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Swedbank Economic Outlook

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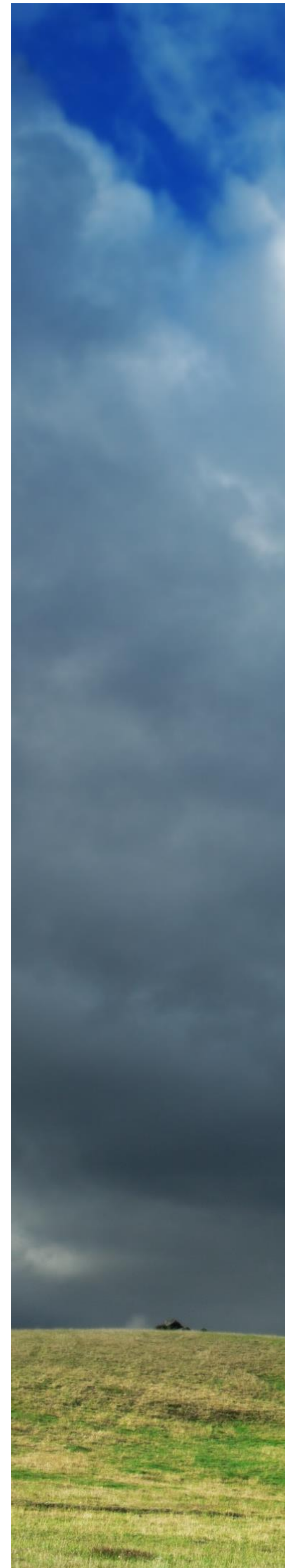

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Resilience and divergence for now, but convergence and stagnation ahead

The rise in central bank policy rates to fight inflation is at peak or close to peak. Inflation is expected to decline, even if core inflation is declining more gradually. So far, many economies have turned out to be more resilient than previously presumed, and labour markets remain tight. But there is divergence among countries. For example, the US economy has so far grown above trend despite the aggressive hiking cycle, whereas the German economy is struggling, the Chinese economy has been a disappointment, and the Swedish economy is clearly coming to a halt.

However, a convergence to low growth across countries and sectors is ahead of us. Monetary policy will remain restrictive in the near term, and central banks will have to wait to pivot and apply lower policy rates, so that the risk of inflation rising again can be avoided. Global economic growth is already showing signs of weakness, and growth will be pulled down further by the lagging effects of higher interest rates and tighter financial conditions.

> “Economic growth will be pulled down further”

Fiscal policy will not be supportive, given that debt levels have risen in many countries, and there is a need to gradually restore fiscal buffers and put debt dynamics on a more sustainable footing.

A soft landing of the global economy appears to be possible. Labour markets will worsen, which will help push down wage growth and, hence, inflation risks, but the increase in unemployment will still be contained. Consumption and investments will decrease, and global trade will continue downwards, possibly reinforced by global fragmentation. Also, financial stability risks appear to be contained for now.

> "Financial stability risks appear contained"

However, a more abrupt and adverse economic development cannot be ruled out. If the economic resilience continues, it could force central banks to extend the hiking cycle of policy rates even further to get inflation down. This could increase financial market volatility and exhaust asset prices, and possibly also increase and expose the global financial system to systemic risk – with the outcome being a much harder and deeper economic downturn.

> "A much harder and deeper economic downturn"

Mattias Persson
Group Chief Economist

0.6%

Mediocre GDP growth in the euro area also in 2024

4.30%

10-year US government bond yield December 2023

4.25%

Riksbank policy rate will peak in November 2023

0 & 1

Rate hikes from the Fed and ECB respectively

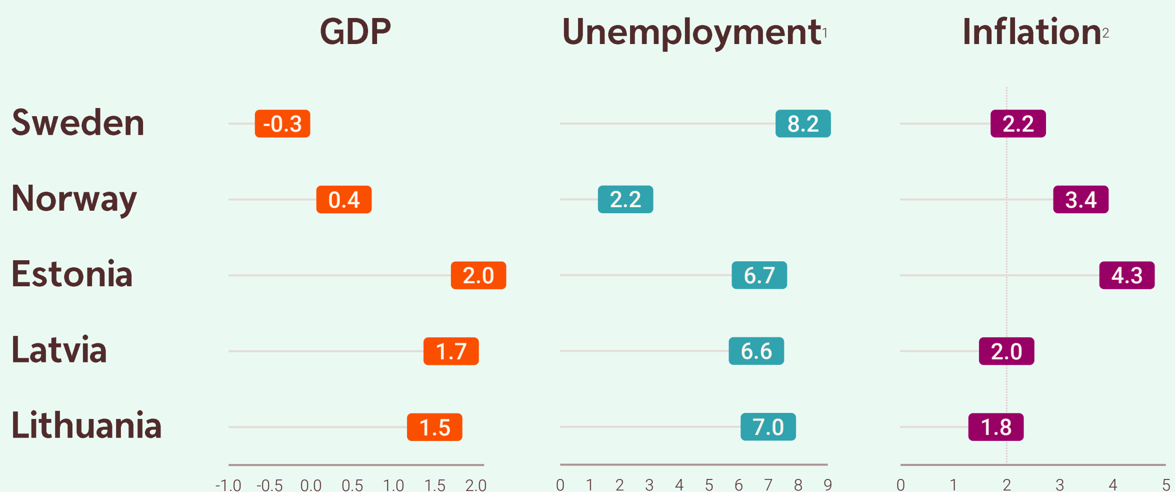
Q2

The quarter in 2024 when the Fed and the ECB will start slashing their rates

12.10

EUR/SEK December 2023

2024 Outlook



[1] Refers to LFS except for Norway, where it refers to the registered unemployment rate (NAV).
[2] Refers to CPI except for Sweden, where CPIF is shown.

Global Outlook

1. The **resilience** seen so far in many countries is **about to crack**. We forecast that global economic activity will slow down starting this autumn and continue slowing into 2024. Household consumption has been sluggish for some time, and we have most likely not yet seen the full impact of higher interest rates. Meanwhile, the global manufacturing cycle is turning down.

2. In both the US and the euro area, **inflation** will continue to fall in the coming months and be **normalised by mid-2024**. The global easing of supply chains, plummeting input costs and declining energy costs have supported monetary policies in bringing inflation down.

Financial Markets

1. The **Fed** has finished its rate hikes in this cycle and the **ECB** is expected to hike one more time in September. Both will gradually start easing monetary **policies** in the second quarter of 2024. We expect Fed funds rate (upper bound) at 3.0% and the ECB's deposit rate at 1.75% at the end of 2025.

2. Government **bond yields** will hover around current levels for the remainder of this year. Volatility will remain high. Beginning next year, when inflation has normalised, we expect that markets will start to price in rate cuts from central banks; this will put downward pressure on yields on all maturities, but especially on the ones with shorter durations.

3. The gloomy global outlook is expected to strengthen the **US dollar** vis-à-vis the euro in the near term, while the **Swedish krona** is expected to weaken further. Beginning mid-2024, as the global economy starts to recover and interest rates decline, the US dollar will weaken while both the Swedish krona and Norwegian krone gain some lost ground.

Sweden

1. Sweden is facing **two years of shrinking GDP** in the wake of low domestic demand and a slowdown in export growth. A recovery is expected to begin next year and strengthen further in 2025.

2. The labour market will weaken later this year, but the **fall in employment** is **expected to be limited**. Unemployment will peak at 8.3% at the end of 2024.

3. **Tight economic policy** is contributing to the downturn. The Riksbank will, however, begin a series of rate cuts in June next year, when price pressures have subsided and the economy has weakened. In the course of 2025, we estimate that inflation will fall below 2%.

Baltics

1. Estonian **GDP** has continued to shrink for six quarters in a row and its economy is likely to be the **worst hit** in the EU this year, while the Latvian and Lithuanian economies are **stagnating**.

2. Despite the weaker economy, the **labour market** has remained resilient, employment is close to record highs, and wage growth has barely decelerated. **Exports may weaken** further, however, which may affect employment in the worst-hit sectors.

3. **Inflation** is down sharply, and wages are growing faster than prices again; this will support household consumption going forward. Rapid wage growth poses some risks for both inflation and exporters' **competitiveness**.

Global – the economic autumn has arrived

The sudden jump in the cost of living in 2022, and the aggressive monetary policy that followed, will eventually hit the global economy. A range of indicators suggests that the manufacturing cycle has turned, while services are just starting to show signs of weakening. The resilience seen so far in many countries is about to crack.

A lasting downturn

When it comes to the global economy, there is some good news. Inflation has peaked and is on a clear downward trend almost everywhere. For the most part, central banks have finished raising policy rates, though lowering them still seems distant. Also, economies and labour markets have so far shown an astonishing resilience to the range of economic shocks that occurred in 2021 and 2022.

Nevertheless, we forecast that global economic activity will slow down starting this autumn and well into 2024. Household consumption and investments, not least in the construction sector, have been sluggish for quite some time, and we have most likely not yet seen the full impact of higher interest rates. Indicators clearly point to a slowdown of the global manufacturing cycle.

Swedbank's GDP forecast

Annual % change	2022	2023F		2024F		2025F
US	2.1	2.0	(1.2)	0.4	(0.5)	1.8
China	3.0	5.0	(5.5)	4.8	(5.0)	4.5
Euro area	3.4	0.5	(0.4)	0.6	(0.7)	1.5
Germany	1.9	-0.3	(0.1)	0.5	(0.7)	1.4
France	2.5	0.8	(0.5)	0.7	(0.7)	1.4
Italy	3.8	0.8	(0.5)	0.4	(0.6)	1.3
Spain	5.5	2.2	(1.2)	0.9	(0.9)	1.9
Estonia	-0.5	-2.0	(-0.8)	2.0	(2.3)	3.0
Latvia	2.8	0.3	(0.6)	1.7	(2.1)	2.8
Lithuania	1.9	-0.3	(-0.3)	1.5	(1.8)	2.3
Sweden	2.8	-1.1	(-1.3)	-0.3	(0.3)	2.1
Norway	3.7	1.3	(1.0)	0.4	(0.4)	1.0
United Kingdom	4.1	0.5	(-0.3)	0.5	(0.8)	0.7

Previous forecast in parentheses.

Source: Swedbank Research

Economic development has varied significantly across countries and sectors. While the US economy has surprised on the upside so far this year, China has disappointed. Within the euro area, we also see diverging developments, with Germany struggling while France, Italy and Spain seem more resilient. (More details on the major economies below.) On a sectoral level, there are now plenty of signs that a slowdown within the manufacturing sector is ongoing. Sentiment indicators such as the purchasing managers' index (PMI) suggest falling manufacturing production in both the US and the euro area. Global trade in goods has fallen during the past year. On aggregate, the services sectors are still holding up relatively well, although we believe that the high inflation and interest rates will eventually also hit this sector. Housing markets are in trouble in many parts of the world.

In most countries, inflation is expected to have normalised within a year

The global easing of supply chains, plummeting energy prices and declining input costs have aided monetary policies in moderating inflation. In the US, the most recent data suggests that the inflation momentum has fully normalised, i.e. the monthly price changes are running at around 2% in annualised terms. Inflation has been stickier in the euro area, which is mainly explained by services inflation. Overall, we expect inflation to have normalised within a year, in terms of most measures and in most countries.

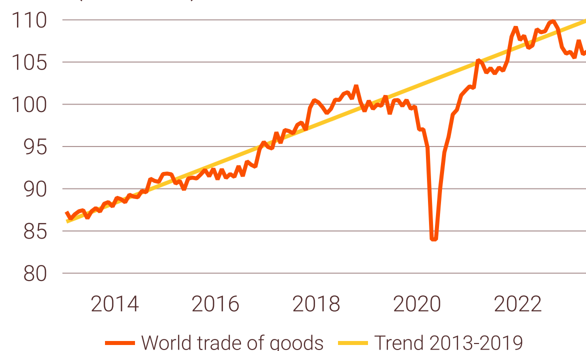
Central banks will be prone to erring on the hawkish side

Despite this relatively benign inflation outlook, we expect both the Fed and the ECB to be on hold until the second quarter of next year before they start cutting rates. Inflation is expected to come down only gradually, and there are still some upside risks to the inflation. Also, we believe that central banks will be prone to erring on the hawkish rather than the soft side. As from mid-2024 we forecast that most central banks, including the Fed and the ECB, have embarked on a rate-cutting journey that will continue until the end of 2025, which is the end of our forecast horizon.

As policy rates will stay on a relatively high level for longer, the economic recovery will be held back. We forecast that a gradual recovery will start during the second half of next year and continue throughout 2025.

World trade of goods

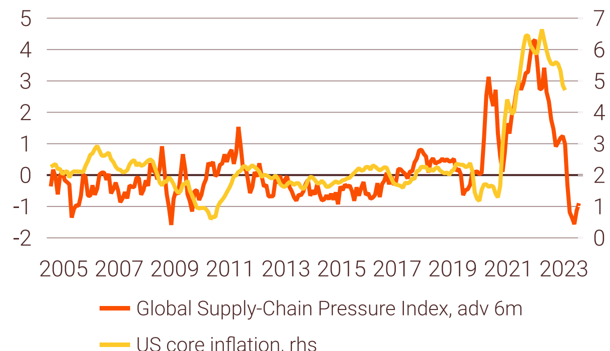
Index (2019=100)



Sources: Swedbank Research & Macrobond

Easing supply-chains, lower inflation

Index (lhs); y/y % (rhs)



Sources: Swedbank Research & Macrobond

However, the recovery will be unimpressive as the economies will grow slowly, hardly reaching their pre-pandemic trend growth levels even by 2025. The outlook is, however, uncertain. The global economy could continue to show a surprising resilience, which in turn would likely lead to elevated policy rates for longer, even if inflation normalises. On the other hand, a harsher landing of the global economy cannot be ruled out; we elaborate on a more pessimistic alternative scenario on p.12.

