The global economy is headed in the right direction – but long-term challenges are great

- The global economy slowed last year. The euro zone is in a recession and the US recovery remains weak. Emerging markets are growing more slowly due to more restrictive economic policies and the slowdown in the West.

- A turnaround is in sight, however. Our “muddling through” scenario in the euro zone appears to be coming true, and the worst of the crisis management is over. Future confidence will improve, at the same time that emerging markets ease their monetary policy. We are maintaining our global GDP growth forecast of 3.1% this year, but expect it to strengthen to 3.4% next year (3.1%).

- We give our main scenario above a probability of 60%, but the risks are great and asymmetrical, with the downside risks outweighing the upside risks. The probability of a worse scenario, where global GDP growth falls below 2%, has been given a probability of 30%. The situation in Spain and even Italy is worsening, which places even greater demands on the euro zone’s crisis management with negative effects on confidence. Higher oil prices, a hard landing in China and a weaker US recovery are also risk factors. We can’t rule out stronger growth, either, closer to potential global growth of around 4%. The probability is low, however, at 10%, and requires greater political confidence, lower oil prices and increased activity in emerging markets.

- In this report, we focus also on the long-term challenges: how to build up the currency union’s institutions as well as how to reduce the divergence in the euro zone, structural unemployment in the West and the effects of the debt crisis. A recovery in a short term is one thing – the bigger challenges in the long term are another.
1. Main scenario: A turnaround has been sighted

During the second half of last year the global economy weakened and financial stress increased, but toward the end of the year global trade strengthened at the same time that the European Central Bank’s fixed-rate loans to banks improved future confidence and the risk appetite.

The recovery in the global economy continues, but growth is expected to be lower this year than in 2011. Two drivers are contributing to this trend and could provide growth a boost in the second half of this year and next year: less pessimism about the debt crisis and more expansive economic policies in emerging markets. We are maintaining our global GDP growth forecast of 3.1% this year, but are revising growth for 2013 upward from 3.1% to 3.4%.

Global GDP forecast

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Source: National statistics and Swedbank’s forecasts.
Note: The countries represent around 70% of the global economy. To gauge total GDP growth, add around 0.3-0.4 percentage points.

The recovery is both fragile and cautious, however. The purchasing managers index for the global economy as a whole rose from 49.6 in November to 51.1 in March, a fairly modest improvement. Higher oil prices due to the situation in the Middle East as well as another flare-up of the euro zone debt crisis with an increased focus on larger economies (and thus larger problems) such as Spain and Italy, could break the rising trend. Other risks include a hard landing in China and more fiscal austerity in the US with potentially significant negative growth effects not only for the US but the rest of the world.
Purchasing managers index – globally and for certain countries/regions

In our main scenario, which we give a 60% probability, the recovery continues, mainly driven by development in emerging markets. The BRIC countries in the table above account for about 80% of GDP growth in 2012, but this is expected to fall to 74% in 2013 when growth in the US and the euro zone strengthen slightly. In a more normal situation, where the global economy is growing by just over 4%, the BRIC countries’ share of growth would hardly exceed 60%.

We have revised GDP growth marginally higher in the US for 2012 and 2013 and in the euro zone for 2013, at the same time that we – due to the crisis countries’ bigger budget and growth problems – expect a slightly more severe recession in the euro zone in 2012 than before. The faster momentum that the US began to show has now tapered off since the labor market's improvement proved short-lived in March and higher oil prices began to dig a deeper hole in consumers' wallets. US growth will be closer to 2% than 3%. Although Europe is less dependent on oil than the US, European households and companies are also affected by higher oil prices. Of course, fiscal austerity and a tighter credit market are having a bigger impact. GDP is expected to shrink in the entire euro zone, but by about 2% in Italy and Spain, at the same time that Germany’s recession is more of a technical nature. France can avoid a recession, but growth will be weaker than normal.

An important ingredient in the continued recovery is the small but important steps that the euro zone’s decision-makers have taken to mitigate the crisis. The European Central Bank (ECB’s) 1% fixed-rate loans with lower collateral requirements have improved confidence and increased the risk appetite in the financial market. Although the effects are beginning to ebb away, there are expectations that the ECB will again take action if the crisis worsens. Stronger cooperation between European politicians through the fiscal pact and “six pack” rules has also improved sentiment, despite the likelihood that the pact will be watered down. While risk premiums are rising again for Greece, Spain and Italy – and the ECB’s purchases are soon over – the

Emerging markets account for 80% of growth

The main scenario has a marginally more positive view of the US…

...while the picture is more negative in the euro zone, at least this year
situation today is much better than last fall, when concerns about a collapse of the euro community dominated the headlines.

In our main scenario, we see Spain and Italy managing without emergency loans, in part through continued reforms to strengthen banks and fiscal policy (including in the regions) and because the ECB is ready to step in and help the banks if needed. To avoid jeopardizing the recovery, the US is expected to extend the tax cuts that soon expire. China is expected to avoid a hard landing. Its real estate market has slowed significantly, but a major crash can be avoided with an additional stimulus through the banks, which will keep prices from falling so much. The main scenario also assumes that oil prices are now peaking and will gradually fall. The average oil price will be USD 119 this year and USD 113 in 2013.

Why isn’t global GDP growth reaching its potential of around 4%? The West (the US, Europe and Japan) are in a period of debt restructuring. This applies to both the private sector, including banks, and the public sector. Europe has taken the steps to restructure its public debt, while the US and Japan have pushed the problem down the road. We expect the debt restructuring to take years, if not decades, to complete. Furthermore, the EMU’s framework creates uncertainty about the future of the currency cooperation.

In this report, we therefore focus to a greater extent than usual on long-term issues: the debt restructuring, global savings imbalances, the divergence in the euro zone and the currency union’s institutions, exit strategies in monetary policy, and unconventional fiscal and structural policy as a tool to strengthen growth and reduce unemployment during times of budget consolidation. The economic challenges are especially great in the West, although emerging markets also have to be cautious to avoid financial crises. This is especially a threat to China, where deregulation of the financial sector is expected in the decade ahead.

After the financial crisis began in the US private sector (households in banks), it spread to Europe, where the focus was on the public sector and private banks. The question is whether it will then return to the US (and Japan) for a new round of debt restructuring in the public sector or if the West can find other ways to pass it on – maybe to emerging markets. The challenges are great: a currency war, protectionism, inflation (or deflation) and a period strong regulation could ensue.

In the short term, the global economy is on the right road, but with weaker than normal GDP growth in the wake of the debt crisis in the West. GDP growth rises from just over 3% to nearly 3.5% in the next two years. In the longer term, the challenges are huge, mainly for the West, which is facing major structural changes and difficulty maintaining welfare systems. From a multilateral perspective there is also the question of agreeing on a balance of power that allows us to tackle the issues of global trade, financial sustainability and climate change.
2. Alternative scenarios: Downside risks outweigh upside risks

The uncertainty in the forecasts is great. The political risks are usually high, especially given the lack of experience in how to “rescue” a currency union as evidenced by less-than-stellar crisis management. Psychology is becoming increasingly important at a time when future confidence is crucial to the strength of the recovery. It's more a question of lowering pessimism than raising optimism, but it probably makes a difference to investment and consumption whether the headlines focus on the EMU's demise or not.

There is also great economic uncertainty. One complicating factor is that quarterly data in many countries have had to be revised significantly since the financial crisis. The severe downturn has made it harder to adjust for seasonal effects. The differences between the production side and the user side are also unusually large. Issuing forecasts based on fluid backward-looking data is a challenge. In many countries, the national accounts are fairly accurate through 2009. After that there is more uncertainty.

The risk picture in our opinion is asymmetrical. Negative risks outnumber and outweigh positive risks. Of course, our projection should be unbiased. The two alternative scenarios should be given the same probability, so that it is just as likely that things get better or worse. We have said, however, that it wouldn't be reasonable to expect more of the negative risks to be realized in the main scenario. It wouldn't be reasonable, either, to exaggerate the positive risks, which are far from convincing.

Our main scenario has been given a probability of 60%, while the probability of a worse or better scenario is 30% and 10%, respectively.

