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Swedbank Economic Outlook

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Low growth and few policy options

Inflation is heading down and getting closer to levels in line with inflation targets. Central banks' policy rates are at peak levels, and the higher-for-longer mantra will soon be replaced with monetary easing. Many economies have turned out to be more resilient than previously presumed, and labour markets have remained tight, but this is now changing. Economic growth is slowing in most economies, unemployment is increasing, and labour market tightness is easing. One exception is China, where growth has recovered on the back of expansionary fiscal and monetary policy.

The direction ahead of us will be similar for many countries: low or stagnating economic growth. Monetary policy will remain restrictive in the near term, but the full effect of the higher interest rates and tighter financial conditions still lies ahead and will push economic growth lower. Weaker growth, higher unemployment and highly limited capacity for more expansionary fiscal policy will force the major central banks to start lowering policy rates in mid-2024 as inflation continues to fall.

> "Low or stagnating economic growth"

A prolonged period of low or stagnating growth cannot be ruled out. First, longer transmission lags and greater-than-expected effects from global monetary policy tightening might not be fully offset by lower policy rates fast enough. Second, fiscal deficits and government debts are well above pre-pandemic levels in many countries, and medium-term fiscal consolidation is in many cases needed to restore budgetary scope for flexibility and ensure debt sustainability. Hence, the policy options seem limited.

> "Fiscal consolidation is in many cases needed"

On a geopolitical level, risks have increased. The war in Ukraine is still ongoing, while global fragmentation intensifies and trade declines. The war in the Middle East sparked by Hamas' recent attack on Israel risks lengthening and deepening the global economic downturn if it spreads to other countries in the region. It could also trigger higher global inflation through commodity prices, further complicating the policy trade-offs for monetary policy. The outlook is foggy.

> "Intensified conflicts risk lengthening and deepening the global economic downturn"

Mattias Persson
Group Chief Economist

0.2%

GDP growth in the euro area will remain mediocre in 2024

4.10%

10-year US government bond yield, December 2024

4.25%

The Riksbank policy rate will peak in November 2023

2.1%

Euro area inflation in 2024

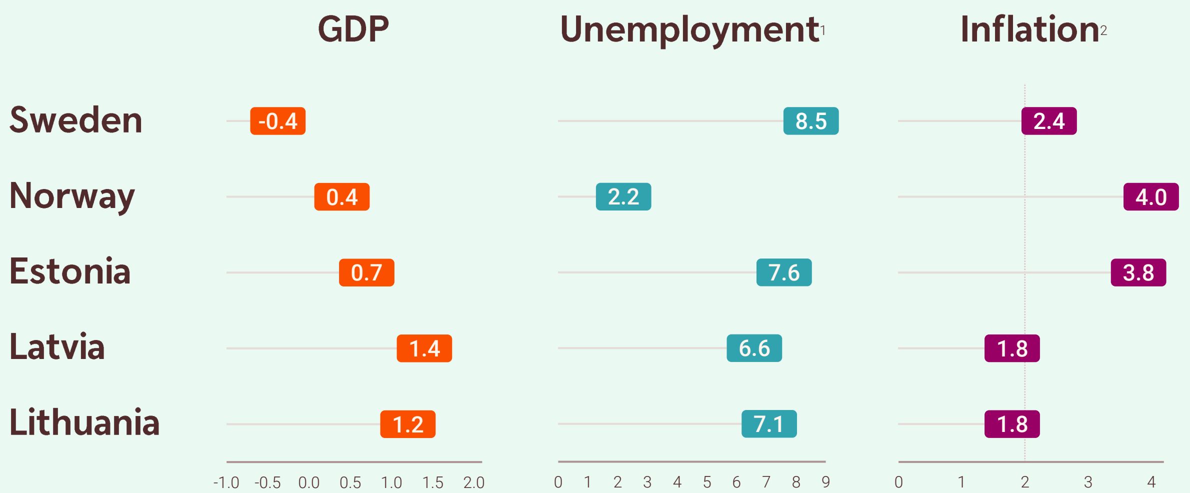
Q2

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

11.20

SEK/EUR December 2024

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. An economic winter is approaching. We forecast that **economic activity will slow down** in both the EU and the US in the near term, as the full impact of higher interest rates is yet to be seen. Global trade is already on a declining path. A modest recovery will start during the second half of 2024.

2. The global easing of supply chains, plummeting input costs and declining energy costs have supported monetary policies in bringing inflation down. Underlying **inflation is expected to continue downwards** both in the US and the euro area.

3. Neither the **Israel-Hamas nor the Russia-Ukraine** war is expected to have any material impact on the global economy. Although the supply of energy is at risk, energy prices have remained stable recently.

Financial Markets

1. Both the **Fed** and the **ECB** have finished their rate hikes for this cycle and are expected to gradually start **easing monetary policies** in the second quarter of 2024. We expect the Fed funds rate (upper bound) to be 3.25% and the ECB's deposit rate to reach 1.75% at the end of 2025.

2. Government **bond yields** have **peaked**, and we expect a gradual decline in 2024 when markets start to price in rate cuts from central banks. This will put downward pressure on yields of all maturities, but especially on those with shorter durations.

3. As global inflation normalises and bond yields fall, the US **dollar** is expected to **weaken** somewhat vis-à-vis the euro, despite the ECB cutting policy rates more aggressively. The Swedish **krona** and Norwegian **krone** are expected to **gain** some lost ground over the forecast horizon.

Sweden

1. The **downturn will be deeper** in Sweden than in most other European countries. We expect GDP to shrink both this year and next and then grow by around 2% in 2025.

2. In Sweden, **high inflation** will linger a little longer, which together with rising interest rates will continue to dampen purchasing power. The **labour market will weaken**, and the number of people employed will fall by 40 000 in the coming year.

3. The Riksbank will begin a series of **interest rate cuts in June**, which will contribute to a recovery starting late next year. We expect inflation to approach 2% in the summer of 2024 before gradually falling below the inflation target in 2025.

Baltics

1. The Baltic economies **stagnated** in the third quarter, and the prolonged Estonian recession seems to be ending. We forecast a tentative recovery in 2024, when **GDP** growth is expected to be close to 1%.

2. **Inflation** will be below 3% in Latvia and Lithuania at the end of this year, and close to **2% in 2024**. Estonian inflation is expected to stay slightly elevated next year, mainly due to the increase in VAT.

3. **Employment** continued to increase (stable in Latvia), and **wage** growth was above 11% in all three countries this year. We expect moderation on both fronts, and higher **unemployment** is likely.

The global economy cools down

We expect stagnant or declining economies in the US and the euro area until mid-2024, when a modest recovery will begin. The Fed and the ECB are expected to start cutting their policy rates during the second quarter of next year. Bond yields have peaked.

Overall slowdown

In many countries, the economic heat that followed the pandemic has dissipated this year. A cooling trend has been seen in most European economies, notably so in Germany. Although the US economy has held up well during the autumn, there are signs that the resilience is about to crack, and we forecast a marked slowdown this winter. The full impact of higher interest rates, as well as the rapidly rising inflation in 2022, have yet to play out fully in the real economy. We therefore expect stagnant or declining economies in the US and the euro area until mid-2024, when a modest recovery will begin. Labour markets will inevitably take a hit and, starting next year, we expect unemployment to rise in the US and the euro area. In China, the first half of this year was slow, but authorities have since managed to stabilise growth by adding stimulus. We expect stable growth ahead, despite the severe challenges in the country's property sector.

Chill

Swedbank's GDP forecast

Annual % change	2022	2023F		2024F		2025F	
US	1.9	2.4	(2.0)	0.8	(0.4)	1.6	(1.8)
China	3.0	5.0	(5.0)	4.8	(4.8)	4.5	(4.5)
Euro area	3.4	0.4	(0.5)	0.2	(0.6)	1.5	(1.5)
Germany	1.9	-0.2	(-0.3)	0.1	(0.5)	1.4	(1.4)
France	2.5	0.8	(0.8)	0.5	(0.7)	1.5	(1.4)
Italy	3.9	0.6	(0.8)	0.2	(0.4)	1.2	(1.3)
Spain	5.8	2.3	(2.2)	0.9	(0.9)	2.1	(1.9)
Estonia	-0.5	-2.5	(-2.0)	0.7	(2.0)	2.3	(3.0)
Latvia	3.4	-0.4	(0.3)	1.4	(1.7)	2.5	(2.8)
Lithuania	2.4	-0.3	(-0.3)	1.2	(1.5)	2.0	(2.3)
Sweden	2.8	-0.7	(-1.1)	-0.4	(-0.3)	1.7	(2.1)
Norway	3.7	1.3	(1.3)	0.4	(0.4)	1.0	(1.0)
United Kingdom	4.3	0.5	(0.5)	0.3	(0.5)	1.1	(0.7)

Previous forecast in parentheses.

Source: Swedbank Research

The Israel-Hamas war – limited economic effects so far

The global economic consequences of the Israel-Hamas war have been limited so far. The initial jump in oil prices, and to a lesser extent natural gas prices, that followed in the days after Hamas' terror attack has recently reversed. A potential widening of the conflict to other parts of the region cannot be ruled out; such a development could potentially result in greater disruption to the oil supply. This is a risk to our economic outlook, mainly via rising energy prices and inflation.

USD 85

per barrel. Oil is cheaper than a year ago

Moreover, the Ukraine war goes on with no peace in sight. Also in this case, however, the global economic impact is currently limited. EU countries seem to have managed to build economic resilience, and the future prices of natural gas are low. Yet the risk of an adverse development on the energy market and commodity prices remains.

No marked uptick in oil prices so far

Oil price incl. future, Brent, USD/barrel

Sources: Swedbank Research & Macrobond

... as well as natural gas prices

Natural gas price incl. future, EUR/MWh

Sources: Swedbank Research & Macrobond

Fed and ECB cuts are approaching

Global inflation pressure is gradually coming down. Most commodity prices have declined since early 2022 and will continue to pull down consumer price inflation going forward. The process of normalising inflation will not be smooth, however. Monthly inflation outcomes are volatile, and headline inflation could even rise in the upcoming months as the current favourable base effects from energy fade. That said, the underlying global inflation will continue to trend downwards.

Q2 2024

As economies weaken and inflation normalises, there will be scope for less restrictive monetary policies. We expect the ECB to start cutting its policy rate in April next year, followed by the Fed in June. The Riksbank and Norges Bank are expected to follow and start cutting in June, despite inflation still running a bit above 2% in Sweden and Norway.

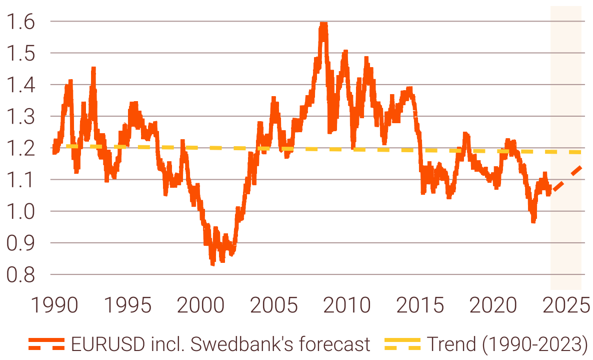
Bond yields have peaked

Government bond yields continued to rise during the autumn in most countries. The uptick was driven by US developments and was observed mainly for long-dated yields, whereas interest rates with shorter durations have remained more stable. Investors have asked for a higher term premium on longer duration, probably due to increased uncertainty and worries about US fiscal stability, see more on p. 14.

Our assessment is that government bond yields have peaked in both the US and Europe, even though a more marked downturn will not be seen until the spring of next year. Short-term yields are expected to fall more markedly than long-term yields, i.e. the yield curve will steepen. While short-term yield will be pulled down more extensively by monetary policy easing, the long-term yields are expected to be stickier.