Financial markets – steeper yield curves, weaker US dollar (just not yet)

Government bond yields rose markedly in 2022 but have trended largely sideways this year. US government bond yields have trended somewhat higher in recent weeks, presumably as a consequence of the active selling of bond holdings by the Fed (quantitative tightening) and a continued large issuance of bonds to finance the bulging budget deficit. In addition, US medium-term fiscal management has been called into question by Fitch Ratings Agency, which downgraded the US credit rating this summer; this may have put further pressure on yields.

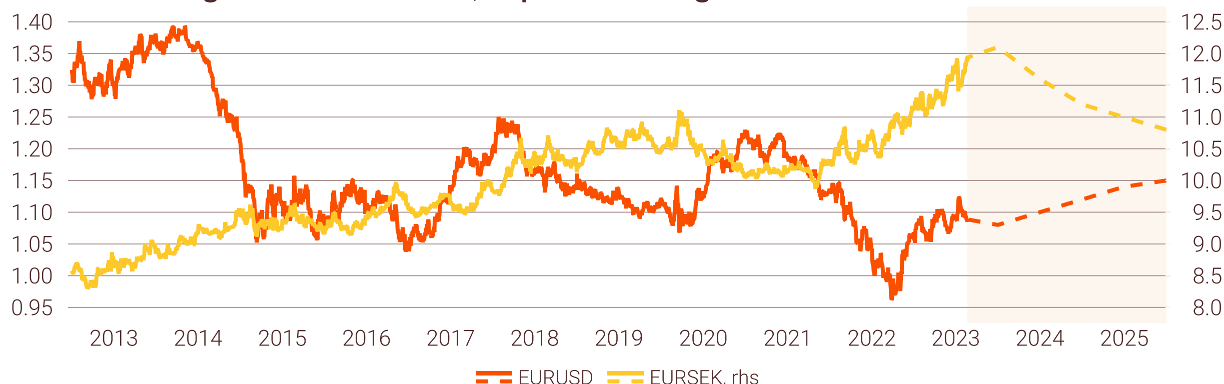
We expect bond yields to stay largely at current levels for the remainder of this year, although volatility will remain high. As from next year, when inflation has normalised, we expect markets to start to price in rate cuts from central banks, which will put downward pressure on yields of all maturities but especially those with shorter durations. The yield curve is therefore expected to steepen from current levels.

Tough times for Scandinavian currencies

The currency market has been volatile this year. Netting out this volatility, the US dollar has weakened somewhat vis-à-vis the euro so far this year, although it has remained on a strong level in a historical perspective. We expect the dollar to strengthen a bit in the near term on the back of the gloomy outlook, but that it will start to weaken later next year when global growth starts to recover and inflation normalises.

The Scandinavian currencies, in particular the Swedish krona, have weakened further this year. Besides an overall low risk appetite for smaller,

US dollar: strength in the near tearm, depreciation longer out



Sources: Swedbank Research & Macrobond

more illiquid currencies, the Swedish krona has probably also weakened on the back of the economy's vulnerability to higher interest rates (emanating from the real estate sector). The Swedish economy is likely to be one of the EU's worst-performing economies next year. The Norwegian krone has recovered somewhat during the summer on the back of higher oil prices and increasing expectations of rate hikes from Norges Bank.

Looking ahead, we expect the Scandinavian currencies to weaken somewhat further until the end of this year. As from mid-2024, as the global economy starts to recover and interest rates decline, both the Swedish krona and Norwegian krone are expected to strengthen somewhat.

The probability of a hard landing remains uncomfortably high

This year started with an almost unanimous expectation that the US and other major economies would be heading into recession. The only uncertainty, it seemed, was whether the landing would be soft or hard. Any kind of landing has been avoided so far, and we continue to forecast only mild contractions of GDP, without major damage to the labour markets. However, we cannot rule out a scenario where many countries may be facing a synchronised, deeper, and longer-lasting downturn.

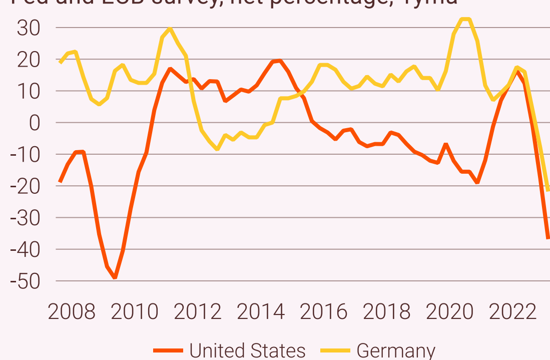
The better-than-expected growth in the US during the first half of this year should not be overplayed or mistaken for an unwavering resilience. The growth of the US economy was supported by the fiscal stimulus, pandemic-era excess savings (which are largely depleted now), and continued strength of the labour market. For China, the damage to the economy from the pandemic, the botched economic policy, and, especially, an ongoing real estate crisis is proving to be larger and may last longer than expected. The euro area has shrugged off the energy crisis, but growth has continued to disappoint on most fronts since the spring. If US growth stutters, all three large economic regions may be facing a synchronised and self-reinforcing downturn.

What might trigger this? Restrictive monetary policy and a turning credit cycle are the obvious candidates. This spring, the timely official response to the cracks seen in the banking sector (mainly in the US) helped to avoid wider panic and a negative effect on business and household sentiment. However, the quality of the banks' balance sheets is likely to continue deteriorating in the US (note the recent credit-rating downgrades) and other countries, especially where residential and commercial real estate prices are continuing to fall. This will further dampen banks' willingness and ability to extend credit. Large credit events cannot be ruled out and may further dent confidence, business investments, and consumption. Many businesses had record profits and profitability in 2022, which allowed them to hoard labour even when demand was weakening (see box on labour market resilience). However, if demand for goods (and, increasingly, services) weakens, pricing power ebbs, and financial conditions tighten further, a rise in unemployment will be much more likely. Such a scenario would further dent household consumption, strain corporate finances, and amplify the already-visible negative economic trends. In such a scenario, to avoid a larger fallout, central banks would need to pivot and cut interest rates faster and sharper than currently expected by the markets.

There is an alternative – almost mirror-image – risk. If demand and labour markets continue to show resilience (due to, e.g., expansive fiscal policies), services inflation may prove to be stickier, and new sources of inflation may emerge (natural gas and oil prices have spiked during recent weeks, and the supply of food commodities may be further disrupted). In this scenario, central banks would have to continue hiking interest rates, albeit through clenched teeth. Even-higher interest rates could further dent asset prices and restrict availability of and demand for credit. The descent and landing would hardly be avoided: it would merely be postponed and start from more dizzying heights.

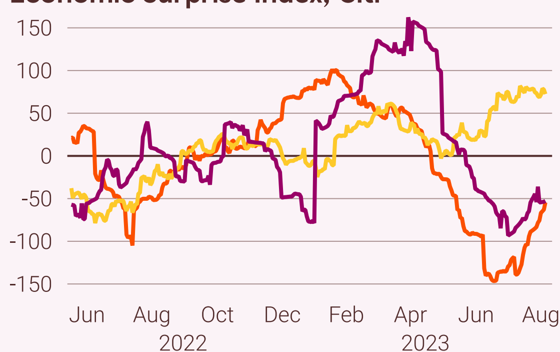
Demand for business loans

Fed and ECB survey, net percentage, 1yma



Sources: Swedbank Research & Macrobond

Economic Surprise Index, Citi



Sources: Swedbank Research & Macrobond

Euro area – inflation is slowing; so is the economy

The second quarter brought a brief relief to the European economy. Retreating inflation is allowing household purchasing power to recover, and the labour market is exceptionally strong. However, export demand and industrial performance are continuing to weaken and risk dragging the rest of the economy with them.

After stagnation in the winter, the second quarter brought modest growth back to Europe. The euro-area economy expanded by 0.3% during the second quarter. Easing inflation led to a stabilisation of household purchasing power that boosted confidence and growth. The labour market continued to improve, and the unemployment rate fell to an all-time-low of 6.4%.

However, the respite might be short-lived. The manufacturing sector reports weakening demand and contracting output. Energy-intensive industries are still being squeezed by higher-than-normal energy prices, while foreign demand is faltering. Concerningly, industrial weakness seems to be contagious – confidence in the services sector is faltering as well. The purchasing managers' index (PMI) indicates slowing economic activity across sectors in the beginning of the third quarter.

Inflation is expected to fall below 3% by year's end

Admittedly, the outlook varies significantly across countries. Germany felt the energy shock more than many of its European peers: its economy has already not grown for several quarters. Early industrial and transportation data indicate that Europe's largest economy is quite likely to contract

slightly during the third quarter as well. France, Italy, and Spain face similar problems within the industrial sector, but more robust domestic demand will ensure at least a modest expansion.

On the brighter side, inflation is on an unwavering downward trend. Headline inflation fell to 5.3% in July, and we forecast it to fall below 3% by year's end. Inflation, excluding energy and food, has been more stubborn but has nonetheless peaked and will fall sharply later this year. Strong demand and rapid wage growth have contributed to higher and stickier inflation in services, but ebbing economic activity is likely to dampen price growth here as well, especially in 2024.

Easing inflation and strong employment should support domestic demand in the second half of the year. Household consumption is likely to expand modestly, but private investment and, especially, construction will be subdued due to high financing costs. Investment activity will be held up somewhat by public investments in defence and the energy transition.

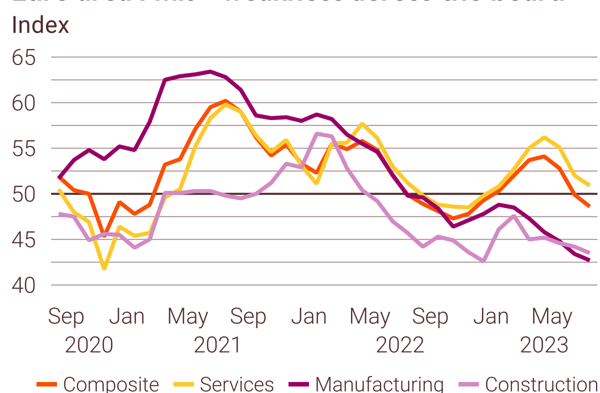
Unfortunately, there are plenty of headwinds to slow the euro-area economy. Credit growth in Europe has crawled to a halt, manufacturing demand is falling, and hopes that China's reopening would boost export demand have proved empty. In this environment, the euro-area economy is expected to stagnate for the rest of the year. Overall, growth in 2023 is likely to reach only 0.5%. Next year is unlikely to be any better given that global growth is expected to remain weak, monetary policy will still be tight, and fiscal policy is unlikely to provide much support. In 2024, GDP growth is expected to inch only slightly higher, to 0.6%.

Economic policy is hindering growth, and export demand will not be much help in the near term

The ECB has clearly shifted towards a more dovish tone during the summer, promising only a step-by-step approach, contingent on the incoming data. This has probably been motivated not only by the falling inflation, but also by depressed and weakening leading indicators. Lacklustre demand for credit and clear indications of a more restricted credit supply (as indicated by the ECB's own survey of banks) have already started to constrain

Euro area PMIs - weakness across the board

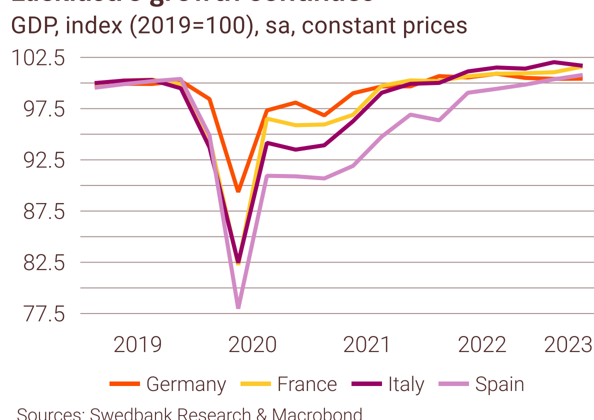
Index



Sources: Swedbank Research & Macrobond

Lacklustre growth continues

GDP, index (2019=100), sa, constant prices

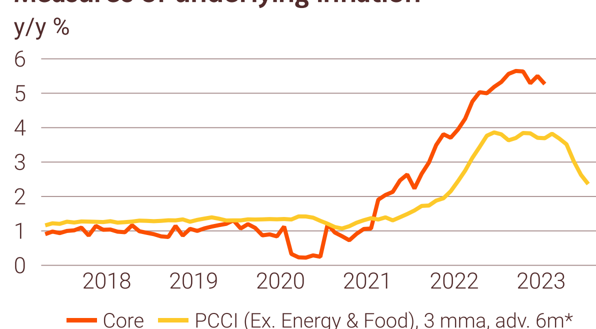


Sources: Swedbank Research & Macrobond

economic activity. However, there could still be some negative inflationary surprises in August (especially if prices of natural gas, oil, and some food commodities go up, as they did in recent weeks), and this could force the ECB to hike interest rates one more time. It is a close call – currently, markets are pricing a close-to-50% probability of another interest rate hike in September. Yet we think that the ECB would rather err on hiking too much than too little, so we are changing our forecast and now expect one more final 25bps rate increase in September. We do not expect rates to remain at the current highly restrictive levels for too long and expect the first cuts in April 2024, after more evidence of lower inflation, weaker growth, and, possibly, cracks in the labour market emerge. We forecast that the ECB will cut rates six times next year and three more in early 2025, leaving the deposit rate at 1.75%, close to neutral levels.