1) New global recession: The worst proves true (30%)

Although the recovery did weaken last year, the global economy has avoided a recession. Export volume has risen and is higher than before the crisis (2008) in emerging markets and the US, but not yet in Japan and the euro zone.

In our more negative alternative scenario, the crisis in the euro zone intensifies once again. Spain and Italy need emergency loans, the euro cooperation is rattled by the need for new crisis measures, political and social concerns grow, the financial market's confidence plunges, and a severe recession and debt and bank crisis spread to other parts of the world.

In China, the stimulus does not reverse the slowdown in the real estate market, which only worsens. Municipalities and regions face major economic problems, at the same time that the banking sector weakens. Weaker economic growth leads to political concerns and instability.
The crisis in the Middle East also escalates in this scenario. Supply problems push the price of oil to about USD 150 a barrel, which reduces global growth by just over 1% during the forecast period at the same time that inflation rises. Geopolitical concerns also affect other commodity prices, as well as investor confidence and the financial markets.

Growth rises and nears its potential (10%)

GDP growth of just under 4% could be realized if, for example, oil prices fall below USD 100 a barrel, the crisis in the euro zone eases and optimism about the future leads to higher investment and private consumption in the West. Emerging markets would focus more on economic stimulus, which would help to get the wheels rolling faster in the West as well.

In the better scenario, the political risks are well managed. In the US, a fiscal compromise is reached that allows for a stimulus in the short term, but with austerity and responsible budget consolidation in a longer perspective. The job market rapidly improves again. In the euro zone, the transition from technocratic to democratic governments goes fairly well, and the responsible actions of new leaders strengthen future confidence.

The likelihood of a worse scenario is greater than the likelihood of a better. In both scenarios, it is a question of whether future confidence is hurt or helped by political decisions. The price of oil is also critical to whether we will see a negative or positive scenario take over.
3. Our long-term challenges

Although there is reason for optimism in the short term, i.e., the most likely scenario is that the global economy will perform decently over next two years, there is also reason for pessimism, since the medium and long term could include weak growth, new crises and considerable national, regional and global tension. The challenges are especially great in the West, but emerging economies are also affected and will face challenges of their own in the next decade. Following is a brief summary.

The West’s challenges:

1) Debt restructuring

In the US, the household sector has been reducing its debt since 2008, but in Europe (except Ireland and the UK) the process hasn’t even begun. The opposite is true of debt restructuring in the public sector, which is under way in Europe, but hasn’t started in the US and Japan. Gross public debt is dropping from the current level of 90% in the euro zone, but will further increase in the US and Japan, where the debt ratios are 107% and 236%, respectively. In these two countries, the primary deficit is between 6 and 9%, while it is 0.5% in the euro zone. Japan and the euro zone also have a lot of work left to reduce debt in their corporate and financial sectors.

Studies of previous periods show that debt restructuring takes a long time. The situation today is that much more difficult: More countries are involved at the same time and they are bigger; debt levels are higher, which means more debt restructuring; and the debt problems reach nearly every sector of the economy (public sector, households, businesses and the financial sector), which reduces the opportunities for restructuring.

Debt restructuring is facilitated by high economic growth, which reduces debt in relation to GDP; higher than normal inflation, which reduces debt in real terms; and extensive budget consolidation. Since a lengthy period of double-digit inflation would be required to significantly reduce the debt and such a change could be difficult to achieve and is associated with risk (e.g., higher nominal interest rates, lower growth, failing wage building and financial instability), it’s not the most important measure. What is needed is a combination of budget consolidation and structural reforms that strengthen growth and facilitate debt restructuring. The inability of politicians to agree on unpopular structural reforms because they can have negative short-term effects could mean that the debt restructuring will take even longer and be more painful in the long term.

To date the financial market has been driver for budget consolidation and debt restructuring in the euro zone through an increase in risk premiums for government bonds. The question is how long the financial market will maintain faith in the US and Japan. The biggest risks for the US are political, given the lack of consensus how to manage the government’s finances in the
medium term. For Japan, there is a risk that when domestic savings decline the dependence on foreign savings will increase, which could raise the cost to finance the government’s debt to unsustainable levels. Global financial stability (interest rates, exchange rates, equities) and in the long run the real economy are threatened unless the US and Japan agree on debt restructuring plans with starting dates, timetables and targets for the budget consolidation.

2) A period of lower than normal growth

The debt restructuring is affecting demand among households and businesses. High public debt could also lead to lower private investment. Economies with shrinking activity or weak growth produce falling asset values, which affect conditions in the financial sector and lead to credit austerity.

In Fischer’s negative spiral (debt-deflation) of lower growth, lower incomes, declining values and deflation, the debt burden grows in real terms and increases the need for even more budget consolidation. The key to breaking this negative spiral is by allowing monetary policy to be as expansive as possible, providing liquidity support to avoid having liquidity problems become solvency problems, implementing structural reforms and getting politicians to create confidence that a turnaround is coming.

3) High and rising unemployment, including structural unemployment and a bigger income gap

In the euro zone, unemployment is nearing 11%, the highest level in 15 years. In the US, unemployment is falling to 8%, but a large part of the decrease can be attributed to the fact that many people have simply dropped out of the work force. When the US begins trimming its public sector debt, there is a risk that unemployment could turn higher again at the same time that it could get stuck at high levels for long in Europe.

In the US, unemployment is mainly seen as a cyclical problem, but because the number of unemployed is so high and the structural percentage is in no way negligible, at least a couple of million Americans are now having a hard time finding work, and countless others who are outside the job market are finding it difficult to start looking again, provided more isn't done to strengthen and update their skills.

The income gap has been growing for several decades as the highest wage earners have seen their incomes grow substantially at the same time that those who earn the least are falling further behind. This trend could intensify throughout the West if the debt crisis leads to increased or continued high unemployment and even more people aren’t even seen in the labor statistics but can be counted among the poor.
4) Deteriorating welfare systems

At the same time that growth remains weak, unemployment is rising or stagnating and welfare systems are eroding. Fewer people are paying tax, demand for transfer payments is rising and due to budget consolidation there are fewer resources to support healthcare, education and social services. The political and social challenges in Europe, the US and even Japan are expected to increase in the next decade with growing tension as a result.

5) The euro zone's challenge: how to strengthen and keep the currency union together in a democratic spirit

Debt crises have arisen in the US, Japan, the UK and a number of euro countries in recent years. In the euro zone, low interest rates helped Greece, Portugal, Spain and Ireland to create bubbles, but it wasn't only there that they occurred. The difference is that these countries can't print their own money to pay their bills. The risk that they would default on their payments exacerbated the financial crisis and made it even more expensive for them to finance their debts because of higher risk premiums.

The crisis countries now have to implement the same type of internal devaluation as the Baltic countries. They also have to consolidate their budgets and reform labor and product markets to encourage competition and reduce the divergence relative to Germany. At the same time Germany has to do what it can to create stronger domestic demand, e.g., by pushing forward investments that increase imports.

The debt crisis has made it clear that the currency union is not designed to handle crises. In the future, institutions will have to be bolstered, so that the problems aren’t repeated. The key is to coordinate fiscal policy, integrate the financial sector and develop the European Central Bank so that it can act as a lender of last resort for banks and nations. If these three pieces of the puzzle are in place, there will also be an opportunity to create a Eurobond market and better manage the bad loans in the banking system. That would reduce the risk of a crisis arising and spreading, and in the long run would increase the chances of the currency union’s survival. It would also reduce the need for the rescue funds and firewalls, which today serve as a secondhand solution. Then the currency union’s survival wouldn’t be at risk if one country is less competitive, has higher inflation or faces fiscal problems, although that could certainly affect the euro zone’s development for other reasons. Nationalism, for example, rises when one or more countries grow more strongly either of their own power or at the expense of the other countries.

