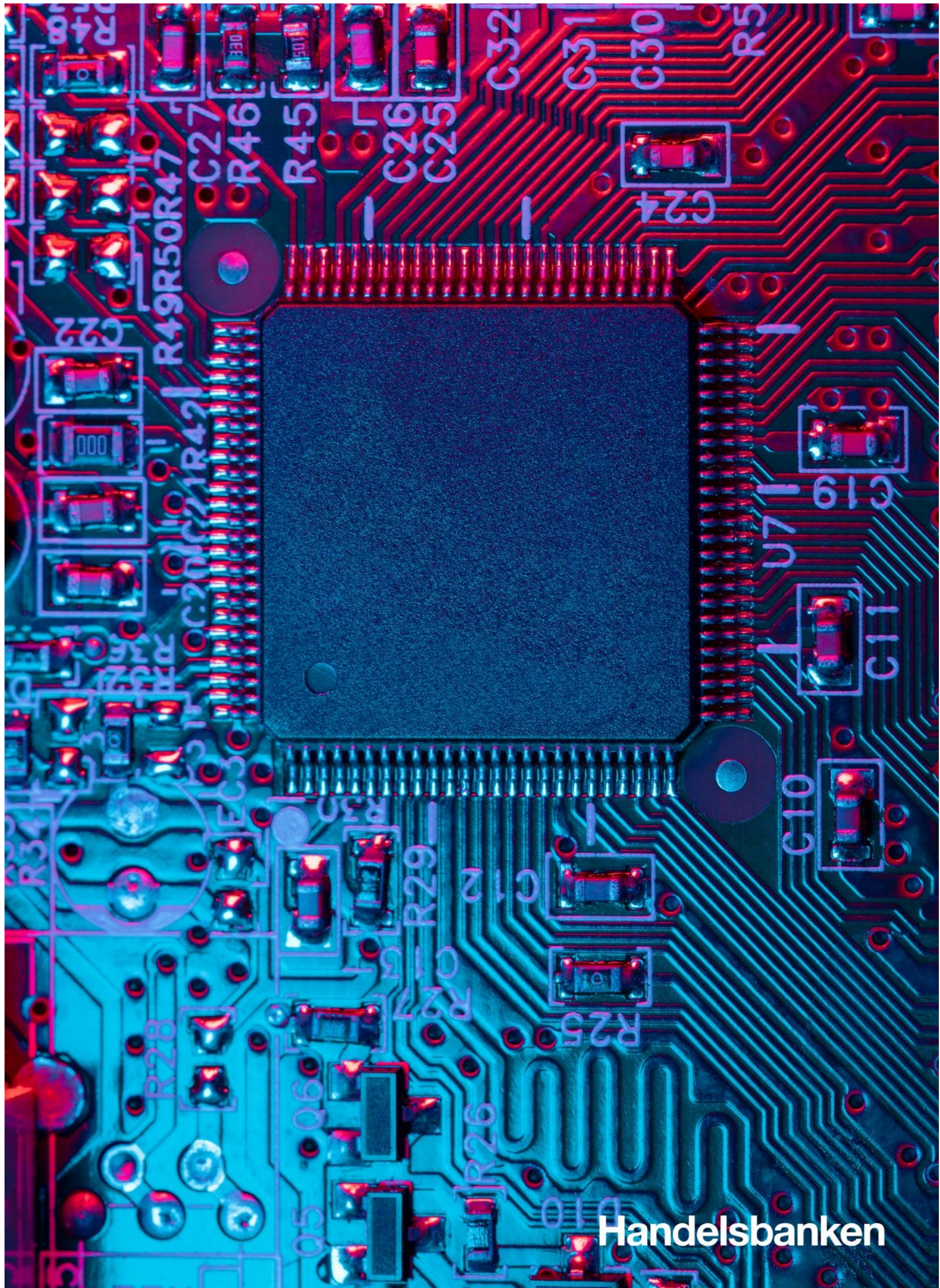
Macro Research

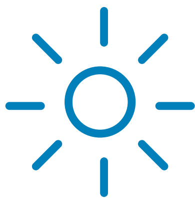
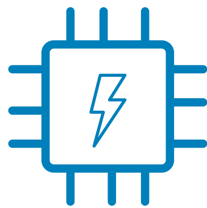
22 May 2024

Global Macro Forecast



To the soft landing, and beyond!

- The great normalisation is on track as inflation mellows and unemployment remains low
- Riksbank first to cut – ECB next in June, BoE and the Fed in September, and Norges Bank early 2025
- Risks: Persistent inflation, loss of confidence in the soft landing and geopolitical tensions
- Long-term, AI has the potential to boost productivity, which should fuel higher interest rates

Our view	Short term	Medium term
GROWTH	→	→
UNEMPLOYMENT	→	→
INFLATION	↘	→
POLICY RATES	↘	↘
LONG-TERM INTEREST RATES	↘	→
EUR/USD	↗	↗

Note: The arrows illustrate our stylised overall direction compared with previous period. Short term refers to 1 year, medium term to 2–3 years.

Source: Handelsbanken

Table of contents

Global backdrop: A soft landing – wheels about to hit tarmac 4

Theme article: AI: Impact on growth and equality could be huge 10

Theme article: Rising r* revisited – Phoenix or Icarus? 13

Eurozone: Closing in on a soft landing 17

Sweden: Household consumption will drive the recovery 19

United Kingdom: Slow lift-off scheduled 21

Norway: No rate cuts by Norges Bank until 2025 23

Finland: Better times ahead 25

Key ratios 27

Disclaimers 30

Global backdrop

A soft landing – wheels about to hit tarmac

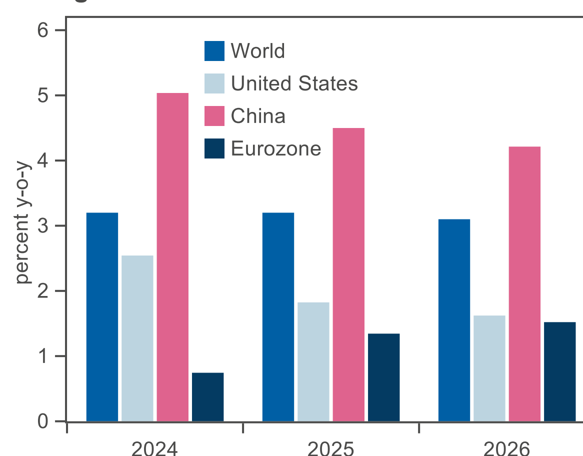
The great normalisation is on track; inflation approaching the target and easing labour market tightness, paving the way for central banks to start loosening monetary policy while unemployment remains low. At the same time, however, wage developments and momentum in disinflation is somewhat unconvincing, in particular in the US, which supports our view that central banks will proceed carefully. We expect the ECB to start cutting rates in June, but believe that the Fed will hold off until September. We forecast a slow rate-cutting cycle where the ECB will end at 2.0 percent in H1 2026, with the Fed at 3.00–3.25 percent at the end of the same year. This contributes to inflation stabilising at the target next year, with a mild rise in unemployment. We emphasise, however, that a soft landing is not a done deal as inflation remains above target and monetary policy has barely begun to normalise, while risks related to geopolitical tensions and global economic fragmentation persist.

The great normalisation is still on track...

- A soft landing has shifted from being a dream scenario to being consensus' main scenario.
- Global imbalances have eased and inflation is approaching the target, while unemployment has remained low.
- Gradual normalisation of monetary policy in ensures that inflation returns to target H1 2025, while supporting resilient economic activity
- Labour cost pressures remain elevated but ease as the labour market cools.
- Global GDP grows by just over 3 percent per year in 2024–26. Eurozone growth is gradually picking up from low levels in the euro area. In the US, the economic slowdown occurs later and growth slows from high levels.
- Chinese GDP growth, characterised by an ongoing real estate crisis and structural challenges, is gradually slowing (see box: "Gradually lower Chinese GDP growth").

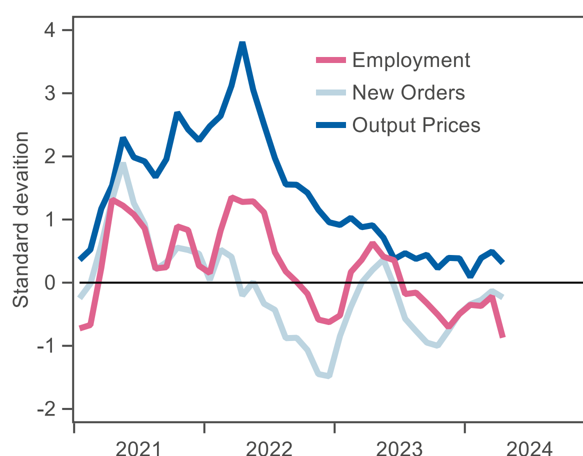
Recent data broadly confirms that inflation is approaching the target and that economic activity remains resilient. Unemployment on both sides of the Atlantic has also remained close to record low as wage trackers indicate wage growth continues to ease, suggesting that a mild upturn in unemployment may be sufficient to bring wage increases in line with the inflation target. Improving sentiment among businesses and consumers, in combination with anchored inflation expectations, are partly self-fulfilling and key for the outlook.

GDP growth



Sources: Macrobond and Handelsbanken

Global PMI



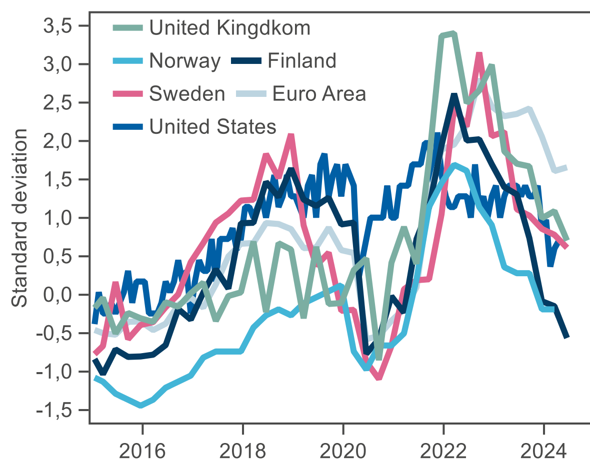
Sources: Macrobond, S&P Global and Handelsbanken

Continued disinflation is also supported by low global producer price inflation. The rise in global energy and freight prices has been contained despite risks of escalation of the Israel-Hamas war, and the Houthi attacks in the red sea.

...but is not a done deal

Labour market tightness has eased considerably in many countries, mirrored in falling vacancy rates, fewer companies reporting labour shortages, and lower employment plans according to PMI. However, in many countries, filling vacancies is still more difficult than normal, and wage pressures continue to be a concern in the ongoing disinflation process. Inflation indicators, such as the PMI output price index, have remained somewhat above pre-pandemic levels, particularly in the service sector, after the sharp fall during 2022 and H1 2023. Price indicators are also elevated relative to output indicators, which means that there is still some uncertainty regarding whether price hikes would remain contained if economic activity strengthens.

Labour shortage indicators



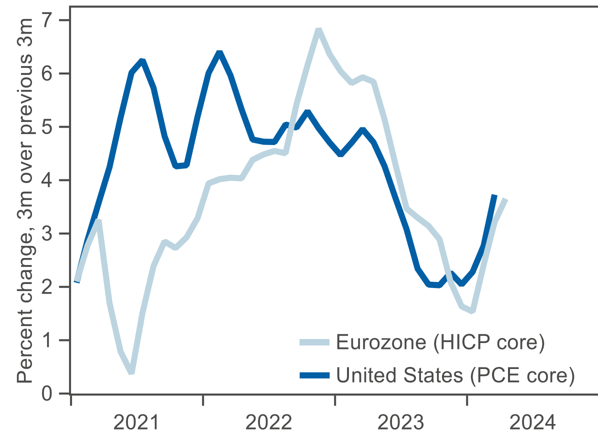
Sources: Macrobond and Handelsbanken

Recent consumer price inflation outcomes neither confirm nor reject whether inflation is on track to fall all the way back to target. Core inflation momentum in the eurozone and the US, measured as average prices in the latest three months compared to the previous three-month period, was 3-4 percent in April, with service inflation higher and goods inflation still noticeably lower.

Relatively stronger US economy

In the eurozone, disinflation has been achieved at the cost of stagnating GDP as the contractionary monetary policy has been transmitted to the economy, reflected in falling housing investment, an elevated savings ratio and slow consumption growth. The US economy, however, has continued to deliver robust growth, powered by the fiscal impulse and households digging deeper into their savings compared to pre-pandemic times. One explanation for the US economy's ability to expand in parallel with cooling labour market tightness is surprisingly large immigration-fuelled labour force growth. At the same time, resource utilisation in the US economy remains high, and recent inflation developments raises questions around what growth rates, and what interest rate, is compatible with inflation returning to target.

