

2005: No solution to global imbalances

Good Swedish growth – continued low inflation

- **Global activity will slow down due to tighter economic policy. However, GDP growth will remain above trend.**
- **Inflationary dangers will grow in the United States, while disinflationary forces will strengthen in Europe.**
- **A widening interest rate gap between the US and Europe will not suffice to turn around underlying imbalances.**
- **Sweden will perform well. Inflation will remain very low, and an interest rate hike is likely only late in 2005.**

In 2004, robust global growth prevailed, but meanwhile underlying global imbalances became worse. The American current account deficit set records, with a dollar decline as a consequence. Low real interest rates sustained stock markets and property prices; the build-up of debts and assets continued throughout the world economy. These are important factors shaping the following qualitative update of key trends and risks in the global and Swedish economy during 2005. SEB Economic Research will present its next complete forecast in the February issue of *Nordic Outlook*.

Trade imbalances between the US and Asia, as well as puffed-up balance sheets, pose latent medium-term threats. Sooner or later, the Americans must boost their savings. Over time they will be forced into gradual adjustments, but during 2005 these will be

comparatively small. The Federal Reserve will raise its key interest rate at a steady pace, but not so much that this will severely hamper American growth.

Given a certain economic deceleration in the US and China, a sharper slowdown in Japan and a euro zone economy that is treading water, the global economy will decelerate a bit this year. Global growth will nevertheless reach about 4%, which is somewhat above the trend level.

This means that for the most part, **global imbalances will persist in 2005**. The dollar will be torn between rising American interest rates and persistent current account deficit problems. The outcome may be temporary surges of strength, but the underlying dollar deterioration will continue.



The dollar decline will continue to affect a number of areas in 2005. Differences between the US and Europe in terms of growth, inflation and interest rates are to a certain extent driven by the weakness of the dollar. This implies a major contrast in the conditions facing central banks on the two sides of the Atlantic. During the second half of 2004 alone, the dollar decline led to a monetary stimulus in the US that almost entirely offset the Fed's rate hikes. In Europe, however, stronger currencies led to a clear tightening, without a corresponding fiscal policy loosening.

Interest rate change that neutralises exchange rate movement during second half of 2004

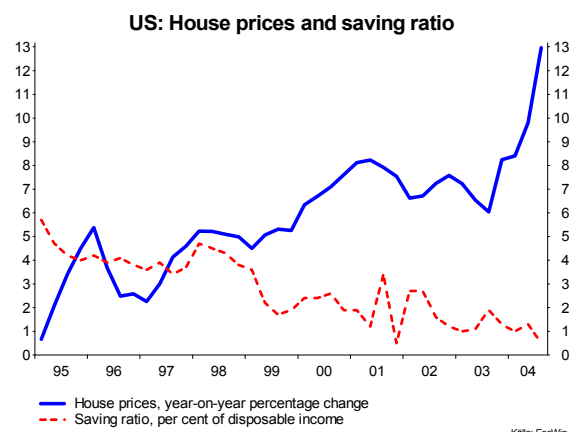
	Exchange rate, % change	Trade-off between interest rate and exchange rate	Equivalent interest rate change, percentage points
US	-8.0	1:10	0.8
Euro zone	3.4	1:7.5	-0.5
Sweden	2.7	1:4	-0.7

Mounting inflationary pressure in the US

Rising short-term interest rates and a less expansive fiscal policy will dampen US growth in 2005, at the same time as a weaker dollar and a pent-up need for capital spending comprise the most important expansive forces. The net effect of these forces will be a slowdown in GDP growth to **around 3½%: slightly above trend growth.**

There are some indications that the risks during 2005 are on the upside. A stronger competitive position has already helped improve the mood of the US manufacturing sector in recent months. Given strong balance sheets, companies have good prospects of financing capital spending internally and are thus rather insensitive to interest rate hikes. The household sector is more vulnerable, with record-low savings and high indebtedness. But as long as home

prices continue upward and job growth keeps chugging along, the household sector can also withstand tighter economic policy – in any case in a short-term perspective.



The threat of inflation has recently become more apparent. Given a weak dollar, the effects of earlier hikes in input goods prices and slowing productivity growth, inflation is slowly creeping upward, with a risk of unpleasant surprises.