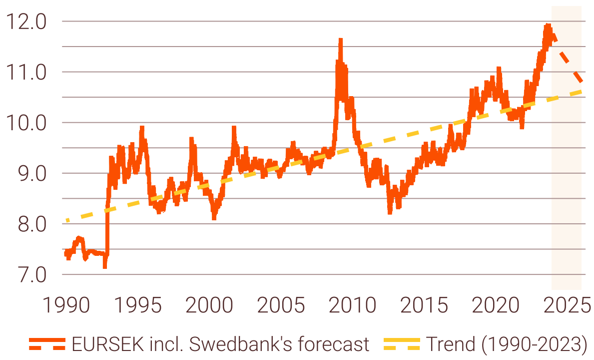
As inflation normalises and bond yields fall, the US dollar is expected to weaken. EUR/USD is, however, expected to rise only gradually, as we forecast that the ECB will cut rates more aggressively than the Fed. The Swedish krona is expected to strengthen somewhat vis-à-vis the euro over the forecast horizon.

Weaker USD starting next year
EURUSD



Sources: Swedbank Research & Macrobond

SEK strengthening towards trend
EURSEK



Sources: Swedbank Research & Macrobond

United States – fiscal sustainability in question

The US is running a large budget deficit despite strong growth and low unemployment. Its fiscal path has become increasingly unsustainable, and a solution seems distant. Real economic resilience has been strong so far, but this trend will come to an end, and we expect more muted growth next year. This sets the stage for the Fed to start cutting rates by next summer.

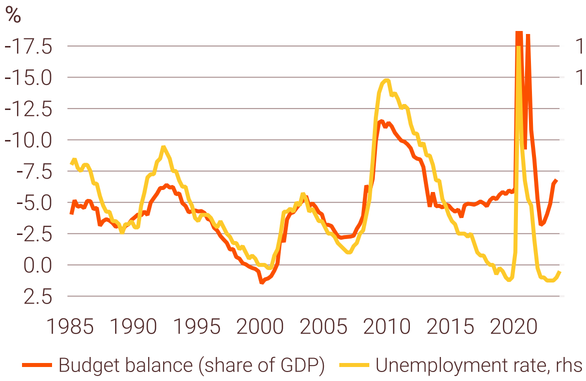
US public finances have become increasingly unsustainable, and given the messy political landscape, it is difficult to see a solution arising in the near term. Earlier this year, Fitch Ratings downgraded US credit ratings, citing "a steady deterioration in standards of governance over the last 20 years". A government shutdown has so far been avoided, despite continued turbulence in Congress during the autumn. However, a shutdown is still possible if lawmakers are unable to pass another spending bill before 17 November.

The federal government budget deficit for this year is expected to reach around 8% of GDP, according to the IMF. Worryingly, the large budget deficit comes at a time of strong growth and a historically low unemployment rate, a rather unusual occurrence. The fiscal outlook looks set to deteriorate even further, both in the short term as the business cycle turns worse but also in the longer term for structural reasons. Projections from the Congressional Budget Office (CBO) show that the federal debt, which is already at its highest level since 1946, is projected to rise to 180% in 2053.

Public finances have become increasingly unsustainable, and it is hard to see a solution in the near term

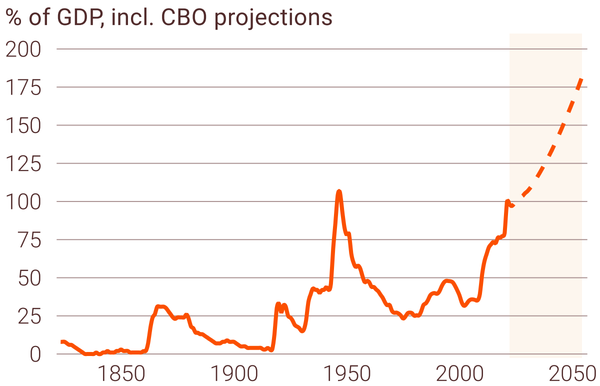
Going forward, the budget could be improved by increasing tax revenues, reducing spending, or both. However, we believe that any such efforts are unlikely between now and the 2024 presidential election. Notably, the Trump-era tax cuts enacted in 2017 are set to expire at year-end 2025, which could present an opportunity to begin reining in the budget deficit. However, the tax cuts could instead be extended; indeed, we even see such a scenario as likely if a Republican is elected President. All in all, the worry relating to the US fiscal outlook, which is probably a driver of the recent rise in government bond yields, is likely here to stay. (See also "Why have US bond yields risen?" on p. 14).

Large budget deficit but low unemployment



Sources: Swedbank Research & Macrobond

Federal debt is projected to skyrocket



Sources: Swedbank Research & Macrobond

Real economic development has remained a bright spot. GDP grew at an annual rate of 4.9% in the third quarter. Not only was this double the pace of growth compared to the second quarter, but it was also the fastest pace in more than two years. Unsurprisingly, the labour market has thus remained strong. Jobs growth has been solid, and unemployment remains at historically low levels despite increased labour supply. There are signs that the resilience is about to give way, however, and we expect a slowdown in growth and a weakening of the labour market in the coming quarters.

Surprisingly strong growth but more muted going forward

Recently, there has been a surge in long-term US government bond yields. To some extent, the rise in yields is likely a result of the abovementioned budget concerns and the associated increased issuance of Treasury debt, although other factors have also been contributing, such as the Fed's quantitative tightening. This is also putting upward pressure on other types of interest rates. For example, the interest rate on 30-year fixed-rate mortgages has risen to almost 8% recently – the highest level since 2000. While consumer spending has remained surprisingly strong, it will eventually give way to the mounting headwinds from rising interest rates and elevated inflation, especially given that real incomes have now fallen four months in a row. Additionally, weaker external demand will negatively affect investments and exports.

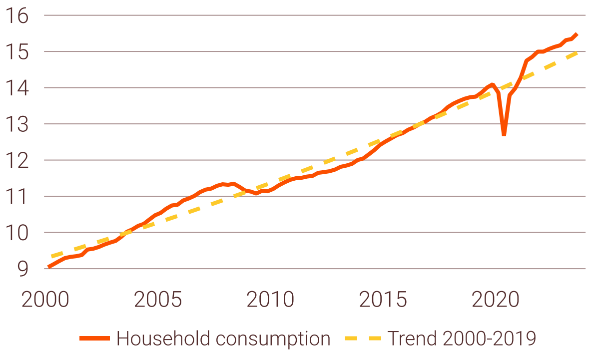
Due to a rise in energy prices, the disinflationary process has recently reversed somewhat. Core inflation, however, has continued to drop. Inflation is expected to decline going forward in line with the overall slow-down of the economy, although it is expected to remain above the Fed's 2% target throughout next year. Still, our assessment is that upside risks will dominate. In particular, if the economy continues to grow more than expected, inflation will likely take longer to come down, while a widened conflict in the Middle East could put renewed upward pressure on energy prices.

The Fed has finished its hiking campaign – we see rate cuts beginning next summer

The Fed has now left the federal funds rate unchanged at two consecutive monetary policy meetings – the first time it has done so since it started hiking the rate in March last year. In September 2023, most Fed officials expected another rate hike before the end of the year, but we believe the Fed has already reached the end of its hiking campaign. Importantly, if bond yields remain high, financial conditions will tighten and the need for additional rate hikes will diminish, while at the same time core inflation will continue trending down. Also, monetary policy works with a lag, and given that the Fed has raised rates at a rapid pace, by a total of 525 basis points between March last year and July this year, significant effects from this tightening are still in the pipeline and have not yet been felt. The economic slowdown and lower inflation should pave the way for the start of rate cuts next summer. The slowdown could also lead to the Fed stopping its quantitative tightening sometime during the second half of next year. The Treasury is flooding the market with bonds, and after all, someone will have to buy them.

Remarkably strong household consumption

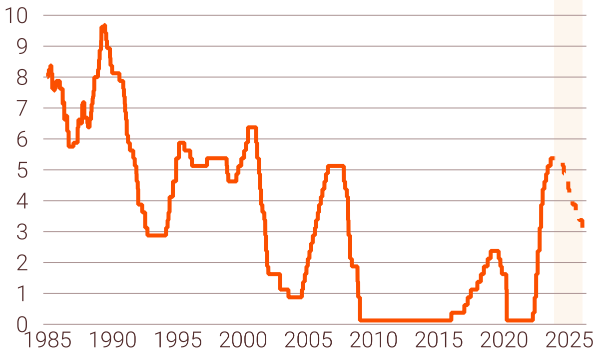
USD trn, annual rate, constant prices



Sources: Swedbank Research & Macrobond

The Fed's hiking campaign has ended

Fed funds rate (mid-point), %, incl. Swedbank's forecast



Sources: Swedbank Research & Macrobond

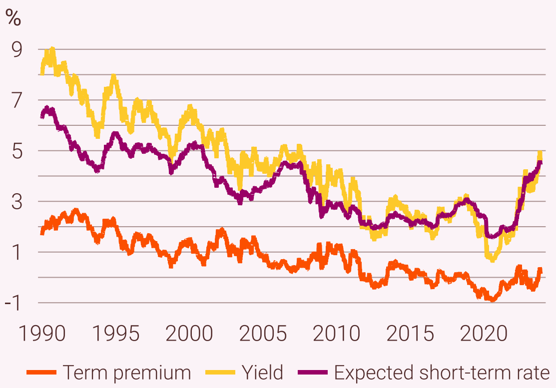
What explains the rise in US long-term interest rates?

The US 10-year government bond yield has risen to almost 5% in October, its highest level since 2007, and remained high in November despite falling slightly to around 4.5% The increase is mainly explained by rising expected short-term interest rates – a rise that is not surprising given the Federal Reserve's rapid increases of the policy rate. However, the rise in the past six months is also due to rising term premiums (see graph below on the left). According to what is known as the expectations hypothesis, the 10-year interest rate can be divided into the expected average short-term interest rate (or the policy rate) for the next 10 years and a term premium that investors demand as compensation for the risk that the interest rate in the future will be higher than expected. Neither the expected future policy rate nor the term premium can be observed directly; these factors must be estimated. The uncertainty in these estimates is considerable, and the results vary somewhat between different models. The estimates published by the Federal Reserve Board of Governors are reported here.[3]

The rising term premium can be explained by increased uncertainty about future short-term interest rates and concerns about the rapidly rising US national debt. Market participants are also discussing whether foreign central banks and other government actors have reduced their holdings of US government securities, driving up bond yields without necessarily increasing expected future policy rates. If bond yields continue to rise, the funding of US public debt could become more difficult, which could result in default, or more likely, higher inflation. Regardless, investors will demand higher compensation (interest) for lending to the US government, and the term premium will then rise further.

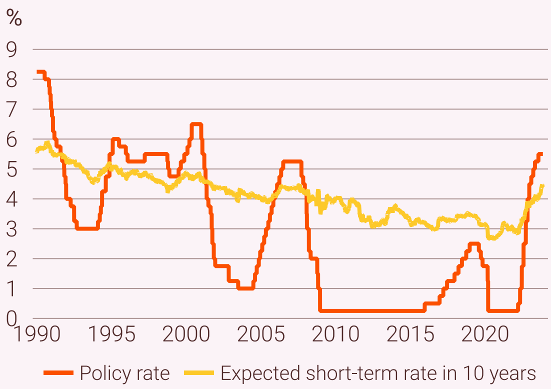
With the same model that is used to calculate the term premium, an estimate of the expected future short-term interest rate can also be obtained. It is a measure of what is known as the neutral nominal interest rate (i*). The expected short-term interest rate in 10 years fell trend-wise from just under 6% in 1990 to just under 3% in the summer of 2020, but has since risen to just over 4% (see graph below on the right). That's a fairly limited rise in light of the Fed's rate hikes of more than 5 percentage points since the start of 2022. The median of Fed members' long-term rate forecast (known as the dot plots) has not changed at all during this period and is at 2.5%. If expectations are met, the 10-year interest rate will be lower going forward, but the decline may be dampened by rising term premiums, which are still low in a longer perspective.

Rising US 10-year government bond yield



Sources: Swedbank Research, Federal Reserve & Macrobond

Moderate increase in expected policy rate



Sources: Swedbank Research, Federal Reserve & Macrobond

[3] The model was developed by Kim and Wright in 2005. See Federal Reserve Board - Yield Curve Models and Data. Data is released with a lag, The last observation in the graphs is November 10

Euro area – prolonged stagnation will prompt pivot by the ECB

Stagnation in the euro area is continuing, and the risk of a prolonged downturn has increased. After a brief rebound, the economy contracted by 0.1% in the third quarter compared to the second. The sparse data that is available for the final quarter of the year suggests that no improvements have occurred yet.