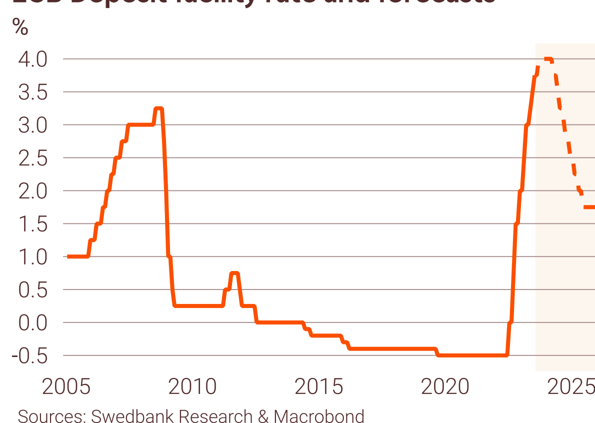
Final hike expected in September, cuts in April

Measures of underlying inflation



* The Principal common component of inflation (PCCI) is one of the indicators published by the ECB. It is an attempt to isolate common inflationary force across products and countries
Sources: Swedbank Research & Macrobond

ECB Deposit facility rate and forecasts



Sources: Swedbank Research & Macrobond

United States – still holding up better than expected

The disinflationary process is continuing at a solid pace, despite a continued resilient economy and strong labour market. The Fed has finished hiking rates and will start cutting rates in the second quarter of next year, thereby managing a soft landing of the economy.

So far this year, the economy has generally performed better than expected despite headwinds such as rising interest rates and elevated inflation. GDP growth was higher than expected in both the first and second quarter, and the resilience of the US economy stands out among its Western peers.

However, the disconnect between on the one hand relatively strong "hard data" (e.g. GDP) and on the other hand relatively weak "soft data" (e.g. sentiment indicators) is large, and we think it is likely that the former will catch up to the latter. As such, while the probability of a soft landing has become increasingly higher, we still expect that growth will be heading lower in the coming quarters, as the cumulative tightening and lags of monetary policy work through the economic system. We forecast that growth will turn negative in the fourth quarter and remain so for one additional quarter, before a recovery begins in the second half of 2024.

The economy has held up much stronger than expected

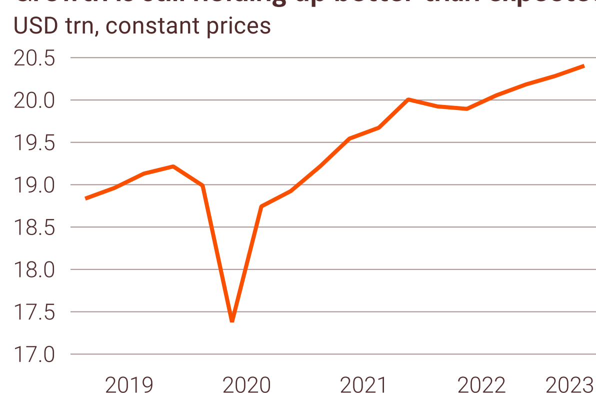
The remarkable resilience in consumer spending is beginning to run out. Although it contributed to almost half of the growth in the second quarter, consumption slowed significantly compared to the first quarter. We expect this slowdown to continue, and that consumption will decline going forward. Higher interest rates are having a negative impact on the availability and demand for credit, while excess savings left from the pandemic are nearly depleted, especially among low-income households with a higher propensity to consume. Additionally, student loan payments will resume in the autumn following a pause of more than three years. Consumption is expected to recover next year as inflation recedes and interest rates are lowered.

Private investments were another major factor that contributed to the economic strength seen in the second quarter; they made a positive contribution to growth for the first time in a year. We believe this to have been a one-off and expect business investments to remain weak for the rest of the year, owing to high interest rates and softer demand. The ISM Purchasing Managers' Index suggests a gloomy business outlook, especially within manufacturing. Although the turmoil following the banking crisis that broke out in March has subsided, lending terms for commercial and industrial as well as commercial real estate loans have tightened considerably, which will weigh on business activity. Residential investment is expected to remain weak until interest rates have already headed lower.

Jobs growth is still strong, but the pace of hiring has been trending down, suggesting that the labour market is gradually cooling. A decrease in firms' hiring plans and job openings, as well as an increase in jobless claims, also corroborate this conclusion. Meanwhile, the unemployment rate has remained at historically low levels for more than a year despite an increase in labour supply. Labour force participation among prime-aged workers is currently higher than before the pandemic. Even though the labour market is expected to soften, we do not expect the worsening to be as bad as during previous economic downturns, given that employers were recently struggling to find workers and might therefore think twice before laying off staff. This could limit the severity of the overall economic downturn.

Growth is still holding up better than expected

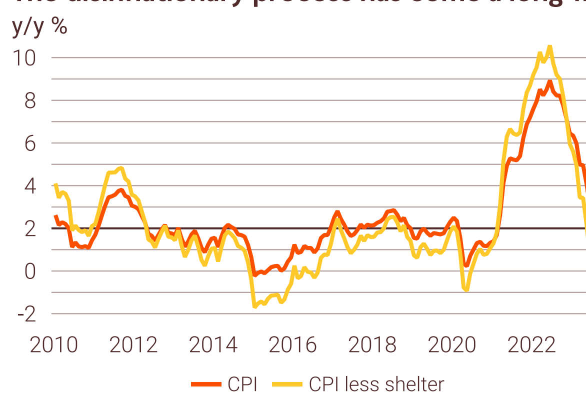
USD trn, constant prices



Sources: Swedbank Research & Macrobond

The disinflationary process has come a long way

y/y %



Sources: Swedbank Research & Macrobond

Inflation has come down substantially since peaking in June last year, and there are many signs that price growth will continue to moderate. Shelter inflation has peaked and is expected to fall rapidly in the coming year (shelter makes up around one third of the CPI basket). Service inflation excluding shelter is already falling rapidly. Moreover, the normalisation of supply-chain issues and lower commodity prices will continue to feed into the disinflationary process for goods prices in general. The overall economic slowdown will also mean less scope for price increases. At the same time, inflation is still expected to be around 3% by the end of this year. So, while the lion's share of the inflation descent has been somewhat rapid, getting down towards that final 2% – the Fed's target – might prove more arduous.

Fed will start cutting rates next spring

The Fed hiked the federal funds rate by 25 bps to 5.25–5.50% at its July meeting and has signalled one more hike by the end of this year. However, we expect that the positive trajectory on inflation will be enough for the Fed to remain on hold for now. That said, core inflation is still uncomfortably high and is not expected to return to target in the near-term. Therefore, we expect that it will take until spring 2024 before the Fed starts cutting the policy rate, moving at 25 bps cuts at every meeting. The pace of rate cuts is then expected to be slowed to every other meeting in 2025.

China – out of steam

Growth was expected to rebound significantly this year following the reopening of its economy. However, economic activity has been muted; this is likely an effect of lasting scars left from the COVID pandemic. Consumers' ability to spend has increased, but their willingness to spend has not. Also, the property sector remains in a slump.

China experienced a strong economic recovery at the start of the year following the rapid reversal of its previously strict COVID strategy, but the recovery quickly ran out of steam. This cycle was expected to be different compared to China's usual upswings. Instead of manufacturing and investments leading the charge, consumption would be the main growth driver as the country reopened. As such, it has not been too surprising that industrial production and net exports have been weak, not least since global demand is faltering. What's more concerning is that retail sales – a key gauge of consumption – have also been weaker than expected.

The economy has been heavily scarred by the pandemic and the property sector slump

An explanation could be that the pandemic may have left a scar on the economy which will take a long time to heal. China's COVID strategy was much more draconian than that of most other countries and it was in place for longer, freezing economic activity and raising uncertainty. Months after the reopening, consumer confidence remained at historically low levels and expectations on future income development are weak. Even if the ability to spend has increased, the willingness to spend has not followed suit. While many countries have been struggling with soaring inflation for the past year, China's economy has recently experienced falling consumer prices – a further sign of weak domestic demand.

Additionally, China's property sector makes up a substantial share of the country's GDP, so the protracted slump has broad ramifications for overall economic activity. Recent data suggests that the property market has not yet bottomed out, with weak construction activity and falling property prices and sales. Here too consumers have been scarred. Given that a large share of household wealth is in property, falling property prices have had an extensive negative impact on wealth, leading households to cut back on consumption.

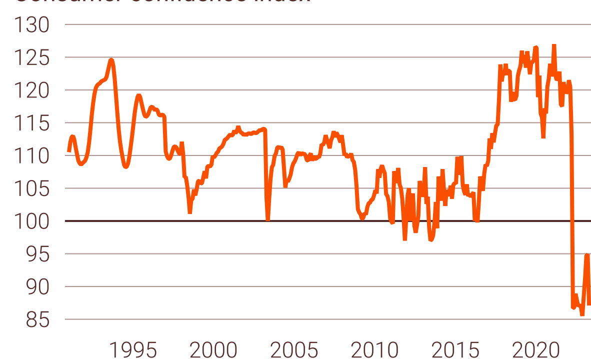
Moreover, youth unemployment has risen to record highs – one in five people between the ages of 16–24 is unemployed. This partly reflects mismatch issues on the labour market and is partly a result of businesses being wary of hiring young workers due to the bleak economic outlook. The high youth unemployment has the potential to lead to social unrest and become a major political issue. China has now temporarily suspended the publication of data on the youth unemployment rate, which is not a good sign.

Record-high youth unemployment

Fiscal and monetary policy support is expected to continue to be aimed at stemming the economic bleeding and aiding the property sector. However, unless consumer confidence and confidence in the property sector are restored, the economic scarring may limit the effectiveness of policy support. We expect GDP to grow by 5% this year, in line with the official target of around 5%. Next year, growth is set to weaken further and is expected to fall below 5%. Structural challenges, for example rebalancing its economy to rely more on domestic growth factors like consumption and services and less on investment and industry, deglobalisation, and an ageing population are weighing on long-term growth prospects.

Consumer confidence is still downbeat

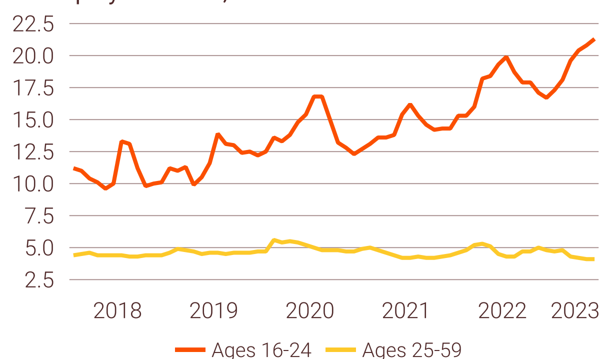
Consumer confidence index



Sources: Swedbank Research & Macrobond

Youth unemployment rising to record highs

Unemployment rate, %



Sources: Swedbank Research & Macrobond

Has inflation made redundancies redundant?

A severe spike in energy prices shook the world economy last year. Europe was at its epicentre, but rising energy and commodity prices stoked inflation around the world. A year ago, there was an expectation that rising input costs and falling purchasing power would have to lead not only to slowing economic activity but also to rising unemployment.

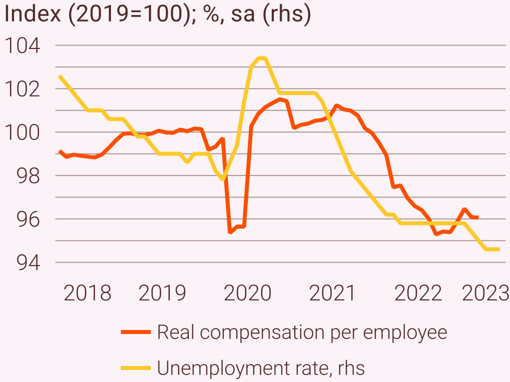
Meanwhile, in fact, the opposite happened. Economic activity did slow down, but in most countries unemployment rates kept falling. In the US and euro area, unemployment dropped to a multi-decade low. The surprising resilience of the labour market in developed economies puzzled many economists and pleased the policymakers. There are several possible explanations for this resilience: the lagging post-pandemic recovery in the services economy, labour-hoarding by firms, and even the structurally declining size of the labour force. However, it is plausible that inflation and falling real cost of labour played a part.

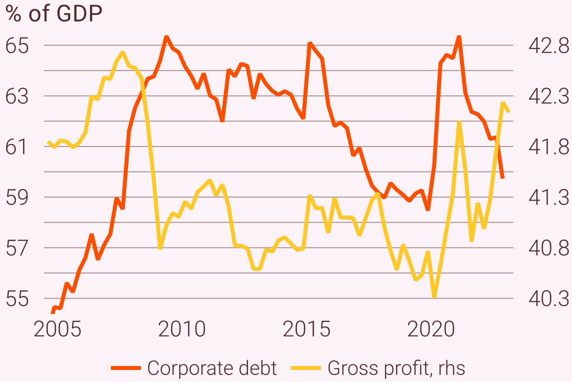
Firms seem to have managed to pass on rising costs to their customers. Both the IMF and the ECB[3] found that, despite higher costs, average profit margins were stable or even expanded last year. This means that, given the very rapid nominal GDP growth, the absolute level of profits was significantly higher. Higher revenues led to a decreasing real cost of financing and labour. Even though real consumption fell in quite a few countries (meaning less labour should be needed to satisfy demand), companies did not lay off workers. And that should not be a surprise – business managers make decisions in money terms – they care about the financial results. If the firm's bottom line is improving, cost-cutting is not demanded by shareholders and is hard to justify to stakeholders.

