidential candidates have raised concerns about the consequences of North American Free Trade Agreement (NAFTA). The failure to increase free trade flows—and, thus, the missing of a chance for higher global growth and more balance geopolitically—is part of our main scenario. The negative scenario would be slower growth due to weaker global trade if new restrictions are implemented.

Even though we expect that the majority of voters will see the risks of giving power to some of the above-mentioned saviours, those risks will still disrupt the policymaking as the political establishment tries to win back their voters or focuses on avoiding the realisation of negative political risks. This means that structural reforms will be politically harder to implement at a time when central banks are close to their limits.

Nordic area: Slowly emerging

The Nordic area outside Sweden is slowly coming out of a slump. In Norway, rising oil prices support an already solid non-oil economy. Denmark is affected by a structural decline, but underlying growth is rising. Finland is gradually recovering, but the medium-term prospects are dependent on difficult-to-implement reforms. As always, these are small, open economies subject to external developments.

Growth in the Mainland economy remains low

Norway: The worst is (probably) past

Growth in the Mainland economy remains low, but key indicators, as well as most real data, suggest that the worst is probably behind us. The contraction in oil-related industries is not over, but it is easing. Quite surprisingly, non-oil-related manufacturing still seems unaffected by the weak krone, but net exports have nevertheless contributed significantly to Mainland GDP growth over the past year. Non-oil investments are slowly increasing, total private consumption is rising, and fiscal policy remains expansionary. We expect Mainland GDP growth of 0.7% for all of 2016, a pickup to 1.4% next year, and the same growth rate in 2018 as the drag from declining oil investments subsides.

Oil unemployment has stopped rising

After rising steadily through 2015, unemployment has stabilised in recent months. Open (registered) unemployment is actually falling in most regions and has stabilised even in Rogaland, the oil-dependent county. The Labour Force Survey confirms that unemployment is stabilising but is also reporting that employment rates are declining. Though still at a low level, the number of new vacancies has risen over the past year, and both jobless claims and layoffs have turned. Overall, recent labour market developments have been significantly better than Norges Bank and most others expected only a short while ago.

No rate cut in September

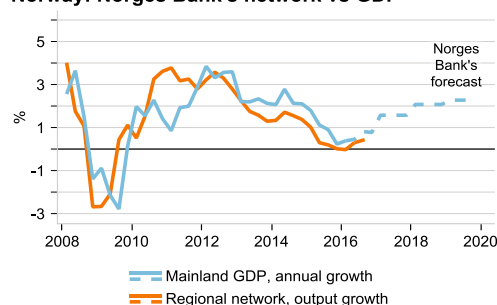
According to oil companies' estimates, investments are set to continue to decline. The bright spot is that the cuts in oil investments are slowing markedly; we expect a decline to 6% in 2017 compared with a 15% decline this year. Oil prices have fallen somewhat over the summer but not enough to materially change the outlook, and they are still well above the levels seen at the start of the year. Oil-related manufacturing has fallen sharply, along with oil investments, over the past two years. The downturn is not over yet, but all manufacturing surveys in recent months signal the beginning of a slowdown in the rate of contraction.

For the longer term, we remain positive on the krone

As was widely expected, Norges Bank kept its main policy rate unchanged in June, while sending strong signals for another cut in September, to 0.25%. Since then, data have been clearly better than expected. Overall consumption is keeping up fairly well on account of strong growth in services consumption. House prices and household debt are accelerating, and an already high ratio of household debt to income is being pushed up further. At the same time, the savings ratio is close to a record high, reducing the risk for a setback in household demand. Consequently, we expect Norges Bank to postpone the "planned" September cut, and we see unchanged rates through 2017 as the most likely outcome. If the economy recovers further in 2018, as we expect, Norges Bank will raise the main policy rate. Inflation is now above 4% but not because of domestic cost pressure; higher prices on imported goods and higher electricity prices are the main culprits. Meanwhile, wage inflation remains muted.

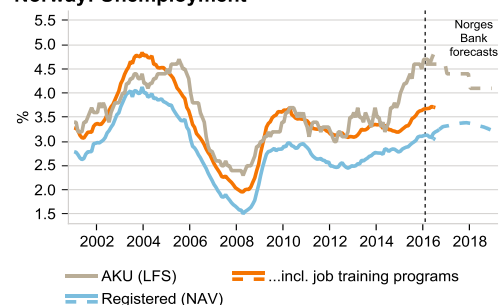
For the longer term, we remain positive on the krone. In part, our case is supported by our view on the oil price, which we think is set to rise to USD 70 /barrel by 2018. But even with oil prices at current levels, we believe cost competitiveness is not an issue for the Norwegian economy at the current levels of the krone. In the very short term, however, the risks are more balanced, as the krone has appreciated substantially, alongside a significant increase in the short-term interest rate spread vs the trading partners, following a stream of better-than-expected Norwegian data.

