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## War and inflation will hamper economic growth

**The COVID-19 pandemic had not yet released its grip** on the world economy before Russia attacked Ukraine, creating a new crisis. Above all, the war is a humanitarian catastrophe. But in economic terms, we are now facing a whole new level of uncertainty and challenges. The invasion has intensified the problems with global value chains, trade, production, input goods, transport and energy shortages that arose during the pandemic. The sanctions against Russia with which the European Union, United Kingdom, United States and others have responded will also have major economic consequences that extend far beyond Russia's borders.

**On top of this, inflation is now so high and widespread** that virtually all central banks have either begun to tighten their monetary policy or plan to do this soon. Inflation – which began with price increases for specific goods and intensified last autumn due to rising transport and energy prices – is now visible everywhere. Central banks have consequently abandoned their previous view that inflation was a transitory effect of pandemic-related supply side disruptions. We will therefore see active measures, in the form of both long series of key interest rate hikes as well as programmes to reduce central bank balance sheets. The idea is to lift both short- and long-term rates in order to reduce demand in the economy, lower inflation expectations, restore confidence in central bank inflation targets and prevent an upward wage-price spiral that risks damaging the economy for a long time to come.

**In such an environment, growth will be negatively affected.** Tightening measures will cause economic activity to slow. It will be harder for businesses to maintain their margins. Higher interest rates and bond yields will make capital spending dearer. Household finances will be squeezed between negative real wage increases, higher home mortgage rates and continued historically elevated prices for electricity and petrol.

These are among the reasons why this *Nordic Outlook* includes clear downward revisions in our growth forecasts for almost all countries, compared with the issue we published in January.

**The big question** is not whether growth will decelerate, but by how much. Will central banks and governments manage to slow down the economy just enough, or are we headed for a deep recession? It will be a tricky and uncertain balancing act, but our main scenario is that a soft landing is likely in spite of everything. Labour markets and demand are strong in most large economies, and households still have savings and strong balance sheets. Many companies are doing well, and governments are prepared to support vulnerable parts of the economy with fiscal stimulus measures. But soft-landing an economy is not easy. History provides many examples of central banks that went too far or too fast, with hard landings as a result. We look forward to continuing to analyse and discuss this extremely difficult but also intriguing financial situation with you.

In this May 2022 issue of *Nordic Outlook*, we offer four in-depth theme articles that discuss the following:

- Commodity shocks
- Russia's new role
- The new wage round
- The changing Baltics

We wish you pleasant reading and a great summer!

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Chief Economist

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# The global economy

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## **The United States | page 19**

An overheated labour market and resilient demand are pushing the Fed to hike the key interest rate quickly. The Ukraine war and China's COVID lockdowns are increasing growth and inflation risks, but our main US scenario is still a soft landing.

## **China | page 29**

Tough COVID restrictions will hamper growth and contribute to higher inflation. Yet monetary policy support has been modest, and fiscal policymakers must do the heavy lifting. We are adjusting our GDP growth forecast somewhat lower.

## **The euro area | page 22**

The Ukraine war is leading to increased euro area investments in defence and faster energy transition. High inflation will erode purchasing power, and growth will slow sharply. The ECB will hike its key rate from July, but more sedately than the Fed.

## **The United Kingdom | page 25**

High energy prices and rising inflation are hurting consumption. After raising its key rate a few times, Bank of England seems to view the inflation risk from pay rises as more important for its policy than the risk of a collapse in purchasing power; it will thus continue to raise the Bank Rate.



## International overview

# Global soft landing likely but downside risks dominate

The Ukraine war is putting pressure on the global economy. Widespread commodity price upturns are fuelling inflation further. Despite a poorer growth outlook, central banks must prioritise their fight against inflation, thus squeezing households and businesses. We have lowered our 2022 global GDP growth forecast by more than one percentage point. Due to fiscal stimulus, pent-up demand, strong private balance sheets and eventual easing of global supply chains, a soft landing is still the most likely outcome.

The international economic outlook has greatly deteriorated in recent months. The war in Ukraine is having a profound effect on global economic and security policy developments. In addition to the tragic humanitarian consequences of the war, an already strong inflation impulse is now intensifying. There are widespread increases in commodity prices; both Russia and Ukraine are major exporters of agricultural products. Russia's metals are also highly important for world market balance. Energy prices are climbing due to powerful sanctions against Russia and the European Union's ambition to quickly reduce its dependence on Russian energy. Renewed COVID-19 outbreaks in China are worsening the situation further, since authorities refuse to relax their highly restrictive lockdown strategy. We thus see no immediate prospect of substantial relief from global supply chain disruptions.

**Central banks are now focusing on inflation**, despite the lower economic growth outlook. The price upturn has broadened as companies have passed rising costs onward to consumers. Earlier comparisons with the supply side-driven inflation wave of 2008 seem increasingly irrelevant, now that we are seeing overheating trends in both goods and labour markets. If central banks do not act, there are major risks that long-term inflation expectations will also take off. As for pay increases, the situation remains divided – with clear acceleration in the United States and the United Kingdom, but still a relatively subdued upward trend in Germany and the Nordic countries.

### Global GDP growth

Year-on-year percentage change

	2020	2021	2022	2023
United States	-3.4	5.7	2.6	1.7
Japan	-4.5	1.6	2.3	1.9
Germany	-4.6	2.9	1.5	3.2
China	2.2	8.1	5.0	5.2
United Kingdom	-9.3	7.4	3.7	2.5
Euro area	-6.4	5.4	2.1	2.8
Nordic countries	-2.1	4.3	2.4	2.1
Sweden	-2.9	4.8	1.8	1.8
Baltic countries	-1.8	5.6	1.1	2.0
OECD	-4.6	5.5	2.6	2.3
Emerging markets (EM)	-2.0	6.6	3.3	4.4
<b>World, PPP*</b>	<b>-3.2</b>	<b>6.1</b>	<b>3.0</b>	<b>3.4</b>

Source: OECD, IMF, SEB. \*Purchasing power parities

**Clear downward adjustments since January.** In response to the outbreak of the Ukraine war, we published an updated forecast in late March. Compared to this, our GDP forecast has generally held up rather well, although the probability of a relatively short war has decreased. But our downward adjustments are sizeable compared to the last *Nordic Outlook* forecast, published in January. We now expect global GDP to grow by 3.0 per cent this year: more than one percentage point lower than in January, and fairly evenly distributed between the mainly affluent OECD countries and the emerging market (EM) economies. Our forecast for 2023 is largely unchanged at the global level. The outlook for the US economy has deteriorated rather gradually as the Federal Reserve's need for monetary tightening has become increasingly evident. Our downgrades are biggest for the euro area and Germany, mainly due to their need for a rapid energy transition. Norway is coping with the changing environment better than other Nordics. Bloated home prices are leading to high interest rate sensitivity in Sweden, and we have lowered our GDP growth forecast sharply to below 2 per cent in both 2022 and 2023. Larger trade with Russia makes Finland and the Baltic countries more vulnerable. But our theme article "The changing Baltics" on page 42 analyses their long-term trend towards weaker links with the Russian economy.

**A soft landing is the most likely outcome.** We are sticking to our soft landing scenario, which is supported by a number of positive forces. New fiscal stimulus measures in the form of subsidies for rising energy costs, as well as intensified investments in defence capability and a green transition, will provide short-term

support for growth in the euro area. Meanwhile some of the stimulus funds provided during the pandemic, especially in the US but also in the euro area, have not yet made their way into the economy but remain as part of large household savings buffers. Strong balance sheets will make the private sector more resilient to rate hikes. The household debt burden is far lighter than before the outbreak of the global financial crisis. It is likely that the supply side problems now driving up inflation will eventually ease. The reopening of the service sector is not yet complete, and a continued shift to service consumption may ease pressure on goods production and shift demand to sectors that do not face the same supply shortages. Also worth pointing out is that real interest rates will remain low despite key rate hikes, which means that economies are not yet facing a clear tightening of monetary policy.

**Downside risks predominate.** The reversals in central bank policies have been dramatic. Although the inflation shock was not easy to predict, fiscal stimulus during the pandemic – combined with zero interest rates and quantitative easing – will be carefully evaluated in the future. Historically, it has been hard to ensure a soft landing in line with our main forecast. This accentuates the downside risks in this forecast. We may possibly be underestimating the interest rate sensitivity of the economy, for example the impact of rates and yields on share and home prices. The inflation upturn may also be stronger and more protracted, thus requiring even more powerful medicine. The possible need for energy rationing in Europe and China's economic headwinds are other downside risks. Upside potential is limited but mainly consists of a faster-than-expected resolution of supply side problems. It is also conceivable that prices will broadly normalise more than we expect, reinforcing the base effects that are the main drivers of the inflation downturn in our main forecast. But overall, the downside bias is bigger than usual. We estimate that the probability of our negative scenario is 30 per cent, our positive scenario 10 per cent.

#### Various scenarios for the OECD countries

GDP growth, per cent

	2021	2022	2023
Main scenario	5.5	2.6	2.3
Negative scenario		1.0	0.5
Positive scenario		3.5	3.0

Source: SEB

**Front-loaded key rate hikes.** We have generally adjusted our central bank forecasts much higher as the banks implement front-loaded rate hikes out of concern

for their inflation targets. The Fed will hike its key rate by 50 basis point steps at its next few policy meetings, moving gradually towards 3.50 per cent by mid-2023. Spurred by upwardly revised inflation forecasts, the European Central Bank will also start its hikes earlier, raising the deposit rate in July and then its entire rate corridor in September, with an end point of 1.00 per cent for the deposit rate. The Riksbank's dramatic policy reversal will be followed by new steps in a hawkish direction, probably including a 50 bp hike in September. Due to weak growth in Sweden, the Riksbank will end its hiking cycle by mid-2023 at a repo rate of 1.75 per cent. Concerns about interest rate-sensitive Norwegian households will justify a gradual strategy by Norges Bank, with five hikes this year and two more in 2023.

**Policy U-turns are pushing up bond yields.** Long-term bond yields have climbed sharply, in line with growing central bank worries about inflation. Rate hikes and quantitative tightening (QT), as well as an increased supply of bonds in Europe, will push 10-year US Treasury yields to 3.50 per cent and 10-year German bonds to 1.60 per cent by end-2023. Sweden's long-term yield spreads against Germany will widen a bit further, driven by more and earlier Riksbank hikes – partly because the Riksbank is moving towards phasing out bond purchases. But by end-2023, spreads will widen again as the ECB also reduces its reinvestments.

**Dollar peak will be delayed.** Because the Fed will hike its key rate faster than other central banks in the near term, the US dollar has not yet peaked. The euro area's proximity to the Ukraine war and its dependence on Russian gas create vulnerability, which is weighing down the euro. EUR/USD will fall to 1.02 before the euro starts to rebound closer to long-term equilibrium; at year-end 2023, EUR/USD will be at 1.15. The krona is being hurt in the short term by the global slowdown and reduced risk appetite, but Riksbank rate hikes will eventually contribute to sharp SEK appreciation as earlier structural outflows linked to negative interest rates and quantitative easing reverse. We foresee a strong tailwind for the krona in 2023 and believe EUR/SEK will bottom out at 9.55 by mid-year.

#### Protracted conflict would have major impact

Russia's attack on Ukraine now dominates global economic and political developments on many levels. This *Nordic Outlook* thus includes two theme articles that deal with different aspects of this. It is now clear that the war will probably become more drawn-out than the 3-6 months that seemed likely when it began on February 24. Today neither Russia nor Ukraine has any strong incentives to seek a negotiated solution. Ukraine

is gradually getting better at defending itself, mainly thanks to support from the US and from EU countries. Russian President Vladimir Putin has not achieved any of the goals mentioned when he began the invasion. With more resources to deploy if needed, Russia is unlikely to back down.

#### **International sanctions will hurt the Russian economy**

both in the short and long term. GDP is expected to fall by 10 per cent this year and another 3 per cent next year. The sanctions – combined with a repressive political environment, weak rule of law and widespread corruption – will probably lead to economic stagnation, causing Russia to continue declining in prosperity compared to its peers. Even in countries whose governments do not distance themselves from Russia's war, most firms that sell goods in the US and the EU will follow the sanctions against Russia. The choice between a stagnant Russian economy and dynamic high-tech Western economies is easy for most companies. But meanwhile it is clear that the Russian economy has not collapsed, partly due to steps Moscow has taken since the 2014 annexation of Crimea to reduce dependence on other countries.

**Divergent views on responsibility for the war.** The rapid, powerful response of the Western world and various other democracies – in the form of sanctions against Russia – has surprised many people. But at the same time a number of governments, including China, have expressed support for Russia's argument that NATO should not expand and that Russia is entitled to defend itself against an existential threat. Other big emerging market economies such as Mexico, Brazil and India have adopted a neutral position on the war. But if the Kremlin were to escalate the war and use chemical or nuclear weapons, countries such as China and India would probably be forced to distance themselves from Russia, which would then become increasingly isolated.

#### **Rising food prices may have severe consequences.**

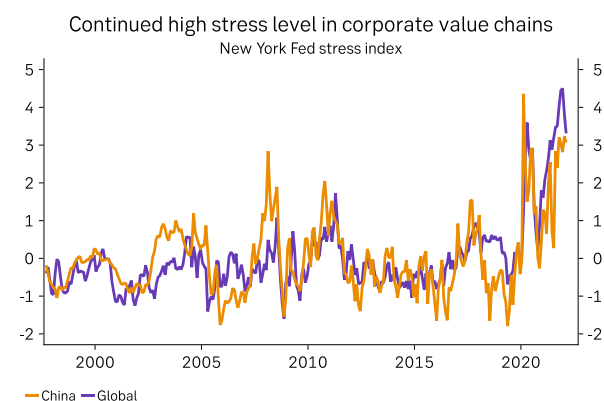
The outbreak of war sent shock waves through global commodity markets. Many prices rose sharply. Aside from fossil fuels – oil, natural gas and coal – Russia is a major exporter of grains, nickel, aluminium, palladium and fertilisers. Several difficult dilemmas are likely to arise in the future. Metal shortages, for example, may delay investments needed to accelerate the transition to sustainability. But the consequences of rising food prices may become more explosive. Wheat prices have doubled and may surge even higher. Due to shortages and high prices, global fertiliser use is declining, leading to smaller harvests even far away from the war. There is a clear risk of food shortages in Africa and elsewhere,

which may lead to social unrest and violence. High food price inflation may also lead to social tensions even in less impoverished parts of the world.

**Difficult to isolate Russia.** This illustrates the dilemma that support for sanctions may decrease if Russia is shut out of the global economy without replacements for its products. Food supply problems are likely to become more acute. The UN World Food Programme is now warning of famine disasters. Tensions related to this will probably increase in parts of the international community. The theme article "Russia's new role" on page 26 discusses various consequences of a lengthy war and persistent global tensions. One conclusion is that Russia is so much more integrated into the global economy today than the Soviet Union was that it is nearly impossible to completely isolate the country.

#### **Continued global supply chain problems**

New virus outbreaks in China are exacerbating disruptions in global supply systems. The authorities are trying to reduce the harmful effects on production and shipment of goods from China, but they are still generally applying a restrictive lockdown strategy. The Ukraine war and the isolation of Russia are also worsening the situation in some areas. Component shortages and bottlenecks in transport systems thus continue to hamper growth and push up inflation. These problems are likely to persist longer than previously anticipated. We now expect the situation to begin improving only early next year. But even in the long term, we may see increased fragmentation of the world economy into clear geopolitical blocks, with production chains becoming more regional instead of global.



Source: Federal Reserve Bank of New York, Macrobond, SEB

#### **EM growth being squeezed from different directions.**

Overall, it is clear that the economic performance of emerging market (EM) countries is under pressure from different directions. The Ukraine war will have catastrophic effects for the two countries directly involved, but also various indirect effects. Chinese growth has slowed sharply due to COVID-related



restrictions and measures to cool the overheated real estate and construction sectors. China's outlook is also being dampened by weaker growth and higher interest rates in the US and the EU. We have adjusted our overall EM growth forecast downward to 3.3 per cent for the full year 2022, compared to 4.5 per cent in the last *Nordic Outlook*, and we have lowered our 2022 growth forecast for China from 5.2 to 5.0 per cent. Our downward adjustment for the EM sphere was not larger due to small increases in our forecasts for commodity-producing economies in Latin America and Africa.

### GDP growth, BRIC countries and EM sphere

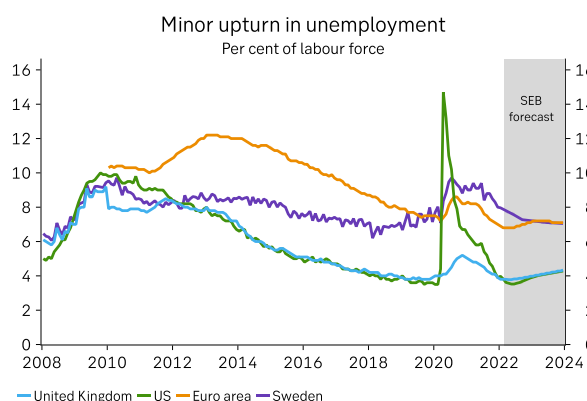
Year-on-year percentage change

	2020	2021	2022	2023
China	2.2	8.1	5.0	5.2
India	-6.6	8.3	4.3	7.5
Brazil	-3.9	4.8	0.9	2.0
Russia	-2.7	4.7	-10.0	-3.0
Emerging markets, total	-2.0	6.6	3.3	4.4

Source: IMF, SEB

### Resilient labour markets

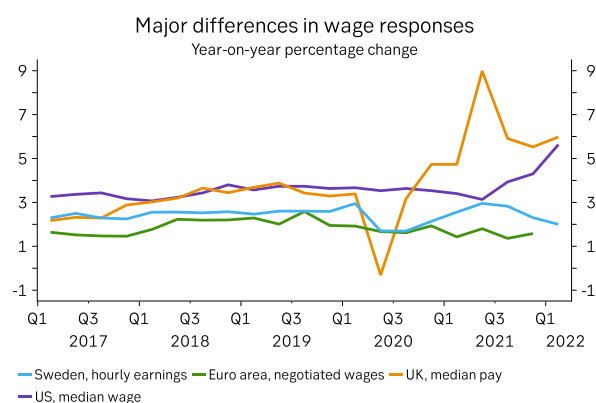
One key question as growth forecasts are beginning to be lowered is the reaction in labour markets. We have made fairly small adjustments to our unemployment forecasts, partly due to the prevailing strong momentum but also because GDP forecasts for 2023 in the US, Sweden and elsewhere are only marginally below trend. Such small changes are not enough to persuade central banks to begin easing their rate hiking plans, especially not when further upward adjustments to inflation forecasts have made this threshold especially high.



Hopes that symptoms of labour market overheating will ease are partly linked to the prospect of an expanding labour supply. In the US, the labour force participation rate for people over age 16 is now only one percentage point below its level before the pandemic, but compared to an underlying slightly positive trend in labour supply,

the gap is wide. We expect a continued increase during our forecast period, but not all the way up to pre-pandemic level, since many older people who have left the workforce are unlikely to return. Reduced sick leaves after Omicron may also contribute to a cooler labour market, and falling labour shortage statistics may help ease upward pressure on wages and salaries.

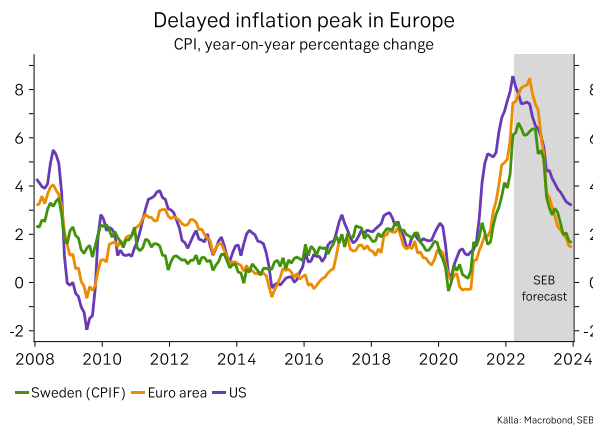
**There is a persistent difference in the rate of pay increases** in the US and the UK, on the one hand, and the euro area and Nordic countries on the other. Because wage formation is more market-driven in these English-speaking countries, overheated labour markets have an especially large impact. In the US, there are signs that we are close to the peak, since labour shortages and planned pay hikes among small businesses have fallen. In northern Europe, the issue of compensating employees for high inflation will be important in future collective bargaining rounds. Germany's IG Metall union has announced higher wage demands than usual, but the connection between such demands and later outcomes has historically been relatively weak. In Sweden, high inflation and the Riksbank's policy reversal have changed the conditions for the 2023 wage round (see the theme article "The new wage round", page 35). Our forecast is that Swedish wages will increase by 3.5 per cent next year and that there is a relatively small risk that multi-year agreements will end up at levels incompatible with the Riksbank inflation target. But if inflation accelerates further in the next six months, we may conceivably see some type of special solution including one-off inflation compensation, or one-year instead of multi-year labour agreements.



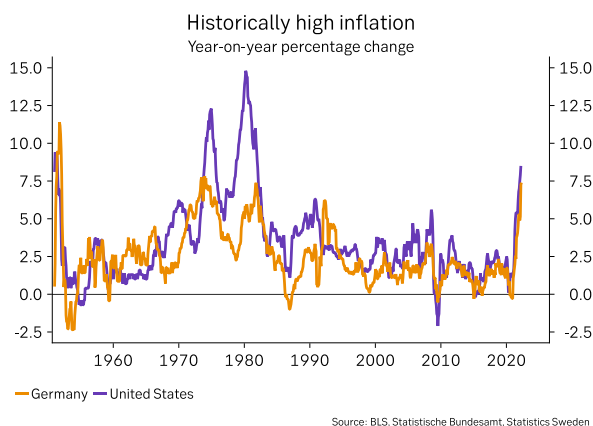
### High energy prices are keeping inflation up

After their initial surge, energy prices have fallen somewhat. This is mainly because the US and other countries have released oil from their strategic reserves and because China's new lockdowns have reduced demand. But both factors are transitory, and we expect energy prices to remain high in the foreseeable future

(see the theme article "Commodity shocks", page 13). We expect the price of Brent crude oil to average USD 106 per barrel this year and USD 85 in 2023. Natural gas prices will also be far above normal levels.

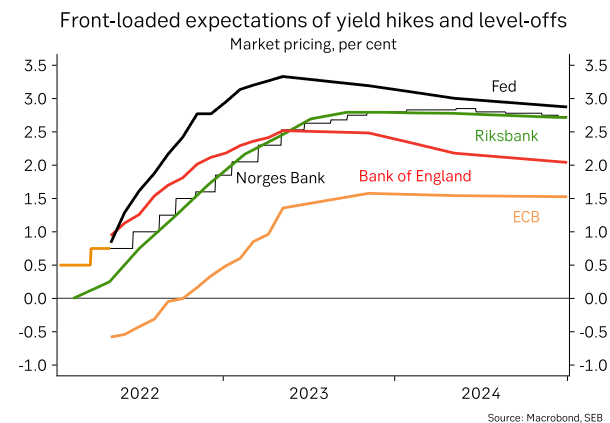


**Comparison with 2008 is irrelevant today.** Now that inflation has now accelerated and also broadened, the experience of the failed tightening measures of 2008 are starting to become irrelevant. Instead, there are two other inflation shocks that can be compared with those of today. The Korean War (1950-53) led to a sharply increasing need for transport and materials, which triggered a surge in inflation. Inflation then fell rapidly, enabling the Bretton Woods system – with its fixed exchange rates and US dollar gold peg launched in 1945 – to pass its first big test. This laid the foundation for the stable inflation environment that predominated in the 1950s and 60s. However, when the OPEC oil cartel implemented major production cuts in 1973, oil prices soared. The Bretton Woods system had recently collapsed. Fiscal policymakers shouldered the main responsibility for sustaining economic activity. Monetary policymakers in most countries mainly accommodated a general acceleration in prices and wages. As a result, economies were plagued by years of high, volatile inflation that hampered capital spending and growth.