Core inflation momentum



Note: Rolling 3 months over previous 3 months, annualised
Sources: Macrobond and Handelsbanken

Fading pricing power

Pricing power was boosted in 2021−22 by large supply and demand mismatches as expansionary policy fuelled demand while bottlenecks restricted supply. The overall high-inflation environment, and its link to shocks originating from the pandemic and Russia's invasion of Ukraine, probably also contributed to greater acceptance of price increases. All contributing factors have gradually normalised and contractionary monetary policy continues to depress demand.

The adjustment of nominal income growth is ongoing with growth in wages and profits abating. We expect companies to carry more of the adjustment than wage earners in 2024. This is key to the soft landing as it allows for a more gradual normalisation in wage growth in parallel with corporations retaining staff and thus softening the rise in unemployment. As lower margin growth continues to contribute to lower inflation, wage earners will accept lower wage increases, creating a positive feedback loop, thus supporting continued disinflation.

Companies holding onto their staff...

Many companies in both Europe and the United States have been holding onto, or even expanded, their workforce despite the weak outlook for demand, elevated nominal wage increases and fading pricing power. This partly reflects that companies had a backlog of unfilled vacancies, but also labour hoarding as they are scarred by recent recruitment problems. As a result, labour hoarding

simultaneously reflects and contributes to labour market tightness.

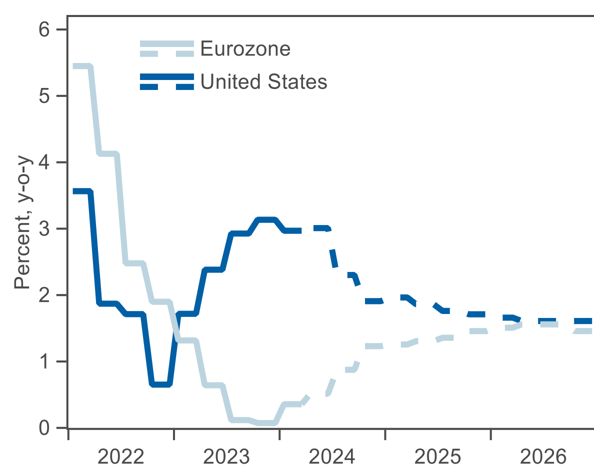
...which supports household demand

Labour hoarding and still-elevated wage growth should sustain nominal labour income , and inflation is no longer eroding real purchasing power. Adding this to (expectations of) gradual rate cuts should boost households' confidence in a soft landing, and hence private consumption and housing demand. This highlights the challenge of monetary policy as companies could respond to improving household demand by passing on costs to protect margin growth.

Normalising economic activity

We assess that overall resource utilisation in the eurozone as well as the US, is close to balance after a gradual correction following the post-pandemic overheating that peaked in 2021. In the eurozone, we expect GDP growth to gradually increase and be somewhat above trend in 2025−26, as easing monetary policy allows an expansion in demand to bring the economy back to balance. This implies GDP-growth gradually rising from 0.8 percent 2024 to around 1.5 percent 2025–26. In contrast, a gradual rebalancing of the US economy implies that GDP growth will gradually slow to slightly below trend in 2025−26. This implies GDP-growth gradually declining from 2.5 percent 2024 to around 1.6 percent 2026.

GDP forecasts



Sources: Macrobond and Handelsbanken

There is considerable uncertainty around the assessment of overall economic slack as well as trend growth, and hence also what growth rate is consistent with inflation stabilising at the target. Indicators of activity and prices in global manufacturing – e.g. production, capacity utilisation business confidence, producer prices and consumer goods prices – suggest that there is spare capacity

Gradually lower Chinese GDP growth

- The Chinese economy is struggling with a real estate sector crisis that has strong ties to the health of the overall economy. The challenges include a mounting debt problem for real estate enterprises and local governments, as well as slowing demographic demand. Years of investment-driven growth lowers capital efficiency and calls for more consumption driven growth.

- Households have accumulated savings over many years but remain hesitant about spending in the absence of social security reforms. Moreover, household confidence has been damaged by the strict zero-tolerance COVID-19 policy and the negative wealth effect from falling house prices.

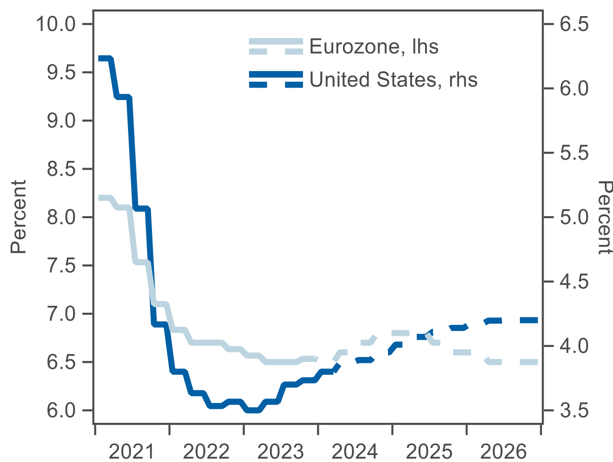
- Overall, these factors contribute to gradually declining Chinese GDP growth going forward. This year's 5 percent growth target had seemed ambitious, but a strong start to the year puts it within reach. Going forward, however, we expect a gradual decline in GDP growth to 4.5 percent in 2025 and 4.2 percent in 2026.

- The production-oriented stimulus approach means that growth may provide less support to global demand, and more to global supply. In some respects, more supply of quality products in key industries such as green energy, batteries and electric vehicles is good news for consumers worldwide.

- However, there are also concerns of unfair subsidies, which could hurt production elsewhere and trigger import restrictions from trading partners. There are some signs of oversupply in China's manufacturing industries, for example rising inventories and falling producer prices. This is partly a cyclical reflection of the real estate sector slump and weak global demand. It also conceals big differences with high efficiency in leading market corporations. In addition, global demand in Chinese "new three" industries – electric vehicles, lithium batteries and solar panels – is broadly viewed as solid. Nevertheless, without a rebalancing towards more domestic consumption-oriented growth, there are risks of structural overcapacity, misallocation of resources, and deflation.

to meet stronger demand. For services, however, reports of continued labour shortages and further price increases, indicate that activity remains above trend. We assess trend growth of around 1.3 percent in the eurozone and just below 2 percent in the US. While there is potential for AI technology to boost productivity growth (see theme article on Artificial Intelligence), there is also a range of factors − tensions and fragmentation in geopolitics, trade, and energy supply − working in the opposite direction.

Unemployment rate



Sources: Macrobond and Handelsbanken

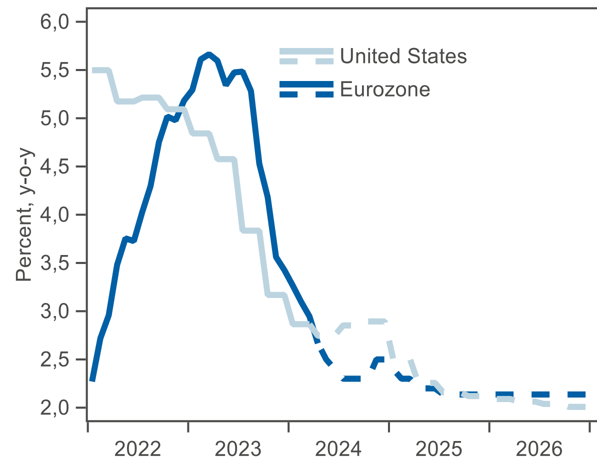
A mild rise in unemployment

Labour hoarding means that companies will have some capacity to meet growing demand with existing staff, which we expect will contribute to a cyclical boost to productivity growth, but also a rise in unemployment in the near future. Productivity is also supported by more efficient allocation of labour and equipment as the final ripple effects from transitory bottlenecks fade. Although we expect this effect to be small, it contributes to a smoother transition for the economy as it softens the increase in unemployment required to ease unit labour cost growth. In the eurozone, we estimate that the unemployment rate is currently at its long-run sustainable level, and that it will peak in 2025 before falling back again from the second half of 2025. In the US, GDP growth below trend is mirrored in a gradual increase in unemployment towards equilibrium during our forecast period.

Slow disinflation during the last mile...

The final part of the path towards the inflation target will be relatively short but likely bumpy, as evidenced by the recent setbacks in inflation momentum in the US and persistent cost pressures in the eurozone service sector. We expect inflation to remain above target throughout 2024, primarily reflecting elevated service prices. Core consumer price inflation should stabilise at its target during the first half of next year.

Core inflation



Sources: Macrobond and Handelsbanken

...and gradual rate cuts

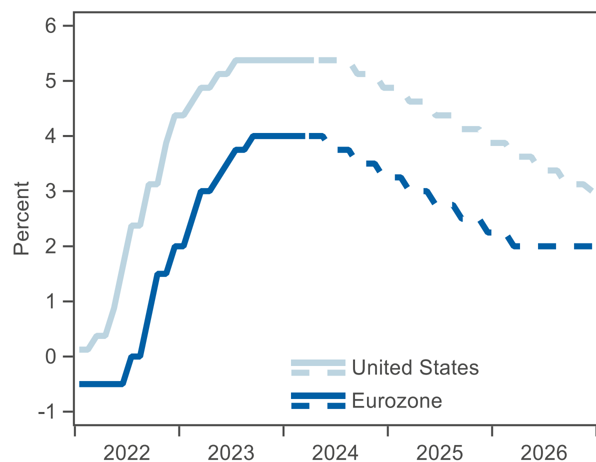
Central banks play a key role in the successful completion of the soft landing and need to remain steadfast in safeguarding the credibility of the inflation target while striking a balance between activity and inflation. While data-dependent central banks have been closely monitoring all signals on their dashboards, the soft landing has, so far, proceeded on autopilot programmed to minimise the upside risks to inflation. Now, however, policymakers should be ready to take over the controls, as incoming data confirms easing costs and price increases. As long as core inflation remains above target, monetary policy decision-makers will agree on gradual rate cuts conditioned on continued signs of easing wage pressures and contained global pipeline price increases. This implies a slow and careful normalisation of interest rates and monetary policy remains restrictive for economic activity. In the eurozone, the growth contribution from fiscal policy is expected be contractionary during our forecast period, in particular in 2024. In the US, the upcoming Presidential election could imply significant policy changes in important in areas such as taxes and trade. Our baseline forecast assumes the status quo for overall fiscal policy. This implies a roughly neutral contribution to growth 2025–26 with the impact of the 2023 stimulus ebbing out in 2024.

A hawkish case with delayed rate cuts could be supported by continued resilience in employment, elevated wage increases, supportive financial conditions and signs of improving economic activity. Looking at these indicators in the rear-view mirror suggests that the risks to economic activity and too-

low inflation are exaggerated, particularly in the US, where recent inflation outcomes cast doubts on whether the last mile of disinflation is consistent with interest rate cuts in the near term. This has not passed unnoticed by other central banks, concerned that they would face a similar trade-off, and worried about inflationary exchange rate developments if the Fed is not on board when they start lowering rates.

During 2024, we expect the ECB to cut three times to 3.25, starting in June, and the Fed to cut twice to 4.75–5.00, starting in September. With inflation gradually approaching the target, we expect next year's monetary policy to be increasingly guided by the outlook for inflation based on estimations of resource utilisation and the medium-term neutral rate of interest (see theme article *Rising r* revisited – Phoenix or Icarus?*). This means that interest rates will be reduced in order to avoid inflation falling below target, rather than being conditioned on certain outcomes for prices and wages. We forecast that the ECB will reach the terminal rate of 2.00 percent at the beginning of 2026 after four cuts during 2025 and a final cut at the beginning of 2026. We expect the Fed to deliver four cuts each year in 2025−26 before ending up at 3.00–3.25 percent.

Policy rate



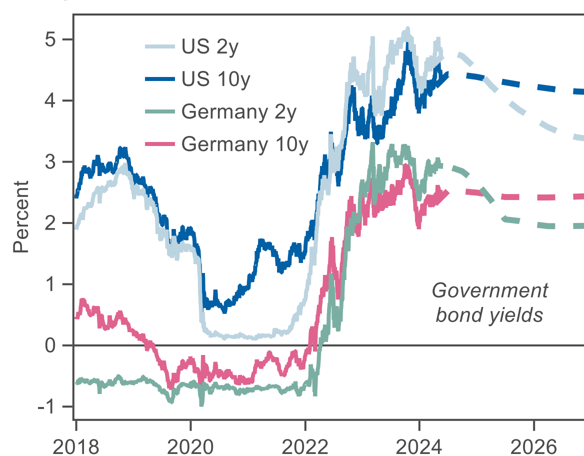
Sources: Macrobond and Handelsbanken

Financial conditions remain supportive

Financial conditions remain supportive of growth as markets expect a soft landing characterised by resilient demand and gradual rate cuts. This is mirrored in buoyant stock markets in parallel with bond market expectations of lower interest rates, squeezed spreads in credit markets and an easing of banks' credit conditions.

