Swedbank

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Swedbank Economic Outlook

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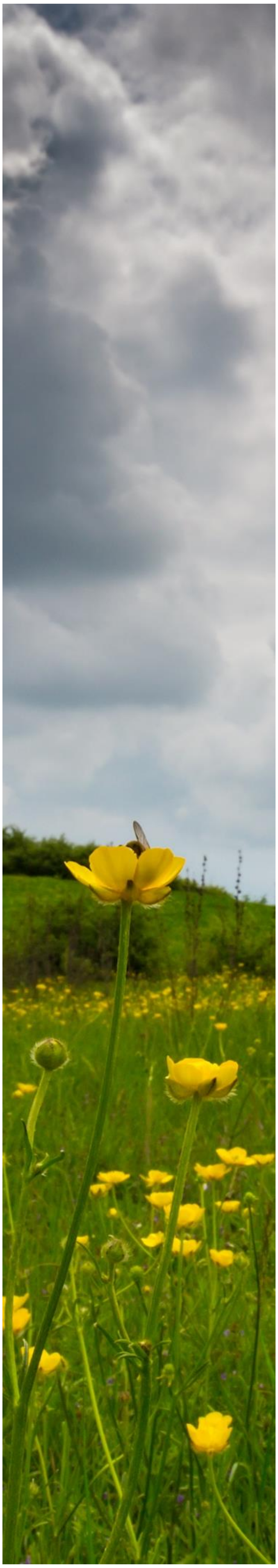

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The current breeze could quickly turn into a storm

Central banks have not yet concluded their global hiking cycle. Even though inflation has declined as central banks have raised interest rates and energy prices have come down, underlying price pressures are proving sticky. Labour markets are tight, and, overall, economies have proven to be resilient, despite policy rates being well above neutral levels. But monetary policy works with lags and the global economy, as well as inflation, will eventually slow on the back of rapidly rising interest rates.

An extended period of subdued economic growth seems inevitable even if central banks pivot next year and cut policy rates. Looser monetary policy also works with lags. Fiscal policy, which in many countries lacks manoeuvrability, will remain tight. There is a risk that central banks are overtightening monetary policy on a global level, taking all the lag effects into account. Central bank credibility is at stake: risks to central banks are asymmetric and the tolerance of inflation is low, but the cost will be lower growth and higher unemployment.

> "The global economy, as well as inflation, will eventually slow"

Adverse reactions from the fast rise in policy rates are also becoming more apparent. Financial stability vulnerabilities came into focus earlier this year, although signs of stress have come down recently. The sharp rise in interest rates could expose the global economy to new threats and shocks, particularly in leveraged asset classes. The current breeze could quickly turn into a storm. So far, the level of losses in the global banking system is low, and the global financial system appears resilient. But central banks and authorities must walk a narrow path to contain risks and at the same time fight inflation.

"Financial stability vulnerabilities have come into focus"

The economic outlook is uncertain and fragile. The risks to the outlook are skewed to the downside, and a financial sector fallout would increase the chances of a deeper and longer economic downturn. Potential vulnerabilities and losses in the global financial system could reinforce even further the credit tightening that has been initiated through higher policy rates and could exacerbate and lengthen the economic downturn. Additionally, both the geopolitical risks, which are elevated, and the current fragmentation of the global economy could have adverse consequences for economic development during the forecast horizon.

"and could expose the global economy to new threats and shocks"

Mattias Persson
Group Chief Economist

2.8%

Modest global GDP growth also in 2024

3.00%

10-year US government bond yield December 2023

4.00%

Riksbank policy rate will peak in June 2023

1

final hike from the Fed by 25 bps in May 2023

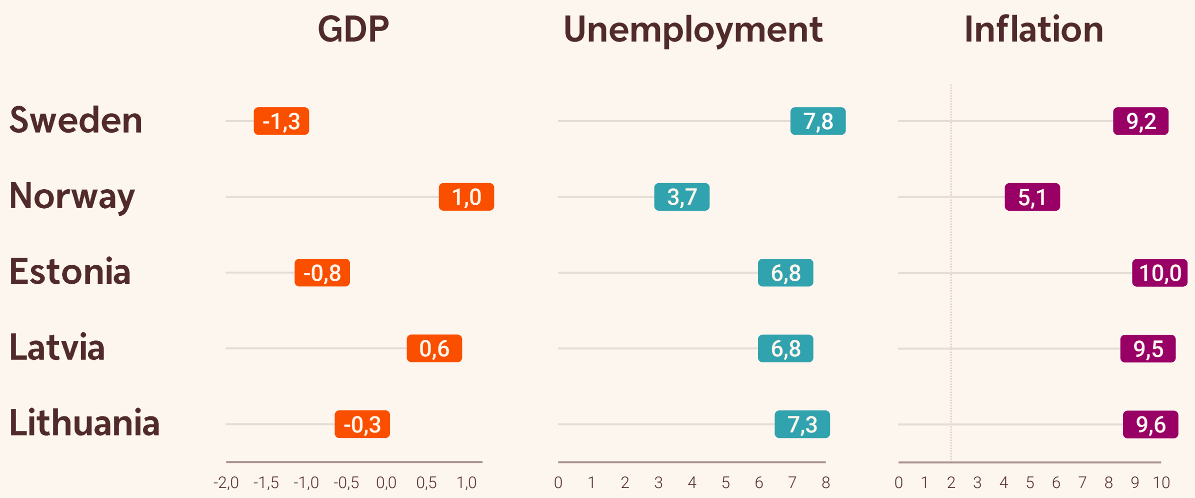
6

Rate cuts from the ECB in 2024, each by 25 bps

1.14

EUR/USD December 2023

2023 Outlook



Global Outlook

1. We expect **low global GDP growth** for both 2023 and 2024. High inflation and interest rates will weigh on household consumption and firms' investments.

2. So far, both the **euro area and US economies have proven resilient** to the high inflation and rapidly rising interest rates. Also, lower energy prices have helped. **China** has reopened and rebounded. But overall, the global outlook remains weak.

3. In both the US and the euro area, **inflation will continue to fall in 2023**. Lower energy and commodity prices, lower freight prices, and large inventories within the retail sector suggest that price pressures will ease. But underlying inflation remains high, not least in the euro area, and will only gradually decline this year.

Financial Markets

1. The **Fed** is expected to deliver **its last rate hike** in this cycle **in May**, while the **ECB** will add **three more hikes** before it is done. We are sticking to our forecast that rate cuts will begin only in 2024.

2. **The turmoil** beginning in the US banking sector in March, with regional banks struggling with higher interest rates, spread broadly to financial markets, lowering bond yields and widening credit spreads. However, as policymakers acted swiftly, the financial stress abated, and since then bond yields have risen and credit spreads tightened. During the forecast horizon, we expect stable or somewhat lower bond yields, while credit spreads will remain relatively wide.

3. An improved risk sentiment is expected to weaken the US dollar and strengthen the euro during the forecast horizon. The **Swedish krona** and **Norwegian krone** are expected to appreciate slowly.

Sweden

1. **Two tough years** await the Swedish economy. Declines in consumption and in housing investment will contribute to the GDP's shrinking this year. Next year, only a weak recovery is expected.

2. The **labour market** will **start deteriorating** more significantly **after the summer**. Unemployment will peak at 8.6% in 2024.

3. The persistently high inflation will lead the **Riksbank** to tighten monetary policy further. We expect the policy rate to **peak at 4.0%** in June. CPIF inflation will likely fall below the inflation target next year, and the Riksbank will initiate a **series of rate cuts**.

Baltics

1. **GDP** is likely to shrink somewhat in Estonia and Lithuania this year, while the Latvian economy will stagnate. **Growth** is likely to resume in 2024, but unlikely to be robust.

2. **Inflation** is on a steep downward path and should fall to low single digits by the end of 2023. **Wage growth**, however, is still close to 10%, and this creates a risk that inflation will be stickier than we forecast.

3. **Household consumption** is likely to strengthen in the second half of 2023 as inflation retreats and wages continue to grow rapidly. **Manufacturing** and exports, however, are likely to shrink this year.

Global economy – some slow years ahead

Inflation remains stubbornly high in many countries, and central banks will push ahead with more tightening in the near term. We expect low global GDP growth during the forecast horizon.

A worsening outlook

Despite the fastest rise in interest rates and in inflation in decades, the global economy has proven resilient so far. In many countries, services and manufacturing output continued to grow while employment levels reached new highs during the first quarter of this year. China has left its zero-COVID policy behind, resulting in a strong economic rebound.

Bleak 2024

But let's leave the champagne in the fridge (if you could afford to buy any). Cracks in the wall appeared already last year, when squeezed households in both Europe and the US started to hold back on consumption, primarily via lower retail activity. Housing prices and credit growth are trending down. Looking ahead, household purchasing power will weaken further this year as wage growth will only slowly catch up with inflation. This, together with low savings and high interest rates, should accelerate the downward trend in household consumption. The downturn will eventually also spread to other parts of the economy. Fixed investments, which

Swedbank's global GDP forecast

Annual % change	2022	2023F		2024F	
US	2.1	1.2	(0.4)	0.5	(1.2)
Euro area	3.5	0.4	(0.2)	0.7	(1.1)
Germany	1.9	0.1	(0.2)	0.7	(1.0)
France	2.6	0.5	(0.4)	0.7	(1.2)
Italy	3.8	0.5	(0.4)	0.6	(1.1)
Spain	5.5	1.2	(1.1)	0.9	(1.3)
Estonia	-1.3	-0.8	(0.0)	2.3	(3.0)
Latvia	2.8	0.6	(-0.9)	2.1	(2.6)
Lithuania	1.9	-0.3	(-0.3)	1.8	(1.8)
Sweden	2.6	-1.3	(-1.3)	0.3	(0.9)
Norway	2.4	1.0	(0.2)	0.4	(0.5)
China	3.0	5.5	(5.0)	5.0	(5.0)
United Kingdom	4.1	-0.3	(-0.9)	0.8	(0.9)
Global GDP (IMF PPP weights)	**3.0**	**2.4**	**(2.0)**	**2.8**	**(3.1)**

Previous forecast in parentheses.

Sources: IMF & Swedbank Research

typically lag the business cycle, are interest-rate sensitive and are expected to slow. As demand slows further, exports and imports will also take a hit.

Overall, we expect low global GDP growth for both 2023 and 2024. The forecast for this year, however, has been revised somewhat upward compared with our previous (January) forecast, due to a better-than-expected outcome during the start of the year for the US, the euro area, and China. Meanwhile, we now foresee a bleaker recovery in 2024 and are revising down GDP growth for both the US and the euro area.

Stubborn inflation, and central banks continue to tighten

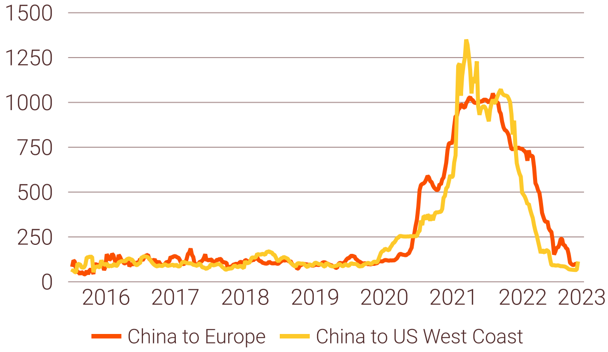
Inflation started to decline last year – during the summer in the US and in the autumn in the euro area, due to lower energy prices since then. Core inflation has proved much stickier, although developments in the US and euro area differ. While US core inflation remains above 5%, it has slowly trended lower over the past six months. Core inflation in the euro area, on the other hand, shows no signs of slowing yet and, in fact, even reached a new record-high in March (5.7%).

There are plenty of reasons to suggest markedly lower inflation going forward. The currently low energy prices compared with a year ago will continue to pull down inflation numbers in the upcoming months. The declining commodity prices over the past year, as well as the rapidly falling freight prices, also suggest lower inflation pressures ahead. Eventually these downward pressures will trickle through to core inflation as well. In addition, the fast tightening of monetary policy will push down demand and inflation further. That said, wage pressures in many economies seem persistent and pose an upward risk to inflation.