The question is how to strengthen integration of the euro zone and build these institutions in a true democratic spirit. While the general public still strongly supports the currency union, it’s probably not because they want power transferred away from the national level. The same applies to politicians and the national central banks and banking associations that don't want to lose power either. The question therefore is what kind of democratic
process it will take to strengthen the currency union for the long term. If reforms are implemented behind closed doors and decisions are taken by a few prime ministers, there is a risk that the solution will not be sustainable. Until then the firewalls have to be big and flexible enough so that new crises can be managed when they arise.

6) Implementation of monetary policy

The central banks in the West have set their policy rates near zero and have implemented quantitative easing, which has swollen their balance sheets. The primary goal has been to restore stability to stressed financial markets and avoid the negative spiral described above, where weaker growth and budget consolidation reduce asset values and create credit austerity and deflation. Once deflation has gained a foothold, it is a difficult cycle to break.

It is reasonable, therefore, that monetary policy is expansive and that unconventional methods are tapped to ease the situation when fiscal policy is clearly tight. Many people are worried about inflation, but it is probably too soon for that. The monetary base is expanding, but not the money supply as long as banks don't increase their lending. The central banks will be able to tighten when the economy turns around. More worrisome would be if inflation expectations begin to rise, e.g., if the central banks are perceived as being in the hands of politicians, which would reduce confidence in inflation targets.

Other negative effects could also arise as a result of current monetary policy. Major liquidity support for banks (and indirectly governments as well) could delay the pace of reform, i.e., there is a risk that banks which should have been shut down are being artificially supported. Japan has created such zombie banks. At times governments may also use support inappropriately by not adopting the necessary reforms.

Quantitative easing and expansive monetary policy can only help, not be the main tool, to reduce unemployment and strengthen growth. In many cases, structural unemployment requires fiscal tools. There is a risk, therefore, that politicians are placing too much faith in monetary policy, since it doesn't work normally during periods of debt restructuring, when loan demand is often lower and transmission mechanisms work poorly. The risk then is that economic policy will be suboptimal.

7) Regulation of the financial sector

Major reform work is being done after the financial crisis to better regulate the financial sector with the goal of avoiding another crisis. It is reasonable that the sector is more tightly and better regulated, but the timing is important to avoid endangering growth and the labor market. The key is also to harmonize regulations on a regional and global level.
Challenges in emerging markets:

1) China’s deregulation of its financial sector

Few countries in history have managed to deregulate and open up their financial sector without creating a bubble that later burst and had a major impact on growth. China realizes that it is a major challenge to liberalize its financial sector, e.g., to make its currency convertible, deregulate in- and outflows of capital, and allow foreign players to operate in China's financial market. Many steps have already been taken, and pilot projects are under way to allow the Chinese currency to be used abroad. It is important that the Chinese are permitted to invest abroad, so that capital inflows don’t create expectations of a stronger currency, which in turn pushes equity and housing prices higher. If deregulation is not managed properly, there is a risk that the next major financial crisis will occur in China.

2) Reduce poverty and strengthen capacity

Many emerging countries such as India and Brazil need to expand their capacity in order to avoid bottlenecks and reduce overheating. Furthermore, more infrastructure investment is needed to reduce poverty and increase the standard of living for more groups.

3) Reduce bureaucracy and corruption and build strong institutions

Many emerging countries still have weak institutions that put them at risk of falling behind. New ways to source the value-added chain can create challenges for low-cost countries as production shifts back to richer countries where institutions are more highly developed.

Global challenges:

1) Find solutions to deal with environmental and climate threats, including energy solutions

Multinational negotiations on trade, the environment and climate change have been neglected lately because some countries have preferred to negotiate bilaterally. The financial crisis has also pushed the threat of climate change to the side. Here is one of the biggest global challenges, i.e., to put these critical issues back at the top of the agenda and find lasting and acceptable solutions.

2) Avoid protectionism and currency wars

The alternative to multinational negotiations is that countries which feel they are competitively threatened take protectionist actions and manipulate their currencies. If the protectionist trend continues, it will be harder to improve living standards.
3) Lasting reduction in savings imbalances

China has set as its goal to strengthen domestic demand, thereby helping to reduce the savings imbalance between it and the US if the goal is met. The US has also strengthened its export and manufacturing sectors since the financial crisis, paving the way for a better balance between exports and imports. Part of the improvement is probably the result of the financial crisis, i.e., that US consumption is growing more slowly, which reduces import demand and improves its trade balance. For China, higher oil prices mean that imports are becoming more expensive and that the trade surplus is shrinking. The question is whether or not this will last.

The risk of major economic mistakes around the world is considerable, since the challenges are great and demanding.
4. Our assumptions about the commodity and financial markets

Since our last forecast, commodity prices have risen at the same time that the developments on equity, fixed income and foreign exchange markets have been more mixed. In the following, we describe our assumptions about the financial and commodity markets, which serve as the basis for the forecast.

Commodity markets

Our previous forecast was that a weaker global economy would reduce demand for commodities and that commodity prices would fall. This assumption proved accurate in 2011, especially as emerging markets led by China slowed, but last fall oil prices rose and at the start of this year metal and food prices have also trended higher. The reasons for this include supply problems in the oil market after the EU’s import embargo of Iranian oil as well as worries about the closure of the Strait of Hormuz and the possibility of war between Israel and Iran. The European Central Bank (ECB) also helped to improve sentiment by providing low interest rate loans to the euro zone’s banks, which improved the risk appetite and investment climate.

Commodity prices (total), food prices and commodity prices excluding oil (index)

In January, we assumed that oil would average USD 102 a barrel in 2012 and USD 96 in 2013. After the higher outcome and increasingly tense geopolitical situation, we instead see prices averaging USD 119 this year and USD 113 next year. We assume, however, that the turbulence in the Middle East will ease, which explains the downward trend from the third quarter of this year. Average metal and food prices are expected to decline in 2012, but not as much as we assumed in January. Prices continue to trend higher throughout the forecast period, but do not reach the peaks noted early last year.
The risk of higher commodity prices, mainly oil, is greater than lower commodity prices. Weather (La Niña) and natural disasters could disrupt food production. If Iran's oil production is not replaced, prices would rise partly due to supply shortages and partly to increased uncertainty. The IMF’s sensitivity analysis shows that a 50% rise in oil prices over two years would reduce global growth by 1.25%. The greatest impact would be in Japan, followed by the rest of Asia, the US and the euro zone.

Inflation and interest rates

Lower oil prices and a slower rise in other commodities are expected to lead to a further decline in inflation compared with 2011. Weaker demand in the euro countries and the UK due to the budget consolidation and high unemployment is reducing wage and price pressure, but in several crisis countries inflation is hanging around due to the one-time effects of tax hikes or high energy prices. The US also has a big production gap, though it is slowly shrinking. Despite oil prices, inflation is under control. Japan, on the other hand, is being affected by higher oil prices and what had been deflation is now shifting to slight inflation.

A further increase in oil prices could have a significant impact on growth

A weak labor market and budget consolidation are keeping price and wage pressures in check
Inflation has also fallen in emerging markets in pace with lower commodity prices and tighter economic policies. Now we are seeing a turnaround in the form of higher oil prices and less restrictive monetary policy as China, India and Brazil, among others, cut their policy rates. Due to capacity shortages in India, high credit growth in Brazil and expectations of more aggressive rate cuts, inflation remains at relatively high levels.

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<td>India</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Russia</td>
</tr>
</tbody>
</table>

Source: National data and Swedbank’s forecasts.

Lower inflation, restrictive fiscal policies, a recession in the euro zone, and a continued weak recovery in the rest of the West create a need (and opportunity) for more expansive monetary policy. After the European Central Bank (ECB) raised its policy rate in April and July of last year, it cut it November and December, and rate levels had returned to around 1%. At the end of the year the central banks in Australia, Norway and Sweden cut their policy rates by 50 basis points, at which point Norges Bank announced an additional rate cut of 25 bp in March of this year.

US monetary policy has been characterized by a policy rate of around zero since the end of 2008 and three rounds of quantitative easing (including the more modest “Operation Twist”). In January of this year, the Federal Reserve clarified that its inflation target is a 2% increase in the private consumption deflator over the medium term. Moreover, the central bank began to communicate its rate path by publishing the forecasts of the 19 (now 17) members of the Federal Open Market Committee (FOMC) who decide on monetary policy. In January, the Fed extended near-zero interest rates until the end of 2014. While this isn’t a promise, the message could become a reality, since the

There is a risk that more expansive monetary policy could again cause higher inflation.