Market pricing of government bonds has been volatile since the summer of last year. The market's pricing of policy rates is broadly in line with our forecast for the coming year. On the other hand, we believe that the pricing of policy rates overestimates the neutral policy rate. This means that, in our assessment, longer-term bond yields are trading too high, and we expect them to fall as the downturn in inflation continues. If we are correct in our assessment of which policy rates are compatible with the inflation target, this is a piece of the puzzle that needs to fall into place. More generally, it is important for central banks to have the markets on board in order for monetary policy to have the intended effect. For example, it is possible that expectations of "too much, too soon" at the beginning of the year have contributed to the recent stubbornly high inflation in the United States.

Long-term interest rates



Sources: Macrobond and Handelsbanken

On top of the outlook for the policy rate, we assume that today's term premiums, which have been depressed since the financial crisis, continue to rise slightly during our forecast period. There is, however, significant uncertainty around this assumption, including the impact of central banks' QT and how high government debt affect the supply and demand for bonds.

Risks tilted to the downside

The risks of a hard landing of the economy have diminished as falling inflation has opened the door to interest rate cuts while unemployment has remained low. However, we maintain our long-held view that a soft landing is not yet a done deal. Critically, inflation remains above target and the journey towards normalisation of monetary policy has barely started. Households, businesses, markets, and policymakers could trigger a negative feedback loop if they lose confidence that all parties will do their part to support continued disinflation and to maintain demand. There is a range of triggers, including wage demands, pricing power, financial market reactions, and timeliness of policy decisions, that could threaten economic activity and inflation. Confidence

effects could go in both directions. However, with policymakers still on guard against upside risks to inflation, we think risks of high unemployment are bigger than risks of high inflation.

We believe that supply-side risks related to remaining ripple effects from the pandemic or energy-related shocks are balanced. It is, however, possible that we underestimate the boost to supply from further easing of transitory supply restrictions still trickling through the economy, which would allow for higher activity and lower unemployment without threatening the return to the inflation target. At the same time, still-elevated levels of labour shortages and business price plans could indicate more persistent problems and thus limit the scope for monetary policy to support demand and risk a sharper rise in unemployment.

Our main scenario assumes that overall geopolitical tensions and geoeconomic fragmentation neither improve nor deteriorate. While these assumptions involve upside risk, we see the risks related the economic consequences being skewed to the downside. One risk scenario, is that mounting trade barriers, in particular between US and China, escalate into a trade conflict between the largest economies in the world. This could send the global economy into a recession as China is not only a huge market but also heavily integrated in global value chains, especially in clean technologies. If Trump should return as president of the US, there are also risks of transatlantic tensions on trade. At the same time, there are ways to overcome trade barriers and US trade with China has been accompanied by increasing trade with countries such as Vietnam with a high presence of Chinese-owned production plants.

Theme: Artificial intelligence

AI: Impact on growth and equality could be huge

Artificial intelligence (AI) has the potential to reshape the global economy in the coming decades. The impact on productivity and living standards is highly uncertain but could be substantial. AI is likely to displace jobs, while also creating new ones, but there is also a risk that it could contribute to increased income inequality. The magnitude of these changes will mainly be determined by technological advancement, the pace at which companies embrace AI, and policy changes (regulations, taxes, subsidies) as a result of AI. In this article, we focus on the implications of AI for four broad areas of the macroeconomy: productivity, employment, income inequality and interest rates.

Selected conclusions

- Historical evidence suggests that it can take many years before new technologies have a significant impact on productivity. But if AI becomes so good that it can completely replace humans in many occupations, the productivity gains may be big in the coming decades.
- AI will not create mass unemployment, but the technology may contribute to a further polarization of the labour force into high and low income earners and that income differences will therefore continue to increase.
- If AI increases productivity, it will also contribute to higher real interest rates.

AI may boost productivity growth...

Paul Krugman once said "*Productivity isn't everything, but, in the long run, it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker*." Enhanced productivity creates the conditions for both higher real disposable incomes and shorter working hours, and problems such as high public budget deficits and the green transition become far more manageable. Yet productivity growth in advanced economics has been sluggish since the global financial crisis in 2008–09. Although AI's impact on global productivity is highly uncertain, it has the potential to increase productivity in the upcoming decades, just as previous technologies such as steam power, electricity and robotisation have done.

Slowdown in productivity growth

Sources: Macrobond and OECD.

There are several channels through which AI may contribute to higher productivity:

1. **AI may replace humans** in some instances and massively boost productivity in those tasks
2. **AI may complement human workers,** freeing them from mechanical tasks and enabling them to spend more time on creative and inventive pursuits that may contribute to higher productivity.
3. **AI adoption may also lead to broad-based productivity gains** if it contributes to the creation of new highly productive jobs as well as increased investment and research. Some even argue that the result might be an economy not simply at a higher level of productivity, but at a permanently higher productivity growth rate.

According to a study by the IMF (2024), global productivity gains from AI could range from 0.1 to 0.8 percent a year over a ten-year period depending on how widely it is adopted and whether it replaces or augments jobs. Other analysis indicates an even greater impact. Research by Goldman Sachs

(2023) suggests that AI could lift productivity growth by 1.5 percentage points over a ten-year timeframe.

However, given the extent of uncertainty about both the technological development of AI and its impact on the macroeconomy, healthy scepticism towards any forecast regarding how AI will change the economy is justified. A key issue is if displaced workers end up in low productive service jobs or high productive jobs. But also how fast this technology will diffuse through the economy will be central for the productivity gains in the coming decade.

...but the short-term impact may be small

Historical evidence suggests that it often takes many years for new technologies to have a significant impact on productivity. Electricity began to be used in the late 19th century, but it was not until after the First World War that the productivity effects started to show up in data. And the productivity boost from computing came decades after the invention of the integrated circuit.

It takes time to transform companies and engage in sufficient investment to reap the full benefits of new technologies

AI is unlikely to be dissimilar in our view, given the substantial investments required in hardware, software and human capital to move the dial on productivity. Access to necessary infrastructure and geopolitical factors will also affect the pace of adoption since AI consumes a vast amount of energy and relies on access to raw materials required to make semi-conductors. Furthermore, regulations, restrictions and taxation on AI services may slow the speed of AI development.

All in all, the impact of AI is likely to be gradual with small effects on growth in the short term. Nonetheless, if the technology becomes so good that AI can completely replace humans in many professions, the productivity increases may be big in the coming decades.

Does AI pose a threat to employment?

There is no doubt that AI will make some jobs redundant, just as industrialisation and automatization did in the 20th century. However, thanks to greater productivity, AI should also cause incomes to rise, enabling people to spend more money on other goods and services, which, in turn will increase demand for workers in new areas. Hence, technological advancement means that demand for workers shifts across sectors and occupations, and the labour market evolves in response to that shift.

60 percent of workers in the US are employed in occupations that did not exist in 1940

Similar to automation, AI will most likely displace jobs while also creating new ones, and we expect a broadly neutral long-term effect on employment. However, there is a risk that unemployment may increase during the transformation process, especially if the disappearance of old jobs outpaces the creation of new roles. In such a scenario, politicians would be likely to impose restrictions and start to tax AI-driven businesses in order to make them less competitive and thereby prevent AI from causing mass unemployment.

A big questions is what types of jobs could be replaced by AI? At the beginning of the 20th century, industrialisation and automation largely displaced jobs that involved routine, physical work. A large body of research suggests that computers and information technology applications have automated routine middle-income jobs, and thus contributed to the polarisation of the labour force into high- and low-income workers. AI has the potential to automate both “routine” and “non-routine” tasks, suggesting that middle- and high-paid service jobs are more exposed to and also more likely to benefit from AI than manual jobs.

40 percent of global employment is exposed to AI

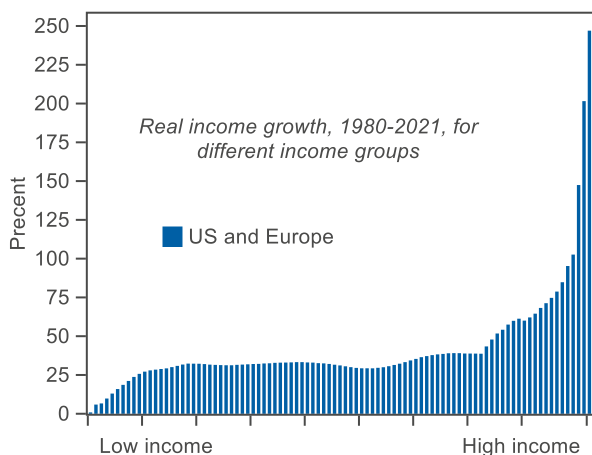
According to a study by the IMF (2024) almost 40 percent of global employment is exposed to AI, with advanced economies at greater risk but also better poised to exploit AI benefits than emerging market and developing economies. In advanced economies, about 60 percent of jobs are exposed to AI, due to prevalence of cognitive-task-oriented jobs. According to IMF, AI is expected to enhance productivity in half of these exposed jobs, signalling a positive impact. For the other half, AI integration could automate

tasks, potentially reducing labour demand and leading to job obsolescence.

Income inequality may increase...

Income and wealth inequality has risen in most developed countries since the 1980s. A range of structural factors have driven the increase in income inequality within most developed countries. In Anglo-Saxon countries, the higher income disparities are mostly related to increasing wage dispersion, often linked to globalisation and technological change favouring high-skilled workers and adversely affecting the wages and employment of lower-skilled labour. Income growth at the top has been accelerating relative to the income growth for middle-income groups, and income growth at the bottom has been sluggish in most developed countries. Looking at wealth, the disparities are even wider.

The rich get richer



Sources: Macrobond and World Inequality database.

There is a risk that AI technology contributes to a further polarisation of the labour force into high- and low-income workers and that income inequality therefore continues to increase. AI may primarily complement the skills of high-income workers, which means that these workers may expect a more-than-proportional increase in their labour income. At the same time, if AI displaces high- or middle-income jobs, a disproportionately large number of workers may end up in low-paid service jobs, where some human presence has an intrinsic value. In addition, wealth inequality may also increase with AI adoption since an increase in demand for AI capital may contribute to increased capital returns and asset values.

...as may interest rates

A common view is that productivity enhancements tend to lower production costs for goods and services, which is disinflationary. On the other hand, companies will need to make investments to take full advantage of AI. Alongside higher incomes due to the productivity boost, this will boost demand and push up inflation. Hence, the net effects of AI on inflation are uncertain and hinge on the timing of these forces. Nonetheless, in the short term, AI will probably be disinflationary and contribute to a more expansive monetary policy.

In the longer term, however, AI could drive up interest rates. The logic here is that AI-boosted productivity growth would lead to more investment opportunities and increase the demand for capital, pushing up real interest rates. However, increased inequality could partially offset the above dynamic. If an AI boom shifts more income to high-income earners than low-income earners, it could lead to an increase in total savings and depress real interest rates.

Rising r* revisited – Phoenix or Icarus?

Long-term interest rates have turned around and picked up, but why is there such big uncertainty about whether or not the surge will last? After all, there is a well-established explanation to the previous decades-long slide in interest rates, and we decided to revise up our estimates of neutral real interest rates already at the start of 2023. But since then, the "r*" debate has blossomed. Revisiting our estimates, we find that new research displays disagreement about the relative strength of drivers, uncertainty about the outlook for these drivers, and difficulty teasing out signal from noise in the current volatile economic climate. We remain of the view that r* has risen, but rather than rising like Phoenix the pickup is partly a short-run phenomenon. That is key to policy rate outlooks, terminal policy rates after this tightening cycle, and long bond yield forecasts.

The million dollar question

Have interest rate trends turned around after a decades-long slide? That was the question we had asked ourselves at the start of 2023, concluding that the answer was likely "yes", and revising up the shorter- to medium-term years in our estimated neutral real interest rates paths. Since then, the "r*" debate has blossomed, with a wide range of new research surfacing. Do the new findings change our assumptions for the neutral rate, and hence the entire outlook for market interest rates, short as well as long term?

What is r?*

- *The real rate of interest that is neither expansionary nor contractionary.*
- *The interest rate that balances saving and investment in capital markets.*
- *It's equal to the marginal product of capital.*

To delve into this, let us first remind ourselves what r* – academic economists' shorthand for the neutral or natural real rate of interest – really is all about. R* is the risk-free real interest rate that would prevail in the hypothetical situation where all shocks have faded and the economy is in balance, i.e. operating with growth at its potential and inflation is at its target.

The million dollar question: Where is this interest rate nirvana? Because it is a hypothetical state of the economy, we can never actually observe it with any certainty – instead we are condemned to estimation methods, but how?

Conceptually, our everyday actual interest rates are underpinned by the neutral rate. But trying to estimate r* with purely statistical methods is a bad idea, because cyclical and temporary factors can put actual interest rates on very lengthy detours off the neutral rate path. That results in the model not giving a clear r* signal, where the noise has not been entirely stripped out.