So, on the way up, inflation could actually have saved the labour market, reducing the real and relative cost of labour, and making the dismissal of workers unnecessary. However, this development is unlikely to last. Producer prices are falling, and consumer price inflation is slowing rapidly. The disinflationary trend is most visible in the commodity and manufacturing sectors, but services will also catch up with a lag. The tailwinds that boosted corporate financial results are waning. In addition, employees are demanding higher wages to compensate for the purchasing power loss they experienced last year.

In the second half of the year, companies will observe notably slower revenue growth, coupled with higher costs of financing and rising real labour costs. This combination is likely to incentivise managers to enact cost-saving measures, even resorting to job cuts. There is a risk that the end of inflation, instead of bringing a relief to household finances, might bring unemployment. As the infamous Top Gear host Jeremy Clarkson once said: "Speed has never killed anyone. Suddenly becoming stationary, that's what gets you".

[3] Europe's Inflation Outlook Depends on How Corporate Profits Absorb Wage Gains,
How have unit profits contributed to the recent strengthening of euro area domestic price pressures?


Real labour cost fell in Europe
Index (2019=100); %, sa (rhs)
104
102
100
98
96
94
8.75
8.25
7.75
7.25
6.75
6.25
2018
2019
2020
2021
2022
2023
Real compensation per employee
Unemployment rate, rhs
Sources: Swedbank Research & Macrobond


Rising profits and falling debt burden in EA
% of GDP
65
63
61
59
57
55
42.8
42.3
41.8
41.3
40.8
40.3
2005
2010
2015
2020
Corporate debt
Gross profit, rhs
Sources: Swedbank Research & Macrobond

Sweden – the downturn has begun

Due to weak domestic and global demand, Swedish GDP will decline this year and next year as well. Tight economic policy is contributing to the downturn. The labour market will weaken towards the end of the year, but the fall in employment is expected to be limited. The Riksbank will begin a series of rate cuts in June next year, when price pressures have subsided and the economy has slowed.

The economic downturn has begun and will intensify during the autumn

The Swedish economy slowed markedly in the second quarter. Goods exports fell, as did business sector output, while household consumption remained at low levels. According to preliminary figures from Statistics Sweden, GDP fell by 1.5% compared with the first quarter. We expect economic activity to continue its decline in the second half of the year, in the wake of weak domestic and global demand. A recovery will begin next year, although growth will remain low due to falling investment and subdued global demand. The economic downturn is depressing business productivity as the fall in hours worked and in employment is expected to be relatively limited. The recovery will strengthen in 2025, as inflation falls below 2% while monetary policy eases.

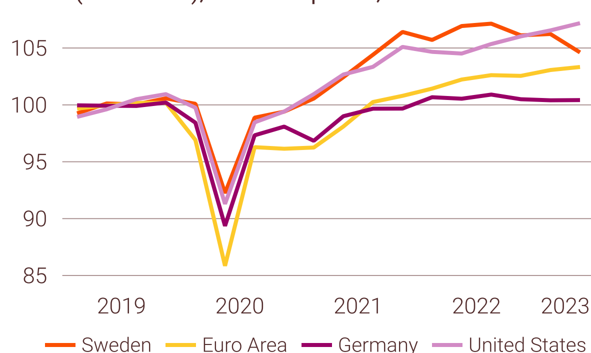
2

years of shrinking GDP

Uncertainty about the outlook is high, and, so far, the resilience of the economy has been surprisingly strong, especially in the labour market, where the employment rate is the highest in decades. We are not ruling out the possibility that this resilience could persist, leading to a milder downturn than we are forecasting. If corporate investment continues to increase, e.g, in green transitioning and technological development, such as AI (see page 38), this could mitigate the decline. However, there could also be a hard landing, like in the scenario described on page 12. In such a scenario, the decline in global demand and the issues in the financial markets will hit the Swedish economy hard; however, strong public finances could cushion the downturn to a certain extent.

GDP has dropped from a high level in Sweden

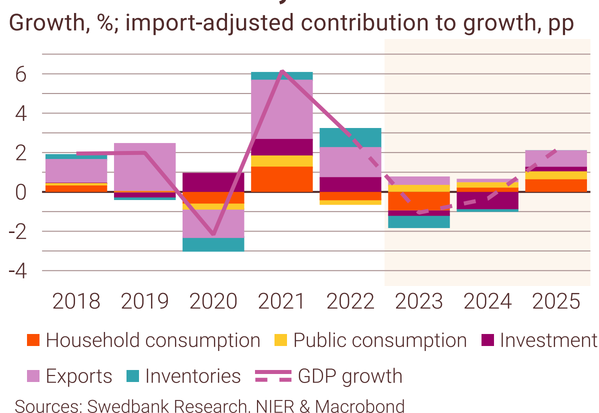
Index (2019=100), constant prices, sa



Sources: Swedbank Research & Macrobond

GDP contraction this year and 2024

Growth, %; import-adjusted contribution to growth, pp



Sources: Swedbank Research, NIER & Macrobond

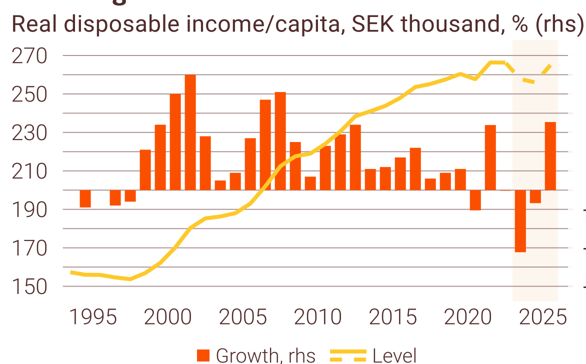
Households are holding back

Households have reduced their consumption during the past year. According to card transaction data from Swedbank Pay, consumers held back even during the summer, and no significant “staycation” effect was seen this year. We expect households to continue cutting back on consumption for a bit longer, as incomes are squeezed by high inflation and rising interest payments. Real disposable income per capita will fall this year and then somewhat further next year, leaving incomes at the 2020 level. In 2025 there will be a clear recovery when inflation has subsided.

A cautious recovery will start in 2024. Consumer confidence has bottomed out, and, above all, households' assessment of the risk of becoming unemployed has fallen back to just below the historical average, suggesting that households will dare to consume more when incomes slowly improve. The good financial position of households is also a contributing factor.

Declining real income also in 2024

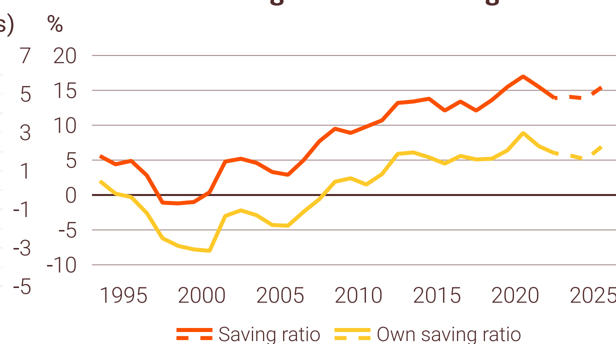
Real disposable income/capita, SEK thousand, % (rhs)



Note: Reference year is 2022
Sources: Swedbank Research & Macrobond

Households' saving ratio remains high

%



Note: Share of households' disposable income plus savings in premium and occupational pensions.
Sources: Swedbank Research & Macrobond

Good financial position with high savings

The financial position of Swedish households is sound, although financial markets have been volatile during the year. Households’ financial assets are increasing, and the savings rate is high both in a historical and international perspective. The savings rate thereby constitutes a buffer even though it has fallen since its pandemic-peak. However, parts of the savings are illiquid, such as pension savings. At the same time, household credit growth is at its slowest pace since 1996; this is explained by fewer housing transactions and falling housing prices, and because some households have increased their monthly amortisation amount or made an extra repayment when a loan was renegotiated. We anticipate that the savings rate will have partially recovered its loss by the end of our forecast period, as households seek to restore their savings.

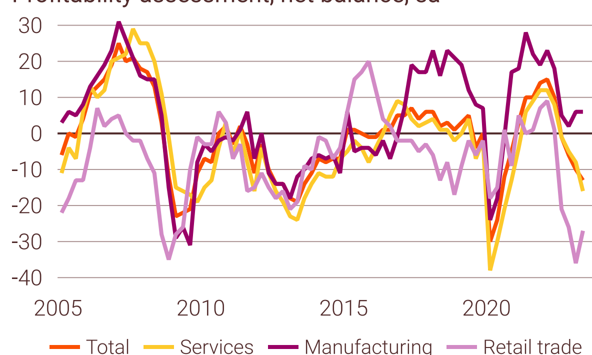
Companies are cutting back on investments

In the corporate sector, tougher times await after a few good years in the sector as a whole. The profit share has risen in recent years and was clearly above average last year. However, profit share varies among industries, and a large part of the increase has taken place in export-intensive companies, partly due to the weak krona. Productivity has taken a beating recently, as output has started to decline while the number of people employed and hours worked have increased markedly. Companies' profitability ratings have generally declined but continue to differ across industries. Going forward, we expect squeezed margins in more industries and that the profit share will fall back down, especially against the background of weakening global demand. Consequently, companies will cut back on investments, especially next year. In addition, housing investment is falling sharply in the wake of high construction costs and low demand, and we expect new housing construction of below 30,000 units per year throughout the forecast period.

The commercial real estate sector, which is highly leveraged, has been significantly affected by the rise in interest rates. Although increased vacancies may affect the sector going forward, it is the need to refund maturing bonds in the coming years that poses the greatest challenge, with maturities next year and in 2025 accounting for about 40% of the Swedish commercial real estate companies' outstanding stock of bonds.[4] It cannot be ruled out that some real estate companies will find it difficult to live up to their commitments and, thus, may default, but we believe that there is a low probability that several large companies will experience payment difficulties; therefore, the effects on financial stability or on the economy in general are expected to be limited.

Firms' profitability has declined

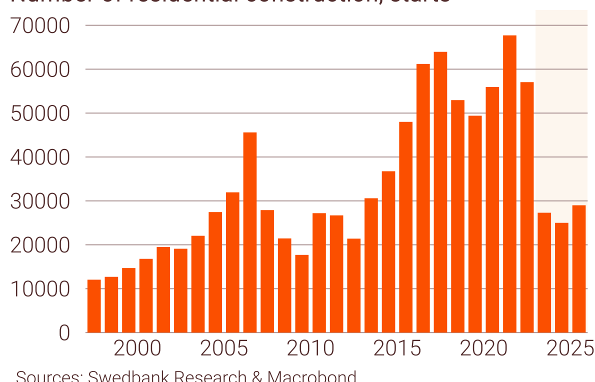
Profitability assessment, net balance, sa



Sources: Swedbank Research & Macrobond

Weak construction during the forecast period

Number of residential construction, starts



Sources: Swedbank Research & Macrobond

[4] Data refers to the coverage of property companies by Swedbank Credit Research and includes bonds and hybrid loans maturing in 2030 at the latest.

Continued weak housing market ahead

Since February last year, Swedish housing prices have fallen by 12%. However, during the summer, housing prices have risen somewhat, as prices have increased for both detached houses and flats. The situation in the housing market remains subdued as the number of housing transactions remains low, many properties are for sale, time on market is long, and bid premiums are low.

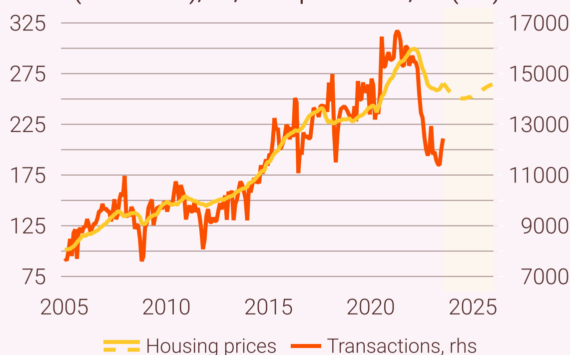
Overall, housing prices are expected to fall by about 15% from their peak in February 2022 to their trough in the first half of 2024. We expect that the current plateau for housing prices will be temporary, and that prices will fall slightly during the autumn and winter.

The recovery will begin in 2024, but the housing market will not take a clear upturn until later during the forecast horizon. There are several factors that suggest a cautious recovery. First, household purchasing power will remain weak next year, as inflation will continue to weigh on households. Second, mortgage rates are expected to remain high for virtually the whole of next year, although we expect the Riksbank to start cutting its policy rate in the summer. The fact that mortgage rates will not return to previous low levels will help contain price increases going forward. Third, there is a large supply of homes for sale, and, although construction starts have dropped dramatically this year, much new construction is still being completed.

The households' sound financial position, and the decision by many households to wait and see if prices fall further before buying a home, indicate that demand for housing will increase when the situation clears up regarding, e.g., mortgage rates.

Cautious recovery starts next year

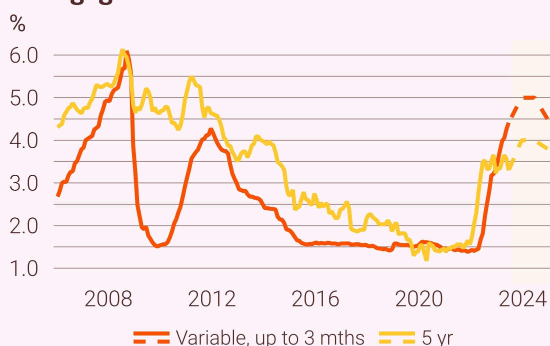
Index (2005=100), sa; level per month, sa (rhs)



Sources: Valueguard, Swedbank Research & Macrobond

Mortgage rates rise further in the near term

%



Note. Average rates, new and renegotiated loans, housing purposes from Statistics Sweden. Forecasts are average rates from the 8 largest MFIs.
Sources: Swedbank Research & Macrobond

The downturn will affect the labour market later this year

The labour market will soon shift from surprising resilience to deterioration. In the near term, its strength will continue to wane, and, in the fourth quarter, we expect employment to decline and unemployment to start rising. Some labour-intensive and consumer-related industries are already struggling, such as retail trade, and are thus expected to reduce their workforce going forward. In the construction industry, the redirection of employees from housing construction to other construction continues; however, this will not completely counteract a deterioration.