Norway: Norges Bank's network vs GDP



Source: Swedbank Research & Macrobond

Norway: Unemployment

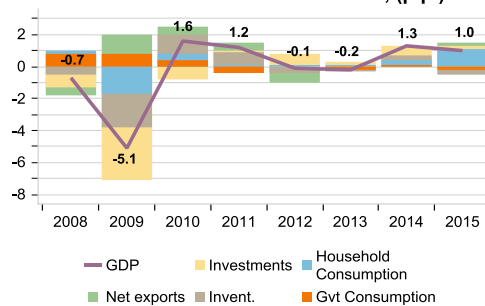


Sources: Swedbank Research & Macrobond

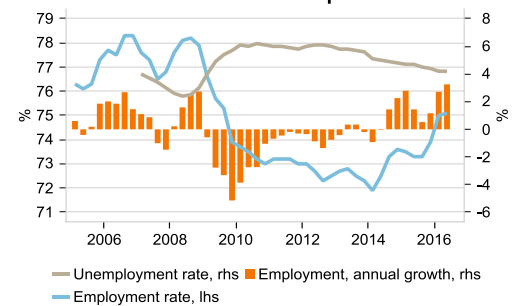
Stronger than it appears**Policy shift to contain overheating****Denmark: Gradually reaching full capacity**

The relative weak growth performance in recent years gives a misleading picture of the Danish economy. Overall growth registered at 1.3% in 2014 and 1.0% in 2015, but was dragged down by a structural decline in the extraction industries (primarily oil and gas in the North Sea). Since 2013, other sectors, such as industry, services, and construction, have contributed more positively to growth. Since these sectors are more labour intensive, the labour market has recovered strongly. Employment increased by 1.5% in 2015 and continues to grow in 2016. Unemployment is currently at 4.2%. Subsequently, domestic demand has been the most important driver of growth, while external demand has been lacklustre.

We expect growth to pick up due to solid domestic demand. In particular, household spending will remain strong. This implies that the slack in the Danish economy is gradually dissipating, creating challenges for economic policy. Monetary policy remains expansive. Following the outcome of the Brexit referendum, safe-haven inflows have increased, forcing the central bank to intervene in the foreign exchange market. With the exchange rate fixed to the euro, the main burden of managing the economy falls on fiscal policy. The government's stated intention is to reduce the budget deficit over the coming years. The main risk to the outlook is external (including the impact from Brexit and due to the dependence on trade), but households remain vulnerable to shifts in financing conditions and house price developments. Household indebtedness is at record levels, and the share of adjustable-rate mortgages is large.

Denmark: Contribution to GDP Growth, (p.p.)

Source: Swedbank Research & Macrobond

Denmark: Labour market developments

Source: Swedbank Research & Macrobond

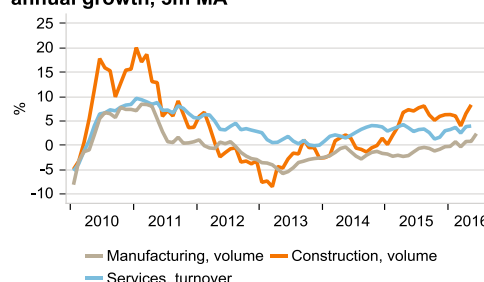
Private consumption and investments behind the GDP growth recovery**Finland: Domestic demand behind the gradual recovery**

In 2016-2018, we expect growth in Finland to improve gradually. However, the pace of the recovery will be sluggish. In 2016, domestic demand will contribute to the growth, whereas export performance will be feeble. The construction and services sectors are the main growth drivers on the production side of the economy, while output volumes in manufacturing are recovering very slowly. In 2017-2018, export growth is expected to improve, whereas private consumption will weaken.

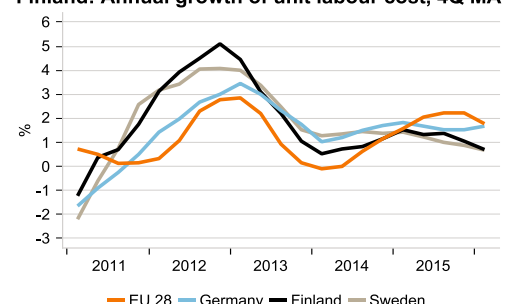
Finland has made progress in narrowing the gap between wage and productivity growth; this has contributed to an improvement in its cost competitiveness. However, its share on the export markets is declining. The structure of both exports and export markets has changed for Finland; meanwhile, finding new conditions that would support growth has proved to be complicated and unduly slow.

Reforms initiated by the government can bear fruit only in the medium term

The Finnish government has set ambitious plans for reforms in order to revive the economy and strengthen public finances. One of the most substantial steps taken thus far in the reform sequence is the signing of the Competitiveness Pact. Complementing other measures taken, this expands hours worked and reduces vacation pay for public sector workers. However, the impact of these reforms, if duly implemented, will be visible only towards the end of the forecast period (2018) or beyond.

Finland: Manufacturing, construction and services, annual growth, 3m MA

Source: Swedbank Research & Macrobond

Finland: Annual growth of unit labour cost, 4Q MA

Source: Swedbank Research & Macrobond

Estonia: More mature and more slow

We revise down the GDP growth rate in 2016 to 1.5%, primarily due to weaker-than-expected investments; meanwhile, exports are growing and consumption growth has been robust. We expect that foreign demand will improve gradually in 2017-2018. This will contribute more to export growth and to the recovery of investments and, in turn, will accelerate economic growth to 2.5% in 2017 and 2.7% in 2018. The labour market remains tight and nominal wages will continue to grow fast. However, after more than three years of deflation, consumer prices are expected to increase in 2017-2018, and this will slow private consumption.