Instead researchers use models with a richer set of economic data, next to the real interest rate:

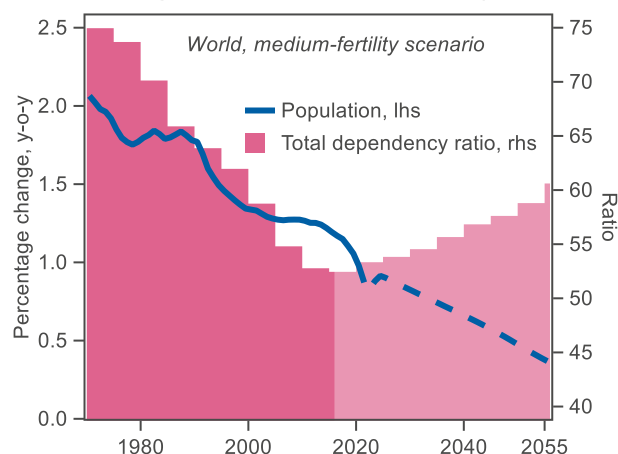
- So called semi-structural models estimate r* together with factors like GDP growth, to identify those interest rate nirvana-moments in time, and link them together through periods of unbalanced economy. These models are agnostic about the underlying drivers of the neutral rate, which can be a drawback.
- To gain a deeper understanding of the forces that cause trend shifts in the balance between saving and investment and hence r* – higher (lower) desire to save decreases (increases) r*, higher (lower) investment needs increases (decreases) r* – more elaborate structural models are used including general equilibrium models popular at central banks (DSGE models). One downside with these large models is that they tend to rely on many more assumptions, and therefore run the risk of being "exactly wrong, rather than roughly right", as the saying goes.

The decades-long r* slide and its drivers

Using a range of these different structural models, a research consensus has formed over the last decade, explaining the long slide in interest rates from the peaks in the 1970s and 80s, to the trough in the 2010s. First, that it was caused by a decline in the global long-run neutral real interest rate, not cyclical conditions. And second, that some structural drivers behind this falling r* can be identified. So,

which are the key factors and how did they cause interest rates to fall?

Population growth slows, dependency ratio up



Sources: Macrobond, UN DESA and Handelsbanken

Key driver I: Demographics

The global megatrend of an aging population has driven the neutral real interest rate down.

- Negative effects on r* since the 1970s/80s:
  - Life expectancy, or longevity, trending higher has meant an increasing desire to save, to provide for one's future retirement.
  - The declining dependency ratio, i.e. non-working age to working-age population, has implied a large share of the population - particularly baby-boomer generation of the 1940s – being in the stage of life when wealth is accumulated, driving up saving.
  - A slowing population growth on the back of lower fertility rates imply decreasing investment needs (falling demand for capital), due to lower potential GDP growth and less need to complement additional labour with capital in the economy.

Key driver II: Productivity

Trend productivity growth has been slowing – a part of the phenomenon that has been labelled “Secular stagnation” – and driven down the neutral rate.

- Negative effects on r* since the 1970s/80s:
  - Slowing productivity growth has dragged down the marginal product of capital, decreasing investment demand.
  - Faltering productivity growth means that households have to reckon with weaker future income growth, which increases the need to save.

Key driver III: Government debt and net safe asset supply

Public sector indebtedness has been on a steady rise, which has contributed to higher neutral rates. On the other hand, rising savings flows from emerging market economies in particular have resulted in a negative net supply of safe assets in total, and hence a lower neutral rate.

- Positive effects on r* since the 1970s/80s:
  - Rising debt issuance has been increasing the supply of “safe” assets, representing an increasing demand for capital in the economy. On top, higher indebtedness adds to bond premiums, which lifts interest rates.
- Negative effects on r* since the 1970s/80s:
  - Global saving glut, not least from emerging market economies on the back of current account surpluses, has given an increased demand for safe assets. And as an extra twist, this has implied capital inflows to advanced economies and hence an accentuated oversupply of saving there.

Our reading is that these three categories of drivers are the most important to help explain the decline in the neutral real interest rate, but the research literature does account for even more structural factors, such as the rising economic inequality. Knowing the three main culprits behind the long r* slide should make it easy to draw conclusions about the future of interest rates, right? Maybe not.

A trend break – the r* outlook

Since last we analysed the neutral interest rate, one and a half years ago, researchers have continued to mostly draw the conclusion that there has been a break in the downward trend, and r* has risen, albeit not clear how high. And the research evidence also displays uncertainty about the future of key drivers, disagreement about the relative strength of driver impact. Let us address these issues each in turn.

The telescope: Where is r* today?

There are many r* estimates available, especially for the world’s biggest economy, the US, but it is difficult to pick any one favourite. That is partly because of the above mentioned challenges in teasing out the signal from the noise when estimating an unobservable variable. But the aim of the various models and their comparative strengths and weaknesses also matters:

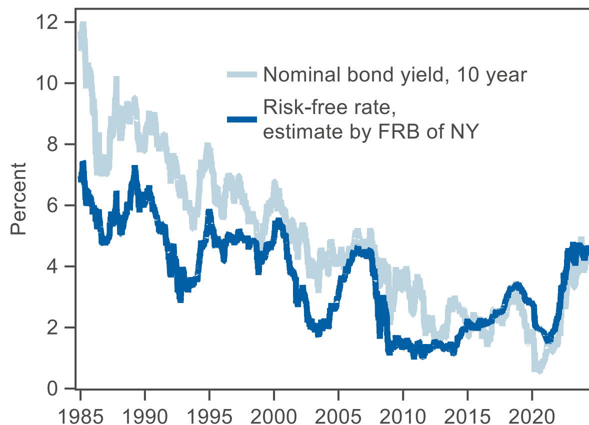
- Some do a better job at gauging the short-run r*, meant to show which level the current central bank policy rate needs to be above (below) in

order for the policy stance to be contractionary (expansionary).

- Others zoom in on the long-run r*, aiming to answer the question where we should expect the terminal policy rate to be, beyond the cycle and other shocks affecting the economy now.

All told, our conclusion from available research is that the neutral real interest rate has risen, but that this is partly a temporary bolstering, i.e. higher short-run r* (see table). The effect is even more accentuated when we turn to nominal neutral interest rates by adding the short-run inflation expectations, which are slightly elevated in relation to both the levels consistent with central banks' 2-percent target and the well-anchored longer term inflation expectations. So, if the short run is temporarily bolstered, where is r* headed next?

Falling interest rate trend is broken



Sources: Macrobond, Federal Reserve Bank of New York and Handelsbanken

The crystal ball: Where is r* heading next?

To assess how the neutral rate will develop ahead, beyond the trend break in recent years, we analyse the outlook for its most important drivers from the 2010s to the 2050s.

Demographic developments are set to change. Contrary to earlier beliefs, there are now many indications that demographics will not raise r*, overall, merely stop contributing to an even lower r*.

- The on-going turnaround to rising dependency ratios started a decade ago in advanced economies and will gain global momentum ahead. Basic life-cycle hypothesis says retirees will stop saving and instead spend accumulated wealth to smooth consumption, and in isolation this would contribute to higher r* ahead. But more recent research reveals that dissaving is much smaller in reality than predicted by the basic rule of thumb, partly for precautionary reasons in face of the risk that savings are depleted too early, in the middle of retirement. That makes for a weaker r* driver than earlier beliefs.
- The continued rise in longevity will firstly increase the population share being middle-aged or older and is thus at a stage in their lives where one tends to have accumulated wealth – a compositional effect that all else equal increases the stock of wealth, counteracting the effect from retirement dissaving. Secondly, the rising life expectancy stretches the retirement period, further driving up the need to save during ones working-age years. However, longevity is not forecast to rise as fast as in recent decades. In addition, countries may choose to raise the retirement age.
- Finally, population growth will keep slowing, even going into reverse in not least many European countries. That implies the drag on investment needs and hence r* continues.
- All in all, we assume that the demographics net effect will be approximately ±0 for our full long-term forecast spanning 30 years. That means positive and negative effects above cancel out ahead – a break with the overwhelmingly negative recent decades.

Productivity growth to leave the doldrums by slowly picking up, we judge, and toward our long-run horizon, in 30 years, reach something resembling normal – a boost to r*.

- We have been assuming a return to 1.5 percent productivity growth toward our long run horizon. Admittedly, some research suggests that it will be difficult to durably rejuvenate trend productivity. On the other hand, there is still much untapped potential if economies succeed in aligning better with the global productivity frontier, by using existing ideas, knowledge and technology.
- On top, the development of artificial intelligence (AI) adds to productivity growth in the coming decades, see theme article AI: *Impact on growth and equality could be huge*.
- Government initiatives to drive the green transition and fight climate change generates frontloaded investment growth, also lifting r*. In the shorter term, however, some productive but climate-hostile capital is likely to become underutilised or even labelled as entirely obsolete, a transition temporarily dampening productivity growth as such. But notably the alternative, a severe climate change scenario, is much worse also in a narrow economic

perspective, as the number of stranded asset would surge, productivity would suffer and r* would sink.

Government debt and net safe asset supply are expected to be more or less counteracting forces ahead, not an overall boost to r*

- Government debt has started to decline from recent peaks in many economies, but far from everywhere with the US one glaring exception. The sustainability of public finances is lacking, so even though many economies are expected to continue to show deficits in the shorter term, we assume that politicians will sooner or later shift to consolidation. Declining debt ahead will dampen r* in the long run, compared to today's high debt situation.
- Slowing globalization, as well as emerging market economies' smaller current account surpluses and more mature domestic financial markets, are reasons why the demand for safe assets appears to have turned around and is assumed to ease somewhat ahead, in isolation driving r* up.

Handelsbanken neutral rate assumptions

Neutral rate of interest. Assumptions January 2023 in parenthesis

	Current		Medium term (2028)		Long term (2054)
	Real	Nom.	Real	Nominal	
US	1.25	3.5	0.75	2.75 (2.5)	Real 1.0 Nominal 3.0
EZ	0.25	2.5	0.0	2.0 (1.75)	
NO	0.5	2.75	0.25	2.25 (1.75)	
SE	0.5	2.75	0.25	2.25 (2.0)	
GB	0.75	3.0	0.5	2.5 (2.5)	

Neither rising Phoenix, nor falling Icarus

All told, after revisiting our r* assumptions from January 2023, we remain of the view the neutral rates have risen, compared to the trough during the 2010s. Not least our assumptions for the current period, but there are reasons to believe that part of the surge is short-lived and our medium-run assumptions are only slightly higher than our previous assessment.

Improved cyclical conditions and high inflation expectations in recent years imply a transitory lift to the short-term real as well as nominal neutral rate, compared to both the structurally founded medium-term r* assumptions we make, and the research literature's long-term r* estimates for the years just before the current volatile economic environment. Our long-term view for the advanced economies under our coverage is one of converging neutral interest rates. In a 30 year perspective, we view productivity growth as the main driver of r*, absent new shocks to demography, debt and other drivers. Our assumed productivity growth of 1.5 percent annually leads us to assume that r* will gravitate toward 1 percent, i.e. 3 percent in nominal terms given credible inflation targets of 2 percent.

Market implications: High for longer

The higher r* is key to both the policy rate outlook and the long bond yield forecast. For central banks, the higher short-term r* means less actual rate cuts are needed 2024–26 to stop restricting the economy – something we have already incorporated in recent policy rate forecast, but formalise further with today's short-term r* assumptions. Beyond that, the higher medium-term r* means the terminal policy rate after this cycle will be higher than what was normal in the low interest environment in the 2010s.

Upgraded short- and medium-run r*, together with our unchanged long-run r* assumption, results in upward revision of our market interest rate forecasts, i.e. swap rates and bond yields (see separate article).

References

Please note that this article is a compact version of our new Macro Comment, where you will find the reference list of research underlying our analysis.

Eurozone

Closing in on a soft landing

With continued disinflation, GDP growth back in positive territory and record-low unemployment, the eurozone is heading for a soft landing. We expect the ECB to start a cautious rate-cutting cycle in June, balancing the need for further disinflation while avoiding a recession through three rate cuts in 2024. We forecast that inflation will return to target during the first half of 2025, with only a mild and temporary rise in unemployment. Disinflation has been achieved at the cost of stagnating GDP, but we think there is a limited amount of slack in the economy. We expect growth to rise to around 1.5 percent in 2025–26 from 0.8 percent this year, supported by a gradual normalisation of monetary policy. The soft-landing scenario is, however, challenged by several risks, including labour shortages, sticky inflation in the service sector and a weak manufacturing sector.

