5 April 2022

Nordic Outlook

Highly uncertain times

- **Denmark: things can almost only get worse**
  - With low unemployment and strong activity, risks are to the downside
- **Sweden: stagflation but not recession**
  - Higher prices lowers growth and sends up interest rates, both moderately
- **Norway: pressures mounting, rates rising**
  - Strong growth has led to very little spare capacity and a need for tighter policy
- **Finland: eastern headwinds cool down the outlook**
  - Less trade with Russia has a significant impact

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Important disclosures and certifications are contained from page 31 of this report.

Contents

Nordic outlook	**At a glance - Highly uncertain times**	4
Denmark	**Things can almost only get worse**	5
	Forecast at a glance	10
Sweden	**Stagflation but not recession**	11
	Forecast at a glance	16
Norway	**Pressures mounting, rates rising**	17
	Forecast at a glance	21
Finland	**Eastern headwinds cool down the outlook**	22
	Forecast at a glance	26
Global overview	**Headwinds piling up**	27
	Economic forecast	30

The ***Nordic Outlook*** is a quarterly publication that presents Danske Bank's view on the economic outlook for the Nordic countries. The semi-annual publication *The Big Picture* sets out our global economic outlook.

At a glance

Highly uncertain times

The war is causing new challenges

Economies were heading for a new phase both globally and in the Nordics even before the Russian invasion of Ukraine. The recovery from the Covid-19 crisis is over in the sense that there is no longer elevated unemployment, but instead high demand and increasing inflation, meaning that growth has to slow. The war has further complicated the situation, especially by triggering higher and very volatile energy prices, which on the one hand reduces spending on other items, but on the other hand further increases inflation and constrains output. In some countries, such as the US, there is a clear need to dampen demand, while the picture is more nuanced in for example the euro area.

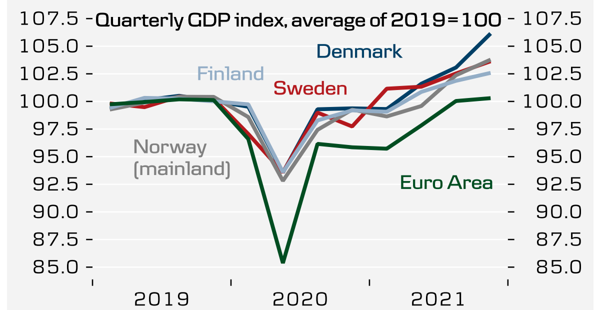
The Nordic countries have all come through the Covid-19 crisis with fewer scars than most other European countries, and have also all had strong recoveries, but they are nevertheless in somewhat different situations now. Finland has to some extent lost a significant trading partner, while the other Nordics only had very limited trade directly with Russia before the war. Consumers are feeling the effects of more expensive energy, but Nordic consumers tend to rely less on oil and natural gas and instead use more communal heating and electricity, and the prices of those items are to varying degrees decoupled from global energy markets. This means that the inflation shock is generally smaller in the Nordics, and hence also that the revisions to the growth outlook are generally smaller than in the euro area, again except for Finland.

Finding the right response

Uncertain times are difficult times for policy makers. Politicians struggle with how and to what extent to shield consumers from rising costs and in some cases boost spending on defence and refugees, while central banks must address rapidly rising inflation. Norges Bank already embarked on a rate hiking course in September and is clearly going to continue that. The situation is more complex for the Swedish Riksbank, which is also now facing high current inflation, but at the same time still has little indication that inflation is spreading to wages and hence becoming more permanent. For Denmark and Finland, monetary policy is set in Frankfurt. While Finland faces uncertainty over trade, the Danish economy is running rather hot compared to the euro area, which determines its interest rate because of the currency peg.

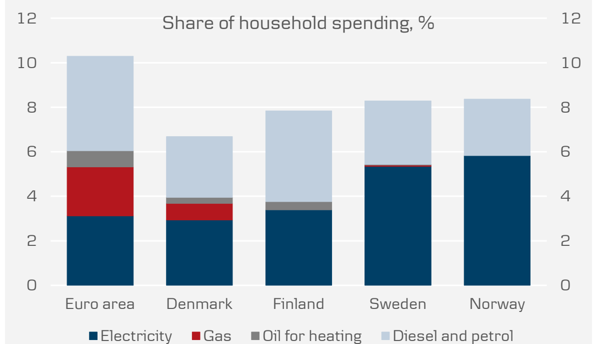
As small open economies, the Nordics are subject to the twists and turns of the global economy, but they are generally in a good position to handle the current uncertainty. Policy options remain available in case they are needed, and as we saw during the Covid-19 crisis, the Nordics can be quite resilient.

Strong Nordic recovery



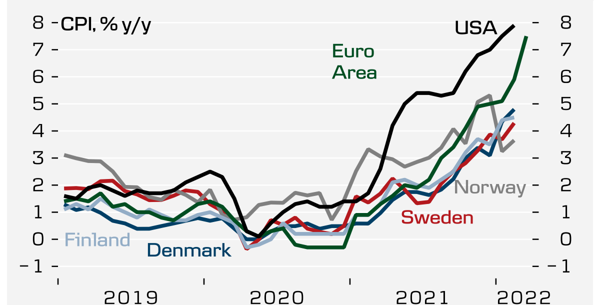
Source: Macrobond Financial

Nordics use less oil and gas



As measured by HICP weights. Source: Eurostat

Inflation rising a bit less



National CPI definitions. Source: Macrobond Financial

Denmark

Things can almost only get worse

- **From a solid starting point, our main scenario is a slowdown with the risk of an actual downturn.**
- **High inflation will hit consumers and therefore demand, though they have a substantial buffer and we expect higher wage growth.**
- **We expect house prices to stagnate on average, so a large share of the market will therefore experience price falls.**
- **Exports look robust, and Danish companies are relatively less sensitive to the effects of war and the danger of recession.**
- **Labour and materials shortages remain a major challenge for Danish companies.**

Strong economy with threats from east and west

Denmark's economy is strong on many fronts. The upswing in the wake of the pandemic is now complete and registered unemployment is bordering on a near 50-year low, but without growth being driven by unsustainable increases in debt, whether that be among households, companies or in the public sector. This also means the economy is running at close to full capacity, so high growth continuing is not realistic, even if demand surprises positively. The risk is predominantly downside, and has grown.

The war in Ukraine and sanctions against Russia are mostly effecting the economy via higher inflation, which means consumer purchasing power is being eroded in Denmark and abroad. In addition, the uncertainty triggered by the war may postpone consumption and investment. Naturally, this will also hit Danish companies, but comes at a time when we already saw labour and materials shortages as the most limiting factors. Moreover, revisions of previous data and very strong growth in Q4 2021 give a high starting point for 2022, so we have actually revised up our growth forecast for the year, even though we expect very little growth during the year. We should also remember that the war is not only negative for demand in Denmark. One consequence of the war is the decision to increase defence spending both in the short and the long term, plus the government estimates that up to 100,000 refugees may end up in Denmark. That would give a very significant extra demand in Denmark, even if the costs were to a greater or lesser extent financed by limiting overseas aid. Moreover, a substantial number of refugees could potentially enter the labour force and so increase capacity.

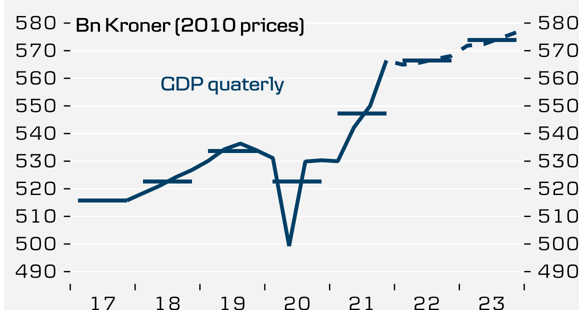
Nevertheless, the war, sanctions and raw materials supplies constitute a clear risk of undermining demand so significantly that it triggers an actual crisis and a noticeable increase in unemployment, even though a further escalation is probably required for that. Another risk factor that could make the outlook somewhat gloomier than in our forecast is the state of the Western economies. Very high inflation necessitates applying the brakes by tightening monetary policy, especially in the US. That could result in a hard landing with a decline in GDP and increasing unemployment in 2023 or 2024 – and in Denmark too.

At a glance

Denmark	Current forecast		Previous forecast	
% y/y	2022	2023	2022	2023
GDP	3.5	1.3	2.5	1.7
Private consumption	2.2	2.5	3.1	2.6
Public consumption	0.6	0.5	-1.2	-0.6
Gross fixed investment	2.0	1.1	2.1	3.1
Exports	6.0	3.1	5.4	3.3
Imports	4.0	4.1	4.9	3.8
Gross unemployment (thousands)	68.5	69.5	71.3	69.4
Inflation	4.5	1.2	2.4	1.3
Government balance, % of GDP	1.7	1.8	1.3	0.9
Current account, % of GDP	7.5	7.7	7.6	6.8

Source: Danske Bank

We expect low growth from here



Horizontal lines are average for the year. Sources: Statistics Denmark, Macrobond Financial, Danske Bank

Higher energy prices felt by industry in particular

In the manufacturing sector, energy consumption is particularly concentrated in the plastics, glass and concrete industry and in the food and drinks sector. Of the almost 100 million gigajoules consumed by industry in total in 2020, these two areas each accounted for about one quarter. Some 31% of total energy consumed came from gas and 25% from electricity. Hence, gas and electricity are the most significant energy inputs for industrial production, and precisely these two sources of energy have set price records throughout the autumn and into the winter.

Manufacturing is the most energy-intensive sector, with the concrete industry and tile works, chemical producers and metal manufacturers deriving a fairly large share of their production input from electricity and gas. Much of the above production requires high temperatures and therefore much energy.

Current electricity and gas prices imply an excess charge for industry of around DKK1bn a month compared to H1 21, assuming the spot price fully feeds through. Given current shortages of both materials and labour, industry may well pass this bill on to its customers, as we have seen in producer prices, which in the past year have risen by 7.5% across the sector, and indeed there is much to suggest that rising prices are on their way to consumers.

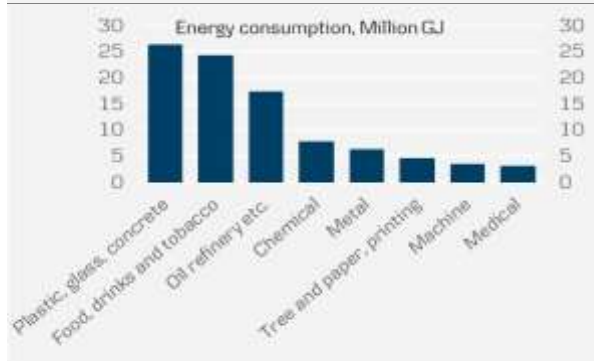
Strong government finances

Much to most people's surprise, including ours, there was a large government surplus of DKK58.7bn in 2021, a year that was to a large extend characterised by lockdowns and expenses for relief packages. Once again it was the tax on pension returns (so-called PAL tax), but also other taxes, that produced more than expected. Given the strong economy and low unemployment, the outlook for the coming years is for a surplus, unless a more comprehensive slowdown or very large expenses for refugees materialise. A large political majority has agreed to target a government deficit of 0.5% of GDP in 2030, in contrast to previous medium-term plans of balanced government finances. In our view, there is little probability of that target undermining the sustainability of Danish government finances in the longer term, but given the decision to increase defence spending to 2% of GDP and an ageing population, prioritisation will be needed to achieve the target. Fiscal policy also faces major challenges in the short term, with clear risks of both overheating and a slowdown, depending on international developments. Hence, there could be a need for both tightening and easing.

Interest rates heading higher

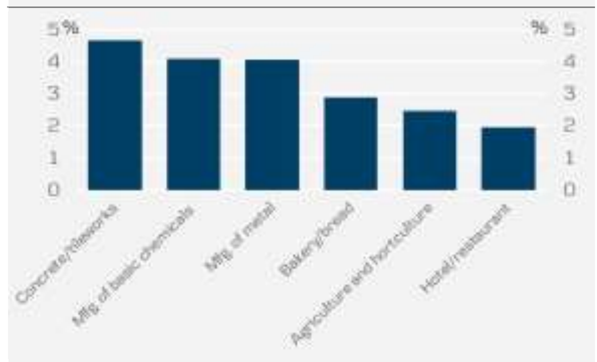
We expect the European Central Bank (ECB) to raise its benchmark rate by 50bp over the coming year and that this will be reflected in Denmark, with Danmarks Nationalbank's certificates of deposit rate thus increasing to -0.1% – though this is of course subject to considerable uncertainty given the current situation in Europe. We do not expect a unilateral shift in Danish rates, even though the Danish krone (DKK) is still trading on the strong side. Long yields have increased, especially on mortgage loans, where the difference to risk free interest rates has increased. Our forecast is that we will see a further but modest increase in long yields, driven by interest rate hikes in both Europe and the US.