Key economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP growth, %	1.2	1.5 (2.0)	2.5 (2.5)	2.7
Consumer price growth, %	-0.5	-0.1 (0.5)	2.5 (2.6)	2.0
Unemployment rate, % ^{2/}	6.2	6.2 (6.5)	6.6 (6.7)	6.7
Real net monthly wage growth, %	8.0	6.4 (4.6)	2.8 (2.6)	3.4
Current account balance, % of GDP	1.9	1.3 (1.0)	0.1 (0.2)	-0.7
General government budget balance, % of GDP ^{3/}	0.4	0.2 (-0.3)	-0.2 (-0.4)	-0.2

^{1/} April 2016 forecast in parenthesis

^{2/} According to Labour force survey

^{3/} According to Maastricht criterion

Economic growth weaker than expected in first half of 2016

Economic growth in the first half of 2016 was weaker than expected, and, according to a preliminary estimation (detailed transactions of the second quarter's GDP had not been released by the time of publication of the current economic outlook), growth was not broad based; its main contributors were private consumption and domestic trade. The decline in manufacturing output volume came to an end. However, a considerable decrease in oil shale mining and the production of shale oil and chemical products has kept the industrial sector, as a whole, in recession. The expected sluggish recovery of oil prices is restraining a fast and assured improvement of production conditions in these industries.

Foreign demand is expected to improve gradually in 2016-2018

Foreign demand from Estonia's major trade partners is expected to improve gradually in 2016-2018, and this, in turn, is expected to promote exports on those markets. The turnover and volume of exports of goods already made a leap upwards in the first half of the year. However, the recovery was not broad based and was driven primarily by electronic and wood products, furniture, and cereals. Since the output of electronic products contains very little value added per unit, the recovery of exports has made a relatively modest contribution to GDP growth, so far. Another issue is that a large, positive contribution to export growth has come from some distant markets, where Estonia has made only a few transactions involving certain products (e.g., cereals and shale oil products); this contribution can therefore be considered temporary. In contrast to the recovering exports of goods, the turnover of services' exports has continued to fall, primarily due to the decline in transit trade with Russia and its negative impact on transport sector value added. The outlook for the transport sector in the forecast period is impaired primarily by difficulties involving warehousing and operations of transport infrastructures.

Price competitiveness of Estonian exports continues to worsen

Industrial sector enterprises in Estonia expect an improvement of export turnover and an increase in new orders, but they estimate that their competitiveness has worsened on foreign markets during the last few years. Indeed, new orders, both export and domestic, of manufacturing enterprises have increased this year. One reason for the expected worsening of competitiveness is the excess growth of labour costs over productivity, but this does not account for product characteristics over time. Estonian exporters have managed to increase their market share in the Nordic countries (Sweden, Finland and Norway), where they have still some room for price convergence. However, their market share in Latvia and Lithuania, where price levels are more similar to Estonia's, have remained roughly flat during the recent medium-term period. Although the growth of unit labour costs is expected to slow, the pace will remain higher than in most of the major trade partners and, therefore, will continue to have a negative impact on price competitiveness, at least in the coming few years.

Investments are expected to pick up

Despite the robust growth of imports, as well as of credit portfolios and new loans of the non-financial corporations' sector, investments, surprisingly, continued to decrease in the first half of 2016. Corporate sector investments have declined now for two-and-a-half years in a row and, therefore, have contributed less to the improvement of productivity in the near future. We expect that investment growth in the corporations' sector will recover, together with the im-

provement of foreign demand in 2017 and 2018, while government will gradually increase payments for investments from the EU structural funds. Currently (end of July), only 5% of the total of EU structural funds allocated for Estonia from the EU 2014-2020 budget has been paid out. At the same time, household sector investment growth is expected to slow, along with a deceleration in the growth of transactions involving dwellings.

Besides the uncertainty of the recovery of demand, the decrease in selling prices has also inhibited investment by nonfinancial corporations. Although the decrease in export prices is receding, on average, the picture is diverse, and there are still many large economic activities, for which the decline in prices has even worsened this year. Nevertheless, industrial sector enterprises' confidence in an increase in selling prices has improved. We expect that average export prices will recover faster than import prices – this will improve the terms of trade of the corporations' sector and, in turn, benefit its financial situation. The recovery of prices will facilitate investments, as it will have a positive effect on leveraging and, with high labour costs leave more room for other expenditures.

Due to the expected recovery of investments and greater demand for production inputs by nonfinancial corporations, import growth will exceed that of exports and will lead Estonia's current account into modest deficits in 2017-2018.

Inflation expected to pick up in 2017-2018

The price level in Estonia has not changed in the past three-and-a-half years. Consumer prices in July 2016 were at around the same level as in spring 2013. We expect this trend to break soon, though. Due to higher prices of commodities and a hike in excise taxes, prices are expected to start growing, over the year in the second half of this year. The strong growth of real incomes will allow the prices of domestic services to be lifted. Price pressures are expected to intensify next year as the prices of commodities in the world markets will grow, and excise tax rates and the value-added tax of accommodation services will be raised.

Labour market remains tight

Employment growth remained surprisingly strong in the first half of 2016, at least according to the Labour Force Survey by Statistics Estonia (some other data sources show that the number of wage earners has actually decreased). Estonian enterprises have handled the combination of low export demand, falling output prices, and strong wage growth relatively well, at least so far. One of the reasons behind the still-rapid employment growth is the labour-intensive part of the economy, i.e., the services sector, where two-thirds of employees work, and which has enjoyed strong sales growth due to the spike in consumption. Employment growth should continue in the second half of the year, as enterprises plan to raise the number of employees in industry as well as in the services sector.