Rate hikes last year have been reversed.

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Rate hikes last year have been reversed.
recovery is slow and fiscal policy will gradually becoming more restrictive when automatic spending cuts take effect next year. If the Bush tax cuts are not extended, fiscal policy will be even more restrictive. The Republicans have announced they would like to replace Fed chairman Ben Bernanke after the election, which could alter the direction of monetary policy in 2013-2014.

One challenge is to predict whether the Fed will embark on another round of quantitative easing, QE3, which would also enlarge the central bank's balance sheet. At this point a majority of the FOMC is against it, but if economic conditions become weaker than expected by summer, it is not unreasonable to expect additional measures, e.g., an attempt to stimulate the mortgage market. In its statements, the US central bank has demonstrated pragmatism and that it won't be afraid to use the tools at its disposal if needed. It is likely, however, that the impact on interest rates will not be as great as with the first round, QE1.

The euro zone was hopeful its crisis management capabilities would be able to handle tighter monetary policy during the first half of last year, but that proved not to be the case. On the contrary, there have been expectations of further cuts, but since the overnight rate is already low, we suspect that the ECB sees 1% as a floor and will remain there during the forecast period.

Instead, ECB President Mario Draghi has stressed the importance of the three-year, 1% loans given to banks in two tranches at a volume in excess of 1 trillion euro. The goal is to reduce credit austerity in the euro zone where banks have to shrink balance sheets to achieve a higher capital adequacy. The loans provide indirect support for the banks' recovery, since profitability improves when they in turn buy government securities from crisis countries at significantly higher interest rates. The loans also indirectly support the crisis countries. Initially risk premiums fell markedly, but lately the effects of the fixed-rate loans have begun to ebb. Concerns about reforms and growth in Spain and Italy are pushing risk premiums higher again. 
If Spain and Italy face greater problems, the ECB has declared it will increase support by buying assets or otherwise supporting the financial market. The ECB’s purchases of government bonds in the secondhand market as part of its Securities Markets Program (SMP) could be expanded from 200 billion euro at the same time that new fixed-rate loans could be made available. This reduces the risk that Spain, or Greece, Ireland and Portugal, will need a rescue package.

The current volume of fixed-rate loans will otherwise remain unchanged, especially in light of growing criticism from the Bundesbank, among others, about the ECB’s provision of liquidity to weaker European banks. The main concerns are inflation and so-called zombie banks. Compared with other central banks, the ECB, together with the Bank of Japan, has the largest assets in relation to the country or region’s GDP, at about 30%, while the corresponding figure for the UK and the US is about 20%.

Central bank balance sheets in their own currencies

Japan has an interest in making its monetary policy even more expansive in order to weaken the yen and create inflation. Its policy rate has been near zero for some time. The quantitative easing has gradually been expanded and the balance sheet has grown by about 10% of GDP since the end of 2008. We see a strong likelihood of additional asset purchases.

In the UK, interest in quantitative easing has waned now that a majority in the Bank of England prefers to wait. It is likely, however, that more government bonds will be purchased during the year. We expect the policy rate to stay at 0.5% during the forecast period in order to offset the negative effects of a restrictive fiscal policy, and inflation is no longer the same obstacle to remaining expansive.

China has begun to ease its reserve requirements for banks and is soon expected to cut its policy rate. Now that inflation is nearing the comfort level of 3%, there is an opportunity to stimulate the economy through the banking system. Credit

The Bundesbank is worried about cheap liquidity

Interest in quantitative easing is beginning to cool at the Bank of England
growth will again increase as a result. The decline in housing prices could be slowed.

Brazil and India have already cut their policy rates from 9.75% to 9.0% and from 8.5% to 8%, respectively. Statements from their central banks suggest that additional rate cuts can be expected, but at the same time the two countries face a challenge keeping inflation in check.

**Policy interest rates 2011-2013**

<table>
<thead>
<tr>
<th>Policy rates</th>
<th>20 April 2012</th>
<th>30-Jun-12</th>
<th>31-Dec-12</th>
<th>30-Jun-13</th>
<th>31-Dec-13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve</td>
<td>0.25</td>
<td>0.25</td>
<td>0.25</td>
<td>0.25</td>
<td>0.25</td>
</tr>
<tr>
<td>ECB</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
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<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>Bank of Japan</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
</tr>
</tbody>
</table>

In the last half year, long-term interest rates (10-year government bond yields) in the US, Germany, the UK and Japan have been the lowest in the postwar period. Low policy rates, growth and inflation, as well as continued high financial stress which is forcing investors to seek out safe harbors may explain the depressed levels. At the same time the risk premiums for crisis countries (Spain, Greece, Italy) are high and continue to rise. In their case, there is little confidence that these countries can finance their national debts, especially since they lack their own printing presses. On the other hand, countries that today enjoy confidence (e.g., the US and Japan) should adopt a new approach, i.e., consolidating their budgets in the medium-term and thereby reducing the risk of a future collapse of confidence.

Long-term interest rates are expected to rise by about one percent during the forecast period, but as long as monetary policy keeps policy rates around zero and there are still expectations of another quantitative easing in light of a weak recovery, they will remain low. The risks include political developments, mainly in the US, where the inability to agree on a medium-term budget could affect confidence and push interest rates higher. Rising inflation expectations in the wake of quantitative easing could also contribute to higher market rates.

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Low policy rates, financial concerns and economic pessimism are keeping pressure on long-term interest rates.
Exchange rates

Last fall a number of currencies fell against the US dollar, except for the Japanese yen, which didn’t start to depreciate until February of this year. The Japanese central bank has tried to reduce the value of the yen, but capital inflows after the tsunami, carry trade and expectations of a trade surplus and deflation strengthened rather than weakened the yen. Now that the trade balance has weakened due to higher oil imports and there are prospects of inflation as a result of the higher energy prices, the yen has declined slightly, but is still at levels that are hurting exporters. Uncertainty in the euro zone and the stronger momentum that US growth and the labor market showed through February – including prospects that the US would grow considerably faster than the euro zone – may explain the weaker euro. The Swiss central bank has essentially pegged its currency to the euro to keep it from appreciating, and to date the financial market is confident that the central bank will defend the level it wants through interventions.

We expect the debt crisis and recession in the euro zone to weaken the euro during the forecast period, down to 1.20 by the end of 2013, which would be positive for the crisis countries. If Spain needs a rescue package, the euro may depreciate even more. The yen continues to weaken in light of lower capital inflows and trade surpluses, and since we assume that the US will basically avoid QE3, that could also contribute to a weaker yen.

Exchange rates 2011-2013

<table>
<thead>
<tr>
<th>FX</th>
<th>20-apr-12</th>
<th>30-jun-12</th>
<th>31-dec-12</th>
<th>30-jun-13</th>
<th>31-dec-13</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR/USD</td>
<td>1.32</td>
<td>1.28</td>
<td>1.26</td>
<td>1.23</td>
<td>1.20</td>
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<tr>
<td>EUR/GBP</td>
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<td>0.81</td>
<td>0.81</td>
<td>0.81</td>
<td>0.80</td>
</tr>
<tr>
<td>RMB/USD</td>
<td>6.30</td>
<td>6.18</td>
<td>6.05</td>
<td>5.94</td>
<td>5.82</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>82</td>
<td>85</td>
<td>87</td>
<td>90</td>
<td>95</td>
</tr>
</tbody>
</table>

China has lowered its sights in terms of allowing its currency to appreciate against the dollar, and the exchange rate has been
more or less unchanged this year. Since June 2010, when the rate was again allowed to rise, it has done so slightly over 8%. The range within which the rate is allowed to fluctuate on a daily basis has now been raised to 1% (from 0.5%), but whether China can accept a faster appreciation is based on how worried it is about a hard landing. We estimate the appreciation at nearly 4% per year in 2012 and 2013 in nominal terms, and slightly more in real terms. Efforts to internationalize the renminbi continue. Due to the lack of a well-functioning financial market and a convertible currency, China is still highly dependent on other major currencies. Moreover, the risk of bubbles rises if the financial sector isn’t deregulated, especially since the renminbi is expected to rise when capital flows into, not out of, the country. This increases the risk that asset prices will skyrocket, with bubbles that eventually burst.

