30 September 2013

Sweden Outlook

Keepin' our hopes up

- **Danske Bank has remained one of the most optimistic forecasters on the Swedish economy since late 2012. We have based this view on nothing less than a post-crisis first increase in global and domestic bank lending to households, implying that lenders and borrowers have started to see eye to eye on future income prospects.**
- **Whether this is also warranted from a longer-term perspective remains to be seen (admittedly, we have some doubts) but in the short run, which this publication covers, it cannot be ignored since it implies that the deleveraging process instigated by the crisis may finally be grinding to a halt.**
- **Of course, there are still downside risks – such as the notably more restraining financial conditions, which we believe provide a litmus test of the first 'real' recovery since the financial crisis hit. Thus, if the world economy and the external trade dependent Swedish economy prevail in the face of higher capital costs, the period ahead looks very bright – perhaps even brighter than our forecasts suggest.**
- **Alas, some indicators, such as US mortgage applications and pending home sales, point to higher interest rates having an adverse impact on the economy. We are wary of such developments reaching a mass that cancels the at least seemingly sustained path of recovery – a concern shared by the Federal Reserve Open Market Committee as it postponed the planned tapering of the large-scale asset purchases. So far, we nonetheless remain sanguine about the negative impact and choose to keep our hopes up.**
- **A sustained recovery in considerable parts of the world economy, and the lion's share of Sweden's export markets, should lead Swedish exports higher – even in the face of a stronger SEK – initiating a virtuous domestic cycle as well. Due to large downward revisions to GDP by Statistics Sweden, we have revised our current year forecast down to 1% y/y (vol., cal. adj.) from 1.7% previously, but the aforementioned export developments, strong fiscal policy measures and a normalising savings ratio have resulted in an upward revision of our 2014 forecast to 2.5% y/y (vol., cal. adj.) from 2.1% y/y previously.**
- **Higher demand will eventually drive unemployment downwards and we foresee an unemployment rate of 7.2% a year hence and thenceforth a gradual decrease towards our estimate of equilibrium unemployment rate of 6.5% past the forecast horizon. Simultaneously, inflationary pressures will rise at a measured pace from current very low levels. That said, we believe that inflation will rise faster than Riksbank forecasts – at least during the coming few quarters. Nonetheless, the inflation target will not be attained during the forecast horizon, which corroborates the current general perception of rates being low for long.**

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Important disclosures and certifications are contained from page 9 in this report

Benign economic and financial conditions

In this first section we will touch upon the most important prerequisites when constructing forecasts for the Swedish economy: (1) economic and financial conditions, including interest rates, the krona, stock and housing markets developments and also the overall fiscal stance; and (2) international developments, or more specifically, the weighted import demand on Swedish export markets, a.k.a. World Market Growth (WMG).

Turning first to the financial and economic policy conditions environment, we could simply conclude that economic policy will remain supportive to growth even past the forecast horizon. However, that claim does warrant some further considerations. **Interest rates**, even in Sweden, have indeed risen rapidly over the past few months. The interest rate move is not as pronounced as, for example, in the US economy, which can probably be attributed to a string of softer domestic data during summer, but nonetheless notable. At the same time, we can conclude that the krona has not strengthened along our previous forecasts but we believe this to be predominantly an effect of relatively weak Swedish economic data alongside the tapering discussions still going on in the US. During autumn and winter, we suspect that economic headwinds to the Swedish economy will turn into tailwinds, if nothing else because the Swedish economy comes across as fundamentally sound when compared to most other developed economies, which should let cyclical forces work uninhibited also in the domestic economy. Market rates as well as the krona should thus resume a stronger trajectory as soon as the summer lull is over. In a year's time, we estimate that the SEK will again approach the EUR/SEK 8 mark and that long-term swap rates will be closer to 3.5%.