## Front-loaded rate hikes amid uncertainty

Parallels with the stagflation era – expansionary fiscal policy, increased acceptance of price increases and rapid inflation in some countries – are being pointed out more and more. The strength of globalisation forces, which have been such an important factor behind the solidly low-inflation environment of recent decades, is also starting to be questioned. In such an environment, the mandates and the determination of central banks to stand up for inflation targets will become increasingly important in preventing inflation expectations from soaring. Central banks now appear to be aiming for a front-loaded hiking cycle, in which key interest rates can revert to a more neutral level relatively fast. We have thus raised our key rate forecasts substantially compared to the *Nordic Outlook* published in January.



## Fundamentals will determine the need for rate hikes.

Despite unexpectedly strong inflation, the ECB must proceed cautiously because euro area dependence on Russian energy is hurting growth. The ECB must also try to prevent the yield spreads between the government securities of countries in the euro area from widening too much. But the US continues to experience excessive demand, due to large-scale fiscal stimulus during the pandemic. For various reasons, there is a bigger risk in the US and the UK that shifting price and wage expectations will spill over into a wage-price spiral. In both countries, flexible wage formation is currently combined with overheated labour markets and tighter restrictions on immigration than have historically been the case. Large negative growth effects from high energy prices will nevertheless lead to slower economic policy tightening in the UK. Interest rate sensitivity in some economies after a long period of low inflation and interest rates is another uncertainty factor. This is especially true of Norway and Sweden, where floating rate mortgages predominate among households.

### The Fed is in a big hurry, while the ECB will lag behind.

We now expect a series of rapid US rate hikes: 50 basis points per Fed policy meeting through September. Hikes will then continue at a more gradual pace, peaking at 3.50 per cent in mid-2023 – slightly above the Fed's estimate of a neutral rate around 2-3 per cent. At its May meeting, the Bank of England combined a hawkish message with gloomy British growth prospects. We expect the BoE to raise its key rate gradually to 2.25 per cent by the end of 2023. The ECB will need to revise its inflation forecasts sharply higher in June, which suggests slightly faster rate hikes. We now believe that the first ECB deposit rate hike will come in July, followed by two more to 0.25 per cent by end-2022, and 1.00 per cent by end-2023. Parallel with rate hikes, central banks will tighten policy via their balance sheets. But the impact of these QT measures is hard to assess, so we still regard key rates as the main central bank tool.

### Central bank key interest rates

Per cent	May 5	Jun	Dec	Dec
		2022	2022	2023
Federal Reserve (Fed)	1.00	1.50	3.00	3.50
ECB (deposit rate)	-0.50	-0.50	0.25	1.00
Bank of England (BoE)	1.00	1.25	1.75	2.25
Riksbank (Sweden)	0.25	0.50	1.25	1.75
Norges Bank (Norway)	0.75	1.00	1.75	2.25

Source: Central banks, SEB

**The Riksbank completely reversed its policy in April,** moving from a rate path showing an unchanged key rate until the second half of 2024 to an immediate repo rate hike and signals of further rapid hikes. We believe that in the near future, high inflation figures will persuade the Riksbank to deliver a 50 bp hike in September, in line with the high-inflation scenario it also unveiled in April. We then expect it to end its rate hikes at 1.75 per cent as early as June 2023, when policymakers feel reasonably sure that inflation will approach their target. Norges Bank left the starting blocks early and is aiming for a more gradual hiking strategy. It will raise its key rate by 125 bps this year and by 50 bps next year, reaching 2.25 per cent by the end of 2023.

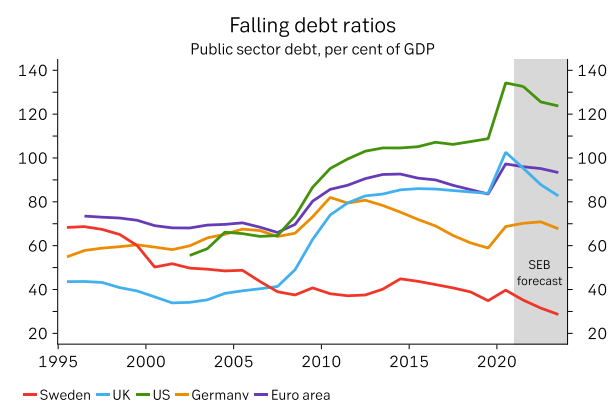
### A new role for fiscal policy

Early in the pandemic, it was quite uncontroversial to let fiscal policymakers play a major role when the impact of monetary policy began to fade. But now that central banks are shifting strongly towards tightening, the situation is becoming more complex. One can still argue that fiscal policy has an important role to play in countering the tightening effects of inflation shocks and higher interest rates. But we must also take into account

the risks that monetary and fiscal policymakers will end up in a destructive tug-of-war, with expansionary fiscal policies exacerbating upward pressure on inflation and, perhaps above all, on inflation expectations.

### High inflation is pushing down public sector debt ratio.

High inflation is now hampering growth by burdening public sector finances, for example due to higher unemployment. But public sector revenues are generally more sensitive than spending to changes in inflation. For example, even if household consumption volume falls, nominal consumption – part of the tax base – may climb. This is especially clear in Sweden, where value-added tax (VAT) is relatively high while the government spending ceiling is expressed in nominal terms. In addition to a positive impact on the budget balance, this also means that the public sector debt ratio will fall as the denominator – GDP at current prices – is driven up by high general inflation.



**Modest stimulus in response to the war.** After their major stimulus packages during the pandemic, fiscal policymakers are now starting to focus more on a few areas. Especially in Europe, households and businesses are receiving compensation for high energy prices through subsidies and tax cuts. In EM economies there is limited flexibility despite great needs, since food and energy make up a larger share of the consumption basket than in richer countries. The Ukraine war is also leading to sharply higher defence spending in many countries, while we are seeing bigger investments aimed at speeding up the energy transition, especially in Europe. In the US not much new is happening due to congressional gridlock, but investments included in earlier stimulus packages are being rolled out and there is a consensus on the need for higher defence spending.

**So far, fiscal policy has been well-balanced.** Overall, fiscal policymakers now seem to be performing their balancing task rather well. Their new stimulus round is relatively limited, and when pandemic-related

programmes are phased out, the fiscal stimulus impulse will tighten a bit in the OECD countries as a whole. Capital spending and defence outlays are unlikely to threaten the central banks' battle against inflation. This is especially true in Sweden, where a balanced budget was achieved as early as 2021 and public sector debt is rapidly falling below 30 per cent of GDP.

### Public sector financial balance

Per cent of GDP

	2020	2021	2022	2023
United States	-14.5	-10.2	-5.0	-4.0
Euro area	-7.1	-5.1	-4.3	-3.2
United Kingdom	-12.5	-12.0	-6.0	-4.0
Sweden	-2.7	-0.2	0.3	0.2
OECD	-10.4	-8.4	-5.1	-3.7

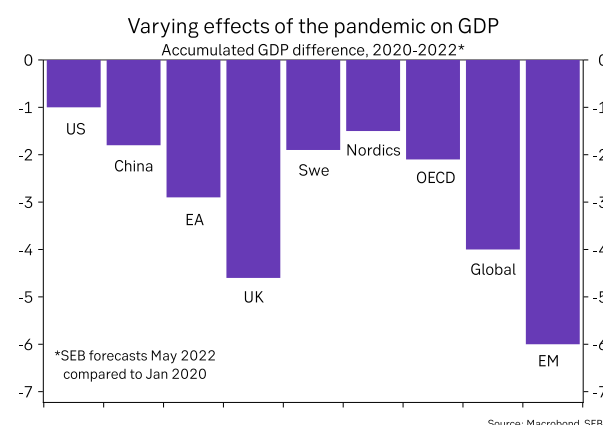
Source: Statistics Sweden, SEB

**Risks of excessive activism ahead.** It cannot be ruled out that differences between the objectives and techniques of monetary and fiscal policies may lead to greater tensions. We have now experienced a rather lengthy period of increased economic policy activism. The pandemic has reinforced this trend – not only the belief that fiscal stimulus should play a larger general role in stabilisation policy, but also an increased tendency to micro-manage. Compensation for rising energy prices is one recent example. If this is pushed too far, there is a risk that we will repeat the mistakes of the 1970s. Fiscal policy activism may drive up inflation expectations, especially if the market begins to suspect that governments do not mind that inflation pushes down the real value of public sector debt. This would further increase pressure for central bank rate hikes.

### Permanent GDP shortfalls?

During the past year, we have tried to track the responses of various economies to the pandemic. We have done this by continuously comparing the latest forecast for 2020-22 with the forecast published just before the pandemic broke out in late January 2020. Since the pre-pandemic economy was in a fairly normal cyclical situation, with forward-looking GDP forecasts close to trend, we also drew the conclusion that the divergences in the following chart can be interpreted as a rough preliminary assessment of the 2022 output gap. This gap would reflect potential above-trend growth from 2023 onward. When our forecasts were at their most optimistic in mid-2021, several economies looked as if they would emerge completely unscathed from the pandemic. Major stimulus measures in the US led to

forecasts of a 2022 GDP level that was even above the pre-pandemic forecast.



**EM economies hardest hit.** Now that we have adjusted our growth forecasts much lower, all economies end up with clear negative figures. Of course, the Ukraine war is contributing to this, but perhaps we can draw the conclusion that the bars in earlier charts could have been interpreted as a warning against exaggerated faith in what economic policy could actually achieve. With tight labour markets and high inflation now forcing monetary policymakers to act, it does not appear as if GDP growth shortfalls will be recovered in the foreseeable future. For most countries, it is not reasonable to forecast above-trend growth, although the deeply depressed GDP levels in the euro area, the UK and elsewhere are exceptions. In the future, we will see whether it is still possible to make up for lost growth in the long term, for example by normalising labour supply and productivity levels. This question is perhaps the most urgent in emerging market countries, where the downward divergence from the pre-pandemic trend is very large in some cases – with India at over 15 per cent as the most striking example.



Theme:

# Commodity shocks

Shortages and record prices due to Russia's war in Ukraine

**Russia's invasion of Ukraine sent shock waves through global commodity markets. The initial reactions have started to wear off, but prices of many commodities are still at very high or even record levels. The invasion will have severe structural consequences for commodity consumers and producers for years to come. Russia enjoys a strong position in the short term, since both the EU and the world desperately need its commodities. However, developments will likely be very negative for Russia in the medium term as Western countries close their doors. Russia is the world's biggest exporter of both fossil fuels and wheat, and Ukraine is number five in wheat. Prices will probably remain high or very high and risk helping trigger a recession. Due to the war's negative impact on the agricultural sector, a global food crisis is also looming during the coming year.**

**Lots of commodities.** Russia has an enormous land area (17 million square kilometres) and an abundance of commodities. It is the world's biggest export of fossil fuels and grains. Russia also sells large quantities of fertilisers (which require a lot of energy), aluminium, nickel, palladium and many other commodities.

**Commodity shock and soaring prices.** Russia's invasion of Ukraine and the resulting sanctions against Russia immediately led to surging commodity prices and greater volatility. Nickel prices quadrupled overnight to USD 100,000/tonne, with a halt to trading for a full week on the London Metal Exchange (LME). Natural gas prices soared to as much as ten times their normal level. Oil prices moved from around USD 100/barrel to above USD 125. Coal prices doubled to new record highs. Since then, the most immediate commodity panic has cooled, but natural gas prices are still five times normal while oil and coal are higher or much higher than normal.

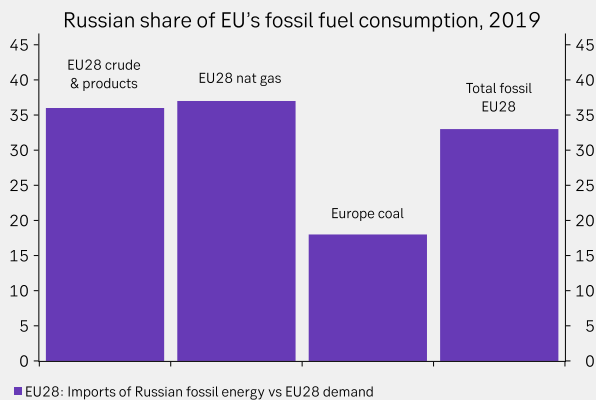
**Energy shock and European energy crisis.** As the world's biggest fossil fuel exporter, Russia's share of world trade in oil, coal and natural gas was estimated in 2019 at 12, 17 and 23 per cent respectively. But its fossil fuel exports are highly concentrated towards Europe. Close to 50 per cent of its crude oil and petroleum product exports as well as 72 per cent of its natural gas exports went to OECD member countries in Europe. In 2019 the EU28 imported 33 per cent of its overall fossil fuel consumption from Russia. This included 4.3 million barrels of oil and 3.0 million barrels of oil equivalent (boe) of natural gas per day.



**Europe is dependent on Russia** for fossil fuels, but the dependence goes both ways. In fact, Russia is more dependent on the EU than vice versa. The EU's long coastlines make it easier to replace Russian imports, though at far higher prices. But the short-term cost of relying so much on Russian energy is extremely high.

### **An energy marriage is approaching its end.**

Commodities are strongly tied to the infrastructure built to transport them. A large network of oil and natural gas pipelines has been built from as far as Siberia all the way to Western Europe. These pipelines have names like Brotherhood and Friendship, signalling a harmonious common future through trade and mutual dependence. They create a strong physical connection between Russia and Western Europe. It has taken decades and billions of USD/EUR/RUB to build them, and they are also meant to last for decades into the future. They form the foundation of today's fossil fuel trade between Russia and Europe. It is no exaggeration to call this an 'energy marriage' between Russia and Europe. With the invasion of Ukraine, it is coming to an end. The two parties remain physically and contractually entangled, but their divorce is now a fact and there is no way back. Western Europe will never again make itself so dependent on Russian fossil fuels, even when Putin leaves power. Within a few years, many oil and gas pipelines connecting Russia and Western Europe will have close to zero value.



**The Catch-22 of a Russian energy embargo.** The purpose of energy sanctions against Russia is to reduce its revenues and weaken its economy. But there is a risk of a Catch-22 situation, with Russia emerging as the winner regardless of how the West acts:

1) Assume that sanctions halt the flow of all Russian energy to Western-aligned countries but that this energy instead finds its way to China, India and other countries in Asia. In that case, the sanctions simply represent a reshuffling of fossil energy around the world. Although the process is more costly and impractical than before, this energy still flows into the

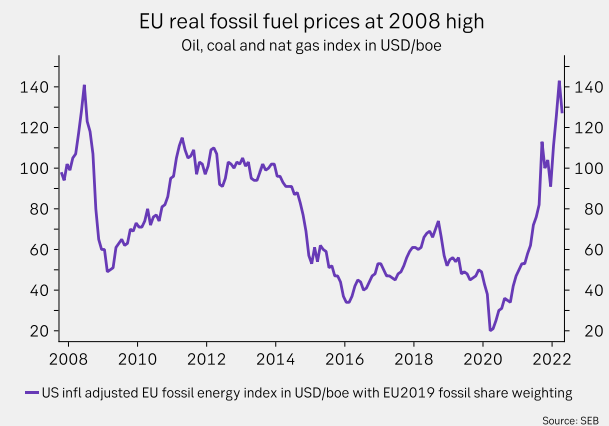
global market. Russia is still well off economically, since its export volumes and prices are unchanged.

2) Assume that the EU embargoes some or all of Russia's fossil fuel imports, but this time Russia finds no new markets, lowering Russian exports by up to 30-40 per cent. That equates to a supply loss of oil and gas to the global market totalling the equivalent of 3.5–5 million barrels per day. Oil and gas prices would rise sharply. Russia would export less but at much higher prices, basically receiving the same revenues as before.

In both these scenarios, there is thus a risk that Russian revenues would be the same despite sanctions, which means that a complete halt to Russian energy exports is unlikely in the short term. Hungary has also stated that it will veto any proposal from the European Commission to embargo Russian energy. While this may hinder any explicit, legal EU embargo it is still very clear that the overall intention within the EU is to move away from dependence on Russia as soon as possible.

**Full-speed EU exit from dependence on Russia.** One EU goal is to reduce imports of Russian natural gas to 20 per cent of normal volumes by the end of 2022.

Germany intends to reduce its imports of Russian oil from 35 per cent of total imports down to zero by as early as this summer.



**Record-high costs for EU fossil energy.** While not yet boycotted, Russian commodity exports are now decreasing because many buyers are reluctant to take them. Not many European companies want their names connected to Russia these days. Oil majors BP, Shell and Total have all stated that they will no longer touch Russian crude and petroleum products.

Natural gas exports from Russia to the EU are now at 2/3 of normal volumes, a loss of about 1 million boe per day. Russian crude oil production is estimated to be down from above 11 m barrels per day pre-invasion to less than 9 m bl/d in mid-April. This adds up to a reduction of around 3 m bl/day of crude oil and natural

gas from Russia. That is a lot, and fossil fuel prices have rallied as a result. Today the EU faces the highest-ever real fossil fuel prices, calculated as a consumer-weighted basket of coal, oil and natural gas. While oil prices are far from their real-term peak of USD 190/bl in 2008, both coal and gas prices are record-high.

**Chinese lockdowns and IEA emergency oil provide short-term relief.** Despite the loss of Russian fossil fuel supplies, we have recently seen price reductions in coal, oil and gas. This is mainly because of two things. The first is that the largest volumes ever are now being released from strategic petroleum reserves (SPRs) by International Energy Agency (IEA) member countries. The second is the extreme COVID-related lockdowns in parts of China, which are reducing demand for oil by at least 1 million barrels per day. However, the contribution from SPRs – about 1.3 million bl/d – will only last for six months, and China will eventually leave its lockdowns behind. The cushion being provided right now by petroleum reserves and lockdowns will thus only last for the next six months or slightly longer.

**War in the breadbasket may trigger a food crisis.**

Russia is the number one wheat exporter in the world, followed by the US, Canada, and France. Ukraine is number five and is important for the global wheat market. In addition to wheat, it also produces a wide range of other agricultural products. For example, it is the world's biggest producer of sunflower oil. Ukraine is located in the middle of one of the world's so-called breadbaskets with lots of black, fertile soil. Ukraine is also a large producer of artificial fertilisers.

**Ukraine's wheat production may fall by 50 per cent.**

Wheat harvests in Ukraine risk declining by up to 50 per cent during the coming season due to the war. Fertilising of already planted winter wheat will likely be significantly reduced, with lower yields as a result. Planting of spring wheat will probably be limited, and it is generally difficult to farm during an ongoing war and amid shortages of everything from machine parts to fertilisers and diesel fuel.

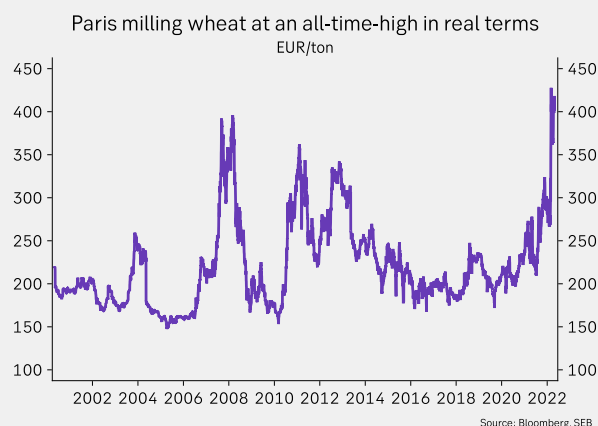
**Smaller harvests globally due to urea shortages.**

Urea is an energy-intensive fertiliser. Natural gas is often the main input in production. The price of urea has shot up across the world because of the current extremely high natural gas prices. Ukraine is normally a large exporter of urea, but those exports are significantly down. Due to shortages and rising prices, farmers around the world are using less urea. This will mean smaller harvests.

**Severe US drought is adding to these problems.** There is a severe drought in the western United States,

including Kansas, the most important wheat producer in the country. This is deeply concerning, since the US and Canada are the world's biggest wheat exporters after Russia and could otherwise have compensated for lower supplies from elsewhere. In areas where there is no drought, there is no sign of increased acreages of wheat planting, despite today's record-high prices. This is because it is already late spring, with little time to react, and because the cost of wages, fertilisers and diesel have gone up so much that it is uncertain whether even record-high wheat prices are enough to make it worthwhile to plant more.

**Wheat prices have doubled but may climb much higher.** Today Bloomberg's broad agricultural product index is only 11 per cent short of its all-time-high from 2011, in inflation-adjusted terms. Wheat prices are already record-high in both real and nominal terms, at roughly twice normal levels.



There is a risk of a widespread food crisis, though we are only in the early stages of such a process. Commodity price movements are often exponential in nature, due to frequent inflexibility in both short-term supply and demand. European natural gas prices spiked to 10-15 times their normal levels earlier this year and are still at five times normal. Wheat prices at twice normal levels are very high for many consumers around the world. But given the nature of commodity prices, there is a risk that prices will climb far higher. As things look now, this will indeed probably happen.

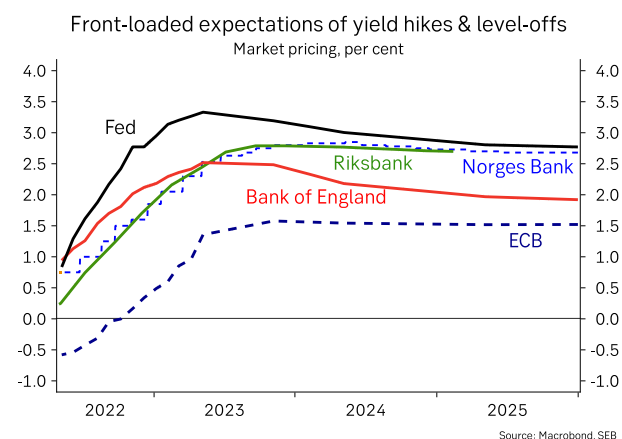
**Riots, hoarding, and export bans.** Looking back to 2011, when food prices spiked last time, the experience was that exporting countries implemented export bans to protect their own population and avoid unrest and riots. This, in turn, severely affected importing countries and was one of the contributing factors behind the Arab Spring. This time around, North Africa is again one of the regions of the world that may be severely affected.

## Fixed income

# Central bank policy U-turns are pushing up bond yields

**Selling pressure in global bond markets has accelerated in step with growing central bank concerns about inflation. We expect 10-year US Treasury yields of 3.50 and 10-year German government bond yields of 1.60 per cent in 2023, with key interest rate hikes and quantitative tightening as the main drivers.**

**Policy U-turns.** The upward trend in long-term yields began early last autumn when the market boosted its expectations of higher key interest rates due to a changed inflation landscape. The increase in yields was further strengthened by the Fed's hawkish change of heart in December. A number of other central banks then followed suit – in April also the Riksbank. The upturn in both US and German long yields has been driven by higher inflation expectations, but in the US also by rising real interest rates. Based on our inflation forecasts, we expect market-priced inflation expectations to fall slightly in H2 2022, leading real interest rates to rise more than nominal ones.