Despite this relatively benign inflation outlook, we forecast that both the Fed and the ECB will raise their policy rates a bit higher over the next few months. The main reason is that, as current inflation remains lofty, we judge that the central bankers will not dare to be forward-looking and

Freight costs are back to normal

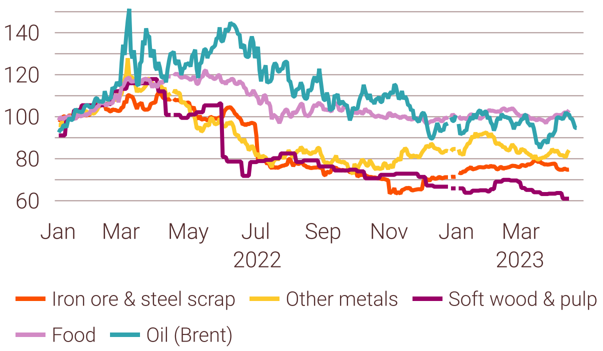
Index (2019=100), shipping



Sources: Swedbank Research & Macrobond

Commodity prices have declined

Index (Jan 2022=100), USD



Sources: Swedbank Research & Macrobond

simply await the lower inflation readings. It's about managing risks and inflation expectations.

Next year, as economies slow more markedly and central banks close in on their inflation targets, we expect a series of rate cuts from most central banks. However, the rate cuts are starting from a high level, and, even at the end of the forecast horizon, we forecast higher policy rates than what we deem neutral/normal. This means that the monetary policies will remain restrictive, but not as restrictive as they are today.

Lower short-term bond yields, stable long-term yields

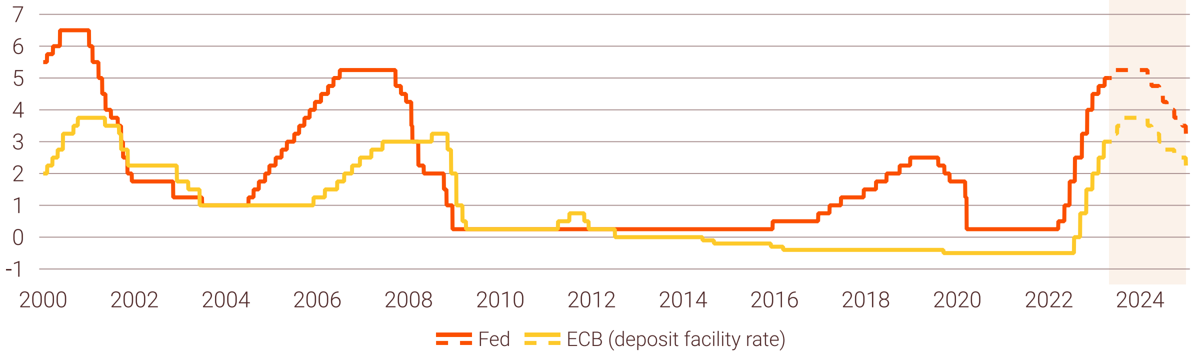
Bond markets have experienced large swings so far this year on the back of varying expectations on inflation and on monetary policy responses. The sudden turmoil in the US banking sector in March, with regional banks struggling with higher interest rates, spread more broadly to financial markets and led to a rapid decline in bond yields and widening credit spreads. However, because policymakers acted swiftly with resolution plans for the failing banks and bailed out depositors, the immediate financial stress abated. Since mid-March, bond yields have risen and credit spreads have tightened.

Even though the acute financial turmoil has calmed down, we expect that somewhat tighter credit conditions will prevail during the forecast horizon. Tighter credit conditions normally also entail somewhat wider credit spreads ahead, meaning that businesses will face higher funding costs. This will likely also weigh on growth, as investments and consumption will be lower than they otherwise would have been. Nor would we rule out more "accidents" popping up on the back of the rapidly rising interest rates.

We expect long-term government bond yields to stay largely unchanged at current levels during the forecast horizon, although volatility around these levels is likely to be high. Short-dated yields are expected to largely stay at their current elevated levels until the summer and then gradually decline later this year, when central banks rate cuts are approaching. Our forecast is close to the current market pricing (swap futures).

Central banks' policy rates – close to peaking

Outcome and Swedbank forecast, %



Sources: Swedbank Research & Macrobond

The glory of the US dollar fades slowly

The two fundamental drivers of last year's US dollar strength – low risk appetite and relative interest-rate advantage – have become its weakness. Although risk aversion spiked in March as the turmoil in the US banking sector evolved, it has come down again in recent weeks. More important, the fear of an imminent energy crisis hitting Europe has abated. Also, the Chinese recovery may stimulate risk appetite. Accordingly, the US dollar has weakened. Interest rate differentials also support the case for a weaker dollar going forward. As the inflation trend has turned down in the US, the Fed is likely to be the first major central bank to halt its hiking cycle. In this environment, we expect the US dollar to gradually weaken and the euro to appreciate.

The Scandinavian currencies had a rough year in 2022; the Swedish krona and the Norwegian krone depreciated markedly and have stayed weak so far in 2023. The main reason for their weaknesses is probably the overall low risk appetite that weighed on smaller, more illiquid, currencies. Looking ahead, we expect that the Swedish krona and Norwegian krone will benefit from the improved risk appetite.

US – stress test

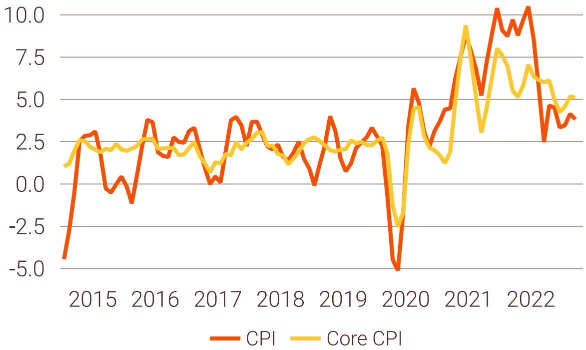
Following high inflation and rising interest rates, turmoil in the banking sector recently emerged, clouding the economic outlook even further. Although the economy has continued to hold up surprisingly well, a recession is still on its way. However, high inflation means that the Fed will continue to tighten monetary policy in the near-term.

Still sticky inflation

Inflation has proven to still be sticky, especially in services. It is true that inflation has fallen since last summer, but the three-month annualised rate of the core CPI stood at more than 5% in March, far above what is consistent with the Fed's 2% inflation target. We still expect inflation to fall throughout the year. Supply-chain issues have abated, and the economy is expected to slow, which means less room for price increases, at the same time that base effects will also exert downward pressure. Nevertheless, core inflation is expected to be above 2% by the end of 2023.

High inflationary momentum

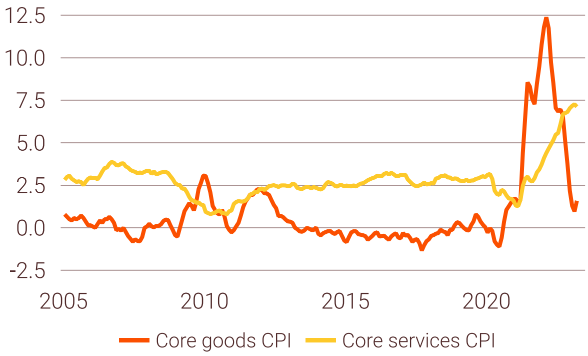
3-month annualised rate, %



Sources: Swedbank Research & Macrobond

Sticky service inflation

y/y %



Sources: Swedbank Research & Macrobond

The US economy has continued to show a surprisingly strong momentum. GDP grew at an annualised rate of 2.6% in the fourth quarter of last year. Furthermore, warm weather at the beginning of this year also boosted activity and caused us to revise up our growth forecast for the near term. This strength is particularly evident in the labour market: nonfarm payrolls increased by more than 1 million in the first quarter, and the unemployment rate stands at a historically low 3.5%. Also, despite the still-elevated inflation and rapidly rising interest rates, consumption has held up quite well. Consumers still have some excess savings left from the pandemic that they continue to run down, and we think they will likely do so in the near term.

Turmoil in the banking sector clouds the economic outlook further

The economic outlook has, however, become even more uncertain due to the recent banking turmoil. The collapses of Silicon Valley Bank and Signature Bank were the second- and third-largest banking failures in US history, respectively, and sent shockwaves throughout the financial system, causing stock markets to drop and market interest rates to fall.

However, policymakers acted swiftly and ambitiously to contain the fallout from the bank collapses, e.g., by guaranteeing all the deposits of the two failed banks and implementing a new lending programme, the Bank Term Funding Program (BTFP), to help banks with liquidity so they could meet the needs of their depositors. Banks have borrowed substantial amounts at both the BTFP and discount window after the collapses. We assume that the measures taken, and policymakers' response to further issues, will be enough to stave off a broader financial crisis. However, we expect the turmoil to lead to tighter financial conditions, meaning that the situation on the financial markets as well as the interest rates and conditions that households and companies face when they need to borrow or invest capital will tighten.

Tighter financial conditions are expected to have a negative impact on the real economy

The commercial real estate (CRE) sector is also a case in point, as it is usually dependent on smaller and regional banks to provide it with funding needs. Banks have already tightened lending standards substantially to CRE and will likely do so further, which could weigh on construction activity and property prices. Also, ever since the Fed started raising rates last year – and even more so lately due to the banking stress – depositors have withdrawn their money, especially from smaller banks, and put it into money market funds. This could further exacerbate the issue by making banks even less inclined to lend. The wider effects of all this are uncertain, but the banking stress is expected to have a negative impact on the real economy. Another risk to both the financial and real economy is the reccurring threat that the US might default on its obligations should the debt ceiling not be raised, although this usually gets resolved in the end.

This financial tightening will also do some of the Fed's work for them in terms of monetary policy. In the span of just over a year, the Fed has raised the federal funds rate by 475 basis points (bps) to 4.75–5.00%. However, the proxy federal funds rate, which also incorporates data from financial markets such as Treasury rates, mortgage rates, and borrowing spreads, is significantly higher, at 6%. This means that monetary policy is much tighter than what the effective federal funds rate indicates. Although financial stability is a top priority for the Fed, one thing has not changed – inflation is still too high. Thus, barring a financial collapse, we expect the Fed to remain hawkish to restore price stability and bring the labour market into better balance. We forecast that the Fed will raise the federal funds rate by a final 25 bps in May to 5.00–5.25% and then be on hold for the rest of the year, since inflation is projected to remain high. Then, when inflation has come down and growth remains weak, we expect the Fed to start lowering the federal funds rate next year, by increments of 25 bps at every meeting, for a total of 200 bps. As such, the federal funds rate is still expected to be at restrictive levels throughout 2024.

5.00-5.25%

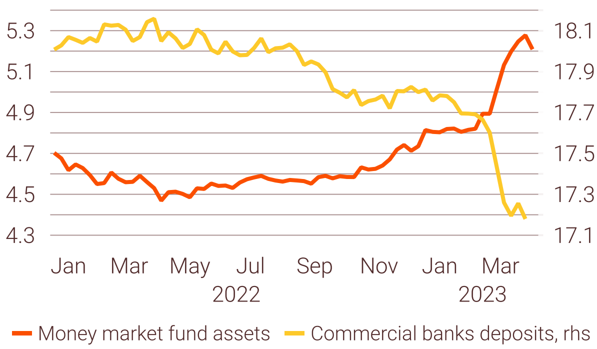
The Fed hikes one last time by 25 bps in May

For more than half a year, we have forecast that the US economy would enter a recession in 2023. However, we have been surprised by the resilience of the economy, even though inflation remains elevated and interest rates are at restrictive levels. We still expect the recession to happen, but have moved its timing to later this year. We forecast that growth will turn negative in the third quarter and remain so for two more quarters. This will also eventually mean that the labour market will weaken, and that the unemployment rate will rise. We estimate full-year growth at 1.2% and 0.5% in 2023 and 2024, respectively – a higher growth forecast for this year but lower for next year than in our previous forecast.