Slowing activity across countries and sectors

The manufacturing sector is weak across Europe due to the global downturn in industrial activity. The contraction is particularly evident in Germany, where the economy is also being dragged down by a decline in energy-intensive manufacturing and by the structural decline of industrial production that began in 2018. Furthermore, the debt-intensive real estate sector is being weighed down by high interest rates. While there are some very early signs that the global manufacturing cycle is beginning to turn, the weakness in the sector is spilling over to the rest of the economy in Europe.

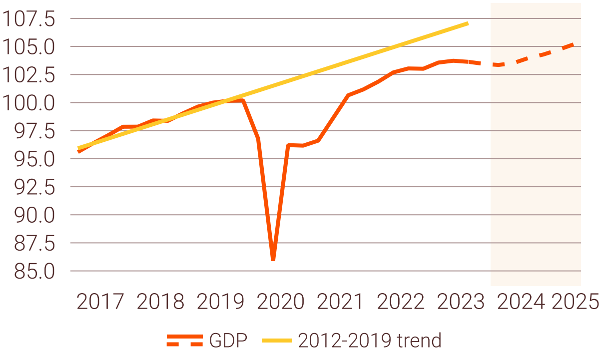
The labour market remains a bright spot for now. The unemployment rate is holding steady at 6.5%. In addition, due to the combination of retreating inflation and slightly accelerated wage growth, purchasing power stopped falling in the second quarter. It is likely that real wages started growing again in the second half of the year. Better trends for real income should boost household consumption, although we expect the unemployment rate to increase slightly, leading to subdued overall growth in domestic demand.

Policy is highly contractionary in Europe

Otherwise, there are few reasons to be optimistic about the real economy. Monetary policy is exerting a massive drag via the credit channel, new credit has dried up, and by September the broad money supply had already fallen by 1.2% annually. Fiscal policy will likely turn from neutral to contractionary next year. It appears unlikely that foreign demand will recover soon and bring relief to the exporting sectors. We expect the euro area to expand by just 0.4% this year and only 0.2% in 2024. However, given the numerous risks, it is very easy to picture Europe slipping into recession.

No growth for a year

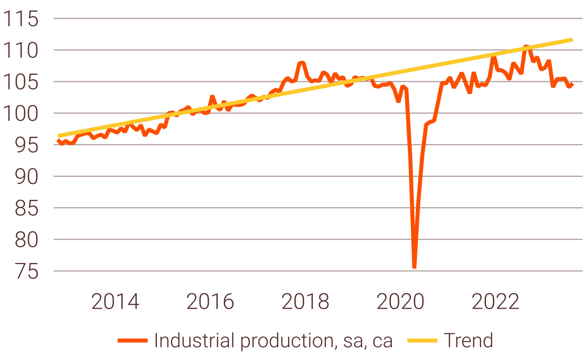
Index (2019=100)



Sources: Swedbank Research & Macrobond

Industry may be approaching a trough

Index



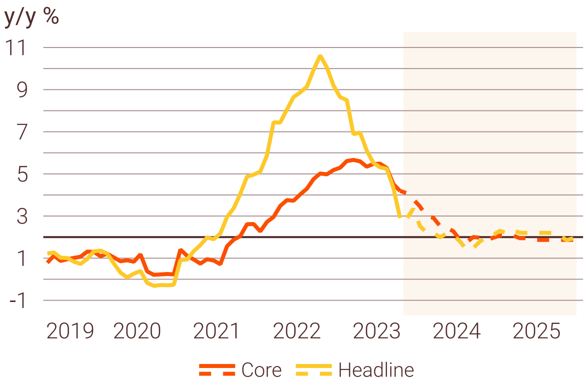
Sources: Swedbank Research & Macrobond

Inflation is declining rapidly

The autumn brought long-awaited relief with regards to inflation. In October, headline inflation decelerated to a two-year low of 2.9%, while core inflation eased to 4.2%. Monthly data shows a significant slowdown in inflation momentum, and underlying measures of inflation indicate that disinflation should persist during the coming quarters. Given that European economic performance has been lacklustre at best, price pressure should drop back to target already next year, sooner than the ECB currently expects.

Energy price volatility might result in a temporary increase in headline inflation. Given the tightness of monetary policy, however, the spillovers to broader price increases would be very limited. Last year, soaring gas prices caused electricity prices to skyrocket and affected every sector of the economy. Now, with storage tanks nearly full and the French nuclear fleet running smoothly, a repeat of energy-driven inflation is a more remote risk.

Will the descent be almost as fast as the climb?



Sources: Swedbank Research & Macrobond

Wage growth is likely to decelerate

Sources: Swedbank Research & Macrobond

The ECB is likely wrong on inflation and will have to make cuts soon

Surprisingly, in September the ECB revised inflation forecasts for 2024 upwards and now expects headline inflation at 3.2% (mainly due to energy and food prices) and core inflation at 2.9%. We think that this is off by a large margin, and we expect both headline and core inflation to be at least 0.5 percentage points below the ECB's current forecast. In the euro area, wages continue to grow roughly twice as fast as they did on average during the last decade, but forward-looking indicators (e.g., Indeed Wage Tracker) indicate a slowdown during the next six months. However, there is evidence[4] that much of the inflationary spike seen last year in many euro-area countries was caused by wider profit margins. In the face of unprecedented supply-chain disruptions (caused by the war in Ukraine and by China's Covid policy), energy price shocks and still-strong demand, many companies hedged this uncertainty by increasing the price of goods and services more than what was justified by the increase in input costs. Now the circumstances and fortunes have turned – many companies are experiencing stagnating or falling demand and benefiting from cheaper

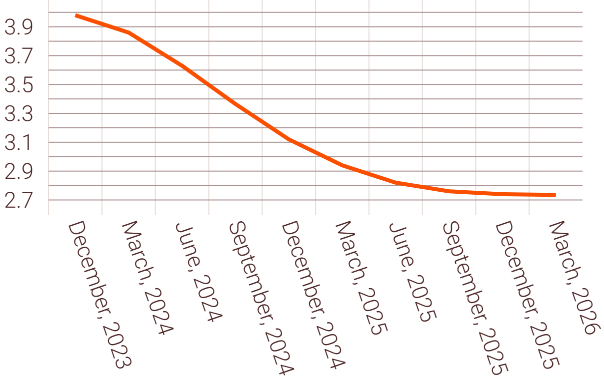
[4] The last mile (europa.eu)

energy and materials. As such, it is likely that margins will adjust downwards to a long-term average, further contributing to disinflation.

Market expectations have become more dovish and have caught up with our forecast – the first cuts are now fully priced in for the ECB's April 2024 meeting. We remain less worried about inflation (see above) and more wary about the underlying economic developments, which will be further dampened by the negative credit impulse and rapidly increasing real rates. Could the ECB start cutting before annual inflation has dropped to 2%? We think it could – it did so during all three previous cutting cycles in 2001, 2008 and 2011. Inflation momentum is already easing, and the trend is likely to continue during the coming months – even if annual inflation remains above 2%, a few more zero or negative monthly price changes may convince the ECB to change course. Furthermore, the ECB's reaction function may start changing soon – it may become harder and too costly to continue ignoring prolonged stagnation and increasing unemployment.

Thus, we maintain our forecast that the ECB will cut rates six times next year starting in April, resulting in a deposit rate of 2.5% at the end of 2024. The markets expect rates to bottom out at around 2.75% in the summer of 2025, but we think this is a bit too high. A recent ECB working paper suggests that the natural rate of interest was close to 0% during the last decade, but "may now be increasing again" and that "the future level of the long-run natural rate is uncertain".[5] Given the sluggish euro-area productivity growth and adverse demographics, we do not think the natural rate has risen much. This implies that the ECB's rates will have to fall below 2% if they are to avoid being restrictive. Such a decline is likely to happen by the summer of 2025.

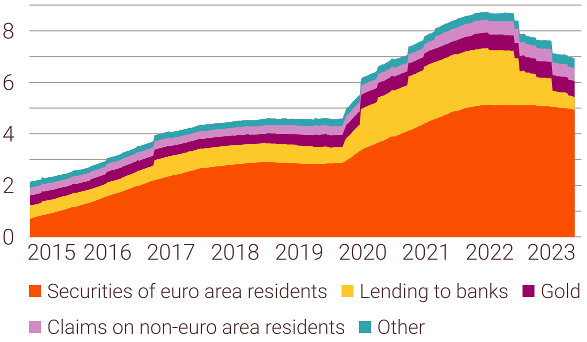
Three-month Euribor futures, %



Sources: Swedbank Research & Macrobond

ECB balance sheet

EUR trn



Sources: Swedbank Research & Macrobond

[5] European Central Bank, Daudignon, S., Tristani, O., Monetary policy and the drifting natural rate of interest, European Central Bank, 2023, https://data.europa.eu/doi/10.2866/35939

The dilemma of public debt in a warming world

In the wake of recent extreme events, such as the Covid-19 pandemic and Russia's invasion of Ukraine, governments have been called upon to adopt a "whatever it takes" approach to assist citizens and companies in weathering the impact of these events. This has resulted in larger fiscal deficits in most countries, and now many of these countries are facing high debt, rising interest rates, and weak growth prospects. Also, public finances will likely be put under even more pressure in the years to come, due to ageing populations and increased defence spending. This situation is challenging and could weigh on efforts to tackle the climate crisis.

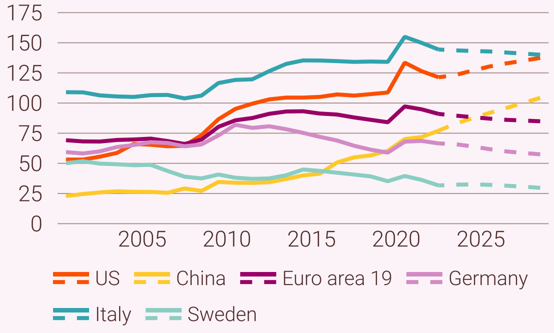
Thus, with yields reaching decade highs and many countries burdened with significant levels of debt with high-for-long interest rates, further debt-financed spending will become more challenging to implement. Funding in other ways has also become trickier. Given that economies are only just now recovering from last year's soaring inflation levels and that elections are approaching in many Western countries, raising taxes may not be politically feasible either.

With pressure mounting from various directions to constrain the growth of public debt, there is a risk that countries may opt to postpone their green transition investments. This risk is particularly concerning in at least two ways. First, delaying climate action will come at a cost, with more adverse consequences such as extreme weather events, thereby contributing to rising public debt. Second, as the year unfolds, new all-time high temperatures have repeatedly been recorded in various locations around the world. This serves as a stark reminder that the tipping point of global warming (a critical threshold where a small change can lead to a significant, possibly irreversible, impact on the environment) could be approaching more rapidly than previously believed. If governments postpone or reduce climate investments, the ambition gap – the disparity between current investment and the targets mandated by climate agreements – will widen. This could result in a failure to achieve timely green transitions. The perceived trade-off between maintaining sustainable public debt levels and advancing the climate transition is a cause for concern.

Carbon pricing could be part of the solution, both by generating revenues and by reducing emissions, as suggested in the IMF Fiscal Monitor from October 2023. According to IMF calculations, carbon pricing could decrease public debt as a share of GDP by 0.8-2.0% annually, as well as bringing down emissions.

Public debt, IMF base projections

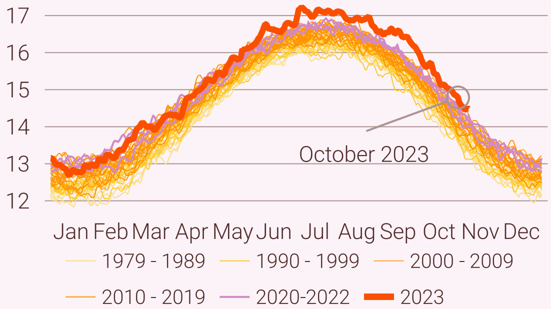
% of GDP, gross debt



Note: IMF's forecast from Fiscal Monitor, October 2023
Sources: IMF, Swedbank Research & Macrobond

Global daily mean of air temperature

Degrees Celsius



Note: 2-metre air temperature
Sources: Climate Change Institute, University of Maine & Swedbank Research

UK – bleak outlook as the higher policy rate has yet to bite

In the UK, inflation is falling but remains higher than in the euro area and the US. The Bank of England (BoE) is expected to keep the policy rate unchanged until mid-2024, when inflation appears to be closing in on the target. Higher rates are weighing on economic activity, and the growth outlook is dire.