We expect the inactivity in the labour market to decrease further in 2017-2018. In addition to a tight labour market, the inactivity will decline due to an increase in the retirement age and a rearrangement of the social benefits system of people with disabilities; these people are now entitled to certain benefits only if they work or actively look for work. At the end of June, there were 5,000 people with reduced working ability looking for jobs through the Estonian Unemployment Insurance Fund. The unemployment rate might have reached its bottom in 2016. The number of unemployed is expected to grow next year as problems in some sectors and the work ability reform will lift the number of unemployed.

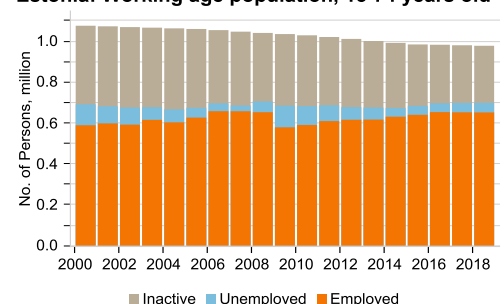
Wage growth remains a concern

Wage growth will remain fast, however, as the lack of suitable labour remains a concern. An agreed 9% increase in the minimum wage in 2017 will lift the average wage level by around 0.5%. The growth of wages in real terms will slow in 2017-2018, as nominal growth of wages will be somewhat slower, prices will grow, and labour taxes will be lowered less than in 2015. This, in turn, is expected to slow private consumption in 2017, followed by modest pickup in 2018. However, private consumption continues to be the major contributor to economic growth during the forecast period.

Estonia: Export of goods, annual growth



Estonia: Working age population, 15-74 years old



Latvia: The breeze is yet to fill the sails

Growth is decent but not good. The economy grew 2.1% in the first half of 2016, slowed by a slump in investments. Construction is in recession. The labour market is tightening, however, continues and consumption growth remains robust. Exports have rebounded strongly after the weak turn of the year, but rising labour costs are eating into competitiveness. The credit cycle for corporates is about to turn positive; not yet for households. Unless supply-side reforms are sped up, growth of 3% is about its potential, above that pushed only by credit expansion.

Key economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP growth, %	2.7	2.1 (3.0)	3.0 (3.0)	3.3
Consumer price growth, %	0.2	0.0 (0.2)	2.5 (2.8)	2.0
Unemployment rate, % ^{2/}	9.9	9.5 (9.2)	8.7 (8.3)	8.0
Real net monthly wage growth, %	7.4	5.5 (5.8)	3.4 (3.1)	3.9
Current account balance, % of GDP	-1.2	0.2 (-1.9)	-2.1 (-4.1)	-3.9
General government budget balance, % of GDP ^{3/}	-1.3	-1.2 (-1.3)	-1.1 (-0.9)	-1.0

^{1/} April 2016 forecast in parenthesis

^{2/} According to Labour force survey

^{3/} According to Maastricht criterion

We expect the drop in investment activity to ease in the second half of this year, but it will not be sufficient to compensate for the weak first half; accordingly, we cut the 2016 GDP growth forecast to 2.1%. The administrative framework of the EU funds' acquisition is by now largely intact, and a fresh breeze from the EU funds should soon start to fill the sails, lifting investments and raising GDP growth next year to 3%. With creditless recovery (six years and running!) gradually drawing to its end, growth will step up to 3.3% in 2018. The key downside risk to the forecast is external – the faltering EU economy and geopolitical turbulence hitting confidence and cutting into investments and consumption. Upside comes from the domestic credit cycle's improving sooner through stronger corporate and household confidence.

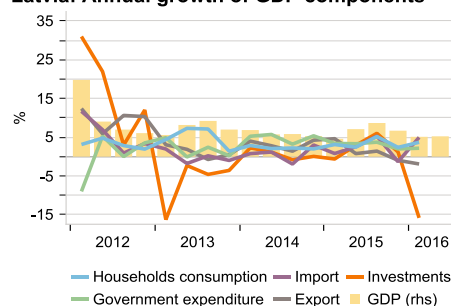
**Investments disappoint;
2016 GDP growth cut to
2.1%**

The EU funds' inflow delay was foreseen, but the annual drop of 15.8% in gross fixed capital formation in the first quarter vis-a-vis that of last year was extremely sharp. The contraction seems to be exaggerated – it was reported along with very high inventory levels, which, with further data revisions, will most likely be partly reassigned to fixed capital – but a 19% drop in construction output in both the first and second quarters against that of a year ago confirms that investments have been poor, indeed. Of the EUR 4.4 billion available in the current planning period of 2014-2020, so far only EUR 101 million has been paid out. Except for some agricultural and public infrastructure projects (e.g., roads), funding programmes are still to be opened. The government aims to fast-track the EU funds' inflow, which should push investments up in 2017. This is long awaited, but such policy-induced stop-go demand volatility will push up construction costs and cut into potential building volumes.