The US is expected to enter a recession later this year

Money flowing to money market funds

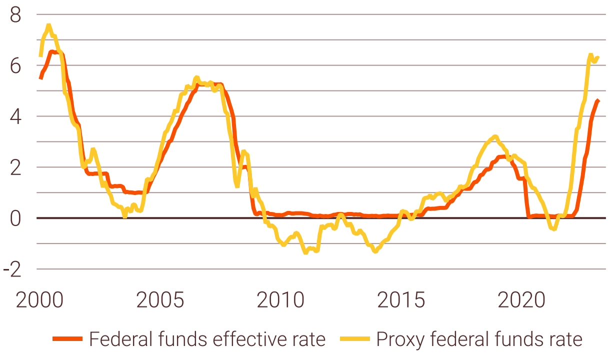
USD trn



Sources: Swedbank Research & Macrobond

Monetary policy is tighter than policy rate implies

%



Sources: Swedbank Research & Macrobond

Euro area – policy tightening about to hit the real economy

The euro-area economy has started the year on a brighter note than expected. Services have remained resilient and the industrial numbers have surprised on the upside. However, the recent historic monetary policy tightening is finally affecting lending conditions, and this will weigh on growth in the second half of this year, as well as next year.

Sentiment indicators point to a moderate expansion in economic activity at the start of the year, but hard data are painting a bleaker picture so far. A broader industrial contraction was expected due to the cost shock, but the real manufacturing output in the euro area is nearly unchanged from a year ago. Energy-intensive industries have suffered due to the energy shock, but growth in the other subsectors led to overall industrial output being unchanged. The price shock failed to reduce production, but consumption took a hit. Real retail trade in the euro area as a whole is a couple of percent lower than a year ago, while in Germany it is down more than 7%.

The economy fared slightly better than expected at the start of the year

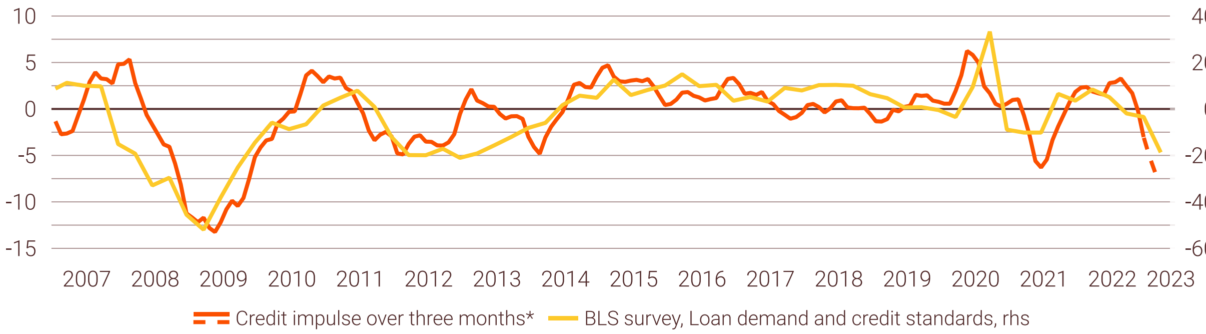
Inflation has been steadily falling since the peak in October 2022. Headline annual inflation was down to 6.9% in March. Much lower energy prices and the easing of supply bottlenecks will exert downward pressure on headline inflation until the end of the year. However, core inflation has not peaked yet and remains uncomfortably high. We expect that core price pressures will peak in the second quarter and start easing, but the decline will be more gradual than the headline inflation. Core inflation is still expected to be around 3% by the end of this year.

Initially, no clear effects of the rapid tightening of monetary policy were seen. However, in the last quarter of 2022, credit standards tightened sharply, and loan demand fell to a very low level. The overall tightness of credit conditions is similar to the years 2011-2013. The turmoil in the banking sector over the past month is likely to further tighten the credit conditions, as banks focus on balance-sheet protection instead of expansion. The smaller flows of new credit will weigh on demand with a lag of a couple of quarters, and negative surprises to growth are quite likely in the second half of the year.

Credit standards are the tightest since the sovereign debt crisis in 2012

Financial conditions and lending in the euro area

% of GDP; index, 3mma (rhs)



*Change in the flow of credit
Sources: Swedbank Research & Macrobond

So far, most euro area economies have remained resilient – domestic economies are strong, and the easing of price pressures has led to a slight rebound in consumer confidence. On the other hand, policy tightening has just started to work its way through the real economy, and its effects will become more apparent over the next several quarters. We expect the euro area economy to expand only by 0.4% this year, and by a still-meagre 0.7% in 2024.

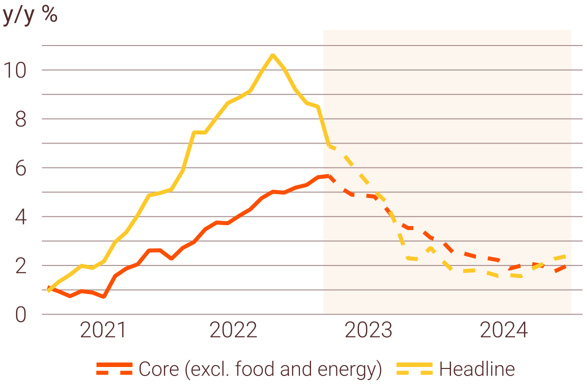
ECB will push ahead with rate hikes until mid-summer

Like many central banks, the ECB is navigating difficult terrain, where it has to calculate when the risk of too-restrictive monetary policy and credit conditions will outweigh the risk of not doing enough to stifle core inflation. So far, most Governing Council members seem determined to stay on the path of higher interest rates, since core inflation has not yet peaked, while economic growth has barely suffered. We now forecast that the ECB will shift to a lower gear but will hike all main policy rates three more times by 25 bps in May, June and July, bringing the terminal rate to 3.75%. We think that, by the autumn, core inflation will be on a clear downward trend, more signs of disinflation will be obvious, and signs of even-tighter credit conditions will warrant the end of this hiking cycle. Admittedly, if recent economic resilience continues and core inflation fails to decline as rapidly as we forecast, the ECB may decide to push rates to 4% or even higher, but for now this is not the most likely scenario. In any case, we still think that current monetary policy is sufficiently restrictive and that at least some euro area economies are likely to be in recession by the end of the year. We maintain our forecast that the ECB will cut interest rates by 1.5 percentage points next year, bringing the deposit facility rate to 2.25%.

For the ECB, the risk of too-sticky inflation still outweighs the risk of recession

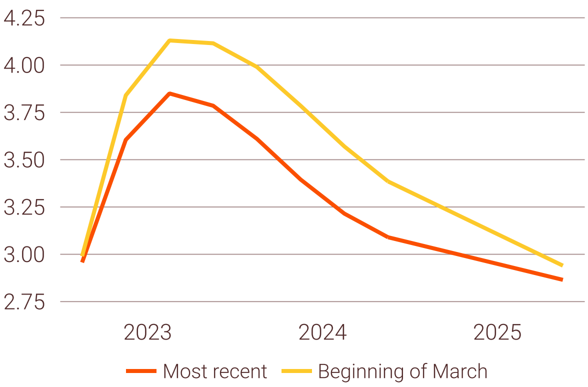
Inflation in euro area

y/y %



Sources: Swedbank Research & Macrobond

3 month Euribor futures



Sources: Swedbank Research & Macrobond

China – bouncing back

The economy got off on a good footing at the start of the year, following the rapid reversal of the country's previously strict COVID strategy and its support to the property sector. Growth is set to rebound from last year's 3% to more than 5% this year.

GDP grew by 2.2% in the first quarter compared with the fourth quarter and by 4.5% compared with the corresponding quarter last year, a clear pickup from the end of last year. China set its official 2023 growth target at "around 5%," which is quite modest considering the low growth in 2022 and the potential for a strong economic recovery this year. As such, we view this target as more of a floor, and actual growth is likely to be reported somewhat above this level. We forecast that GDP will grow by 5.5% this year and 5% next year.

5.5%

China's expected GDP growth in 2023

China's reopening will be the biggest growth driver this year, generally through an increase in household consumption, not least for services. With the country under strict COVID restrictions for almost three years, there is a lot of pent-up demand. Total retail sales increased by 10.6% in March from the corresponding month last year. Leading indicators, such as the rapid pickup in the number of flights to and from China, as seen in the graph to the left below, point to continued strength in consumer demand. Also, global tourism will gain from China's reopening in the coming years. However, there are risks to the recovery on the consumption side, due to the still-depressed consumer confidence and the still-notable uncertainty regarding developments in house prices and – by extension – consumer wealth.

China's property sector is showing signs of a recovery. Home-buying sentiment is improving, as prices for both new and existing homes rose for the first time in almost one and a half years in February, and prices increased further in March, while at the same time home sales increased by 7.1% in the first quarter of the year compared with the corresponding quarter last year.

Signs of a recovery for the property sector

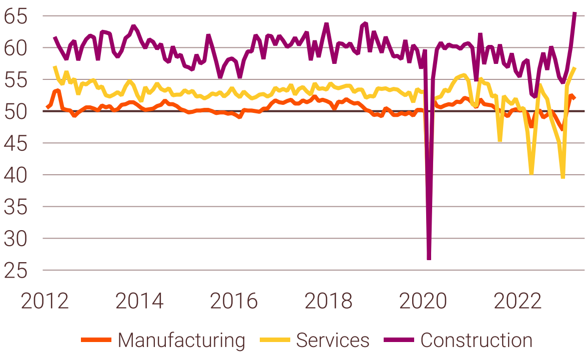
China's consumer recovery is ready for takeoff

Flights between China and rest of the world, 7d ma

Sources: Swedbank Research & Macrobond

Strong rebound for services and construction

Purchasing Managers' Index, sa



Sources: Swedbank Research & Macrobond

Furthermore, the number of building completions has rebounded and are this year thus far higher compared to last year. However, residential property investments and housing starts have continued to fall, indicating that future construction work will remain weak, and that the property sector is not out of the woods yet.

Heightened geopolitical tensions

There are plenty of risks to the growth outlook, also in the long-run perspective. Geopolitical tensions are heightened, as US-China relations have deteriorated further. Pressures have built up in the wake of the spy balloons incident and the recent meeting in the US between Taiwan's President and the US House Speaker. Last year, the US imposed export controls on China's access to advanced semiconductor technology; recently, the Netherlands and Japan have joined in on these efforts, which will likely hamper China's chip industry. Structural challenges – e.g., rebalancing the economy to rely more on consumption and less on investment, deglobalisation, and an ageing population – are weighing on long-term growth prospects.

Sweden – two tough years

Continued high inflation will further weaken households' purchasing power and tighten monetary policy even further. In addition, fiscal policy will be contractionary. Declines in consumption and in housing investments will contribute to a slowdown in growth this year. Next year, only a weak recovery is expected. The labour market will start deteriorating more significantly after the summer.

A more protracted downturn is forthcoming

Two tough years await the Swedish economy, as high inflation erodes purchasing power and interest rate hikes have their full impact. We expect GDP to fall by just over 1% this year and to grow by a low 0.3% next year. This is a weaker outlook than in our previous forecast, reflecting a weaker development of household consumption; meanwhile, export growth is moderating more in the wake of slower growth in the euro area.

The decline started already last year. Sales in retail trade have declined significantly in volume terms since the summer of 2022, and in the fourth quarter the number of employees in retail was almost 8,000 fewer than a year earlier. At the same time, new construction has slowed sharply, and the number of housing starts halved at the end of last year. However, the development differs across sectors, and production has continued to increase in more business-related service industries. Services exports also increased strongly last year, while goods exports slowed.