The slowdown is also spreading to other parts of the economy, and households' pent-up demand for services will weaken in the autumn, contributing to a downturn in employment. In the manufacturing industry, the situation is also becoming gloomier, as exports of both goods and services are being weighed down by falling global demand. The deterioration will continue in 2024, and unemployment will peak at 8.3% by year's end. However, several industries are expected to continue facing steady demand with a need for more staff, not least in the IT sector, the defence industry, and surrounding industries, as well as in environment and energy. In the public sector, staffing needs are extensive, and together these industries will form a cornerstone in ensuring only a limited fall in employment.

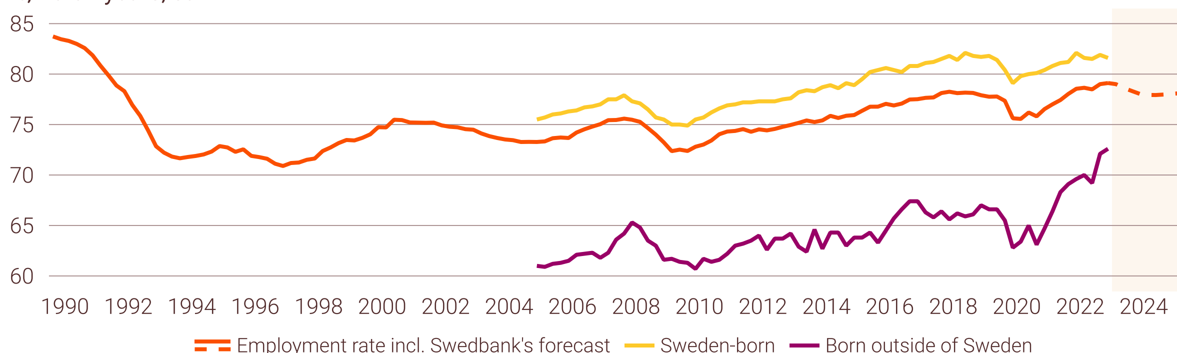
8.3%

Unemployment rate to peak Q4 2024

The employment rate is currently at its highest level since the 1990s. In particular, the increase in employment among those born outside Sweden has been remarkable; it also accounts for the largest increase in the labour force in recent years. The strong demand for labour can probably be explained by post-pandemic reopening effects, combined with the decline in real labour costs, as evidenced by falling real wages in 2022 and early 2023. In 2023, however, wage-related costs will rise, and employers' social security contributions for young people have already returned to their previous higher level. The structural skills shortage in the Swedish labour market will contribute to wage growth being relatively high in the coming years and will add to the burden on labour-intensive companies in the near future.

The highest employment rate since the 1990s will fall back somewhat next year

%, 16-64 years, sa



Sources: Swedbank Research & Macrobond

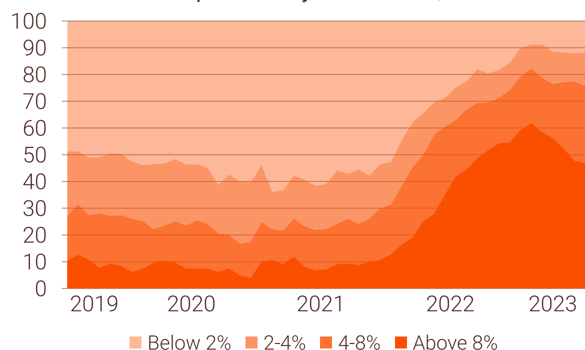
High short-term inflation turns into weak price pressure

Swedish inflation fell during the first half of the year but has remained high; in July, the annual CPI rate was 9.3%. With the exception of electricity prices, monthly price increases have also remained high, contributing to a limited decline in inflation. After a year and a half of large and broad price increases, inflation is now increasingly characterised by the tug of war between factors that contribute to lower inflation and factors that sustain price pressures. The difference is most pronounced across sectors, where the trend in goods inflation is declining, while price pressures in the services sector are increasing. At the same time, the weak krona will lift import prices and add fuel to the inflation fire. We expect the price pressure to remain strong in some sectors in the near term, although it will subside overall during the autumn; accordingly, the downhill trend for Swedish inflation will be somewhat steeper by then.

Looking further ahead, we expect inflation to continue falling and eventually approach 2%. Economic activity is decelerating, and the recovery will be slow, limiting the scope for new price increases. In addition, several of the cost increases contributing to inflation have stalled or even reversed, not least for transport and raw materials. In the course of 2025, we estimate that price pressures will be weak, and that inflation will fall below 2%.

Inflation is still high and broad-based

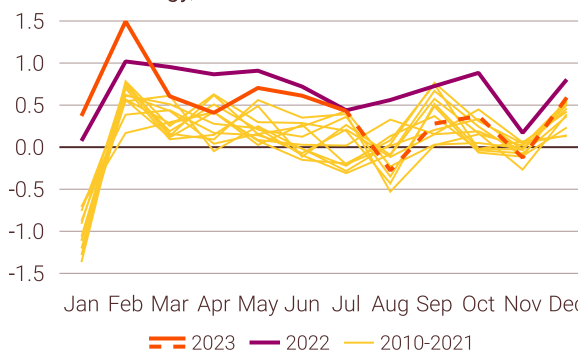
Share of CPI components by annual rate, %



Sources: Swedbank Research & Macrobond

Lower price hikes towards the end of 2023

CPIF excl. energy, m/m %



Sources: Swedbank Research & Macrobond

Tighter monetary policy this autumn but rate cuts next year

Due to high inflation and the weak krona, the Riksbank will continue to tighten monetary policy throughout this year. We expect the policy rate to be raised by 25 basis points during the meetings in both September and November, to a peak of 4.25%. However, in view of the weakening economy and declining inflation trend, it is possible that the last rate hike of the cycle will be in September. It is even more difficult to predict at what point the Riksbank will change its position and start cutting its policy rate; we expect it to begin a series of rate cuts starting in June next year. Although annual inflation will remain above 2%, price pressures will have eased considerably by then; monthly price increases will be back at low levels, while the labour market will have deteriorated. Towards the end of 2025, we expect the policy rate to reach 2.5%.

2.5%

Policy rate in Q4 2025

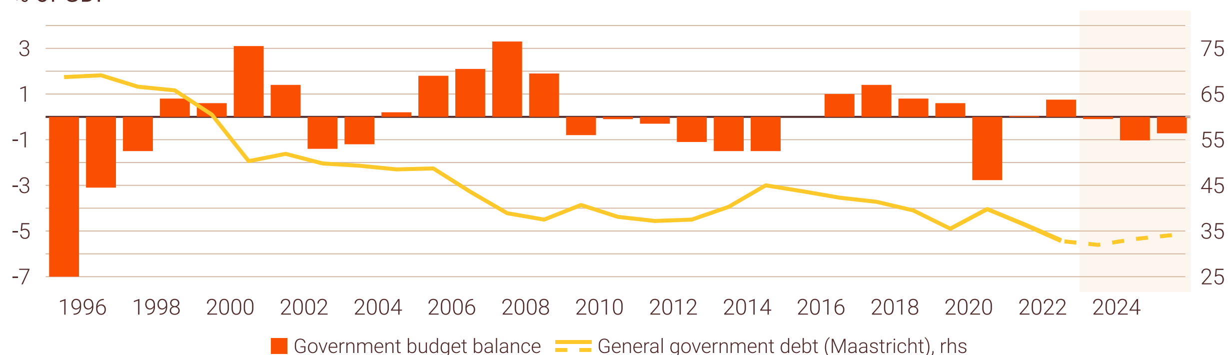
Fiscal policy is tightening but transfers to households are rising

The government's budget for 2024 will be presented at a time when the outlook for the Swedish economy is gloomy and inflation remains high. The budget thus involves two balancing acts – one based on the economic situation, and the other balancing the different preferences of the government parties and the Sweden Democrats. Several tax proposals were submitted during the spring, but it is unclear which ones will be included in the budget for next year. We are revising our view and believe that most of the tax cuts aimed at households (such as earned income tax credits and reduced taxes on pensions) will not be implemented until 2025. We expect unfunded fiscal measures of SEK 30 billion per year in 2024 and 2025. The unfunded expenses for next year include, among other things, SEK 10 billion in increased government grants to the local government sector, paused indexation for fuel and energy taxes, and continued strengthening of the defence and judicial systems. However, uncertainty is unusually high, partly because of the economic situation and partly because the government's communication has been limited so far.

We do not believe that there will be any additional electricity support payments for households and businesses this coming winter. On the one hand, we expect this winter's increase in electricity prices to be much more limited than last winter's, and on the other hand, the experience from the previous winter showed the difficulties of using Svenska kraftnät's congestion income in this way. In addition, the rise in the price base amount means that transfers to households will increase next year; as a share of GDP, they will rise to just over 13% compared with 12.5% this year.

The Maastricht debt will rise but remain below 35% of GDP

% of GDP



Sources: Swedbank Research & Macrobond

Norway – inflation remains excessive

The Norwegian economy continues to expand moderately, with large differences across sectors, but inflation remains a prominent issue for the central bank. Higher policy rates will eventually lead to weaker credit growth and dampened economic activity.

Two-speed economy, riddled by high inflation

The economy remains divided in terms of pace of growth, but overall it has expanded moderately during the past few quarters. Looking ahead, it is expected that the moderate growth will continue in the short term. The economic momentum is being maintained by the oil and services sectors, which are likely to continue expanding; meanwhile, industries focused on households, such as construction and retail, remain the laggards. Non-oil-related manufacturing is also experiencing a more pronounced slowdown, in line with European peers. The outlook for households is mixed, as even-higher interest rates are expected, while real wage growth should improve and employment growth has been sturdy. Nevertheless, precautionary savings may increase in the face of heightened uncertainty going forward. Despite anticipated solid growth in petroleum investments, slowing credit demand from both households and corporates is expected to contribute to slower GDP growth in the coming years.

5.3%

CPI-ATE in December 2023

The labour market has slowly started to soften. The number of unemployed people has already been increasing for a year, but the unemployment rate is staying at a relatively low level (1.8%). However, with bleaker growth prospects, an increase in the unemployment rate can be expected over the next year as growth slows. Labour shortages are also moderating somewhat as the number of new vacancies has decreased from elevated levels.

Inflation is still too high, and the inflation momentum remains higher in Norway than in Sweden, the euro area, and the US. The weakening of the Norwegian krone (NOK) this past year, together with higher expected wage growth, remains the most important driver of the current inflation momentum. Core CPI, which excludes energy and taxes, reached 6.4% in July, with alternative measures of core inflation even higher. While slowing global inflation is affecting imported price growth, the past weakening of the NOK has delayed the transmission of these impulses to Norwegian prices. Domestic price pressures are expected to remain high in the short term, due to the tight labour market and indirect effects from financing costs and a weak NOK. Core inflation is expected to slow more markedly during the second half of this year, towards 5.3%, and it will likely remain well above 2% for most of next year.

Norges Bank delivered a rate hike of 25 basis points (bps) in August, bringing the policy rate to 4.00%. The latest rate path from June signals one more hike to 4.25% at the September meeting, while market pricing suggests some probability of a further rate hike later in the autumn. The central bank is, regardless, expected to maintain a hawkish stance due to higher-than-target inflation, a fragile NOK, and limited signs of a weakening labour market. However, the lagged effects of Norges Bank's faster-than-normal rate hikes could be greater on the economy once the pandemic savings have been exhausted. Credit growth has started to moderate, both for households and nonfinancial corporates, a sign that higher policy rates are starting to have an impact. However, the spending of past savings and strong disposable income growth are supporting the economy for now. In the near term, inflation will likely remain the key variable for Norges Bank to monitor. Therefore, we expect that the bank will hike the policy rate to 4.50% by November, which may be the peak in this tightening cycle. As the economy is projected to slow further next year, rate cuts are expected to commence around the summer of 2024.

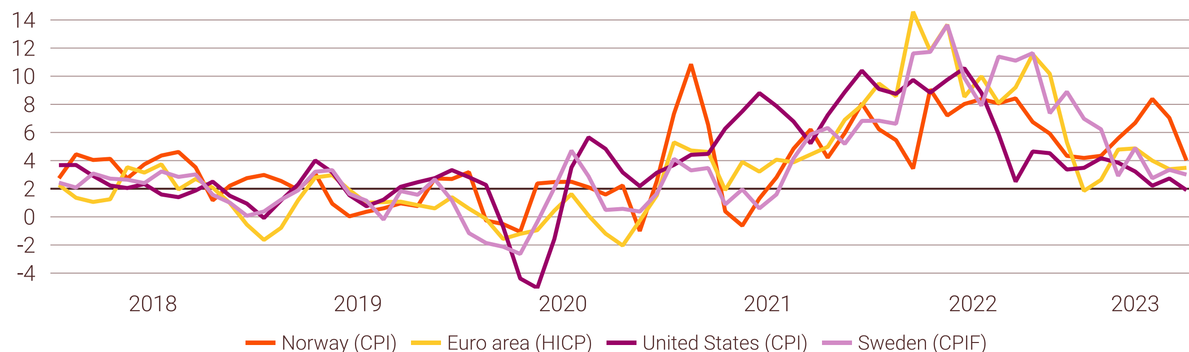
4.50%

Norges Bank's policy rate expected to peak in November 2023

Housing prices in Norway have remained close to an all-time-high over the past few months, despite higher mortgage rates, high household leverage, and the fact that most homeowners have floating mortgage rates. This strong performance can be attributed to four factors: the eased mortgage regulations implemented this year; a tight market balance, with a limited amount of homes available for sale; good credit availability for households; and strong income growth. However, looking ahead, we anticipate that housing prices will decline, as the market balance has shifted and credit growth has started to fade. Real housing prices have already fallen from the peak, but there will be another 5% drop to come, according to our projections.