**Key interest rates are pushing long yields higher.** History shows that US long-term yields normally tend to peak just before the end of a key rate hiking cycle, at slightly above the key rate. Our forecast that the US federal funds rate will peak at 3.25-3.50 per cent implies that we expect the 10-year yield to reach 3.50 per cent by mid-year 2023. We also expect the shrinking of the Fed's balance sheet to contribute to higher long yields.

**The European Central Bank has been an important driver** behind low long-term yields in the euro area, with its net purchases of government securities exceeding issuances over the past two years. This is changing, now that the ECB intends to end its purchases during Q3 2022. Meanwhile the bond supply is expected to increase due to the security policy situation and climate investments. We also expect the ECB to hike its deposit rate to 1.00 per cent by next autumn. German 10-year bond yields will reach 1.60 per cent in 2023; if the market prices in additional ECB rate hikes, bond yields will rise further.

**If GDP growth turns negative,** long-term yields will peak both earlier and at lower levels. On the other hand, if growth surprises on the upside, the hiking cycle will be lengthier and long-term yields will also end up higher.

**Swedish long-term yield spreads against Germany** have risen since the beginning of 2022 to their highest level since 1997. This upturn is mainly being driven by rising expectations of Riksbank key rate hikes. The Riksbank is hiking its key rate more and earlier than the ECB, which suggests that Swedish yields will continue climbing more than German ones over the next six months, even though the market has already taken into account the difference in interest rate policy this year. The Riksbank will halve its bond purchases during the second half of 2022, which will also contribute to comparatively higher yields. Over the next year, we expect the Riksbank to largely end its asset purchases. This suggests that long-term Swedish yields will also rise slightly more in the first half of 2023. But towards the end of next year, the yield spread against Germany will narrow again as the ECB also lowers its reinvestments.

**Norwegian long-term yields were pushed up** by Norges Bank's early rate hikes. As market expectations about ECB rate hikes have risen, the long-term yield spread against Germany has narrowed somewhat from historically high levels. We expect Norges Bank to continue its gradual rate hikes in line with current market pricing. Issuance of a new 20-year bond may help maintain the long-term spread, but our main scenario is that it will narrow as German long-term yields rise.

## 10-year government bond yields

Per cent

	May 5	Dec 2022	Jun 2023	Dec 2023
United States	2.93	3.40	3.50	3.50
Germany	0.98	1.30	1.45	1.60
Sweden	1.93	2.30	2.35	2.50
Norway	2.89	3.10	3.20	3.25

Source: National central banks, SEB

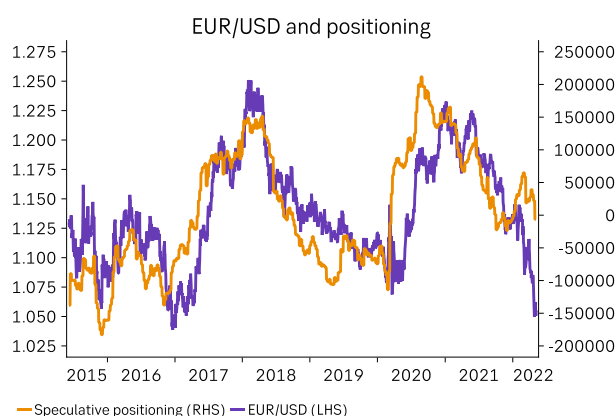


## The FX market

### Fed and low risk appetite will support USD another while

After Russia's invasion of Ukraine, expectations about central banks have changed dramatically. The war's impact on global growth has also affected the FX market. Due to the great vulnerability of the euro area, the euro has been unable to leverage its defensive qualities. We believe the EUR/USD rate will keep falling in the near term, before the valuation argument becomes more important. The SEK is being hurt in the short term by the global slowdown, but Riksbank rate hikes will contribute to a sharp appreciation in 2023.

**Dollar peak will be delayed.** The EUR/USD exchange rate has already fallen to the levels we predicted for Q2 2022, but we are not convinced that the bottom has already been reached. The Federal Reserve will hike its key interest rate faster than any other central bank in the near term, while the European Central Bank must balance very high inflation against rapidly declining growth. The euro area's geographic proximity to the war and its dependence on Russian gas create vulnerability. We thus expect the ECB to proceed cautiously, even if it carries out an initial rate hike as early as this summer.



**The valuation argument will eventually stick.** Given the prevailing market sentiment, it is hard to expect any rapid turnaround, but US dollar valuations are beginning to be stretched, especially against the krona. Absent any serious crisis or deep recession, the valuation argument will ultimately be USD-negative. Weak US fundamentals will also keep pushing down the USD's share of global

reserves. We expect EUR/USD to fall to 1.02 before bouncing back late 2022. The euro will climb in 2023.

**The British pound will continue to defy weak fundamentals,** and the EUR/GBP exchange rate is near a multi-year low. The UK economy however is vulnerable in the long term although in the coming months its structural problems will be overshadowed by Bank of England rate hikes as well as greater vulnerabilities in the euro area. We are sticking to our forecast that the EUR/GBP rate will range trade in the coming months around 0.84/0.85, but high valuations and weak fundamentals in the form of poor competitiveness and external deficits will later take their toll, and EUR/GBP climb to 0.90 by the end of 2023.

#### Exchange rates

	May 5	Dec 22	Jun 23	Dec 23
EUR/USD	1.05	1.07	1.11	1.15
USD/JPY	130	133	130	127
EUR/GBP	0.84	0.87	0.89	0.90
EUR/SEK	10.40	10.15	9.55	9.70
EUR/NOK	9.93	9.90	9.70	9.70

Source: Bloomberg, SEB

**Strong tailwind for the krona in 2023.** The Riksbank has begun to implement its planned rapid rate hikes over the next 12 months. In the near term, the krona will find it hard to take advantage of positive key rates as the global economy slows and the euro area remains vulnerable. But the widening gap between Riksbank and ECB policies should gradually create a tailwind as structural outflows linked to negative key rates and QE programmes are replaced by neutral or positive flows. This applies, for example, to an increased interest among Swedish companies to start buying kronor, using the large sums in their foreign currency accounts, as well as increased appetite for Swedish government securities among foreign investors. The Riksbank will also end its purchases for the foreign exchange reserve at the turn of the year. We thus foresee strong SEK appreciation in 2023 and expect the EUR/SEK rate to reach 9.55 by mid-year.

**EUR/NOK should fall again.** Norwegian key rate hikes and rising oil prices will provide support for the krone. Meanwhile other cyclical currencies have weakened as risk appetite has fallen, which will also affect the NOK. Norway's currency purchases have climbed to NOK 2 billion per day, creating a clear headwind, but we believe valuations and rate hikes will have the greatest impact and that EUR/NOK will fall during the second half of 2022. The NOK/SEK exchange rate climbed earlier from parity towards 1.10. Today's level of around 1.05 is reasonable but we expect a downturn to about 1.03 by year-end.

## The stock market A risky balancing act

**The size of downward revisions in economic growth and corporate earnings will determine the long-term potential for equities, during a year when central bank expectations are controlling the short-term stock market mood. A soft landing – without either large further interest rate and bond yield upturns or overly weak growth – are discounted on stock exchanges, where the most aggressive share valuations have been lowered. If this balancing act is successful, there is hope for decent stock market performance.**

In the first four months of 2022, stock market conditions have increasingly come to resemble a pessimist's Christmas. Rising inflation, interest rates and yields, downward adjustments in economic growth forecasts, continued disruptions in global supply chains, soaring energy prices, a tragic war on European soil and forceful pandemic lockdowns in China – the factory of the world – are creating great concern among investors.

**The normalisation of rates, yields and monetary policies** is largely welcome. But aside from pushing down growth, troublingly high inflation is of course creating the risk of bigger key interest rate hikes. The surge in bond yields raises the question of when fixed income investments will come into play. Our forecasts point to moderately rising yields, which need not trigger any stock market drama. In recent years, interest support has turned into a headwind for stock markets.

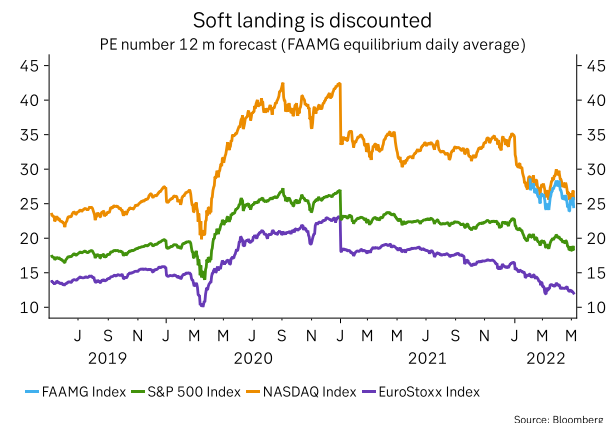
It is worth noting that because of rising yields and wider credit spreads, running yield for an investment grade US bond index has climbed to above 4 per cent. The corresponding figure for high yield bonds is nearly 7 per cent. As yields reach increasingly investable levels, the TINA (There Is No Alternative) argument is weakened.

**Global economic growth forecasts are being dialled down**, and not only by us. But so far this has not had a major impact on aggregate corporate earnings forecasts. Global earnings forecasts for 2022 have only been lowered marginally this year: from +8.9 to +5.6 per cent. Forecasts for 2023 are stable at around 8 per cent. This year's forecasts may well be lowered further,

but if these forecasts hold, they will help sustain share prices, especially since price/earnings ratio valuations have generally fallen in recent quarters.

**Positioning provides support.** Not only are companies continuing to show good adaptability, but a more cautious approach and positioning by investors is also providing reasonable support for share prices. Expectations have been lowered, and professional investors have reduced risk in their portfolios by holding a higher proportion of cash equivalents and a lower proportion of equities than the historical average. In equities, they are overweighting more stable sectors such as pharmaceuticals at the expense of industrials. Geographically, they are more cautious about Europe, which is logical given geopolitical and growth concerns.

Among this year's losers are previous winners – growth companies. This means that bloated valuations for these companies have come down and the historically wide gap compared to other market segments has narrowed. This is most evident in smaller companies with the very highest valuations, but global digital dragons Facebook/Meta, Apple, Amazon, Microsoft and Google/Alphabet (FAAMG) also follow the pattern.



**With storm clouds overhead** and unusually powerful forces in motion, we expect stock market performance in the coming months to be determined by the news about inflation, central banks and economic growth potential. There are major challenges, including the risk of higher inflation, rates and yields if central banks are unsuccessful in their battle against inflation. Another risk is that growth will be squeezed towards recession, eroding corporate earnings and justifying lower share valuations. But if inflation can be curbed and if growth forecasts hold up, we see potential for stock markets to deliver a reasonable return given the risk.

## The United States

### Uncertain soft landing after inflation shock

Overheated labour markets and still resilient demand are increasing the pressure on the Federal Reserve while the war in Ukraine and China's COVID lockdowns create new risks for both growth and inflation. We have raised our expectations of Fed rate hikes and believe that growth will slow down somewhat below trend. The main scenario is still that the economy will manage a soft landing and that a recession will be avoided.

The past few years have seen dramatic shifts in the US growth and inflation outlook. We are lowering our GDP growth forecast further to 2.6 per cent in 2022 and 1.7 per cent in 2023. Meanwhile we have revised both our inflation and key rate forecasts higher. The Federal Reserve raised its key rate by 50 basis points in May. We expect further hikes totalling 150 bps at the next three policy meetings to a rate close to the Fed's estimate of a neutral rate of just below 2.50 per cent. We now forecast that the key rate will reach the 2.75-3.0 per cent range by year-end and peak at 3.25-3.50 per cent in mid-2023. The Fed will gradually shrink its balance sheet by nearly USD 100 billion per month.

#### Key data

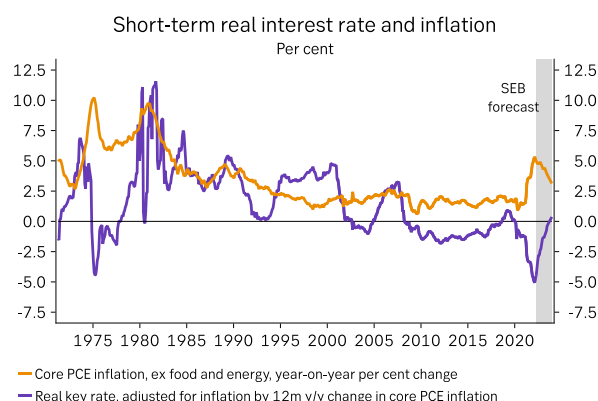
Year-on-year percentage change

	2020	2021	2022	2023
GDP	-3.4	5.7	2.6	1.7
Unemployment*	8.1	5.4	3.7	4.1
Wages and salaries	4.9	4.2	5.0	3.7
Core PCE (Fed target metric)	1.4	3.3	4.9	3.8
Public sector balance**	-14.5	-10.2	-5.0	-4.0
Public sector debt**	134	134	130	128
Fed funds rate, %	0.25	0.25	3.00	3.50

\*% of labour force \*\*% of GDP \*\*\*upper end of Fed funds rate interval.  
Source: Macrobond, SEB

**A tough balancing act for the Fed.** Our forecast implies that growth will decelerate to slightly below trend this year but that a recession – with falling GDP – will be avoided, that joblessness will rise only slightly above

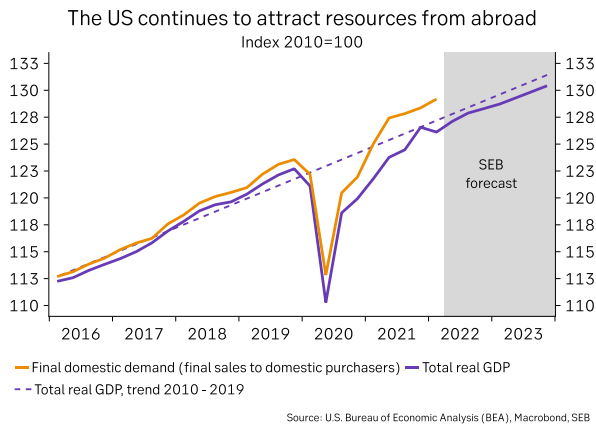
the Fed's view of equilibrium unemployment (4 per cent) and inflation will gradually subside. Historical experience calls for humility about the Fed's ability to achieve this kind of soft landing. We may be underestimating how much the Fed will need to hike its key rate and how big the costs to the economy will then be. Our forecast implies a short-term real interest rate of around 0.5 per cent (calculated on 12-month changes in the core PCE) at the end of the forecast horizon, which is a still moderate level seen over the last 10-year period and far below what was required to overcome inflation in the early 1980s.



**Limited hikes compared to historical interest rate cycles, for several reasons.** Inflation has been partly driven by temporary pandemic-related factors. This will make the Fed's task easier, although its policymakers have been forced to drop the "transitory" inflation narrative. Fed rate hikes can be expected to have an impact at lower levels than has historically been the case, due to the downturn in the neutral interest rate – the level that neither slows nor expands the economy. In our assessment, today's real neutral interest rate is 0.0-0.5 per cent, compared to 3 to 4 per cent in the early 1980s. The Fed's hikes are also being supplemented by the quantitative tightening of its balance sheet, but this is a relatively untested tool and its impact is hard to quantify. In addition, large cost increases in themselves have a cooling effect, as long as economic policymakers do not compensate businesses and households. But the longer that high inflation persists, the greater the risk that expectations will decouple from the Fed's inflation target and that price and wage dynamics will change, compared to the low-inflation environment of recent decades. Fed economists have recently produced several analyses about the risk of persistently high inflation, which indicates that they are worried about the issue. This supports a front-loaded hiking cycle.

**A bad start to the year, but better than at first glance.** Year-on-year GDP growth plunged from +6.9 per cent in

Q4 2021 to -1.4 per cent in Q1 2022 but this overstates the weakness of the economy. Foreign trade made a big negative contribution, reflecting strong imports and still-subdued exports. Due to high domestic demand, the US continues to attract resources from elsewhere. Inventories contributed negatively to GDP after a strong build-up in Q4. Private investments accelerated, while private consumption grew at a slightly faster pace.

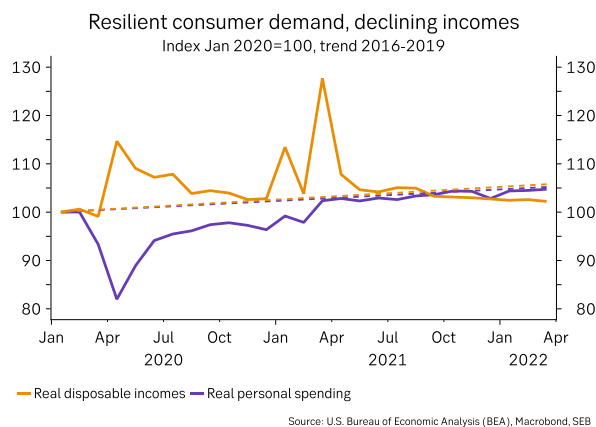


### Business slowdown, pessimistic small enterprises.

Business sentiment indicators such as the Institute for Supply Management (ISM) survey are at levels that have historically indicated relatively good growth but are down from their peaks in 2021. April surveys of manufacturers by the Philadelphia and New York Fed show marked declines in the 6-month outlook. The National Federation of Independent Business (NFIB) survey shows expectations among small enterprises at their lowest levels since the start of the series in the mid-1970s. A deteriorating outlook and rising interest rates will dampen business investment compared to previous forecasts. But vehicle purchases, for example, have been held back by supply constraints. In the short term this will create a pent-up need for investments. Home prices are rising faster than before the 2008 financial crisis, but low inventory – plus lower loan-to-value ratios and interest costs as a share of disposable income – will decrease the risk of a new real estate crisis. Yet sales of new and existing homes have slowed in recent months, and we expect a continued slowdown.

**Contradictory consumption forces.** A strong labour market and growing employment are continuing to support incomes but are being offset by high inflation. Fiscal stimulus has faded since the beginning of 2022, and combined with the rising costs of vehicle fuel, food and other consumer goods, this is squeezing household purchasing power. Real disposable income has moved steadily lower since mid-2021, but so far consumption has been resilient. Total real consumption is rising in line with its pre-pandemic trend. There is little prospect of

new federal fiscal stimulus before the likely shift in congressional majorities to the Republicans this autumn, given continued internal divisions among Democrats. But the March 2021 stimulus package included increased support for families with children equivalent to 0.5 per cent of yearly private consumption, with the second half to be paid as part of income tax refunds later this spring. Households need to apply for this benefit, and surveys indicate that many of them are unaware of this option. The Fed's interest rate hikes are a new risk factor for households. Strong balance sheets and long-running mortgages will create resilience, but rising mortgage rates – now at their highest levels since 2018 – have caused a sharp decline in applications for new home loans and for refinancing of existing ones.

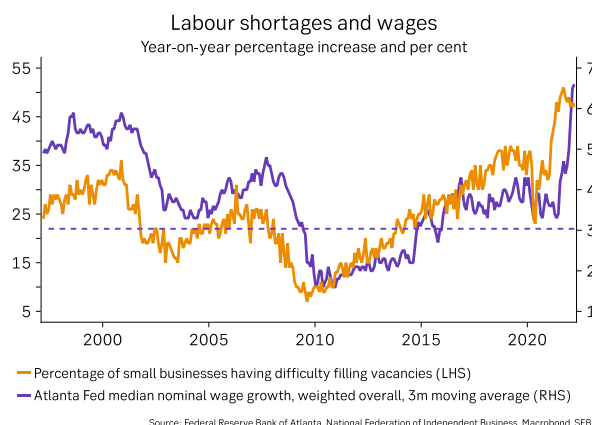


**Financially strong but depressed.** During the pandemic, households have built up substantial savings buffers totalling at least USD 2 trillion, equivalent to nearly 10 per cent of GDP, and can thus maintain consumption in spite of declining disposable incomes. These buffers are not evenly distributed; higher asset prices mainly benefit higher-income households. Increased savings early in the COVID-19 pandemic were driven by reduced consumption of services, in which such households dominate. However, cash stimulus payments and increased unemployment benefits made the biggest difference for lower-income households. There is a wide range of estimates of how large a share of the savings surplus has gone to those with the lowest incomes and highest propensity to consume. According to one Fed analysis, the 40 per cent of people with the lowest incomes account for 29 per cent of the savings surplus during the pandemic – well above normal.

**Consumption is growing, at a slower pace.** Uncertain prospects suggest that households are unlikely to reduce their savings to the same extent as they increased them during the pandemic; at its peak, the savings ratio was more than 30 per cent of disposable income. This means buffers are not being fully utilised.



Normally, the savings ratio moves in the opposite direction from consumer confidence. Sentiment indices are now diverging. The Michigan index has fallen to levels normally only seen during recessions, while the Conference Board index is still slightly above its historical average. But both surveys show a clear decline in future expectations, which correlate better with private consumption. Overall, we believe that household consumption will remain somewhat below normal, but that previous excesses will cease.

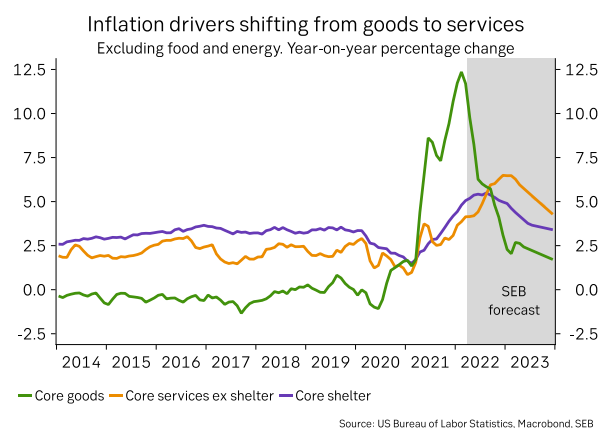


**The US labour market is historically tight**, judging from the number of job openings per unemployed person, but labour shortages among small businesses seem to have peaked and plans for pay hikes have fallen. This suggests that we may be close to a peak in wage increases. Labour force participation has been in focus for resource utilisation analyses. Participation among people over age 16 is now 1.2 percentage points below its pre-pandemic level, which means that about two thirds of the initial loss has been recovered. Among those over 55, participation is still depressed. At the end of last year, people in this age category accounted for about a third of the gap. If their withdrawal from the labour force was due to early retirement, the prospect of their returning is probably limited. Low participation by other categories of people may reflect a combination of concerns over the virus, school closures, caretaking needs and increased financial flexibility due to fiscal stimulus benefits. These factors should gradually fade. But due to matching problems after economic crises, labour force participation normally lags behind the drop in unemployment; we see no reason to expect it to be different this time. We foresee a continued gradual upturn in participation, but not all the way back to its initial level during our forecast period. Subdued business activity and reduced sick leave after Omicron should still contribute to a somewhat cooler labour market.