Equities

When sentiment improved after the ECB announced its fixed-rate loans, not only did commodity prices rise late last fall but also equity prices. After concerns again increased that Spain and even Italy may need emergency loans – reducing the growth outlook in the euro zone and the global economy as a whole – stocks in Europe and emerging markets in particular declined, while the US stock market continued to benefit from unexpectedly weak labor market data in March, which changed the risk picture. Presidential and parliamentary elections in the US, France and Greece this year, as well as Germany, Italy and Japan next year, may affect the stock market depending on how politics are expected to impact the debt crisis and the economy.

Stock markets in the emerging world (MSCI EM), US (S&P 500), euro zone (FTSE EZ 300) and Japan (Nikkei 225) 2007-2011, Index January 2007 = 100

After recent gains: new concerns about the euro zone are weighing on market sentiment
5. Emerging markets are driving the global economy

The global economy shifted into lower gear last year, but with the help of stimulus measures in emerging markets and less future pessimism we expect the pace to increase in coming quarters. The contribution of emerging markets to global growth is unusually high due to the financial crisis and recession in the West. In addition, the euro zone is again in recession, and although we expect it to be over by the end of this year, debt restructuring and credit austerity will mean weak growth for several years, significantly below its potential.

**Contributions to global annual GDP growth**

In the spirit of Okun's law, unemployment usually falls when GDP growth exceeds its potential. In the diagram below, we have estimated potential growth at 2.5% in the US and 2% in the euro zone. Lately growth has been below that in the euro zone, which is why unemployment has risen to nearly 11%. In the US, unemployment has fallen faster than the difference between GDP growth and potential growth would suggest. One reason is that more people are dropping out of the labor force and the employment rate has declined from 66% in 2008 to about 64%.

**Interplay between unemployment and GDP growth in the euro zone and US (%)**

US unemployment has decreased faster than economic theory would suggest – the reason is that more people are dropping out of the labor force.
US: Pushing budget problems down the road

- Slight upward revision of GDP growth against the backdrop of stronger economic data and a more optimistic sentiment. Negative real interest rates are providing support for the housing market.

- Unemployment continues to fall, but not as quickly as earlier this year. Structural unemployment is being neglected.

- The Bush tax cuts are being extended and fiscal challenges are being kicked down the road, while monetary policy remains expansive even without new quantitative easing.

Our view of the US economy is largely the same as it was in January. We have revised GDP growth marginally upward, from 2.0% to 2.1% in 2012, and from 2.2% to 2.3% in 2013, on the basis of slightly stronger than expected economic data, at the same time that higher oil prices are taking a bite out of household consumption and limiting growth.

GDP grew by 3% on an annual basis in the fourth quarter of 2011 (which means quarterly growth of 0.7%), at the same time that the labor market strengthened in December, January and February with around 200 000 net jobs added per month. Since then growth has slowed. In March, only 120 000 people were added to the workforce, and economic activity (capital goods orders and purchases) slowed slightly. The higher job growth in December–February was probably the result of warmer than normal weather and a reaction to previously weak job growth.

The purchasing managers index (PMI) for industry and the service sector is at levels that signal continued growth, however, and the general trend in the economy remains upward. The

The risk of recession has decreased significantly
likelihood of a new recession has decreased significantly since last fall.

Looking ahead, the slow recovery is likely to continue. High oil prices are hurting growth. Businesses and households are benefitting at the same time from negative real interest rates. Investment is growing decently. A cautious rebound in the housing market seems to be holding up, and number of new mortgages is rising again. Average job growth should be over 120 000, but hasn't been able to sustain a level of 200 000, since GDP growth remains below its potential. As a result, unemployment, at 12.7 million, is declining slowly, and the number of long-term unemployed remains a challenge for the economy and politicians. They now number 5.3 million, down from a peak of 6.7 million in the fourth quarter of 2010, but still the highest in history.

US academics as well as decision-makers in the government and central bank all seem to agree that long-term unemployment isn't structural. A continuation of expansive economic policies should help to support the recovery, and eventually long-term unemployment will drop to more normal levels of around 1-1.5 million. Experts claim that only a third or less can be attributed to structural causes. Even that number is unusually high, and by denying its structural problems the US is at risk of suboptimal economic policy, which would produce more unemployed than if support is given to labor market measures such as retraining and continuing education.

The biggest risks for the US economy are a global slowdown initiated by the euro zone and even higher oil prices, which would impact growth and inflation. That is in addition to fiscal policy, which, if the Bush tax cuts are not extended, could subtract a percentage point from growth. Any decisions about a budget consolidation in the medium term will be pushed off until after the election, and the impact on growth probably won't be felt until 2014.

An important measure of the recovery's strength is household consumption, which has been supported to date by lower savings, at the same time that real incomes have declined. It is not unlikely that we will see a negative rebound, i.e., the savings ratio increases and consumption slows. In addition, consumption is being adversely affected by the high oil prices.

If the labor market again shows signs of weakness at the same time that growth slows, the Federal Reserve may – this summer after some time to analyze the situation – decide on a third round of quantitative easing (QE3) in some form. Right now a majority of the Fed's Board of Governors questions the need for a new easing, and we expect it could be avoided if the economy accelerates. Keeping the fed funds rate at around zero until 2014 isn't a promise, just a prediction from the Fed, but if the recovery remains weak with growth of around 2% (which we consider reasonable), unemployment will fall slowly and it is likely that the rate forecast will hold true.
China: Slowing but avoiding a hard landing

- GDP growth is slowing to 8.1% this year in pace with weaker exports and investment, and is stabilizing around this level despite a target of 7.5%.

- The goal to rebalance the economy will take time to reach and require more reforms, especially in the financial sector and of social security systems.

- Inflation has trended lower, which means that monetary policy can now be less restrictive.

GDP growth in China slowed during the first quarter to 8.1% at an annual rate and 1.8% at a quarterly rate, from an annual rate of 8.9% in the fourth quarter of 2011. This was slightly weaker than we had expected and is the slowest growth rate since the financial crisis. We are revising our forecast for 2012 downward to 8.1% (8.2%), but are revising it upward slightly for 2013 to 8.0%, from 7.8% in January.

The main reason for the slowing growth rate was the decrease in housing investment. The number of new housing units is no longer rising, and prices have slowed or even fallen in some areas. Service sector activity has declined at the same time that industrial activity is still relatively strong and lending by the banking sector is again beginning to rise.

We feel that China’s economic slowdown culminated during the first quarter and that we will see a slight increase in growth during the second half-year. The authorities are now accepting faster growth in the money supply and will continue to lower reserve requirements for banks and even to cut interest rates. This is now increasingly possible given lower inflation, which in March was 3.4%, i.e., a slight increase from the previous month but clearly lower than July 2011, when inflation reached 6.5%.

China’s goal of 7.5% growth this year probably won’t be reached, but the party’s declaration still reflects a desire to gradually reduce growth and correct internal imbalances (toward a lower investment ratio and higher consumption ratio). Even if new stimulus measures are adopted later this year, or economic policies are loosened, it isn’t likely that they will be enough to lift GDP growth above 9% again. Only if the crisis in Europe worsens and the Chinese economy is at risk should the stimulus be increased significantly.

In addition to China’s concerns about global conditions, higher oil prices are impacting its domestic economy. China is becoming increasingly dependent on energy imports. Exports and imports have both declined, but import volume in particular isn’t rising as quickly as before, since higher commodity prices are making imports more costly. Although the trade surplus fell last year compared with 2011, there is a risk that it will rise again (as it did in March), which wouldn’t help the global economy to reduce the...
savings imbalances between China and the US. One reason the surplus is rising is that the rate of investment will decline more than savings, which is also reducing import demand.