Inflation momentum remains higher in Norway

m/m %, 3mma, saar



Sources: Swedbank Research & Macrobond

Estonia – enduring a prolonged recession

The short-term outlook for the Estonian economy is not rosy, and the recovery from the recession is expected to be sluggish. However, the labour market will remain strong and the unemployment rate will pick up only moderately. The slowing inflation and robust wage growth will improve households' purchasing power.

The Estonian economy has contracted year on year since the second half of last year. The decline in energy production, forestry, and real estate activities has contributed the most to the GDP decline. The economic contraction was even larger per employed person, as employment has picked up. Thus, real labour productivity has deteriorated even further. The preliminary data show that the recession has abated slightly, while recovery is expected to be sluggish. The Estonian economy will continue to grow in nominal terms in the next two years, but growth will slow below the long-term average.

Manufacturing and energy production, as well as retail volumes, are in extensive contraction. Roughly three-fourths of the decline in manufacturing comes from the production of wood, metal, and chemical products, construction materials, and furniture. Thus, manufacturing production is largely being affected by the deterioration in the construction and real estate sectors. According to recent confidence surveys, the share of industrial sector enterprises that are suffering from weak demand has picked up to 74%. This is close to the highs reached early-on during the COVID crisis. Furthermore, the share is larger than in Latvia, Lithuania, Sweden, and Finland. Economic confidence has continued to worsen, especially in the industrial and construction sectors. Export expectations for the industrial sector have dropped to the level of 2009 – a year of deep economic contraction.

74%

of industrial enterprises suffer from weak demand

Headline inflation is coming down firmly, thanks to lower energy prices and high comparable price level last year. The growth in food prices is slowing, but this product group is still contributing the most to consumer price inflation. Export, import, and manufacturing producer prices are declining, and the growth in construction prices is receding. Although we expect that consumer price inflation will continue to decelerate in 2024, planned tax hikes will have some inflationary impact and thus limit the slowdown.

Planned tax hikes will limit the slowdown of inflation in 2024

Weak demand and slowing inflation have brought down nonfinancial corporations' turnover and profit growth. However, the picture in terms of economic activities is diverse. Recently, most of the profit growth has come from energy production and wholesale trade, while the large profits

that manufacturing firms saw in 2021 and 2022 have fallen back to their pre-pandemic levels.

So far, households and nonfinancial corporations have coped well with the rising interest rates. The share of nonperforming loans is still very small. Although high interest rates are dampening economic activity, the negative impact on growth is less than that of a rapid inflation and rise in the cost of living.

As the nominal growth of value added of nonfinancial corporations' is expected to decelerate this year and in 2024, enterprises will have to limit the growth of their labour costs to mitigate the fall in profitability. Although the double-digit growth of nominal wages seen this year is expected to slow, wage growth will remain robust going forward. Real wages have already picked up, as nominal wage growth has exceeded inflation. We expect that this will increase private consumption with a delay. The excess savings that accumulated during the COVID crisis and with the pension reform have shrunk – especially in real terms – and will contribute less to consumption. Although we expect a minor and short-lived boost to private consumption at the end of this year, ahead of the tax hikes in 2024, consumption will remain in contraction compared with last year. Recovery will be slow, with lower than long-term-average real consumption growth in 2024.

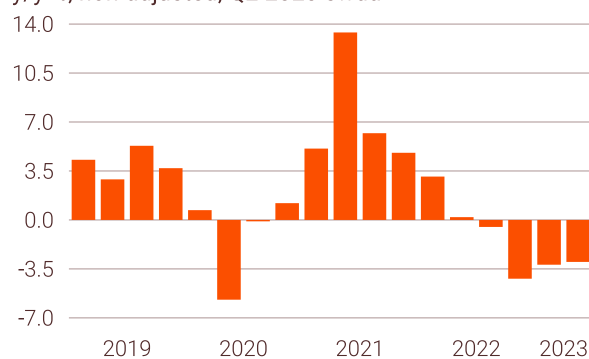
Unemployment will pick up moderately

The recession has started to affect the labour market. Unemployment picked up in the second quarter, and employment contracted compared with the previous quarter. However, we expect that unemployment will pick up only moderately this year and in 2024.

So far, the strong labour market has helped to prevent a substantial price correction of residential real estate. The annual growth of housing prices has only decelerated. The ratio of apartment prices to wages has started to improve, and housing affordability is likely in the trough.

Economy has contracted since 1H2022 y/y

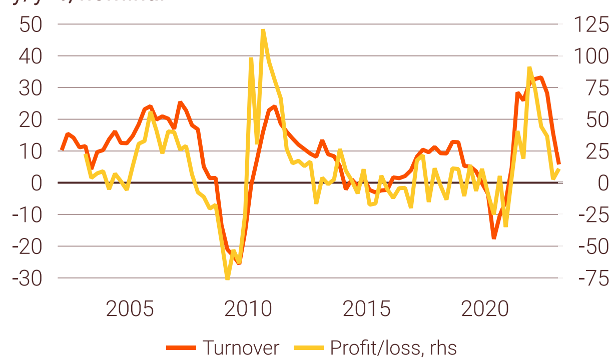
y/y %, non-adjusted; Q2 2023 swda



Sources: Swedbank Research & Macrobond

Corporations' profit growth has slowed down

y/y %; nominal



Sources: Swedbank Research & Macrobond

Latvia – in stagnation mode

The Latvian economy is currently in stagnation mode. Some divergence is being observed, though, with investments seeing a long-awaited pick-up while exports continue to disappoint. The ongoing government crisis could also be a drag on the economy. GDP will post meagre growth next year and show a more pronounced recovery only in 2025. The good news is that inflation is retreating fast and is expected to land within a modest 2-2.5% range in the coming years.

GDP flat this year, growth below potential in 2024

The winter months were encouraging – the Latvian economy performed better than feared. However, in the second quarter of 2023, the high cost of living and the deteriorating economic environment of Latvia's trade partners made their mark – GDP contracted both over the first quarter and the previous year. Economic output in 2023 is projected to stay nearly flat vis-à-vis last year's levels, with GDP posting growth below potential in 2024 and experiencing only a modest recovery in 2025.

The current slowdown is led by weak exports. Goods exports have been on a clear downward trend for more than half a year now, due to the ailing construction and real estate sectors of Latvia's trade partners. Sentiment in manufacturing is downbeat, and order books are low. Given the gloomy growth prospects of trade partners, there is little optimism about goods exports going forward. On the bright side, the post-pandemic recovery is continuing in services exports, which are showing double-digit growth. Air transport and business services are likely the strongest contributors to the rise. However, service export growth is unlikely to remain this strong. Overall exports are expected to decline this year, since services account for only around one-fourth of total exports.

Having surprised on the upside at the end of 2022, consumption in Latvia has declined this year. The weakness is linked chiefly to the high price level and the loss of purchasing power seen for more than a year. The good news is that inflation is dropping fast, and wages are strong – real wage growth turned positive in June. Consumer sentiment has also improved notably from the winter lows. However, in the coming quarters, we still expect the lagged effects of the previous drop in purchasing power to continue as a drag on consumption.

Some signs of a weaker labour market

The labour market has been resilient but will likely show some signs of weakening in the coming quarters. After an unexpectedly sharp decline in the first quarter of 2023, the unemployment rate was stable in the second quarter. The data on registered unemployment signal a slight increase in unemployment levels in July and August. Businesses' employment expectations have turned more pessimistic than at the start of 2023. This, together with the continued sluggish GDP growth, suggests that we could see a slight pickup in unemployment in the coming quarters.

High interest rates and lingering uncertainty have resulted in a notable slowdown of loan portfolio growth of both households and nonfinancial corporations. At the same time, total investments in the economy have finally picked up, aided by a sizable increase in construction activity – construction output grew by 16% in the first half of the year. This, in turn, is chiefly because EU funds are finally starting to flow into the economy. Investments will continue to support growth in the coming years.

Public investment is supporting the economy

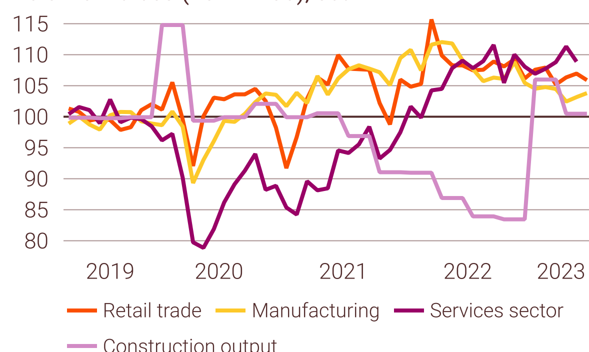
Latvia is facing a government crisis – the Prime Minister recently resigned, and the search for a new government is under way. The budget for next year needs to be drafted, and a tax reform is currently hanging in midair. A prolonged process to form the new government could be yet another drag on growth. Furthermore, several populist initiatives have surfaced, most notably concerning the financial sector in light of the high interest rates and sizeable profits. These are unlikely to have the desired positive long-term effect on borrowers and could spook investors and hinder medium-term growth.

Services inflation shows no signs of slowing

Inflation is plummeting largely due to base effects, since prices this time last year were already very high. But it is not just that – in recent months, consumers have seen prices decline not only for fuel and in energy-related segments, but also for food. At the same time, services prices continue to rise at an uncomfortably fast pace, with no clear signs of slowing. Wages – a key input cost in the services sector – are rising fast. The labour shortage has abated somewhat but is still comparatively large. This allows workers to seek higher compensation to recover the purchasing power they lost in the past year. The year 2024 will see a further hike in the minimum wage, which will result in higher wage increases than the soft economic growth would imply. Despite the trends in the prices of services, the disinflationary story will prevail. Inflation is expected to continue to fall going forward, reaching around 2% at the end of the year. The next couple of years will see inflation settle near the 2-2.5% range. These forecasts assume that no major tax changes are implemented next year.

Diverging paths

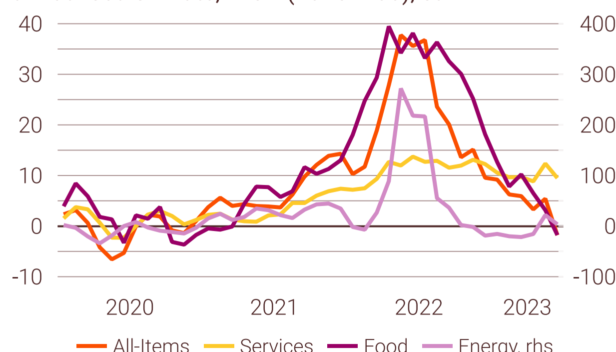
Volume indices (2019=100), sca



Sources: Swedbank Research & Macrobond

Descending Mount Inflation

annualised 3m rate, HICP (2015=100), sa



Sources: Swedbank Research & Macrobond

Lithuania – a roller coaster

A sharp contraction in the first quarter was followed by an even sharper rebound in the second quarter, and is likely to be followed by further swings during the coming quarters. We maintain our forecast that the economy will shrink by 0.3% this year, before resuming tepid and uneven growth in 2024.

The Lithuanian economy has been shrinking since the last quarter of 2022, but the recession ended abruptly when GDP, somewhat unexpectedly, spiked in the second quarter of this year. The economy rebounded despite still-weak retail trade, which has been flattish since last summer and in the second quarter was 1.5% lower than a year ago. Manufacturing increased slightly in the second quarter, but large divergences between subsectors remain (see chart below).

It appears that the largest recent boost to growth has come from public construction of engineering infrastructure (roads, bridges, electrical grid, etc.); such construction makes up more than half of total construction works and has increased by 45% compared with the same period a year ago. These investments have fully offset a slight fall in construction of residential buildings. We see this as a timely and well-targeted fiscal stimulus.

In line with our forecast, inflation has continued to decline rapidly. Average prices have been flat or falling since April, and we estimate that annual inflation will be down to 2.5% by year's end. However, major divergences have emerged – prices of goods have been falling, thanks to cheaper energy, commodities, and transportations costs, while annual inflation of services has not yet budged and is still close to 12%.

2.5%

Annual inflation at the end of 2023

Lithuanian manufacturing output

2023 January-June, y/y %	
Metals	-27.2%
Chemicals, fertilisers	-27.1%
Wood	-25.6%
Furniture	-15.9%
Textiles	-10.4%
Rubber and plastics	-9.4%
Total	-3.6%
Food	3.6%
Pharmaceuticals	12.7%
Computer, electronic, optical products	18.9%
Transport euipment	25.5%
Electric equipment	49.7%

Sources: Swedbank Research & Macrobond

Going forward, we expect GDP growth to be supported by rapidly growing real wages and a recovery of household consumption. We forecast that average annual inflation will drop to 1.8% next year, although there is a risk that prices will be pushed higher by a continued increase in labour costs. Wage growth is expected to moderate to 8.6% but will remain much faster than productivity gains. The government has already agreed with business representatives and trade unions to increase the minimum wage by 10% at the start of 2024. In an environment of very fragile global demand, this could be a risky decision – it may have unwanted side effects, such as even weaker exports, higher unemployment, and stickier inflation of services.