**Inflation will probably peak soon.** CPI inflation rose in March to 8.5 per cent, and to 6.5 per cent excluding

food and energy – in both cases the highest in more than 40 years. We believe that this represents the peak. A key reason is that high monthly price increases in the second quarter of 2021 are now disappearing from the 12-month statistics. Recent inflation trends are also somewhat reassuring. Used car prices, an important inflationary force this past year, have begun to fall. Monthly increases for other goods, excluding energy and food, have slowed. Service prices are beginning to take over as a driving force for inflation, but this is partly due to increased travel and overnight hotel stays, probably linked to the opening up of the service sector and a normalisation of transport to its pre-pandemic trend. Rents are rising faster than before the pandemic but have not accelerated in recent months. Natural gas and oil prices have stabilised below their peaks right after the outbreak of the Ukraine war in late February.

**Upside risks dominate.** We expect continued faster than normal price increases throughout 2022-2023 and see upside risks to our forecast. We have probably not yet seen the full impact of higher commodity prices due to the Ukraine war. China's COVID lockdowns are causing new short-term disruptions in supply chains. Purchasing managers' indices (PMIs) for April showed a new upturn in input costs and new peaks for sales prices in both the manufacturing and service sectors. Rising wages will continue to push services prices higher.



**Unusually easy to raise prices.** Demand for goods has slowed but is still unsustainably high, well above the earlier trend. As long as a better balance between supply and demand is not achieved, businesses can continue to pass on cost increases to consumers. We view increased pricing power as one important reason behind the sharp rise in inflation over the past year. This, in turn, was made possible by generous stimulus policies during the pandemic, especially cash payments in early 2021. Calmer consumption will be needed to reduce acceptance for price increases, while cooler labour markets may dampen employee bargaining power.

## The euro area

# Energy exposure the most crucial issue

The war in Ukraine has shifted priorities within the EU. Increased investments in defence and a faster energy transition will help to sustain growth. Meanwhile high inflation will erode purchasing power, and GDP growth will slow substantially as consumption decelerates. GDP will increase by 2.1 per cent in 2022, a clear downward adjustment from our earlier 4 per cent forecast. High and rising inflation will force the ECB to hike the deposit rate in July, but later hikes will be much more sedate than other central banks.

### New crises again bring the EU together

Russia's attack on Ukraine has once again shown that crises can increase European Union cohesion, just as they did during the pandemic and the latter part of the euro crisis. Underlying differences of opinion are being set aside, and Germany's reversal will fundamentally alter the security policy situation in Europe. Emmanuel Macron's victory in the French presidential election will reduce uncertainty about the EU cooperation climate, but it remains to be seen how much support he will receive in the June parliamentary election. European cooperation is thus enjoying a tailwind now, but as external pressures ease there is again a risk that the divergent priorities of individual countries will pose new obstacles.

### Key data

Year-on-year percentage change

	2020	2021	2022	2023
GDP	-6.4	5.4	2.1	2.8
Unemployment*	8.0	7.7	6.9	7.2
Wages and salaries	-0.6	4.0	3.5	3.5
CPI	0.3	2.6	7.4	3.0
Public sector fiscal balance**	-7.1	-5.1	-4.3	-3.2
Public sector debt**	97.2	95.6	93.0	98.0
ECB deposit rate, %***	-0.50	-0.50	0.25	1.00

\*% of labour force \*\*% of GDP \*\*\*At year-end. Source: Eurostat, SEB

### Deceleration inevitable; energy dependence matters.

Russia attacked Ukraine at a time when the euro area

economy was benefiting from an easing of pandemic-related restrictions to a minimum. This was especially beneficial to the service sector. On the other hand, inflation was about to speed up, eroding household purchasing power. Meanwhile disrupted supply chains meant a continued uphill battle for manufacturers. The Ukraine war is now changing the playing field. Trade relations with Russia are largely governed by the proximity principle and energy, but only small economies such as Finland and the Baltics have land borders with Russia. The country's share of all euro area external trade is generally low, totalling less than 4 per cent of imports and 2.5 per cent of exports. As for natural gas and oil imports, Russia accounts for a full 35 and 20 per cent, respectively. In Germany, 40 per cent of natural gas imports come from Russia. Despite major investments in renewable energy, obviously it is largely Russian gas that has replaced German nuclear power.

**Energy dependence is creating tensions.** In other words, energy dependence is clearly crucial. Although Germany has now abandoned its "Wandel durch Handel" (change through trade) strategy, heavy dependence on Russian gas is one reason why further sanctions packages are slow to materialise. Yet the EU has set an ambitious goal of reducing gas imports from Russia by two thirds during 2022 and is rapidly cutting back Russian energy purchases. Italy also imports a lot of Russian gas but recently signed an agreement with Algeria expanding gas deliveries. The government says 30-40 per cent of Russian gas can be replaced immediately. Plans for finding alternative energy sources are moving ahead, but the process will take time. However, Europe has created good potential for long-term gas storage. But although the weather is now getting warmer, stockpiles have been reduced. This will create major challenges as next winter approaches.

### A pause in the recovery

We expect weak economic performance during Q2 and Q3 2022. In the short term, consumption will be squeezed mainly by reduced purchasing power. Consumer confidence has rapidly deteriorated and is now close to pandemic lows, but underlying recovery forces will help ensure that growth will bounce back in the autumn. The clearest potential is in service production, once households can return to a more normal life after more than two years of restrictions. Large accumulated savings, low unemployment and fiscal stimulus will also contribute to economic growth. But general uncertainty will tend to make households cautious even in the slightly longer term and high prices for essentials such as food and energy will lower other

consumption. The full-year consumption upturn in 2022 will thus reach only 1.2 per cent. We expect overall GDP growth in the euro area to reach 2.1 per cent – a sharp downgrade from 4.0 per cent in our last *Nordic Outlook*. Due to lower resource utilisation, we see potential for an increase in the growth rate to 2.8 per cent in 2023. One downside risk is that energy rationing cannot be ruled out, for example if gas pipelines are damaged or if Russia should turn off the flow in response to tough external sanctions.

### GDP forecast

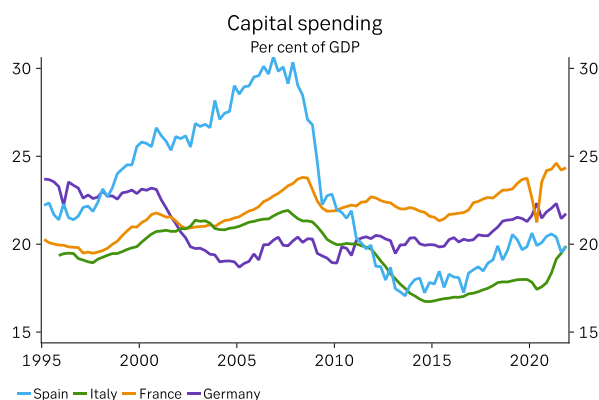
Year-on-year percentage change

	2020	2021	2022	2023
Germany	-4.9	2.9	1.5	3.2
France	-7.9	7.0	2.5	1.9
Italy	-9.0	6.6	2.5	2.5
Spain	-10.8	5.1	4.4	3.8
Euro area	-6.4	5.4	2.1	2.8

Source: Eurostat, SEB

### A continued uphill struggle for manufacturers.

Industrial production has remained mostly flat during 2021 and 2022, mainly due to problems with delivery disruptions in value chains. Purchasing managers' indices and other business surveys indicate that supply problems have decreased somewhat, but the situation is far from normal. Continued COVID-19 lockdowns in China and the Ukraine war are now adding to earlier problems. Delayed and insufficient deliveries are also contributing to a broad increase in goods prices. Reinforcing this trend is that businesses must now compensate for rising costs. In Germany and France, price expectations are still high and are rising in some quarters – suggesting that normalisation has just begun.



Source: Eurostat, Macrobond

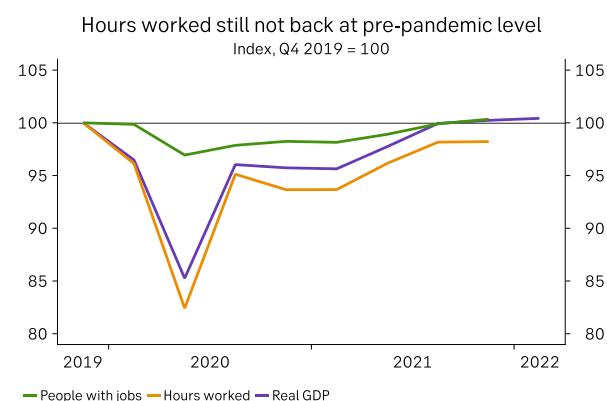
### New stimulus programmes and capital spending.

Fiscal policymakers are continuing to help sustain the economy. Their focus today is on easing the impact of high prices – mainly for energy – on households and on

especially vulnerable sectors such as agriculture.

Another ambition is to increase national self-sufficiency and thus reduce vulnerability to international crises. Fiscal policy will thus also be used for capital spending that can reduce energy imports, although such a process will take a relatively long time. Meanwhile businesses must make their own investments in order to boost production. The pandemic seems to have contributed to a much-needed acceleration in capital spending. We estimate that such investments will climb by 6 per cent in 2022 and 4 per cent in 2023.

**Larger deficits can be expected.** Most indications are that the EU will continue to be more forgiving of deficits in individual countries and related to jointly funded projects, Next Generation EU, which was launched during the pandemic, will also begin to have a more concrete effect next autumn. The EU is likely to keep its Stability Pact on hold in 2023 as well, for example in order to allow more room for green investments and security policy spending. We have thus adjusted our forecast of public sector budget deficits upward. But because of the phase-out of temporary pandemic stimulus programmes, public deficits will gradually shrink from more than 5 per cent of GDP in 2021 to 3 per cent in 2023. Public sector debt will remain relatively constant at slightly below 100 per cent of GDP during the period 2021-2023.



Source: Eurostat, Macrobond, SEB

### Spare capacity in labour markets

Unemployment has continued to fall and is now at its lowest since the introduction of the euro, but there are big differences between countries. In 2005, German unemployment peaked at 11.2 per cent and has since shown a declining trend to the current 2.9 per cent. In France and the Netherlands, unemployment is close to previous lows, while Italy has a long way to go before reaching its jobless level from before the global financial crisis. Businesses still have ambitious hiring plans and also complain about relatively big labour shortages. The number of people with jobs is now above pre-pandemic

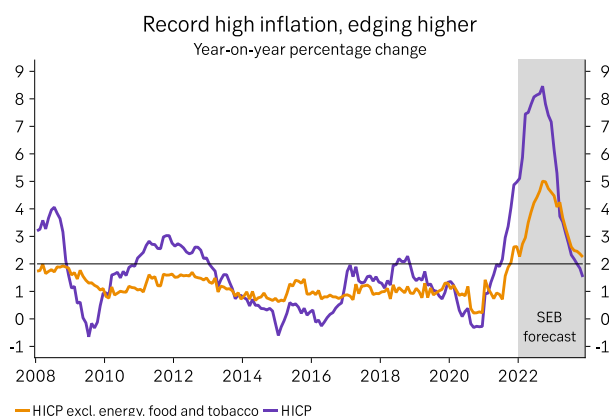
levels, but the number of hours worked is still 2 per cent lower. This indicates lower average working hours. Combined with a lower participation rate, this indicates that there is still spare capacity in labour markets, despite low unemployment. We thus estimate that the jobless rate will remain at its current 6.9 per cent on average in 2022, rising slightly to 7.2 per cent in 2023.

#### Modest acceleration in the rate of pay increases.

Tighter labour markets suggest a faster rate of pay increases, but so far no major acceleration is visible in wage and salary statistics. But these statistics lag worryingly far behind in the euro area, and the issue of employee calls to be compensated for high inflation will be important in the near future. As usual, the wage demands of Germany's IG Metall labour union will be a focus of attention in this year's negotiations. In an ECB survey in January, businesses stated that they regarded compensation demands related to frozen wages during the pandemic as a bigger issue than compensation for inflation. But it is worth bearing in mind that inflation forecasts have climbed sharply since January.

#### Inflation is alarmingly high but will soon fall

Euro area inflation has risen dramatically, reaching 7.5 per cent in April. Although inflation has broadened, it is still largely driven by energy, food and other goods. In April the rise in food prices was the highest in any single month over past 20 years. All indications suggest more rises will come. In addition, the effects due to the war will further push the already high inflation rate even higher. It is also possible that we are underestimating the spill-over effects of rising energy and commodity prices. Upside risks will thus continue to dominate.

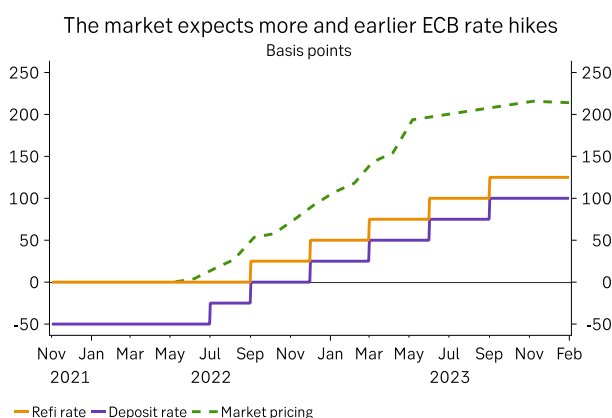


#### Rising inflation rate despite dampening base effect.

The inflation rate continues edging higher, but there are indications that the rise will start abating. Early in 2021, there were large price increases that will now disappear from the 12-month figures, which will moderate the coming rise in the inflation rate. In late 2022 and early 2023, such base effects will contribute to a rapid

slowdown in inflation towards 2 per cent. Because price increases has been so concentrated in energy and food, the gap between headline and core inflation is record-sized. While total inflation will be above 8 per cent until autumn, we expect core inflation of around 5 per cent. In the summer of 2023, both metrics will fall to about 2 per cent. If commodity prices fall back from today's elevated levels, inflation may drop even lower in 2023.

**The ECB will hike its key rate this summer.** Despite record-high inflation, the European Central Bank has continued to take a more cautious stance than other leading central banks. One reason is that the inflation upturn is not as broad as in countries like the US and the UK. In spite of rising labour shortages, there are still few signs of any acceleration in pay increases. The ECB must take into account the risks of creating excessive interest rate and yield spreads between euro area countries. But the ECB shares the concerns of other central banks that the indirect effects of rising energy and input goods prices – and above all, compensation demands during pay negotiations – will permanently drive inflation above target. Although euro area wages are probably more slow-rising than in the US and the UK. ECB policymakers have expressed concern that compensation demands may emerge very quickly. They also point to the risk that a surge in service prices may occur after a significant delay. The ECB has not been entirely passive and has accelerated its phase-out of bond purchases with the intention to raise the rate “some time” in the third quarter. But conditions are changing fast. In June, the ECB will once again need to make a major revision to its inflation forecast. Since ECB policymakers keep saying their decisions are data-driven, we expect the ECB to raise the deposit rate by 25 basis point in July. In 2023 we expect three more hikes, bringing the deposit rate to 1.00 and refi rate to 1.25 per cent by year-end.





## The United Kingdom A collapse in purchasing power?

We have revised our 2022 GDP growth forecast lower because of the deteriorating outlook for private consumption. The government has only compensated one third of the erosion in purchasing power caused by soaring energy bills. But the labour market is historically strong. The Bank of England risks losing control of inflation if its exit policy is too slow. By the end of 2023, we expect the key interest rate to be 2.25 per cent. The BoE is expected this autumn to initiate an active QT policy by selling fixed income securities.

**From opportunities to growing challenges.** Early in 2022, the British economy showed relatively healthy growth prospects despite rising inflation. Due to the effects of the Ukraine war on inflationary pressures and the future prospects of households and businesses, we are now revising GDP growth to 3.6 per cent in 2022 (previously 4.5 per cent) and to 2.3 per cent in 2023 from the previous 2.9. The reason growth is still so high is that the big GDP slide in 2020 has created especially large potential for recovery.

### Key data

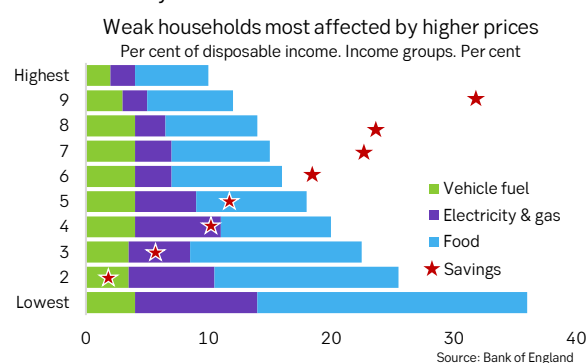
Year-on-year percentage change

	2020	2021	2022	2023
GDP	-9.3	7.4	3.6	2.3
Unemployment*	4.5	4.5	3.8	4.2
Wages and salaries	1.8	5.9	3.4	2.4
CPI	0.9	2.6	8.3	5.5
Public sector fiscal balance*	-12.5	-12.0	-6.0	-4.0
Public sector debt**	104.5	108.0	108.0	109.0
Key interest rate, %***	0.10	0.25	1.75	2.25

\*% of labour force \*\*% of GDP \*\*\*At year-end. Source: ONS, SEB

**Household purchasing power has greatly weakened** in the past year. This applies especially to households with weak finances. These households also tend to have a high marginal propensity to consume, which increases the downside risk to growth. Boris Johnson's government has decided on a GBP 9 billion stimulus package to ease the impact of high energy prices. About 80 per cent of households are expected to receive a

temporary council tax rebate of GBP 150 and a further electric bill discount of GBP 200 starting in October, but the latter "rebate" must be repaid. These measures only offset one third of the real income shock affecting households in 2022-2023, but the pandemic pushed up savings to very high levels, which will help to soften the blow. Government "promises" of future tax cuts – before the next election – will hardly help households today, though. UK public sector debt of about 109 per cent of GDP by the end of 2023 will force the government to be cautious, which may be wise given the difficult inflationary situation.



**Strong labour market.** Unemployment has fallen. In February it was 3.8 per cent; the same as before the pandemic and close to a 50-year low. Long-term unemployment is also historically low, partly because of reduced labour supply and immigration due to Brexit and the pandemic. The number of hours worked thus remains more than 2 per cent lower than before the pandemic. Pay growth has risen to 5.5 per cent. As a result of increased labour supply and weaker GDP growth, unemployment will rise in the future. We expect demand for labour in the service sector to increase. Because of the tight labour market, the risk of wage-driven inflation is relatively high.

**We expect inflation to peak at 8.3 per cent in April**, the highest in 40 years. We expect it to remain above 7 per cent at year-end 2022, mainly driven by energy prices and global goods inflation. Average inflation this year will be 8.3 per cent, falling in 2023 to 5.5 per cent. Long-term inflation expectations have also climbed this spring and are at 4.4 per cent for the next 5-10 years.

**After raising its key interest rate four times since December 2021**, the Bank of England (BoE) seems ready to deliver further hikes. The risk of a collapse in household purchasing power seems to be considered less important than inflation risks due to pay rises and inflationary expectations. We expect the BoE to hike its key rate three more times this year and two times in 2023, leaving the bank rate at 2.25 per cent at the end of 2023.

Theme:

# Russia's new role

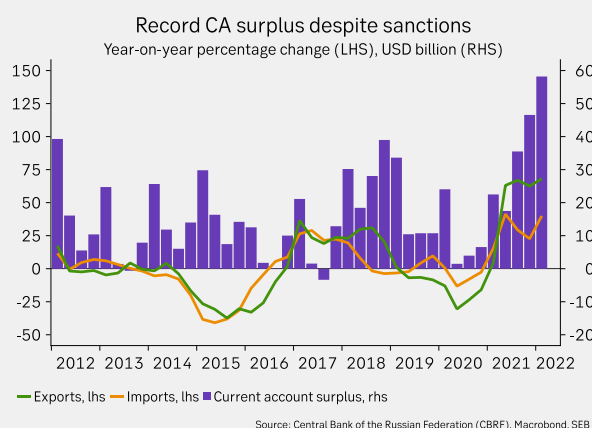
The need to win risks creating a long-lasting war

The war in Ukraine threatens to shut Russia out of the global economy and reduce its potential growth to a fraction of the levels in other countries. Russia enjoys some international support for its opposition to NATO expansion, and many countries will continue to buy energy and other commodities from Russia. Total isolation similar to North Korea is unlikely. Countries like China and India will stay neutral for as long as they can. If Russia escalates the war and uses nuclear weapons, however, the choice will also be easy for Russia's allies; only regimes that attach little importance to economic growth will choose to ally themselves with a country with a stagnant economy and a corrupt state apparatus instead of the more dynamic economies of the Western world.

The Russian invasion of Ukraine has entered its third month, and the war has become part of a – hopefully – temporary normal situation for the world economy. The situation has also stabilised in Russia, which was facing a collapse following the introduction of international sanctions that initially led to a severe weakening of the currency, a plunging stock market and long queues of people withdrawing cash. The stock and bond markets in Moscow are again open for trading, if not fully for foreign investors. The rouble has recovered to pre-invasion levels due to continued capital inflows from oil and gas exports, as well as restrictions on capital outflows. Despite Russian oil being traded at a larger discount than normal against Brent oil, Russia's current account surplus is expected to be record-high this year due to increased oil production and reduced general imports. Despite the sanctions, there is still no severe shortage of goods in Russia. After sanctions were imposed in connection with the annexation of Crimea in 2014, the Kremlin has gradually sought to increase the supply of domestically produced goods that can serve as substitutes for imports, especially food.



**Sharp decline in GDP.** It is clear that the Russian economy will be hit hard by the invasion of Ukraine. We expect GDP to fall by about 10 per cent this year and by another 3 per cent in 2023. However, there is great uncertainty in our forecast, which assumes that Russia will not escalate the war by using chemical or nuclear weapons or by attacking a NATO country. The EU is expected to gradually reduce its imports of Russian oil in 2022. Starting in 2023, a gradual reduction in gas imports will also begin. But various other countries including China and India will continue to import Russian oil and gas, thereby softening the impact of EU actions on the economy.

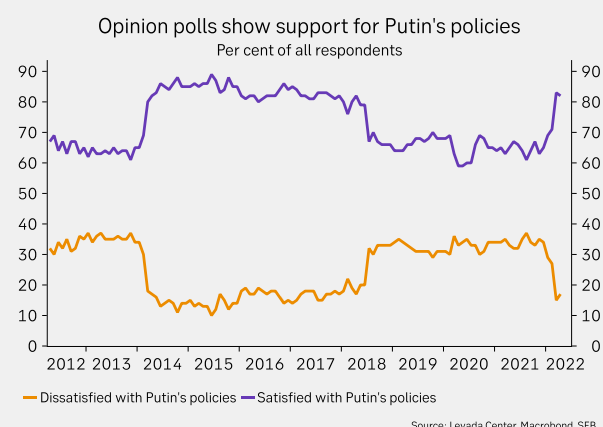


This year's decline in Russian GDP is mainly driven by cutbacks among foreign companies, reduced capital spending and lower private consumption. Increased net trade surpluses, along with rising public sector consumption, will probably only partially offset the downturn in the other parts of the economy. A large majority of the foreign companies planning to reduce or completely cease operations in Russia have announced that they will pay salaries to their employees for three to nine months. These payments will prevent a major drop in consumption during 2022. Next year, we expect unemployment to continue climbing, which will lead to weak consumption. In addition, net foreign trade will hamper growth if the EU succeeds in lowering imports of Russian oil and gas as announced. Investments in domestic production to offset the loss of imports are likely to provide some support to the economy, but not enough to prevent a further decline in GDP.