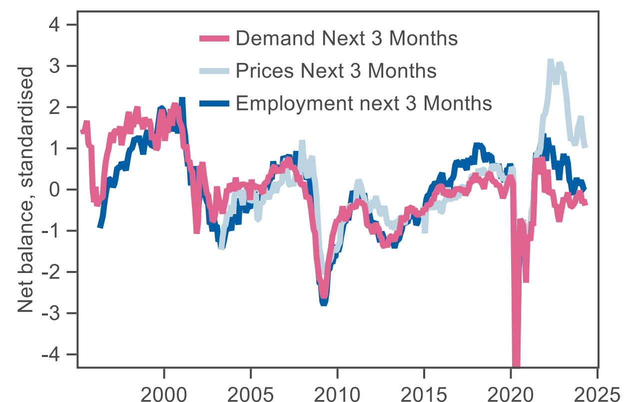
Soft landing approaching

The eurozone is closing in on a soft landing. Disinflation is on track and there are positive signals for growth and unemployment. Preliminary national accounts data for Q1 2024 showed GDP growing at a modest 0.4 percent y-o-y. Unemployment remained at a record-low 6.5 percent in March and core inflation fell to 2.7 percent in April, with inflation expectations broadly in line with the 2 percent target. In the short run, we expect households to be the main contributor to demand as confidence in a soft landing builds and they reduce their saving rate to pre-pandemic levels and return to the housing market. At the same time, however, tight monetary conditions continue to weigh on demand with the full transmission of previous rate hikes still ahead. A key condition for household demand materialising is that businesses continue to hold onto their employees despite still-elevated nominal wage increases, and a risk that demand remains weak. Hence. laying the ground for the soft landing involves a positive feedback loop whereby business confidence prevents companies from shedding labour, thus boosting consumer confidence and household demand, while anchored inflation expectations contain wage demands and price increases.

Challenges in the service sector...

Business survey indicators in support of improving GDP-growth, continued labour market resilience alongside easing inflation are mixed. Price expectations among wholesale and retail trade companies, for example, have normalised, with employment expectations above the historical average. In the service sector, however, resilient activity and employment come at the cost of price expectations still well above pre-pandemic levels and persistent labour shortages. Moreover, profit shares in many service sectors have fallen below pre-pandemic levels, suggesting that it may be challenging to absorb high-unit labour costs. Goods producers, which have a profit share above pre-pandemic levels, and less dominant wage costs, may need to carry a larger share of the price adjustment.

Total Service Sector



Note. Y-axis is cut at -4. Demand and employmet fell to 5.6 and 6.7 in april 2020.
Sources: Macrobond, DG ECFIN and Handelsbanken

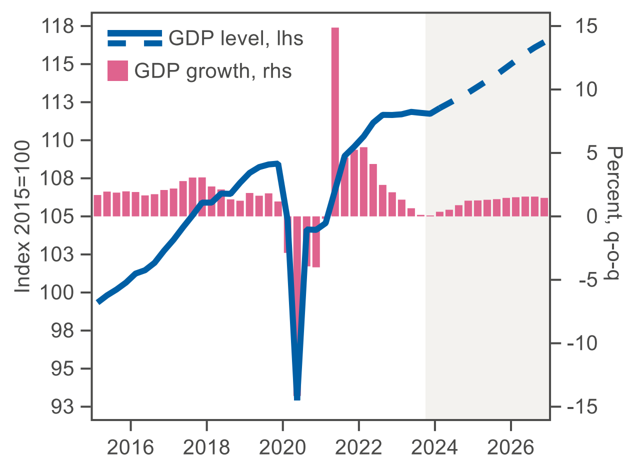
...as well as in manufacturing

Business confidence indicators still paint a gloomy outlook for demand in the eurozone manufacturing industry, with labour shortages an ongoing problem for a large proportion of companies. While low demand is partly a global phenomenon, manufacturers in the eurozone are also facing structural challenges, particularly in energy-intensive industries. Although energy prices have decreased, supported by a reduction in demand for natural gas in combination with expanded capacity in renewables in the power sector, challenges related to securing a long-term stable supply persist.

Growth rising but unemployment climbing

The impact of tight monetary policy continues to be transmitted to the economy, and disinflation has come at the price of stagnating GDP. However, there is little evidence of any slack in the economy, in particular in the labour market. Hence, we do not see much room for growth above trend going forward, which we have at 1.3 percent annualised.

GDP forecast



Sources: Eurostat, Macrobond and Handelsbanken

In the near term, the recent improvement in sentiment indicators suggests growth close to trend. Due to the weak overhang heading into the year, we expect growth to settle at 0.7 percent in 2024, rising to 1.3 percent in 2025 and 1.5 percent in 2026, closing the GDP gap, supported by a gradual normalisation of monetary policy. Low unemployment partly reflects labour hoarding, which suggests that businesses can meet rising production with little additional demand for labour during the remainder of 2024. This contributes to unemployment rising slightly to 6.8 percent around year-end. During the second half of next year, when the slack from labour hoarding has faded and growth has risen slightly, we expect a gradual fall in unemployment to 6.5 percent in 2026.

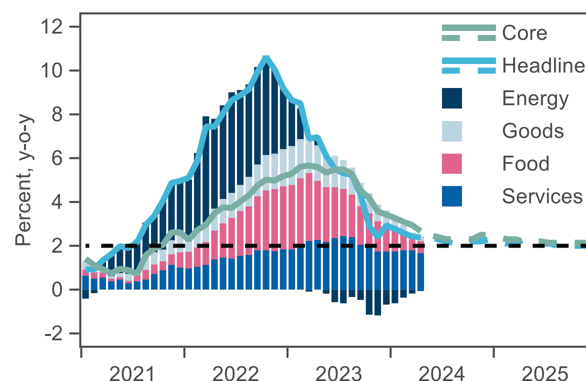
Wage growth easing slowly

Labour market tightness has eased from last year's peak and there are signs that wage-cost pressures are abating, in particular the marked downward trend in wage growth advertised in job postings. In addition, a cyclical upswing in productivity as companies partly use capacity slack to meet demand, also contributes to easing unit labour cost growth. At the same time, recent months have offered little new evidence of easing labour market tightness, and wage cost pressures remain a concern that could delay the disinflation process and postpone rate cuts. The significant lag in data releases is problematic for policymakers who are still waiting for final evidence of easing wage growth during the first quarter of the year.

Inflation to stabilise at target in H1 2025

The April flash release showed core inflation at 2.7 percent, extending its steady decline since summer last year. Easing goods inflation has been the key contributor to falling core inflation this year, while service inflation has remained sticky. Even with annual service inflation easing somewhat in April, momentum is ambiguous and may challenge the continued descent in core inflation. Overall, we expect core inflation to ease slightly in the coming months, partly due to favourable base effects, but remain elevated at 2.5 percent at the end of the year. We expect headline inflation to remain slightly below core inflation and end this year at 2.3 percent. Our forecast is for inflation to stabilise at target during the first half of 2025, supported by a gradual normalisation of wages and continued disinflation in the service sector.

Inflation and contributions by components



Note. Food includes alcohol & tobacco. Goods refers to non-energy industrial goods
Sources: Eurostat, Macrobond and Handelsbanken

Gradual normalisation of policy

We expect the first quarter wage data and May inflation figures to be the final go ahead for a rate cut by the ECB in June. A gradual normalisation of monetary policy from today's restrictive stance is key to ensuring a soft landing. Nonetheless, a slow and careful approach is warranted against the background of remaining cost pressures and uncertain inflation momentum. In our view, this means three cuts in 2024, followed by five cuts in 2025 as evidence builds of inflation having stabilised at the target, with a final cut in 2026 resulting in a terminal rate of 1.75 percent. Efforts to bring down budget deficits and the rolling back of measures introduced to cushion the impact of high energy costs imply that fiscal policy will be restrictive in 2024 and, to a lesser extent, in 2025–26..

Sweden

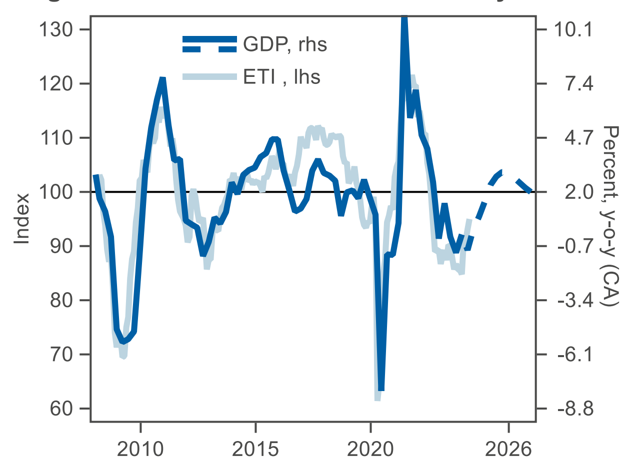
Household consumption will drive the recovery

The outlook for the Swedish economy is beginning to brighten. Lower inflation, rising real disposable incomes, and the prospect of more expansionary economic policy are paving the way for a recovery from the end of 2024. Wage growth will stay fairly high ahead, restoring households' purchasing power. However, while lower inflation has opened the door to rate cuts, there are reasons to doubt that the path to further disinflation will be straight. Together with Sweden's fast monetary policy transmission, we expect this to result in merely a gradual loosening from the Riksbank in 2024 and 2025.

Recovery in sight

The Swedish economy has stagnated since 2022 and we assess that the economy is currently in a mild recession. Interest-sensitive areas of the economy such as household consumption and housing investment have declined significantly, while net exports and business sector investment excluding housing have developed quite strongly. GDP was nearly unchanged in the first quarter, according to the GDP flash indicator, and both business and consumer confidence are still at levels that imply muted growth in the second quarter. Nonetheless, lower inflation, rising real disposable incomes and the prospect of rate cuts mean that the outlook for the Swedish economy is gradually improving.

Brighter outlook: GDP and NIER survey

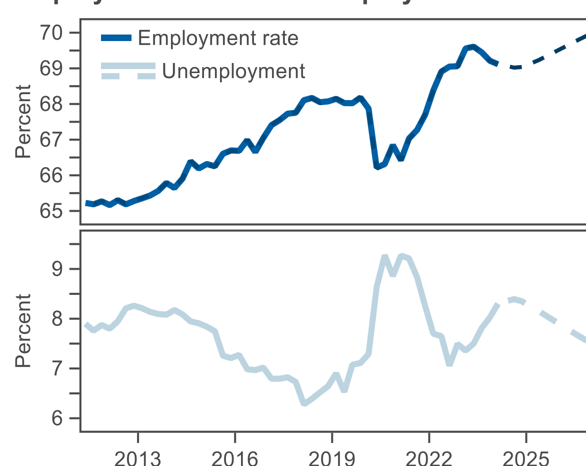


Sources: Macrobond and Handelsbanken

The brighter outlook is reflected in many survey-based indicators that are trending upwards and, most significantly, households have become far less pessimistic in recent months. We expect GDP growth to pick up in the second half of this year as household consumption increases. However, our assessment is that the economic recovery will not get any real wind in its sails until 2025, when we see a move to an expansionary fiscal policy, further normalisation of monetary policy and a brighter labour market. Consumption will be an important driver of the recovery.

Overall, we forecast GDP to increase by 0.4 percent this year and rise by 2.8 percent in 2025 and by 2.4 percent in 2026. Hence, growth in 2025 and 2026 will be stronger than in most other European countries. The key reasons for this are a more expansionary fiscal policy in Sweden and the fact that the Swedish economy is more sensitive to interest rates, which contributes to a stronger recovery when interest rates are lowered. While many countries in Europe need to consolidate public finances, the debate in Sweden is rather that the public debt is unnecessarily low. Public debt is expected to remain low and stabilise at just under 33 percent of GDP in 2025 and 2026.

Employment rate and unemployment



Sources: Macrobond and Handelsbanken

Employment holding up well

The labour market has cooled down, with rising unemployment and a fall in the number of temporary workers. However, there is not a rapid deterioration in labour demand and there are tentative signs that forward-looking indicators are reversing from negative levels. For example, employment plans for the business sector show an almost unchanged workforce in the upcoming months. Our view is that

unemployment will continue to rise slightly until the autumn. The gradual strengthening of demand in the economy should then lead to an increase in demand for labour, which will result in a drop in unemployment. All in all, we believe the labour market will weather the downturn relatively well. The employment rate has fallen back slightly from the record peak levels, but we expect it to increase to new record highs again in 2026.

Inflation opened the door to rate cuts…

Since December, inflation has eased more than expected even though the year started on a higher note, much like we had forecast in our January report. Headline CPIF inflation was 2.3 percent in April, within striking distance of the Riksbank's target.

As we have highlighted previously, the severe risk of spiralling inflation in recent years has now been muted for an extended period. Hence, the low inflation outcomes meant the door to policy rate cuts opened. But in deciding the appropriate number of cuts ahead, the inflation outlook must be considered.