A few sectors account for the bulk of energy consumption in industry



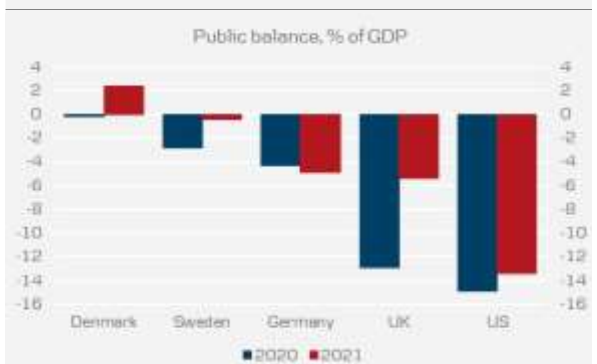
Sources: Danske Bank, Statistics Denmark

Electricity and gas share of total input in production



Sources: Danske Bank, Statistics Denmark

Danish publish finances in a call of its own



Sources: Macrobond Financial, Danske Bank

Outlook for greater wage growth

Ever since the first reopening, wage growth in the private sector (as measured by employer organisation DA's data) has been stable at around 3.2% p.a. We expect the combination of high inflation and very low unemployment to result in higher wage growth in the next couple of years. The extent of the growth will very much depend on whether longer-term inflation expectations have increased among workers and employers. Wage growth is currently higher than among Denmark's trading partners, but this follows on the heels of a period when the opposite has more often been the case, and Danish competitiveness is essentially solid. Public sector wages are regulated relative to the private sector but with a delay, so public sector workers will typically experience a rather large decline in real wages in 2022, as will receivers of transfer incomes.

Broad increase in consumer prices

Inflation surged in early 2022. Energy prices were already pushing inflation higher in H2 21, and in 2022 food prices also began to noticeably climb. After an extended build up, prices have now also begun to rise faster across a broad range of goods and services. Russia's invasion of Ukraine has further thrust energy prices to hitherto unseen heights, which in February drove inflation to its highest level since 1989. We assess inflation to have risen even further here in the spring, but we expect it will begin to ease soon. Much depends on energy prices, and here the level of uncertainty is extraordinary. Our forecast is built on a gradual decline in energy prices from H2 22 and into 2023. However, prices will remain high throughout the forecast period.

Inflation will remain high this year, in our view, and then fall considerably in 2023 as energy prices pull it lower. However, underlying price pressures in the economy will increase during the forecast period. Rising wage pressures and commodity prices provide an increasing incentive for companies to raise prices, and now that price increases have been initiated there will probably be less reluctance to hike prices than we saw in 2021. We can also expect bigger rent increases across the regulated segment of the rental market, as rents are adjusted in accordance with the net price index.

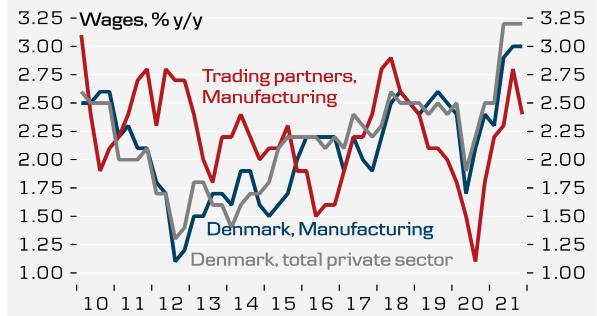
Rising prices will eat into consumption

We have revised our consumption estimate lower, and now no longer expect 3.1% growth in 2022 but 2.2% growth. This is mainly due to the impact of rising energy prices, which erodes purchasing power – not least for families with gas-fired heating or who have high energy expenses generally. Widespread district heating and generally significant financial buffers will dampen the effect to some extent, but this is nevertheless clearly negative for consumption.

Consumption is also being curtailed by significant supply chain problems, particularly in the car industry – a problem that has not diminished following the war in Ukraine, as both Ukraine and Russia are important suppliers to European car manufacturers.

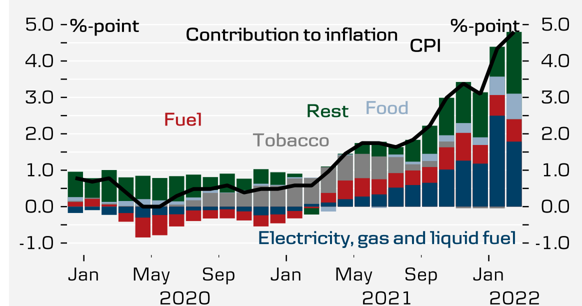
Despite the negative impact of rising prices on purchasing power, Danish household finances are on average relatively robust. Recent years have been characterised by many building up their savings, and this has been further supported during the pandemic – when rising home equity, postponed consumption due to lockdowns and extraordinary holiday allowance payouts

Wage growth has picked up in Denmark



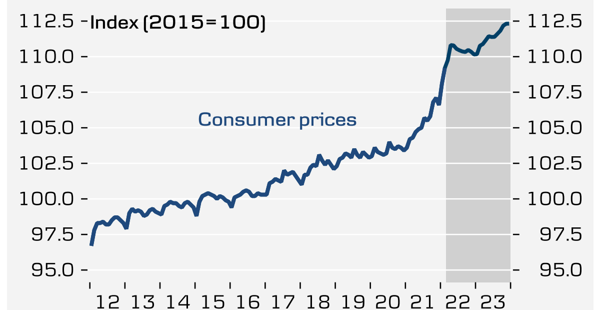
Sources: Confederation of Danish Employers, Macrobond Financial

No longer just energy lifting inflation



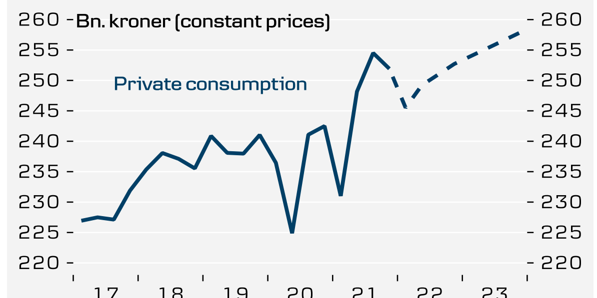
Sources: Danske Bank, Statistics Denmark, Macrobond Financial

Prices will level off but underlying price pressures have increased



Sources: Danske Bank, Statistics Denmark, Macrobond Financial

Rising energy prices will dampen consumption, but still growth ahead



Sources: Statistics Denmark, own calculations, Macrobond Financial

in 2020 and 2021 have provided more financial latitude. Meanwhile, low levels of unemployment and rising wages have helped increase Danish incomes overall.

We generally expect to see an increased divergence when it comes to developments in household finances over our forecast period. The individual family's source of heating and transport needs will lead to significant differences in how much costs increase. Moreover, the gap between those in employment – not least those in the sectors with the highest degree of wage drift – and those outside the labour market will grow. Transfer incomes are regulated in line with wage growth, but with a significant delay.

Rising interest rates and tax reform could hit house prices

Going forward, we expect rising interest rates to put a significant damper on the Danish housing market. Meanwhile, increasing energy costs have added to many homeowners' fixed expenses – not least those with gas-fired heating. All else being equal, this has made being a homeowner more expensive compared to just a year ago – especially in the more expensive areas, which also experienced steep price increases during the pandemic.

All in all, we are generally expecting modest price declines on houses going into H2 2022, though with a considerable spread in price developments. The impact of higher interest rates is expected to be greater on homes in the expensive areas and, as they have appreciated higher increases in prices in recent years compared to other housing types, and will also be hit hardest, relatively speaking, by property tax reforms and the new property valuations.

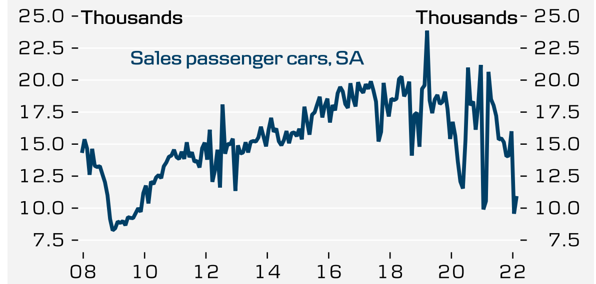
That being said, housing supply in the expensive areas remains very limited and this is expected to support prices along with still decent levels of activity. Moreover, employment continuing to increase and rising wages should provide a significant boost to nominal incomes over the forecast period. We should also note that many of the measures introduced in recent years to dampen housing price growth have focused on diminishing the impact of extremely low interest rates on house prices. These measures will also tend to reduce the effects of higher interest rates.

There is considerable uncertainty on the outlook for the housing market at the moment and visibility is low. However, even in the hardest hit areas, we do not expect a downturn to below the prices prevailing before lockdowns caused a surge. Note that the picture is muddled further, by large discrepancies between different sources of house price statistics at the moment.

Production input shortages main growth brake on exports

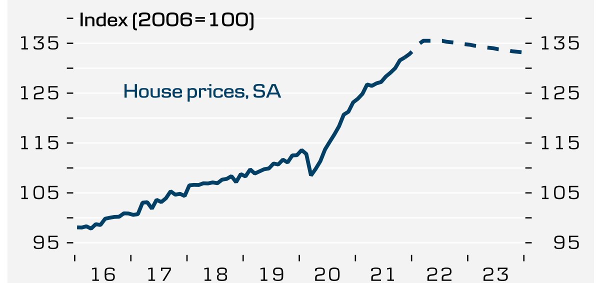
Exports got off to a fine start in 2022 and remain characterised by the elevated global demand for goods and production input shortages ranging from materials to labour.

Supply problems in the car industry will dampen consumption



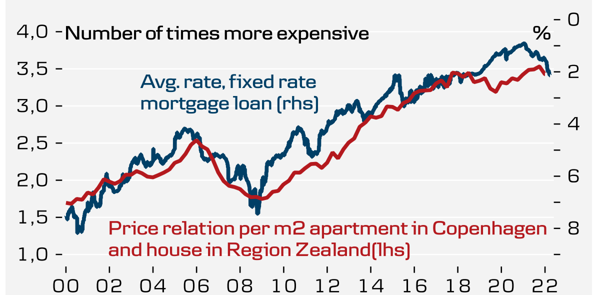
Sources: Statistics Denmark, Macrobond Financial

House prices expected to fall slightly from H2



Note: Own seasonal adjustment. Note that prices for December and January are also projections, as the figures from Statistics Denmark in these months are expected to undergo major revisions.
Sources: Statistics Denmark, Macrobond Financial and own calculations

Rising interest rates to hit relatively harder in expensive areas



Note: Prices are a one quarter moving average.

Sources: Boligmarkedsstatistikken, Macrobond Financial and own calculations

Direct exports to Russia have been modest since the annexation of Crimea in 2014. The sanctions imposed on Russia are therefore mainly affecting Danish exports through higher energy prices, lower growth in export markets and potential disruptions to supply chains. Apart from energy, Denmark's main imports from Russia were iron and steel in 2021. Looking beyond conventional trade figures and instead focusing on where the final demand for production in Denmark stems from, then construction is probably the industry here that has the largest production that ultimately ends up in Russia[1]. Taking the current overheating in the construction sector into consideration, we do not assess sanctions will have any major impact on construction activity.

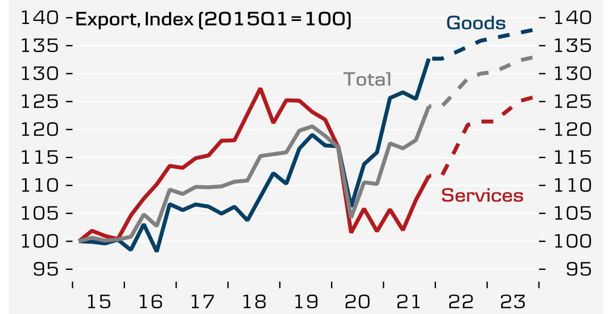
So far, the European industrial sector has come through relatively unscathed, but expectations for the coming months in, for example, Denmark's most important direct trading partner, Germany, are somewhat gloomier. We expect growth in Denmark's key export markets to decline. However, we do not expect the decline in demand to have a 1:1 effect on Danish exports, as we have long been in a period where production could not keep up with demand and, furthermore, Danish exports very much follow a different pattern than that dictated by the business cycle due to large exports of medicine, wind turbines and food.

Service exports in Q4 21 were still 10.8% below H1 2019, when they last peaked. We are reckoning on a marked increase in tourism this summer, but do not expect it to reach pre-pandemic levels within our forecast period. Moreover, 2018 and 2019 were extraordinarily good years, boosted by construction investments abroad that we cannot count on be repeated to the same extent.

The current account surplus has grown significantly in the past six months. This is largely due to a growing surplus on the services balance, which has been boosted by shipping, in particular, on the back of very high freight rates. That being said, freight rates have softened a little this year, and we expect this trend to continue in H2 as more space gradually opens up at container terminals around the world. This will obviously contribute to reducing the surplus on the services balance, especially in 2023. In addition, goods imports have become considerably more expensive due to rising energy prices in particular. Denmark is a net importer of energy, so rising energy prices reduce the current account surplus. However, the reopening of the Tyra oil and gas field in summer 2023 means Denmark will again be self-sufficient in natural gas, which will boost the goods balance.