1.5%

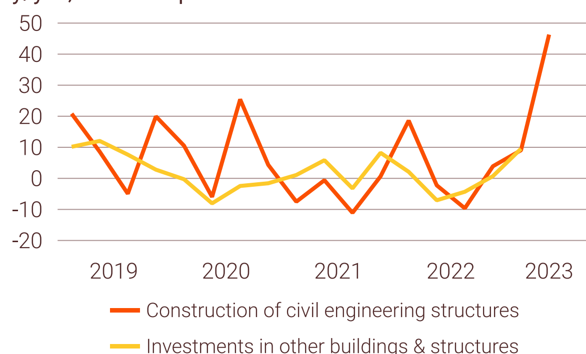
GDP growth in 2024

Somewhat unexpectedly, unemployment fell to 5.9% in the second quarter of this year, but we expect it to increase again and stay close to 7% next year. Household purchasing power, especially of low-income earners, will be further improved by the decision to increase the non-taxable income threshold by 20% next year. We estimate that household purchasing power will be restored to the pre-inflationary peaks already at the start of 2024.

Despite these positive developments, we remain wary of growth prospects during the coming quarters for two main reasons. First, transactions in housing remain very depressed by historical standards and are unlikely to recover before interest rates start falling. This has already started to affect construction – housing completions and housing starts are falling, while new building permits are down almost 30% this year. Second, and most important – global demand remains shaky, and we do not expect an imminent recovery of exports. Employment in construction and some manufacturing sectors may fall, and this could further depress the real estate market and, in turn, create negative trends in other sectors as well. Quarterly GDP contractions are still likely, but for now, we remain cautiously optimistic and expect a gradual recovery next year and, especially, in 2025.

Construction and investments in buildings

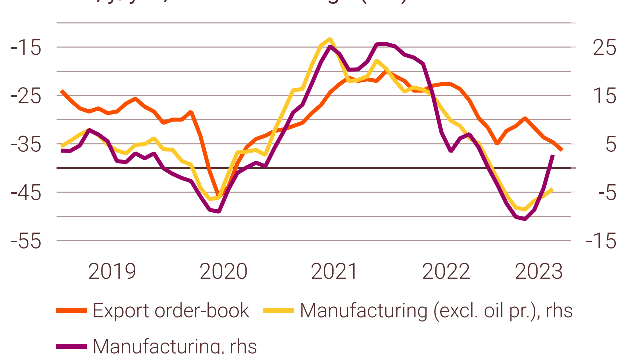
y/y %, constant prices



Sources: Swedbank Research & Macrobond

Export orders and manufacturing output

Balance; y/y %, 3 month average (rhs)



Sources: Swedbank Research & Macrobond

Raging storms, rising costs

The surge in surface temperature is escalating the likelihood of extreme weather events, such as heatwaves, floods, or storms. To date, the realised economic losses in the Nordic and Baltic regions have been relatively limited within the broader European context. Nevertheless, the greatest risks originate from external sources, such as supply chain disruptions and increased product prices.

Summer's bewitched fury

The heatwaves that affected Europe this summer—Cerberus and Charon—named after, in Greek mythology, the three-headed dog who guarded the gates of the underworld and the ferryman who transported the deceased, underscore the severity of the threat. Persistent heat leads to health risks, forest fires, melted asphalt, poorer air quality, lower productivity, and finally, tourists opting for cooler locations.

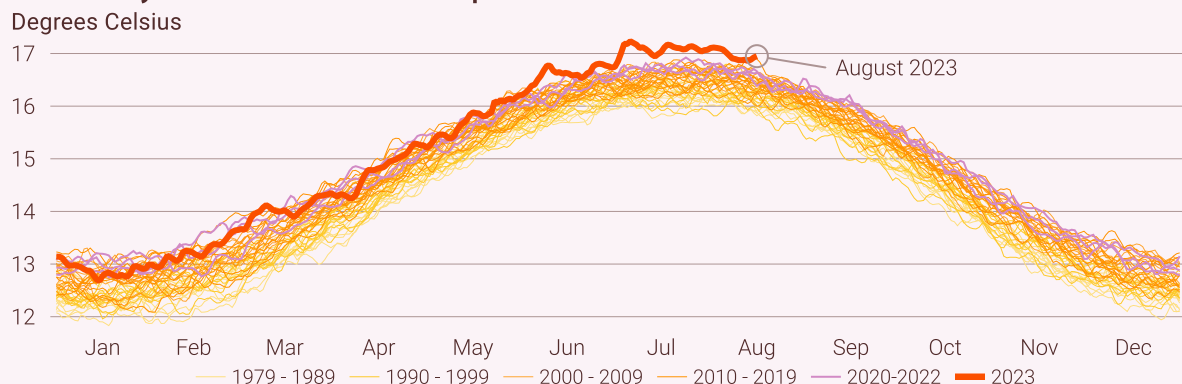
Heatwaves also contribute to higher prices, including electricity prices. For example, in Spain, data show that electricity consumption is higher during the summer than during the winter months due to 24/7 air conditioning usage. Last year, the drought resulting from extreme heat in France diminished the amount of electricity generated by French nuclear power plants, contributing to higher energy prices. Moreover, extreme heat puts a strain on the electricity grid, leading to a decrease in transmission capacity, which also affects prices. Lastly, some regions are experiencing water shortages due to the heat, creating additional difficulties for a number of sectors. Hence, heatwaves have a broad-based economic impact.

The extreme heat also impacts productivity, making work more challenging. According to a recent report, high temperatures often result in slower work, increased risk-taking, and diminished cognition – all factors that reduce productivity. Additionally, workdays might need to be cancelled due to the extreme heat, which would also contribute to a decline in GDP.

In early July, the Earth's average temperature set a new all-time record, shattered three times within the same week. Scientists project that countries bordering the Mediterranean Sea will frequently experience heatwaves exceeding 45 degrees Celsius, with a strong likelihood that temperatures will increasingly surpass the 50-degree Celsius mark by 2100. In turn, the Nordic and Baltic countries are progressively gaining appeal as tourist destinations during the summer, due to their climate.

Global daily mean of 2-metre air temperature

Degrees Celsius

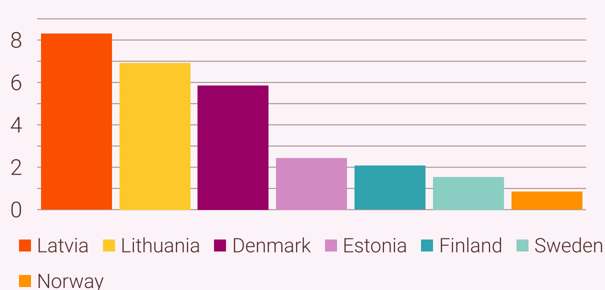


Sources: Climate Change Institute, University of Maine & Swedbank Research

The probability of facing additional catastrophic events, such as storms, floods, and droughts, has markedly risen since the 1980s, and global warming has emerged as a pivotal factor shaping the occurrence, magnitude, and duration of these events. It is estimated that the direct global costs of these extreme weather events are constantly rising; since 2010, they have stood at around EUR 100 billion each year.

Cumulative losses over the period 1980 to 2020, including estimate of indirect costs

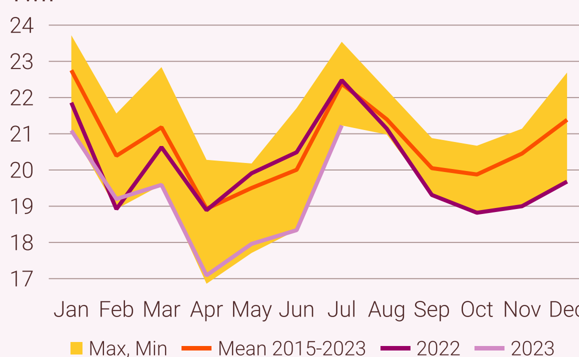
% of GDP in 2020



Note: Indirect cost included with a multiplier of 2.
Sources: European Environmental Agency & Swedbank Research

Electricity demand in Spain

Twh



Sources: Ember & Swedbank Research

The impact on the Baltics and Nordics

The escalation of extreme weather events will affect our countries' economies, with variations seen at both regional and national levels. Thus far, the realised economic losses in the Nordic and Baltic regions, except Denmark, have remained relatively limited within the broader European context.

The cumulative direct economic losses from extreme weather events from the 1980s to 2020 reached around EUR 1500 per capita in Denmark, whereas the corresponding amount is approximately EUR 400 in Latvia, Lithuania, Finland, and Sweden. The higher costs in Denmark are largely attributed to the presence of numerous large cities near the waterfront which increases the risk of flooding. On average, the expense per capita for euro-area countries totals EUR 870.

However, the actual economic losses have likely been even larger. For example, while El Niño does not directly affect Nordic or Baltic nations, these are open global economies, making them especially responsive to shifts in international prices. For instance, a reduced coffee harvest in Brazil or Colombia would translate into higher coffee costs in the Nordics and Baltics. Hence, elevated raw material prices inevitably translate into costlier end products.

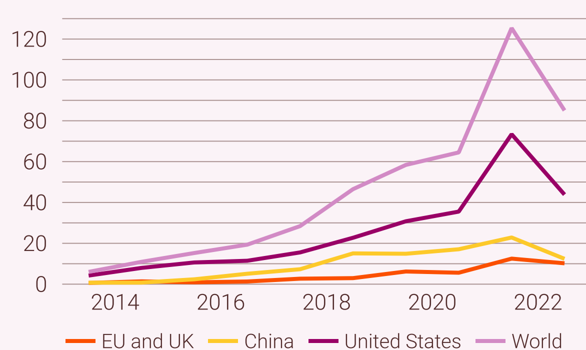
Factoring this in and computing the indirect costs using a research-based estimate, the cumulative annual losses between 1980 and 2020 for Latvia amount to more than 8% of Latvia's GDP in 2020, or about EUR 800 per capita. A comparison across the other Nordic and Baltic nations highlights that extreme weather has also substantially affected Lithuania and Denmark. Meanwhile, for the economies of Sweden, Norway, Finland, and Estonia, the impact is considerably less pronounced. To read the full analysis and macro focus, click here.

How disruptive is generative AI?

The genie is out of the bottle. In November 2022, OpenAI released ChatGPT, a conversational chatbot based on a generative pre-trained transformer model, marking a significant leap in the field of generative artificial intelligence (AI). The platform reached 1 million users within five days, and 100 million in the first two months. Unlike traditional AI, which consists of rules programmed to perform specific tasks (like search engine optimisation), generative AI involves training a machine learning model to generate new content that is similar to a set of training data. During the past decade, AI investments, as well as the number of patent filings, have grown substantially. Global corporate investment in AI has increased thirteenfold since 2013, reaching nearly USD 190 billion in 2022. In this in-depth analysis, we focus on labour market effects, productivity growth, and inflation when analysing the macroeconomic impact of generative AI. The full analysis, including references, can be found here. Or you can read a summary of it produced by ChatGPT below:

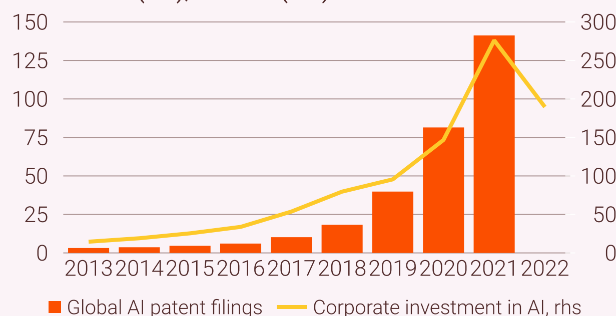
> *"The fear of AI centres on its impact on jobs, as evolving generative AI threatens to make certain tasks and jobs obsolete. AI already excels in tasks like coding and text generation. Historical evidence shows that technological shifts have complex effects on employment, with new jobs often emerging. AI adoption risks job changes and wage pressures. AI could reduce labour market inequalities, benefiting low-ability workers. MIT research suggests AI, like ChatGPT, raises productivity and narrows output gaps. AI's impact on the economy includes potential productivity gains and GDP growth, affecting interest rates and inflation dynamics. The AI's future impact remains debated."*

Private investment in AI, 2013-2022
USD bn, constant 2021 prices



Sources: 2022 AI Index Report, Swedbank Research & Macrobond

Global investment in AI and number of AI patent filings, 2013-2022
Thousands (lhs); USD bn (rhs)



Sources: CSET, Swedbank Research & Macrobond

Narrowing the productivity gap between workers

So far, introducing generative AI into the workforce has boosted productivity and efficiency, and previously time-consuming and resource-intensive creative tasks can now be accomplished rapidly with the assistance of various forms of AI. Additionally, productivity effects vary between workers at different skill levels, benefitting low-ability workers more than other workers. Cognitive work, with a focus on producing text and images, is at higher risk than physical labour.

While some jobs will become obsolete with this new technological development, history shows that many existing jobs will change and entirely new ones will emerge. The need to retrain and transition workers to new tasks, or even occupations, might be highly disruptive, at least in the short term.

However, the liberation from some tasks may help redistribute certain workers to sectors currently experiencing severe labour shortages.

Generative AI – the next chapter in the economy

Going forward, the effects of AI could be much more disruptive. Generative AI could give the global economy just the boost it needs, or it could cause severe labour market upheaval; it all depends on application. In cases where the technology complements existing jobs, productivity will increase, raising global GDP growth. If AI is targeted toward already-satiated markets, jobs will be lost in the affected industries, possibly disrupting the labour market. However, the prospect of retraining and relocating displaced workers could, in the long term, contribute to economic growth through other industries. Generative AI could further bring down cost curves and prices for services and dampen inflation.