A stagnating economy

Inflation in the UK is on a downward trajectory from very high levels. Both headline and core inflation have continued to decline in the last couple of months, although they are still higher than in the euro area and the US. Hitherto, large exposure to gas imports, as well as high wage growth due to a shrinking labour supply, is contributing to the gap. In September, service inflation edged slightly higher; it remains one of the key variables for the BoE going forward.

5.25%

Policy rate until June 2024

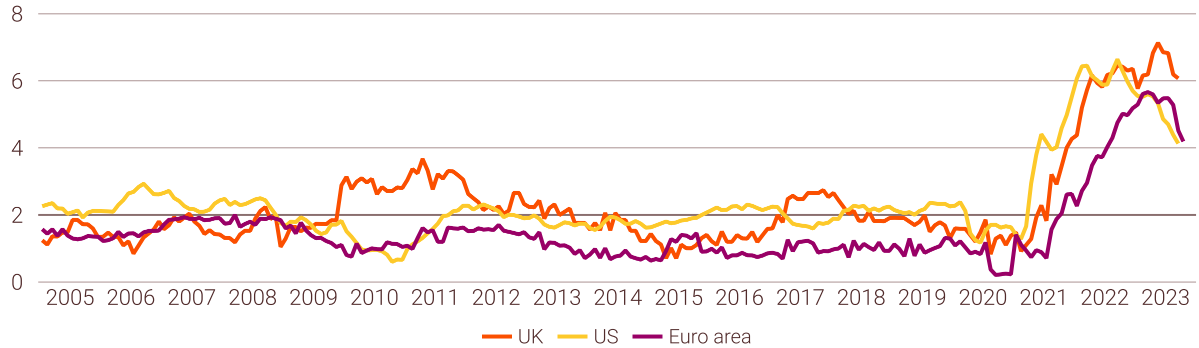
At its meeting in November, the BoE held the policy rate unchanged at 5.25% for the second meeting in a row, and we are sticking to our call that the rate-hiking cycle is over. Given that inflation is still well above target, however, with indicators of inflation persistence not fully relaxing, we do not expect any rate cuts until summer 2024.

The labour market has started to cool, but some measures of wage growth remain very high and will be under close monitoring by the BoE. Economic activity has weakened as indicated by, e.g., falling manufacturing PMI. We expect GDP growth to be subdued during the forecast horizon, as the full effect of the higher policy rate is yet to unfold.

The run-up to the general election has slowly started, and the next election is expected to take place in the autumn of 2024. Members of the governing Conservative Party have called for tax cuts, and the government is being pressured by declining support in opinion polls. However, lowering taxes could have an inflationary effect, and the market turmoil connected to last year's "mini-budget" is fresh in mind. The next fiscal budget update will be presented on 22 November and, so far, British finance minister Jeremy Hunt has indicated that tax cuts will not be on the table in November.

Inflation in the UK remains higher than in the US and the euro area

y/y %, core inflation (excluding energy and food)



Sources: Swedbank Research & Macrobond

China – back on track

Growth stabilised in the third quarter, and it seems like this year's growth target of around 5% is within reach. The property sector crisis will, however, weigh on the economy for years to come.

Recent data, such as retail sales and industrial production, has shown encouraging signs of a stabilisation after the disappointing economic activity in late spring and summer. GDP rose by more than expected in the third quarter and was up 5.2% in the first three quarters compared to the corresponding period last year. Economic activity is expected to continue its recent positive momentum for the rest of the year, which means that the official growth target for 2023 of "around 5%" is likely to be achieved. Going forward, we expect growth to moderate slightly and fall to around 4.5% in 2025.

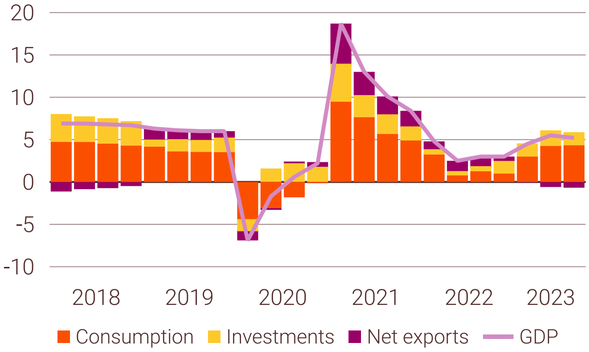
Ramped-up policy support has contributed to the stabilisation. The People's Bank of China has gradually eased monetary policy, and we expect further monetary policy easing ahead to keep the growth trajectory on track. Increased fiscal support was also approved recently. Specifically, to bolster the economic recovery, the government plans to issue an additional RMB 1 trn (around USD 135 bn) in sovereign bonds in the fourth quarter, which will widen this year's budget deficit from 3 to 3.8%. The funds will be used to support infrastructure development in regions that have suffered from natural disasters. Half of the funds will be used this year and the other half next year, which should prop up growth also in 2024.

Monetary policy easing and fiscal stimulus will contribute to the economic recovery

The growth outlook remains clouded by the stress in the property sector. 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. Policy support has been directed at helping property developers complete unfinished housing projects; however, the large number of defaults might impede their ability to do so. Country Garden, China's biggest private developer in terms of sales, recently defaulted on one of its international bonds. Meanwhile, the number of construction starts is at its lowest level in the past ten years, and real estate investments as well as housing prices are declining. The property sector crisis will likely remain a drag on growth for years to come.

On track to reach this year's growth target

Contributions to GDP growth, pp & y/y % ytd



Sources: Swedbank Research & Macrobond

Property developers under pressure

Share price of selected developers, index (2020-01=100)

Sources: Swedbank Research & Macrobond

Sweden – high inflation despite recession

In Sweden, high inflation will linger a little longer, which together with rising interest rates will continue to dampen purchasing power. GDP is expected to decline more than in most European countries. The labour market will weaken, and the number of people employed will fall by 40 000 in the coming year. The Riksbank will begin a series of interest rate cuts in June, which will contribute to a recovery starting late next year.

Falling GDP this winter

The Swedish economy is contracting, and we expect a further decline during the winter before a recovery commences next year. Preliminary data shows that GDP fell in both August and September, and that economic activity declined by 3% in September compared to the corresponding period last year. The economy will cool further this winter as rising interest rates and high inflation continue to dampen demand. We expect GDP to shrink both this year and next and then grow by around 2% in 2025. The downturn will be deeper than in most European countries, but it will be from a stronger starting point because of Sweden's rapid recovery after the pandemic.

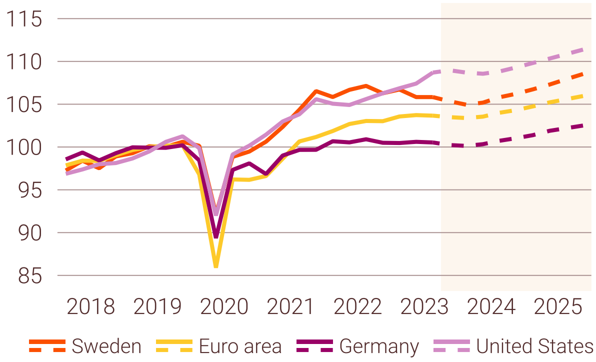
-0.4%

GDP decline in 2024

Housing investment will decline further going forward. We also expect business investments to contract, which will impede growth, particularly next year. The global economic picture is mixed, and so far, Swedish exports have held up comparatively well. One explanation may be the strong development in the US. At the beginning of this year, the US surpassed Norway as the largest export market for Swedish goods and services. Looking ahead, we expect much more subdued export growth due to bleak prospects in Europe at the same time as the US economy is decelerating.

GDP will decline from a high level

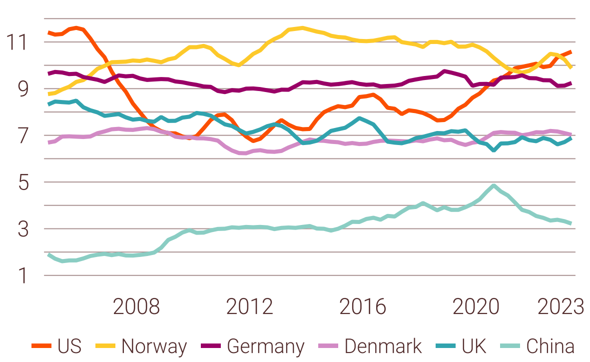
Index (2019=100), constant prices, sa ca



Sources: Swedbank Research & Macrobond

The US is Sweden's largest export market

% of total exports, 4q ma



Sources: Swedbank Research & Macrobond

Price pressures will subside and inflation will ease further

Swedish inflation continued to fall this year, and in October the annual rate of CPIF, i.e. CPI with fixed interest rate, was 4.2%. The decline can mainly be explained by falling electricity prices, but the underlying price pressure is also showing signs of normalising, although it remains high compared with other European countries. Prices for freight and several other commodities have also fallen, contributing to a slower rate of producer price increases.

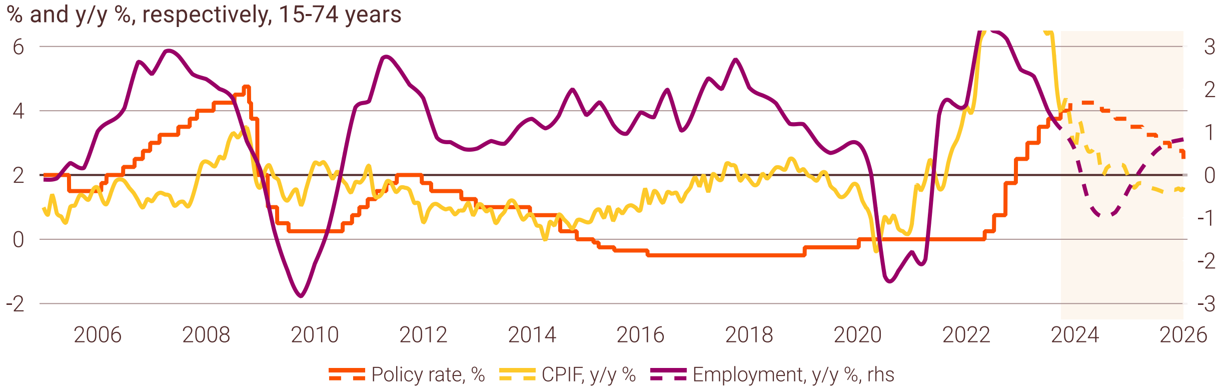
1.4%

CPIF inflation in 2025

Rising unit-labour costs and higher import prices are causing an increase in producer prices and pose a risk of being passed on to consumer prices, but we believe that the scope for new, large price increases is limited. We expect inflation to continue to fall going forward, and that the year-on-year increase in CPIF will approach 2% in the summer of 2024 before gradually falling below the inflation target in 2025. When the Riksbank begins to cut the policy rate, mortgage rates will follow, and CPI inflation will quickly approach CPIF inflation in early 2025.

The Riksbank will cut the policy rate when CPIF inflation nears 2% and employment falls

% and y/y %, respectively, 15-74 years



Sources: Swedbank Research & Macrobond

The Riksbank will raise the policy rate one more time just in case...

Inflation has marginally surprised the Riksbank on the upside in recent months, while the krona remains weak. In its latest Monetary Policy Report, in September, the Riksbank indicated a significant probability of another interest rate hike, either in November or early next year. Facing a difficult trade-off, we expect the Executive Board to raise the policy rate by 25 basis points to 4.25% at its November meeting to ensure a rapid decline in inflation. Although inflation is clearly on its way down, the Riksbank is reluctant to declare the struggle against inflation over before the outcome data confirms it, and will therefore raise the policy rate one more time.