There are thus **reasons to speed up economic policy tightening in the US.** To some extent, this will certainly also occur by means of continued Fed rate hikes during the first half of 2005; each Federal Open Market Committee meeting is likely to take such action. Meanwhile the FOMC's concerns about short-term cyclical developments will be in the background; Alan Greenspan does not want his final year as Fed chairman to be characterised by an excessively fast run-up in interest rates that stops the cyclical upturn.

Fiscal policy will move in the direction of a tightening. But our main prediction is that the Bush administration is too bound to its tax, social security and defence policies to allow any resolute shift in fiscal policy to occur this year.

US forecast

	Year-on-year percentage change		Risk bias
	2004	2005	
GDP	4.4	3.6	Upside
Core inflation (CPI)	1.5	2.6	Upside
Fed funds rate	2.25	3.75	Upside

So our conclusion is that the total dose of economic policy tightening is **insufficient to correct the imbalances in the US economy**. House prices will continue upward, the current account deficit will not improve and household savings will remain extremely low. This means that the current account deficit will continue to exert downward pressure on the dollar, although ever-wider interest rate gaps between the US and Europe will slow this decline and probably allow some short-term dollar rallies.

To date, the real-term effective exchange rate adjustment has amounted to less than half the previous dollar downturn (during the late 1980s), even though the external imbalances are far greater now. This can be seen as an indication that the long-term downward trend of the dollar will continue.

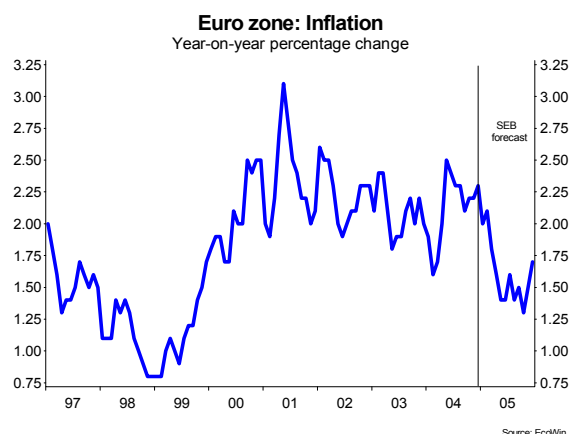
The noose is closing around the ECB

Falling confidence indicators and an ever-stronger euro have led to gloomy forecasts for the euro zone in general and for Germany and France in particular. The consensus forecast for 2005 GDP growth is now beginning to approach 1½%. **This pessimism may perhaps be overstated**. The latest information indicates a slight recovery during the fourth quarter of 2004. In a situation of long-term upward pressure on the euro, it is nevertheless difficult to foresee strong enough growth to enable the output gap to shrink.

However, we see a possibility that inflation will decline faster than the

consensus scenario indicates. To date, the price response to the oil price downturn and to exchange rate movements has been sluggish. But in the next six months, the effects of these will interact with the inflationary impact of tax changes and other administratively established prices in a way that will lead to a substantial downturn in the inflation rate.

Given growth below potential, continued high unemployment and inflation that is creeping downward towards 1½%, the **European Central Bank's risk situation will change**. When warnings of "second-round effects" or of other treacherous inflationary dangers are no longer credible, pressure for interest rate cuts will mount. This tension will be a dominant element of the economic policy environment in 2005.



The ECB will put up a resistance for as long as it can. It will focus even more relentlessly on worries related to inflationary expectations, credit growth and home prices. It will cite the absence of far-reaching structural changes and the lack of budgetary discipline as obstacles to lowering interest rates. Regional imbalances and concerns about countries with high inflationary pressure and overheated residential property markets may also receive greater attention. The Bank is also

likely to use interventions in the foreign exchange market similar to its actions in the autumn of 2000 (in the opposite direction) before resorting to an interest rate cut.

Euro zone forecast

Year-on-year percentage change			
	2004	2005	Risk bias
GDP	2.0	1.8	Neutral
Inflation (HICP)	2.1	1.6	Downside
Key interest rate (refi)	2.0	2.25	Downside

Unfortunately 2005 is not likely to mark the big breakthrough for structural reforms. At the European Union level, this process is sluggish. The fiasco of the EU's Lisbon strategy and the events surrounding the Stability Pact speak loudly and clearly. Implementation of the EU's directive on services will admittedly begin this year, but is unlikely to have any rapid impact. In the longer term, the directive will be an important element of the reform task, since this is where the EU lags most clearly behind the US.