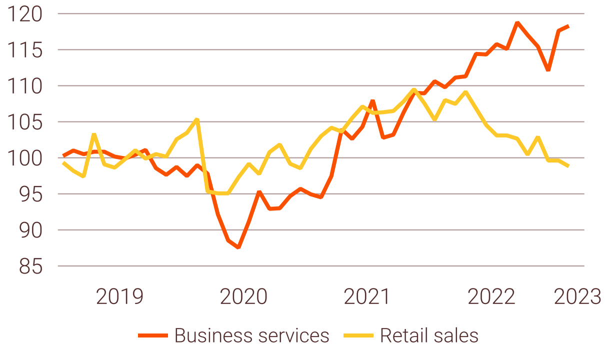
0.3%

Weak GDP growth in 2024

Looking ahead, we expect a further decline in household consumption and housing investment, and that the slowdown will spread to more parts of the economy. Business investment will decline in the coming year, although the decrease will be more limited than in previous economic downturns. Export growth, in both services and goods, is decelerating as growth in many export markets slows. Import growth will be sluggish as household consumption, investments, and exports slow.

A twofold economy

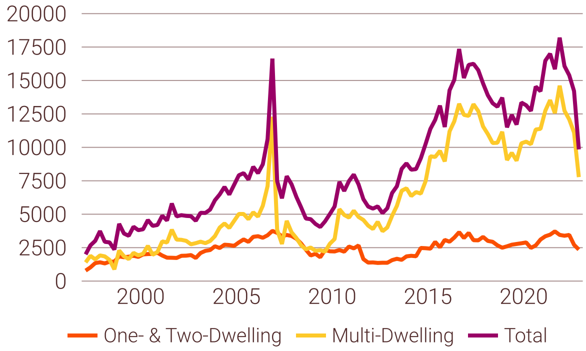
Production value index (2019=100), sa, ca, volume



Sources: Swedbank Research & Macrobond

Housing starts are declining fast

Number, sa

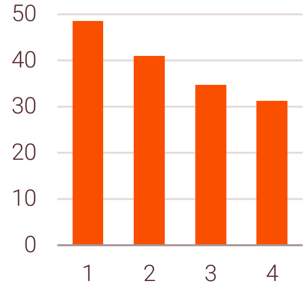


Sources: Swedbank Research & Macrobond

Household consumption will decline more than expected

Household purchasing power is being squeezed by high inflation. Last year, the purchasing power of the household sector decreased by almost SEK 190 billion because of the rapid price increase, and this year we expect a similar decline. Prices have risen the most for essential expenditures, such as food and housing, and low-income households are being hit particularly hard. Data from Statistics Sweden show that essential expenses account for about half of total consumption for households with the lowest income; meanwhile, these expenses account for only 30% among households with the highest income (see graph to the right).[1]

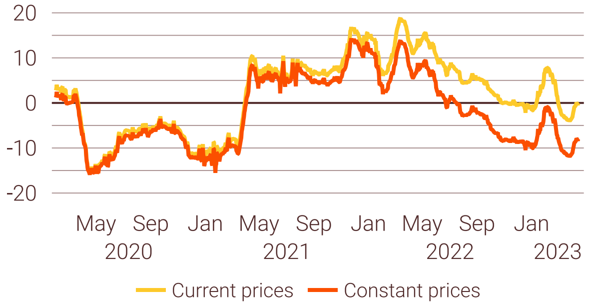
Essential spending per income group
% of total spending



Households' interest expenses doubled from SEK 32 billion in 2021 to SEK 66 billion in 2022; another doubling is expected this year as interest rate hikes affect more and more households. Although wage growth will be higher both this year and next as a result of the new industrial agreement, the wage sum will grow more slowly as employment starts to decrease. Together with a tighter fiscal policy, real disposable income for households will fall by around 3% this year, and only a weak recovery is expected next year. Despite the decrease, the real income level is in line with the pre-pandemic level. This is not the case for real wages, which will drop to the level seen in 2013 (see graph below).

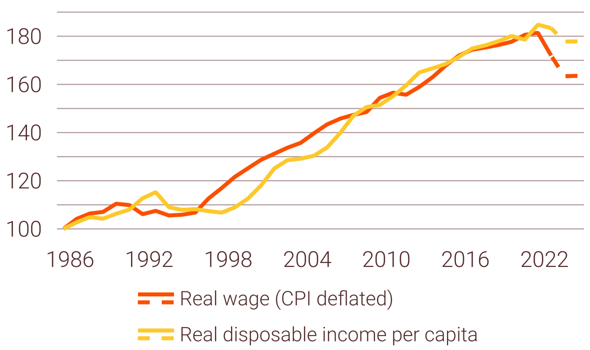
Households have started to cut back on spending. Card statistics from Swedbank Pay show that price-adjusted consumption was 8% lower in the period 19 March – 15 April than in the corresponding period last year. Looking ahead, we expect the decline to continue, as purchasing power is squeezed further; consumption will fall by 1.4% this year and remain unchanged next year. This is a weaker outlook than in our previous forecast, largely due to higher inflation and interest rates.

Total spending on a downward trend
Transaction turnover, y/y %, 4wma



Note: Deflated using the CPIF index excl. electricity.
April data is deflated with the Swedbank forecast.
Sources: Swedbank Pay and Swedbank Research

Smaller decline in real disposable income
Index (1985=100)



Sources: Swedbank Research & Macrobond

[1] SCB, Households' expenditure 2021. The data is divided into four income groups, where the median household expenditure in each income group is distributed across various goods and services subgroups (COICOP).

Financial stability, but weaker purchasing power is a risk

Households can cope with higher interest rates, but need to adjust consumption

Compared with the rest of Europe, Swedish households have higher indebtedness, and their loans have significantly shorter interest-rate fixation periods. This means that interest rate hikes have a faster impact on household finances in Sweden, and that households need to adapt consumption more quickly. According to the Swedish Financial Supervisory Authority's annual survey of borrowers who have recently taken out new loans, and thus generally have higher debt than households in the loan portfolio, such borrowers are resilient and only a very small share are expected to have difficulties servicing their debt. This is an assessment shared by the Riksbank. Also, according to a review by the International Monetary Fund (IMF) of risks in the Swedish financial sector, Swedish households will be able to service their mortgages even after higher interest rates.[2] Our assessment is that Swedish households will be able to service their debt even at the interest rates we foresee.

However, households need to reduce their consumption. According to an analysis by the Riksbank, an interest-rate hike has double the impact on Swedish consumption today compared with 15 years ago, because household indebtedness is so much higher now.[3] This means that many households will need to adjust their consumption to be able to pay for necessary spending, such as housing-related expenses and loan payments, as well as food. The way in which households adjust their finances in this new economic situation will depend on their housing, family, and financial situation.

Reduced consumption may lead to payment difficulties in other sectors

All in all, this means that any payment difficulties experienced by mortgagors are not expected to lead to major credit losses in the banking sector. But, as the Riksbank points out, some house-holds may still have problems. This is especially true for households that have taken out consumer loans (which account for just below 6% of household lending), as these households generally have poorer debt-servicing ability than mortgagors; this means that consumer credit companies, in particular, may see increased credit losses. In addition, the banking sector as a whole may suffer credit losses from those companies that are now affected by the fact that households need to cut back on spending. This, in turn, could also spill over to the commercial real estate sector, which could suffer from increased vacancies and reduced rental income. If property companies that are particularly exposed to consumer-oriented companies face increased financing costs at the same time, there is a risk that they will find it difficult to live up to their commitments. In this context and from a macro perspective, however, we would note that the large Swedish property companies have relatively well-diversified real estate portfolios. Therefore, we believe that there is a very low probability of several large property companies experiencing payment difficulties. However, we cannot rule out that individual companies that have greater exposure to vulnerable sectors, such as retail, hotels and restaurants, may see a larger proportion of vacancies in the future and encounter problems meeting their commitments.

[2] Swedish Financial Supervisory Authority (2023), *The Swedish mortgage market 2023*, 2023-03-28, Sveriges riksbank (2022), *Financial stability*, 2022-11-09, IMF (2023), *Sweden: Financial Sector Stability Assessment*, 2023-03-16.

[3] Pär Stockhammar, Ingvar Strid, Tommaso Tornese, How has the impact of the policy rate on consumption changed when the debt-to-income ratio has risen?, Sveriges Riksbank, 2022.

More protracted deterioration in the labour market

The labour market is facing a weakening. We expect employment to fall from midyear onwards and unemployment to rise more pronouncedly. Consumer-related industries with many employees are being hit hard by the deteriorating household purchasing power. These industries include hotels and restaurants, retail trade, as well as construction. In addition, employers' contributions for young people are returning to higher levels. Meanwhile, both collectively agreed wage increases and rents for premises will be higher, which adds to the burden for many companies. In the Riksbank's February business survey, several companies reported that they had ceased to recruit replacement employees. The number of bankruptcies also continued to rise in March, with the above-mentioned industries standing out. So far, bankruptcies have largely involved sole proprietorships; however, as we look ahead, we expect bankruptcies and redundancies to increase. We also expect companies in more industries to adjust to the lower demand.

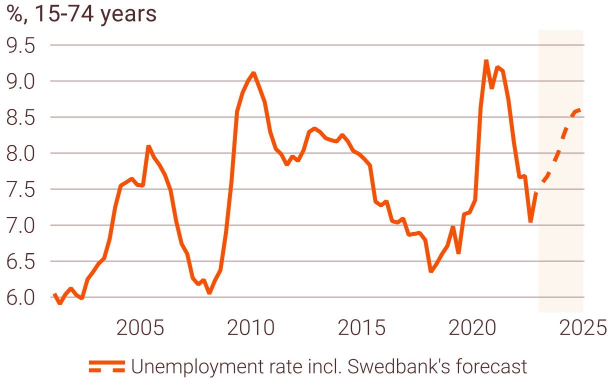
Overall, we expect an increase in unemployment from 7.5% in the fourth quarter of 2022 to just over 8.6% in the fourth quarter of 2024; this corresponds to about 70,000 more unemployed people. At the same time, the picture is somewhat mixed, as demand remains high in certain sectors such as the defence industry and green technology. According to the National Institute of Economic Research (NIER) Economic Tendency Survey for March, employment plans differ across sectors. However, the decline in the most employment-intensive sectors cannot be completely mitigated. Recruitment needs in the public sector remain very strong; the employers' organisation, the Swedish Association of Local Authorities and Regions (SALAR), estimates that employment needs to increase by just over 90,000 during the period 2021–2031 to meet a growing population with a larger proportion of elderly people. Together with replacement recruitments, the need is 400,000 new employees, which corresponds to about 8% of all employed people. The public sector is also affected by rising interest rates and costs, and, to meet the greater demand, increased government grants are needed, read more on page 25. But it is not only about resources, and finding the right competencies is a problem not only for the public sector. The structural matching problem between job vacancies and unemployed people requires long-term action.

Unemployment will peak in 2024 at

8.6%

Unemployment increases as the economy slows

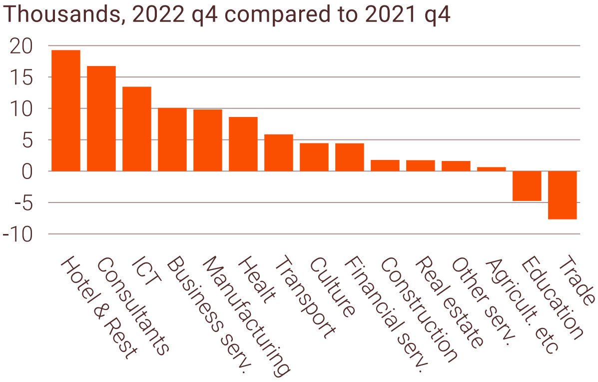
%, 15-74 years



Sources: Swedbank Research & Macrobond

Falling employment in the trade sector

Thousands, 2022 q4 compared to 2021 q4



Sources: Swedbank Research & Macrobond

Historic industrial agreement in place, but negotiations are still ongoing

On 31 March, the negotiating parties agreed on a new industrial agreement that sets the norm for the rest of the labour market. The new norm was set at 7.4% over two years – the highest level since the first industrial agreement was signed in 1997. The agreement is front-loaded, with wage cost increases of 4.1% in 2023 and 3.3% in 2024. However, the negotiations are not over: around 280 agreements remain to be renegotiated before year-end, the majority of which expire in April. So far, there has been great alignment with the norm, and, even in industries that previously signalled they were prepared to take industrial action, such as trade and transport, the unions have agreed with employers on wage increases in line with the norm. The agreements can also be interpreted as the parties' continued confidence in the Riksbank's inflation target. The relatively high level of wage increases adds some cost pressure and may pose additional difficulties for industries hit hard by the economic downturn. Compared with new agreements in, e.g., Germany and Denmark, the agreed wage growth is lower. We expect total wage growth of around 4.2% in 2023 and 3.9% in 2024. Real wage growth will not turn positive until the second half of 2024. On average for 2024, we expect real wages to grow at a modest rate of 0.1%.