2.50%

Policy rate in Q4 2025

... but will begin a series of cuts next summer

Looking ahead to next summer, we believe that both the Fed and the ECB will have started cutting their key interest rates, while employment in Sweden will have fallen significantly. This will increase pressure on the Riksbank to also cut its policy rate, even though the year-on-year growth in CPIF excluding energy is expected to remain above 3%. However, inflation momentum will be much lower, and monthly changes that are consistent with the inflation target are expected already during the summer. In this environment, we expect the Riksbank to be a bit more forward-looking at the same time as the real economic development will weigh in more heavily than usual. We see the Riksbank deciding on a first cut at its meeting in June. As inflation further decreases towards the end of 2024 and 2025 and while activity in the Swedish economy remains sluggish, the Riksbank will ease monetary policy and gradually cut the policy rate to 2.5% by the end of 2025.

Sustainable public finances, but unsustainable policies

In several countries, particularly the US, the focus is shifting towards unsustainable public finances, but not in Sweden. After extensive measures were taken during the pandemic, public-sector net lending strengthened as the economy recovered and temporary measures expired. As early as 2022, net lending was back in surplus. Due to the slowing economy, public finances have weakened slightly since then, and net lending will turn negative again next year. The budget deficit remains, however, considerably lower compared to the euro area and the US. The increase in interest expenditure has also been relatively limited in Sweden, and is partly offset by the fact that capital income also increases with higher interest rates. The public sector's total capital expenditure is expected to rise to 1% of GDP in 2025, which is low in a historical and international perspective, while net capital income will remain positive.

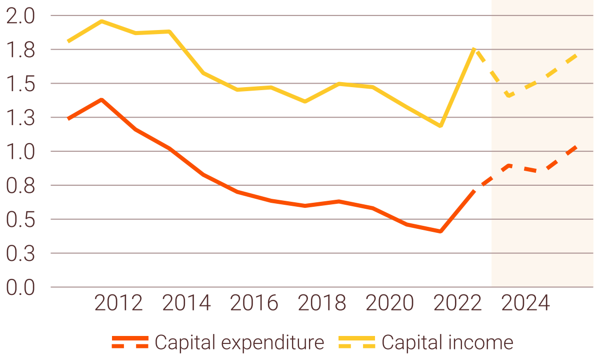
1.0%

General government capital expenditure, % of GDP in 2025

The central government budget for next year includes about SEK 40 billion in unfunded measures, of which just over SEK 30 billion will go to the local government sector and to increased central government consumption and investments. General government grants to municipalities and regions will be permanently increased by SEK 10 billion, which will be essential to counteract extensive staff reductions in the sector. Households will receive a much smaller share of the measures; however, transfers to households will still rise as a share of GDP next year because of the increased price-base amount that is linked to the CPI. On the tax side, the measures will basically cancel each other out, and the tax burden will be

Capital income higher than expenditures

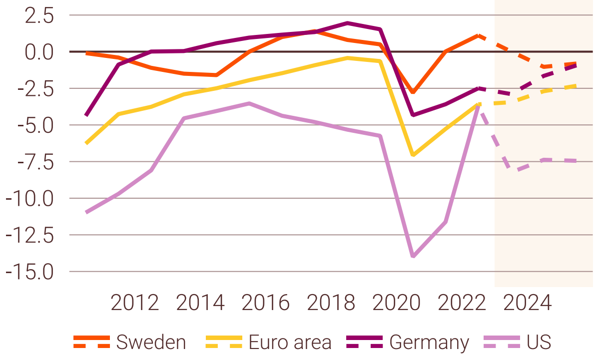
Public sector, % of GDP



Sources: Swedbank Research & Macrobond

Budget deficit smaller in Sweden

General government balance, % of GDP



Sources: Swedbank Research, IMF & Macrobond unchanged compared to this year. The long-term effects of the government's policies on employment will thus be limited. In the short term, reduced taxes on fuels are expected to cause an increase in greenhouse gas emissions. For 2025, we expect SEK 50 billion in unfunded measures.

Weaker labour market from now on

A deterioration in the labour market has begun and will continue into next year. The number of temporary workers has been declining since mid-2022, indicating that overall employment will soon decline. We expect unemployment to peak at 8.5% in 2024. Nevertheless, there is a risk that the labour market will weaken further if labour-hoarding subsides or if the public sector is pressured to make major staff cuts.

The labour market outlook varies across sectors. Housing construction is very low, which is weighing on related services provided by professionals such as architects and engineering consultants. At the same time, however, employment is being held up by other forms of construction, partly because of increased investments in the public sector. Industries such as hospitality and retail are struggling as households hold back on consumption, and goods exports are being weighed down by weaker demand from abroad. Service exports are expected to hold up somewhat better, and industries such as IT, defence and green technology will continue to meet strong demand. Although the economic situation is tough, investments in certain parts of the public sector, such as the judicial system, will also offset parts of the downturn.

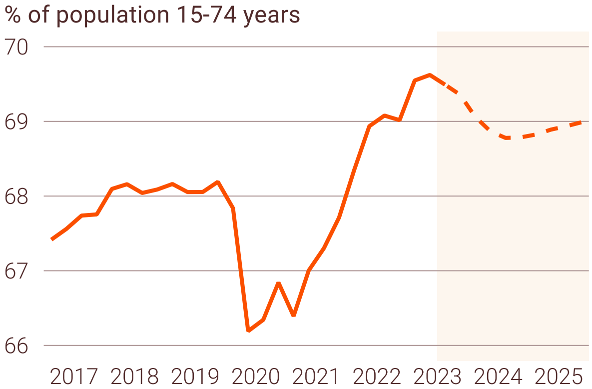
-40 000

Change in the number of people employed, between now and end-2024

Centrally negotiated salaries will contribute to annual wage growth of around 3.8% during this year and next. So far, real wages in Sweden have fallen more than in several other European countries as well as the US, and they are not expected to rise again until mid-2024. The increased maintenance requirement for non-EU/EEA citizens[6] poses a challenge to

The employment rate will fall

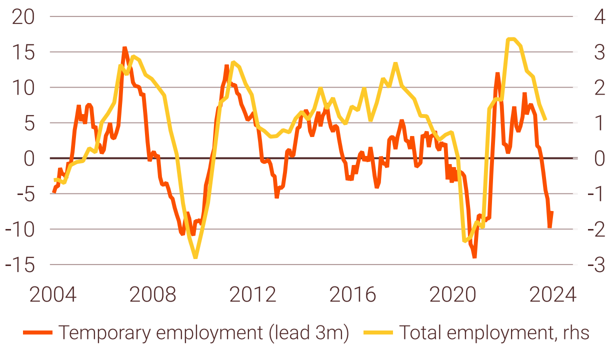
% of population 15-74 years



Sources: Swedbank Research & Macrobond

Temporary employment has been falling for a year

y/y %



Sources: Swedbank Research & Macrobond

[6] Increased maintenance requirement for work permits to SEK 27 360. Swedish Migration Agency, *"The new maintenance requirement for work permits is now in force",* *November 2023.*

the Swedish wage-setting model, where the parties negotiate wage levels without the imposition of political provisions. Above all, the labour supply could be negatively affected, adding to Sweden's structural skills shortage. Demographic factors are also contributing to the challenges of a shrinking workforce and an increasing need for health care.

Households will hold back for a while longer

Households' real disposable income has fallen significantly in the past year, and the development is expected to remain weak for a while longer. Although the declining inflation rate and somewhat higher government transfers will improve purchasing power going forward, the weakening of the labour market means that household income development will remain weak next year. In addition, it will take some time before the effects of higher interest rates have a full impact on household incomes. For the whole of 2024, real disposable income is expected to be unchanged compared with this year, meaning that average per capita income will continue to fall slightly. In 2025, disposable incomes are seen rising because of the expected recovery in the labour market and a decline in interest expenses.

So far, households have dealt with weak purchasing power by cutting back on consumption and saving. This year, consumption is expected to fall by 2% compared with last year, while the savings ratio will fall to lower levels than in the pre-pandemic years. We expect households to become more cautious going forward as the labour market weakens and pent-up demand after the pandemic subsides, which means that the savings ratio will remain close to this year's level for the rest of our forecast period, while consumption will gradually begin to rise next year.

Housing market in limbo

Housing prices are expected to fall by a further 5% during the next six months. Several factors indicate that prices have not bottomed out. Mortgage rates are rising, household purchasing power is weak, and many newly produced homes are still being completed, contributing to an increased supply along with the record number of unsold homes. In addition, the situation remains cautious in the housing market, with unusually few transactions, long times on the market and low bidding activity.

We expect housing prices to bottom out in the first half of 2024. During the spring, household purchasing power is expected to stop falling, and by next summer, mortgage rates are expected to begin to fall. Prices of single-family homes and tenant-owned apartments peaked in March 2022 according to data from Svensk Mäklarstatistik, and have since decreased by 12% and 8%, respectively. Overall, we expect housing prices to fall around 15% from peak to trough, with prices for single-family houses generally falling more than for apartments.

Sharp drop in new construction risks reducing labour-market mobility

Last year, construction on more than 56,000 homes was started, but this year the number of housing starts is expected to more than halve to less than 26,000 homes, according to our forecast. Construction has not been this low since the period following the global financial crisis, and the level of housing starts is expected to remain very low also in 2024 and 2025. This means that the number of completed homes will fall sharply from next year. During the past year, total housing investment has fallen by 23%.

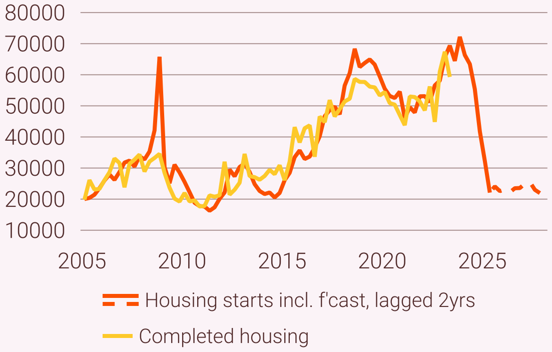
A slowdown is also evident in the other Nordic countries. In Sweden, Norway and Denmark, housing investment has fallen by about the same amount in relation to GDP, but it is also falling in Finland, although not as sharply. In the United States, too, there has been a clear decline in housing investment during the past year, while in Germany it remains on a high level. The fall in housing construction in most countries is due to the fact that interest rates and inflation have risen significantly, dampening the willingness of both households and companies to invest. In addition, construction costs have skyrocketed, but they have been higher in Sweden and Norway than in comparable countries for a long time. This could be one of the explanations for why housing investment remains high in countries such as Germany and France. Another contributing factor could be the differences between countries with regards to sensitivity to interest-rate changes. Given that interest rates and construction costs have risen sharply at the same time as uncertainty about economic development has increased, it is particularly difficult to make the investment pay off in countries where construction costs were already high. The fact that the Swedish rental market is regulated makes it even more difficult to recoup investments. In an environment of low interest rates and rising housing prices, it was easier for housing developers to obtain financing when the risks were lower.

The current sharp fall in construction risks hampering labour-market mobility, which is particularly unfortunate in growth regions, where demand for housing is high. A complicating factor is that the Swedish housing market suffers from a few structural problems; these are partly explained by the regulated rental market. In many cities, queue times for rental housing are very long and subletting is expensive, which has led to a sharp rise in the price of owner-occupied housing. For workers to want to move to regions where there are more jobs, it is important that these regions have sufficient housing, both rental and owner-occupied. However, new construction is decreasing, and so is the flexibility of the housing market.

The Swedish government's proposed measures to improve the functioning of the housing market are a positive factor. The proposals include making more land available for development and shortening planning processes, as well as significantly simplifying the rules in the Planning and Building Act and the Environmental Code. The government also proposes support for office conversions to housing. Moreover, we believe that minor adjustments to the extended amortisation requirement may also be considered if the government assesses that these will not counteract the Riksbank's efforts to curb inflation.