**Stagnation – the Russian economy after 2023.** At present, it is highly unlikely that President Vladimir Putin will end the war and withdraw from Ukraine as a result of the sanctions imposed by the US and the EU, among others. For Putin, this is an existential geopolitical decision and the cost will be something that Russia will have to adapt to. The purpose of the sanctions is instead to convince the Russian people and the power sphere

outside of Putin's inner circle that the war is not worth the cost. The hope is that increased costs and reduced prosperity will cause these groups to try to persuade Putin to end the war and withdraw the troops. If this does not succeed, high costs will hopefully at least deter or hamper future attacks on other countries.

**The sanctions have yielded results** in the form of increased problems, both on the battlefield and for the Russian economy, but so far there have been few signs that domestic support for the war has decreased. The Kremlin's objective has apparently shifted from unconditional surrender, a change of government in Kyiv and control of all of Ukraine to the conquest of as much territory as possible in the eastern and southern parts of Ukraine. At present, Russia is showing virtually no willingness to negotiate. Ukraine's defence capabilities are gradually improving with the help of weapons from the US, the UK and some EU countries. The war may thus drag on for much longer than the 3-6 months we assumed when it broke out on February 24.

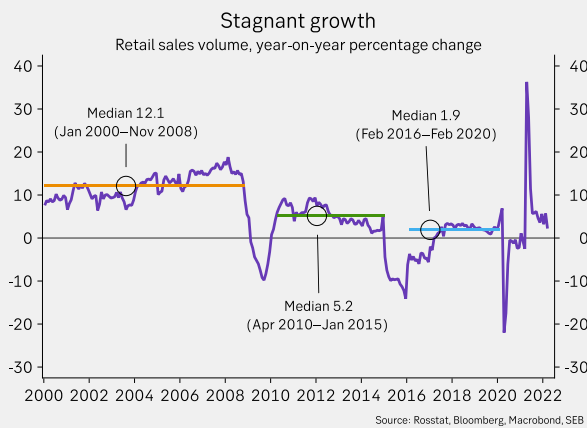


**No solution in sight.** As long as President Putin is in power, Russia will probably not make any significant concessions in the war against Ukraine, and most of the sanctions imposed in connection with the war will stay in place. It is difficult to see any solution that would allow him to end the war while somehow preserving his honour. Ukraine is hardly prepared to make the major concessions that would be needed to enable Putin to save his political reputation. Instead, we expect the sanctions to intensify over time. As the EU reduces its dependence on Russian gas and oil, steps will be taken to further cut off Russia from the outside world, both politically and economically.

**Sanctions will hamper the economy both in the short and long term.** In addition to measures aimed at individuals, the sanctions will mainly have three effects on the Russian economy: 1) by preventing foreign financing, they will push up interest costs in Russia, dampening consumption and capital spending; 2)



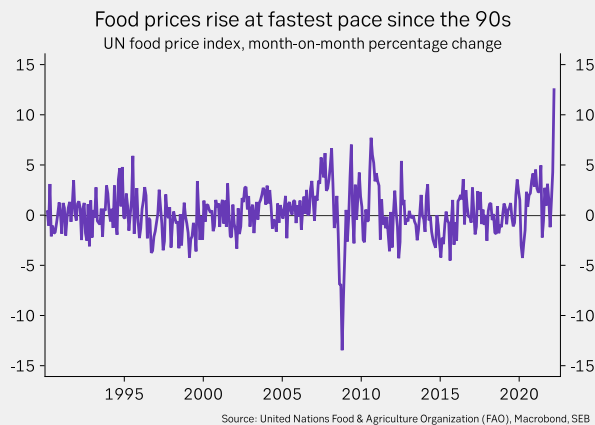
sanctions against specific sectors will hamper the development and growth of such sectors as energy and the military, which are dependent on American and European technology; 3) sanctions against banks and international transactions will prevent the importation of key inputs for Russian industry. The sanctions – combined with a repressive political environment, weak rule of law and widespread corruption – will lead to economic stagnation. Russia's economic growth rate slowed significantly after the annexation of Crimea and the previous wave of sanctions. A further slowdown can be expected in the next few years as we see yearly Russian potential growth fall from today's 2-3 per cent to around 1 per cent.



**Russia's role: reduced but still important.** In the absence of a better term, the near future will be characterised by a new cold war between Russia and Belarus on one side and the US and its allies on the other. Although the protagonists are largely the same – the US and Russia (Soviet Union) – there are significant differences compared to the Cold War of 1947-1991. Most of the world's governments want to stay neutral and are refusing to impose their own sanctions on Russian companies, banks and public authorities. Russia is more closely integrated into the global economy today than it was after the Second World War. It has a leading role in the production of energy, grain, metals, and – together with Belarus – fertilisers. For both practical and political reasons, it is impossible to completely cut off Russia, a G20 country, from the global economy.

**Commodity-producing countries will benefit.** Russia accounts for about 10 per cent of global oil production. Saudi Arabia and the United Arab Emirates, the only countries that could increase production enough to replace Russian oil, have announced that they will not do so. Russia is also the world's largest exporter of wheat and a key producer of maize and fertilisers, as well as such metals as nickel, palladium, iron, aluminium,

platinum, tungsten, copper and gold. The prices of these goods have risen due to the Ukraine conflict. In general, commodity-exporting countries such as Brazil and South Africa and oil exporters in the Middle East can benefit from higher prices. But at the same time, higher costs for foods and food production risk causing famine disasters in the poorest parts of the world. High food price inflation may also lead to social unrest even in richer economies. This illustrates a dilemma: public support for sanctions may decrease if Russia is excluded from the global economy without replacements for its products.



**Divergent views of NATO's role.** In the Western world and various other democracies, there is a widespread belief that Russia alone is to blame for the war in Ukraine. But several governments, including China, have expressed support for Russia's position that NATO should not expand. The Kremlin's view – that NATO poses an existential threat that Russia must defend itself against – has thus gained widespread support internationally. Large emerging market (EM) economies such as Mexico, Brazil and India have adopted a neutral position on the war. Yet, a vast majority of companies that sell goods in the US and the EU in some form will adopt the sanctions against Russia, since the choice between the stagnant Russian economy and dynamic high-tech Western economies is easy for most of them. But to completely shut out Russia from the world economy – like North Korea, Iran or Venezuela – will not work, since Russia still enjoys political support in much of the world. If, on the other hand, the Kremlin were to escalate the war and use chemical or nuclear weapons, countries such as China and India would probably come under increasing pressure to distance themselves clearly from Russia.



## China COVID strategy dampening the outlook

China is diverging from other countries by sticking to a strategy of trying to stop the spread of COVID-19 through mass testing and severe restrictions. The more contagious the virus, the more difficult it will be to succeed, and Beijing will probably miss its growth target for 2022. The strategy will also hamper global growth and contribute to higher inflation, but China is not expected to abandon it until after the Communist Party's national congress this autumn.

**China's COVID strategy will dampen growth** during most of 2022. The government has acknowledged that the economic costs of this strategy are significant but has not shown any inclination to back down. This is partly because local authorities are responsible for mass testing, quarantines and lockdowns. President Xi Jinping has also repeatedly stated that it is impossible to relax this policy now. Since only 80.5 per cent of the population over age 60 has been fully vaccinated as of end-April, a change in strategy is regarded as too politically risky ahead of the Communist Party's national congress this autumn.

### Key data

Year-on-year percentage change

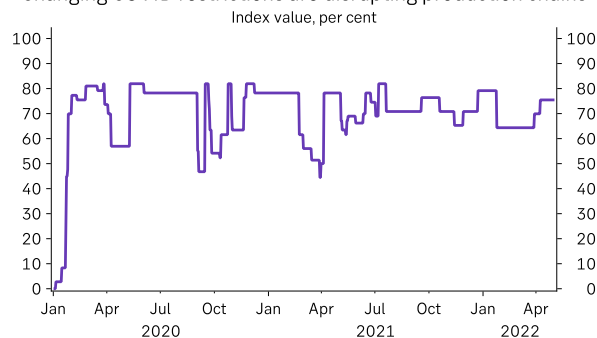
	2020	2021	2022	2023
GDP	2.2	8.1	5.0	5.2
CPI	2.5	0.9	2.4	2.1
Public sector fiscal balance	-11.2	-7.5	-6.8	-6.2
Bank reserve req, %**	12.5	11.5	11.0	11.0
1-year loan prime rate, %**	3.85	3.80	3.60	3.60
7d reverse repo rate, %**	2.20	2.20	2.10	2.10
USD/CNY**	6.53	6.36	6.40	6.25

\*% of GDP \*\*At year-end. Source: IMF, SEB

**Shanghai, with more than 25 million inhabitants**, was locked down in late March, but a gradual reopening began in late April. Despite restrictions, some manufacturing activity continued as long as employees could remain at their workplaces around the clock. Yet the economic slowdown has been noticeable,

particularly in the logistics sector. A budding wave of infections in Beijing has now raised virus controls in the capital. Elsewhere, the decline in traffic congestion indicates that local officials have imposed pre-emptive restrictions. Overall, this has contributed to a downward adjustment in our 2022 GDP growth forecast to 5.0 per cent from 5.2 per cent in the last *Nordic Outlook*. We are also adjusting down our 2023 forecast to 5.2 per cent growth from 5.4.

Changing COVID restrictions are disrupting production chains



— China: Degree of COVID-related restrictions

Source: University of Oxford, Macrobond, SEB

**Fiscal policymakers will do the heavy lifting.** As the 5.5 per cent 2022 growth target has become increasingly elusive, the Politburo has promised fiscal stimulus measures. Beijing has promoted an accelerated pace of government bond issuance to increase public spending as soon as restrictions are lifted. In order to increase efficiency, China's leadership is prioritising regions with stronger financial positions and lower debt burdens when allocating the bonds. Promises of increased support for growth have so far been general, but the government has recently committed greater funding for infrastructure investments and stimulus for the real estate sector. But the problem is that increased financial resources are not much help as long as the restrictions remain in place. A relaxation of China's COVID strategy would thus be the most effective action at present.

**Despite mounting risks to growth**, monetary policy support has been modest. The central bank lowered its average reserve requirement from 11.50 to 11.25 per cent in April and has promised further actions, especially to help manufacturers and small businesses. A key interest rate cut has been made more difficult by large capital outflows in response to the tightening of US monetary policy, but some monetary easing is still possible. Looking ahead, we expect the yuan to weaken in the near term for three reasons: 1) the economic slowdown; 2) rising US and falling Chinese rates and yields; and 3) the government will allow it in order to stimulate the economy.

# The Nordics

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## Sweden | page 31

Consumption is slowing. Despite Sweden's favourable industrial structure, growth will fall below trend in 2022-23. The Riksbank faces a tough balancing act; high home prices make the economy interest rate-sensitive. Pay hikes will accelerate.

## Denmark | page 40

Economic uncertainty and high inflation have caused a collapse in consumer confidence. The outlook for households is challenging, but employment, wages and home prices are rising. Fiscal stimulus is helping, and capital spending will grow.

## Norway | page 38

The removal of pandemic-related restrictions will boost the economy this spring. Households are pessimistic yet resilient to high energy and goods prices, but rising interest rates will slow growth. Norges Bank will continue gradual hikes.

## Finland | page 41

Finland's economic links to Russia have decreased in recent years. Inflation is high, but lower than in many EU countries and manageable. Household demand is resilient. The labour market is strong and the capital spending outlook is favourable.

## Sweden

# Inflation and rising interest rates squeeze households

High inflation and interest rate hikes are now causing household consumption to slow. Although Swedish industry is benefiting from increased demand for investment and input goods, we have lowered our GDP growth forecast to below trend in both 2022 and 2023. The Riksbank is facing a difficult balancing act as bloated home prices make the Swedish economy extra sensitive to interest rates. The next national wage round will lead to accelerated pay increases, but there is little risk of a serious wage-price spiral.

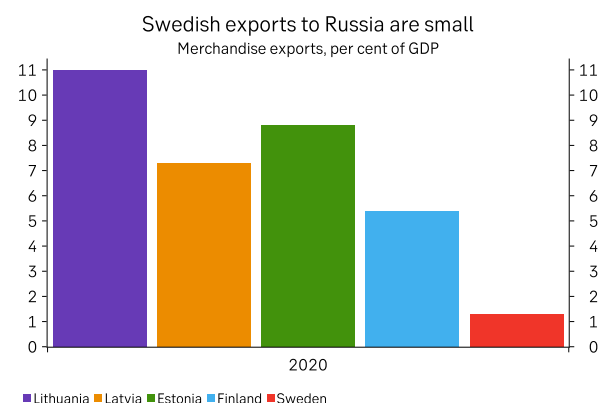
Rapidly rising inflation is eroding household income and forcing the Riksbank to raise its key interest rate. In the revised forecast that we published in late March, we lowered 2022 GDP growth to 1.8 per cent from 3.0 per cent in our January forecast. According to preliminary figures, GDP fell by 0.4 per cent in Q1 and Q2 looks set to be weak. Next year, too, we expect GDP growth of 1.8 per cent, a downward adjustment by one percentage point. Interest rate-sensitive households and decreased construction suggest that growth will be slower in Sweden than in the euro area. We now expect the Riksbank to hike its key rate to 1.75 per cent by the end of 2023, somewhat higher than the Riksbank's new rate path. We also expect somewhat more front-loaded hikes. But our rate path remains lower than current market expectations. Various kinds of downside risks in the economy, such as a big drop in home prices, make the monetary policy balancing act extra complex.

	2020	2021	2022	2023
GDP	-2.9	4.8	1.8	1.8
Unemployment*	8.5	8.8	7.6	7.5
Wages and salaries	2.1	2.7	2.7	3.5
CPIF	0.5	2.4	5.9	3.0
Net lending**	-2.7	-0.2	0.3	0.2
General government debt**	39.6	36.7	31.9	29.1
Repo rate, %***	0.00	0.00	1.25	1.75

\*% of labour force \*\*% of GDP \*\*\*At year-end. Source: SEB, Statistics Sweden

## Mixed outlook for manufacturers

Russia's invasion of Ukraine was one reason why Swedish merchandise exports slowed in March. But according to both purchasing managers' indices (PMIs) and the Economic Tendency Survey of the National Institute of Economic Research (NIER), businesses are relatively optimistic, which suggests that we are facing a fairly mild slowdown. Differences between sectors are significant, though. Sectors related to commodities, defence and energy are the main beneficiaries, while companies affected by high input goods prices are being squeezed hard. Compared to many other European countries, Swedish industry has a relatively favourable structure, especially because of its emphasis on investment goods. Electricity prices have climbed far less than the European average, especially in Sweden's northern price zones. The low share of natural gas in the energy supply is also an advantage. The proportion of Swedish exports that go to Russia is only 2 per cent. Downside risks for manufacturers are thus mainly connected to our having underestimated the consequences of high energy prices for the European economy in general. Late in 2022, the export and manufacturing outlook is expected to improve, supported by stronger external demand and the easing of supply disruptions. Overall, we expect exports to grow by 3.7 per cent in 2022 and 4.4 per cent in 2023.



Source: Macrobond, SEB

**Manufacturing investments will decelerate** due to greater uncertainty and weaker demand. Rising interest rates and material costs will also contribute to slower residential investments late in 2022. Commercial property construction began to fall even before the pandemic. Higher interest rates will intensify that trend. But due to rising public investments and rapid energy sector expansion, total capital spending will increase in 2022-2023, though more slowly than in 2021.

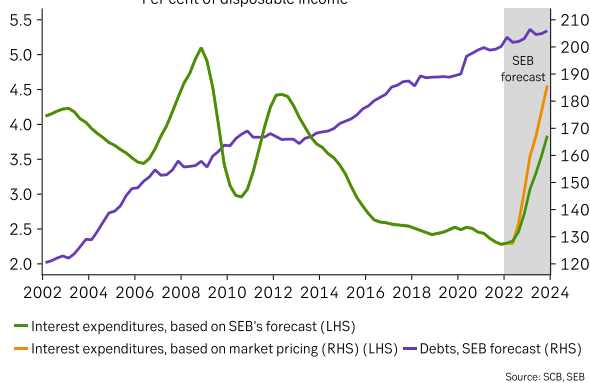
## Squeezed by inflation and interest rates

High energy and food prices as well as rising home mortgage rates are now squeezing households. The



decline in real wages looks set to be the biggest since the Swedish economic crisis of the early 1990s. Meanwhile we expect interest costs to increase from just over 2 per cent to nearly 4 per cent of incomes. Because of expansionary fiscal policies and rising employment, the decline in real household incomes will be only 1.4 per cent this year. During the next couple of years, we expect consumption to be sustained in part by reduced household savings. Household savings are very high in both a historical and international perspective. However, a large part of these savings consists of occupational pensions and net purchases of single-family houses and tenant-owned units. Personal savings are equivalent to only 3-4 per cent of income; far from the 17-18 per cent that make up total savings.

Household debts and interest expenditures  
Per cent of disposable income



**Riskier housing market.** Our forecast implies that household consumption will continue to grow at a decent pace starting in the second half of 2022. Developments in the labour market will be important, however. The household confidence indicator has fallen to levels on a par with the global financial crisis. This is a worrisome signal that savings will increase, rather than decrease, if historical patterns are followed. Another important prerequisite for our consumption forecast is that home prices will be fairly resilient to rising interest rates. We believe that home prices will start declining later this year and that they will then fall by 5 per cent in 2023. It would require a relatively large home price decline to have a clear impact on consumption.

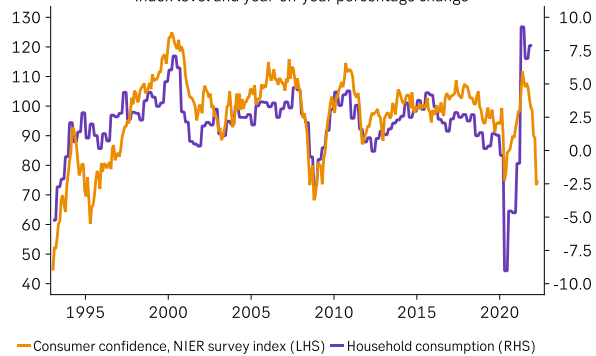
### Household incomes and savings ratio

Year-on-year percentage change

	2020	2021	2022	2023
Real disposable income	-0.1	4.0	-1.4	-0.4
Private consumption	-4.7	5.8	1.6	1.0
Savings ratio, % of income	18.0	17.1	14.1	13.0

Source: Statistics Sweden (SCB), SEB

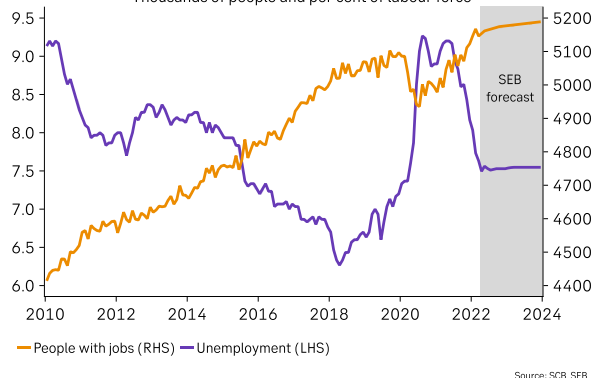
Consumer confidence points to falling consumption  
Index level and year-on-year percentage change



### Unemployment will soon level off

Labour market resilience will be important in order to avoid a negative spiral. Conditions are strong, with employment indicators at close to record levels. Employment has also returned to its historical trend, while the jobless rate is approaching lows last seen in 2018. We now expect an economic slowdown, with unemployment levelling off at around 7.5 per cent this year and staying at this level in 2023, but the risk of an upturn in the second half of this year is relatively large.

Challenges in a strong labour market  
Thousands of people and per cent of labour force



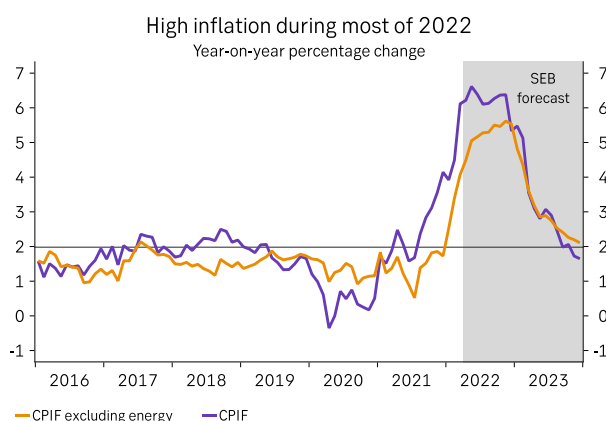
**Big labour shortages.** Today's strong conditions are also reflected in the fact that the percentage of businesses reported labour shortages in the latest NIER Economic Tendency Survey was on a par with the highest-ever levels. We expect these shortages to decline somewhat, but the pay negotiations that will begin late in 2022 still appear likely to take place in a relatively strong labour market situation. More important to these negotiations, however, will be long-term inflation expectations and how to deal with a period of significantly declining real wages. The main labour union strategy so far is apparently to retain the Riksbank's 2 per cent inflation target as an anchor. Industrial unions and employers will probably continue to set the tone for other sectors. The issue of compensation for rising costs will make the upcoming wage round the hardest for many years. We have raised



our 2023 pay hike forecast to 3.5 per cent. High inflation expectations suggest that upside risks are greater than downside (see theme article, page 35).

### Ukraine war adding to already high inflation

When Swedish inflation began to rise sharply late in 2021, high energy prices were the dominant driver, while the CPI excluding energy remained below target. Early in 2022, however, we saw a dramatic broadening of inflation as this underlying inflation metric doubled in just three months. The March figure of 4.1 per cent was the highest since 1993. This upturn is mainly the result of rising commodity prices, due to high international price pressures and the indirect effects of high energy prices. The most dramatic upturn has been for food inflation, which reached almost 6 per cent in March. There are many indications that food inflation will continue rising above 10 per cent by the end of 2022. Service prices have also risen as energy and food costs have been passed on to consumers.



**Because of falling energy prices, CPIF is close to peaking.** How long high inflation will persist mainly depends on international energy and commodity price developments as well as supply chain disruptions. The domestic wage response will also be important, and in the short term also the exchange rate. Our main forecast is that inflation, as elsewhere in the world, will fall as supply chain problems ease and demand for consumer goods slows. CPIF inflation now appears close to peaking, since energy prices seem to be on their way down – partly as a result of tax cuts. This autumn, we expect the downturn to be intensified by base effects as 2021 energy price increases vanish from the 12-month figures. According to our forecast, the contribution of energy prices to CPIF inflation will fall from 2.5 per cent in March to just below zero in December. Total CPI inflation will be pushed upward by higher interest rates both this year and next, and CPI will thus end up higher than CPIF.

**Upside risks are still dominant.** Energy prices will remain volatile, and the outlook can change rapidly. The upturn in commodity prices may become generally stronger. It is also possible that goods price increases in the world market will not react especially much to cooler demand and diminishing supply side problems will ease. But there are also downside risks. Historically, large price increases for goods have been quickly reversed when a balance between supply and demand has been reached. Our forecast that the CPIF will fall below 2 per cent some months into 2023 may seem aggressive, but it would not be especially strange if a combination of base effects and normalisations of price levels temporarily pushed inflation even lower.