China allowed its currency, the yuan or renminbi, to appreciate in June 2010 after the recovery was firmly in place. After that the yuan appreciated by slightly over 8% against the US dollar. More recently the rate of appreciation has slowed, probably because the weakening economy is worrying authorities, who want to avoid a rapid slowdown in export growth. The central bank recently announced that the range in which the yuan was allowed to fluctuate against the dollar over the course of a day was being increased from 0.5% to 1%. In other words, the rate of appreciation is being allowed to accelerate.

Credit growth, cash requirements for small and large banks, and savings and lending rates

With housing prices falling in parts of the country (including Beijing), there are concerns that the real estate market will contribute to a hard economic landing. The importance of the real estate sector to the provinces can’t be underestimated, and there are many indirect effects on activity if housing prices fall. To prevent a rapid decline, cash requirements for banks are being lowered and there are expectations that lending rates will be cut by a full 1 percent during the year. This is possible because inflation is trending closer to the comfort level of 3%, but in March rose to 3.6%.

The key questions for China are still the difficulty in creating sustainable growth from a financial, economic, demographic and environmental perspective, as well as better income distribution. Opening up the financial sector to the rest of the world and to competition is necessary in order to reduce the risk of bubbles. This process has begun, but takes time and will be fraught with doubt along the way.

China has been more flexible in adjusting its currency, but still remains cautious

Lower cash requirements and interest rates are boosting the stimulus through the banking sector

Liberalizing the financial sector is a major challenge
Japan: Growing as Tohoku is rebuilt

- **GDP is expected to increase this year when reconstruction work intensifies. Next year the growth rate will slow slightly.**

- **Industry has been hurt by the strong yen and slowdown globally, including in China. A slight turnaround is expected, but competitive challenges remain.**

- **The Bank of Japan is implementing further quantitative easing and fiscal policy is becoming more expansive.**

The Japanese economy shrunk by 0.2% at a quarterly rate and 0.7% at an annual rate in the fourth quarter. Compared with the same quarter in 2010, growth was -0.6%, and for the full-year 2011 GDP fell by 0.7%.

Considering the huge disaster Japan lived through last spring, with a tsunami, earthquake and nuclear accident, the economy has held up better than first anticipated. It is always hard to calculate the impact of a natural disaster, and the total costs this time are still in doubt. This also means that it is difficult to calculate how quickly the reconstruction will continue and how much it will raise GDP this year and next.

Within three months of the disaster, 93% of manufacturers reported that their businesses had been fully restored. This may seem fast, but it is still longer than after previous earthquakes. This means that the impact on the global supply chain was that much greater, especially since some of the production was highly specialized and all the suppliers were unique in their own way. The remaining problems after the disaster are the reconstruction, difficulty attracting companies to the region and the effect on energy production (in March only two of 54 nuclear power plants were in operation).

In addition to these problems, Japan has struggled with a strong yen, deflation, weakening international demand and a slowdown in China. An increased dependence on fossil fuels is raising imports and contributing to the current account deficit.

In 2012, we expect growth to receive a boost from the major investments in connection with the reconstruction. The government has allocated 12 billion yen in its budget (2.4 % of GDP on top of earlier 1.2 % of GDP). Debt restructuring will take a back seat in the years ahead, and Prime Minister Noda's attempts to raise the consumption tax will not result in any changes until after the election by August of next year.
Continued weakness in the manufacturing sector is evident by production data, despite that the purchasing managers index noted a modest increase. Although the yen is slightly weaker, it is still at a historically strong level, and this is affecting the competitiveness of Japanese industry. The Bank of Japan expects to keep its policy rate around zero and continue to buy assets in financial markets to weaken the yen and limit deflation problems. Higher oil prices will mean that Japan will see slight inflation this year rather than deflation. GDP growth is rising to 1.5% this year as a result of the reconstruction, before leveling off at 1.2% next year when investments are phased out.

### India: Putting its trust in rate cuts

- **GDP growth is foreseen at 6.7% this year and at 7.3% the next year.** Growth will receive support from expansive economic policy and improved global growth.

- **Despite that inflation is again on the rise due to higher energy prices, monetary policy is being loosened.** More rate cuts are expected to support the economy.

- **The budget deficit is expected to be 5-5.5% of GDP this year, but even more serious is the timid reform aims.**

Growth in the Indian economy has fallen from 8.3% in the fourth quarter of 2010 to 6.1% in the same quarter last year. An important reason is the tighter monetary policy, which became necessary in order to slow inflation. Another reason is the global slowdown, which is holding export and investment growth in check.
The rate of increase in the consumer price index has fallen from 16% at the beginning of 2010 to 5.3% in February, but rising energy prices pushed the index to 7.4% in March. There is a risk that inflation is now accelerating again. Nevertheless, the Reserve Bank of India has begun to cut its key policy rate, from 8.5% to 8%, with the possibility of further cuts to stimulate growth.

**Interest and exchange rates**

We expect GDP to grow by 6.7% this year, before rising 7.3% next year in pace with slightly stronger global demand, looser monetary policy and lower oil prices. There is a risk that India will find it difficult to return to its previously high growth rate of around 9%. There are several reasons why: a slower pace of reform, budget problems, weak investment and political intransigence, which contributes to passivity.

One example is how the retail sector was about to be liberalized and allow foreign companies to open for business in India, but how the reforms were canceled at the last moment. Subsidies and welfare programs in the agricultural sector help politicians to win votes, but are costly from a budget perspective. The railway minister was forced to resign after trying to raise ticket prices for the first time in ten years. The budget deficit is expected to drop to slightly over 5% of GDP next year. Continued oil subsidies and overly expansive fiscal policy (and possibly even monetary policy) could drive the inflation rate higher again, which could lead to overheating and hurt growth. India has not resolved its underlying problems, and attempts to stimulate growth could backfire at a later point.

**Slower pace of reform, budget problems, lower investment and a difficult political environment are among India’s problems**
Brazil: A bottom has been reached

- **Rate hikes, higher inflation and weak export growth have tempered GDP growth, which reached the bottom in late 2011.**

- **Lower inflation and weaker activity have forced the central bank to cut its policy rate, which helps households in particular.**

- **GDP is increasing to 3.1% this year and 3.5% next year. Growth is benefiting from higher commodity prices, but a strong real is a competitive detriment.**

The Brazilian economy has significantly slowed in the last two years. In early 2010, growth was over 9% on an annual basis, but by the end of last year it was only 1.4%. When the rebound after the global recession ebbed away, the global economy slowed and monetary policy became increasingly restrictive, GDP growth slowed.

Households have been the most affected by austerity, through slower credit growth. Together with high inflation and weak real income growth, this has meant slower private consumption. As the central bank now cuts interest rates and inflation falls, the situation for households will improve.

Exports are expected to benefit from the higher commodity prices, and together with investments for the 2016 Summer Olympics and the 2014 World Cup the growth rate will rise, cautiously at first and then more noticeably after the forecast period. Leading indicators signal that a turnaround in the economy has already begun. We expect GDP to grow by 3.1% this year and by 3.5% next year. Our cautious outlook for next year is because we expect Brazil to be hurt competitively when inflation rises again, at the same time that the exchange rate remains relatively strong.
Euro zone: Recession, then weak growth

- The euro zone is in recession due to shrinking economies in southern Europe, and from a purely technical standpoint Germany as well, though in Germany’s case it expects to grow more and faster later this year.

- The ECB’s liquidity support has helped to mitigate the crisis and reduced the scope of credit austerity, though it can’t be avoided altogether. The policy rate remains at 1%.

- Increased focus on Italy and Spain, where the challenges are great. We expect them to manage without a rescue package.

GDP in the euro zone fell by 1.2% at an annual rate in the fourth quarter of 2011, which means negative quarterly growth of 0.3%. At an annual rate, growth was 0.7%, in line with our January forecast. We have revised our GDP forecast for the euro zone downward slightly this year (from -0.3% to -0.5%), but see room for slightly higher growth next year (from 0.2% to 0.4%), mainly due to stronger development in Germany and to some extent to France as well.