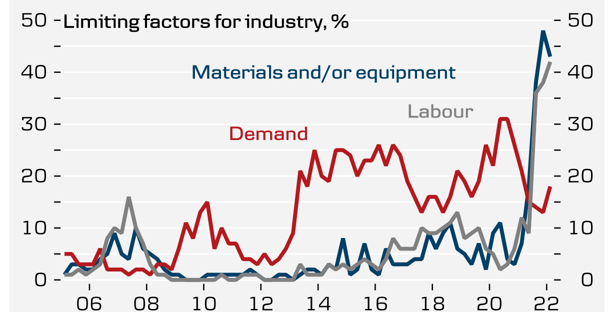
In contrast, higher interest rates will put downward pressure on foreign investment income in Denmark as it largely consists of bonds, and that will lift net investment income.

Rebound ahead for service exports



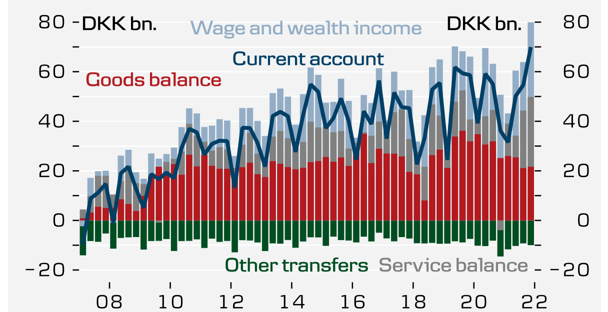
Sources: Statistics Denmark, Macrobond Financial

Demand is not the main limiting factor for industry



Sources: Statistics Denmark, Macrobond Financial

Trade in services has increased current account surplus



Sources: Statistics Denmark, Macrobond Financial

[1] Source: OECD TiVA data

At a glance

			Forecast	
National account	2021	2021	2022	2023
	DKK bn (current prices)		% y/y	
Private consumption	1105.3	4.3	2.2	2.5
Government consumption	557.7	3.7	0.6	0.5
Gross fixed investment	493.8	5.6	2.0	1.1
- Business investment	302.5	5.8	2.7	2.1
- Housing investment	116.3	6.1	1.0	-4.0
- Government investment	75.0	4.3	0.9	5.3
Growth contribution from inventories		0.3	-0.2	0.1
Exports	1367.6	7.8	6.0	3.1
- Goods exports	809.8	12.7	4.6	1.5
- Service exports	557.8	-0.6	8.1	5.4
Imports	1196.3	8.2	4.0	4.1
- Goods imports	704.6	12.0	2.2	2.6
- Service imports	491.7	2.6	7.1	6.6
GDP	2318.0	4.7	3.5	1.3

Economic indicators	2021	2022	2023
Current account, DKK bn	206.2	203.5	212.7
- % of GDP	8.3	7.5	7.7
General government balance, DKK bn	58.7	45.0	50.0
- % of GDP	2.4	1.7	1.8
General government debt, DKK bn	917.3	880.0	840.0
- % of GDP	36.7	32.6	30.3
Employment (annual average, thousands)	3060.1	3159.4	3185.4
Gross unemployment (annual average, thousands)	105.6	68.5	69.5
- % of total work force (DST definition)	3.7	2.4	2.5
Oil price - USD/barrel (annual average)	71	110	95
House prices, % y/y	11.2	5.0	-0.9
Private sector wage level, % y/y	3.0	3.7	4.0
Consumer prices, % y/y	1.9	4.5	1.2

Financial figures	04/04/2022	+3 mths	+6 mths	+12 mths
Lending rate, % p.a.	0.05	0.05	0.05	0.55
Certificates of deposit rate, % p.a.	-0.60	-0.60	-0.60	-0.10

Sources: Statistics Denmark, Danmarks Nationalbank, Macrobond Financial, Danske Bank

Sweden

Stagflation but not recession

- **After a year of strong growth, the outlook is clouded with uncertainty, inflation is eroding households' purchasing power, and their consumption is set to take a hit.**
- **Despite looming rate increases, the strength of the Swedish housing market should not be underestimated.**
- **Core inflation is expected to move further up on the back of sustained supply disruptions, forcing the Riksbank to act to defend credibility, but the hiking cycle is expected to be short.**
- **Letting the 35 % debt anchor guide fiscal policy instead of budget balance would free up funding while being financially responsible.**

At a glance

Sweden				
	Current forecast		Previous forecast	
% y/y	2022	2023	2022	2023
GDP, calendar adjusted	2.5	2.0	3.0	2.2
Private consumption	3.3	1.9	4.1	2.4
Public consumption	1.3	1.2	1.4	1.2
Gross fixed investment	2.8	2.2	5.4	2.2
Exports	5.1	3.9	3.4	4.0
Imports	5.6	3.4	5.6	3.4
			0.0	0.0
Unemployment rate	7.0	6.8	7.3	6.5
Inflation	4.0	1.3	2.0	1.3
Government balance, % of GDP	0.8	0.8	0.2	0.7
Current account, % of GDP	4.8	5.1	3.9	4.1

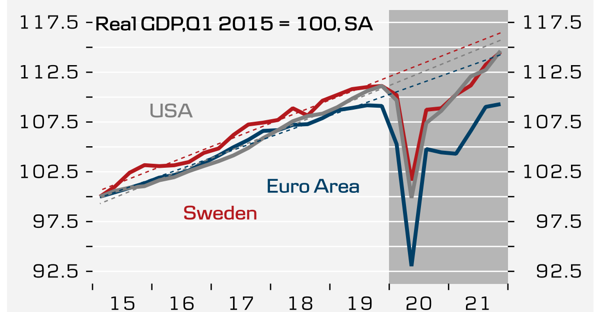
Source: Danske Bank

Growth to be dragged down by consumption and exports

Although infections remained high and the pandemic hit some sectors hard, 2021 was a year of strong economic expansion. With GDP growth of 4.6%, Sweden performed better than the euro area and on a par with the US despite a big difference in fiscal stimulus. The outlook, however, is very uncertain. Energy prices began to climb across the board back in November and December, and in Sweden's case it was mainly power prices that hit unprecedented levels. These high energy prices correlate well with the decline in consumer confidence to well below normal. Russia's attack on Ukraine has pushed energy prices up further. Spending on services has picked up after being squeezed hard during the pandemic, but we still expect household consumption to weaken given the high price of energy. Soaring energy prices have also brought levels of inflation last seen back in the 1990s. This time around, inflation has been supply-led (driven by supply disruptions) rather than demand-led (driven by wage growth), which means that real wages have plummeted, greatly eroding households' purchasing power. Historically, real wages have correlated well with disposable income and, not unsurprisingly, household consumption. With less money coming in, households quite simply spend less. Given that we expect inflation to remain high (see separate section below) and both wages and hours worked to rise by 2%, a substantial decline in disposable income is to be expected. The decline indicated is actually bigger than that at the start of the pandemic, but remember that government support packages then limited the drop in disposable income. The contributions to date from fiscal policy fall well short of full compensation, although there are calls for more, but they will of course soften the blow.

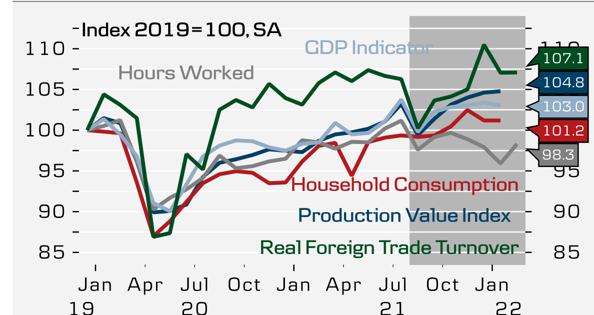
As household consumption accounts for a substantial share of GDP, a drop in household consumption spells a downward revision of GDP growth. We also expect exports to grow more slowly, mainly in the light of our bleaker view of growth in the euro area than before war broke out. Global uncertainties are rarely good for the growth outlook, given that they also tend to reduce business investment and so put a damper on growth through that channel too. Our forecast for GDP growth next year is unchanged at 2.0% despite our downward revision for this year from 3.0% to 2.5%.

Swedish growth in line with US despite big difference in stimulus



Source: Macrobond

Labour market lagging behind



Sources: Statistics Sweden, Macrobond

Strong demand for labour

The labour market has not recovered as quickly as many other parts of the economy. Although both unemployment (7.1% according to the Swedish Public Employment Service) and employment have returned to pre-pandemic levels, hours worked are lagging behind. According to Statistics Sweden, this can be explained by sickness absence caused by the pandemic. A return to pre-crisis levels is not an end in itself for unemployment, however, because it was already rising at that time. The recovery has also been unevenly distributed between sectors: those hit hardest by the pandemic, such as retail, hotels/restaurants, culture and transport, are still a fair way from pre-crisis levels in terms of hours worked. We have seen an improvement in hotels/restaurants and transport over the past two months, but a deterioration in both retail and culture. There is clearly demand for labour, however. Vacancies are record-high, and employment expectations in the Swedish National Institute of Economic Research's business survey are also high – especially for hotels/restaurants. Difficulties sourcing labour have increased in the same survey, although shortages are not yet considered to be greater than those in 2017-2019. The unused labour supply, consisting of the unemployed, the underemployed (those working fewer hours than they would like) and "latent" jobseekers (those outside the labour force who would have chosen to work but are not actively looking), has decreased gradually relative to employment over the past year. One explanation, of course, is that unemployment has come down, but the unused labour supply has fallen further than unemployment, which suggests that the other groups have also contributed. Of course, it is unlikely that all of the unused labour supply can be matched with employers looking for staff, but if the unused labour supply had been low and not, as is currently the case, well above the average for 2015-2019, we would have been much more concerned about the labour shortages firms are now reporting.

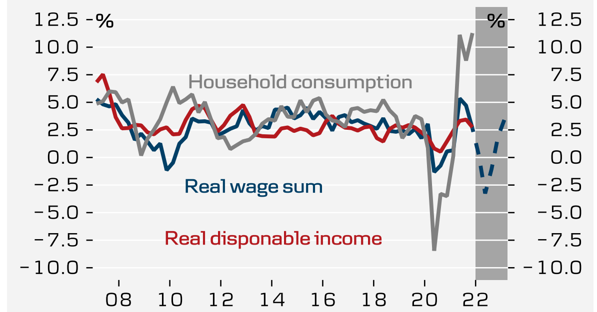
Despite the current uncertainty in the economy, we expect unemployment to fall further, but somewhat more slowly than over the past year. Hours worked should nevertheless increase slightly faster given that sickness absence is expected to fall.

Housing market cooling but not headed for a fall

The housing market remains robust. Global stock markets have had a difficult start to the year, and policy rate expectations have pushed up fixed mortgage rates, but the housing market seems to have shrugged this off. According to Valueguard, prices have climbed 4% since December, with houses and apartments contributing equally to the rise. More time spent at home was previously the dominant theme during the pandemic, boosting demand for larger properties in particular and causing house prices to rise considerably more than apartment prices.

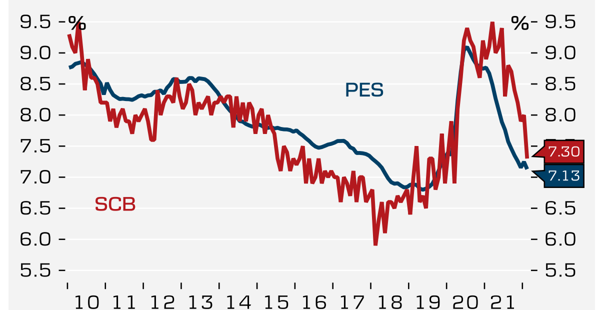
The rise in prices during the pandemic coincided with record-high turnover, so the demand is certainly there. Looking ahead, there are obviously a whole bunch of risks worth noting: 1) the Riksbank might have to raise its policy rate more than we are currently anticipating in order to rein in inflation; 2) inflation might reduce disposable income to the extent that housing prices are too high and so head down; 3) high energy prices and overly restrictive monetary policy might tip the economy into recession and cause unemployment to surge; 4) there might be changes to housing policy, such as reduced mortgage interest tax relief or a reintroduction of property tax; and 5) global uncertainties might

Are we headed for a consumer recession? Or will there be further fiscal stimulus?