…but reasons to doubt further disinflation

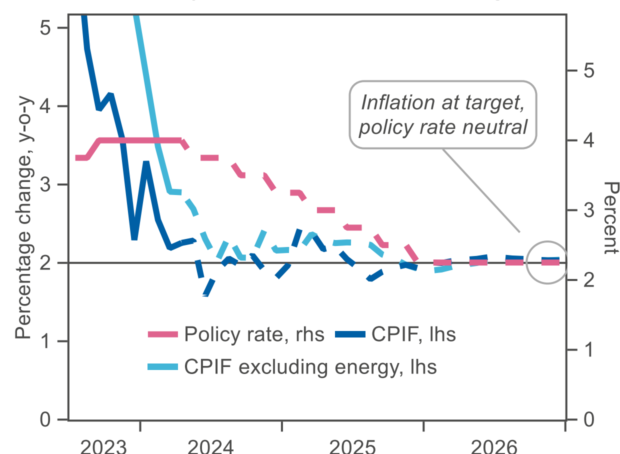
Overall, established leading indicators suggest that CPIFXE inflation should settle in the 1.5–3 percent range. That is promising, but we continue to forecast a bumpy somewhat elevated inflation path in the near term, and an ultimate achievement of the 2-percent target conditioned on some maintained monetary policy restrictiveness in 2024–25.

Firstly, a range of global commodity, producer and consumer price indices show plateauing or even resurging price rises – inflation impetus that as usual shows signs of now reaching Sweden's open economy, with higher prints in goods price gauges.

Secondly, the krona has been depreciating more than expected and we have revised its outlook in a weaker direction, which spills over into inflation pressure. Our forecast is that the krona will move towards stronger levels only when the Fed begins its interest rate cuts in September. From today's EUR/SEK of around 11.60, the krona is expected to strengthen to 11.35 by the end of 2024 and reach 10.60 by the end of 2026

And lastly, analysis of firms' price-setting is yet to deliver proof that "behaviour" has returned to pre-pandemic norm. That implies stronger-than-normal propagation of future supply shocks as well as exchange rate pass-through, i.e. an upside tilt to the inflation outlook. Nevertheless, we keep the baseline forecast for inflation to be considered as practically back at 2 percent around yearend 2024.

Rate cut slowly to keep inflation at target



Sources: Macrobond, Statistics Sweden and Handelsbanken

Fast transmission of policy changes

Now that the Riksbank is scaling back its restrictive policy, it must continue to take into account the high interest-rate sensitivity of the Swedish economy. It implies fast monetary policy transmission – both from tightening, like recent years, and loosening ahead. The IMF recently analysed cross-country differences in the important housing channels of monetary policy, and finds Swedish sensitivity to be average – likely an underestimation, we judge. At least two deficiencies in the IMF's results for Sweden say so: 1) the *de facto* prevalence of fixed rate mortgages has been lower than the IMF recognises, as Sweden's average mortgage duration is very short, and 2) the housing price overvaluation in the midst of the pandemic boom is excluded, seemingly due lacking Swedish data access at the IMF.

This suggests that disinflation and subpar economic performance in Sweden are not signs of overtightening, but rather of quick transmission.

Riksbank's awkward loosening position

As we had anticipated, the Riksbank delivered an outsized dovish policy pivot in March. Given the lower inflation outcome alone, it might appear as though the Riksbank will lower the policy rate substantially ahead. All told, however, we see the Riksbank's position as more awkward ahead of the continued policy loosening. This is partly due to our forecasts for inflation and the krona, including the risks to those variables. And then there is the fast policy transmission, calling for a careful cutting cycle. Lastly, we assess the neutral rate of interest to be higher than before, so the Riksbank's terminal rate is forecast to be 2.25 percent.

United Kingdom

Slow lift-off scheduled

The shallowest recession in UK post-war history is behind us, but the road ahead will not lead to sunlit uplands anytime soon. While many of the challenges of the past few years – from energy costs to inflation – are fading, there are still a battery of issues slowing growth: more costly debt, higher taxes and ongoing constraints on government spending. Hence, our forecast continues to be for slow growth over the course of this year and into next. Moreover, central bank caution suggests interest rates will fall less rapidly than initially hoped, and while the latter part of the year is almost certain to see a general election and a likely change of government, we do not expect it to lead to any meaningful change of direction in fiscal policy.

Green shoots of growth, stunted by slugs

The beginning of 2024 saw the UK emerge from the shallowest recession it has experienced since the Second World War, with a total economic loss of just 0.4 percent of GDP. However, the nature of the recession means the economy is not going to rebound quickly; growth over the course of this year and next is set to be slow as we forecast just 0.4 percent this year and 1.4 percent growth in 2025.

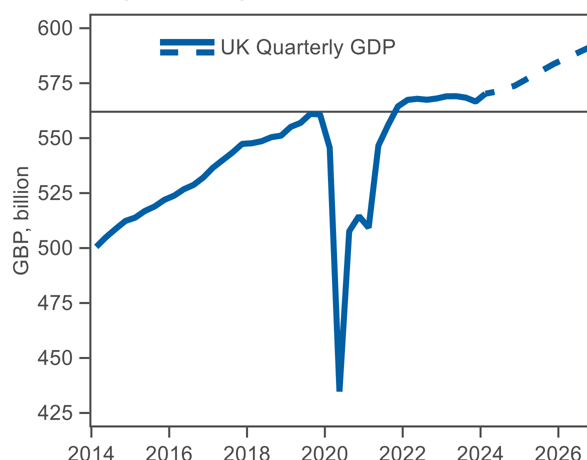
Much of this mild upturn is enabled by the easing of the economic headwinds of recent years, higher energy costs, interest rates, taxes and inflation, all of which reduced consumer expenditure by 3.9 percent in 2022 and by a further 0.3 percent in 2023. Looking forward, the abating of these headwinds should allow consumer expenditure to grow by 0.5 percent in 2024. On top of this, earnings have turned firmly positive, rising by 1.3 percent in real terms this year, a trend rate of growth we expect to prevail in 2025.

Tax is likely to be an area of considerable debate in 2024, particularly as we approach a general election. The Conservatives will focus on the fact that the Chancellor has reduced national insurance (effectively an income tax) by 4 percent in the last two fiscal events and rather less on the equally true but less palatable fact that the overall tax burden at 37.1 percent of GDP is within 0.1 percent of its post-war high set in 1948. The uncomfortable truth for all politicians is that the scope for new spending, or substantive tax reductions, remains extremely limited without substantial reallocations or reductions in present areas of spending.

Along with changes to the mix of taxation, Conservative Chancellor, Jeremy Hunt, outlined in his March 2024 budget that government spending would grow at no more than 1 percent per annum in real terms. Even the health service, the largest recipient of government cash, is seeing only limited rises in its budget. Given that record-high tax receipts are accompanied by an ongoing public finances deficit of 5.1 percent, this seems prudent. In our forecast we use one percent as a limit to future growth in government expenditure.

As for business investment, the purchasing managers surveys all indicate that confidence remains positive and there is an intention to invest over the coming few years. We therefore forecast investment to run at 80 percent of the pace of growth seen pre-pandemic, although, in cash terms, this equates to total investment roughly 40 percent greater than it was before COVID-19.

UK GDP (GBP Mln)



Sources: Macrobond, ONS and Handelsbanken

Jobs for everyone

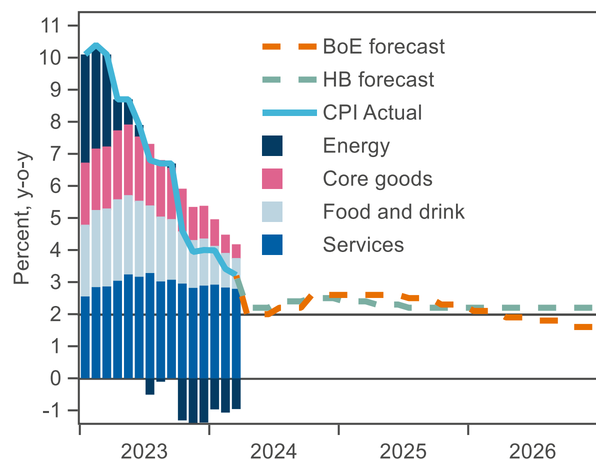
There has been some concern regarding the accuracy of the Labour Force Survey data, which is being reconfigured to improve response rates and thus reliability. Nonetheless, there is enough supporting data from various alternative sources to put together a fairly sound picture of what is happening to the UK labour market. For some time, it has been clear that the peak in unemployment was going to be well below that seen during recessions over the past 40 years, and we lower our expected

mid-2024 peak further again from 5.5 percent to 5.2 percent. The relatively benign employment outlook continues to be underpinned by a good degree of flexibility in earnings in parts of the workforce, and employers wishing to keep workers on in anticipation of rising demand over the course of the next couple of years. There are concerns about the number of people who are registering as long-term sick, but the overall mix of employed and inactivity rates is well within long-term historical norms at 60 and 37 percent, respectively.

Interest rates – when will the cuts begin?

The most recent meeting of the Bank of England's Monetary Policy Committee (MPC) saw a complete disappearance of the hawks calling for interest rate rises. Instead, the question has been, when might cuts start. Two factors are critical here. Firstly, the BoE's desire to reestablish credibility (in light of having badly missed its 2 percent inflation target) is likely to result in a degree of additional caution towards reducing interest rates. This is evidenced by MPC members declaring that they want to see inflation hitting its target before they will contemplate lowering interest rates.

UK CPI



Sources: Pantheon, Bank of England and Handelsbanken

Secondly, MPC members have made it clear that they are looking for the 2 percent target for inflation to be met through services inflation at 3.0 percent and goods inflation sustainably at -1.0 percent. At the moment, however, services inflation is sitting at 6 percent, while goods inflation is 0.9 percent. The former is largely driven by earnings and has scope to decline further, but is looking sticky. Meanwhile negative goods inflation in the pre-pandemic world was experienced against a backdrop of globalisation. The assumption that such deflation will dominate in future seems less safe in a world where globalisation is no longer focused on lowest cost production. Our expectation in the medium term is therefore for inflation to fluctuate just above its 2 percent target and thus the BoE is likely to respond by ensuring that monetary policy bears down on this, with interest rates sitting at 3 percent in 2027.

New government likely, little will change

The Prime Minister must call a general election by the end of January 2025, but is widely expected to request that the King dissolve Parliament in October, and thus the UK will see a general election in November. On current polling, which has been remarkably steady, the opposition Labour Party is odds on to form the next government, with Sir Keir Starmer as Prime Minister and Rachel Reeves as Chancellor. While the party manifestos will not come out until the election is called, Shadow Chancellor Reeves has been at pains to emphasise that she will be broadly adhering to the present Conservative government's fiscal plans and fiscal rules, which stipulate that borrowing is only used to fund investment and budgets are set so that the debt burden to GDP ratio falls over the course of the coming five years.

Value of GBP in the hands of others

The UK has spent several years at the forefront of international financial concerns, from the Scottish and Brexit referendums, to the exact form of Brexit, coping with COVID-19 and the viability of a substantially reflationary budget. The impact of all of these domestic machinations on Sterling was at times quite marked. However, with a bit of luck we now face a period in which the winds buffeting Sterling will be international as opposed to domestic.

Our view is still that interest rate differentials remain critical, and that while there is not any official co-ordination of monetary policy, the ECB and BoE are seeing their respective economies at similar points in the economic cycle. All eyes are on when the BoE will begin to reduce interest rates – our view is that it will kick off with a 25bp cut in August 2025, with a further 25bp reduction in December. The co-incidence of timings in monetary loosening, the ECB and the Federal Reserve will be on a similar path, which points to Sterling remaining range-bound throughout the rest of 2024. Hence, over the next two years, we still expect GBP/EUR to drift from 0.86 towards 0.88 and believe the USD/GBP will move from 1.25 to 1.33.

Norway

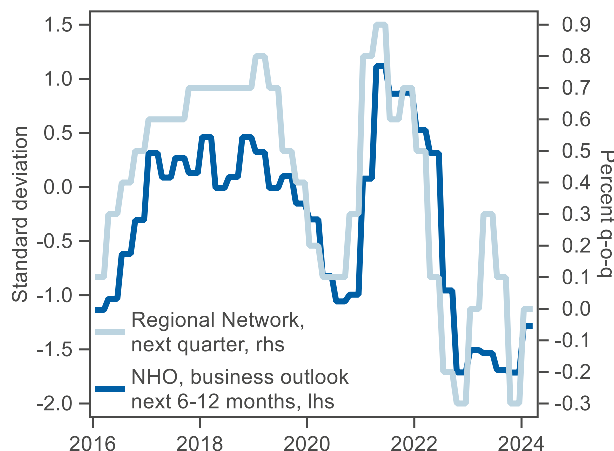
No rate cuts by Norges Bank until 2025

Downside risks to the economy have gradually dissipated, but growth remains below trend. Nonetheless, even though capacity pressures are easing, the core inflation rate remains sticky. This must be seen in the context of the weakening NOK exchange rate, which continues to feed through to elevated wages and thus domestic price inflation. Norges Bank will have to take this currency channel into further account, and we now believe that Norges Bank will defer making its initial interest rate cut until Q1 2025.