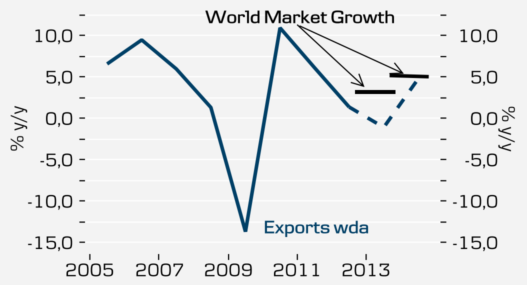
Even in nations where **fiscal policy** is suitably concentrated on structural issues, any fiscal decision is likely to have cyclical consequences when being promulgated through the economy. And according to the incumbent centre-right Alliance, there is apparently space for additional structural measures – mainly tax cuts for low- and middle-income earners – but the calculations are based on an optimistic 2.7% y/y potential GDP growth rate, which is quite far from our own 1.5% y/y expectation. While we can understand the political rationale behind such arguments, given the strong legal framework surrounding the sustainability of fiscal policy, the government is likely in time (past the forecast horizon) to be forced to cut back on some of its promises or even reduce spending (or hike taxes). In our forecast, government expenditures are set to expand by c1% y/y in both 2013 and 2014, which together with the aforementioned tax cuts push central government net lending to -1.2% of GDP this year and -1.0% of GDP next year.

To conclude our discussion on **the economic policy mix**, our estimates indicate that while monetary policy is suitably expansionary throughout the forecast horizon, we see a risk of overly expansionary fiscal policy necessitating future austerity, perhaps at a more sensitive stage of the business cycle.

As customary these days, domestic **equity markets** have not displayed any allegiance to domestic real developments but rather have focused on the tug of war between Fed tapering and real improvements in the US and the global economy. Going forward, the fear of tapering should be replaced by genuine confidence in the real economy, pushing also Swedish equity markets to grow in line with nominal GDP – i.e. rise by 3-5% a year.

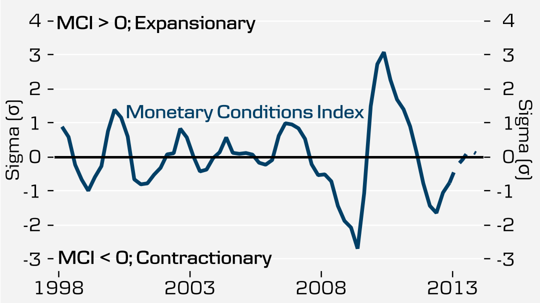
Another important asset market, vital for explaining, *inter alia*, household consumption behaviour, is the **housing market**. Up until recently, we were

Swedish exports dependent on global investments outlook



Sources: National Institute for Economic and Social Research (NIESR), National Institute for Economic Research (KI) and Statistics Sweden (SCB). Danske Bank calculations

Monetary Conditions balanced



Note: MCI is calculated as the deviation from a filtered trend of different interest rates and an exchange rate index (all variables are normalised).

Source: Macrobond. Danske Bank calculations expecting a small drop in house price levels in order to become more aligned to fundamentals. However, price data for 2013 so far does not show any signs of abating, but rather a reacceleration during the summer. This has led us to take a more positive stance on house price developments in 2013 than previously but we continue to expect a controlled decline in price levels over the coming years. For the current year, house prices are set to rise by 2.5% y/y, whereas in 2014, we expect a decline of 5% y/y. From a longer-term perspective, our view is that Swedish house prices are above their fundamental value by more than 20%, underlining that something will probably have to yield; either prices demonstrate a more abrupt correction or – in a more benign scenario – household incomes rise while house prices remain stable.

Summing up **economic and financial conditions**, we believe that supply and price of credits no longer pose restrictions to the Swedish economy; it is rather a lack of demand for credits – viable investment projects – that is the issue. This probably has more to do with depressing expectations of future incomes than anything else. A more pronounced shift in the income outlook– in line with our short-term forecasts – will nonetheless benefit from credits freely available. There is even a non-negligible risk that this process will pick up steam much faster than we expect due to the extremely loose global monetary conditions, creating a not so clear cut policy dilemma for many central banks.