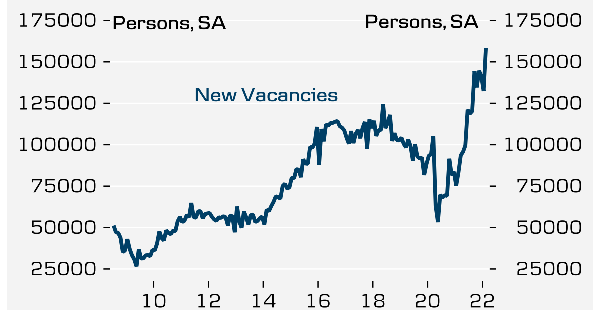
Sources: Statistics Sweden, Macrobond

Unemployment lower than before pandemic but should fall further



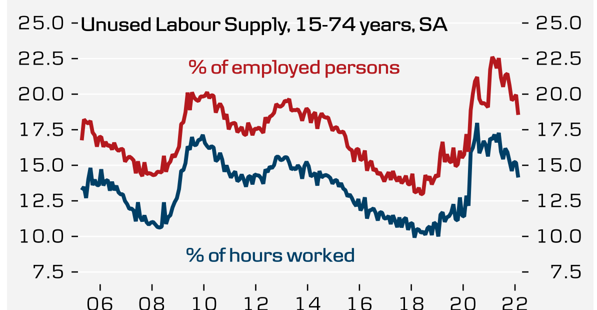
Sources: Swedish Public Employment Service, Statistics Sweden, Macrobond

No doubt the demand for labour is there



Sources: Swedish Public Employment Service, Macrobond

Relatively large unused labour supply should ease the shortages many firms are signalling



Sources: Statistics Sweden, Macrobond

escalate further, causing stock markets to collapse. While the housing market has not reacted negatively to the decline in share prices to date, there will undoubtedly be a pain threshold if losses continue.

Although inflation is currently very high, we expect it to head down again next year, and so we believe that the Riksbank will only manage to raise the repo rate to 0.75% before going back on hold (see separate section below). In other words, we will see rate increases, but the repo rate is expected to remain low by historical standards, albeit with each hike having more of an impact as debt levels rise. Here and now, though, we reckon that the biggest drag on housing prices will be households' interest rate expectations and the expectation that disposable income will fall as a consequence of strong inflation at the same time that the Riksbank is hiking the repo rate. On the other hand, we are still expecting unemployment to continue to improve gradually, with no fresh increases. When it comes to housing policy, this is an election year, which makes changes highly unlikely.

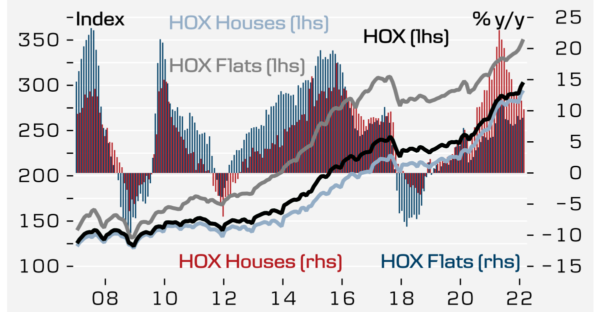
Despite the risks above, the pandemic (not to mention the years before that) have taught us not to underestimate the housing market. All in all, we reckon that drivers such as continued low interest costs in relation to disposable income, together with the labour market gradually improving, will play a greater role. We therefore estimate that housing prices will rise by around 5% in 2022 and 2% in 2023.

Inflation very high but still only temporary

There is no denying that inflation was surprisingly strong in the first two months of the year, and it is no longer primarily a matter of high energy prices – it is the core rate that has risen further than expected, even though we did predict a sizeable jump. The background to this, not unexpectedly, is that firms' costs have increased due to rising freight and transport costs, higher prices for intermediate goods and a weaker SEK. It is now clear that inflation has become more broad-based in the sense that more of the components of the CPIF ex energy are now rising at more than the target rate of 2% – nine out of twelve, in fact. However, we are still seeing, for example, that food prices are not climbing as quickly as might be expected given warnings from the industry and soaring prices for animal feed and fertilisers. We therefore expect core inflation to rise somewhat further in the coming months. We hardly need say that the outlook for energy prices is extremely uncertain. However, we reckon power prices will gradually return towards more normal levels as we move into summer, the weather gets warmer, and the spring melt refills reservoirs in the north of the country. That said, the past six months with the European energy crisis and Russia's war against Ukraine have shown that high gas prices on the continent can have repercussions in the two southernmost of Sweden's four power regions, with region 3 (which includes Stockholm) accounting for two-thirds of total household electricity consumption.

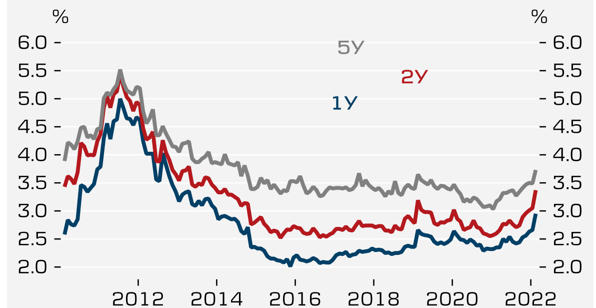
From a purely analytical perspective, the surge in inflation is almost exclusively a result of not just one but several successive supply disruptions. First, the pandemic had a negative effect through soaring global freight rates and commodity costs which gave price pressures concentrated to global goods prices. Now, Russia's attack on Ukraine has pushed energy and commodity prices up again. This type of inflation, which is exogenous to household finances, is bad for households' purchasing power (means negative real wage growth), as discussed above in the section on growth and consumption. This is

House prices have benefited most from pandemic but trend has now flattened



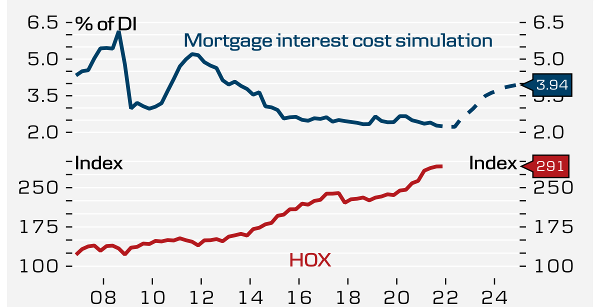
Sources: Valueguard, Macrobond

Households' interest rate expectations have risen sharply and will be important to keep an eye on



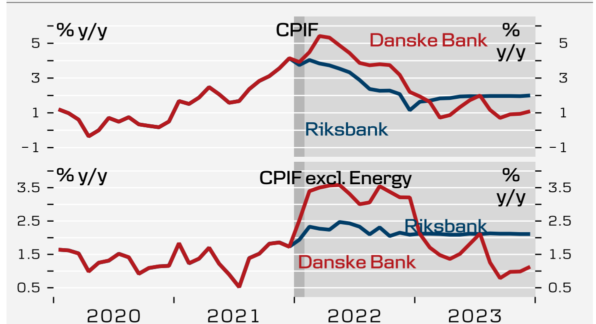
Sources: Swedish National Institute of Economic Research, Macrobond

Rate hikes will reduce households' disposable income



Sources: Danske Bank, Macrobond

Inflation with or without energy will be well above Riksbank target in 2022



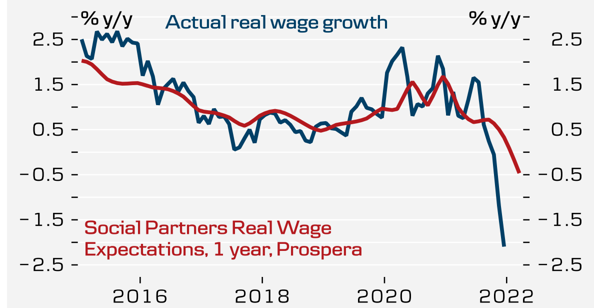
Sources: Statistics Sweden, Sveriges Riksbank, Danske Bank

very different to wage-led inflation, which is good for purchasing power (means positive real wage growth). The situation in Sweden is not the same as in the US, where inflation is also being fuelled by rampant demand thanks to extremely expansionary monetary policy and rising wages.

We expect core inflation to hold around 3.5-4.0% for much of this year before falling back to levels closer to 1.5% next year. This is partly because consumption and consumer prices will normalise in 2023, and partly because we believe that the round of wage bargaining kicking off in the first quarter of 2023 will not result in appreciably higher pay increases than normal. History shows that these are good neither for employees nor for employers. The heads of the industrial unions recently said exactly that in the press, which we take as a clear signal that the marker set by manufacturing will be at a reasonable level.

Our forecast for CPIF inflation does not allow for the government cutting the price of motor fuel. The opposition has proposed a reduction of SEK 5 per litre, and the government appears willing to go along with this. A cut of this size would reduce the rate of inflation by an estimated 0.4-0.5 percentage points.

Supply-led inflation behind the severe plunge in real wages and will weigh on expectations



Sources: Statistics Sweden, Swedish National Mediation Office, Prospera and Danske Bank's calculations

Riksbank must act – for the sake of credibility

Like most Swedish forecasters, the Riksbank was caught flat-footed by the pace of inflation at the beginning of the year, especially core inflation. Governor Ingves has made no secret of this in recent comments. Previously, most of the inflation could be put down to energy prices, but no longer.

We expect the Riksbank to revise up its inflation forecast at the upcoming meeting in April, and also to revise down its growth forecast somewhat in the direction of stagflation. Given the inflation numbers for February, we believe that the Riksbank will signal a first increase in the repo rate in September with further hikes at the next two meetings in November and February.

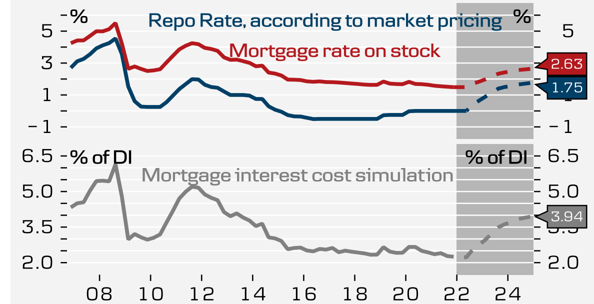
Very aggressive Riksbank pricing for the next three years – way beyond what we expect

Incremental CB pricing - Annual (per calendar year)			
As of 23-03-2022	2022	2023	2024
Last date	2022-12-29	2023-12-28	2024-12-27
ECB	50.7	84.1	2.8
FED	188.5	44.7	-32.9
BoE	133.9	31.5	-47.5
BoJ	0.6	10.5	1.9
SNB	32.3	84.7	5.9
Riksbank	69.6	85.8	20.7
Norges Bank	83.8	85.0	0.0
DKs Nationalbank	52.7	89.2	4.7

Source: Danske Bank

Although the Riksbank is aware that the current high inflation is supply-led and so contractionary in itself, we believe that it will feel forced to act because there is otherwise a risk of households and firms losing confidence in the inflation target. It is therefore likely that the Riksbank will limit the scale of its rate increases. The bank's own analysis shows that a 1 percentage point increase in the policy rate in the near future would double households' interest costs! This is, of course, a result of household debt having risen sharply in recent years, meaning that any rise in the repo rate will be that much more potent.

Mortgage costs will double their share of disposable income if Riksbank raises repo rate in line with



Sources: Sveriges Riksbank, Statistics Sweden, Danske Bank's calculations

Could the Riksbank move more quickly? Yes – we cannot rule out the possibility of the Riksbank raising the repo rate as early as the June/July meeting if the data show that the situation is deteriorating further. Besides core inflation now being well above target, we reckon that other factors will play a role, such as the ECB signalling a tighter stance. Long-term inflation expectations, which are said to reflect the credibility of the inflation target, will be watched closely, especially if they look like impacting on the upcoming round of pay talks.

When it comes to bond purchases, the Riksbank has already announced that it plans to keep its balance sheet intact this year before letting it shrink in 2023. However, we reckon purchases could be tapered further in the third quarter this year, with the balance sheet then starting to come down from the fourth quarter.

Let the debt anchor guide fiscal policy

Sweden's public finances are extremely strong, but the fiscal framework needs to be overhauled. The reason is that the surplus target, or even the alternative of a balanced-budget target, is at odds with the debt anchor. The current surplus target should be abolished, allowing central government to run deficits to the extent that Maastricht debt can be kept constant at the level of the debt anchor: 35% of GDP. Given that Maastricht debt will in all probability be lower than that this year, GDP growth could be used to fund a substantial share of the government sector's investment needs without having to raise taxes. Unfortunately, Sweden's politicians are still obsessed with bringing the debt ratio down further, despite Maastricht debt now being expected to drop towards 33% at the end of this year.

Abolishing the surplus target is a particularly interesting alternative in the light of the substantial additional funding the armed forces will need in the coming years now that defence spending is to rise to 2% of GDP from today's 1.2%. A simple simulation where annual GDP growth is assumed to be 4.1% through to 2030 (the same as the average for 2010-2021) shows that growth alone would generate fiscal space of around SEK 90bn in 2025 and SEK 110bn in 2030 with the debt ratio kept stable at 35%. Sweden would thus have no more debt in relative terms and could also reap a number of rewards: 1) taxes would not need to be raised; 2) provided that local government has a balanced-budget target, this financing corresponds to a budget deficit of just under 1.5% of GDP, well within the ceiling of 3% stipulated by the Maastricht criteria; 3) the increase in Sweden's defence spending to 2% could be covered by part of this deficit, and the rest could be used for government investment; and 4) the 35% target would still be sufficient to meet serious challenges in the future, as developments during the pandemic in particular clearly demonstrated: Maastricht debt increased by only around 5 percentage points to around 40% before heading back down.