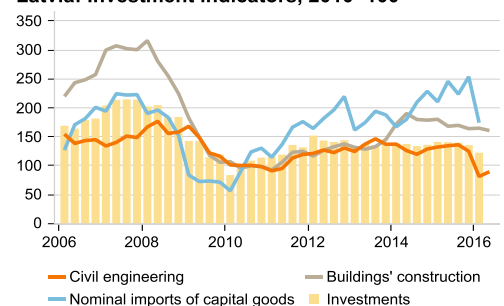
EU funds inflow and corporate credit growth will improve investments and push GDP growth to 3% and 3.3% in 2017-2018

The current weakness is more than just the delay with EU funds. Low raw milk prices (30% below the five-year average) have put milk farms under huge stress – to survive they forgo capital expenditures, let alone new investment. Manufacturing order book levels have inched up recently, but production expectations do not show marked improvements. Capacity utilisation remains high, but not elevated. And given that manufacturing surveys mark a lack of demand as the key obstacle to raising output, investment remains cautious. The credit cycle, however, is turning, and the stock of bank loans to nonfinancial institutions may report positive growth later this year – corporate balance sheets are strong (good profitability, loan-to-deposit ratio is down to 1.5 from the recession peak of 4.5), and the recent ECB bank lending survey points to rising demand for loans from both corporates and households. Alas, new lending is driven by commercial real estate and adds little to export growth potential.

Latvia: Annual growth of GDP components



Latvia: Investment indicators, 2010=100



Despite the job loss in construction sector, unemployment continues to decrease

Low inflation and robust wage growth keep consumer spending growth at ca 4%

Exporters surprise positively in the second quarter; positive current account balance likely in 2016

Government discussing reforms to boost growth potential above 3%

All in all, gross fixed capital formation this year will fall below the 2015 level, but over the next two years, unless upset by the global economy or geopolitics, investments will expand by 10% annually. In our view, most corporates remain overly cautious – external demand is growing and delaying investment will undermine their competitiveness and profitability.

The labour market remains sturdy. Hit by poor demand, the construction industry has shed some 10'000, or 13%, of its jobs against the first half of last year. The worst is over, and the sector's employment expectations have now stabilised without major negative spillovers to other sectors and with no drop in total employment. The unemployment rate is, though, a tad higher than expected. But, with economic growth and slow job creation continuing, we forecast it to decrease towards 8% in 2018. As expected, nominal wage growth this year has slowed to 5-6%, which we see to continue into 2017-18 as the labour market is tightening.

Inflation is lower than expected, and we have cut its forecast. There is a clear dichotomy, with goods' prices falling (driven by external factors) and services' prices rising (driven by domestic demand, changes in administratively regulated prices and taxes). Six consecutive months of deflation ended in July; but with the euro now slightly stronger and low wheat prices, among other factors, inflation this year could remain below our current forecast of 0%. Low inflation supports household consumption, which grew by a robust 3.7% in the first quarter. The relative weakness of retail (up only 2% so far this year) is due to consumers' shifting their preferences towards services. Inflation will pick up to 2-2.5% (also driven by higher oil prices) in 2017-18, but real wage growth will remain sturdy; with credit growth returning, household consumption is likely to grow by around 4% per annum over the coming years.

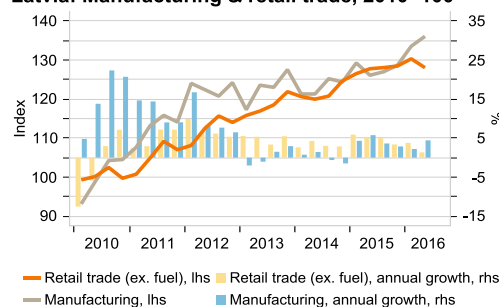
With the termination of residency permit programme, residential real estate activity remains subdued and prices are stagnant. With deleveraging mind-set lessening, we expect more activity closer to 2018, which would finally push household loan stock up into growth territory. Structural unemployment seems to be stuck at about 9%, and a residential sector recovery is essential to push unemployment lower since construction can absorb less-skilled workers.

Exporters surprised, again. Following a 1.9% drop in the first quarter, exports of goods and services rebounded strongly in the second quarter, pencilling in about 2% volume growth for the first half of the year. We see output expanding in most manufacturing subsectors, with wood processing up 10%, metal products 10.8%, and non-metallic minerals (construction materials) up 8.1% compared with the first half of last year. Sales are broadening to Asia and other less-known markets. Brexit – and, especially, the weak pound sterling – must cut into exports (so far, no major impact is seen), but exporters have demonstrated their ability to adjust in the past, and we retain the forecast of 2.5% export growth this year. Global demand is forecast to grow by over 3%, and we expect exports to expand by about 4% a year in 2017-18. Wage growth exceeding productivity growth will be an increasing problem; this is already seen in the stagnating or falling export market shares in the traditional markets of Latvian exporters.

With poor investments, we cut the import growth forecast for this year below 4%. The drop in import prices has been deeper than that for exports (-9% vs. -4.2% so far this year), and the current account could report its first surplus since 2010. Import growth will speed up towards 7% in 2017-18 as investment activity strengthens. FDI inflows' have been revised down in 2016 as the financial sector has cut its capital in response to a shrinking loan portfolio.

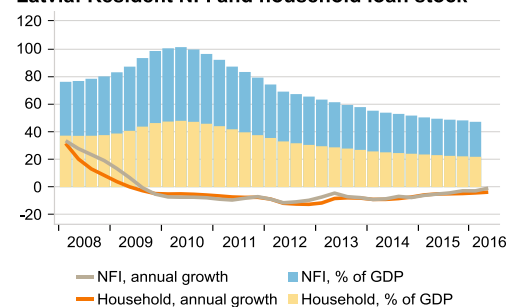
Despite nominal GDP falling behind the government's forecast by about 2%, tax revenues so far this year are in line with the plan. This is, at least partly, due to a squeeze on tax evasion. Hence, the budget deficit will exceed its target of 0.9% of GDP largely due to the smaller-than-forecast GDP. The government has started discussions on tax policy and other reforms to boost growth. These are promised to be a part of the 2018 budget. Unless growth-enhancing reforms are successfully implemented, with declining demographics and growth driven only through productivity, potential GDP growth is below 3% a year.