Downside risks are dissipating...

The mainland economy performed a little better than expected during the winter, and growth signals have also strengthened slightly. As shown in the chart below, near-term growth signals from Norges Bank's regional network have now improved to around zero percent q-o-q. However, the business outlook for the next six to twelve months is still negative, according to the Confederation of Norwegian Enterprise (NHO), but even here the deepest pessimism has started to lose some of its grip. We also note that the sectors that have been hit hardest by higher interest rates and inflation (i.e. construction and retail) have now revised their outlooks upwards. This is especially true for the retail sector, but at the margin, also for construction. All told, downside risks have continued to dissipate. Given also a stronger carry-over effect from 2023, a slightly more expansionary revised fiscal budget, we raise our estimate for mainland GDP to 0.8 percent this year, versus 0.1 percent previously. This is still well below trend, and implies that capacity pressures are easing further.

GDP: Downside risks dissipating

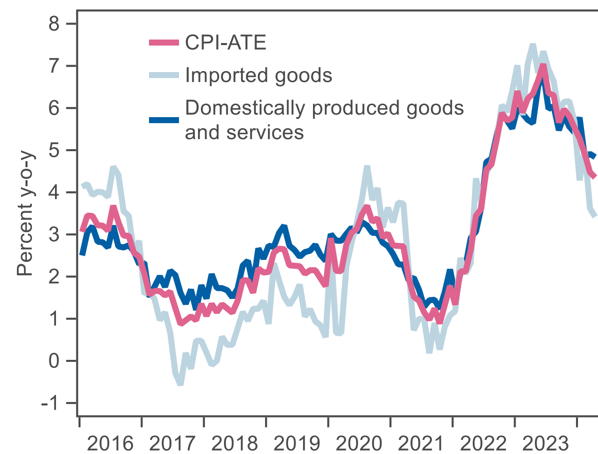


Sources: Macrobond and Handelsbanken

...and core inflation remains sticky

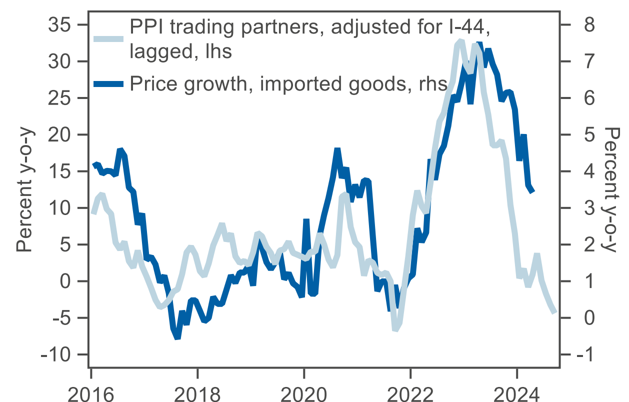
The key challenge is that core inflation remains sticky. While it is true that the CPI-ATE has fallen sharply recently, this has been driven by a steeper decline in price inflation for imported goods. Given the global disinflationary trend on the goods side, we expect to see a further decrease in imported price inflation ahead. Nonetheless, price inflation for domestically produced goods and services remains high, and the combination of elevated wage growth and meagre productivity will continue to put upward pressure on domestic prices.

CPI-ATE, by supplier sector



Sources: Macrobond and Handelsbanken

Imported price impulses

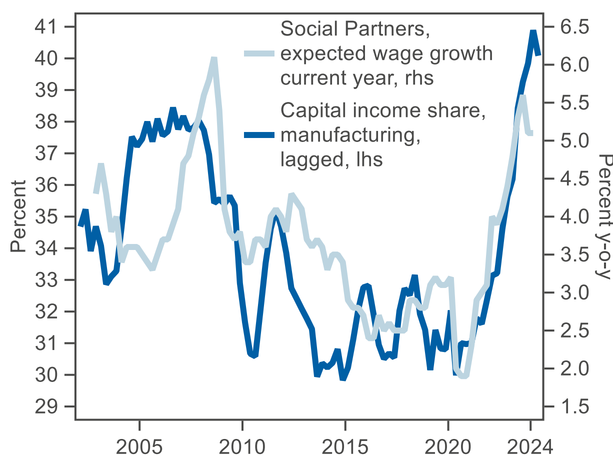


Note: PPI trading partners, after adjustment for changes in the krone exchange rate, versus imported goods price inflation
Sources: Macrobond and Handelsbanke

Contrary to Norway's peers, nominal wage growth has barely started to soften. The wage settlement for 2024 implies a target of 5.2 percent, which is just trivially below the actual outcome for 2023. This follows directly from the Norwegian model – 'frontfagsmodellen' – where the wage capacity in the

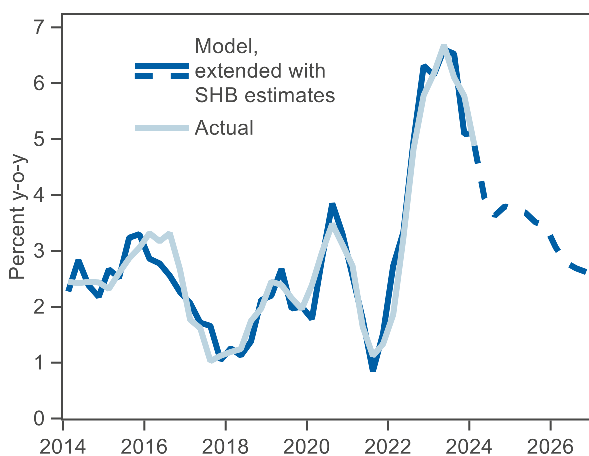
external sector (manufacturing) sets the bar for general wage formation. The idea behind the model is to keep the manufacturing income shares between labour and capital constant over time. The same wage growth should then spill over to the other sectors of the economy, regardless of the wage capacity, which suggests that prices will have to be adjusted in order to keep the respective income shares in balance. The key point is that the manufacturing sector has also seen a solid increase in its wage capacity over the past year, which – in line with the model – also serves to push wage growth upwards in 2024. With productivity growth running at around zero percent for the private sector, this indicates that general domestic inflationary impulses will remain strong. As a consequence, even though we have lowered our 2024 estimate for the CPI-ATE – following a sharper decline in imported inflation – we raise our medium-term outlook, and do not expect Norges Bank to hit its inflation target during our forecasting horizon.

Wage capacity in manufacturing vs expectations



Sources: Macrobond and Handelsbanken

CPI-ATE: Actual and expected



Sources: Macrobond and Handelsbanken

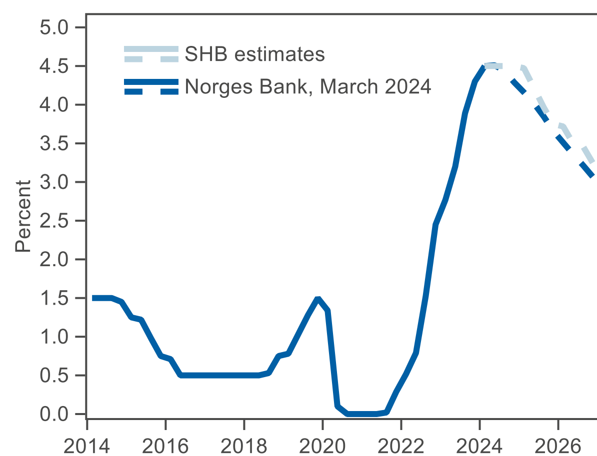
The mechanisms described above also illustrate Norges Bank's struggle with the weak NOK exchange rate. In other words, the increased wage capacity in the manufacturing sector – which pushes up overall wage growth, and thus inflation – must be viewed in context of a weaker currency, simply because it raises manufacturing selling prices measured in NOK.

No rate cuts until 2025

This leaves us with a conundrum. Even though Norges Bank has raised its policy rate more than 'everyone' expected, we now also note that since market expectations relating to Norges Bank have risen relative to Norway's trading partners, the NOK has continued to perform fairly poorly. Given this further increase in the risk premia, Norges Bank cannot allow itself to be deemed as 'soft on inflation,' as it could risk a further weakening of the NOK. The good news in this regard is that the economy appears to be coping better with current interest rates than previously assumed. Which allows Norges Bank to hold off from rate cuts for now, and be patient in bringing inflation down to target.

To summarise, given (1) delayed rate cuts across Norway's trading partners – the US in particular, (2) the increased risk premium in the NOK, (3) feeding into still-solid wage and thus inflationary pressures, we now believe that Norges Bank will delay its initial rate cut even further. Up until now, we had forecast an initial rate cut in December this year, but we now postpone our call to Q1 2025. The market is still leaning towards December, so if we are right, there is scope for some strengthening of the NOK ahead. We see the EUR/NOK at 11.60 over the next three to six months.

Expectations for Norges Bank's key policy rate



Sources: Macrobond and Handelsbanken

Finland

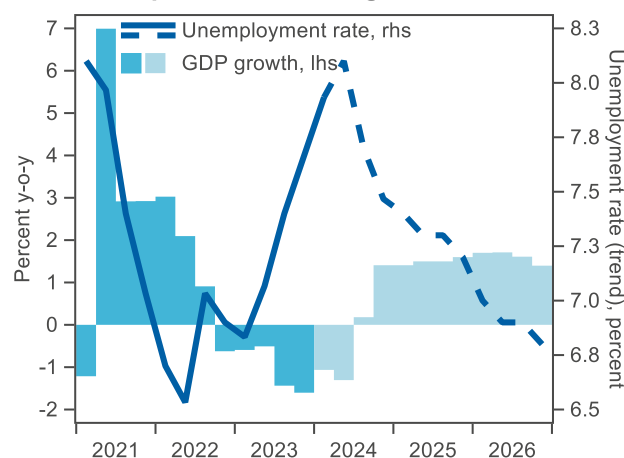
Better times ahead

As we headed into 2024, economic activity was subdued, politically motivated strikes were impacting industrial production and exports, and construction remained weak, while service fared better. Although we expect growth prospects to improve as the year progresses, we still forecast that GDP will shrink by 0.2 percent in 2024, but pick up to around 1.5 percent in 2025–26. We believe that private consumption, exports and investments will be the main growth drivers during our forecast period (2024–26) and that the unemployment rate will peak in 2024, declining thereafter. We expect the government's measures to consolidate public finances (including a 1.5 percentage point hike in the VAT tax rate) to have some impact on inflation and economic growth in 2024 and 2025. Overall, we believe that inflation will moderate below two percent by 2026.

Growth driven by services at start of year

Political strikes were a drag on industrial production and exports while a pause in the decline of short-term interest rates hampered the housing market and household consumption. However, according to the flash data, Q1 GDP increased by 0.5 percent since Q4 2023 led by services. The weak carryover from 2023 and the government's measures to improve general government finances underpin our forecast that GDP will decline by 0.2 percent in 2024. For 2025-26, however, we forecast around 1.5 percent in GDP growth.

Gradual improvement during 2024



Sources: Macrobond, Statistics Finland and Handelsbanken

External demand prospects to improve

Industrial production was quite sluggish in the first quarter, while strikes held back the pick-up in production. We note that new manufacturing orders declined between January and March and that manufacturing confidence remained subdued. On the positive side, external demand prospects have gradually improved in the key markets for Finnish exports. We expect that this improvement in the manufacturing business cycle will also be reflected in Finnish industry, leading to an increase in new orders and higher exports. The digitalisation trend continues to underpin the potential for growth in service exports although the latter has stagnated somewhat in recent years.

During the forecast period, export and import growth should normalise versus the large fluctuations seen in 2022–23. We forecast that exports will grow by 1.5 percent in 2024 and return to an average growth rate of over 3 percent in 2025–26. We expect imports to outgrow exports, hence the contribution from net exports will be negative. We believe that the current account will remain in deficit during our forecast period.

Modest growth in private consumption

Surprisingly, private consumption grew last year and we expect this development to continue in 2024. Although consumer sentiment is currently rather downbeat, we expect it to improve during the year as inflation comes down, wage increases exceed inflation causing an increase in real disposable income, and interest rates decline further. The labour market outlook is somewhat murky and we expect unemployment to increase slightly in the near term. In 2025, we forecast that employment will pick up as economic growth improves. We expect the government's 1.5 percentage point VAT hike (to be implemented in September 2024) to have a marginal effect on private consumption growth and forecast that private consumption will grow by 0.6 percent in 2024 and accelerate in 2025–26.

Strong growth in public investments

Weak development in construction investments paved the way for a decline in private investments in 2023. Soft and hard data for the early part of 2024 indicates that it will take some time before we see a pick-up in investments. We highlight that building permits are currently at the lowest level in almost 30 years. In 2024, we expect to see growth in investments in areas such as machinery and

equipment. Moreover, as interest rates decline and uncertainty around the economic outlook dissipates, we should see a gradual turnaround in investments on a broader basis.