### Dramatic U-turn in monetary policy

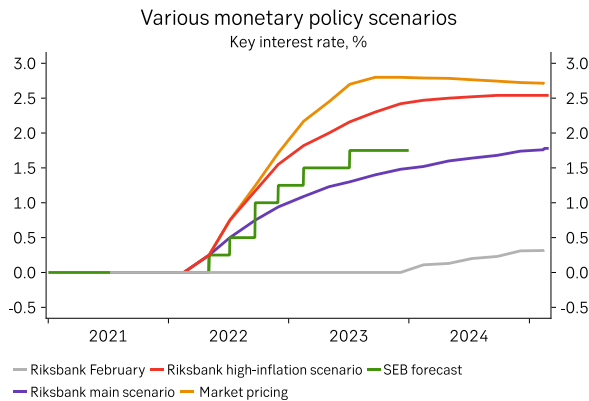
After having signalled an unchanged key rate until autumn 2024 as recently as February, the Riksbank reversed itself in April and hiked its key interest rate above zero for the first time since 2014. It is clear that strong upside surprises in recent months have now turned inflation into the primary focus of monetary policymakers. The Riksbank's main forecast is that it will raise the repo rate to 1.0 per cent in 2022, 1.50 percent in 2023 and 1.75 per cent by the end of 2024. The risks are also on the upside, as illustrated by one alternative scenario in which the Riksbank hikes its key rate to nearly 2.5 per cent by end-2023 if inflation continues to surprise on the upside.

### High interest rate sensitivity in the Swedish economy.

Like other central banks, the Riksbank will face a dilemma in the future when inflation well above its target is combined with downside risks to growth. In Sweden, bloated home prices also mean that the decline in growth could be significant if interest rates climb rapidly. Many households have variable or short mortgage interest fixing periods, which makes the risk greater. Although the Riksbank cannot explicitly take home prices into account at present, it also cannot ignore the consequences of high interest rate sensitivity in the Swedish economy in terms of the long-term inflation and growth outlook.

**A 50 bp rate hike in September is likely.** Our inflation forecast for the next few months is higher than the Riksbank's. We thus expect somewhat more front-loaded rate hikes, with a 50 basis point increase in September and a repo rate of 1.25 per cent by the end of 2022. Given our more pessimistic growth picture, we believe the Riksbank will stop at 1.75 per cent and end its hiking cycle in July 2023 when it is reasonably confident that inflation is approaching its 2 per cent target. Market expectations for the repo rate are close

to the Riksbank's high inflation scenario, while we expect significantly fewer rate hikes next year.



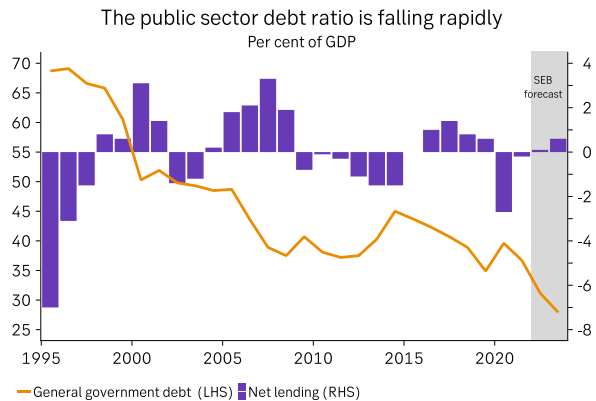
In April, the Riksbank decided to halve its bond purchases during the second half of 2022 to less than SEK 20 billion per quarter, which was in line with our forecast. We believe that early in 2023, purchases will be reduced to a few billions per year and be undertaken in order to have a better preparedness in case the Riksbank needs to accelerate its bond purchases during a future crisis.

### Balanced budget, despite new stimulus

Swedish public finances continue to show signs of strength. The 202 deficit was the largest since 1996, but as early as 2021 two thirds of the increase in the debt ratio was reversed. Net lending was then largely in balance, while Germany and France, for example, had public sector deficits of 3.7 and 6.5 per cent, respectively. Government finances have received support from various quarters. Pandemic responses cost less than feared, and tax revenues have surprised on the upside as employment has continued to increase.

**Uncertain consequences of the inflation shock.** The outlook is now more mixed. Although growth is slowing, employment continues to increase. Even if we adjust household consumption lower in volume terms, inflation VAT and other tax revenues will hold up due to high inflation. High electricity prices are driving up tax revenues and network fees, but new compensation programmes have also led to increased costs. Including the measures in the spring budget bill, we believe fiscal policy will be largely neutral in 2022. In addition to compensation for high energy prices and other input prices, there will be additional spending for defence and migration services due to the war in Ukraine. The latter items are, however, partly offset by declining development assistance allocations. We believe that more stimulus measures may be added in the near future, but as long as the economy does not weaken significantly, their amounts will probably be relatively

small. Overall, net lending is expected to improve slightly further this year.



**Uncertain election outcome.** The parliamentary situation has been shaky in recent years, with the recently formed Social Democratic one-party government being forced to accept the opposition's budget proposal. Due to the public opinion situation and the positions of the political parties on conceivable governing coalitions, the situation remains unclear. However, our forecast for 2023 assumes that the post-election budget will be relatively expansionary, contributing to a slight weakening of net lending. There will also be higher costs for interest deductions as home mortgage rates increase. But due to a continued rise in nominal GDP, the government debt ratio will fall to about 29 per cent of GDP next year; the lowest level in modern times.

Theme:

# The new wage round

Low risk of a wage-price spiral, despite difficult conditions

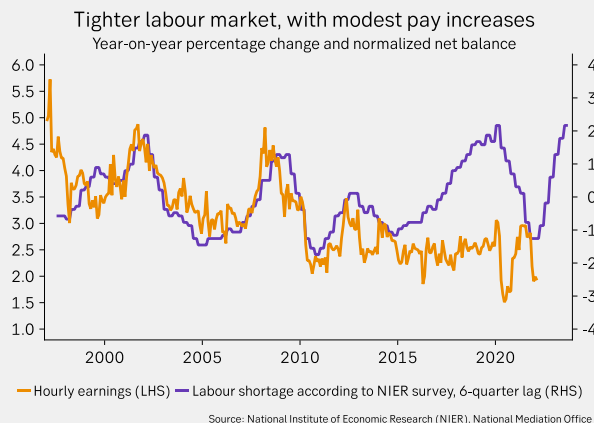
Surging inflation, plus the Riksbank's new interest rate strategy, has quickly changed the wage round situation. As unions and employers formulate their positions ahead of upcoming negotiations, there are many indications that pay hikes will speed up. But both sides have much to gain by agreeing on pay levels that will not force the Riksbank to accelerate its key rate hikes. Our forecast is that wages and salaries will increase by 3.5 per cent next year: far more slowly than in the US and UK. There is relatively little risk of pay hikes at levels regarded as incompatible with the inflation target. If inflation becomes even more problematic, the most likely outcome is special solutions including front-loaded contractual pay hikes, one-off compensation or shorter agreements.

Recent Swedish national wage rounds have taken place in turbulent environments. When the pandemic broke out in early 2020, negotiations had to be suspended just as unions and employers were approaching the finish line. Talks resumed that autumn and ended up with marginally higher pay increases than in the previous round. But this only applied to the forward-looking part. If we also take into account that pay levels were frozen for much of 2020, the average pay hike for the full period from the end of the previous agreements in the spring of 2020 represented a slower increase.

After many years of complaining about uncomfortably low wage and inflation expectations, the Riksbank has made a policy U-turn and is now planning recurrent key rate hikes during the upcoming wage round. This has created a completely new situation for economic policymakers and for the interactions between the Riksbank and the two sides negotiating new labour agreements. As in some of the previous wage rounds, the negotiations will thus focus on one question: To what extent can employees' purchasing power be preserved in the new inflation environment? It will probably take time before the two sides have formulated their positions and had a chance to identify suitable strategies.

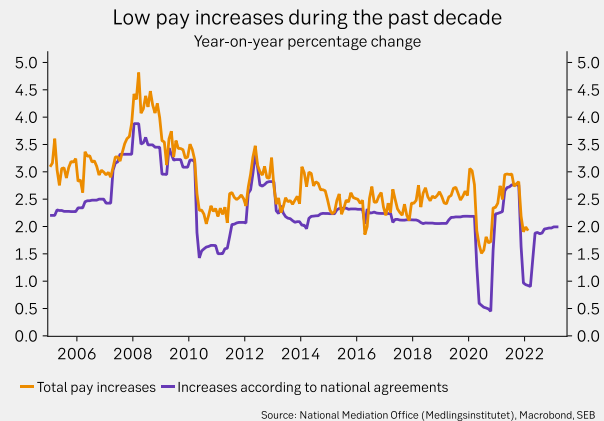


Pay hikes that were so low that they created a problem for monetary policymakers began in the aftermath of the global financial crisis. A combination of Swedish interest rate hikes in 2010-2011 and the euro crisis led to gradually falling Swedish inflation, partly driven by strong krona appreciation that pushed down the EUR/SEK exchange rate to nearly 8. When the Riksbank then chose to accept low and falling inflation, for example citing risks in the housing market (the “leaning against the wind” argument), unions and employers became sceptical of using its inflation target as an anchor for wage formation. Despite the Riksbank's major policy shift in 2014, it did not really succeed in restoring credibility for the target. The problems were largely due to external factors, but has been continuous discussion about how trust between the Riksbank and the two sides could be improved. As recently as February 2022, the Riksbank signalled “perpetually” low interest rates as a way of raising inflation expectations, which can probably be viewed as the last act in this drama.

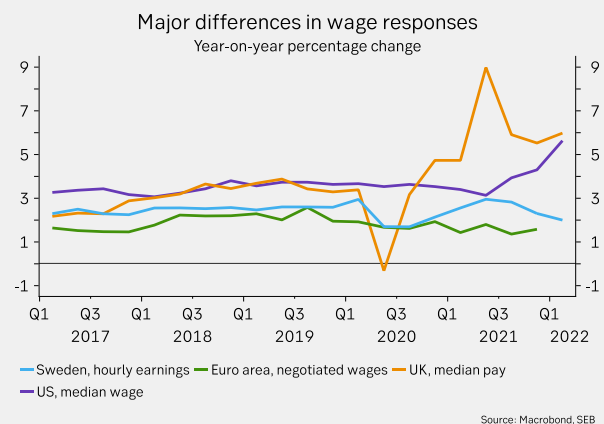


**Tumultuous change in conditions.** Now that we suddenly find ourselves in a more classic situation where the Riksbank needs to take steps to bring down inflation, it is clear that some actors are eager to revise their positions. Various proposals from union chief economists have recently illustrated the situation in a rather pedagogical way. Economists at the mainly blue-collar Trade Union Confederation (LO) have argued that the Riksbank should hold off on rate hikes. But economists at Unionen, a white-collar union, have declared that the Riksbank might as well act quickly. It is easy to understand both views. On the one hand, rate hikes may provide a valuable signal ahead of the wage round that the Riksbank is taking the situation seriously and will stop “playing with the fire of inflation”. On the other hand, repeated rate hikes may be interpreted as a lack of confidence in the ability of the two sides to conclude responsible labour agreements and may also

worsen the situation, since higher interest costs increase the burden on employees.



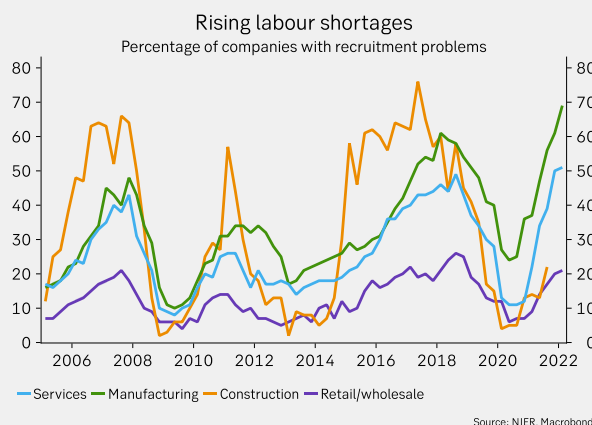
**Can the Industrial Agreement withstand the challenge?** Union leaders and negotiators have kept a low profile so far, but on March 18 the five chairmen of Swedish Unions within Industry published an opinion article in the newspaper *Dagens Nyheter* saying that the working methods in the 1997 Industrial Agreement provide the best guarantee for responsible action, even in the current difficult situation. They warned about the risks of a free-for-all if pay demands begin diverging. They also asked employer organisations to stop saying that “the inflation target is of no importance to wage formation”. It is hard to know what this actually means, especially with inflation still rising. But we see the contours of a compromise in which unions invest in credibility by accepting the role of the inflation target even if this means short-term real wage cuts, while employers show greater acceptance of the current stabilisation policy framework now that – for the first time in a decade – they might benefit from the disciplinary function of the inflation target.



**Muted wage response in northern Europe.** So far, official statistics do not provide clear signs of pay increases in Germany and the Nordic countries on the scale of those in the US and the UK. But there may be time lags in the statistics, and in Sweden the unions and



employers have recently had a pay revision checkpoint that has not yet had an effect on the outcome data. Germany's IG Metall union also recently issued higher wage demands than usual, but it is normally very difficult to interpret what this will finally mean.



**Tight labour market.** At present, Swedish companies are reporting large labour shortages. Overall, we are on a par with historical peaks. For the manufacturing and service sectors, the shortfalls are record-sized. The resource situation was also stretched in the pre-pandemic years, without wages then rising significantly. There is still a long way to go before the next wage round starts in earnest. The first major event will be the union coordination discussions in late 2022. The outlook is uncertain in the near term, but our main forecast is that shortages will ease a bit even if no major change in unemployment is likely.

#### Timetable for the 2023 wage round

Oct-Nov: Union coordination discussions

Jan-Feb: The two sides begin negotiations

March 31: Agreements expire in industry etc.

April 30: Agreements expire in construction etc.

**Differences and similarities compared to 2007.** The most recent wage round that led to pay hikes that were uncomfortably high for the Riksbank occurred in 2007. At that time, the labour market was also tight and inflation was on its way up, driven by rising commodity prices. The inflation expectations of the two sides were also on a par with today's. The wage round led to an average pay hike of 4.3 per cent in 2008. After that the rate of increases fell sharply when the consequences of the Lehman Brothers crash reached Europe in earnest. The 2007 wage round is usually cited as an example of the importance of letting industry lead the way on pay increases, since the retail/wholesale and financial sectors subsequently concluded agreements with clearly higher pay hikes than in industry.

**A focus on 2023 wage and salary forecasts.** In its April forecast, the Riksbank projected pay hikes of 3.2 per cent in 2023, while the National Institute of Economic Research landed at 3.0 per cent in its March forecast. At this early stage, it is natural to make rather cautious assumptions about the outcome of the wage round. Our own forecast is that pay increases in 2023 will end up at 3.5 per cent, despite our more pessimistic view of Sweden's future growth prospects. But we also believe that in the near term, inflation will exceed the Riksbank's forecast. This may drive up inflation expectations further and thereby complicate the wage round. But it is still likely that significantly lower inflation in early 2023 will have become evident by the time the wage round enters a critical phase. In such a scenario, we are unlikely to see multi-year agreements at levels that are incompatible with the inflation target.



#### Special solutions conceivable if the situation worsens.

If inflation were to accelerate further, it is easiest to envisage arrangements in which the unions successfully negotiate some form of one-off inflation compensation but meanwhile try to make it clear that further ahead (for example, later in the contract period) they will revert to lower pay hikes. It is also conceivable that the parties will be forced to settle for one-year agreements, which have served as an emergency solution a few times over the past 10-15 years when conditions have been so difficult that the two sides have not reached their goal of three-year agreements. One issue is the extent to which fiscal stimulus initiatives that maintain household purchasing power can help make the next wage round easier. For many years, there has been a widespread reluctance in Sweden to include this kind of "incomes policy" in wage formation. But even without such explicit intervention, it is still possible that programmes which maintain household purchasing power could indirectly facilitate the wage round.

# Norway

## Economic recovery as life returns to normal

The removal of all pandemic-related restrictions in February is boosting economic activity this spring. Private consumption will withstand high energy and commodity prices, but rising interest rates will slow mainland GDP growth towards trend in 2023. High resource utilisation, a tight labour market and external price pressures are resulting in rising prices and wages. Core inflation will rise to 3 per cent this year but stabilise near target in 2023. Norges Bank thus favours gradual key interest rate hikes.

Economic activity was weak at the turn of the year, after the government reinstated national COVID-19 restrictions in mid-December due to the outburst of the Omicron variant. Q1 data will be published on May 13, but monthly data indicate a fall in sequential growth of nearly 0.6 per cent. The government removed all restrictions in February and changed its strategy. It now views COVID-19 as similar to a seasonal flu, reducing the risk of new lockdowns. Activity is rebounding, led by the service sector. The Ukraine war brings uncertainty, but its negative impact on mainland GDP is expected to be mild and related to the indirect effects of weaker international demand and supply disruptions. Private consumption will withstand high energy and commodity prices, but rising interest rates and a normalised consumption pattern will slow growth towards trend in 2023. Mainland GDP will grow by 3.7 per cent in 2022 and 1.5 per cent in 2023. Reviving capital spending in the petroleum sector will support total GDP which will grow by 3.6 per cent in 2022 and 2.9 per cent in 2023.

### Key data

Year-on-year percentage change

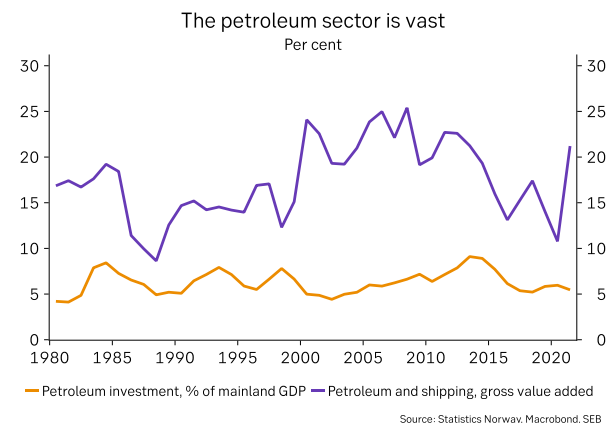
	2020	2021	2022	2023
GDP	-0.7	3.9	3.6	2.9
Mainland GDP	-2.3	4.2	3.7	1.5
LFS unemployment*	4.6	4.3	3.1	3.2
Wages and salaries	3.1	3.1	4.0	3.6
CPI-ATE inflation	3.0	1.7	2.7	2.5
Key interest rate, %	0.00	0.50	1.75	2.25

\*Per cent of labour force. Source: Macrobond, SEB

### High energy prices boost petroleum income

High oil and gas prices are resulting in abundant petroleum revenue for the government, which is nevertheless advocating cautious fiscal spending to avoid economic overheating. Fiscal policy will turn contractionary this year. Excess revenue will be transferred to the Government Pension Fund Global and invested abroad. The government will unveil its revised budget on May 12.

**Energy production at full throttle.** Norway produces the equivalent of 4.3 million barrels of oil and gas including natural gas liquid (NGL) per day. The government has approved permits for higher natural gas production from the Norwegian continental shelf to increase deliveries to Europe. Since production is already running near full capacity, the increase in gas production will be only around 10 per cent. The lack of new large development projects has lowered capital spending by 7 per cent since the peak in 2019. A further 6 per cent decline is projected for 2022. Higher demand for Norwegian petroleum exports will support capacity-enhancing investments in coming years. Combined with a pipeline of projects to be approved before the Parliament's tax measures package expires by year-end, it should support a cyclical turnaround starting in 2023 – with capital spending rising 10 per cent.

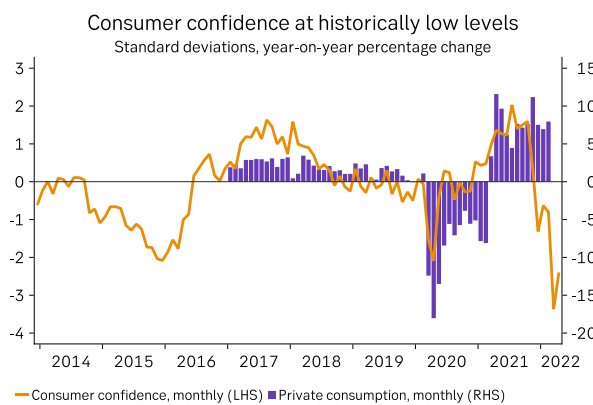


**Some support for mainland economy too.** The petroleum and shipping sectors account for 21 per cent of GDP, but the mainland economy has become less petroleum-dependent since the oil downturn in 2014-2017. Some positive demand impulses are nonetheless likely via higher activity and capital spending among petroleum suppliers. Above-normal capacity utilisation in manufacturing will also support business investment. We forecast that mainland investments will boost growth by nearly 1.0 per cent in 2022 and 2023.

### Pessimistic households

High inflation and energy prices, combined with rising interest costs, are squeezing household real disposable

incomes. Private consumption fell 6.4 per cent from November to January, with large declines in both goods and service consumption. The latter recovered following the removal of restrictions, but households remain cautious. The monthly consumer confidence indicator fell to a record low in March. Despite a rebound in April, households remain pessimistic about their financial situation. With 95 per cent of households having floating mortgage rates, upcoming key rate hikes will have a strong impact on disposable incomes.



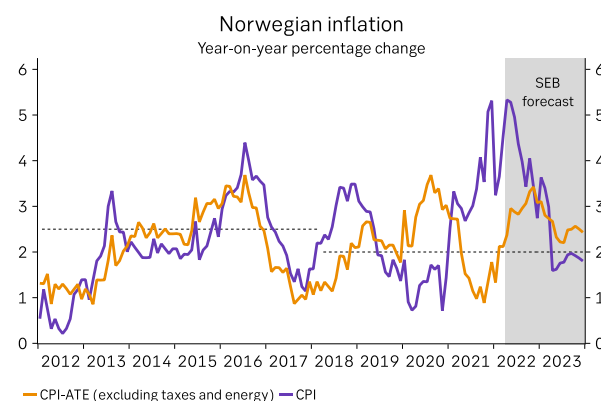
**Counteracting forces.** There are some supportive factors for private consumption. The government has extended subsidies until March 2023 to offset part of higher electricity costs. Households have also built up ample financial buffers during the pandemic. The savings ratio has increased to 9.9 per cent, well above the 2009-2019 average of 6.6 per cent. Moreover, the registered jobless rate has fully recovered from its rise during the pandemic. At 1.9 per cent, it is below Norges Bank's 2 ¼ per cent estimate of natural unemployment. The lifting of restrictions, high capacity utilisation and labour shortages suggest a tight labour market, as reflected in rising pay expectations. This year's wage negotiations are under way. The norm set by the manufacturing sector is 3.7 per cent. Including wage drift, we forecast 4.0 per cent annual increases. We have lowered our forecast for private consumption growth to 5.9 per cent in 2022 and 3.2 in 2023.

**Existing home prices started the year on a very strong note.** Prices are up 2.9 per cent – the highest first quarter growth since 2007. This mainly reflects temporary supply-side bottlenecks stemming from new regulations. Hence, momentum in existing home prices should slow and higher interest rates will dampen demand further ahead. We forecast annual price growth of 5.4 and 0.8 per cent in 2023 and 2024, respectively.