Latvia: Manufacturing & retail trade, 2010=100



Source: Swedbank Research & Macrobond

Latvia: Resident NFI and household loan stock



Source: Swedbank Research & Macrobond

Lithuania: Bronze in rowing & canoeing

Like our athletes' performance in the Rio Olympics, economic growth is ok, but could have been much better. Growth slowed to 1.8% in the second quarter of this year, down from 2.4% in the first. There was a huge negative impact from shrinking inventories, and investment growth took a pause. Household consumption and even exports, on the other hand, have been growing faster than expected. Ahead, we see the manifestation of a midlife crisis – growth above 3% becomes increasingly unlikely.

Key economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP growth, %	1.6	2.5 (3.3)	3.0 (3.0)	2.5
Consumer price growth, %	-0.9	1.2 (1.8)	3.0 (3.2)	2.5
Unemployment rate, % ^{2/}	9.1	8.0 (8.1)	7.4 (7.4)	7.2
Real net monthly wage growth, %	5.8	6.2 (5.0)	4.2 (2.6)	3.2
Current account balance, % of GDP	-1.7	-3.3 (-3.3)	-0.2 (-3.6)	-0.9
General government budget balance, % of GDP ^{3/}	-0.2	0.0 (-1.4)	-0.2 (-0.4)	0.5

1/ April 2016 forecast in parenthesis

2/ According to Labour force survey

3/ According to Maastricht criterion

GDP growth is slower than expected this year, but largely due to temporary one-offs

We expect GDP growth to accelerate in the second half of this year, but overall annual economic growth will fall short of our previous forecast of 3.3%. We have revised downwards our forecast to 2.5%. Underlying assumptions, however, are unchanged – household consumption remains very strong, exports recover from last year's contraction, and investment growth is not cancelled, just delayed. After a mild recovery in the second half of this year, we expect gross fixed capital formation to grow by 9% in 2017 and continue expanding at a healthy pace in 2018.

Investments shrank, but mainly in public sector, and growth is likely to resume soon

In the first quarter, inventories alone made a negative contribution of 2.8 percentage points to GDP growth. Maybe companies were worried about China, its hard landing, and possible geopolitical upheavals, but the size of the adjustment suggests that it may also be a statistical discrepancy. More unexpectedly, investments shrank in the first quarter and probably still did not grow in the second quarter of this year.

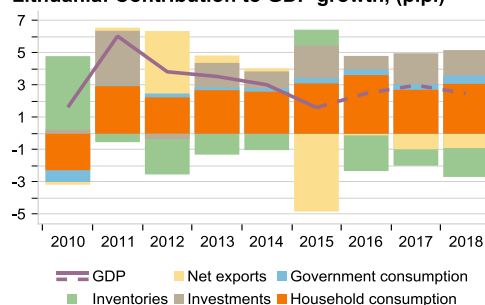
However most of the drag was due to the public sector – its investments in fixed tangible assets (at current prices) in the first quarter were 20% lower than a year ago. At the same time, private sector investments were almost unchanged. Volatility from quarter to quarter is not unusual, and we do not see any particular reason for slowdown or stagnation in investment growth.

Most likely, lags in the distribution and acquisition of EU funds were the reason why some of the investments were postponed. EU structural support for the current seven-year period amount to EUR 6.7 billion. Until the end of July, the projects funded under the agreements signed are valued at EUR 1.2 billion already – almost one-fifth of the total amount. However, only around EUR 0.5 billion had been paid out, or 8.4% of the total amount.

Manufacturing stumbled in the second quarter, but only due to some sectors

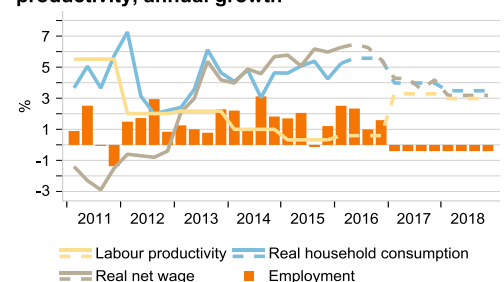
Manufacturing output contracted by 0.7% in the second quarter of this year, in annual terms, largely due to shrinking production of refined oil products, as well as of tobacco products. Although the majority of industries continued expanding at an accelerated pace, the shine of some former manufacturing stars seems to be fading – manufacturing of furniture is decelerating, while that of food products is having a hard time returning to the growth path enjoyed before the highly profitable Russian market slammed its doors.

Lithuania: Contribution to GDP growth, (p.p.)



Source: Swedbank Research & Macrobond

Lithuania: Wage, employment, consumption and productivity, annual growth



Source: Swedbank Research & Macrobond

Exports are likely to continue growing by 5-6% per year

Export growth so far has been a pleasant surprise this year – annual real growth was 9.3% in the first quarter. This slowed in the second quarter, but the slowdown was largely due to weaker exports of refined petroleum products, resulting from maintenance work at the oil refinery, as well as shrinking downstream margins. Export growth was supported by growing exports of grain, but this effect should start fading in the second half of the year.