Falling housing investments and housing prices falling in autumn

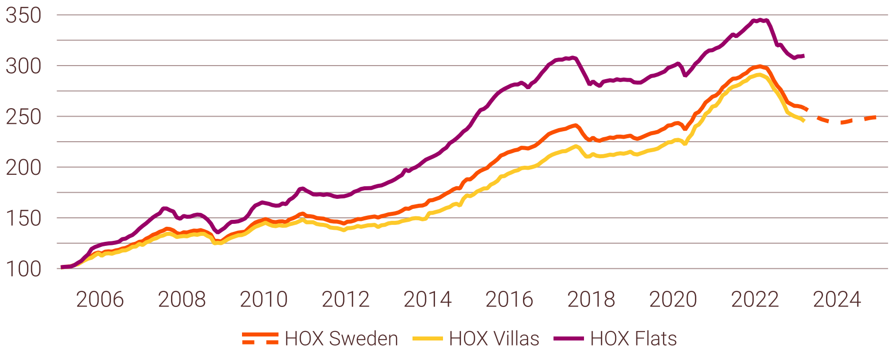
We expect that most of the price adjustment in the housing market has already taken place and that the price decline going forward will not be as dramatic as last summer and autumn. But, since mortgage rates are expected to be a little higher and peak somewhat later than we previously thought, we expect prices to continue to decline until well into the autumn of this year. All in all, we still expect the price drop to be around 20%, but that the bottom will be reached in the autumn instead of in the summer.

20%

House price decline

Housing prices will decline somewhat more

Index 2005=100, SA



Sources: Valueguard & Swedbank Research

Housing investment is falling sharply in the wake of increased construction costs, higher interest rates, and reduced demand. We expect 28,000 housing starts this year and 25,000 next year. This means that fewer new homes will come onto the market, which in the short term is expected to counteract the price decline. Falling housing investment will weigh down GDP growth by almost 1 percentage point this year and slightly less next year.

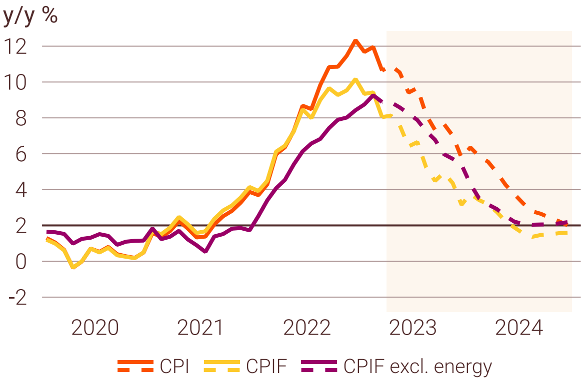
Stubbornly high inflation in the near term before the downhill steepens

Swedish inflation remained high at the beginning of the year; in March, the annual rate of the CPIF (consumer price inflation with fixed interest rate) was 8.0%. At the same time, the CPI, which also includes households' mortgage expenditure, was 10.6% higher than in the corresponding period last year. In recent months, Swedish inflation has been characterised not only by falling electricity prices, but also by a strong momentum in underlying inflation, measured as the annual rate of the CPIF excluding energy. We expect price pressures to remain strong in the near term and that they will not subside until the summer, which means that the steep downhill climb for Swedish inflation will take a while longer.

CPIF inflation to fall below the inflation target in 2024

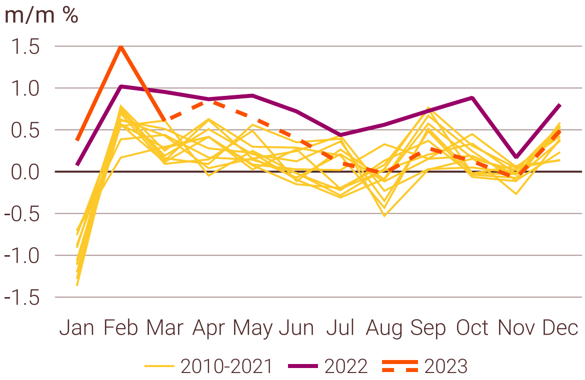
Looking a little further ahead, we expect inflation to fall faster and start approaching 2% again. Several of the cost increases that have driven inflation have recently slowed or started to reverse, including in raw materials and transportation. In addition, economic activity is decelerating more clearly, limiting the scope for large price increases. Core inflation is expected to approach 2% some time into 2024, while the annual CPIF rate will fall below the inflation target. However, this means that consumer prices will stabilise at higher levels and that major price falls will not occur. Read more in "High inflation finds renewed momentum" on page 25.

Inflation is past its peak



Sources: Swedbank Research & Macrobond

Strong momentum in CPIF excl. energy



Sources: Swedbank Research & Macrobond

The Riksbank will raise interest rates further – but rate cuts will follow next year

The persistently high inflation will lead the Riksbank to tighten monetary policy further. We expect the policy rate to peak at 4.0% in June. The tightening will be exacerbated by a rapid liquidation of the Riksbank's securities holdings during our forecast period, which will take place through both maturities and active sales of government bonds. As inflation falls and activity in the economy weakens, the need for a sharply tightening monetary policy will gradually decrease. Starting in February next year, the Riksbank will therefore initiate a series of interest rate cuts, resulting in a policy rate of 2.75% by the end of 2024.

2.75%

Interest rate at the end of 2024

High inflation finds renewed momentum

At the beginning of the year, the rate of price increases in the Swedish economy accelerated in accordance with underlying inflation measures. Excluding energy, first-quarter 2023 consumer prices rose more than in the first quarter of last year, even though price increases are now coming from clearly higher levels and in a weaker demand environment. One explanation is that the more consumer-oriented companies, which are probably still struggling with last year's increased costs, are forced to incur new expenses linked to factors such as higher rent for premises and increased labour costs. A number of these companies, not least in the consumer discretionary and services sectors, are likely to have insufficient profit margins to absorb the cost increases and will instead be forced to pass them on. The continuous weakening of the krona since the end of 2021 is also having a major impact, especially on food prices, which are now 21% higher than at this time last year.

The large and broad cost increases that prompted last year's rise in inflation are trickling through to consumer prices with a delay, which is partly why we continue to see large price increases. For example, non-energy commodity prices as a whole have moved sideways or fallen for a year, with no visible effect on inflation. This also gives an indication of the self-sustaining properties of inflation, as both rent and wage increases occur as a consequence of rising inflation and interest rates. All other things being equal, inflationary pressures should fade as more and more of the companies' total costs are passed on to consumers; however, for the abovementioned reasons, the course looks set to be more protracted than previously thought.

We remain hopeful that a more normal price pattern will be in place by the autumn, but, as before, the forecast is surrounded by risks. One of these is the development of energy prices, which is difficult to predict. Energy prices have not only direct but also indirect effects on inflation, e.g., through food prices. We expect food prices to rise for a while longer before stabilising, but with no major fall in prices during the forecast period. In our opinion, there is greater potential for falling prices in durable goods, such as furniture and recreational goods, which should be more sensitive to the economic cycle. How much depends on the degree of pricing power that companies manage to maintain. In a more unfavourable scenario, with weaker economic development than expected, Swedish consumers may be able to enjoy larger price falls for more demand-sensitive goods and services. Overall, the risk picture for inflation is balanced but wide, and tail risks remain more significant than usual.

Tighter fiscal policy than the government expects

Fiscal policy faces a difficult balancing act when inflation remains high while the economy slows. The government, in cooperation with the Sweden Democrats, have clearly communicated that fiscal policy should not fuel inflation, and this has characterised this year's budget bill.

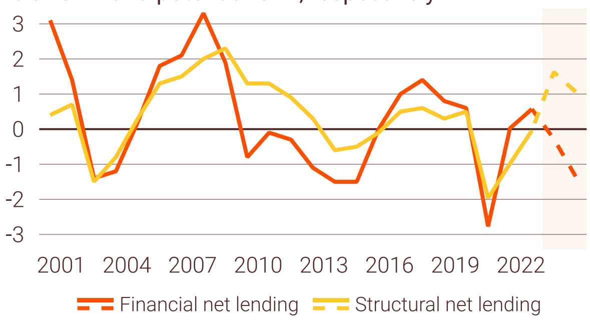
Nevertheless, we expect more measures going forward, when inflation has decelerated and economic growth is low. In total, we expect unfunded fiscal measures to the extent of SEK 40 billion in 2024, most of which are tax cuts announced in the Tidö Agreement (on lower labour income and pensions) and government grants to the local government sector.

We expect SEK 40 billion in unfunded measures next year

Government grants are expected to be increased by SEK 15 billion due to the demographic challenge and the cost increases caused by high inflation. SALAR and the NIER expect the local government sector to face a deficit of SEK 15–25 billion next year if revenues do not increase or costs are not cut. However, with our forecast, total contributions are in line with the peak during the pandemic in nominal terms, but only in line with pre-pandemic levels in real terms. In addition, we expect more targeted subsidies to households. In line with NIER's latest assessment, we expect SEK 25 billion in electricity support payments to households and companies next year to be financed by capacity fees.

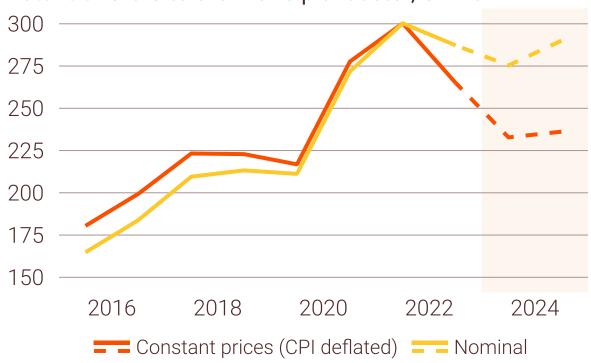
We believe that fiscal policy will be more restrictive this year than the government expects, and that there is scope to take further measures going forward. Structural net lending can be used to get an indication of the direction of fiscal policy and corresponds to general government net lending when adjusted for the business cycle. As structural net lending increases, fiscal policy is assumed to be tightened compared with the previous year. Our assessment (based on the method used by NIER) is that structural net lending will increase to 1.6% of potential GDP this year and will fall slightly to 1.1% next year. Hence, fiscal policy is considered to be restrictive this year. Also, the combined surplus from structural net lending in 2023 and 2024 will free up a fiscal space of around SEK 100 billion. In the long run, especially in light of the demographic developments and the green transition, we advocate replacing the surplus target with a balance target, which would free up further fiscal space.

Structural net lending above surplus target
% of GDP and potential GDP, respectively



Note: The calculation of structural net lending uses the NIER method and assessment of potential GDP
Sources: Swedbank Research, NIER & Macrobond

Government grants will decline in real terms
Total transfers to the muncipial sector, SEK bn



Sources: Swedbank Research & Macrobond

Norway – strong, but challenges ahead

The Norwegian economy has fared better than expected recently and is seen to maintain a sound momentum in the short term. Higher policy rates will eventually lead to weaker credit growth, reducing growth capacity into next year.

Diverging developments, but overall solid for now

The Norwegian economy has exhibited robust growth in recent quarters and is expected to continue on a positive trajectory in the near term. However, there are signs of divergence within the economy, with the oil and services sectors likely to continue expanding while industries focused on households, such as construction and retail, may face challenges ahead. The outlook for households is weakening due to higher interest rates, although improving real wage growth and low unemployment rates are mitigating the negative impact. 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 may contribute to slower overall activity growth in the coming years.

The labour market remains resilient for now, with registered unemployment at historically low levels of 1.7%, last seen in 2008. However, with bleaker growth prospects, an increase in the unemployment rate can be expected in the second half of this year as growth slows. Labour shortages are also moderating somewhat as the number of new vacancies has decreased from elevated levels.