AI could give the global economy a major kick-start

The gains in labour productivity could stretch to an economy-wide productivity increase. AI-based tools might not just increase efficiency in already-existing jobs, but also detect strategies to enhance productivity overall. As we have seen from previous industrial revolutions, technology helps to boost productivity.

As no one can say exactly what effect AI will have on the labour market, it is increasingly difficult to expand the scale to the broad economy. Some estimates say that AI could increase productivity of all cognitive work by 30%, and, as cognitive work stands for about 60% of all labour, this would result in an overall productivity increase of 18% over time. Other predictions show a potential increase in annual global GDP of 7% over a 10-year period as a result of this global labour productivity boost.

Inflation could go either way

Increasing production capacity could temporarily exert a downward pressure on inflation. Consumer demand increases at a slower pace than production, hence capping price increases. Past examples of this are the late 1990s productivity surge and the trade expansion following China's entry into the WTO in the 2000s as well as the shale gas revolution in the 2010s.

However, if they expect rising real wages, consumers will start to even out their consumption and increase their spending today. Heightened demand before an increase in production would, instead, boost inflation. To keep prices down in the near term, real interest rates need to be utilised in order to reduce demand.

The effects will also depend on legislation

While frameworks and laws are being drafted across countries, innovation is still advancing rapidly. Governments have admitted to dropping the ball on regulating social media, and they do not want to make the same mistake with AI. Kent Walker, President of Global Affairs at Google and Alphabet, warns that obstructing innovation could mean missing out on groundbreaking advances in health care and science, proclaiming that "social media isn't going to cure cancer, but AI has the potential to". Additionally, the threat of Russia or China reaching the finish line first with a next-generation advanced AI might discourage even the most tech-conservative legislators in both Washington and Brussels from imposing the strictest regulations on the technology.

Appendix

SWEDEN: Key economic indicators, 2022-2025

Annual % change unless stated otherwise	2022	2023F		2024F		2025F
Real GDP growth (average, calendar-adjusted)	2.8	-0.9	(-1.1)	-0.3	(0.3)	2.3
Real GDP growth (Q4-Q4, calendar-adjusted)	-0.4	-1.4	(-1.5)	1.3	(1.6)	2.4
Real GDP growth	2.8	-1.1	(-1.3)	-0.3	(0.3)	2.1
Household consumption	1.9	-2.5	(-1.4)	0.7	(0.0)	1.9
Government consumption	0.1	1.3	(1.2)	1.1	(1.8)	1.7
Gross fixed capital formation	6.1	-1.4	(-3.6)	-3.0	(-1.4)	1.4
private, excl. housing	8.5	3.4	(-1.4)	-2.9	(0.4)	0.4
public & NPISH	-0.6	2.4	(4.8)	5.0	(5.4)	4.1
housing	4.9	-18.7	(-17.9)	-14.2	(-15.5)	2.5
Change in inventories (contribution to GDP)	1.0	-0.6	(-0.9)	-0.1	(-0.2)	0.0
Exports, goods and services	7.0	0.4	(1.1)	0.6	(2.0)	2.2
Imports, goods and services	9.4	-1.0	(-0.9)	0.5	(1.3)	1.4
Domestic demand (contribution to GDP)	2.5	-1.1	(-1.3)	-0.2	(0.1)	1.7
Net exports (contribution to GDP)	-0.9	0.7	(0.9)	0.0	(0.4)	0.4
CPI (average)	8.3	8.7	(9.2)	3.8	(3.8)	1.4
CPI (Dec.-Dec.)	12.3	4.8	(5.8)	2.8	(2.0)	1.1
CPIF (average)	7.7	6.1	(6.5)	2.2	(2.2)	1.7
CPIF (Dec.-Dec.)	10.2	2.7	(3.2)	2.1	(1.6)	1.9
CPIF ex energy (average)	5.9	7.6	(7.6)	3.2	(2.6)	1.8
CPIF ex energy (Dec.-Dec.)	8.4	5.6	(5.4)	2.6	(2.2)	1.7
Riksbank policy rate (Dec.)	2.50	4.25	(4.00)	3.50	(2.75)	2.5
Unemployment (% of labour force, 15-74)	7.5	7.5	(7.8)	8.2	(8.5)	8.2
Change in labour force (15-74)	1.2	1.6	(0.7)	0.1	(0.0)	0.6
Change in employment (15-74)	2.7	1.5	(0.4)	-0.6	(-0.8)	0.5
Number of hours worked (calendar-adjusted)	2.4	2.3	(0.2)	-1.0	(-0.6)	0.8
Nominal hourly wage (NMO), whole economy	2.7	4.0	(4.2)	3.9	(3.9)	3.7
Household real disposable income per capita	0.0	-3.2	(-3.4)	-0.7	(0.1)	3.5
Household nominal disposable income	7.5	3.6	(3.2)	2.5	(3.4)	6.1
Household savings ratio, % of disposable income	13.9	14.1	(12.7)	13.8	(13.1)	15.4
General government budget balance (% of GDP)	0.8	-0.1	(-0.3)	-1.0	(-1.3)	-0.7
General government debt (Maastricht), % of GDP	32.8	32.0	(31.8)	33.2	(33.3)	34.1

Previous forecast in parentheses
Source: Statistics Sweden & Swedbank Research

ESTONIA: Key economic indicators, 2022-2025

Annual % change unless stated otherwise	2022	2023F		2024F		2025F
Real GDP	-0.5	-2.0	(-0.8)	2.0	(2.3)	3.0
Household consumption	2.0	-2.0	(-0.5)	2.0	(2.0)	3.5
Government consumption	0.1	1.5	(0.0)	3.0	(2.0)	2.0
Gross fixed capital formation	-3.7	-3.0	(4.0)	4.0	(4.5)	5.0
Exports of goods and services	3.0	-3.0	(-1.0)	2.5	(2.5)	3.5
Imports of goods and services	3.2	-4.5	(-2.5)	2.0	(2.8)	3.5
CPI (average)	19.4	9.8	(10.0)	4.3	(4.3)	2.4
Unemployment (% of labour force)	5.6	6.5	(6.8)	6.7	(6.1)	5.4
Employment	4.1	2.2	(-0.5)	0.5	(0.6)	0.3
Gross monthly wage	11.6	11.2	(8.7)	7.8	(7.0)	7.4
Nominal GDP, billion euro	36.0	38.4	(38.5)	40.6	(40.6)	42.7
Exports of goods and services (nominal)	23.5	-1.1	(6.0)	5.1	(5.5)	6.6
Imports of goods and services (nominal)	22.7	-4.0	(5.3)	4.5	(5.9)	6.6
Balance of goods and services, % of GDP	-0.6	1.8	(0.0)	2.1	(-0.4)	2.2
Current account balance, % of GDP	-2.9	0.0	(-1.6)	0.5	(-1.9)	0.5
General government budget balance, % of GDP	-0.9	-2.6	(-3.6)	-3.0	(-3.2)	-2.8
General government debt (Maastricht), % of GDP	18.5	19.1	(20.0)	21.3	(22.4)	23.6

Previous forecast in parentheses
Sources: Statistics Estonia & Swedbank Research

LATVIA: Key economic indicators, 2022-2025

Annual % change unless stated otherwise	2022	2023F		2024F		2025F
Real GDP	2.8	0.3	(0.6)	1.7	(2.1)	2.8
Household consumption	8.1	0.1	(3.7)	2.4	(2.6)	3.5
Government consumption	2.8	3.0	(1.0)	1.4	(1.6)	2.4
Gross fixed capital formation	0.7	6.9	(1.5)	4.0	(5.8)	3.5
Exports of goods and services	9.1	-1.9	(-1.2)	2.0	(1.6)	4.3
Imports of goods and services	11.7	1.5	(2.0)	2.6	(2.5)	4.3
CPI (average)	17.3	9.0	(9.5)	2.0	(2.0)	2.5
Unemployment (% of labour force)	6.9	6.5	(6.8)	6.6	(6.6)	5.9
Employment	2.6	0.0	(0.4)	0.0	(0.5)	0.7
Gross monthly wage	7.5	11.5	(9.0)	8.0	(8.0)	7.5
Nominal GDP, billion euro	39.1	42.9	(43.4)	44.9	(45.5)	47.6
Exports of goods and services (nominal)	28.5	-4.7	(-4.1)	3.1	(2.7)	5.5
Imports of goods and services (nominal)	32.0	-6.1	(-5.7)	2.5	(2.4)	5.0
Balance of goods and services, % of GDP	-5.8	-4.1	(-3.9)	-3.7	(-3.6)	-3.3
Current account balance, % of GDP	-6.4	-3.4	(-3.2)	-3.0	(-2.9)	-2.7
General government budget balance, % of GDP	-4.4	-3.8	(-4.3)	-2.7	(-2.4)	-2.0
General government debt (Maastricht), % of GDP	40.8	40.4	(40.6)	40.2	(39.6)	40.1

Previous forecast in parentheses
Sources: Statistics Latvia & Swedbank Research

LITHUANIA: Key economic indicators, 2022-2025

Annual % change unless stated otherwise	2022	2023F		2024F		2025F
Real GDP	1.9	-0.3	(-0.3)	1.5	(1.8)	2.3
Household consumption	0.5	0.8	(0.5)	3.7	(3.7)	4.0
Government consumption	0.5	0.5	(0.5)	0.5	(0.5)	1.0
Gross fixed capital formation	2.6	6.5	(3.0)	4.5	(5.0)	5.5
Exports of goods and services	11.9	-2.5	(-1.2)	2.8	(3.3)	4.4
Imports of goods and services	12.3	-1.2	(-0.5)	4.6	(4.6)	5.4
CPI (average)	19.6	9.4	(9.6)	1.8	(1.8)	2.5
Unemployment (% of labour force)	5.9	7.3	(7.3)	7.0	(7.0)	6.7
Employment	3.8	0.6	(-0.1)	-0.2	(-0.2)	0.0
Gross monthly wage	13.3	12.2	(10.9)	8.6	(7.2)	6.5
Nominal GDP, billion euro	66.8	72.7	(72.9)	75.1	(75.7)	78.8
Exports of goods and services (nominal)	29.3	-3.5	(-1.5)	5.0	(5.0)	5.9
Imports of goods and services (nominal)	40.1	-9.0	(-3.0)	5.5	(5.5)	6.5
Balance of goods and services, % of GDP	-2.0	2.8	(-0.6)	2.4	(-0.9)	2.0
Current account balance, % of GDP	-5.1	0.9	(-3.0)	1.0	(-2.4)	0.9
General government budget balance, % of GDP	-0.6	-1.9	(-2.9)	-1.7	(-1.9)	-1.4
General government debt (Maastricht), % of GDP	38.4	37.1	(39.7)	37.5	(40.2)	39.1

Previous forecast in parentheses
Sources: Statistics Lithuania & Swedbank Research

Interest and exchange rate forecasts

	Outcome 2023 21 Aug	Forecast 2023 31 Dec	2024 30 Jun	2024 31 Dec	2025 30 Jun	2025 31 Dec
Policy rates (%)						
Federal Reserve, USA (upper bound)	5.50	5.50	5.00	4.00	3.50	3.00
European Central Bank (refi rate)	4.25	4.50	4.00	3.00	2.25	2.25
European Central Bank (deposit rate)	3.75	4.00	3.50	2.50	1.75	1.75
Bank of England	5.25	5.75	5.25	4.25	3.25	2.25
Riksbank	3.75	4.25	4.00	3.50	2.75	2.50
Norges Bank	4.00	4.50	4.25	3.75	3.25	2.75
Government bond rates (%)						
US 2y	4.97	4.50	4.10	3.80	3.70	3.50
US 5y	4.46	4.40	4.20	3.90	3.80	3.80
US 10y	4.34	4.30	4.10	4.00	4.00	4.00
Germany 2y	3.10	2.90	2.60	2.50	2.10	2.00
Germany 5y	2.70	2.50	2.40	2.40	2.20	2.10
Germany 10y	2.70	2.60	2.50	2.50	2.30	2.20
Exchange rates						
EUR/USD	1.09	1.08	1.10	1.12	1.14	1.15
EUR/GBP	0.86	0.88	0.87	0.85	0.85	0.85
EUR/SEK	11.94	12.10	11.60	11.20	11.00	10.80
EUR/NOK	11.52	11.70	11.30	10.90	10.70	10.50
USD/SEK	10.97	11.20	10.55	10.00	9.65	9.39
USD/CNY	7.23	7.25	6.50	6.50	6.50	6.50
USD/JPY	146.3	138.0	130.0	125.0	120.0	120.0
NOK/SEK	1.03	1.03	1.03	1.03	1.03	1.03
KIX (Trade-weighted SEK)	131.7	133.3	129.3	124.8	122.3	120.0

Sources: Swedbank Research & Macrobond

Swedish interest rate forecasts (%)

	Outcome 2023 21 Aug	Forecast 2023 31 Dec	2024 30 Jun	2024 31 Dec	2025 30 Jun	2025 31 Dec
STIBOR 3m	4.01	4.25	4.10	3.50	2.80	2.50
Government bond yields						
2y	3.56	3.50	3.20	3.00	2.90	2.70
5y	3.05	3.10	3.20	3.10	3.00	2.90
10y	2.90	3.00	3.10	3.05	3.00	3.00
Swap rates						
2y	4.10	4.00	3.65	3.40	3.30	3.10
5y	3.61	3.60	3.65	3.50	3.40	3.30
10y	3.41	3.50	3.55	3.45	3.40	3.40

Sources: Swedbank Research & Macrobond

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