We expect the recovery in construction investments to gain pace in 2025–26. We forecast that machine and equipment investments and other investments will also show solid growth thanks to the green transition, digitalisation and artificial intelligence investments. Furthermore, investments in security, border control and national defence, in particular the delivery of the new multirole fighter aircrafts from 2025, will significantly increase public investments during our forecast period. We believe that total investments will grow by 1.1 percent in 2024 and by around 4 percent in 2025–26. The marked increase in public investments should also accelerate total investments in 2024–25.

Housing market bottoming out

The housing market has been rather flat thus far in 2024.The pause in the decline of short-term market interest rates and economic uncertainty among households are the main reasons for the weak development in house sales and prices of old dwellings in housing companies. As inflation falls further and interest rates decline, we expect to see a gradual recovery in the housing market in 2024. However, we anticipate that the recovery will be quite slow and that the pace will vary across Finland. Due to weak January data carryover, we estimate that prices of old dwellings in housing companies will decline by 1.5 percent this year (monthly changes are expected to be positive between February-December). In 2025, however, we expect prices of old dwellings in housing companies to rise by 3 percent.

Inflation set to moderate further

Inflation slowed down at the beginning of this year and was 1.9 percent in April. The decline in inflation has been broad based − transport and food prices have moderated and lower interest rates have impacted inflation. However, the contribution of interest rates to CPI inflation is clearly higher than usual. In April, the contribution from interest rates on housing loans and consumer credit was 1.65 percentage points.

In terms of HICP inflation, Finland had the second lowest reading of inflation (0.6 percent) in the eurozone in April. Decline in energy prices is the main factor behind the low HICP inflation.

We expect inflation to moderate further this year. We believe that food prices will be under less pressure and that the price of electricity will moderate. Housing inflation should also subside as interest rates decline further. However, higher crude oil prices will keep some upward pressure on transport fuel prices. We note that wage increases underpin service inflation and the VAT tax hike (planned for September) will increase inflation in 2024 and 2025 if fully passed through to consumer prices. We forecast that inflation in Finland will slow down to 2.3 percent both in 2024 and 2025 before falling to 1.8 percent in 2026.

Sluggish labour market improving

Employment declined and unemployment increased in the first quarter of 2024. As a consequence, the trend rate of unemployment increased to 7.9 percent. In the first quarter, employment increased most in human health and social work activities and decreased most in construction and manufacturing over the past year. Currently, the business sector's employment expectations are quite low. We expect the unemployment rate to peak in the second quarter and then gradually decline as economic activity improves. We forecast that the unemployment rate will average 7.8 percent in 2024, 7.3 percent in 2025 and 6.8 percent in 2026.

Aiming to boost public finances

In its general government fiscal plan for 2025–28, Petteri Orpo's government outlined new measures designed to improve public finances. The government agreed on EUR 3bn in additional measures on top of the initially agreed EUR 6bn in its government programme. The new measures are split into spending cuts amounting to EUR 1.6bn and tax increases totalling EUR 1.4bn (primarily the VAT increase). With the implementation of these measures, Finland should be able to avoid the EU's excessive deficit procedure.

Sluggish economic activity in 2024 has taken its toll on tax accrual. However, as the business cycle improves, it should also help the tax intake and public finances. Thanks to these measures, we expect the deficit in public finances to shrink and the debt-to-GDP ratio to rise from 75.8 percent in 2023 to 79.0 percent in 2026.

Key figures

GDP

		Annual average		
	2023	**2024p**	**2025p**	**2026p**
Sweden*	0.0	0.4 (0.1)	2.8 (2.4)	2.4 (2.5)
Finland	-1.0	-0.2 (0.1)	1.5 (1.7)	1.6 (1.5)
Norway. mainland economy*	1.1	0.8 (0.1)	1.2 (1.4)	1.5 (1.8)
Eurozone	0.5	0.7 (0.4)	1.3 (1.3)	1.5 (1.7)
United Kingdom	0.1	0.6 (0.5)	1.4 (1.7)	1.5 (1.8)
United States*	2.5	2.5 (1.6)	1.8 (1.6)	1.6 (1.7)
China	5.2	5.0 (4.5)	4.5 (4.3)	4.2 (4.1)

*Calendar adjusted

Inflation

		Annual average		
	2023	**2024p**	**2025p**	**2026p**
Sweden. CPI	8.5	3.3 (3.5)	1.8 (2.0)	1.8 (2.0)
Sweden. CPIF	6.0	2.2 (2.3)	2.1 (2.0)	2.0 (2.1)
Finland	6.2	2.3 (2.2)	2.3 (1.9)	1.8 (2.0)
Norway. CPI	5.5	3.8 (4.2)	3.1 (2.6)	2.7 (2.3)
Norway. CPIATE	6.2	4.1 (4.6)	3.6 (3.2)	2.8 (2.3)
Eurozone	5.4	2.3 (2.5)	2.1 (2.0)	2.0 (2.0)
United Kingdom	7.3	2.7 (2.9)	2.3 (2.0)	2.2 (1.7)
United States. PCE Core	4.1	2.8 (2.5)	2.3 (2.2)	2.0 (2.0)

Unemployment

		Annual average		
	2023	**2024p**	**2025p**	**2026p**
Sweden	7.7	8.3 (8.2)	8.1 (8.1)	7.7 (7.8)
Finland	7.2	7.8 (7.6)	7.3 (7.2)	6.9 (6.8)
Norway*	1.8	2.0 (2.2)	2.2 (2.3)	2.2 (2.3)
Eurozone	6.5	6.7 (6.8)	6.7 (6.8)	6.5 (6.6)
United Kingdom	4.3	4.9 (5.0)	5.1 (5.4)	4.8 (5.2)
United States	3.6	3.9 (4.1)	4.1 (4.4)	4.2 (4.2)

Source: Handelsbanken *Registered unemployment NAV

In brackets: Handelsbanken Global Macro Forecast 24 January 2024

Exchange rate forecast	End of year			
	2023	2024p	2025p	2026p
EUR/SEK	11.10	11.35 (10.70)	10.90 (10.20)	10.60 (10.00)
USD/SEK	10.04	10.51 (9.47)	9.91 (8.79)	9.46 (8.51)
GBP/SEK	12.75	13.35 (12.59)	12.82 (12.00)	12.47 (11.76)
NOK/SEK	0.99	0.99 (0.96)	0.98 (0.94)	0.97 (0.93)
CHF/SEK	11.98	11.35 (10.92)	10.69 (10.30)	10.19 (10.00)
JPY/SEK	7.12	7.35(6.76)	7.23(6.42)	7.06(6.35)
CNY/SEK	1.42	1.46(1.35)	1.44(1.27)	1.41(1.27)
	2023	2024p	2025p	2026p
EUR/USD	1.11	1.08 (1.13)	1.10 (1.16)	1.12 (1.18)
USD/JPY	141.02	143.00 (140.00)	137.00 (137.00)	134.00 (134.00)
EUR/GBP	0.870	0.850 (0.850)	0.850 (0.850)	0.850 (0.850)
GBP/USD	1.27	1.27 (1.33)	1.29 (1.36)	1.32 (1.38)
EUR/CHF	0.93	1.00 (0.98)	1.02 (0.99)	1.04 (1.00)
USD/CNY	7.08	7.20 (7.00)	6.90 (6.90)	6.70 (6.70)
-	2023	2024p	2025p	2026p
EUR/NOK	11.24	11.50 (11.20)	11.15 (10.90)	10.95 (10.80)
SEK/NOK	1.01	1.01 (1.05)	1.02 (1.07)	1.03 (1.08)
USD/NOK	10.17	10.65 (9.91)	10.14 (9.40)	9.78 (9.19)
GBP/NOK	12.92	13.53 (13.18)	13.12 (12.82)	12.88 (12.71)
CHF/NOK	12.14	11.50 (11.43)	10.93 (11.01)	10.53 (10.80)
JPY/NOK	7.21	7.45 (7.08)	7.40 (6.86)	7.30 (6.86)

Source: Handelsbanken

In brackets: Handelsbanken Global Macro Forecast 24 January 2024

Interest rate forecast		End of year		
Policy rates	**2023**	**2024p**	**2025p**	**2026p**
United States	5.375	4.875 (4.375)	3.875 (2.875)	3.125(2.50)
Eurozone	4.00	3.25 (3.25)	2.25 (2.00)	2.00 (1.75)
Sweden	4.00	3.25 (3.25)	2.25 (2.25)	2.25 (2.25)
United Kingdom	5.25	4.75 (4.50)	4.00 (2.75)	3.00 (2.25)
Norway	4.50	4.50 (3.75)	3.75 (3.00)	3.25 (2.50)
Interbank rates	**2023**	**2024p**	**2025p**	**2026p**
United States. SOFR	5.59	5.04 (4.00)	4.04 (2.80)	3.08 (2.55)
Sweden. STIBOR	4.05	3.23 (3.23)	2.25 (2.25)	2.25 (2.25)
Euro Area. EURIBOR	3.91	3.30 (3.30)	2.30 (2.05)	2.05 (1.80)
Norway. NIBOR	4.73	4.85 (4.10)	4.00 (3.35)	3.50 (3(2.85)
2 year govt. bond yield	**2023**	**2024p**	**2025p**	**2026p**
United States	4.23	4.51 (3.38)	3.70 (2.82)	3.37 (2.74)
Eurozone (Germany)	2.38	2.65 (2.21)	1.98 (1.65)	1.96 (1.60)
Sweden	2.88	2.66 (2.39)	2.22 (2.11)	2.22 (2.12)
Finland	2.41	2.75 (2.15)	2.10 (1.60)	2.03 (1.65)
United Kingdom	3.98	4.00 (3.26)	3.86 (2.57)	3.77 (2.42)
Norway	3.54	4.10 (3.50)	3.70 (3.25)	3.30 (3(3.00)
5 year govt. bond yield	**2023**	**2024p**	**2025p**	**2026p**
United States	3.84	4.32 (3.37)	3.89 (3.12)	3.71 (3.08)
Eurozone (Germany)	1.93	2.40 (1.91)	2.13 (1.74)	2.15 (1.79)
Sweden	2.03	2.50 (2.41)	2.43 (2.31)	2.44 (2.34)
Finland	2.33	2.70 (2.20)	2.35 (2.00)	2.30 (2.10)
United Kingdom	4.62	4.09 (3.51)	4.08 (3.09)	4.09 (3.01)
Norway	3.23	3.80 (3.25)	3.60 (3.15)	3.60 (3.00)
10 year govt. bond yield	**2023**	**2024p**	**2025p**	**2026p**
United States	3.88	4.39 (3.65)	4.23 (3.50)	4.14 (3.46)
Eurozone (Germany)	2.02	2.50 (2.02)	2.42 (1.97)	2.44 (2.04)
Sweden	2.02	2.59 (2.63)	2.71 (2.60)	2.75 (2.65)
Finland	2.57	2.85 (2.55)	2.80 (2.40)	2.75 (2.50)
United Kingdom	3.60	4.18 (3.75)	4.29 (3.60)	4.40 (3.60)
Norway	3.24	3.80 (3.30)	3.70 (3.30)	3.60 (3.00)
2 year swap rate	**2023**	**2024p**	**2025p**	**2026p**
United States	4.07	4.39 (3.25)	3.55 (2.73)	3.18 (2.69)
Eurozone	2.80	3.00 (2.55)	2.30 (1.97)	2.26 (1.90)
Sweden	2.91	3.04 (2.72)	2.55 (2.42)	2.52 (2.42)
United Kingdom	4.28	4.47 (3.73)	4.33 (3.04)	4.24 (2.89)
Norway	3.95	4.30 (3.70)	3.90 (3.45)	3.50 (3.20)
5 year swap rate	**2023**	**2024p**	**2025p**	**2026p**
United States	3.53	4.04 (3.12)	3.60 (2.89)	3.41 (2.88)
Eurozone	2.43	2.73 (2.31)	2.43 (2.07)	2.41 (2.04)
Sweden	2.38	2.79 (2.72)	2.70 (2.59)	2.69 (2.59)
United Kingdom	4.98	4.39 (3.80)	4.37 (3.38)	4.38 (3.31)
Norway	3.43	4.00 (3.45)	3.80 (3.35)	3.80 (3.20)
10 year swap rate	**2023**	**2024p**	**2025p**	**2026p**
United States	3.47	4.00 (3.29)	3.84 (3.17)	3.74 (3.16)
Eurozone	2.49	2.74 (2.37)	2.64 (2.24)	2.64 (2.24)
Sweden	2.35	2.82 (2.90)	2.93 (2.84)	2.95 (2.85)
United Kingdom	3.54	4.30 (3.87)	4.41 (3.72)	4.52 (3.72)
Norway	3.33	4.00 (3.60)	3.90 (3.60)	3.80 (3.30)

Source: Handelsbanken

In brackets: Handelsbanken Global Macro Forecast 24 January 2024