Inflation remains a concern, with the weak Norwegian krone (NOK) and higher expected wage growth potentially keeping inflation higher than expected for several more months. Moreover, prices are rising across many product groups as high electricity and financing costs feed through pricing behaviour and companies protect their margins. Core CPI, which excludes energy and taxes, reached 6.2% in March, with other measures of core inflation even higher. While slowing global inflation may affect imported price growth, the recent weakening of the NOK may contribute to sustained higher growth in imported goods' prices. Domestic price pressures are expected to remain strong in the short term due to the tight labour market and indirect effects from financing costs and a weak NOK. However, core inflation is expected to slow more markedly in the second half of this year towards 4% and likely remain above 2% for most of next year.

4.1%

CPI-ATE in December 2023

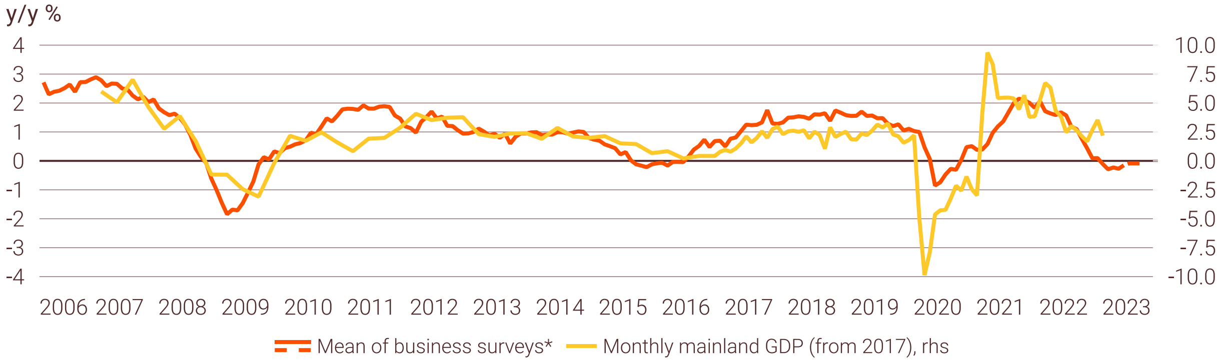
Norges Bank delivered a 25 bps rate hike in March, leaving the policy rate at the current 3.00%. The rate path signals further hikes of 25 bps each in May and June, with some probability of another hike after the summer. The central bank is expected to maintain a hawkish stance due to higher-than-expected headline inflation, a continued weak NOK, and limited signs of weakening labour markets. Although Norges Bank, like other central banks, will be data-dependent, the impact of US banking issues on credit standards, funding rates, and credit spreads in Norway has been minimal so far. However, the lagged effects of Norges Bank's faster-than-normal rate hikes could be larger on the economy once pandemic savings are exhausted. 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 3.75% by September, 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 next year.

3.75%

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

Housing prices in Norway have experienced a strong rebound this year and are currently only one percent below the peak observed last autumn. Despite higher mortgage rates, high household indebtedness, and mostly floating mortgage rates, housing prices have outperformed expectations. This strong performance can be attributed to eased mortgage regulations implemented this year, a tight market balance with limited houses available for sale, and good credit availability for households. However, looking ahead, it is anticipated that housing price growth will cool, and prices may decline, as credit demand should decelerate over the coming years.

Business surveys signal slowdown ahead



*Regional Network, SSB business survey, PMI, NHO
Sources: Swedbank Research & Macrobond

Baltics – cooldown, not a crisis

Baltic economies continued muddling through at the start of this year – Lithuanian and Estonian GDP probably continued to shrink, while the Latvian economy seems to be stagnating. Household consumption is likely to recover soon as wage growth overtakes inflation, but exporters will have to wait for their recovery.

Inflation continued to retreat across the Baltic countries, to 15-17% in March. The decline was mostly led by easing energy and commodity prices and lower transportation costs. Unsurprisingly, producer prices have been falling since the beginning of this year. We forecast that inflation will fall to low single digits by the end of 2023 and will be close to 2% on average in 2024 in Latvia and Lithuania. In Estonia inflation is likely to be slightly higher due to a planned VAT hike.

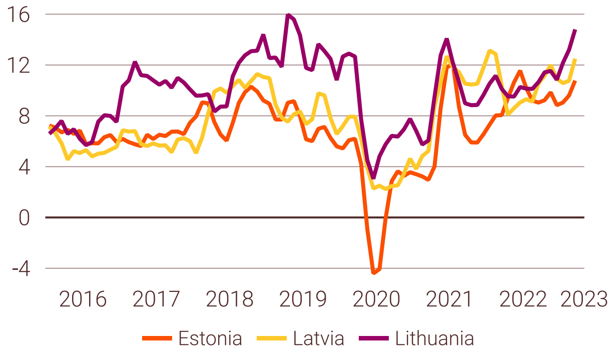
Admittedly, there are risks related to labour costs, which continue fuelling prices of most services, as well as eroding at least some of the cost competitiveness and providing further headwinds for exporters. Swedbank customer data suggest a further wage-growth acceleration during the first quarter of 2023, as the minimum wage hikes kicked in. The unemployment rate continued falling across the Baltics early this year, except in Lithuania, where it has been inching up since last summer. A further uptick in unemployment is possible across the Baltics, but, given ongoing labour shortages, it will be limited. The labour market strength and retreating inflation have led to some recovery in household confidence, although it is still below the long-term average in Estonia and Latvia.

Steady labour market

January and February retail sales signal a further shrinking in household consumption in Estonia, while consumption seems to have levelled off in Lithuania. Retail trade has been more resilient in Latvia, although its relative levels are somewhat lower. Given the rather low indebtedness of households, the higher interest rates will have a limited impact on consumption, but demand in housing markets is likely to remain weak. Hence, as private purchasing power starts to improve in the summer, consumption is expected to grow somewhat later in the year across the Baltics.

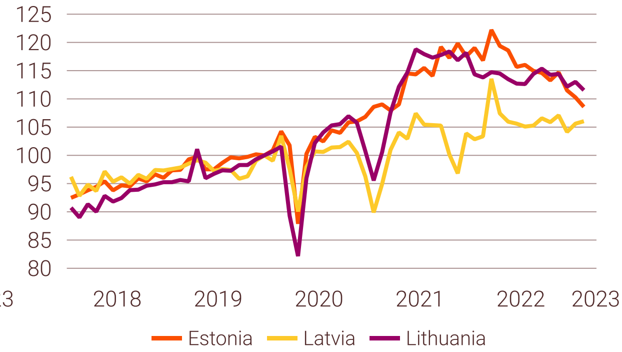
In general, Lithuanian and Estonian GDP increased above the long-term trend line in 2021; thus, the current correction is a return to a more sustainable growth path, rather than a crisis. Latvian GDP remained below the trend during recent years; thus, there is more room to catch up. GDP growth is likely to be supported by investments, especially when various EU funds inflows accelerate. Demand in most export markets is weak, and export orders remain well below the long-term average (in Latvia and Estonia); thus, we see shrinking exports this year, before a tentative recovery in 2024.

Average net wage nominal growth
y/y %, 3mma, Swedbank customer data



Sources: Swedbank Research & Macrobond

Retail sales
Index (Dec 2019=100), constant prices, sca



Sources: Swedbank Research & Macrobond

Estonia – two years in recession

The Estonian economy will continue declining in the first half of this year. The labour market will remain strong, and unemployment will not rise to an alarming rate. The government's tax increases next year will limit the recovery of household purchasing power. This will cut private consumption and GDP growth a bit.

Last year, Estonia was the only country in the EU in which the economy contracted in real terms. In nominal terms, growth was the strongest in14 years. This enabled the business sector to raise wages robustly while increasing profits.

Nominal growth was the strongest in 14 years

The deepening GDP contraction in real terms at the end of last year will carry over into the first half of 2023. The worsened purchasing power is reducing household consumption, and weaker foreign demand is limiting exports. The fast growth of producer and export prices has eroded the export competitiveness of Estonian enterprises. In 2022, nonfinancial corporations' inventories increased to a historically high share of GDP. We expect that this will reduce enterprises' production going forward, as demand is expected to remain weak in the coming months.

Industrial and construction enterprises' confidence continued to worsen during the first three months of this year, while the drop in confidence of the services and retail sectors has stabilised. At the same time, consumer confidence has climbed out of the trough and is gradually improving. Households' inflation expectations are easing, and they are more optimistic about their financial situation.

Last year, the number of employed persons reached the highest level ever. Although we forecast that employment will fall modestly this year, it will remain high. The unemployment rate continued to decrease in the first months of this year, and it will not rise to an alarming rate, as the economy will continue to expand moderately in nominal terms. We expect the annual average unemployment rate will pick up to 6.8% in 2023 and fall to 6.1% in 2024.

Inflation peaked in August last year. Even though consumer prices still increased 15.3% year-on-year in March, they have risen only 1.9% compared with the peak. We expect that inflation will drop to a single-digit rate in the coming months. We forecast that, as an annual average, it will slow to 10.0% this year and to 4.3% in 2024. The largest contribution to the drop will come from lower energy prices, which will primarily affect housing and transportation costs.

1.9%

Price-level increase from the peak seven months ago

The slowdown in inflation, together with robust wage growth, will increase purchasing power in the second half of this year. However, households' excess savings which accumulated during the pandemic are diminishing and will contribute less to consumption. The recovery of foreign demand will be sluggish, but it is expected to enable Estonian exports to grow again later this year. However, the worsened price competitiveness of Estonian exports could limit the recovery. We forecast that Estonian GDP will drop 0.8% in 2023 – the second year of economic recession in a row. We expect that the economy will return to year-on-year growth in the second half of the year and that it will expand 2.3% in 2024, as household consumption and exports improve.

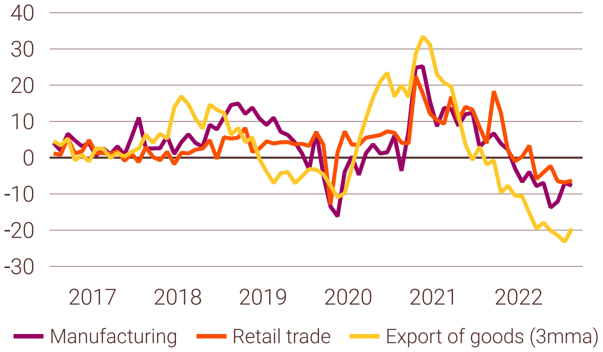
So far, households and enterprises have weathered the higher interest rates well. The share of nonperforming loans in the Estonia's total loan portfolio is very small. However, housing affordability has deteriorated, and new mortgage loans are decreasing. Due to the high uncertainty, increasing interest costs, and reduced cash flow, nonfinancial corporations' credit growth is expected to be modest as well. This will limit investment growth this year.

Households and enterprises have weathered the high interest rates well

The general government budget is expected to remain in deficit during the forecast period. The government will increase revenues by hiking taxes as of next year, including VAT, income taxes, excises, etc. At the same time, the impact of higher taxes will be partly compensated by the unifying of tax exemptions on all income levels and by higher minimum wages. We expect that the tax increases will limit the slowdown of inflation and the recovery of purchasing power. This will cut private consumption and GDP growth a bit.

Economy will be in recession in H1 2023

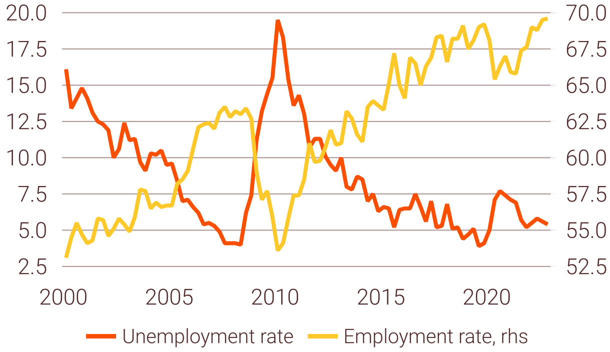
y/y %, real



Sources: Swedbank Research & Macrobond

Labour market remains tight

%, age 15 to 74 years



Sources: Swedbank Research & Macrobond

Latvia – from mild recession into stagnation

Having experienced a mild recession last year, the Latvian economy surprised us at the end of 2022 by being more resilient than forecast in the face of the cost-of-living crisis. Despite the expected purchasing power recovery in the second half of 2023, we do not project a major rebound in GDP growth, due to the bleak export outlook. GDP growth is expected at 0.6% in 2023, while it will pick up to an unimpressive 2.1% in 2024.