In its forecast, the Swedish National Debt Office anticipates a budget surplus of around SEK 140bn in 2022, but the outlook now suggests an even larger surplus, as the persistent downward trend in the net borrowing requirement continued in February (around SEK 11bn less than expected). The forecast includes fiscal space of SEK 74bn in 2022 as well as a few extra billions for measures introduced in three amending budgets. The reduction in energy tax on petrol is not included, however, and could run to more than the SEK 14bn announced. It is, of course, important to take into account that interest rates have risen considerably in recent months as a result of central banks signalling policy rate hikes, which will push up not only government borrowing costs but also the cost of mortgage interest tax relief. These effects are not taken into account in the scenario above.

Scenario with constant Maastricht debt of 35% funding increased defence spending and other

Date	2010-2021 average	2025	2030
Nom GDP growth	4,1	4,1	4,1
Defence spending	52,0	126,0	155,0
Defence (% of GDP)	1,2	2,0	2,0
Maastricht debt (% of GDP)	39,4	35,0	35,0
Change in MD if constant at 35%		87,0	106,0
Budget deficit (% of GDP)		1,4	1,4
Extra to defence (0,8% of GDP), SEK		44,0	54,0
Left for reforms, SEK BN		43,0	43,0

Source: Danske Bank's calculations

At a glance

			Forecast	
National account	**2021**	**2021**	**2022**	**2023**
	SEK bn (current prices)		% y/y	
Private consumption	2325.9	5.7	3.3	1.9
Government consumption	1399.3	2.5	1.3	1.2
Gross fixed investment	1378.3	5.9	2.8	2.2
Growth contribution from inventories		0.4	0.0	-0.3
Domestic demand	5147.1	5.3	2.6	1.5
Exports	2489.2	7.2	5.1	3.9
Aggregate demand	7636.3	5.9	3.4	2.3
Imports	2255.0	9.1	5.6	3.4
Growth contribution from net exports		-0.5	0.0	0.4
GDP	5381.3	4.6	2.5	1.8
GDP, calendar adjusted	5369.9	4.5	2.5	2.0

Economic indicators	**2021**	**2022**	**2023**
Trade balance, SEK bn	208.8	206.9	226.6
- % of GDP	4.0	3.9	4.2
Current Account, SEK bn	263.8	256.9	276.6
- % of GDP	5.1	4.8	5.1
Public sector savings, SEK bn	-25.0	45.0	45.0
- % of GDP	-0.5	0.8	0.8
Public debt ratio, % of GDP*	37.0	33.0	30.0
Unemployment, % of labour force	8.8	7.0	6.8
Hourly wages, % y/y	2.7	2.0	2.1
Consumer prices, % y/y	2.2	4.0	1.3
House prices, % y/y	14.0	5.0	2.0

* Maastricht definition

Financial figures	**04/04/2022**	**+3 mths**	**+6 mths**	**+12 mths**
Leading policy rate, % p.a.	0.00	0.00	0.25	0.75

Sources: Statistics Sweden, Macrobond Financial, Danske Bank

Norway

Pressures mounting, rates rising

- **Capacity utilisation has increased further, although growth has been as expected.**
- **There are now signs of a shift towards greater consumption of services, and business investment is growing fast**
- **Unemployment is still falling, and both wages and prices have risen more than expected. .**
- **Norges Bank therefore raised its policy rate by 25bp in March and signalled another hike in June and two more by the end of the year.**
- **The housing market has been tighter than expected, but the prospect of higher interest rates will put a damper on prices**
- **The NOK is being pulled both ways, and the outlook is more uncertain than for a long time, but we would wager that it will weaken slightly in the short term.**

At a glance

Norway				
	Current forecast		Previous forecast	
% y/y	2022	2023	2022	2023
GDP (mainland)	3.8	2.0	3.8	2.0
Private consumption	6.5	2.5	6.5	2.0
Public consumption	1.3	1.3	1.3	1.3
Gross fixed investment	3.1	2.0	3.1	2.0
Exports	6.0	4.0	6.0	4.0
Imports	7.5	4.0	7.5	4.0
Unemployment (NAV)	2.0	1.9	2.3	2.2
Inflation	3.3	1.8	2.6	1.8

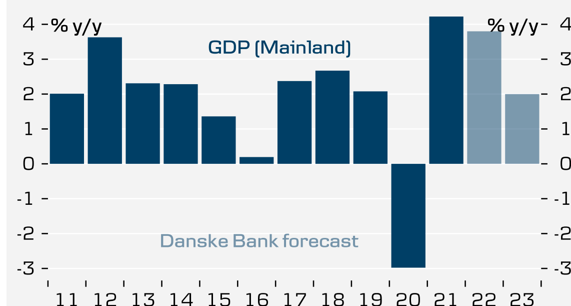
Source: Danske Bank

Higher-than-normal activity levels

Economic growth has been as expected since our previous forecast in December, but its composition has changed greatly. There has been very strong growth in business investment (excluding oil) and solid growth in housing investment. Private consumption has increased more slowly, however, probably as a result of lower real wage growth, government demand has risen only moderately, and there has been a clear drop in net exports (excluding oil) and oil investment.

Norges Bank's regional network survey for the first quarter showed an increase in the aggregated output index from 0.95 to 1.65, which corresponds to annualised growth of 3.3% over the next six months. This was higher than we expected, as the bulk of the recovery effect from the pandemic is now over, and firms are feeling the effects of bottlenecks and higher cost growth.

Growth much higher in 2021 but set to slow



Sources: Macrobond Financial, Danske Bank

Not unexpectedly, firms supplying services to households were the most upbeat, and retailers (which supply goods to the same households) were the most downbeat. This clearly illustrates the shift we have been expecting in private consumption now that Covid restrictions are behind us. Otherwise, the greatest optimism was in business services, such as consulting and recruitment, which presumably reflects the rise in investment activity and to some extent also the strong demand for labour. In the manufacturing sector, the growth outlook is brightest in oil-related industries, which needs to be seen in the light of higher oil prices and the petroleum tax package adopted last year. On the other hand, optimism in the export industry is ebbing after hitting its highest level since 2007 late last year. Expectations in the construction sector are also on the way up again after weakening in the second half of last year on the back of rapidly rising prices for materials and long delivery times.

The most interesting thing about the survey, however, is that the share of firms reporting that they are operating at full capacity climbed from 54.7% to 59.1%,

the highest since 2007. This confirms our assumption that the output gap is positive and widening, even though growth has been as expected.

We have not revised our growth forecast for 2022 and still expect mainland GDP to rise by 3.8%. We also still expect growth of 2.0% next year, although the composition of this growth has changed somewhat.

Ukraine war will impact via prices

The direct effects of the sanctions against Russia will be limited, at least at an aggregated level. Russia accounts for less than 1% of Norway's exports and less than 3% of its imports. Most of the effects on the Norwegian economy will therefore be indirect via financial and commodity markets. To date, the impact on financial markets has been very limited, and there are virtually no signs of problems sourcing funding or liquidity, although higher USD rates have brought slightly higher money rates in Norway too.

On the other hand, energy and commodity prices have rocketed, with repercussions for the Norwegian economy. First, higher petrol and electricity prices (via higher European gas prices) will erode households' purchasing power and reduce growth in their spending. It is estimated that consumer prices will rise by an extra 0.7% this year as a result. Without the government's support package to help consumers with their electricity bills, inflation would be 1 pp higher still.

For firms, the increase in costs will, of course, depend on their exposure to commodities and energy, but again we are looking at higher electricity, fuel and commodity prices which could have a particular impact on the likes of the transport industry. This will lead to reduced profitability, (temporary) shutdowns and/or even bigger increases in consumer prices. As mentioned above, we have not changed our growth forecast for this year, as the effect of higher commodity and energy prices in isolation of around -0.2 pp will be offset by changes in other components.

Lowest unemployment since before financial crisis

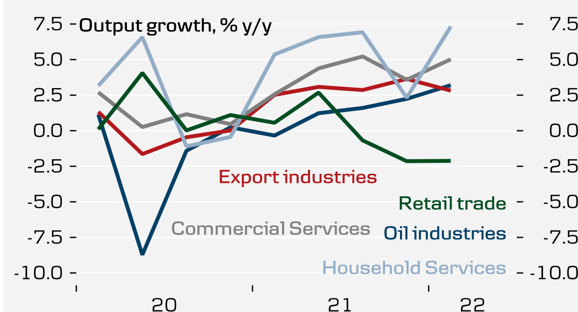
Strong demand for labour has meant that unemployment has fallen further since our December forecast, despite the pandemic restrictions in place from early December to mid-February. Registered unemployment dropped to X% in March, its lowest since before the financial crisis. According to the national accounts, the number of people in work increased by almost 39,000 in the fourth quarter, and the number of unemployed fell by 13,000.

Despite this strong job growth, there were still 95,600 vacancies, only 700 fewer than at the start of the quarter. This points to extremely strong growth in demand for labour given the big increase in employment during the same period.

Although the balance in the labour market has improved somewhat since our December forecast, there are still significant bottlenecks. Besides there still being a huge number of vacancies, the share of firms in the regional network survey reporting labour shortages as a constraint on production increased from 40.3% to 47.7%, the highest for 15 years.

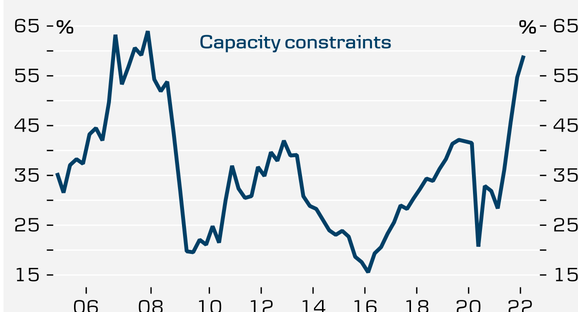
A closer look at flows in the labour market shows that there were almost 40,000 fewer foreign nationals on temporary work permits than normal in the fourth quarter. This is partly because there are still some complications with crossing borders, but may also be a result of substantial labour shortages in neighbouring countries. The big uncertainty is therefore whether these flows will return to pre-Covid levels.

Reopening effect very clear



Sources: Macrobond Financial, Danske Bank

Increasing capacity constraints



Sources: Macrobond Financial, Danske Bank

Jobless rate to drop below 2%

Sources: Macrobond Financial, Danske Bank

We have revised down our forecast for unemployment from 2.3% to 2.0% this year and from 2.2% to 1.9% next year.

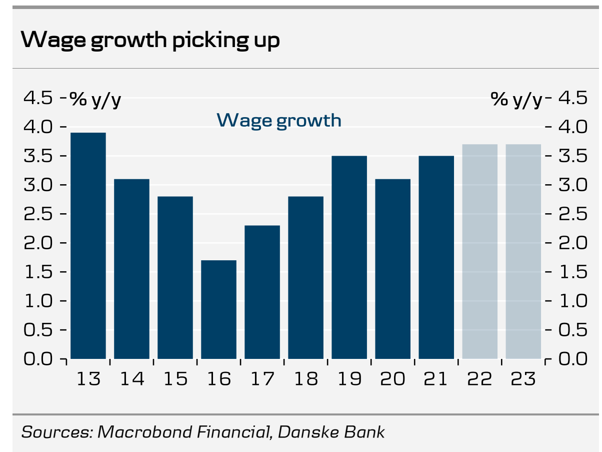
Wages and prices accelerating

Core inflation has surprised to the upside since our December forecast, hitting 2.1% in February. The surprise has mainly come from food and other imported goods, such as furniture, as domestic inflation has been more as we expected at around 2%. In other words, inflationary impulses from abroad have been stronger than expected despite the NOK appreciating. This is probably a reflection of global inflationary pressures being on the way up and stronger than anticipated.

Since one of the effects of the war in Ukraine is even higher commodity and energy prices, we can assume that global price pressures will increase. We must therefore expect further rises in imported inflation unless the NOK strengthens considerably, at least for the rest of this year.

Wage growth has also been higher than expected, ending up at 3.5% last year, somewhat higher than our forecast in December of 3.2%. This spells slightly stronger domestic inflationary impulses during the year. It also appears that the unions will be looking for compensation for inflation in this year's pay settlements, which we now expect to come out at 3.7%, up from our previous forecast of 3.4%. This is confirmed by the regional network survey, where firms' wage expectations for 2022 climbed from 3.3% to 3.7%.