### Core inflation above 3 per cent in 2022

CPI-ATE (excluding taxes and energy) accelerated from low levels in late 2021. The upturn has continued this

year to 2.1 per cent in March, even though monthly data have been volatile – with big surprises in both directions. Rising goods prices are the most important driving force, with food prices also turning higher after falling during much of last year. Manufacturers report rising cost pressures and foresee accelerating price increases. International prices will continue exerting upward pressure on goods inflation, although this co-variation has historically been relatively low. The strong labour market and rising demand suggest that service inflation will gradually rise. We forecast that CPI-ATE inflation will temporarily exceed 3 per cent this autumn, falling back towards target in 2023.



**Peak for CPI.** Sharply rising electricity prices lifted CPI inflation above 4 per cent at the end of 2021, although strong subsidies to households have restrained the upturn. The extension of the subsidy implies that new price increases will be limited to the electricity component in CPI. Forward markets point to substantially lower electricity prices during late spring and this summer. We project that CPI inflation will be significantly lower than CPI-ATE during the second half of 2022 and in 2023.

### Norges Bank advocating a gradual approach

Norges Bank has hiked the key interest rate in three steps to 0.75 per cent since September 2021. Its rate path signals one hike per quarter to 2.50 per cent, which is above the estimated neutral rate of 1.7 per cent. Rising price and wage pressures, combined with a widening positive output gap, suggest front-loaded rate hikes. But the Monetary Policy and Financial Stability Committee is worried about household sensitivity to interest rates. Norges Bank believes a gradual approach will suffice to stabilise inflation near target over time but that persistently high inflation would justify faster rate hikes. We forecast four hikes to 1.75 per cent by year-end and believe the strong transmission mechanism will result in a terminal rate of 2.25 per cent.

# Denmark

## Challenging climate

Following a strong end to last year, driven by household consumption, new challenges have emerged in the shape of rising inflation and bond yields. On the one hand, consumer confidence has collapsed to the lowest level since 1988. On the other hand, the government has suspended its budget ceiling to provide fiscal stimulus. We think this is sensible given the strong public sector balance, but still see downside risks to our GDP forecast if supply shocks persist.

**Strong end to 2021.** GDP growth in 2021 was revised upward from 4.2 per cent in the preliminary release to 4.8 per cent, compared to our forecast of 4.0 per cent in the previous *Nordic Outlook*. At the same time, 2022 has seen a more challenging environment, so we now expect GDP growth of 2.4 per cent in 2022 and 2023, down from 3.3 per cent and 3.0 per cent respectively.

### Key data

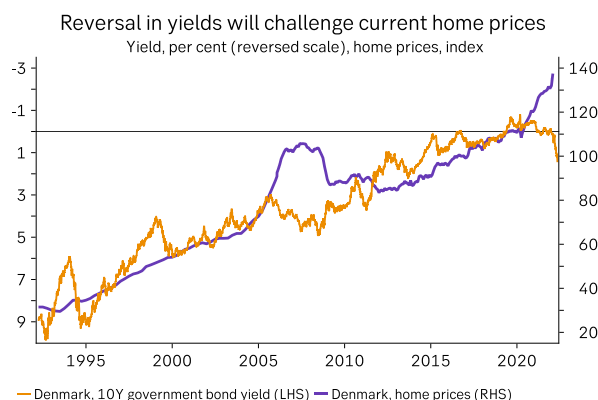
Year-on-year percentage change

	2020	2021	2022	2023
GDP	-2.1	4.8	2.4	2.4
CPI	0.4	1.9	5.9	3.7
Wages and salaries	1.9	2.3	2.9	3.7
Public sector fiscal balance*	-3.0	0.5	2.0	4.0
Public sector debt*	44.0	40.0	35.0	30.0
Current account*	7.5	7.5	7.0	6.5
Key interest rate (CD rate), %	-0.50	-0.60	0.15	0.90

\*% of GDP. Source: Statistics Denmark, DØRS, SEB

**Positive backdrop for growth.** Household consumption declined by 1 per cent in Q4, reflecting the partial lockdown that continued through January. Fundamental drivers are intact, since employment increased by 1.1 per cent in Q4, taking full-year growth to 2.6 per cent and supporting incomes. Home prices also accelerated towards year-end, extending positive wealth effects. Finally, all pandemic restrictions were removed in February, marking a return to 'normal' life and a boost for the consumption of services.

**Challenging environment for consumers.** The economic climate for consumers has deteriorated. Soaring inflation and rising bond yields also put pressure on house prices. The Danish 10-year government bond yield has increased by over 100 basis points since the start of 2022 and media reports suggest housing turnover is falling, normally a precursor of a peak in prices. Unemployment is likely to continue falling, but at a slower pace, to 3.9 per cent by the end of 2023, with wage inflation rising to 3.7 per cent in the same year.



Source: Statistics Denmark, Macrobond Financial AB, Macrobond, SEB

**Consumer confidence collapse.** Consumer confidence has declined to its lowest level since the infamous 'potato diet' in the late 1980s, below the global financial crisis low. Retail sales have declined 10 per cent from their reopening peak in March 2021 but remain 5 per cent above their pre-pandemic level. Strong balance sheets still support spending, but there is substantial downside to our 3.3 per cent consumption growth estimate for 2022 if inflation continues to depress real income and lift yields.

**Solid investment level (for now).** The revised data on corporate revenues that helped lift GDP in Q4 were mainly due to the service and constructions sectors, while manufacturing was revised lower. Capacity utilisation and high profits support industrial investment, although geopolitical uncertainty may delay major investment decisions. Residential construction has slowed, however, as interest rates and other costs have increased. It remains a downside risk. We expect total capital spending to increase by 4.1 per cent in 2022.

**Budget ceiling suspended.** The war in Ukraine has led to a change in policy priorities. The Danish government suspended its budget ceiling to make room for increased defence spending and has also unveiled plans to support incomes of households with high energy costs. We do not see this as a problem, due to the government's budget surplus and the high external surplus. At the same time, pressure on the DKK has eased after last year's interventions and rate cut.

## Finland

# Households resilient despite high inflation

The war in Ukraine is not only changing the economic outlook, but also the political outlook as Finland's formerly neutral stance is now tilting towards full NATO membership. Economic links to Russia are stronger in imports than exports and will be a drag going forward. Households are relatively resilient, since inflation is not as high as in comparable countries. We have cut our 2022 forecast by 1.2 percentage points and now expect GDP to grow by 1.8 per cent. In 2023, growth will be only 1.5 per cent.

### The geopolitical crisis is having an economic impact.

Finland has traditionally pursued a cautious, balanced policy towards Russia. This pragmatic approach has led to relatively close business relations, putting Russia in fifth place among trading partners in 2021, with 5.5 per cent of Finnish merchandise exports heading there. Mostly due to a high volume of oil trade, Russia supplied a full 12 per cent of Finland's merchandise imports last year. In the long run, trade flows can be diverted to other countries, but for the moment some disruption seems unavoidable, limiting export growth to 2.8 per cent in 2021.

### Key data

Year-on-year percentage change

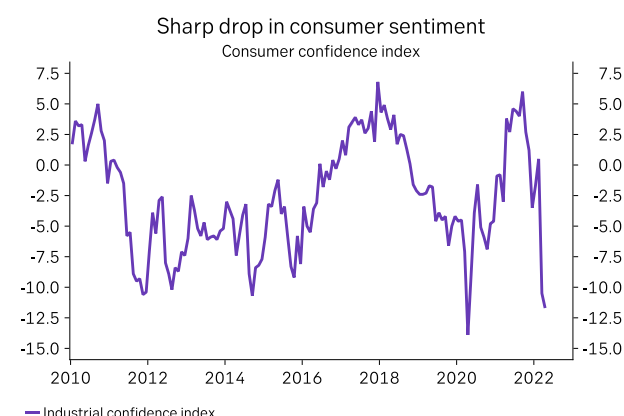
	2020	2021	2022	2023
GDP	-2.3	3.5	1.8	1.5
Private consumption	-4.1	3.1	2.0	1.7
Exports	-7.5	4.7	2.8	3.5
Unemployment*	7.7	7.6	6.8	6.5
Wages and salaries	1.8	2.3	2.5	2.2
HICP inflation	0.3	2.1	4.5	1.8
Public sector fiscal balance**	-5.5	-2.6	-2.2	-1.8

\*% of labour force \*\*% of GDP. Source: Eurostat, SEB

**Inflation will be high, but manageable.** Household consumption will not face as strong an inflation headwind as in most of Europe. Food and energy, which have seen the highest price increases, make up a smaller proportion of household expenditures than the euro area average. In addition, the upturn in food and energy prices has been among the smallest in the euro area. In 2022 Finland will

experience its highest inflation since 1990, but it will still be only 4.5 per cent.

**Household demand will prevail.** Finnish consumers have been adversely affected by Russia's attack on Ukraine. The sharp drop in consumer sentiment in March was the largest such monthly decline ever recorded. Yet its effect on consumption will probably be limited in the short term, since the decline was driven by a more negative assessment of the general economic outlook rather than by respondents' personal financial situation. We do not foresee a drastic drop in consumer spending and instead expect private consumption to increase by 2.0 and 1.7 per cent in 2022 and 2023 respectively.



**No big changes in the labour market.** We do not expect the current geopolitical situation to have a major impact on the Finnish labour market, despite a lower growth outlook. According to business surveys, employment expectations have eased but remain high in historical terms. Unemployment will continue to decline gradually, reaching 6.8 per cent this year and 6.5 per cent in 2023.

### The capital spending outlook still appears favourable.

Businesses that previously hesitated due to the COVID-19 pandemic are now more eager to invest. High capacity utilisation in industry needs to be addressed, while increased demand for services should also favour investments, but previously high construction volumes will gradually slow and start to contribute negatively to investment growth. We expect capital spending to rise by 2.7 per cent in 2022 and 1.8 per cent in 2023.

**A historic NATO decision.** Economic issues have been relegated to the background as Parliament prepares to make a historic decision on whether to join the NATO alliance. Even if Parliament should decide against it, which is not the most likely outcome, much higher spending on defence is already a certainty. The government deficit will be around 2 per cent of GDP in 2022-2023.



Theme:

# The changing Baltics

Growth takes a hit but dependence on Russia has decreased

In addition to inflation, the Ukraine war and related sanctions are also hampering growth in the Baltics. Given their geography, it is easy to assume that Russia's neighbours Estonia, Latvia and Lithuania are among countries losing the most from the situation. Since the war started, we have revised our forecasts lower – but perhaps not as low as expected. The economic links between the Baltics and Russia are less important than many people believe. Years of uneasy relations with an increasingly autocratic Russia have forced the Baltics to diversify their economic and political risks. The outcome is reduced dependence, especially for exports. This is why today commodity shortages and supply side disruptions, rather than loss of Russia as an export market, are causing problems.

Although Russia's full-scale invasion of Ukraine came as a shock to most, it was less surprising for many people in Estonia, Latvia and Lithuania. History and geographic proximity have contributed to a high level of worry but also of awareness. After 50 years of Soviet occupation, Estonia, Latvia and Lithuania regained their independence in 1991 and since then they have been vigorously working to protect themselves from history repeating itself, for example by joining NATO and the EU to hedge political as well as economic risks.

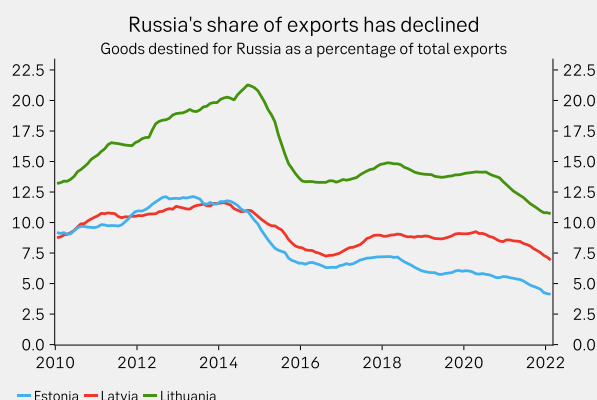
**Decreasing their economic dependence.** Trade is often heavily dependent on geography, with neighbours typically being major trading partners. But although Estonia, Latvia and Lithuania share a total of 780 km of border with Russia, direct economic ties between the countries are not as close as one might think. This has not always been the case, but various economic and political shocks in recent decades have confirmed that doing business with Russia entails political and economic risks that the Baltics are not prepared to take.



The latest turning point was Russia's 2014 occupation of Crimea, but earlier events such as the rouble crisis of 1999, the conflict between Estonia and Russia in 2007 after the removal of a Soviet monument and Russia's invasion of Georgia in 2008 have also contributed.

#### Trade statistics overestimate Russia's importance.

The impact of current sanctions against Russia on the Baltic economies may be more limited than statistics show. In 2021, 11 per cent of Lithuanian, 7 per cent Latvian and 4 per cent Estonian merchandise exports went to Russia. However, only a small fraction of these goods was produced in the Baltic countries. In Estonia and Lithuania, where more detailed statistics are available, domestically produced goods accounted for less than 2 per cent of total exports to Russia. Instead most were transit exports – goods that only passed through these countries on the way to their final destination. While transit export volumes have benefited the wholesale and logistics sectors, the value-added from such services tends to be low. Looking at exports of goods, excluding re-exports, Lithuania is actually more exposed to Ukraine than to Russia, in which case both logistical constraints and lower demand might be challenging.



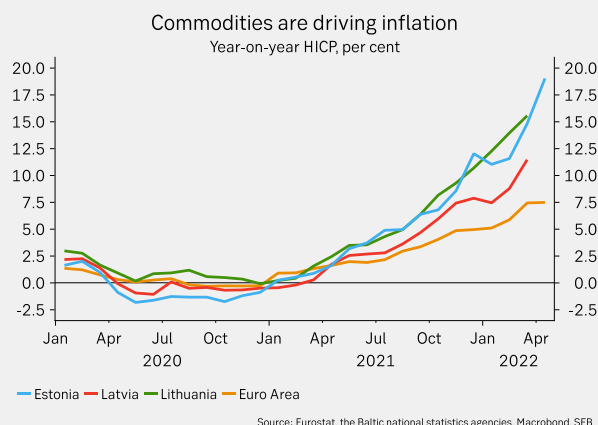
**Russian energy imports can be replaced.** In 2021, goods from Russia accounted for 12 per cent of total imports to Lithuania, 10 per cent to Estonia and 9 per cent to Latvia. Here, too, the figures may be somewhat misleading, since crude oil and refined petroleum products accounted for 60 per cent of total Baltic imports from Russia. Latvia and Estonia previously re-exported Russian oil to other countries. The only oil refinery in the Baltics, in Lithuania, has now stopped oil purchases from Russia and switched to other suppliers. As for natural gas, Estonia and Lithuania have said that they will stop such purchases from Russia, relying fully on liquefied natural gas (LNG). Latvia is expected to follow suit next year. Lithuania has had a functioning LNG terminal since 2014 while Estonia, together with

Finland, plans to set up facilities to receive LNG vessels in the coming months in Paldiski, Estonia – a project that might later be joined by Latvia.

#### Loss of Russian imports a concern for manufacturers.

The situation is more concerning for the region's large wood processing sector and metal industries, which have previously imported a substantial part of their production inputs from Russia. Estonia and Latvia are two of the most forested countries in Europe, so there is no direct shortage of raw materials, although prices may rise. Substituting Russian metal input will be more complicated. But at higher prices, steel and iron can also be sourced from other countries. Although a lot of imports from Russia are thus replaceable, this will lead to higher raw material prices, which in turn will have a negative effect on margins and exacerbate the already rapid rise in construction prices. Another sector that will be adversely affected is agriculture, which will face a shortage of imported fertilisers.

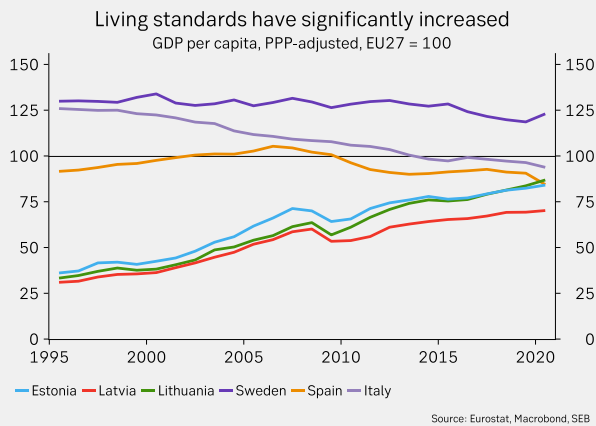
**Double-digit inflation.** However, the biggest economic problem for the Baltics right now is that the war is broadly driving up commodity prices and ultimately consumer price inflation. Compared to the wealthier Nordic countries, the share of food and energy in Baltic consumer price indices is much higher. In Sweden the share of food in the HICP basket is 14 per cent, while the corresponding figure in Estonia and Lithuania is 19 per cent and in Latvia 23 per cent. Energy, which makes up less than 10 per cent of household expenditures in Sweden, accounts for 13 per cent in Lithuania and 16 per cent in Latvia and Estonia. On the other hand, all three Baltic countries are net producers of food, which secures their food supply and benefits many companies.



#### Living standards are now on par with southern

**Europe.** Although the income level of the Baltic countries is still less than half that of Sweden, years of rapid economic growth have significantly raised the standard of living. In 1995, purchasing power parity-adjusted per capita GDP in the Baltics was just over 30

per cent of the EU27 average. Today the corresponding figure is almost 90 per cent in Lithuania and Estonia, surpassing Spain and closing in on Italy. Latvia, which suffered the most in the global financial crisis, has a somewhat lower GDP per capita but shares a similar trend with its Baltic peers.



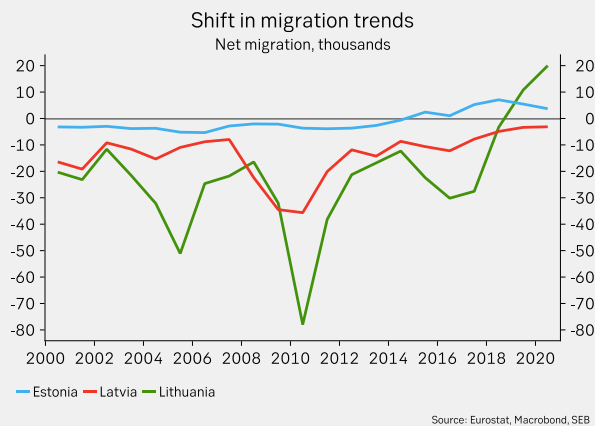
#### Loss of Russian transit flows restructured economies.

Along with the growth in welfare, significant changes have taken place in the structure of the Baltic economies. In Latvia and Estonia, these changes are linked to the diminishing economic relations with Russia. The volume of Russian cargo passing through these countries has declined over the years, reducing the size of their logistics and storage sectors. Both countries have also experienced a gradual decline in manufacturing as a share of GDP. In the 1990s, manufacturing made up around 20 per cent of total value-added, falling to around 12 per cent in Latvia and less than 15 per cent in Estonia by 2021. Both countries are also notable for very low manufacturing productivity. One reason is that many big Nordic companies own production units in the Baltics, while higher value-adding services such as product development and sales stay in their country of origin.

**A shift to service economies.** As a general trend, the role of services has increased in the Baltic economies over the past decade. Lithuania has been very successful in developing its transport sector, taking advantage of its geographic location. Lithuania has also been able to retain a higher share of manufacturing in GDP and thus higher productivity than its Baltic peers. As in many other countries, the role of the IT and tech industry has been increasing in the Baltics. The biggest gains have been made in Estonia, where the information and communication sector has risen to almost 9 per cent of total value added, surpassing such industries as construction, transport and storage.

**Migration trends are changing.** One of the biggest problems for the Baltic countries has been emigration,

which intensified especially in the years right after the global financial crisis. Latvia and Lithuania have lost more than 20 per cent of their populations since 2000. Estonia's population decline has been only 5 per cent. This is related to their differing migration patterns. While Latvians and Lithuanians looked for work far from home – in countries like the UK or Germany – Estonians were more likely to commute weekly to neighbouring Finland. Today the situation has dramatically improved. Net migration turned positive in Estonia in 2015, with Lithuania following in 2019. In Latvia outflows continue to exceed inflows, but this trend seems likely to reverse in the near future. A large share of inward migration has consisted of Baltic citizens returning home, but rising standards of living have also started to draw more people from other countries.



**The Ukraine war is reshaping labour markets.** The rapid economic growth of recent years has made the Baltic labour markets extremely tight. This has forced companies to seek employees from abroad. One important source of foreign labour in recent years has been Ukraine. This has relieved labour shortages in the construction sector, but increasingly also in manufacturing and IT. When the war started, many Ukrainian men left the Baltic countries to defend Ukraine. Instead the Baltics have now welcomed a large number of Ukrainian women and children fleeing the war. By the end of April, Estonia and Latvia had each accepted around 25,000 refugees and Lithuania almost 50,000. Many of these refugees have been remarkably successful in finding jobs. Hopefully this may continue to alleviate some of the previous Baltic labour shortages.



# The Baltics

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## **Lithuania | page 46**

Growth will slow as trade with Russia and Belarus declines, but relations with them have decreased significantly since 2014. Double-digit inflation will cool consumption, and the government will implement an anti-inflationary package.

## **Estonia | page 48**

With the highest April inflation in the EU, consumers are being squeezed and GDP will grow by only 0.6 per cent in 2022. Exports will slow, but low government debt will open the way for more public spending.

## **Latvia | page 47**

Extensive ties with Russia will be manageable, since many export goods can be sold to others. Steel and fertiliser firms face big challenges to replace imports of input goods from the east. Double-digit inflation makes fiscal stimulus necessary.





# Lithuania

## Cutting off ties with Russia and Belarus

Lithuania has greatly reduced its economic relations with Russia since the annexation of Crimea in 2014. Sanctions and a voluntary retreat from Russia and Belarus will lower Lithuanian GDP for two consecutive quarters. The inflation rate is expected to remain in double digits at year-end. Household consumption growth is still strong, but not sustainable. The labour market does not show any signs of weakness yet. The government will sharply increase spending in 2022.

The war in Ukraine had only a limited impact during the first quarter of 2022. GDP increased by 0.9 per cent compared to Q4 2021, confirming solid growth. But this will not be the case in next few quarters, since trade with Russia and Belarus will decline sharply. The magnitude of economic loss will largely depend on the ability of businesses to switch from their current Russian or Belarusian suppliers to other suppliers at reasonable cost. Our growth forecast for this year is 0.9 per cent. We expect a rebound to 1.8 per cent in 2023.