The differences in growth between the euro countries were great in the fourth quarter of 2011. Unexpectedly strong growth (0.2%) was reported in France, and Finland also noted slightly positive growth (0.1%), while Germany, Austria, Czech Republic, Belgium and (unexpectedly) Spain managed just slightly negative growth (0.1-0.3%). Not unexpectedly, Portugal and Italy posted bigger GDP declines, though export-dependent countries such as the Netherlands and Slovenia also saw their GDP slip, by 0.7%.
The reasons why GDP is falling are, in the case of the crisis countries, the debt crisis, budget cutbacks, credit austerity and higher oil prices, which are also hurting future confidence, and in the case of export-dependent countries a slowdown in export orders, higher oil prices and weak confidence among households and businesses.

Since our January forecast the euro zone has managed to take small but important steps to improve its crisis management. The fiscal pact facilitated the ECB's long-term fixed-rate loans to banks, now totaling over a trillion euro, which have lessened the need for austerity, reduced government bond yields in the crisis countries and rejuvenated the banking sector. The impact of the loans has begun to ebb away, however. The focus is returning to whether the crisis countries are meeting their reform requirements. Following the agreement, the interest rates on new loans for countries such as Spain, Italy and even Greece from lenders and the troika have again begun to rise.

We expect the ECB to keep its policy rate at 1%. Cutting it further isn't considered necessary when the overnight rate is already low. Another wave of quantitative easing could be possible if concerns about rising risk premiums for the crisis countries escalate. The question of whether the two rescue funds, EFSF and ESM, are big and flexible enough is important if confidence is going to be maintained in the euro and the euro collaboration. The measures to expand them and let them coexist are a step in the right direction, but whether they are sufficient won't be tested until a large country like Spain faces an emergency.
Concerns about Spain center on high unemployment, weak banks, regional overspending and difficulty trimming the budget deficit from 8.5% in 2011 (the goal was 6%) to 5.3% in 2012 at the same time that the recession worsens. This concern is clearly reflected in the 10-year government bond yield, which again neared the 6% level. The last time this happened was when the crisis peaked in November. The risk premium relative to Germany is slightly over 4 percentage points. The decision of the new Spanish government led by Prime Minister Rajoy not to immediately address uncertainty about its fiscal policies until after local elections in March and to renegotiate the deficit from the EU Commission's 4.4% to 5.8% hardly garnered respect, especially since the compromise ended up being 5.3% and few experts believe Spain can handle even that. Unemployment of 23%, and for young adults nearly 50%, complicates budget consolidation, as well as labor market reforms. The government has found savings of 27 billion euro, however, as well as an additional 10 billion euro in health and education.

Housing prices have fallen by only 23% to date (compared with declines of 50% in Ireland and 34% in the US). The banking system is under threat, and a major decline in housing prices could force Spain to seek outside support.

The tougher requirements on Spanish banks to set aside 50 billion euro to better handle the recession and housing slump is a positive step. Of the 325 billion euro in loans related to the housing sector, it is estimated that 175 billion euro are nonperforming. A major economic slump could cause the mountain of bad debt to grow, which would also complicate the consolidation and reform of the banking sector. We expect, therefore, that how the banking system is handled will be critical to the likelihood of a rescue package – this time for a considerably larger economy than Greece, Portugal and Ireland. The situation in the regions could also be critical. Plans call for 140 billion euro to be refinanced, and if interest rates rise significantly above the current level of just over 6% Spain could face problems. At this point, however, we expect it to manage without outside support.

We do not expect the Spanish economy to grow at all in the next two years (-2.2% this year and -0.8% next year), but if the recession and slowdown in the housing markets are worse than expected, the support package may be needed. It is important therefore to combine budget austerity with growth oriented reforms that also have a positive effect in the short term, and not just in the medium and long term as they usually do.

Despite that Italy's technocratic government led by Prime Minister Monti is implementing structural reforms and has gained greater confidence from the international market and at home for its ability to alleviate the crisis, we still believe, as we did in January, that Italy's recession is unavoidable. The financial markets concerns about Spain have recently spread to Italy with rising risk premiums as a result, especially since 450 billion euro of government debt has to be refinanced. Increased political
uncertainty leading up to the 2013 election will also gradually affect sentiment.

We expect GDP to decline by 1.8% this year and by 0.3% next year. Unemployment has risen to 9.3%, the highest level since 1991. Possibly even worse is the participation rate, which has fallen to 56.9%, denoting a large group of inactive Italians in the formal labor market. This is a problem for domestic demand, and naturally for fiscal austerity and cautious credit markets as well. Oil prices are pushing inflation higher despite slumping demand.

The reforms in the labor and product markets focus on making it easier to hire and fire employees, simplifying regulations for the service sector and opening up “protected professions” to competition. Unions and other interest groups are fighting the changes. Reducing the high public debt ratio is also a goal, with a balanced budget by 2013. If the recession doesn’t get any worse, this is achievable, at the same time that Italy doesn’t share Spain’s problems in its banking sector and housing market. Household and corporate savings are relatively high, which compensates for some of the huge public debt. More troublesome is the growing competition from low-cost countries facing some Italian manufacturers, often SME’s. Italy, and its export growth, would certainly benefit from a weaker euro.

Greece is holding an election on 6 May, and there is great uncertainty how political power will be shared. However, the parties that take over from Prime Minister Papademo’s technocratic government are committed to the reform agenda that has been agreed upon, and if the country is to remain in the euro zone it has little leeway to adopt a more expansive policy. The key is to clean up the government’s finances, reduce corruption, deregulate markets and privatize. It is also important for the country’s cohesiveness that growth-oriented reforms which could also have a positive effect in the short term receive support. This could mean pushing forward investments and cooperating with private players in infrastructure. We expect GDP growth to be weakly positive next year, assuming that political and social concerns do not escalate and the reform program is followed. The reason is that the Greek economy will then have shrunk for five consecutive years and that a weak turnaround isn’t unreasonable to expect once costs are reduced.

Portugal is at risk of negative GDP growth this year and next. Concerns that Portugal will have to extend and increase its rescue package are growing as a result. The idea was to rejoin the regular capital market in 2013, but this could be difficult when growth weakens and the risk premium again rises (even as the result of increased concerns about Spain and Italy). The budget deficit is expected to fall from 5.8% last year to 4.4% this year. If economic conditions do not worsen and austerity policies are adopted, the deficit could be closed to nearly 3% next year. The reform agenda is similar to those in the other crisis countries, but with a greater focus on restructuring state-owned enterprises.
**France**

In *France*, the first round of presidential elections is scheduled for 22 April with a runoff on 6 May. Despite that France is losing the financial market’s confidence due to the lack of urgency in addressing its budget deficit, the problem isn’t being seriously debated in the election campaign. The forecast is that the debt ratio will exceed 90% at the same time that the budget deficit will be just over 5% in 2013, a marginal improvement compared with last year and 2012 but higher than the euro zone’s agreed level of 3% in 2013. Among the euro countries, only Greece and Spain will have larger deficits next year, but among the larger countries the US, the UK and Japan are all expected to manage worse than France.

France’s GDP growth held up fairly well in the fourth quarter of 2011, and it may be able to avoid a recession in the technical sense. Investment growth has been surprisingly strong. Going forward, however, the high unemployment – nearly 10% - will be an obstacle to private consumption. Regardless of whether the Social Democratic candidate, François Hollande, who currently leads opinion polls, or President Nicolas Sarkozy wins, measures will have to be taken after the election if the goal is to reach 3%. High oil prices also mean relatively high inflation. We forecast that GDP will grow by 0.3% this year before reaching a modest 0.6% next year despite slightly stronger global conditions.

**Germany**

Germany’s GDP fell by 0.2% in the fourth quarter of 2011. We think it is likely that the first quarter this year will also see a shrinking GDP, but by 0.1%. Technically, we are forecasting a recession in Germany, but its chances of a rebound are better, and annual growth is projected at 0.5% this year and 1.3% in 2013. In total, this represents an upward revision of 0.5 percentage points over two years compared with January. While Germany is certainly affected by higher oil prices, the growing recession in the euro zone and slightly weaker global conditions this year compared with the January forecast, global growth has been revised slightly upward next year, which benefits an export-driven country like Germany. The credit austerity in the crisis countries in southern Europe is not as manifest in Germany, which facilitates further investment. Fiscal austerity is over and a period of slightly expansive fiscal policy can begin.