We forecast export growth to stay around 5-6% in the coming years. Faster growth is unlikely due to much weaker overall growth in Lithuania's main exports markets – both in the east and the west. In 2018, Russia may become a positive surprise if it decides to lift its embargo on food products, but market shares will not be regained overnight, and few companies will rush to substantially increase their exposure in this volatile and unpredictable market. In the long run, Russia and other CIS countries are likely to contribute substantially to export growth.

Inflation is still low, but only due to cheap goods and not for long

Despite our expectations and forecasts, inflation has failed to pick up this year – largely because of still-cheap grains, oil, and other commodities. Prices of goods were still shrinking, while prices of services increased by 3.5% during the first seven months of this year, compared with the same period a year ago. We forecast this divergence to continue, but prices of goods will start increasing and push overall inflation to 3.0% in 2017.

Trends in the labour market are hard to complain about – employment is growing, unemployment is shrinking, wages are increasing, and the gains are more broadly distributed. It seems that wage growth will be slightly faster than we anticipated at the beginning of this year and will reach 7%. Growth is even more impressive in the private sector – 7.6% higher in the first quarter than a year ago. Part of the growth was due to rapid increase in the minimum wage, but the lack of skilled labour and increasing negotiation power of employees contributed as well. Wage growth is likely to ease to 6.0% in 2017 and 2018, but will be sufficient to offset larger inflation and sustain an increase in purchasing power.

Wage and employment growth has been remarkable, but (almost) all good things come to an end

Employment increased by 2.4% in the first half of this year – much more than we had expected. This is remarkable, considering that the working-age population is shrinking by 1.8% per year. So far, the labour force and employment have been increasing due to the healthy increase in the labour force participation rate. This, however, will no longer be sufficient, and we forecast employment to shrink by 0.4% in both 2017 and 2018. This is one of the major factors severely denting potential output and a reason why it is hard to expect sustained GDP growth of above 3%.

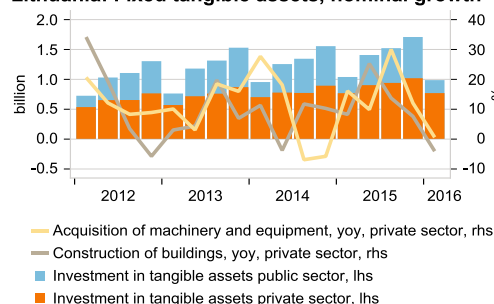
Household consumption is expected to grow by 5.5% this year, before moderating to 4.0% and 3.5% in 2017 and 2018. Interestingly, we forecast real wage bill growth to reach 8.3% this year – households seem to have increased their savings ratio. But at the same time annual growth of household loan portfolio keeps increasing and reached 7.0% in June, indicating households' confidence and willingness to increase their financial leverage.

The stellar performance in domestic demand is well reflected in public finances. During the first seven months of this year, national budget revenues were 4.3% above the plan and 7.4% higher than a year ago. Budget revenues have been boosted by the very strong growth in the wage bill, but it also seems that the authorities have managed to squeeze unofficial pay.

This year may be the first one in a quarter of a century when public finances will be balanced

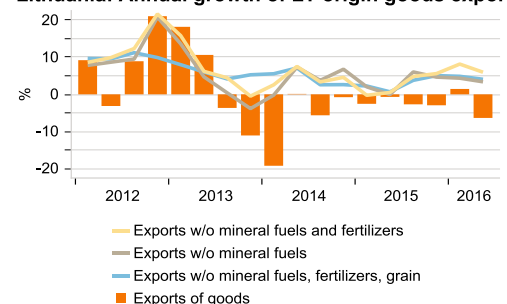
It seems that 2016 may turn out to be the first year since the reinstatement of independence when public finances will be balanced. This, although some cause for celebration, makes little economic sense when borrowing costs are at record lows (10-year yields are below 0.5%). Of course, increasing government spending and the budget deficit would make sense only if higher spending would boost competitiveness and potential output. That is not easy to achieve.

Lithuania: Fixed tangible assets, nominal growth



Source: Swedbank Research & Macrobond

Lithuania: Annual growth of LT origin goods export



Source: Swedbank Research & Macrobond

Appendices

I. The Estonian outlook

ESTONIA: Key economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP grow th, %	1.2	1.5 (2.0)	2.5 (2.5)	2.7
Household consumption	4.8	4.6 (3.4)	3.0 (3.0)	3.4
Government consumption	2.1	1.8 (1.9)	2.0 (2.5)	2.0
Gross fixed capital formation	-5.0	0.0 (2.0)	4.0 (4.5)	5.0
Exports of goods and services	-1.1	2.5 (1.5)	3.5 (3.7)	3.7
Imports of goods and services	-1.8	4.0 (2.3)	4.5 (4.7)	4.6
Consumer price grow th, %	-0.5	-0.1 (0.5)	2.5 (2.6)	2.0
Unemployment rate, % ^{2/}	6.2	6.2 (6.5)	6.6 (6.7)	6.7
Real net monthly wage grow th, %	8.0	6.4 (4.6)	2.8 (2.6)	3.4
Nominal GDP, billion euro	20.5	21.3 (21.4)	22.3 (22.6)	23.5
Exports of goods and services (nominal), % grow th	-2.5	1.8 (0.9)	4.0 (4.3)	5.3
Imports of goods and services (nominal), % grow th	-3.6	3.0 (1.7)	5.0 (5.3)	6.2
Balance of goods and services, % of GDP	4.0	3.1 (3.3)	2.3 (2.6)	1.6
Current account balance, % of GDP	1.9	1.3 (1.0)	0.1 (0.2)	-0.7
Current and capital account balance, % of GDP	5.8	3.5 (3.8)	2.0 (2.2)	0.2
FDI inflow, % of GDP	-0.8	2.1 (3.3)	3.1 (4.0)	3.8
Gross external debt, % of GDP	93.6	88.8 (88.5)	84.5 (83.7)	80.9
General government budget balance, % of GDP ^{3/}	0.4	0.2 (-0.3)	-0.2 (-0.4)	-0.2
General government debt, % of GDP	9.7	9.6 (9.7)	9.8 (9.9)	10.0