More resilient economy, but bleak prospects

In 2022, the Latvian economy expanded by 2.8% – better than forecast. In the fourth quarter, we saw a 1.2% growth instead of the expected continuation of the downturn registered in the middle of the year. The big surprise at the end of last year, and the main reason why the economy was not still in decline, was the strength of private consumption. Even though purchasing power has suffered immensely due to high inflation, retail trade is holding up well, and the services part of the economy seems to be doing fine. Even at the start of 2023, retail figures, as well as commercial bank card data, suggest a flattish development in consumption. The rather tight labour market, milder winter, and strong government support, as well as the switch in savings patterns, help explain the resilience. Part of the story might also be linked to inequality. Just as there is high income and wealth inequality in Latvia, there is also considerable inflation and consumption inequality. The rich account for a disproportionately larger share of total consumption in all EU economies, but especially so in Latvia. Therefore, even if the poorer part of the population rein in consumption in response to higher prices, the better-off, who coincidentally also account for a disproportionately large share of bank deposits, can easily offset this. Going forward, private consumption will be supported by falling inflation, the end of the heating season and the related gradual recovery of household purchasing power.

In 2022, the Latvian economy expanded by 2.8% – better than forecast

The other leg of domestic demand – investment – was weak in 2022 and is expected to remain so this year. Private investment is held back by uncertainty and the high-interest-rate environment, while public investment has not been the support hoped for by the economy. EU funds-related investment is constantly being delayed, increasing the risks of a rushed and inefficient use of available resources. Projections envisage a pickup in investment activity towards the second half of this year, followed by stronger investment growth in 2024, as private investment also starts to recover.

Public investment has not been the support hoped for

The story is least bright on the side of exports. A major decrease in real exports was seen already in the fourth quarter of 2022; a further decline is likely to have occurred at the start of this year, given the latest hard data as well as the downbeat export expectations in manufacturing. With higher interest rates and tightening credit conditions exerting a drag on growth for Latvia's trade partners, exports are projected to decline this year and to experience only a slight rebound in 2024. Beyond external demand fluctuations, a major risk to the export outlook is still Latvia's competitiveness, given the insufficient increases in productivity and rapidly rising labour costs.

The story is least bright on the side of exports

Labour market still tight, wages will put pressure on inflation

The unemployment rate uptick at the end of last year and start of this year was mostly due to seasonal factors, while unemployment fell in March. Moreover, employment expectations improved in March across all sectors. The observed labour market resilience, coupled with the recent data on expectations, suggest a further tightening in the job market. Therefore, notwithstanding the stagnating economy going forward, we expect that unemployment will decline to 6.8% this year and 6.6% in 2024.

Labour shortages, a minimum wage hike of 24% in 2023, and a hike of another 12% in 2024 will continue to drive wage growth over the forecast horizon. We are revising our wage growth forecast up to 9% this year on the back of slightly stronger than expected inflation effects on the wage negotiations, and we are sticking to 8% for 2024. The average real net wage will remain largely unchanged this year, with positive growth rates expected in the second half of the year.

Inflation has started to decline, reaching 17.3% in March. It will continue to fall going forward, with large differences in inflation components. Housing-related costs are set to decline significantly due to lower energy prices, the reduction of utility tariffs, and the liberalisation of the gas market. Although food inflation has started to ease, food prices are likely to be rather sticky. At the same time, core inflation is still stubbornly high and to a large extent driven by the lagged effects of the energy price shock. Going forward, we will likely see rapid wage growth become a much more important driver of core inflation. We admit that this raises wage-price spiral risks; however, we don't think that a wage-price spiral is the most likely scenario, as overall inflation is expected to decline sharply going forward. At the end of the year, annual inflation might settle close to 3%, averaging 9.5% in 2023. The key reason for higher projected inflation this year is that inflation outcomes, especially for food and services, have surprised on the upside.

Inflation to decline to

3%

by end of 2023

Lithuania – confident consumers and wavering exporters

GDP started shrinking at the end of last year, and this trend is likely to have continued at the start of 2023. However, the malaise is unevenly spread – despite the loss of purchasing power, consumption is holding up relatively well, while exporters are on shakier ground. A large fallout is still unlikely, but we do not expect a strong recovery during the forecast horizon.

Despite the serious dent in purchasing power – the average net real wage fell by 5.6% – household consumption increased by 0.5% last year. As the energy crisis abated, inflation ebbed, and nominal income growth has accelerated, consumer confidence has recovered and is now above the long-term average again. Household consumption is further supported by favourable demographic trends – due to record-high immigration, the number of inhabitants increased by 1.8% last year (mainly Ukrainians). We expect net migration to remain positive this year, but to ease to

24 000 people (from 72 000 last year). Employment increased by 3.8% last year; thus, the real wage bill shrank by only 2%, explaining the resilience in household consumption.

10.9%

Wage growth

Inflation fell to 16.6% in March and is now on a clear downward trend – we expect it to reach 3.3% by the end of this year. The price of energy and some food products (e.g., dairy) has started falling, but prices of services are quite sticky – in March, they were 11.9% higher than a year ago and show no signs of easing. This, of course, is related to rapid wage growth, which, during the first months of this year, was close to 15%. Wages are driven by the strong negotiation power of workers and the 15% increase in the minimum monthly wage. We see this as unsustainable and see a risk of a wage-inflation spiral and a dent in competitiveness. We forecast wage growth to slow to 10.9% in 2023 and 7.2% in 2024. Admittedly, for the past five years we have been forecasting a wage-growth slowdown that has, so far, failed to materialise.

During the first two months of this year, retail trade was 0.5% lower than a year ago, mainly due to falling consumption in food and beverages, which shrank by 7.5% during the same period. At the same time, turnover in restaurants and bars is 10.4% higher than a year ago, illustrating the unpleasant and gaping divergences between those who had to cut down on necessities and those who can continue enjoying everyday pleasures. We expect household consumption to recover somewhat later this year, as wages start growing more rapidly than prices again. However, demand is likely to remain shaky, as we forecast employment to shrink somewhat this year and next year, mainly in exporting sectors.

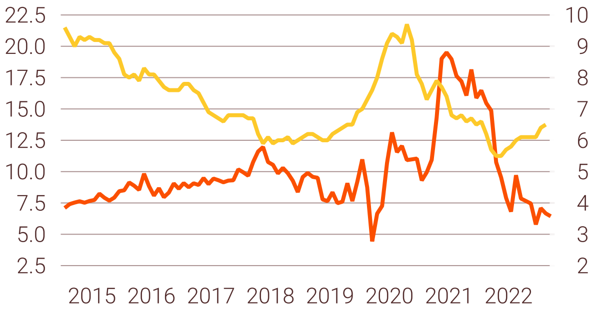
Exports and employment are likely to shrink this year

The prospects of exporters look a lot less rosy than domestic demand – manufacturing output started shrinking already last year, and, during the first two months of this year, it was 7.4% lower than a year ago. Export orders recovered somewhat at the start of this year, but industrial confidence remains weak. The booming global demand for goods during the pandemic years was a boon for many exporters, who managed to increase volumes, prices, and market shares. However, stagnating global demand may expose some cracks, and some exporters are rightfully worried about their competitive position. Here, too, are large divergences – the production of chemical products, furniture, some metals, and wood has fallen sharply, while the manufacturing of vehicles, computers, electronics, and certain food products is still growing rapidly. It is likely that weak global demand for goods, coupled with rapid wage growth, will force some businesses in open sectors to cut down the number of employees. Already at the start of this year, the unemployment rate increased, while job vacancies fell to the lowest level in almost a decade.

We expect investments to grow this year and the next, but high interest rates and uncertain economic prospects will continue exerting downward pressure. Furthermore, the government has introduced the controversial "solidarity tax" on "excess" net interest income of financial institutions. Although new loans are exempt, the tax may still weaken banks' capital and tighten financial conditions, and, most importantly, it may have adverse effect on foreign direct investment inflows in the longer term. There is also a risk that stagnating real estate transactions will lead to a prolonged slump in construction. Better-than-expected export and employment growth could materialise sooner than expected, but, so far, we remain on the cautious side.

Job vacancies and unemployment

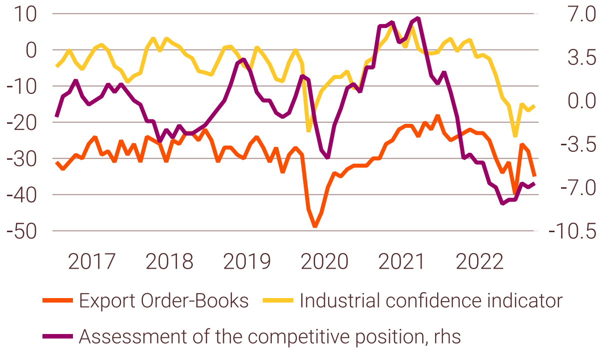
Thousand; % (rhs)



Sources: Swedbank Research & Macrobond

Manufacturers are facing headwinds

%



Sources: Swedbank Research & Macrobond

Inflation Reduction Act – a blessing or a curse for global growth?

As the global economic cycle is making a downturn, there is growing concern about how countries can boost growth going forward. Investing in the green transition not only serves as a crucial step to curtail global warming, but also represents a way to boost economic growth. Industrial policy such as the US Inflation Reduction Act (IRA) is a current example. However, while industrial policy can be a powerful tool for promoting economic growth, it may also create barriers to trade and thereby harm growth. Here is a short Q&A on the IRA and the EU response; the full analysis can be found here.

What is the IRA?

The IRA is a government bill and climate law considered to be the most significant climate legislation in US history, allocating $400 billion (1.5% of nominal GDP in 2022) in federal funding over 10 years.

Enacted in 2022, the primary objective of the law is to accelerate the transition to a greener economy by curtailing carbon emissions, promoting domestic production of clean technology and countering China's dominance in this area.

It also aims to fight inflation by, e.g., reducing energy costs, hence the bill' name. Yet, while it will boost manufacturing in the US, it poses a series of possible risks.

Will the IRA fuel the green transition?

Experts regard the IRA as a transformative initiative that could propel the green transition by generating clean energy technology, mitigating green-house gas emissions, and enabling the US to reach its net-zero objectives by 2050.

Given that the US is the world's third-largest contributor to global emissions, the efforts of the IRA towards reducing the country's carbon footprint are key for reaching global targets.

The IRA might also serve as a catalyst in motivating other countries to ramp up their green investments. Nonetheless, the IRA also builds on protectionism, which induces a trade-off between national and global green transitions.

For the EU, the transition may already have been delayed due to the reallocation of investments towards the US.

Are industrial policy instruments effective in bolstering economic growth?

Governments worldwide have introduced industrial policies to boost specific sectors of their economies, but their efficacy remains debatable.

While industrial policies can promote growth, their success hinges on various factors (such as the design of the policies, their transparency, and the nature of the industry, e.g., natural monopolies).

Generally, supporting research, innovation and trade in a broad sense is widely recognised as positive for growth, but there is little evidence that government support to specific sectors and companies is an effective policy in the long term.

Is the IRA important for other countries as well?

The IRA is undeniably crucial, not just for the US economy but for other countries as well. The legislation promotes green tech investments and incentivises companies to relocate to the US and restructure supply chains, thereby reducing reliance on China.

The EU also has a goal of reducing reliance on China. Moreover, the inclusion of "local-content requirements" in the IRA disqualifies companies outside of North America from receiving subsidies for components.

Hence, the IRA could lead to a "race to the top," wherein the competitive emphasis is placed on who can provide the most substantial subsidies.