No major political changes are expected next year despite the possibility of a power shift after the fall election, and most indications are that Chancellor Angela Merkel will remain in power, though with different coalition parties. The labor market has continued to improve. Unemployment is now down to 6.7%, a level we haven’t seen since reunification of East and West Germany in 1990. This allows Germany to increase domestic demand (read imports), which could reduce the current account surplus and thus the gap with southern Europe.
UK: The pain continues

- We are revising GDP growth upward to 1.0% next year, but are maintaining our forecast for this year (0.5%). The crisis in the euro zone, as well as debt restructuring by the state and households, is holding back growth.

- Inflation has fallen, which allows the central bank to maintain an expansive monetary policy. Industry is no longer benefiting from a weaker pound and must raise productivity.

A weaker investment climate reduced the UK’s GDP by 0.2% in the fourth quarter of 2011, while exports and consumption performed better. Unemployment has risen to levels last seen in 1995 at around 8.5%. Employment has stagnated, mainly due to public sector layoffs. Households are affected by weak income growth at the same time that debt restructuring continues.

After reaching 5.2% in September 2011, inflation (annual CPI) has since declined significantly, to 3.4% in February after the one-time effects of a VAT rate hike and a weaker pound were no longer reflected in the annual figures. The Bank of England is maintaining an expansive monetary policy, has managed to alleviate inflation concerns in recent years, and is expected to implement another quantitative easing after its announcement in February.

We expect the policy rate to remain at 0.5% this year and next in order to help the economy while fiscal policy remains restrictive. The budget deficit is estimated that 8% this year and could decline to 6.5% by 2013. In business cycle adjusted terms, the deficit is improving from just over 6% to 5%, which means it will take some time, probably until 2015-16, before the structural balance shows a surplus. As a result, the debt ratio (government

A large budget deficit and growing national debt mean the UK isn't out of the woods yet
debt in relation to GDP) continues to rise and will probably exceed 90% next year.

The British pound weakened significantly in 2008 and has since trended slightly higher, especially against the euro in the last year. We expect the pound to stabilize against the euro, which means that exporters won't receive much help and instead will have to strengthen productivity and reduce costs on their own. The purchasing managers index has risen since last November and points to stronger industrial production in the near future. The service sector is also signaling increased activity, which could help to raise the growth rate from 0.5% this year to 1% next year.

### Nordic countries: Mixed signals

- **Denmark continues to grow below its potential in the wake of its own financial and real estate crises. Finland has been adversely affected by weaker global demand and a weaker competitive situation. Norway is benefiting from strong domestic demand.**

- **Compared with 2012, however, all three countries will see higher growth, and pressure is increasing on politicians to adopt reforms that increase competitiveness and access to skilled labor.**

The Danish economy had not recovered from the collapse in the real estate market in 2007-2008 when concerns about the debt crisis again impacted activity in 2011. The second half-year saw slowing domestic demand, mainly from households, a recession, while foreign trade contributed positively to growth, which ended up at 1%. During the forecast period we expect Denmark’s growth to fall below its potential due to household debt restructuring and the global slowdown. In 2013, stronger global growth and slightly higher public investment could provide a boost, but the budget consolidation means that any recovery will be modest. GDP will grow by 0.5% this year and 1% next year.

Last year Finland’s GDP grew by 2.7% due to strong consumption and investment demand. On the other hand, growing competitive disadvantages due to low productivity growth and higher labor costs, contributed to lower export growth. In 2011, export volume fell by 0.3% and the current account balance was negative for the first time since 1993. This year we expect GDP growth to slow to 0.8% since household balance sheets have been hurt by lower stock prices and weak real estate markets. The outlook for real income improvements is complicated by slower activity in the labor market. When global demand rises in 2013 and uncertainty eases, incomes will improve and GDP is expected to grow by 1.7%. 

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*Danish economy* Stays below its potential

*Finland is struggling with competitive problems, but still expects growth to turn higher next year*
The Norwegian economy was able to hold its own despite the global slowdown late last year. GDP then increased by 0.5% from the previous quarter. For 2011 on average, GDP rose by 1.5% (with 2.6% for the mainland economy). The growth engines were strong domestic demand, which led to a high level of activity in the business and real estate sectors, stronger labor markets and good growth in private consumption. Export industry will be impacted going forward by weak global conditions. Low interest rates and a continued strong labor market are contributing to a robust increase in domestic demand, although risks remain high for household debt. GDP will grow by 2% this year and 2.5% next year, and in the mainland economy growth will be even faster.

6. Conclusions for our home markets

Sweden and the Baltic countries, which are small, open economies with Europe as their most important export market, are being especially hard hit by the lengthy period of debt restructuring and weak growth in the euro countries. While exports are being diversified to other regions, the high-volume European markets are still more important, and shrinking demand will adversely affect exports and investments in the years ahead.

The crisis in our neighboring region also has other effects. Not only the EMU – but also the EU – is affected. Integration of the common market could ground to a halt if nationalism and xenophobia gain the upper hand. On the other hand, the crisis could speed up integration if the reforms implemented lead to greater trade in services. Integration of the service sector has long been a low priority, but demands from Germany to accelerate reforms in this area could also benefit our home markets.

The Baltic countries, where Estonia is an EMU member and has the euro and where Latvia and Lithuania have their own currencies pegged to the euro, may be helped by a weaker euro. It would be positive, especially since unit labor costs are already rising despite a continued need to improve competitiveness mainly through higher productivity. For Sweden, there is a concern that the krona will become too strong in the years ahead. This would force Swedish companies to do much more themselves than in recent years to maintain or improve their competitive strength. This would best be accomplished by investing in new technology that increases productivity, improves efficiencies and keeps cost increases in check.

In Sweden, interest in EMU membership has cooled from already low levels, while it is still fairly high in Latvia and Lithuania. Even if it takes another year or more before these two countries become members, their route is staked out. Trying to stimulate domestic competition in the meantime, so that inflation grows more in line with other euro countries, would be in their economic

Norwegian households are benefiting from a stronger labor market and low interest rates

Weak growth in our neighboring region is strongly affecting us

A weaker euro benefits the Baltic countries, but could increase the need for efficiency improvements by Swedish companies

EMU membership is a natural step for Latvia and Lithuania, and having to wait a year or so isn't a problem
policy interests. It is also important that they evaluate the so-called Balassa-Samuelson effect with naturally higher inflation during a "catching-up" period. Disproportionate differences in price levels could necessitate a lengthy period of adjustment before the countries are ready for membership. It is also important to investigate whether previously large current account deficits have been eliminated or whether they can quickly return if the growth strengthens, which in that case could reflect structurally weak competitiveness. For Latvia and Lithuania, where floating exchange rates are not a future alternative, it makes more sense to continue working toward membership than for Sweden and Poland, for example, where the currencies float against the euro.

Weak growth and rising unemployment in the euro zone could create increased mobility in the labor market, where workers from crisis countries move to faster growing parts of the region, mainly in northern Europe. It is important, especially considering the growing demographic challenges, that there is a positive attitude toward immigration. For the Baltic countries, where the labor market has already become tight in some sectors and wage pressures could rise, there is every reason to more actively welcome workers from the rest of the region.

Crises often lead to greater reform efforts. The question is whether Sweden and the Baltic countries will be able to keep pace. The situation today is brighter for them than for the crisis countries in southern Europe, and there is a risk therefore that the pace of reform will slow. It is important to continue to reform the markets, not least the labor market, so that they contribute to more innovation, expand infrastructure and lead to better regional coordination. Creating fertile soil for business makes us all more prosperous in the long run. The potential is great: many business opportunities are still untapped in our region.

Cecilia Hermansson

Sweden and the Baltic countries could benefit from emigration of labor from crisis countries in Europe

The crisis countries are reforming – can we keep pace?