1/ April 2016 forecast in parenthesis

2/ According to Labour force survey

3/ According to Maastricht criterion

II. The Latvian outlook

LATVIA: Key economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP grow th, %	2.7	2.1 (3.0)	3.0 (3.0)	3.3
Household consumption	3.3	4.0 (4.2)	3.5 (3.5)	4.0
Government consumption	3.1	1.5 (1.5)	2.0 (2.0)	2.0
Gross fixed capital formation	2.7	-1.5 (4.0)	10.0 (10.0)	10.0
Exports of goods and services	1.4	2.5 (2.5)	4.0 (4.0)	4.0
Imports of goods and services	1.8	3.8 (4.5)	7.0 (7.0)	7.0
Consumer price grow th, %	0.2	0.0 (0.2)	2.5 (2.8)	2.0
Unemployment rate, % ^{2/}	9.9	9.5 (9.2)	8.7 (8.3)	8.0
Real net monthly wage grow th, %	7.4	5.5 (5.8)	3.4 (3.1)	3.9
Nominal GDP, billion euro	24.4	25.1 (25.6)	26.6 (27.0)	28.5
Exports of goods and services (nominal), % grow th	2.1	0.4 (3.1)	5.0 (5.7)	6.0
Imports of goods and services (nominal), % grow th	0.8	-0.9 (4.2)	9.1 (9.8)	9.1
Balance of goods and services, % of GDP	-1.4	-0.6 (-2.0)	-2.8 (-4.3)	-4.6
Current account balance, % of GDP	-1.2	0.2 (-1.9)	-2.1 (-4.1)	-3.9
Current and capital account balance, % of GDP	1.6	1.6 (0.6)	0.8 (-1.3)	-1.6
FDI inflow, % of GDP	2.6	0.4 (3.1)	2.6 (3.1)	2.8
Gross external debt, % of GDP	137.7	135.2 (133.3)	131.4 (130.8)	128.2
General government budget balance, % of GDP ^{3/}	-1.3	-1.2 (-1.3)	-1.1 (-0.9)	-1.0
General government debt, % of GDP	36.4	40.4 (39.9)	37.4 (37.4)	36.9

1/ April 2016 forecast in parenthesis

2/ According to Labour force survey

3/ According to Maastricht criterion

III. The Lithuanian outlook

LITHUANIA: Key economic indicators, 2015-2018 ^{1/}

	2015	2016f	2017f	2018f
Real GDP grow th, %	1.6	2.5 (3.3)	3.0 (3.0)	2.5
Household consumption	4.9	5.5 (4.9)	4.0 (3.8)	3.5
Government consumption	2.0	2.0 (3.0)	2.0 (1.5)	1.0
Gross fixed capital formation	10.3	4.0 (9.0)	9.0 (6.0)	6.0
Exports of goods and services	-0.2	5.0 (3.0)	6.0 (5.0)	5.5
Imports of goods and services	6.0	5.0 (7.0)	7.0 (6.5)	6.5
Consumer price grow th, %	-0.9	1.2 (1.8)	3.0 (3.2)	2.5
Unemployment rate, % ^{2/}	9.1	8.0 (8.1)	7.4 (7.4)	7.2
Real net monthly wage grow th, %	5.8	6.2 (5.0)	4.2 (2.6)	3.2
Nominal GDP, billion euro	37.1	38.4 (39.0)	40.7 (41.3)	42.8
Exports of goods and services (nominal), % grow th	-4.1	1.0 (2.5)	8.5 (8.0)	6.5
Imports of goods and services (nominal), % grow th	-1.4	-1.0 (5.5)	9.5 (8.5)	7.5
Balance of goods and services, % of GDP	-0.3	-2.5 (-2.5)	0.5 (-2.9)	-0.2
Current account balance, % of GDP	-1.7	-3.3 (-3.3)	-0.2 (-3.6)	-0.9
Current and capital account balance, % of GDP	1.3	-0.7 (-0.7)	2.5 (-0.8)	2.1
FDI inflow, % of GDP	1.5	1.5 (1.5)	1.5 (2.0)	1.5
Gross external debt, % of GDP	75.4	74.0 (72.9)	70.5 (69.5)	67.8
General government budget balance, % of GDP ^{3/}	-0.2	0.0 (-1.4)	-0.2 (-0.4)	0.5
General government debt, % of GDP	42.8	40.4 (40.5)	43.3 (42.1)	38.4

1/ April 2016 forecast in parenthesis

2/ According to Labour force survey.

3/ According to Maastricht criterion.

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