World market growth on the rise, but Swedish exports lag

Turning next to international developments, from a Swedish perspective, we can clearly see that the stronger US economy is also reverberating through the global economy with Great Britain being prime beneficiary, core European country economies slowly healing and indicators stabilising even in the hardest hit peripheral countries in Europe. Even the dismal situation in some developing nations finally seems to have moved past an inflection point, which is at least in some part attributable to the return of American demand.

Even though the stabilisation is tentative, the US and Europe represent some 85% of Swedish export markets, solidifying previous expectations of a rebound in Swedish export markets and, hence, export growth. All in all, **world market growth** is expected to reach 3.1% y/y in 2013 and increase further to 4.7% y/y in 2014, which – to be fair – is still quite weak compared with historical recovery phases.

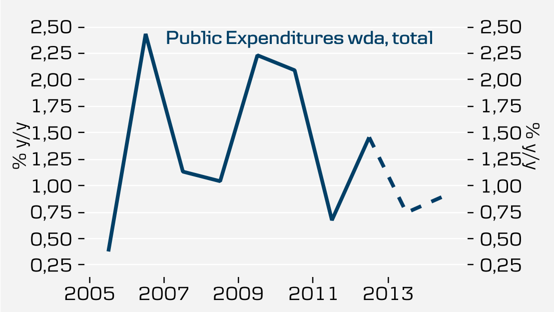
The opaque state of production factors and the volatility of external demand over the past few years make it unusually difficult to decide if the investment goods laden Swedish export industry is at an advantage or disadvantage as international demand picks up again. Exports so far in 2013 have been thoroughly depressing, falling more than 3% annualised in H1. The main impetus behind these developments has been weak input goods exports, especially within the volatile petrochemical industry. Elsewhere, developments were actually quite strong with investment goods (especially the transportation industry) and consumption goods posting positive consecutive growth.

Looking ahead, export indicators are nonetheless overwhelmingly positive. Statistics Sweden's data on export orders, the Export Managers Index surveyed by Business Sweden, the export order component in the NIER's business confidence survey as well as in the PMI survey all point to a broad-based upturn in exports over the coming months and quarters. However, despite the recent strengthening of export indicators, some caution is probably warranted, since these indicators have demonstrated an inclination to be overly optimistic on the export outlook ever since the onset of the financial crisis. Under any

Net exports losing their shine

Sources: KI and SCB. Danske Bank calculations

A pork barrel can come in many forms



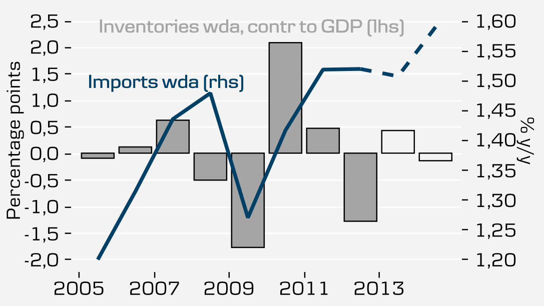
Sources: KI and SCB. Danske Bank calculations.

circumstances, the foreseen upswing in exports during the second half of 2013 (close to 4.5% annualised) will not suffice to produce a positive full year reading for 2013. Instead, we expect a fall in exports amounting to -1.1% y/y for the current year. It is only in 2014, when global investments pick up pace, that Swedish exports will be able to match world market growth and grow by 4.8% y/y.

Investments remain bleak from most perspectives

A stylised Swedish business cycle model would demonstrate strong causality between exports and investments and, despite the stronger reliance on domestic industries for propelling investment growth in the wake of the financial crisis, this relationship remains intact. Investments fell by more than 6% h/h (annualised) during the first half of 2013, mirroring the weak export outlook as it was concentrated to the manufacturing industry. Investments in the services industry were also notably lower in H1 13, whereas housing investments was (again) the odd man out, reflecting the improved situation on the housing market.