However, the labour market policy reforms that were carried out in Germany last year may turn out to have more far-reaching significance than expected, and may be viewed in retrospect as the first major step towards a rejuvenation of the German economy.

Stubborn deflation in Japan but no hard landing in China

After a deceleration in the Japanese economy during the latter part of 2004, there are no signs that deflation will loosen its grip during 2005. Growth is shifting downward, households are cautious about their consumption plans and the Bank of Japan will be unable to begin normalising its monetary policy during the year.

In China, tightening of credit and deceleration of public sector investments

have led to a cautious slowdown in growth. More importantly, inflation fell significantly during the autumn. This will reduce the need for more aggressive tightening. It is thus likely that a **hard landing can be avoided**. For this reason, growth will be comparatively good in 2005, only a bit lower than in 2004.

China's currency has now been firmly pegged to the dollar for 10 years. Since a number of other Asian countries follow the Chinese yuan, a *de facto* Asian dollar block has emerged. The advantage for Asian countries is currency stability and rapid export growth, but the system as a whole helps to perpetuate the underlying imbalances in the world economy.

During 2005, China will probably seek to mitigate these negative effects by carrying out a **minor yuan revaluation against the dollar**. We anticipate a 5% appreciation and expect several other Asian currencies, among them the South Korean won, to follow suit. This will ease some of the pressure on the euro. However, the revaluation will not suffice to change competition conditions or global imbalances in any fundamental way.

Central bank key rates in selected countries

Per cent, year end			
	2004	2005	2006
US	2.25	3.75	4.50
Euro zone	2.0	2.25	2.50
Japan	0.0	0.00	0.50
UK	4.75	4.50	4.00
Sweden	2.0	2.25	3.00
Norway	1.75	2.25	3.50

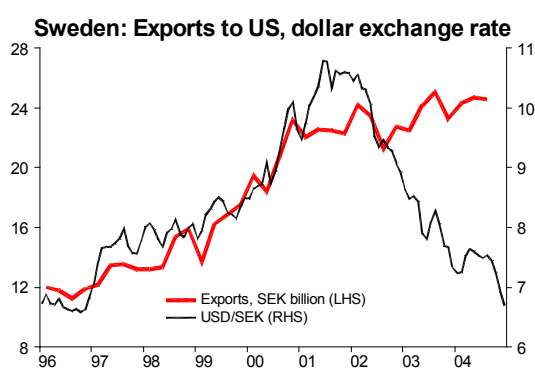
The Swedish economy: continued smooth sailing

With high growth and low inflation, the Swedish economy found itself in the best of all worlds during 2004. Its performance was surprisingly positive in three inter-related

areas: exports, productivity and inflation. Looking ahead at 2005, the key questions focus on what will happen in these three areas. Should we expect reversals, normalisation or a further strengthening of the 2004 trend?

Strong international growth, coupled with favourable growth in the demand for both technology and commodities helped Swedish **exports** achieve double-digit growth figures in 2004. This year, a global slowdown, the krona appreciation and less favourable trends in major export sectors will result in somewhat lower growth.

However, the dampening of demand will be mainly attributable to slower growth in the US and Asia, whereas key Swedish export markets in northern Europe will instead strengthen. Meanwhile an exchange rate of around SEK 8.80 per euro should not be too hard to bear. Thus our main forecast must be that export growth will maintain parity with market growth, i.e. 7-8%. The risk is that we may possibly be underestimating the accumulated effect of the dollar decline during recent years and that Sweden's exports to dollar countries will suffer a bigger shock.

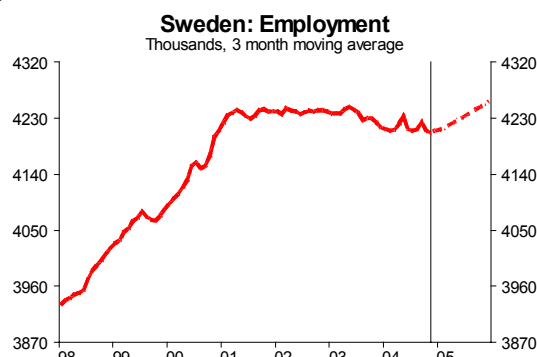


Given only a modest deceleration in export growth, the GDP growth rate will be around 3%. There is little doubt that domestic demand will show an expansive

trend this year. Capital spending activity is clearly on the way up, most obviously in the construction sector, while household consumption will benefit from strong balance sheets and low interest rates.