While the US and the EU are potentially equipped to engage in such a contest, it is crucial to recognise that this may have harmful implications for the greater global community.

What has been the EU's response?

As a response to the IRA and its local content requirements, the EU has presented two climate legislation proposals: the Net-Zero Industry Act (NZIA) and the Critical Raw Materials Act (CRMA).

Together these proposals set a benchmark for self-sufficiency of green technology capacity within the EU, and for raw material supply chains. No tax credits or grants are specified within these proposals, but are part of earlier climate legislation (REPowerEU will mobilise up to €300 billion of green investments). EU subsidies for renewable energy amount to more than the IRA, but the crucial difference is rather the IRA's discrimination against producers outside of North America and the lower EU transparency.

The EU has also adopted the world's first carbon border tax and sharpened the Emission Trading System (ETS) to include more sectors and reduce overall emission allowances within the EU, which will have an effect on both sectors and countries with less ambitious emission reduction strategies.

What are the risks associated with the IRA?

First, a compressed timeline for decoupling from China may lift component prices, causing "greenflation" in the short term (see our analysis, p. 19).

Second, these regulations could harm global trade, which is a risk to global growth. Trade distortions driven by protectionism, in turn, risk hampering the green transition on a global scale, especially if other countries turn to protectionism and if investments are permanently crowded out.

Finally, geopolitical risks may lead China to halt exports of essential components for the energy transition, making the IRA's implementation more challenging in the short term.

Appendix

SWEDEN: Key economic indicators, 2022-2024

Annual % change unless stated otherwise	2022	2023F		2024F	
Real GDP growth (average, calendar-adjusted)	2.7	-1.1	(-1.1)	0.3	(0.9)
Real GDP growth (Q4-Q4, calendar-adjusted)	-0.2	-1.5	(-1.6)	1.6	(1.7)
Real GDP growth	2.6	-1.3	(-1.3)	0.3	(0.9)
Household consumption	2.1	-1.4	(-1.5)	0.0	(1.0)
Government consumption	0.0	1.2	(1.1)	1.8	(1.8)
Gross fixed capital formation	5.2	-3.6	(-3.2)	-1.4	(-0.9)
private, excl. housing	7.2	-1.4	(-1.4)	0.4	(2.5)
public & NPISH	-0.2	4.8	(4.7)	5.4	(5.4)
housing	4.2	-17.9	(-15.3)	-15.5	(-19.5)
Change in inventories (contribution to GDP)	1.0	-0.9	(-0.7)	-0.2	(-0.1)
Exports, goods and services	6.6	1.1	(1.0)	2.0	(2.7)
Imports, goods and services	8.7	-0.9	(-0.4)	1.3	(2.2)
Domestic demand	2.2	-1.3	(-1.2)	0.1	(0.7)
Net exports (contribution to GDP)	-0.6	0.9	(0.7)	0.4	(0.3)
CPI (average)	8.3	9.2	(8.7)	3.8	(3.2)
CPI (Dec.-Dec.)	12.3	5.8	(4.5)	2.0	(2.2)
CPIF (average)	7.7	6.5	(5.7)	2.2	(1.6)
CPIF (Dec.-Dec.)	10.2	3.2	(1.6)	1.6	(1.6)
CPIF ex energy (average)	5.9	7.6	(5.5)	2.6	(2.3)
CPIF ex energy (Dec.-Dec.)	8.4	5.4	(2.9)	2.2	(2.3)
Riksbank policy rate (Dec.)	2.50	4.00	(3.50)	2.75	(2.50)
Unemployment (% of labour force, 15-74)	7.5	7.8	(7.9)	8.5	(8.0)
Change in labour force (15-74)	1.3	0.7	(0.4)	0.0	(0.4)
Change in employment (15-74)	2.7	0.4	(0.0)	-0.8	(0.2)
Number of hours worked (calendar-adjusted)	2.4	0.2	(-0.2)	-0.6	(0.3)
Nominal hourly wage (NMO), whole economy	2.7	4.2	(3.7)	3.9	(3.7)
Household real disposable income	-0.1	-2.8	(-2.9)	0.6	(1.2)
Household nominal disposable income	7.1	3.2	(4.0)	3.4	(3.6)
Household savings ratio, % of disposable income	13.3	12.7	(11.4)	13.1	(11.6)
General government budget balance (% of GDP)	0.6	-0.3	(-0.3)	-1.3	(-0.7)
General government debt (Maastricht), % of GDP	32.5	31.8	(30.7)	33.3	(31.9)

Previous forecast in parentheses
Source: Statistics Sweden & Swedbank Research

ESTONIA: Key economic indicators, 2022-2024

Annual % change unless stated otherwise	2022	2023F		2024F	
Real GDP	-1.3	-0.8	(0.0)	2.3	(3.0)
Household consumption	2.3	-0.5	(0.0)	2.0	(3.0)
Government consumption	-0.3	0.0	(2.0)	2.0	(2.0)
Gross fixed capital formation	-10.9	4.0	(4.0)	4.5	(7.0)
Exports of goods and services	5.0	-1.0	(0.0)	2.5	(3.0)
Imports of goods and services	5.8	-2.5	(-2.5)	2.8	(3.5)
CPI (average)	19.4	10.0	(9.2)	4.3	(2.5)
Unemployment (% of labour force)	5.6	6.8	(7.3)	6.1	(5.9)
Employment	4.1	-0.5	(-1.1)	0.6	(0.6)
Gross monthly wage	8.9	8.7	(8.5)	7.0	(7.0)
Nominal GDP, billion euro	36.2	38.5	(38.6)	40.6	(40.7)
Exports of goods and services (nominal)	25.7	6.0	(7.0)	5.5	(6.1)
Imports of goods and services (nominal)	25.9	5.3	(5.3)	5.9	(6.6)
Balance of goods and services, % of GDP	-0.6	0.0	(1.0)	-0.4	(0.6)
Current account balance, % of GDP	-2.2	-1.6	(0.0)	-1.9	(-0.6)
General government budget balance, % of GDP	-0.9	-3.6	(-3.1)	-3.2	(-2.7)
General government debt (Maastricht), % of GDP	18.4	20.0	(19.2)	22.4	(21.9)

Previous forecast in parentheses
Sources: Statistics Estonia & Swedbank Research

LATVIA: Key economic indicators, 2022-2024

Annual % change unless stated otherwise	2022	2023F		2024F	
Real GDP	2.8	0.6	(-0.9)	2.1	(2.6)
Household consumption	8.1	3.7	(-1.0)	2.6	(3.4)
Government consumption	2.8	1.0	(-0.5)	1.6	(1.0)
Gross fixed capital formation	0.7	1.5	(1.2)	5.8	(5.8)
Exports of goods and services	9.1	-1.2	(-0.3)	1.6	(2.9)
Imports of goods and services	11.7	2.0	(-1.2)	2.5	(3.9)
CPI (average)	17.3	9.5	(9.0)	2.0	(2.5)
Unemployment (% of labour force)	6.9	6.8	(7.2)	6.6	(6.5)
Employment	2.6	0.4	(0.0)	0.5	(0.8)
Gross monthly wage	7.5	9.0	(8.5)	8.0	(8.0)
Nominal GDP, billion euro	39.1	43.4	(43.1)	45.5	(45.5)
Exports of goods and services (nominal)	28.5	-4.1	(-0.8)	2.7	(3.9)
Imports of goods and services (nominal)	32.0	-5.7	(-3.7)	2.4	(3.9)
Balance of goods and services, % of GDP	-5.8	-3.9	(-2.4)	-3.6	(-2.3)
Current account balance, % of GDP	-6.4	-3.2	(-1.9)	-2.9	(-1.6)
General government budget balance, % of GDP	-4.4	-4.3	(-3.0)	-2.4	(-0.8)
General government debt (Maastricht), % of GDP	40.8	40.6	(41.0)	39.6	(40.1)

Previous forecast in parentheses
Sources: Statistics Latvia & Swedbank Research

LITHUANIA: Key economic indicators, 2022-2024

Annual % change unless stated otherwise	2022	2023F		2024F	
Real GDP	1.9	-0.3	(-0.3)	1.8	(1.8)
Household consumption	0.5	0.5	(0.0)	3.7	(3.0)
Government consumption	0.3	0.5	(1.0)	0.5	(1.0)
Gross fixed capital formation	2.6	3.0	(2.5)	5.0	(5.5)
Exports of goods and services	11.3	-1.2	(-0.5)	3.3	(3.5)
Imports of goods and services	11.1	-0.5	(-2.0)	4.6	(4.5)
CPI (average)	19.6	9.6	(9.2)	1.8	(2.0)
Unemployment (% of labour force)	5.9	7.3	(6.5)	7.0	(6.0)
Employment	3.8	-0.1	(-2.4)	-0.2	(-0.1)
Gross monthly wage	13.3	10.9	(9.5)	7.2	(7.0)
Nominal GDP, billion euro	66.9	72.9	(74.1)	75.7	(77.0)
Exports of goods and services (nominal)	29.0	-1.5	(-2.0)	5.0	(4.0)
Imports of goods and services (nominal)	39.0	-3.0	(-5.0)	5.5	(4.0)
Balance of goods and services, % of GDP	-2.0	-0.6	(0.9)	-0.9	(0.9)
Current account balance, % of GDP	-5.1	-3.0	(-0.7)	-2.4	(-0.4)
General government budget balance, % of GDP	-0.6	-2.9	(-3.5)	-1.9	(-1.9)
General government debt (Maastricht), % of GDP	38.4	39.7	(38.8)	40.2	(39.3)

Previous forecast in parentheses
Sources: Statistics Lithuania & Swedbank Research

Interest and exchange rate forecasts

	Outcome 2023 21 Apr	Forecast 2023 30 Jun	2023 31 Dec	2024 30 Jun	2024 31 Dec
Policy rates (%)					
Federal Reserve, USA (upper bound)	5.00	5.25	5.25	4.25	3.25
European Central Bank (refi rate)	3.50	4.00	4.25	3.25	2.75
European Central Bank (deposit rate)	3.00	3.50	3.75	2.75	2.25
Bank of England	4.25	4.50	4.50	3.50	2.50
Riksbank	3.00	4.00	4.00	3.25	2.75
Norges Bank	3.00	3.50	3.75	3.50	3.00
Government bond rates (%)					
US 2y	4.17	4.00	3.50	3.30	3.00
US 5y	3.66	3.60	3.40	3.20	3.00
US 10y	3.57	3.50	3.30	3.20	3.00
Germany 2y	2.91	2.80	2.60	2.40	2.30
Germany 5y	2.52	2.50	2.40	2.30	2.20
Germany 10y	2.48	2.50	2.40	2.30	2.20
Exchange rates					
EUR/USD	1.10	1.11	1.14	1.15	1.15
EUR/GBP	0.89	0.89	0.88	0.86	0.85
EUR/SEK	11.33	11.15	10.90	10.80	10.70
EUR/NOK	11.65	11.15	10.70	10.50	10.30
USD/SEK	10.35	10.05	9.56	9.39	9.30
USD/CNY	6.89	6.80	6.70	6.50	6.50
USD/JPY	134.4	129.0	125.0	120.0	115.0
NOK/SEK	0.97	1.00	1.02	1.03	1.04
KIX (Trade-weighted SEK)	125.9	124.1	121.2	120.6	119.7

Sources: Swedbank Research & Macrobond

Swedish interest rate forecasts (%)

	Outcome 2023 21 Apr	Forecast 2023 30 Jun	2023 31 Dec	2024 30 Jun	2024 31 Dec
STIBOR 3m	3.53	4.15	4.00	3.25	2.75
Government bond yields					
2y	3.11	3.10	2.80	2.70	2.60
5y	2.65	2.70	2.60	2.55	2.50
10y	2.48	2.50	2.50	2.50	2.50
Swap rates					
2y	3.71	3.65	3.30	3.15	3.00
5y	3.20	3.25	3.10	3.00	2.90
10y	3.02	3.05	3.00	2.95	2.90

* Outcomes refer to March 2023
Sources: Swedbank Research & Macrobond

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