The inventory cycle continues to revolve

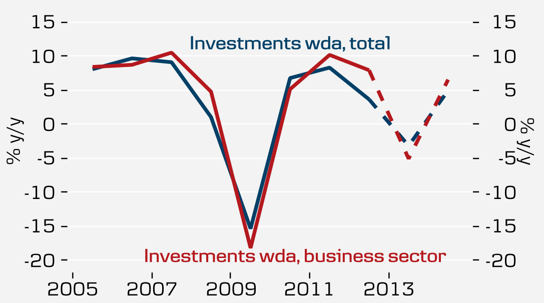


Sources: KI and SCB. Danske Bank calculations.

When looking ahead we cannot rely on Statistics Sweden's investments survey (if we ever did) since it has not been updated since our previous forecast. However, we have noticed that estimates of capacity utilisation from both Statistics Sweden and NIER have, on trend, dropped for more than a year, something that underlines the weak near-term outlook for investments – at least in the business sector. However, and as we have dwelled upon in many previous editions of *Nordic Outlook*, given a certain degree of structural transformation and a prolonged period of low or even negative *gross* investments, we would expect to see some dynamics developing going forward. Restructuring and replacement investments, in combination with a rebound in both external and domestic demand, should eventually suffice to drive (*net*) investment growth in the business sector higher, even though we do not expect this to be particularly pronounced over the coming few quarters. It is only in 2014 that the planets should be fully aligned for a more pronounced rise of the capital stock.

One sector that seems unaffected by all negative dynamics surrounding it is the housing sector. Fiscal incentives, an excess of cheap financing, a continued rise in price levels and a chronic lack of housing supply, predominantly in urban areas, has for better or worse kept the soil fertile for housing investments. Now that labour market conditions seem to be improving and the economic outlook has stabilised or – in short – housing demand is set to return, we believe there is no reason to expect a downturn during the forecast horizon. Due to the risks we associate with the elevated price levels, and the apparent regulatory risks, we have nonetheless chosen to temper our expectations on housing investment growth to some degree.

Investments growth at nadir



Sources: KI and SCB. Danske Bank calculations

Public investments are expected to continue at a high level during the forecast horizon but most of the zest is probably gone and only small increases in public investments in, for example, infrastructure have been announced.

All in all, growth in gross fixed capital formation should remain low during the remainder of 2013, resulting in a drop of 3.2% y/y this year. Investment growth is nonetheless forecast to pick up during the course of 2014 and reach 4.9% y/y on average.

Labour markets turning a corner

Despite a superficial weakening of Swedish labour markets during H1, the lingering impression is one of relative stability. The newfound flexibility among both employers and unions has let hours worked (and thus by and large also the monthly pay cheque) become a buffer instead of large lay-offs at the first sign of a deceleration. This pattern has been discernible ever since the onset of the great recession and seems to have worked well, even though we cannot fully suppress the feeling of this merely being traditional labour hoarding, albeit in a somewhat more sophisticated version.

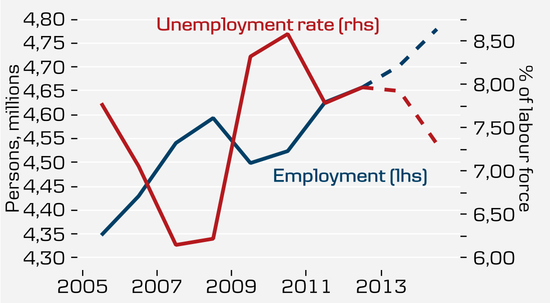
Despite the labour market normally lagging growth by a couple of quarters, we can clearly see that labour markets have turned a corner, with the unemployment rate now receding. Looking forward we become even more optimistic due to the continued improvement of labour market indicators. Not only have notices of lay-offs come down close to 'normal' levels, employment plans and other survey data on the labour market are unanimously improving. Also, investment growth has historically proven to be perhaps the most reliable indicator for employment since investments not only demand people to construct and install, but also to operate, new equipment. We do not think this time around will be much different, but remain observant of the large pool of people outside the labour force, who might keep unemployment rates higher for longer even with pronounced improvements in employment.