Last year's record-high **productivity growth** raises many questions. Both internationally and historically, Sweden's figures were exceptional. The productivity gains noted in the late-90s "new economy" era were surpassed by a wide margin.

It does not appear reasonable that last year's rate of increase can continue intact. This would imply that Sweden has undergone a structural shift that no other mature industrialised country has come close to. Because domestic demand will play a larger role than before, it is also likely that the job market will benefit. Thus, our forecast is that a cautious upturn in employment, just above ½%, will occur this year.



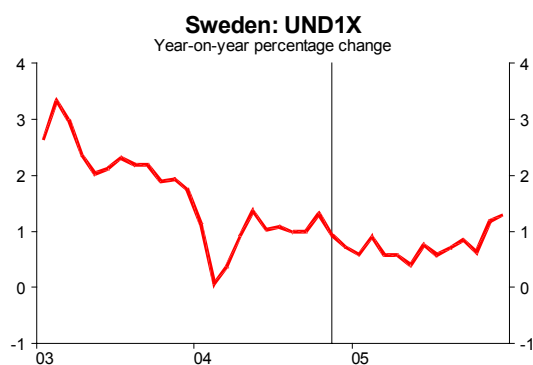
So far, however, we see no clear signs of any major thaw in the labour market, despite having searched high and low for such a trend in leading indicators, which are normally capable of providing a good projection six months ahead. This makes our forecast uncertain; both a "ketchup effect" and the complete absence of improvement would have major consequences.

If Sweden's exports and productivity growth move towards normalisation, the **low-inflation trend will actually strengthen this year**. Aside from macro factors such as the stronger krona and low unit labour costs, inflation will also be pushed downward by tougher price competition among food and clothing retailers. Falling energy prices will also play a role during much of the year. Our main forecast implies that underlying inflation will stay a little above ½% for most of the year. However, the risks are on the downside, and it is not impossible that we will see monthly figures that touch the zero mark.

Riksbank in the line of fire

The debate on monetary policy will certainly be a consistent theme during 2005. Assuming good growth, credit expansion and a continuing upturn in home prices – as well as fiscal policy that will probably become even more expansive in the run-up to the September 2006 election – interest rate hikes appear justified. But given an inflation rate below the lower threshold of the Riksbank's tolerance interval, it is difficult for the central bank to act.

Not until the final quarter of the year will inflation creep above the 1% mark, which may possibly open the way for a **first rate hike late in 2005**.



The Riksbank's situation resembles that of the ECB – though its dilemma is even more accentuated. Interest rate policy is completely controlled by a two-year inflation forecast, which may end up being an unexpected shortcoming of an otherwise successful inflation target strategy. We anticipate that over time, more members of the Riksbank's Executive Board will be prepared to bend the strict "rule of action" the Bank has applied to date, and will thus want to take greater account of the risk of a property bubble and fiscal instability. This will at least contribute to an unwillingness to carry out further interest rate cuts.

Swedish forecast

Year-on-year percentage change

	2004	2005	Risk bias
GDP	3.8	2.9	Neutral
Inflation (UND1X)	1.0	0.8	Downside
Key rate (repo)	2.0	2.25	Downside

In any event, interest rates will remain low during 2005. The **krona will continue to appreciate** both against the dollar and the euro. In these respects, the Swedish economy appears set to show strength again this year.

Meanwhile a number of problems are growing. Question marks about the government's fiscal policy framework will grow larger, since the budget balance is moving ever further away from its official target. Meanwhile important reforms in the social insurance system are being postponed.

Economic Research:

Klas Eklund, Chief Economist	+46 8 763 80 88	klas.eklund@seb.se
Håkan Frisén, Head of Economic Research	80 67	hakan.frisen@seb.se
Bo Enegren, Economist	85 94	bo.enegren@seb.se
Ann Enshagen Lavebrink, Research Assistant	80 77	ann.lavebrink@seb.se
Olle Holmgren, Economist	80 79	olle.holmgren@seb.se
Mikael Johansson, Economist	80 93	mikael.johansson@seb.se

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