Housing starts will remain very low

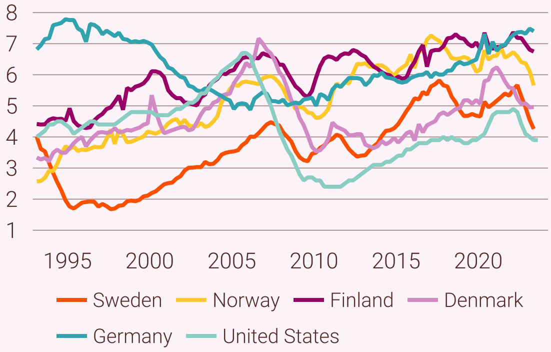
Number, sa ar



Sources: Swedbank Research & Macrobond

Housing investments have declined

% of GDP, sa



Sources: Bundesbank, Eurostat, Swedbank Research & Macrobond

However, the proposed measures will not be enough to address the structural problems on the Swedish housing market. A comprehensive review is needed, including much larger issues like rent regulation, the tax system and other measures that affect the housing market, such as macroprudential policy measures. Although these measures in themselves would probably not contribute to increased housing construction here and now, such a review is long overdue. To ensure that sustainable long-term rules of the game are created in the housing market, it is desirable that such changes be decided by cross-party agreements in the Swedish Parliament. Otherwise, there is a risk that the changes will be reversed after the next parliamentary election. However, given the current political landscape, it will probably be difficult to achieve such an agreement.

Norway – a divided economy

The Norwegian economy is seen nearing a standstill over the next year, while inflation and a weak currency remain prominent issues for the central bank. With variation across sectors, we are likely to see both hard and soft landings.

Hard and soft landings

The Norwegian economy remains uneven in terms of growth pace, but overall, it has expanded a little during the past few quarters. We expect the mainland economy to near a standstill in the short term. The economic momentum is being maintained by the oil and services sectors, which are likely to expand further, but household-focused industries such as construction and retail are already in recessions. Non-oil-related manufacturing is also experiencing a more pronounced slowdown, in line with peers in continental Europe.

2.6%

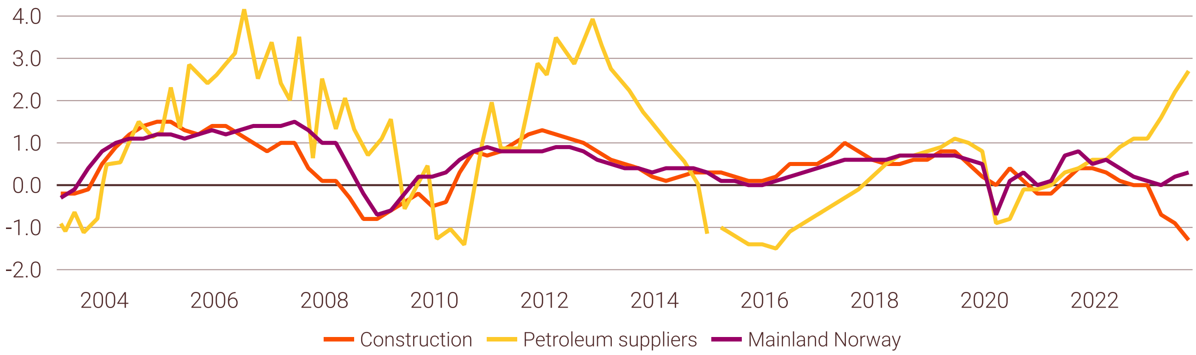
CPI-ATE in July 2024

The outlook for households is mixed as higher interest rates are biting, while real wage growth has improved markedly, and employment growth has stayed sturdy. Nevertheless, precautionary savings may increase in the face of heightened uncertainty going forward, especially as house prices are seen declining more through the autumn. Despite anticipated solid growth in petroleum investments, slowing demand from both households and corporates may contribute to slower overall activity growth in the coming years.

The labour market has been on a weakening trend in the past year, albeit only very slowly. The number of unemployed people has increased, as unemployment within the construction sector has risen. Still, at 1.9%, the unemployment rate is staying close to historically low levels. A further increase in the unemployment rate is, however, expected in the next year as growth slows, especially within construction and the retail trade. Labour shortages are also moderating somewhat, as the number of new vacancies has decreased from elevated levels.

Norges Bank's Regional Network shows that Norway remains a divided economy

q/q %, expected growth current quarter, sa



Sources: Swedbank Research & Macrobond

Headline inflation has come down markedly, as electricity prices have dropped by more than 30% compared to the corresponding period last year. Still, core inflation remains far too high, and it will take time before we see clear signs that it will converge more permanently towards the inflation target of 2%. A weak Norwegian krone (NOK) and higher expected wage growth remain the most important drivers of the current inflation momentum. Core CPI, which excludes energy and taxes, reached 6.0% in October, with other measures of core inflation even higher. While slowing global inflation is affecting imported price growth, the past weakening of the NOK has delayed the impact of these impulses on Norwegian prices. Domestic price pressures are expected to remain elevated in the short term due to high unit-labour costs and a weak NOK. However, core inflation is expected to slow more markedly during the first half of next year, towards 2.5% next summer.

4.50%

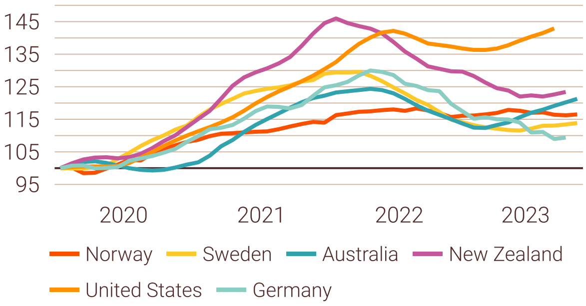
Norges Bank's policy rate expected to peak in December 2023

Norges Bank left the policy rate unchanged at 4.25% in November, but signalled that the policy rate would likely be hiked by 0.25pp at its December monetary policy meeting. The latest rate path, from September, signals that the potential December hike should be the last one, as we also expect. Regardless, the central bank is seen maintaining a hawkish stance due to higher-than-target inflation, a fragile NOK, and limited signs of weakening labour markets. However, the lagged effects of Norges Bank's faster-than-normal rate hikes could become more extensive once the pandemic savings have been exhausted. Credit growth has started to moderate, both for households and non-financial corporates, a sign that higher policy rates are starting to have an impact, although spending of past savings and strong disposable income growth is 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 Norges Bank will hike the policy rate to 4.50% in December, which should 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.

Housing prices in Norway have remained close to their all-time highs over the past few months, despite higher mortgage rates, high household leverage, and mostly floating mortgage rates. This more sideways development is in contrast to that of several peer economies, where house prices rose strongly during the pandemic years and have declined more thereafter. However, looking ahead, it is anticipated that housing prices in Norway will decline as more houses are put up for sale, and credit growth has started to fade as interest rates bite. Real house prices have already fallen from the peak, but there could be another 5% drop to come, according to our projections.

Real estate price development: more sideways in Norway than in peer economies

Index (2020-01=100)



Sources: Swedbank Research & Macrobond

Estonia – a dim light at the end of the tunnel

The prolonged economic recession is retreating slowly. Real wages are increasing, but it will take time for private consumption to pick up. The sluggish recovery in foreign demand will lead to bleaker export opportunities in the short term. We forecast meagre economic growth next year and expect that GDP will not catch up to its pre-recession peak during our forecast period, i.e. until 2026.

The economic contraction is retreating slowly in Estonia, and GDP volume for the first three quarters of 2023 was 3% below the level for the corresponding period last year. The decline in manufacturing production and retail volumes has stabilised. However, the decline in the volume of energy production, which contributed roughly half of the GDP contraction in the first half of this year, has intensified. The reason for the decreased volume of energy production is a combination of lower energy prices, while producing electricity that originates largely from oil shale has become less competitive, and reduced energy consumption. Manufacturing production volume has been falling since June last year; it has dropped to a level last seen five years ago.

-3%

Economic decline in the first three quarters of 2023

Confidence in all economic sectors has continued to deteriorate. Manufacturing production expectations for the next few months have worsened, while the weakening in service-sector demand expectations has stabilised. The share of industrial enterprises which are suffering from insufficient demand rose to 82% in the fourth quarter of this year. The sluggish recovery in foreign demand, on which the Estonian economy is highly dependent, will generate bleak export opportunities in the short term, at least.

Manufacturing unit-labour costs have surged, and industrial enterprises' estimated competitiveness on the domestic and foreign market has worsened considerably. This deterioration in competitiveness could limit the export recovery when foreign demand starts to improve.

Deterioration in competitiveness could limit the export recovery

Despite the prolonged economic recession, the Estonian labour market has been quite resilient. Employment has increased this year, unemployment has picked up moderately, and wage growth is robust. Job losses in manufacturing and construction have been compensated by the high rate of employment in services, primarily in the public sector.

Given that business sector turnover is declining and that enterprises' profitability is under pressure, we expect the labour market to cool. However, we forecast only a minor decrease in employment next year, and that it will remain high. Unemployment will increase gradually, but labour shortages, labour-hoarding and a high rate of employment are expected to prevent it from rising to an alarming rate. It is unlikely that the business sector will be able to continue increasing its labour spending as much as it did this year and last year. Nominal wage growth will slow down, but we forecast that it will be robust during the forecast period, until 2025. Minimum wages will pick up by 13% next year, and we foresee that their strong growth will continue in the next few years. The labour unions and employers' confederation have agreed to raise the minimum wage to 50% of average wage by 2027, and it will reach around 42% next year.

Minimum wages will increase by
13%

Inflation is slowing steadily. On average, consumer prices have not increased month on month during the last six months. The rise in food prices has slowed compared to last year, while energy prices have dropped substantially. Price growth for services is coming down faster than price growth for non-energy goods. Price pressures from the business sector have retreated, and inflation expectations on the part of both households and retail have dropped to a long-term average level. Private consumption has been contracting for more than a year in real terms, and the weakened demand is limiting the pass-through of increasing prices to consumers. We expect that the disinflation will continue, but tax hikes (especially the two-percentage-point increase in VAT) will limit the slowdown in price growth next year.

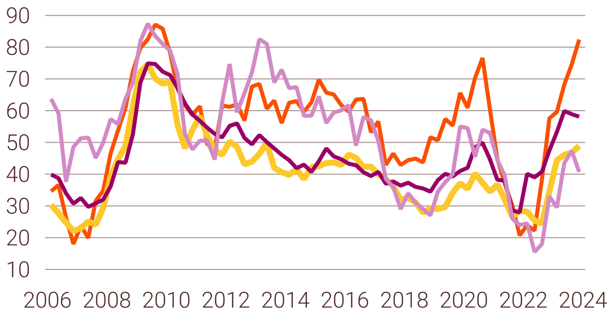
Real wages are already going up. However, given that households are increasingly worried that they may experience unemployment and a worsened financial situation, we expect a delay before their improving purchasing power leads to an increase in consumption. Next year's VAT hike will likely add some momentum to private consumption at the end of this year. The recovery in private consumption is expected to be sluggish, and its real growth will remain below the long-term average next year.

The Estonian government has planned budget savings, cost cuts and tax hikes in 2024 and 2025 to reduce the large budget deficit and to limit debt growth in the next few years. However, the expected increase in the use of EU funds will add fiscal stimulus next year.

Cost cuts and tax hikes in 2024 and 2025

Weak demand is limiting production

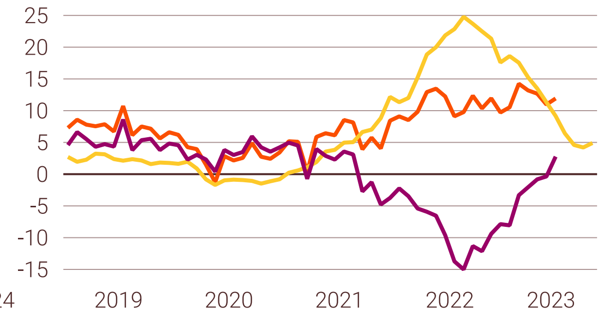
% of industrial sector respondents, sa



Sources: Swedbank Research & Macrobond

Real wages are picking up

y/y %



Sources: Swedbank Research & Macrobond

Latvia – lost in legislation

The Latvian economy continues to stagnate. Exports and consumption are weak, while public investments are supporting the economy. Inflation has declined to 2.1% and will be low in the coming years. The populist initiatives that are now being pushed through parliament risk damaging the country's medium-to long-term economic development.