To conclude, the good news is that labour markets seem to be safely through the worst, with most forward-looking indicators also pointing in a positive direction. Therefore, we expect employment to improve near term. However, growth in average hours worked has been depressed, which is why a more pronounced upturn might take some time. As investment growth picks up steam and developments in more labour-intensive industries such as construction and retail also progress, we should nonetheless see a more substantial improvement in both employment and the unemployment rate but we expect that to take place mainly during next year. In numerical terms, we estimate that employment will grow by 1% y/y in 2013 and by 1.6% y/y in 2014. This will be enough to push the unemployment rate close to 7% by the end of the forecast horizon. Students looking for a job, low level of average hours worked and people returning from outside the labour force constitute, however, risks to our forecast.

Consumption picking up steam

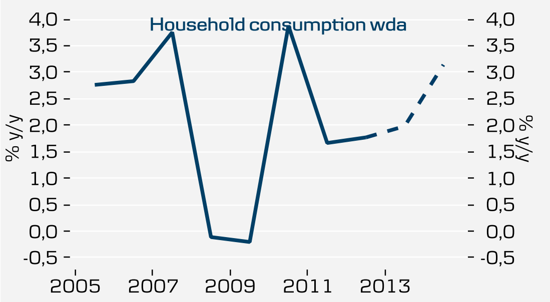
Disposable income growth is low and has been low for some time. However, due to even more subdued price increases, real disposable income is expected to grow faster than the historical average in 2013. In 2014, large income tax cuts and still restrained pricing behaviour will drive disposable income growth even higher. In addition, risks to the housing market seem to have subsided and equity markets have shown real stamina so possible wealth effects should also leave a positive impact on the consumption outlook. Indeed, household confidence is improving after reaching a nadir during the winter months, and the NIER's consumer confidence index is now some way above its historical average, suggesting a rather dramatic shift from earlier this year. Back then, the general risk sentiment was artificially pessimistic in anticipation of a number of decisive international events, but notices of lay-offs had also shot up and the Riksbank seemed intent on driving down housing wealth. In response, households increased their savings further, from already very high levels. Now, as headwinds have receded and have been replaced by strong tailwinds, we expect strong underlying household consumption growth throughout the forecast horizon. Furthermore, the historically high savings ratio constitutes an

Labour markets to surprise...



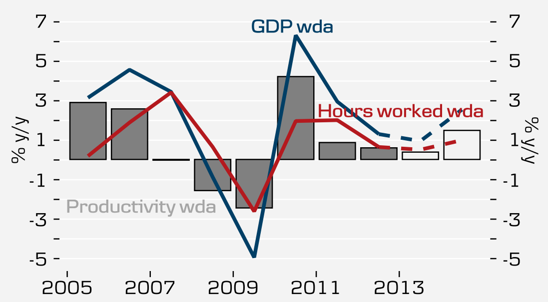
Sources: KI and SCB. Danske Bank calculations

...and consumption to follow suit



Sources: KI and SCB. Danske Bank calculations

Productivity growth weak...



Sources: KI and SCB. Danske Bank calculations.

upside risk, since we foresee only a rather tepid decrease over the coming quarters. Should a more positive international scenario unfold, any remaining fears of joblessness and/or dramatic house price falls will probably be laid to rest, leading savings lower faster than we currently expect. However, learning from experiences of recent years, we have chosen not to revise this variable to any larger extent.

Restrained price developments, fiscal incentives, a stronger labour market and generally improved sentiment make us forecast strong household consumption growth, 2.0% y/y, in 2013, and even stronger growth in 2014, estimated to reach 3.1% y/y.

Resource utilisation and inflationary pressures

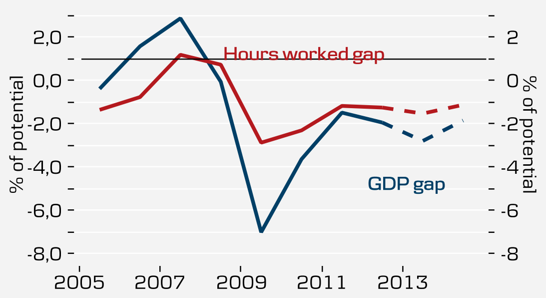
In the preceding sections we have touched upon the main components when compiling GDP. And the lingering impression is one of an improving economic environment, but it is a recovery that is rather bleak by any historical comparison and one that is still laden with large risks to the downside, ready to push the world economy and the export-dependent Swedish economy into the doldrums without much notice. Nevertheless, and despite apparent downside risks, for the first time in many years, we are also able to identify upside risks in the nexus of very strong liquidity, rising asset prices and a more pronounced shift in sentiment.