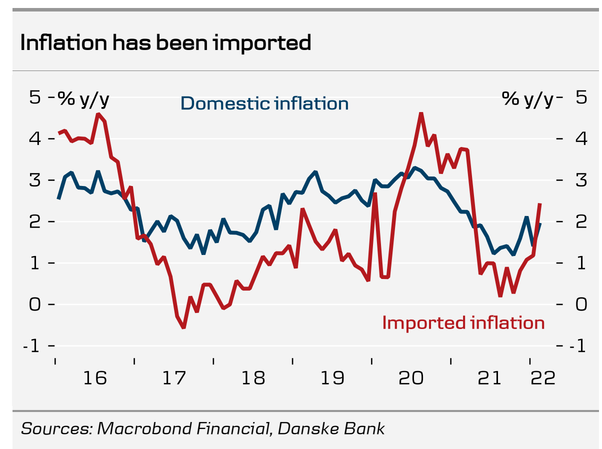
Wage growth picking up



Sources: Macrobond Financial, Danske Bank

We have therefore revised up our forecast for core inflation this year from 1.8% to 2.6%. Our forecast for 2023 is unchanged at 2.1%, because we expect the significant tightening of global monetary policy to put a damper on global inflationary pressures during the course of the year. We expect headline inflation to rise to 3.3% this year but drop back to 1.8% next year on the back of lower power prices.

Inflation has been imported



Sources: Macrobond Financial, Danske Bank

Housing market tighter than expected but will cool

Housing price inflation has been surprisingly strong so far this year, which appears to be a result of an unexpectedly tight market, with relatively few properties for sale in relation to turnover. This could be because housing starts were much weaker in the second half of last year than we had anticipated. One possible explanation is that the sharp rise in building costs since last summer, combined with long delivery times for many building materials, has led to some planned projects being delayed or cancelled.

On the other hand, there are now clear signs that interest rates are on the way up, and uncertainty around how high mortgage rates will go will probably limit homebuyers' ability and desire to push prices much higher.

We therefore expect prices to fall slightly towards the end of this year, giving an increase of just under 4% for 2022 as a whole. With a negative overhang from this year, further increases in interest rates and a slightly larger supply of properties, we now expect prices to decrease by just over 1% in 2023.

It is important to stress that the risk of a strong supply-driven decline in housing prices is only moderate. While the supply of properties has improved somewhat, and there is now a better balance in the market, it remains relatively tight in terms of the stock-to-sales ratio.

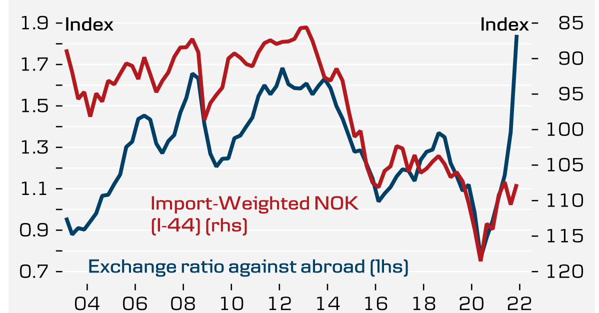
NOK pulled both ways

It is a long time since the outlook for the NOK has been this uncertain. On the one hand, the risk of a global slowdown, and so a reduced appetite for risk, has increased as a result of strong inflation, tighter monetary policy and higher energy prices. This would normally be a time where less liquid currencies such as the NOK perform poorly, especially when inflation expectations begin to fall.

On the other hand, the war in Ukraine has challenged the consensus expectation that all fossil energy will be phased out, oil and gas prices will tumble, and investors will eliminate all fossil exposure. Oil and gas prices have shot up, and Norway's terms of trade have hit unprecedented levels. We cannot rule out the possibility of this being a structural shift, where market participants are looking to increase their exposure to commodities in general, and oil and gas in particular, either as an investment or as a hedge against higher energy prices. Coupled with the RUB probably being a no-go for investors for some time, this could spell greater interest in the NOK, causing it to appreciate.

At the time of writing, it would appear that the latter effect is dominating, but over the course of this year we still expect policy rate hikes and QE tapering in a number of countries to push up global real rates, boost the USD and slow/reverse the rise in inflation expectations. All of these factors will act as headwinds for commodities and commodity-based currencies such as the NOK. We therefore still think the NOK could weaken slightly despite signals of higher interest rates, and head towards 10 against the EUR and move above 9 and up towards 9.50 in 12 months against the USD. But we would again stress that there is more uncertainty than for a long time.

NOK seeing a structural shift?

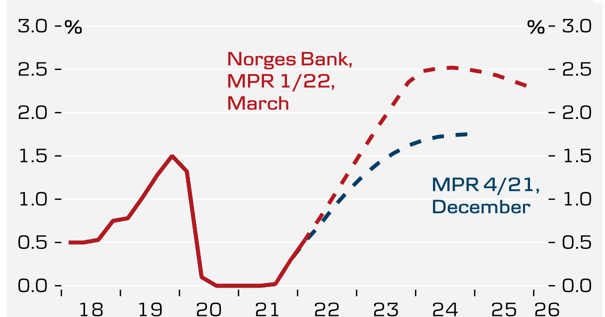


Sources: Macrobond Financial, Danske Bank

Norges Bank continues normalisation of monetary policy

As we expected, Norges Bank raised its policy rate by 25bp to 0.75% at its March meeting and signalled that it will most likely go up again in June. The projections in the accompanying monetary policy report then show two further hikes this year (September and December) and another four in 2023, taking the policy rate to around 2.5% at the end of 2023. This is a marked upward revision from December and is a result of increased capacity utilisation, rising wage and price inflation, and higher interest rates among Norway's trading partners. The central bank notes the upside risk from wages and prices rising faster than it expects, but also that the war in Ukraine could bring weaker global growth than it is assuming. We largely share Norges Bank's view of the outlook for Norway, but believe that the pressures in the economy will begin to ease earlier, during the first half of this year, as interest rates begin to hit demand. On the other hand, we anticipate a global slowdown as inflation undermines households' purchasing power and pushes up firms' costs. Energy prices will probably also remain relatively high, and central banks will not have the option of stimulating growth given the pace of inflation. We therefore expect the policy rate to be raised again in June, with Norges Bank then delivering two further hikes this year (September and December) but only two more next year (March and June). This would leave the policy rate at 2%, or slightly above the natural rate, from next summer.

Norges Bank policy rate projections revised up sharply



Sources: Macrobond Financial, Danske Bank

At a glance

National account	2021	2021	2022	2023	
			Forecast		
	NOK bn (current prices)	% y/y			
Private consumption	1530.8	4.2	6.5	2.5	
Public consumption	965.8	3.0	1.3	1.3	
Gross fixed investment	966.4	1.0	3.1	2.0	
Petroleum activities	177.5	-1.5	-6.0	8.0	
Mainland Norway	785.6	0.9	4.0	3.0	
Dwellings	48.3	3.2	3.7	3.0	
Enterprises	48.9	1.4	4.5	4.0	
General government	221.5	-2.5	2.0	1.3	
Exports	1722.7	4.1	6.0	4.0	
Traditional goods	492.9	6.5	3.0	3.0	
Imports	1206.5	2.0	7.5	4.0	
Traditional goods	831.3	5.0	4.5	2.8	
GDP	4144.1	3.8	3.8	2.0	
GDP Mainland Norway	3265.3	4.0	3.8	2.0	
Economic indicators		**2021**	**2022**	**2023**	
Employment, % y/y		1.1	2.3	0.8	
Unemployment (NAV), %		3.1	2.0	1.9	
Annual wages, % y/y		3.5	3.7	3.7	
Consumer prices, % y/y		3.5	3.3	1.8	
Core inflation		1.7	2.6	2.1	
Housing prices, % y/y		9.0	3.9	-1.2	
Financial figures		**04/04/2022**	**+3 mths**	**+6 mths**	**+12 mths**
Leading policy rate, % p.a.		0.75	1.00	1.25	1.75

Sources Statistics Norway,: Norges Bank, Macrobond Financial, Danske Bank

Finland

Eastern headwinds cool down the outlook

- **The Russo-Ukrainian war has a big economic impact on Finland, which is the most exposed Nordic country measured by the value of foreign trade. We have lowered our GDP growth forecast to 1.7% in 2022 (was 2.8%). Relatively strong employment shields the economy from a bigger impact.**
- **Inflation will be higher for longer also in Finland, which takes some wind out of consumption, which was earlier expected to continue its good recovery from Covid-19 restrictions.**
- **Uncertainty is likely to delay investment decisions, but investment in domestic energy and national crisis management abilities contribute positively. Housing construction is booming in H1, but uncertainty is likely to put some new projects on hold in H2.**
- **We expect housing market to calm down with fewer transactions, but we do not anticipate decreasing housing prices on average.**
- **The economic slowdown together with likely investment into energy infrastructure and national defence put pressure on public finances.**

From high hopes to an era of uncertainty

The Finnish economy has made a broad based recovery from the Covid-19 induced economic slump, with limited long-term economic damage. Structures intact, the economy has been able to regain speed faster than we expected. GDP exceeded its pre-covid-19 level in Q3 2021. GDP per capita rose to a new record level in 2021. The previous record was set in 2008, before the financial crisis. Many other European countries recovered faster from that crisis, but Finland was held back by weak export competitiveness, loss of the Nokia mobile phone business and slowdown in trade with Russia after the annexation of Crimea in 2014. The output gap was not fully closed in 2021, Covid-19 lockdown measures have been lifted to a large extent, and the outlook for 2022 was good at the beginning of the year, before the Russian invasion into Ukraine made the outlook less promising.

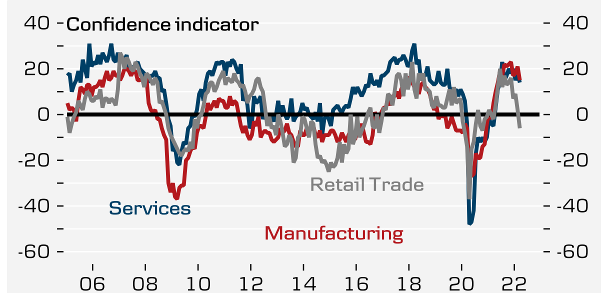
The Russia-Ukraine War has a big economic impact on Finland, which is the most exposed Nordic country measured by value of foreign trade. Russia was Finland's fifth largest export market in terms of the value of goods exports in 2021. Russia's role in imports has been even greater, especially due to the import of oil and natural gas. Russia has played an even bigger role in the past, but its importance shrank after the occupation of Crimea in 2014. The economic connections between the countries are significant in other ways as well. Many Finnish companies have had production facilities in Russia and Russian tourism has been a big source of revenue for the Finnish travel industry and retail trade. However, these connections have also declined in recent years. Ukraine's direct importance to the Finnish economy is small, but the war has indirect effects trough global markets in raw materials such as grains. Inflation will be higher for longer also in Finland. One potentially big impact comes through uncertainty in geopolitical and economic sense. Uncertainty could postpone investment decisions in many industries.

At a glance

Finland				
	Current forecast		Previous forecast	
% y/y	2022	2023	2022	2023
GDP	1.7	2.0	2.8	1.6
Private consumption	2.3	2.5	3.5	1.5
Public consumption	1.0	1.0	1.0	0.5
Gross fixed investment	3.0	3.0	4.0	3.0
Exports	3.0	3.0	6.0	3.0
Imports	4.0	3.5	6.5	3.0
Unemployment rate	7.0	6.6	6.9	6.6
Inflation	4.4	2.0	2.6	1.8
Government balance, % of GDP	-3.0	-1.8	-2.3	-1.3
Current account, % of GDP	0.2	0.4	0.8	0.7

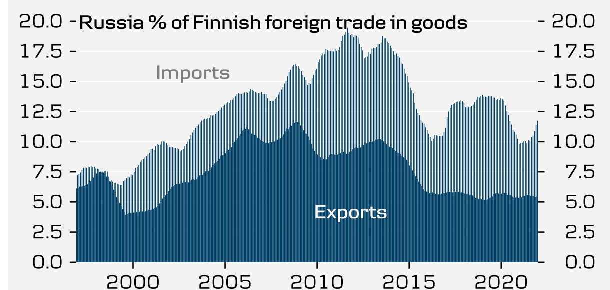
Source: Danske Bank

Business confidence slightly down in March



Sources: Macrobond Financial data, Statistics Finland

Finnish trade with Russia lost significance after 2014

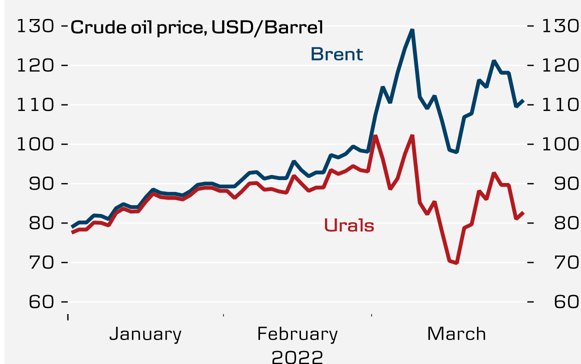


Sources: Macrobond Financial, Statistics Finland

Adaptation has begun

Finnish companies have already started replacing Russian material with other sources. Urals crude oil is being replaced with North Sea Brent. Russian timber is being replaced by domestic sources. In both examples companies continue to operate, but with higher costs and possibly lower profit margin. On the other hand, prices for sawn materials from Finland may rise without Russian competition. The degree of adaptation is more challenging for companies that have significant production or other operations in Russia or Ukraine. Several factories in Russia have been closed already, also without pressure from sanctions. In some cases, these closures are permanent and may imply additional investments in Finland or somewhere else in the West. Accelerated implementation of renewable energy and other energy related projects, attention to defence spending as well as investment into civil crisis preparedness could boost investment. On the other hand, uncertainty and political considerations could put some commercial investment plans on hold. This applies for example to the Hanhikivi nuclear power plant, which is based on a Russian reactor and is one third owned by a Finnish subsidiary of Russia's Rosatom.