Latvian GDP was 0.4% lower in the first three quarters of 2023 than in the corresponding period last year. In the first half of this year, there was a technical recession which only revealed itself after a major data revision was completed in September. The third quarter surprised with robust GDP growth (0.6% q-o-q), supported by strong income from product taxes, which will likely be subject to revisions. Overall, our interpretation of the state of the economy has not changed – Latvia is in a prolonged stagnation. Economic growth is expected to continue hovering around zero in the coming quarters. A more notable pick-up is expected only towards the second half of 2024 – as interest rates decline more markedly and a recovery begins in export markets. As a result, we will see very slow growth in 2024, followed by a rather unimpressive 2025.

Investment activity is slowing in the private sector, but rather strong in the public sector, helped by the inflow of EU funds. The Ministry of Finance's plans for 2024 include a notable further increase in investment related to EU funds, which will drive the construction sector. Exports are falling and will likely remain weak until mid-2024, when demand will start to pick up across Latvia's export markets. A more pronounced export growth should be seen in 2025 as the recovery gains traction among trading partners.

Consumption is also on a downward path this year, but could recover slightly sooner than exports. Workers' purchasing power is returning – the very strong nominal wage growth coupled with low inflation means that real wages have been growing since mid-2023. The labour market will feel the impact of economic stagnation, but the rise in unemployment will be relatively mild. Consumer confidence is recovering, although it remains below the long-term average. The price level remains stubbornly high, however, and will act as a drag on consumption.

Core inflation is still above
7%

The (dis)inflation story continues as forecasted. Inflation stood at 2.1% in October, and a further decline is still expected. In energy-related sectors, prices are falling. Month on month, the price level for food and services declined in recent months. Core inflation is still elevated at 7.2%, however, suggesting that underlying pressure for price increases remains strong. We do not foresee the recent month-on-month deflation trend continuing beyond this year, and we expect muted inflation in the coming years.

Parliament has set in motion a legislative process to limit the impact of high rates on households with mortgages. Only 14% of Latvian households have a mortgage, but the effects of a higher Euribor have been felt immediately, given that more than 90% of mortgages in Latvia are issued with floating rates. It is predominantly the better-off households who hold mortgages. The Bank of Latvia states that 83% of issued amounts are to households in the fourth and fifth income quintiles. Swedbank data suggests that less than 0.5% of households are more than a month late with their mortgage payments – a share that has been stable for the past couple of years. Compared to June last year when the Euribor was below zero, the monthly mortgage payment has increased by less than EUR 100 for 67% of households, while for 8% of households the increase has been more than EUR 250. This indicates that some households, especially those with a recently acquired mortgage, are experiencing a large spike in monthly payments, but the problem is far from systemic. Furthermore, the spike is expected to be temporary, as interest rates are forecast to decline in a couple of quarters.

Less than

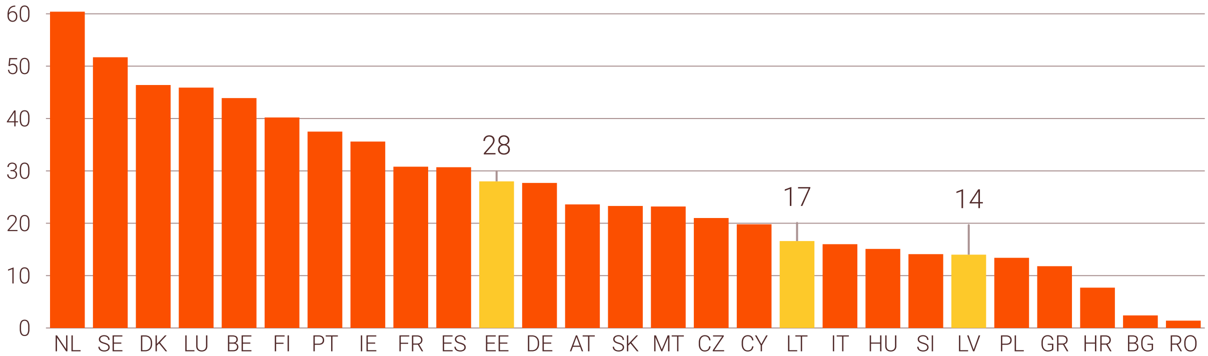
0.5%

of mortgage borrowers are late with payments

Despite the lack of a systemic issue, politicians are insisting on broad support to mortgage borrowers. The final shape of the legislation is still uncertain, but it will likely entail forcing banks to provide a "discount" on mortgage borrowers' interest rates. The approach is regressive, poorly (if at all) targeted to those who need support, and tantamount to regulating prices in the financial sector. In addition, the massive administrative burden which will result from the new legislation will lie on the banks. The medium-term risks include a worsening investor view of the business environment, as well as weaker and more expensive credit to the Latvian economy. This is something Latvia, given its low investment as a share of GDP, simply cannot afford. The legislation presents moral hazard risks, with future borrowers potentially not taking full responsibility for their financial decisions and starting to expect to be "saved" in case of any future episodes of high interest rates. Furthermore, the initiative is in contrast with the aim of the ECB and interferes with monetary policy transmission. It would be a "helicopter" type of support to those with mortgages and, given the already-high underlying price pressures, could risk adding to inflation.

A low share of households with mortgages in Latvia

2021, % of total



Sources: Swedbank Research & Macrobond

Lithuania – a textbook soft landing

So far this year, Lithuanian economic development has fit the classic definition of a soft landing – consumers have pulled back, the economy has cooled down and inflation has receded rapidly, while unemployment, delinquencies and bankruptcies have remained low. Admittedly, some sectors are worse off than others, and things could still take a turn for the worse, but we forecast a gradual resumption of growth in 2024 and 2025.

In line with our expectations, the Lithuanian economy stagnated in the third quarter, and contracted slightly during the first three quarters of this year, compared with the same period a year ago. At the same time, inflation declined rapidly and was down to 2.8% in October. Thus, we maintain our inflation and GDP forecasts (unchanged since January, we must brag) – the economy will shrink by 0.3% in 2023, and inflation will fall to 2.5% in December. Unemployment has increased somewhat, but only due to a higher labour-force participation rate – employment increased by 0.6% and has almost reached all-time highs.

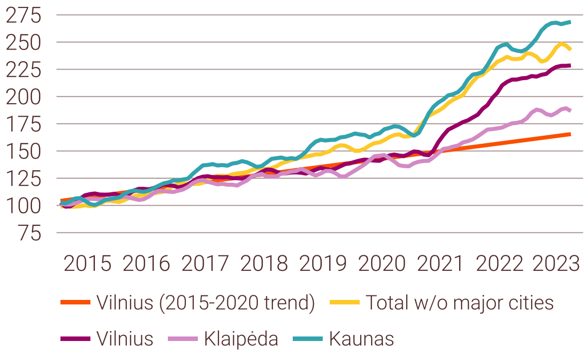
2.8%

Inflation in October

We maintain our forecast that inflation will fall to 1.8% on average in 2024. Weak global demand, cheaper energy and commodities, falling producer prices (especially in China) – all these factors will contribute to continued disinflation. We expect regulated natural gas prices to be cut by approximately 20% in mid-2024, mainly due to cheaper market prices, but the upcoming parliamentary elections in the autumn of next year may also play a role. Furthermore, as in many other Western countries, wider profit margins in some sectors contributed to inflation last year and are now likely to adjust downwards. The risks are symmetric here – weaker-than-expected global demand could squeeze margins and, consequently, prices lower, while rapid growth in labour costs could again boost price growth for services.

Residential real estate prices, repeat sales

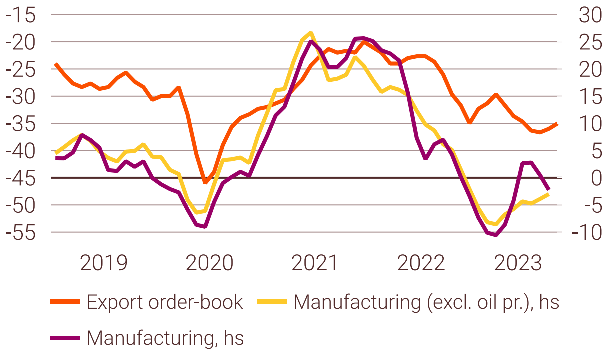
Index (2015=100)



Sources: Bank of Lithuania, Swedbank Research & Macrobond

Export orders and manufacturing output

Balance; y/y %, 3 mma (rhs)



Källor: Swedbank Analys & Macrobond

We forecast that the average gross-wage growth will ease to 8.5% and that, given low inflation and the planned 20% increase in the non-taxable income threshold, real net wages will increase by 7% next year. Public sector wages and pensions will grow even more rapidly, and all this is likely to boost domestic demand. Household consumption will start growing next year, although the recovery is likely to be gradual, given that we expect higher unemployment and that wary households are likely to increase their savings ratios. Job vacancies have fallen to their lowest level in 10 years, as the manufacturing capacity utilisation level is now much lower than it was a year ago. Many businesses are trying to control labour costs in the face of lower demand and fiercer competition.

Residential real estate transactions are at their lowest level in 5 years, while housing affordability dropped to the lowest level seen in 12 years. Surprisingly, prices remained quite resilient as developers tried to offer various benefits, such as free parking spots, rather than cut prices. Rising wages, stagnating prices and a retreat in interest rates will boost affordability in 2024, and we could see the first signs of a recovery.

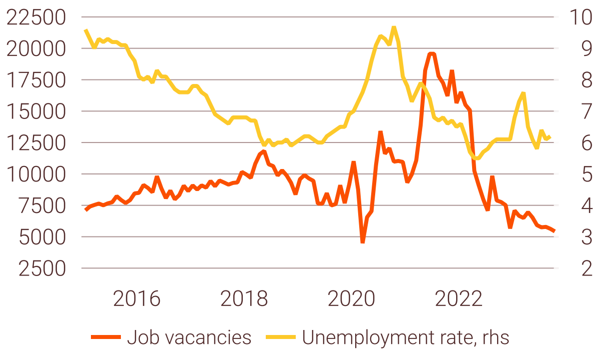
We are cutting our 2024 and 2025 forecast for GDP growth to 1.2% and 2.0%, respectively. An export recovery is likely, but will be tentative given that global demand remains weak, while cost competitiveness has eroded during recent years. Investments are likely to continue growing in the public sector, particularly in the energy and defence sectors, but the private sector is likely to be held back by funding costs and uncertainty. The government budget deficit will increase by more than a percentage point to 2.6% of GDP in 2024. The government had intended to close some income tax loopholes and introduce semi-universal real estate tax (welcome plans in our view), but this reform is unlikely to reach the finish line, as disagreements have emerged among members of the government coalition and there is little appetite to anger voters before the three upcoming elections in 2024 (EU Parliament, Presidential and National Parliaments). Many populist initiatives have been floated and additional ones remain likely to emerge, but we hope that level-headedness and a focus on the long term can be preserved.