To sum up, GDP growth is expected to accelerate in 2013 and 2014 as we have chosen to keep our optimistic stance. In 2013, GDP is estimated to grow by 1.0% y/y (previously 1.7% y/y), the revisions being by and large the result of large downward revisions to national accounts data. For 2014, we have instead made a small upward revision and now expect GDP growth of 2.5% y/y versus 2.1% y/y in our previous forecast.

Optimistic in comparison to other forecasters maybe, but from a historical perspective this is still a meagre outcome for a recovery phase. However, we believe that the great recession has altered the structures of the world economy and, hence, also of the Swedish economy. The most obvious change is an ongoing, fundamentally warranted, strengthening of the Swedish krona that still has some way to go. The stronger SEK pushes low value added export companies into dire straits and some of them will probably be put out of business or be forced to relocate production to other economies. Still having a rather rigid labour market, the effects on the Swedish economy are already visible – stubbornly high unemployment rates. Eventually, we might see more decisive political measures to address this problem, but given the highly sensitive ideological nature of the resolutions on offer, we suspect this will take a long time. In the meantime, estimates on potential growth should recede, and we have 'guesstimated' – with the use of mainly demographical projections – long-term GDP growth at no higher than 1.5% y/y. Beware, though, that given the very limited time series on hand, effects on potential estimates are difficult to assess quantitatively and are also very sensitive to specifications.

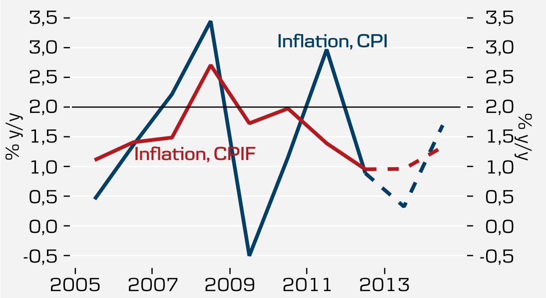
Weak potential growth will mean that even the feeble growth rates foreseen over the next couple of years should be able to reduce slack – increase resource utilisation – and give way to increasing inflationary pressures. Make no mistake about it though, current levels of resource utilisation are very low, and have been a restraining factor in earlier wage negotiations. Going forward, the deflationary impact of low wage growth will to some extent be balanced by low productivity growth keeping cost pressures – measured in terms of Unit Labour Costs (ULC) – around 1.5% y/y during the forecast horizon, levels deemed

...but resource utilization still low...



Sources: KI and SCB. Danske Bank calculations

...and inflation to remain below target



Sources: SCB, Riksbank and Macrobond. Danske Bank calculations sufficient to gradually lead inflation higher *towards* the inflation target (2%). However, the structural strengthening of the SEK works in the other direction, which is why we will probably need to move beyond 2014 to see the operational inflation target, CPIF (CPI excluding the impact of interest costs), being attained.

Riksbank stomping ahead

It has been open season on the Riksbank for some time and by now most people, including ourselves, have probably taken a shot at the central bank. The thrust of the arguments have honed in on the low inflation outcomes and the apparent reluctance of the Riksbank majority to react in force. And even now, when the institutional framework regarding financial stability has been clarified, the Riksbank continues to point to household indebtedness as one obvious reason to remain less expansionary than warranted by price developments alone.