### Key data

Year-on-year percentage change

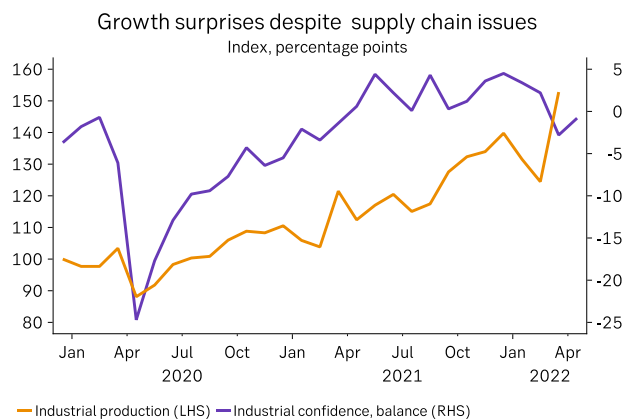
	2020	2021	2022	2023
GDP	-0.1	5.0	0.9	1.8
Household consumption	-2.1	7.4	2.4	2.0
Exports	0.4	15.9	-2.5	2.0
Unemployment*	8.5	7.1	6.8	6.9
Wages and salaries	10.1	10.5	9.0	6.5
HICP inflation	1.1	4.6	14.7	3.8
Public sector fiscal balance**	-7.3	-1.0	-4.5	-2.3

\*% of labour force \*\*% of GDP. Source: Eurostat, SEB

**Almost independent from Russian energy.** As of April, Lithuania completely stopped buying Russian natural gas, and all demand is now satisfied through the Klaipeda LNG terminal. Orlen Lietuva, the only oil refinery in the Baltics, has also replaced Russian crude oil with supplies from other countries. Purchases of electricity from Russia are also minimal, but since the

Lithuanian grid remains synchronised with Russia, a cut-off would cause some tension.

**Replacing suppliers will lead to higher material prices and lower profitability.** Russia and Belarus used to be the main sources for imports of some steel and wood products. Companies in construction, metal processing and furniture production are now working to find new suppliers. So far, industrial production has continued to surprise on the upside. Export order books are strong and companies have solid inventories. Political tensions with China have led to an almost total halt in exports to that country, but imports are almost unaffected.



**Households are becoming more cautious about the future.** Inflation has accelerated well above disposable income growth. The household savings ratio has dropped sharply. People are not in a hurry to reduce real consumption, but instead are using surplus savings accumulated during the pandemic. Demand for labour remains strong, and the integration of Ukrainian refugees into the labour market has been quite successful. Growth in household consumption will decelerate during next few quarters as inflation remains elevated and pay increases become smaller.

**Lithuania has one of the highest inflation rates in the euro area.** Although energy and food prices climbed the most, core inflation also surged, reaching 9 per cent in March. This clearly demonstrates that retailers and service providers have successfully passed higher costs onward to consumers, since demand remains strong. Year-on-year inflation is expected to peak during Q2.

**The government has proposed an anti-inflationary package** that will boost income for low earners and cap increases in electricity and natural gas prices. Defence spending will rise from 2 to 2.5 per cent of GDP. We forecast that such additional expenditures will lead to a budget deficit of 4.5 per cent of GDP in 2022.

## Latvia

# Multiple risks suppressing growth

Economic sentiment slumped in March as the Russian-Ukrainian war raged, adding to already high uncertainty. The year started on a strong note, but momentum will decelerate. We have lowered our GDP growth forecast for 2022 to 1.8 per cent and to 2.5 per cent for 2023. Inflation should peak in the third quarter. Unemployment will increase to 7.1 per cent by year-end, cooling wage growth to around 7.5 per cent.

**Strong start to the year.** Incoming data have so far confirmed that 2022 started on a strong footing. However, in March sentiment slumped in all sectors except retail. In the first half of the year household consumption will be one of the main growth drivers. There is still good momentum in manufacturing and exports. In the second half, the negative impact of high inflation and sanctions on Russian trade will become more pronounced and weaken momentum. We expect GDP to grow by 1.8 per cent this year and 2.5 per cent in 2023. Crucial factors will include epidemiological obstacles, the energy market situation and Latvia's success in finding substitutes for Russian trade.

### Key data

Year-on-year percentage change

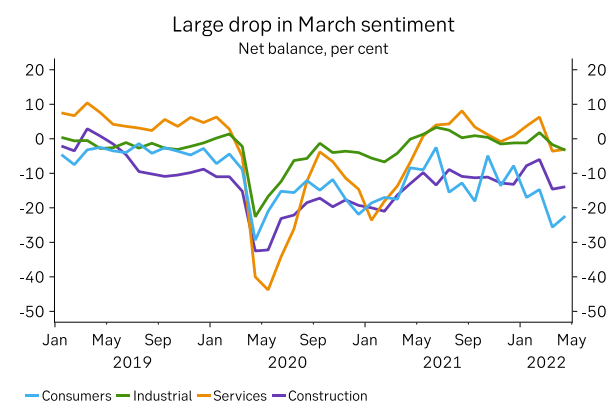
	2020	2021	2022	2023
GDP	-3.6	4.8	1.8	2.5
Household consumption	-10.0	4.8	2.5	3.7
Exports	-2.7	6.2	2.3	4.0
Unemployment*	8.1	7.6	7.4	7.3
Wages and salaries	6.2	11.8	7.1	8.2
HICP inflation	0.1	3.3	10.7	3.6
Public sector fiscal balance**	-4.5	-7.3	-4.2	-2.6

\*% of labour force \*\*% of GDP. Source: Statistics Latvia, SEB

### Russian-related risks are significant but manageable.

Export growth in the first two months this year was still around 30 per cent but waning Russian trade will halt expansion. The Russian market usually accounts for about 7.3 per cent of total exports. The largest category

of goods is non- and alcoholic beverages, which account for a quarter of exports. Reorienting this category could be made easier by replacing banned Russian beverages. More time-consuming will be reorienting trade in machinery and electrical equipment. A huge test will be the replacement of iron and steel products as well as fertilisers. Existing stocks will provide a breather. The Russian factor will exacerbate inflationary pressure and complicate capital spending, but EU funds will act as a stabiliser. Manufacturing and agriculture could see increased export opportunities westwards, allowing export growth of around 10 per cent in 2023.



**Double-digit inflation.** In March the inflation rate reached 11.5 per cent. Food, transport and housing were the key drivers, contributing 9.1 percentage points. The situation is challenging, with both energy and food sharply reducing purchasing power. These two components account for 40 per cent of the consumption basket, among the highest in the EU. Inflation will start abating in 2023 but still remain somewhat elevated.

**Lower pay rises covered by savings.** Wage and salary growth will cool to 7.1 per cent this year. Savings accumulated during the pandemic will now be used. The number of people struggling to cover their expenses will increase. Unemployment is edging higher and will dampen wage growth in 2022, but pay increases will accelerate in 2023. The government needs to prepare new stimulus measures that consider various scenarios. Targeted measures would be more efficient, but general support may also be needed to limit disproportionate cost increases, especially for utilities and food.

### Public finances in 2021 were better than expected.

The budget deficit reached 7.3 per cent of GDP and public sector debt rose to 44.8 per cent of GDP 2021, allowing some manoeuvring room for fiscal stimulus. Parliamentary elections are due on October 1. The current geopolitical situation might make it easier for the current governing parties to stay in power, since there could be less demand for populist policies.

## Estonia

## Headwinds from high inflation

Uncertainties about the economic outcome of Russia's war in Ukraine continue to shroud the forecasting horizon. Due to very high inflation, we expect real GDP growth to be limited to only 0.6 per cent in 2022. However, nominal growth as well as business activity will remain strong. As inflation eases, growth will pick up in 2023, but a moderation in demand as well as supply side constraints will limit expansion to 2.0 per cent.

## Trade with Russia is not as important as it once was.

Since the annexation of Crimea, trade volume with Russia has been on a downward trend. In 2021 it constituted only 4 per cent of total merchandise exports. In addition, more than half of this trade consisted of low value-added re-exports. The further loss of trade volume will affect the transport and wholesale sector negatively, but also manufacturing. Possibly more important, exports will also be hindered by slower growth in Finland, Estonia's largest trading partner. We thus expect the growth in exports to be only 3.8 per cent in 2022. On the import side, Russia is more important, especially for large wood and metal processing companies. In the short term, this might be a more difficult headwind than slower export growth.

## Key data

Year-on-year percentage change

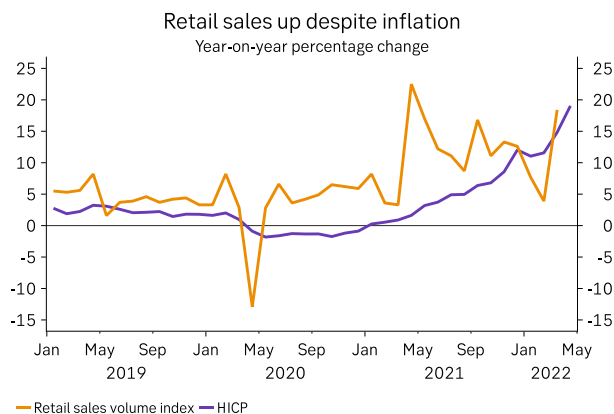
	2020	2021	2022	2023
GDP	-3.0	8.3	0.6	2.0
Private consumption	-2.5	6.3	0.8	2.4
Exports	-5.0	19.8	3.8	5.0
Unemployment*	6.8	6.2	5.6	5.5
Wages and salaries	2.9	6.9	7.0	6.5
HICP inflation	-0.6	4.5	13.0	0.8
Public sector fiscal balance**	-5.6	-2.4	-2.9	-2.0

\*% of labour force \*\*% of GDP. Source: Eurostat, SEB

**The biggest concern continues to be inflation.** In April, year-on-year HICP reached 19 per cent, the highest inflation in the euro area. With energy and food making up one third of Estonia's consumer basket, the outlook does not look good, but due to a higher base in 2021 year-on-

year inflation will gradually slow during the coming months. We estimate that HICP will average approximately 13 per cent in 2022. In 2023 inflation will be limited to 0.8 per cent.

**A slowdown in household demand seems imminent.** For now, there is little hard data to confirm this. In March retail sales volume grew by 18 per cent despite almost 15 per cent inflation. Wage and salary growth is likely to have remained strong in the first quarter, helping households to cope despite fast-increasing prices. Pay hikes will not fully offset the surge in prices, but the previously very high savings ratio will provide a buffer. The year-on-year increase in household savings was 13 per cent in March, confirming there is potential not only to cope with increasing costs, but also increase consumption volume. In the coming months households are unlikely to remain as optimistic, which is why private consumption growth will be limited to 0.8 per cent this year.



**New era in the labour market?** A tight labour market has become almost a permanent condition in the past couple of years. Now up to 12,000 working-age Ukrainian refugees may soon be seeking jobs. Those who have already done so have been remarkably successful. This will ease shortages in some sectors but also hold back wage growth. Since the methodology of the Labour Force Survey fails to address quick changes in the labour supply, unemployment will fall to 5.6 per cent this year.

**Government spending will increase.** Strong tax revenues and high GDP growth kept the 2021 budget deficit below our forecasts. These gains will come in handy. The government has approved a supplementary budget of EUR 800 million to cover the costs of helping refugees, but also to expand ammunition stockpiles to counter potential threats. Another budget bill seems likely this autumn. We expect the deficit to reach 2.9 per cent and public debt 20.5 per cent of GDP in 2022. Given current geopolitical conditions, few will complain.

## Global key indicators

Yearly change in per cent

	2020	2021	2022	2023
GDP OECD	-4.6	5.5	2.6	2.3
GDP world (PPP)	-3.2	6.1	3.0	3.4
CPI OECD	1.4	4.0	7.5	4.1
Oil price, Brent (USD/barrel)	43	71	106	85

## US

Yearly change in per cent

	2020 level, USD bn	2020	2021	2022	2023
Gross domestic product	22,996	-3.4	5.7	2.6	1.7
Private consumption	15,742	-3.8	7.9	2.8	1.6
Public consumption	3,250	2.0	1.0	-0.3	1.4
Gross fixed investment	4,942	-2.0	6.1	3.2	3.0
Stock building (change as % of GDP)	-20	-0.6	0.1	0.7	-0.4
Exports	2,478	-13.6	4.5	3.7	3.6
Imports	3,397	-8.9	14.0	7.3	1.1
Unemployment (%)		8.1	5.4	3.7	4.1
Consumer prices		1.2	4.7	7.5	4.2
Core CPI		1.7	3.6	5.7	3.9
Household savings ratio (%)		16.6	12.3	9.5	8.5
Public sector fiscal balance, % of GDP		-14.5	-10.2	-5.0	-4.0
Public sector debt, % of GDP		134	134	129	127

## Euro area

Yearly change in per cent

	2020 level, EUR bn	2020	2021	2022	2023
Gross domestic product	11,405	-6.4	5.4	2.1	2.8
Private consumption	5,905	-7.9	3.5	1.1	2.4
Public consumption	2,572	1.1	3.9	1.9	1.6
Gross fixed investment	2,497	-7.0	4.2	4.6	4.8
Stock building (change as % of GDP)	0	-0.5	0.4	-0.1	-0.1
Exports	5,177	-9.1	11.0	6.0	4.0
Imports	4,754	-9.0	8.8	6.0	4.0
Unemployment (%)		8.0	7.7	6.9	7.2
Consumer prices		0.3	2.6	7.4	3.0
Core CPI		0.7	1.5	4.0	3.1
Household savings ratio (%)		19.5	17.8	14.2	13.4
Public sector fiscal balance, % of GDP		-7.1	-5.1	-4.3	-3.2
Public sector debt, % of GDP		97.2	95.6	93.0	98.0



## Other large countries

Yearly change in per cent

	2020	2021	2022	2023
<b>GDP</b>				
United Kingdom	-9.3	7.4	3.7	2.5
Japan	-4.5	1.6	2.3	1.9
Germany	-4.6	2.9	1.5	3.2
France	-7.9	7.0	2.5	1.9
Italy	-9.0	6.6	2.5	2.5
China	2.2	8.1	5.0	5.2
India	-6.7	8.3	4.3	7.5
Brazil	-3.9	4.8	0.9	2.0
Russia	-3.0	4.7	-10.0	-3.0
Poland	-2.5	5.7	3.5	4.0

### Inflation

United Kingdom	0.9	2.6	8.3	5.4
Japan	0.0	-0.2	1.9	1.3
Germany	0.4	3.2	7.4	2.4
France	0.5	2.1	5.6	2.9
Italy	-0.1	1.9	7.1	2.9
China	2.2	0.9	2.4	2.1
India	6.6	5.1	5.4	5.0
Brazil	3.2	8.3	8.5	5.0
Russia	3.4	6.7	19.0	15.0
Poland	3.4	5.1	11.0	7.0

### Unemployment (%)

United Kingdom	4.5	4.5	3.8	4.2
Japan	2.8	2.8	2.6	2.5
Germany	3.8	3.6	3.3	3.5
France	8.0	7.9	7.3	7.6
Italy	9.3	9.5	8.3	8.5

## Financial forecasts

Official interest rates		May 5	Jun-22	Dec-22	Jun-23	Dec-23
US	Fed funds	1.00	1.50	3.00	3.50	3.50
Japan	Call money rate	-0.10	-0.10	-0.10	-0.10	-0.10
Euro area	Refi rate	0.00	0.00	0.50	0.75	1.25
United Kingdom	Repo rate	0.75	1.25	1.75	2.00	2.25

### Bond yields

US	10 years	2.93	3.10	3.40	3.50	3.50
Japan	10 years	0.22	0.25	0.25	0.40	0.40
Germany	10 years	0.98	1.00	1.30	1.45	1.60
United Kingdom	10 years	1.98	2.00	2.30	2.45	2.60

### Exchange rate

USD/JPY	130	131	133	130	127
EUR/USD	1.05	1.04	1.07	1.11	1.15
EUR/JPY	137	136	142	129	146
EUR/GBP	0.84	0.85	0.87	0.89	0.90
GBP/USD	1.25	1.22	1.23	1.25	1.28

## Sweden

Yearly change in per cent

	2020 level, SEK bn	2020	2021	2022	2023
Gross domestic product	5,381	-2.9	4.8	1.8	1.8
Gross domestic product, working day adjustment		-3.2	4.7	1.9	1.9
Private consumption	2,357	-4.7	5.8	1.6	1.0
Public consumption	1,411	-1.3	2.8	0.8	0.8
Gross fixed investment	1,358	-0.3	6.1	3.0	2.5
Stock building (change as % of GDP)	20	-0.7	0.4	0.2	0.0
Exports	2,489	-4.6	7.5	3.7	4.4
Imports	2,255	-5.6	9.4	4.3	3.6
Unemployment, (%)		8.5	8.8	7.6	7.5
Employment		-1.3	1.1	2.1	0.4
Industrial production		-4.5	8.8	2.0	2.0
CPI		0.5	2.2	6.1	4.2
CPIF		0.5	2.4	5.9	3.0
Hourly wage increases		2.1	2.7	2.7	3.5
Household savings ratio (%)		18.0	17.1	14.1	13.0
Real disposable income		-0.1	4.0	-1.4	-0.4
Current account, % of GDP		6.1	5.5	5.0	4.5
Central government borrowing, SEK bn		-221	78	200	10
Public sector fiscal balance, % of GDP		-2.7	-0.2	0.3	0.2
Public sector debt, % of GDP		39.6	36.7	31.9	29.1

Financial forecasts	May 5	Jun-22	Dec-22	Jun-23	Dec-23
Repo rate	0.25	0.50	1.25	1.75	1.75
3-month interest rate, STIBOR	0.42	0.70	1.50	1.85	1.85
10-year bond yield	1.93	2.00	2.30	2.35	2.50
10-year spread to Germany, bps	95	100	100	90	90
USD/SEK	9.87	9.90	9.49	8.60	8.43
EUR/SEK	10.40	10.30	10.15	9.55	9.70
KIX	119.2	118.7	116.6	108.9	109.6

## Finland

Yearly change in per cent

	2020 level, EUR bn	2020	2021	2022	2023
Gross domestic product	238	-2.3	3.5	1.8	1.5
Private consumption	122	-4.1	3.1	2.0	1.7
Public consumption	58	0.4	3.2	2.5	1.0
Gross fixed investment	58	-0.3	1.2	2.7	1.8
Stock building (change as % of GDP)	1	0.3	1.0	0.7	0.4
Exports	85	-7.5	4.7	2.8	3.5
Imports	85	-6.6	5.3	2.3	2.7
Unemployment, OECD harmonised (%)		7.7	7.6	6.8	6.5
CPI, harmonised		0.3	2.1	4.5	1.8
Hourly wage increases		1.8	2.3	2.5	2.2
Current account, % of GDP		0.8	0.9	0.1	-0.2
Public sector fiscal balance, % of GDP		-5.5	-2.6	-2.2	-1.8
Public sector debt, % of GDP		69.0	65.8	66.1	67.0

## Norway

Yearly change in per cent

	2020 level, NOK bn	2020	2021	2022	2023
Gross domestic product	3,538	-0.7	3.9	3.6	2.9
Gross domestic product (Mainland)	2,992	-2.3	4.2	3.7	1.5
Private consumption	1,475	-6.6	5.0	5.9	3.2
Public consumption	884	1.8	3.9	1.2	1.5
Gross fixed investment	904	-5.6	-0.3	3.1	4.3
Stock building (change as % of GDP)		-0.4	-0.1	0.3	0.0
Exports	1,276	-1.2	4.8	5.0	4.2
Imports	1,091	-11.9	2.0	6.9	4.8
Unemployment (%)		4.6	4.3	3.1	3.2
CPI		1.3	3.5	4.1	2.2
CPI-ATE		3.0	1.7	2.7	2.5
Annual wage increases		3.1	3.5	4.0	3.6

Financial forecasts	May 5	Jun-22	Dec-22	Jun-23	Dec-23
Deposit rate	0.75	1.00	1.75	2.25	2.25
10-year bond yield	2.89	2.90	3.10	3.20	3.25
10-year spread to Germany, bps	191	190	180	175	165
USD/NOK	9.41	9.28	9.25	8.74	8.43
EUR/NOK	9.93	9.65	9.90	9.70	9.70

## Denmark

Yearly change in per cent

	2020 level, DKK bn	2020	2021	2022	2023
Gross domestic product	2,330	-2.1	4.8	2.4	2.4
Private consumption	1,042	-1.4	4.4	3.3	2.5
Public consumption	574	-1.7	3.7	2.1	1.9
Gross fixed investment	521	5.1	5.9	4.1	5.9
Stock building (change as % of GDP)		-0.1	0.3	-0.3	0.0
Exports	1,278	-6.9	8.0	3.0	3.8
Imports	1,128	-4.1	8.5	4.1	4.6
Unemployment, OECD harmonised (%)		6.0	4.5	4.3	3.9
CPI, harmonised		0.4	1.9	5.9	3.7
Hourly wage increases		1.9	2.3	2.9	3.7
Current account, % of GDP		7.5	7.5	7.5	6.5
Public sector fiscal balance, % of GDP		-3.0	0.5	2.0	4.0
Public sector debt, % of GDP		44.0	40.0	35.0	30.0

Financial forecasts	May 5	Jun-22	Dec-22	Jun-23	Dec-23
Deposit rate	-0.60	-0.60	0.15	0.40	0.90
10-year bond yield	1.24	1.24	1.52	1.65	1.80
10-year spread to Germany, bps	26	26	26	26	26
USD/DKK	7.05	7.15	6.95	6.70	6.48
EUR/DKK	7.44	7.44	7.44	7.44	7.45

## Lithuania

Yearly change in per cent

	2020 level, EUR bn	2020	2021	2022	2023
Gross domestic product	50	-0.1	5.0	0.9	1.8
Private consumption	29	-2.1	7.4	2.4	2.0
Public consumption	9	-0.4	0.5	0.3	0.1
Gross fixed investment	10	-1.8	7.0	0.0	5.0
Exports	36	0.4	15.9	-2.5	2.0
Imports	32	-4.4	18.7	-1.8	2.8
Unemployment (%)		8.5	7.1	6.8	6.9
Wages and salaries		10.1	10.5	9.0	6.5
Consumer prices		1.1	4.6	14.7	3.8
Public sector fiscal balance, % of GDP		-7.3	-1.0	-4.5	-2.3
Public sector debt, % of GDP		46.6	44.3	41.5	42.3

## Latvia

Yearly change in per cent

	2020 level, EUR bn	2020	2021	2022	2023
Gross domestic product	29.3	-3.6	4.8	1.8	2.5
Private consumption	16.1	-10.0	4.8	2.5	3.7
Public consumption	5.9	2.6	4.4	3.0	2.5
Gross fixed investment	6.9	0.2	3.0	3.5	4.1
Exports	17.7	-2.7	6.2	2.3	4.0
Imports	17.3	-3.3	13.5	5.0	4.2
Unemployment (%)		8.1	7.5	7.4	7.3
Wages and salaries		6.2	11.8	7.1	8.2
Consumer prices		0.1	3.3	10.7	3.6
Public sector fiscal balance, % of GDP		-4.5	-7.3	-4.2	-2.6
Public sector debt, % of GDP		43.5	44.8	46.1	45.2

## Estonia

Yearly change in per cent

	2020 level, EUR bn	2020	2021	2022	2023
Gross domestic product	27	-3.0	8.3	0.6	2.0
Private consumption	13	-2.5	6.3	0.8	2.4
Public consumption	6	3.0	3.9	3.5	2.5
Gross fixed investment	8	19.9	3.3	-7.0	3.5
Exports	19	-5.0	19.8	3.8	5.0
Imports	19	0.9	20.6	2.0	4.0
Unemployment (%)		6.8	6.2	5.6	5.5
Wages and salaries		2.9	6.9	7.0	6.5
Consumer prices		-0.6	4.5	13.0	0.8
Public sector fiscal balance, % of GDP		-5.6	-2.4	-2.9	-2.0
Public sector debt, % of GDP		19.0	18.1	20.5	22.0



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