1.2%

GDP growth in 2024

Job vacancies and unemployment

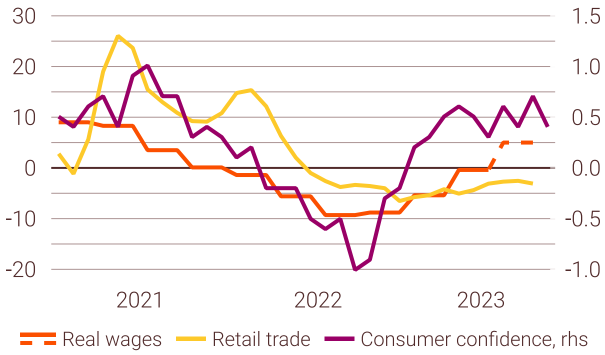
Number; %



Sources: Swedbank Research & Macrobond

Retail trade lags behind wages and confidence

y/y %; standardised index



Sources: Swedbank Research & Macrobond

Appendix

SWEDEN: Key economic indicators, 2022-2025

Annual % change unless stated otherwise	2022	2023F		2024F		2025F	
Real GDP growth (average, calendar-adjusted)	2.8	-0.5	(-0.9)	-0.4	(-0.3)	2.0	(2.3)
Real GDP growth (Q4-Q4, calendar-adjusted)	-0.4	-0.7	(-1.4)	0.8	(1.3)	2.1	(2.4)
Real GDP growth	2.8	-0.7	(-1.1)	-0.4	(-0.3)	1.7	(2.1)
Household consumption	1.9	-2.0	(-2.5)	0.2	(0.7)	2.3	(1.9)
Government consumption	0.0	1.9	(1.3)	1.4	(1.1)	1.6	(1.7)
Gross fixed capital formation	6.2	-2.1	(-1.4)	-3.1	(-3.0)	0.0	(1.4)
private, excl. housing	8.4	1.7	(3.4)	-2.2	(-2.9)	-1.1	(0.4)
public & NPISH	-0.9	5.9	(2.4)	4.2	(5.0)	3.3	(4.1)
housing	5.3	-21.3	(-18.7)	-15.6	(-14.2)	0.5	(2.5)
Change in inventories (contribution to GDP)	1.0	-0.6	(-0.6)	-0.3	(-0.1)	0.0	(0.0)
Exports, goods and services	7.0	1.6	(0.4)	0.4	(0.6)	2.1	(2.2)
Imports, goods and services	9.3	-0.1	(-1.0)	-0.2	(0.5)	1.6	(1.4)
Domestic demand (contribution to GDP)	2.4	-1.0	(-1.1)	-0.4	(-0.2)	1.4	(1.7)
Net exports (contribution to GDP)	-0.8	0.9	(0.7)	0.3	(0.0)	0.3	(0.4)
CPI (average)	8.3	8.6	(8.7)	3.8	(3.8)	1.4	(1.4)
CPI (Dec.-Dec.)	12.3	4.7	(4.8)	2.3	(2.8)	1.1	(1.1)
CPIF (average)	7.7	6.1	(6.1)	2.4	(2.2)	1.4	(1.7)
CPIF (Dec.-Dec.)	10.2	2.6	(2.7)	1.7	(2.1)	1.4	(1.9)
CPIF ex energy (average)	5.9	7.6	(7.6)	3.1	(3.2)	1.7	(1.8)
CPIF ex energy (Dec.-Dec.)	8.4	5.7	(5.6)	2.3	(2.6)	1.6	(1.7)
Riksbank policy rate (Dec.)	2.50	4.25	(4.25)	3.50	(3.50)	2.50	(2.50)
Unemployment (% of labour force, 15-74)	7.5	7.7	(7.5)	8.5	(8.2)	8.4	(8.2)
Change in labour force (15-74)	1.5	1.6	(1.6)	0.2	(0.1)	0.5	(0.6)
Change in employment (15-74)	3.1	1.4	(1.5)	-0.7	(-0.6)	0.6	(0.5)
Number of hours worked (calendar-adjusted)	2.3	1.5	(2.3)	-1.2	(-1.0)	0.9	(0.8)
Nominal hourly wage (NMO), whole economy	2.7	3.8	(4.0)	3.7	(3.9)	3.4	(3.7)
Household real disposable income per capita	-0.8	-4.1	(-3.2)	-0.2	(-0.7)	2.8	(3.5)
Household nominal disposable income	6.8	2.9	(3.6)	2.7	(2.5)	5.1	(6.1)
Household savings ratio, % of disposable income	13.3	11.6	(14.1)	11.8	(13.8)	12.0	(15.4)
General government budget balance (% of GDP)	1.1	0.0	(-0.1)	-1.0	(-1.0)	-0.8	(-0.7)
General government debt (Maastricht), % of GDP	32.7	31.4	(32.0)	32.1	(33.2)	32.7	(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	-2.5	(-2.0)	0.7	(2.0)	2.3	(3.0)
Household consumption	2.0	-2.2	(-2.0)	1.5	(2.0)	3.5	(3.5)
Government consumption	0.1	1.0	(1.5)	1.5	(3.0)	2.0	(2.0)
Gross fixed capital formation	-3.7	-13.0	(-3.0)	3.0	(4.0)	5.0	(5.0)
Exports of goods and services	3.0	-4.5	(-3.0)	1.0	(2.5)	3.0	(3.5)
Imports of goods and services	3.2	-6.0	(-4.5)	0.7	(2.0)	4.0	(3.5)
CPI (average)	19.4	9.5	(9.8)	3.8	(4.3)	2.4	(2.4)
Unemployment (% of labour force)	5.6	6.8	(6.5)	7.6	(6.7)	6.3	(5.4)
Employment	4.1	2.0	(2.2)	-0.4	(0.5)	0.3	(0.3)
Gross monthly wage	11.6	11.2	(11.2)	7.4	(7.8)	7.1	(7.4)
Nominal GDP, billion euro	36.0	38.2	(38.4)	39.8	(40.6)	41.6	(42.7)
Exports of goods and services (nominal)	23.5	-1.6	(-1.1)	3.0	(5.1)	5.1	(6.6)
Imports of goods and services (nominal)	22.7	-4.6	(-4.0)	2.7	(4.5)	6.1	(6.6)
Balance of goods and services, % of GDP	-0.6	2.0	(1.8)	2.1	(2.1)	1.4	(2.2)
Current account balance, % of GDP	-2.9	-1.4	(0.0)	-0.5	(0.5)	-1.4	(0.5)
General government budget balance, % of GDP	-0.9	-2.6	(-2.6)	-3.0	(-3.0)	-2.5	(-2.8)
General government debt (Maastricht), % of GDP	18.5	19.6	(19.1)	21.1	(21.3)	22.5	(23.6)

Previous forecast in parentheses
Source: Statistics Estonia & Swedbank Research

LATVIA: Key economic indicators, 2022-2025

Annual % change unless stated otherwise	2022	2023F		2024F		2025F	
Real GDP	3.4	-0.4	(0.3)	1.4	(1.7)	2.5	(2.8)
Household consumption	6.0	-2.1	(0.1)	1.3	(2.4)	3.4	(3.5)
Government consumption	2.8	4.4	(3.0)	1.6	(1.4)	2.0	(2.4)
Gross fixed capital formation	0.6	6.0	(6.9)	4.2	(4.0)	3.6	(3.5)
Exports of goods and services	10.3	-4.0	(-1.9)	0.5	(2.0)	4.4	(4.3)
Imports of goods and services	11.1	-2.4	(1.5)	0.5	(2.6)	4.8	(4.3)
CPI (average)	17.3	9.0	(9.0)	1.8	(2.0)	2.5	(2.5)
Unemployment (% of labour force)	6.9	6.5	(6.5)	6.6	(6.6)	6.1	(5.9)
Employment	2.6	0.0	(0.0)	0.0	(0.0)	0.5	(0.7)
Gross monthly wage	7.5	11.5	(11.5)	8.0	(8.0)	7.5	(7.5)
Nominal GDP, billion euro	38.9	41.8	(42.9)	43.6	(44.9)	46.1	(47.6)
Exports of goods and services (nominal)	29.9	-5.9	(-4.7)	1.6	(3.1)	5.6	(5.5)
Imports of goods and services (nominal)	31.7	-6.5	(-6.1)	0.5	(2.5)	5.5	(5.0)
Balance of goods and services, % of GDP	-4.5	-3.6	(-4.1)	-2.7	(-3.7)	-2.7	(-3.3)
Current account balance, % of GDP	-4.7	-2.8	(-3.4)	-2.0	(-3.0)	-2.0	(-2.7)
General government budget balance, % of GDP	-4.6	-2.5	(-3.8)	-3.4	(-2.7)	-1.7	(-2.0)
General government debt (Maastricht), % of GDP	41.0	40.4	(40.4)	41.6	(40.2)	41.5	(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	2.4	-0.3	(-0.3)	1.2	(1.5)	2.0	(2.3)
Household consumption	2.0	-1.0	(0.8)	2.8	(3.7)	4.2	(4.0)
Government consumption	0.4	0.5	(0.5)	1.0	(0.5)	0.5	(1.0)
Gross fixed capital formation	3.6	8.5	(6.5)	3.2	(4.5)	5.5	(5.5)
Exports of goods and services	12.2	-2.8	(-2.5)	2.5	(2.8)	4.4	(4.4)
Imports of goods and services	12.4	-3.0	(-1.2)	4.0	(4.6)	5.4	(5.4)
CPI (average)	19.6	9.4	(9.4)	1.8	(1.8)	2.5	(2.5)
Unemployment (% of labour force)	5.9	6.7	(7.3)	7.1	(7.0)	6.7	(6.7)
Employment	3.8	1.0	(0.6)	-0.7	(-0.2)	0.1	(0.0)
Gross monthly wage	13.3	11.7	(12.2)	8.5	(8.6)	6.2	(6.5)
Nominal GDP, billion euro	67.4	73.4	(72.7)	75.6	(75.1)	79.0	(78.8)
Exports of goods and services (nominal)	29.4	-4.6	(-3.5)	4.2	(5.0)	5.5	(5.9)
Imports of goods and services (nominal)	40.3	-10.5	(-9.0)	5.0	(5.5)	6.5	(6.5)
Balance of goods and services, % of GDP	-2.0	3.1	(2.8)	2.5	(2.4)	1.8	(2.0)
Current account balance, % of GDP	-5.5	1.4	(0.9)	1.1	(1.0)	0.7	(0.9)
General government budget balance, % of GDP	-0.6	-1.3	(-1.9)	-2.6	(-1.7)	-2.2	(-1.4)
General government debt (Maastricht), % of GDP	38.4	37.5	(37.1)	38.8	(37.5)	41.3	(39.1)

Previous forecast in parentheses
Sources: Statistics Lithuania & Swedbank Research

Interest and exchange rate forecasts

	Outcome 2023 13 Nov	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	5.25	4.25	3.75	3.25
European Central Bank (refi rate)	4.50	4.50	4.00	3.00	2.25	2.25
European Central Bank (deposit rate)	4.00	4.00	3.50	2.50	1.75	1.75
Bank of England	5.25	5.25	5.00	4.00	3.25	2.75
Riksbank	4.00	4.25	4.00	3.50	3.00	2.50
Norges Bank	4.25	4.50	4.25	3.75	3.25	2.75
Government bond rates (%)						
US 2y	5.04	4.70	4.20	4.00	3.70	3.50
US 5y	4.65	4.40	4.20	4.05	3.90	3.80
US 10y	4.61	4.50	4.20	4.10	4.00	4.00
Germany 2y	3.06	2.90	2.50	2.30	2.10	2.00
Germany 5y	2.64	2.60	2.50	2.50	2.50	2.50
Germany 10y	2.70	2.70	2.60	2.60	2.70	2.70
Exchange rates						
EUR/USD	1.07	1.06	1.08	1.10	1.12	1.14
EUR/GBP	0.87	0.87	0.88	0.89	0.87	0.85
EUR/SEK	11.65	11.75	11.40	11.20	11.00	10.80
EUR/NOK	11.87	11.70	11.35	11.15	10.95	10.75
USD/SEK	10.91	11.08	10.56	10.18	9.82	9.47
USD/CNY	7.29	7.30	7.15	7.00	7.00	7.00
USD/JPY	151.5	148.0	140.0	135.0	130.0	120.0
NOK/SEK	0.98	1.00	1.00	1.00	1.00	1.00
KIX (Trade-weighted SEK)	128.7	130.2	126.3	123.9	121.5	119.2

Sources: Swedbank Research & Macrobond

Swedish interest rate forecasts (%)

	Outcome 2023 13 Nov	Forecast 2023 31 Dec	2024 30 Jun	2024 31 Dec	2025 30 Jun	2025 31 Dec
STIBOR 3m	4.13	4.25	4.10	3.50	2.80	2.50
Government bond yields						
2y	3.51	3.50	3.20	3.00	2.70	2.70
5y	2.91	3.00	3.00	2.90	2.90	2.90
10y	2.85	3.00	3.00	3.00	3.00	3.00
Swap rates						
2y	3.88	3.90	3.50	3.30	3.00	3.00
5y	3.36	3.45	3.40	3.25	3.20	3.20
10y	3.27	3.40	3.40	3.35	3.30	3.30

Sources: Swedbank Research & Macrobond

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