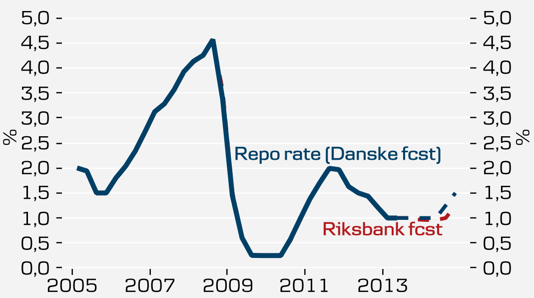
In addition, stronger demand – both internationally and domestically – as well as fewer available resources than perceived, should according to our calculations lead to a faster rise in inflation than the Riksbank currently expects.

Buoyant household credit growth and rising inflationary pressures were sure to eventually stoke calls for repo rate hikes. Market expectations, as well as a few respected commentators, are already suggesting that such a move could or should come as early as H1 14 and continue at a slow pace thereafter.

Despite displaying one of the most optimistic forecasts for the Swedish economy, we are not quite as aggressive, at least not in the short term. Our line of reasoning runs something like this: the Riksbank has openly declared guilty of making too high inflation forecasts, hence holding interest rates too high as well. For any modern monetary policy maker this is quite a big deal. Thus, in a show of repentance, the Riksbank hawk *par excellence* – Per Jansson – recently stated that not even stronger economic data (than forecasted) would suffice to change the Riksbank's expansionary monetary policy stance. To us, this implies that the Riksbank wants, or perhaps needs, to see inflation closing in on the 2% inflation target before hiking rates. We would even go so far as to say that the Riksbank also wants to see 'the right type' of inflation before embarking on – what will probably be – a swifter hiking cycle.

What then, is the right type of inflation? It is, in two words, *wage inflation*. Bar domestically generated, old school, wage inflation, of some magnitude, we believe that the Riksbank will be very attentive not to push inflation expectations further south of the inflation target. *Low for long* remains the Riksbank mantra, but once the inflation genie has reappeared, we are certain that the Riksbank will be ready to act, implying a swifter hiking cycle once the conditions to hike are there.

A hike is a long way hence



Sources: Riksbank and Macrobond. Danske Bank calculations.

Sweden: Forecast at a glance

	2011 SEK bn	2011 Vol growth in %	2012	2013	2014
Private consumption	1673	1,7	1,6	2,0	3,1
Government consumption	926	0,8	0,7	1,2	0,8
Fixed gross cap formation	646	8,2	3,1	-3,1	4,8
Stocks*	41	0,5	-1,3	0,4	-0,1
Domestic demand	3245	2,7	1,6	0,7	2,8
Exports	1749	6,1	0,7	-1,1	4,6
Aggregate demand	3285	3,2	0,4	1,2	2,6
Imports	1532	7,1	-0,6	-0,8	5,3
Net exports*	217	-0,1	0,6	-0,2	0,0
GDP	3503	2,9	1,0	1,0	2,4
- GDP, Calendar adjusted		*2,9*	*1,3*	*1,0*	*2,5*

* contribution to GDP growth

	2011	2012	2013	2014
Trade balance, SEK bn	78	85	63	80
in % of GDP	2,2	2,4	1,7	2,1
Current Account, SEK bn	228	219	190	200
in % of GDP	6,6	6,2	5,3	5,3
Public sector savings, SEK bn	-3	-21	-43	-38
in % of GDP	-0,1	-0,6	-1,2	-1,0
Public debt ratio, % of GDP*	38,4	38,1	39,8	40,0
Unemployment, % of labour force	7,8	8,0	7,9	7,3
Hourly wages, % y/y	2,4	3,1	2,9	3,1
Consumer prices, % y/y	3,0	0,9	0,1	1,4
House prices, % y/y	0,8	-1,0	2,5	-5,0

* Maastricht definition

	25.09.13	+ 3 mths	+ 6 mths	+ 12 mths
Repo-rate	1,00	1,00	1,00	1,00
2-yr swap yield	1,55	1,70	1,80	2,05
10-yr swap yield	2,84	3,30	3,30	3,35
SEK/EUR	869	850	840	830
SEK/USD	643	639	646	654

Source: Danske Bank Markets

Disclosure

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First date of publication

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