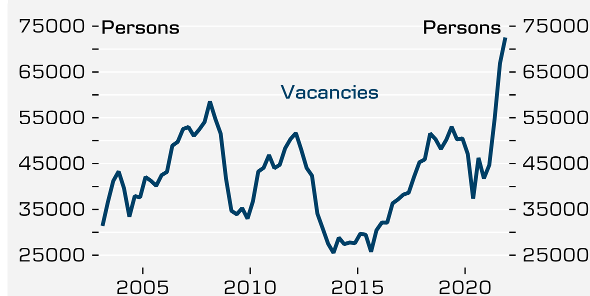
Alternative to Russian crude oil costs more



Sources: Macrobond Financial data

Demand from Russia is harder to replace for some companies, but goods are mostly universal in nature and could be sold elsewhere. According to the BEC trade classification, manufacturing production goods exports accounted for 45.5 per cent of Finland's exports to Russia. Capital goods, such as mining and forestry equipment, accounted for 31.3 per cent. Refined fuels and lubricants accounted for 8.9 per cent and transport equipment for 8.2 per cent. The share of consumer goods was only 4.0 per cent. Forestry and mining activity could increase outside Russia, which could bring new orders over time.

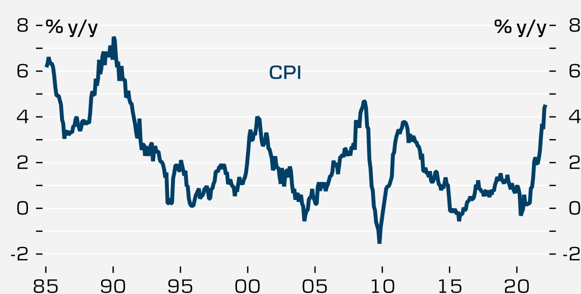
Open vacancies are plentiful and harder to fill



Sources: Macrobond Financial data, Statistics Finland

Finnish labour market has become tight during the recovery phase. The seasonally adjusted trend of the employment rate was 74.0 per cent and the trend of the unemployment rate was 6.8 per cent in February 2022. The peak in employment before the Covid-19 crisis was 72.6 per cent in February 2020, and the rate has been higher only in the early 1990s. Open vacancies increased to a record figure of 122,000 new vacancies and an increasing number of companies have reported lack of skilled labour as the main barrier to growth. Loss of trade with Russia and weaker economic growth will lead to some layoffs, but we expect the strong labour market to absorb the shock without significant rise in unemployment.

Inflation hits the consumer purchasing power



Sources: Macrobond Financial data, Statistics Finland

Inflation measured by the national CPI rose to 4.5 per cent in February. Fuel and electricity together with housing renovation made the biggest contributions. Food is expected to become more expensive and labour costs are rising more than before. We expect inflation to rise to over 5 per cent during spring, and slowly fall towards the end of the year. Domestic electricity production should lower cost pressures. The third unit of the Olkiluoto nuclear power plant has become operational and should reach full capacity in July, and the unit is expected to cover about 14 percent of Finland's electricity consumption. Electricity has been imported mostly from Sweden and Russia. We forecast the annual average inflation to reach 4.4 per cent. Higher inflation means an additional burden on consumers and slows down the recovery of consumer demand from the collapse caused by the Covid-19. To counter the negative impact, Finnish households have a good employment situation and,

on average, more savings than ever before. We still expect consumer demand to recover especially in services, unless the geopolitical situation gets worse.

The housing market looks stable

The Finnish housing market continued to perform well in 2021 and early 2022. Housing prices rose 5.4% in the Helsinki region and 2.4% year-on-year in the rest of the country in Q4 2021. Household purchase intentions were high in early 2022, according to Statistics Finland’s monthly survey. The corona crisis has supported active buying so far. When people spend a lot of time at home, and also work from home, there is an increased need to find new housing. Search for yield has also encouraged many individuals to become real estate investors and enter the buy-to-let market. Currently people are starting to return to the workplace, which reduces demand for extra space.

Supply of both old and new homes has been limited, but increasing construction boosts supply in 2022. Housing construction is booming in H1, but uncertainty caused by the war in Ukraine is likely to put some new projects on hold in H2. We expect the housing market to calm down with fewer transactions, but we do not anticipate decreasing housing prices on average. Home purchase intentions remained above average in March. We expect prices still to rise in growth centres, and stay flat or fall in locations with shrinking population. Finland is behind many other EU countries in terms of urbanisation, which makes it likely that a trend towards urban living will continue in the future. Refugees from Ukraine are likely to need rental housing in the near future.

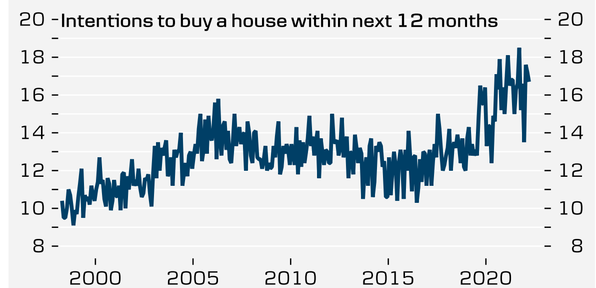
Growth slows but does not stop

Uncertainty about the future is great and the development of the war is difficult to predict. In the best case scenario for the economy, Russia and Ukraine would agree to a ceasefire, Russia would park its tanks behind the border, and the situation would calm down. Even in this case, there would be an impact, as many companies have already withdrawn from Russia and trade flows have been diverted. In the worst case, the war will escalate, energy supplies will be cut off, and Finland, together with the rest of Europe, will fall into a recession. There are different scenarios between these outcomes. Our base case is that the war continues this year, but does not expand outside Ukraine.

The war has both immediate and long-lasting effects on Finland's economic outlook. The direct shock from the loss of trade is significant. In the longer run, Finland must adapt to a world with fewer commercial ties with Russia. The magnitude of impact on the Finnish economy as a whole is difficult to quantify. Much depends on the development of the situation and the ability of Western economies to adapt to the closure of Russia's borders. Slowdown in the euro area has a second round negative impact on Finnish exports.

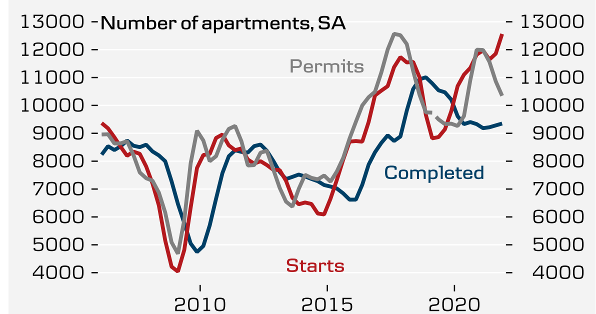
We have lowered our GDP growth forecast to 1.7% in 2022 (was 2.8%). The forecast includes a brief recession in mid-2022, but relatively strong employment shields the economy from a bigger impact. We expect 2.0% growth in 2023, assuming that the geopolitical situation does not get much worse. Lower inflation boosts consumption and investment projects focus on renewable energy. Escalation of the war or a big energy disruptions could drive the economy into a deep recession. The prolongation of the war and expansionist Russian foreign policy would mean a long-term adjustment to time without significant economic relations with Russia. Sanctions are not the

Household interest in home purchase has peaked



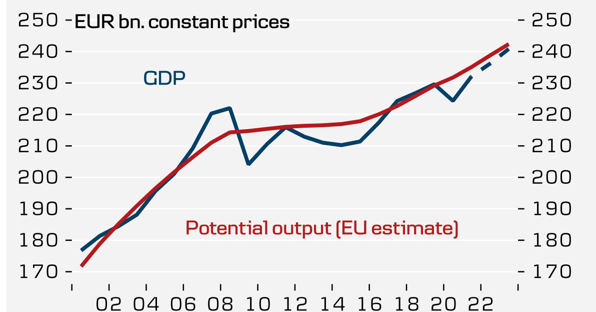
Sources: Macrobond Financial, Statistics Finland

New starts indicate active housing construction



Sources: Macrobond Financial, Statistics Finland

Output gap closing in late 2023



Sources: Macrobond Financial, Statistics Finland

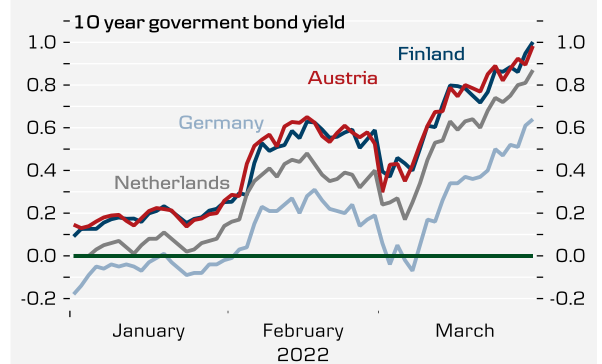
only thing limiting trade, other considerations like voluntary boycotts of goods and services of Russian origin matter too. There exists also other risks, like a recession in the US.

Public finances and geopolitical uncertainty

According to the latest supplementary budget, the central government net borrowing need is EUR 7.6bn in 2022. We expect a larger deficit in the light of the Russian invasion into Ukraine. The economic slowdown together with likely investment into energy infrastructure and national defence put pressure on public finances. The debt-to-GDP ratio fell more than we anticipated in 2021, because the recovery improved public finances and the government was able to tap funding raised in 2020. We now expect the public debt-to-GDP ratio to rise moderately in 2022. Ageing population implies significant increase in age-related costs in coming years. Rating agencies expect structural reforms to boost economic growth and keep ageing related costs down.

Finland shares a more than 1000km long border with Russia and was part of the Russian empire between 1809 and 1917. Finland has maintained a non-allied but Western oriented foreign policy for a long time. Finland has also maintained an ability to raise a large land army with continued conscription, unlike in most of Western Europe, and recently decided to purchase 64 F-35 fighters from the US to replace the old F-18 fighters. Russian authorities have warned that consequences will follow if Finland joins NATO. Finland has had stable relations with Russia for decades. Putin himself has in the past described the relations as extremely good. Due to the unpredictability of Russia's current politics there obviously exists an increased sense of geopolitical risk, albeit small. NATO membership is an issue that is under active discussion and has in surveys become more popular in recent weeks. In terms of geopolitical risk, even under the current political unpredictability, a military confrontation looks unlikely. Finnish government bond yields have moved up largely in line with European peers with similar rating, irrespective of the geopolitical position.

FGB yield moves higher largely in line with peers



Sources: Macrobond Financial

At a glance

National account	2021	2021	2022	2023	
			Forecast		
	EUR bn (current prices)	% y/y			
GDP	252.9	3.5	1.7	2.0	
Imports	97.9	5.3	4.0	3.5	
Exports	98.5	4.7	3.0	3.0	
Consumption	188.8	3.6	1.9	2.0	
- Private	127.8	3.1	2.3	2.5	
- Public	60.9	3.2	1.0	1.0	
Investments	59.1	1.2	3.0	3.0	
Economic indicators		**2021**	**2022**	**2023**	
Unemployment rate, %		7.7	7.0	6.6	
Earnings, % y/y		2.3	2.8	2.6	
Inflation, % y/y		2.2	4.4	2.0	
Housing prices, % y/y		3.7	0.5	2.0	
Current account, EUR bn		2.3	0.5	1.0	
- % of GDP		0.9	0.2	0.4	
Public deficit, % of GDP		-2.6	-3.0	-1.8	
Public debt/GDP, % of GDP		65.8	66.1	65.5	
Financial figures		**04/04/2022**	**+3 mths**	**+6 mths**	**+12 mths**
Leading policy rate, % p.a.		-0.50	-0.50	-0.50	0.00

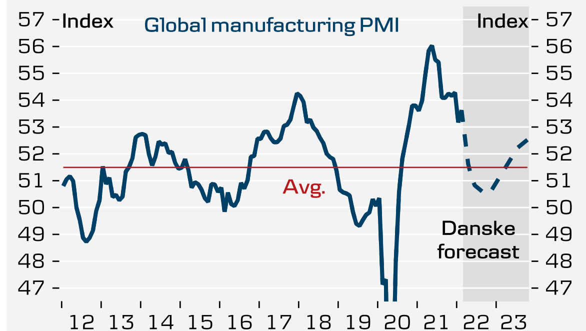
Sources: Statistics Finland, Macrobond Financial, Danske Bank

Global overview

Headwinds piling up

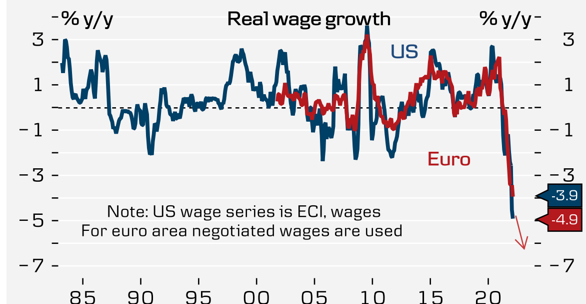
- **The world economy is facing severe headwinds following the breakout of the war in Ukraine. Rising commodity prices, financial tightening and renewed uncertainty is set to push the global economy close to recession over the coming quarters. However, we expect the global economy to gather pace again going into 2023.**
- **On a 1-2 year horizon, we see renewed risk of economic weakness or recession in the US, as monetary policy tightening lowers activity.**
- **Inflation is set to rise to even higher levels and we look for euro inflation to move above 9% in April before levelling off. In the euro area we look for inflation to fall back to around 2% in 2023 based on a stabilisation in commodity prices and moderate wage growth.**
- **We look for the Fed to respond strongly by hiking rates on every meeting rest of the year and with 50bp hikes on the next three meetings. ECB is more challenged by a weaker economy and we look for the rate hike take-off to happen in December. Lower wage growth should allow ECB to be more patient.**

Global manufacturing activity to slow from a high level



Source: Danske Bank

Major erosion of purchasing power from decline in real wages



Sources: Markit, Macrobond Financial, Danske Bank

Ukraine war clouds macro outlook

The Russian attack on Ukraine and the swift sanction response from the West has triggered the biggest geopolitical crisis in Europe since the Second World War. Key commodity prices have soared from already elevated levels following tightened sanctions on Russia and uncertainty prevails about its supply of commodities to the world market, including oil, gas, precious metals and grain. This has re-awakened fears of stagflation or even a global recession similar to the oil price shocks in the 1970s.

Our updated forecasts after the Ukraine broke out

		2022		2023	
GDP	Euro Area	2.5% (3.8%)	↘	2.8% (1.9%)	↗
	China	4.7% (5.0%)	↘	5.3% (5.0%)	↗
	US	2.8% (3.5%)	↘	2.0% (2.2%)	↘
Inflation	Euro Area	7.0% (4.7%)	↗	2.0% (1.6%)	↗
	China	3.0% (2.0%)	↗	2.5% (2.2%)	↗
	US	7.2% (6.4%)	↗	3.0% (2.8%)	↗

Previous projections in parenthesis

Sources: Macrobond Financial, Danske Bank

Before the war hit, we expected global growth to be around trend growth most of the year. However, the recent headwinds has increased the risk that we could see a short recession in 2022. First, the commodity price shock is eroding real wage growth significantly. The euro area will likely face a 6-7% real wage decline in coming months. While some of the higher energy bill is compensated by governments the income hit will still be significant. Second, financial conditions have tightened with bond yields moving higher and equities and credit spreads taking a hit. Third, there will be a direct effect from lower exports to Russia and the countries most exposed the Russian economy. This effect is not expected to be big as for example euro exports to Russia are only 3% of total exports. But nevertheless the effect will be there. Finally, we have seen a hit to sentiment. German ifo expectations dropped sharply in March suggesting a high level of uncertainty. High input costs amid a hit to consumer demand and uncertainty over oil and gas availability is likely affecting the sentiment. The sum of these headwinds are hard to quantify. In our baseline scenario, we don't see a recession but risk is rising and the likelihood is highest in Europe.

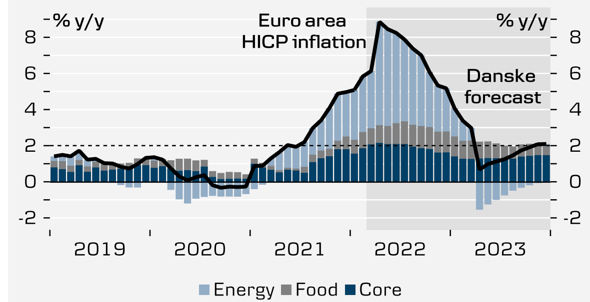
Another factor weighing on the global growth picture is renewed challenges for the Chinese economy. New covid outbreaks hitting the major cities of Shenzhen and Shanghai has led to lockdowns which weigh on consumption and add further challenges to supply chains. On top of this, the property crisis continues to linger with renewed stress in early 2022 and the uncertainty related to the risk of sanctions on China, higher commodity prices and a more bleak export outlook is set to dampen private investment activity. We expect more easing measures to compensate for the headwinds but don't think it's enough to lift growth in H1. Instead we see a recovery in H2 on the back of more stimulus measures and a gradual improvement in the construction sector.

Overall, we have lowered our real GDP forecast for the euro area from 3.8% to 2.5% this year. The hit to growth is somewhat smaller in the US and China, where we have lowered our growth forecast to 2.8% and 4.7%, (from 3.5% and 5% respectively) in 2022.

Already high inflation and further price pressures from higher commodity prices pose a dilemma for Western central banks about how to mitigate the weakening growth outlook. We have raised the inflation trajectory for both US, euro area and China. We expect both the Fed and ECB to continue their normalisation of monetary policy, perhaps at a slightly slower pace than prior to the start of the war. This adds to the current tightening of financial conditions weighing on economic growth. The exception is China, where much more muted inflation pressures provide room to stimulate growth through modestly expansionary monetary and fiscal policies. However, near-term headwinds from COVID-19 outbreaks, property sector stress and weakening export demand will weigh on China's recovery.

In our base-case with elevated but stable commodity prices, we see a modest economic rebound in late 2022 and 2023. In Europe, we expect public and private investments to pick up speed, to boost the green transition and energy efficiency to reduce dependency on fossil fuels. In the US, investments in shale oil are also expected to pick up. Moreover, real incomes should recover as inflation declines and wage growth accelerates. Furthermore, helped by the stimulus in China, strengthening economic activity will also spill over to higher export growth in the US and euro area. As a result, we see real

Euro Inflation significantly above target in 2022

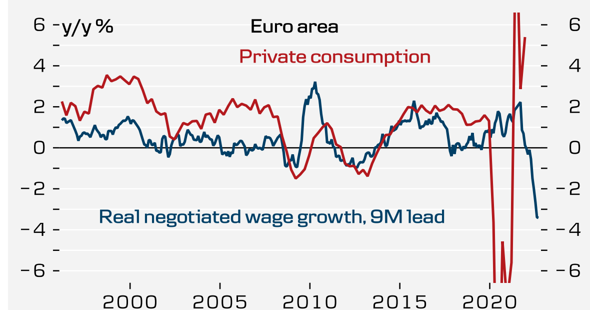


Sources: Eurostat, ECB, Macrbond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future

Euro consumer as well as business confidence has taken a big hit

Sources: Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future

Major real wage squeeze for euro consumers



Sources: ECB, Eurostat, Macrobond Financial, Danske Bank

GDP growth increasing to 2.8% (1.9% previously) in the euro area in 2023, and 5.3% in China (5.0% previously), while the US is now expected to grow by 2.0% in 2023 (2.2% previously).

In a downside scenario, where there is an escalation of the war possibly beyond the borders of Ukraine or Russian application of non-conventional weapons, the risk of recession in Europe increases significantly. Global risk sentiment will likely take a beating, while sharply rising commodity prices would provide a sharp hit to private consumption and investment. The euro area will be most at risk given the geographical exposure to the conflict and the hit to energy supplies, possible production cuts and further spikes in gas and oil prices.

Another major risk for the global outlook in 2023 and 2024 is that monetary policy tightening in the US might lead to a significant economic slowdown or outright recession. Given that inflation has become very high and widespread, the Fed has little room for manoeuvre to delay rate hikes, even if the economy start showing signs of weakness. There is a very high level of uncertainty over the outlook for inflation and the economy more widely, and that increases the risk that the Fed will misjudge the need for policy tightening and inadvertently trigger a recession.

Economic forecast

Macro forecast. Scandinavia

	Year	GDP[1]	Private cons.[1]	Public cons.[1]	Fixed inv.[1]	Ex-ports[1]	Im-ports[1]	Infla-tion[1]	Wage growth[1]	Unem-ploym[3]	Public budget[4]	Public debt[4]	Current acc.[4]
Denmark	2021	4.7	4.3	3.7	5.6	7.8	8.2	1.9	3.0	3.7	2.4	36.7	8.3
	2022	3.5	2.2	0.6	2.0	6.0	4.0	4.5	3.7	2.4	1.7	32.6	7.5
	2023	1.3	2.5	0.5	1.1	3.1	4.1	1.2	4.0	2.5	1.8	30.3	7.7
Sweden	2021	4.5	5.7	2.5	5.9	7.2	9.1	2.2	2.7	8.8	-0.5	37.0	1.4
	2022	2.5	3.3	1.3	2.8	5.1	5.6	4.0	2.0	7.0	0.8	33.0	4.8
	2023	2.0	1.9	1.2	2.2	3.9	3.4	1.3	2.1	6.8	0.8	30.0	5.1
Norway	2021	4.2	5.0	3.9	-0.3	4.8	2.0	3.5	3.5	3.2	-	-	-
	2022	3.8	6.5	1.3	3.1	6.0	7.5	3.3	3.7	2.0	-	-	-
	2023	2.0	2.5	1.3	2.0	4.0	4.0	1.8	3.7	1.9	-	-	-

Macro forecast. Euroland

	Year	GDP[1]	Private cons.[1]	Public cons.[1]	Fixed inv.[1]	Ex-ports[1]	Im-ports[1]	Infla-tion[1]	Wage growth[1]	Unem-ploym[3]	Public budget[4]	Public debt[4]	Current acc.[4]
Euro area	2021	5.3	3.5	3.8	4.3	10.9	8.6	2.6	4.1	7.7	-6.9	99.8	3.1
	2022	2.5	2.8	3.9	3.7	7.3	9.4	7.2	2.5	6.7	-3.6	97.6	3.2
	2023	2.8	1.2	3.7	4.5	5.3	4.9	2.0	3.4	6.5	-2.1	96.7	3.4
Germany	2021	2.9	0.1	3.1	1.3	9.8	9.1	3.2	3.4	3.6	-4.9	71.4	6.6
	2022	1.0	2.8	2.6	0.2	6.2	8.8	7.4	3.2	3.1	-2.1	69.2	6.6
	2023	3.6	1.6	4.1	4.0	6.4	4.9	2.7	3.8	2.9	-0.5	68.1	6.8
Finland	2021	3.5	3.1	3.2	1.2	4.7	5.3	2.2	2.3	7.7	-2.6	65.8	0.9
	2022	1.7	2.3	1.0	3.0	3.0	4.0	4.4	2.8	7.0	-3.0	66.1	0.2
	2023	2.0	2.5	1.0	3.0	3.0	3.5	2.0	2.6	6.6	-1.8	65.5	0.4

Macro forecast. Global

	Year	GDP[1]	Private cons.[1]	Public cons.[1]	Fixed inv.[1]	Ex-ports[1]	Im-ports[1]	Infla-tion[1]	Wage growth[1]	Unem-ploym[3]	Public budget[4]	Public debt[4]	Current acc.[4]
USA	2021	5.7	7.9	0.5	7.8	4.5	14.0	4.7	4.0	5.4	-13.4	129.7	-3.5
	2022	2.8	2.5	0.1	2.9	4.9	5.5	7.2	5.0	4.0	-4.7	125.6	-3.5
	2023	2.0	1.9	1.0	3.5	1.5	1.8	3.0	4.6	3.8	-3.1	124.0	-3.3
China	2021	8.0	10.2	-	5.2	-	-	0.7	5.0	-	-5.6	68.9	3.0
	2022	4.7	6.0	-	3.0	-	-	3.0	5.5	-	-7.0	72.0	1.0
	2023	5.3	6.0		4.5			2.5	5.5		-6.8	74.5	0.7
UK	2021	7.4	6.2	14.3	5.9	-1.3	3.8	2.6	4.9	4.5	-5.4	95.6	-3.0
	2022	5.1	6.1	3.3	6.5	3.3	4.8	5.2	3.2	4.0	-3.9	95.5	-4.6
	2023	2.4	2.5	0.8	4.8	3.4	3.7	2.9	3.9	3.7	-1.9	94.1	-4.2
Japan	2021	1.8	1.4	2.7	-1.1	10.9	5.9	-0.2	-	2.8	-	-	-
	2022	2.4	3.3	2.2	-0.5	3.0	2.0	0.4	-	2.6	-	-	-
	2023	1.2	1.4	0.7	0.4	3.2	2.0	0.5	-	2.5	-	-	-

Sources: OECD and Danske Bank. 1) % y/y. 2) % contribution to GDP growth. 3) % of labour force. 4) % of GDP.

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