

# Economic Outlook

January 2009





## Data overview

Key figures.....	6
Interest rates .....	7
Exchange rates .....	7

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## Nordic economies

■ <b>OVERVIEW</b> After winter comes spring.....	4
■ <b>DENMARK</b> Facing storm .....	8
■ <b>FINLAND</b> Sharp drop and moderate rise .....	11
■ <b>NORWAY</b> Stimuli dampen impact .....	14
■ <b>SWEDEN</b> There is hope after all! .....	17
■ <b>ICELAND</b> Entirely new order of the day after financial meltdown .....	20

## Major economies

■ <b>USA</b> Still going down, but the parachute is now open .....	21
■ <b>JAPAN</b> Economy in reverse .....	24
■ <b>EURO AREA</b> Headed for deep recession.....	26
■ <b>UK</b> Hangovers!.....	29
■ <b>SWITZERLAND</b> Economy sliding downhill .....	31

## Emerging Markets

■ <b>POLAND</b> Barely avoiding recession.....	32
■ <b>ESTONIA</b> Deep in recession .....	33
■ <b>LATVIA</b> Plunging deeper .....	34
■ <b>LITHUANIA</b> Recession just around the corner.....	35
■ <b>RUSSIA</b> In the midst of a financial crisis.....	36
■ <b>CHINA</b> Lowest growth since 1990.....	37
■ <b>INDIA</b> Reasons for optimism, but not in the near term.....	39
■ <b>BRAZIL</b> The good times lasted longer than in other places .....	40

## Commodities

■ <b>OIL</b> Supply cuts will eventually balance the fall in demand .....	41
■ <b>METALS AND PULP</b> Base metal prices continue to decline .....	42

## After winter comes spring

Since the September issue of *Economic Outlook* the economic situation has deteriorated dramatically. With Lehman Brothers' collapse on 15 September the financial markets froze completely, which contributed to an unprecedented meltdown of the global economy. For the first time since World War II all the major economies in the world have slid into recession at largely the same time, and the crisis made it quite clear that it was not possible for any country to decouple from the economic events in the US. The US recession, which started as early as at the beginning of 2008, spread like ripples in the water and now even countries such as China, India and Russia, which previously seemed able to escape recession, are hit by the downturn.

The financial market meltdown was reflected in the biggest stock market falls since the 1929 crash on Wall Street which unleashed the Great Depression of the 1930s. It has been discussed whether the current recession could evolve into a depression, but we emphasise that this is not our baseline scenario. Actually, we see light at the end of the tunnel and expect a gradual recovery of the world economy in H2 2009. However, it should be noted that unemployment will continue to rise well into 2010 and that a turnaround in the beleaguered housing and property markets is not imminent. Also the currently much tighter credit standards will dampen the strength of the upswing compared to previous economic recoveries in recent times.

### Record-low policy rates

The main reason why we expect a reversal as early as this year is the fast political response in most countries to counter the effects of the crisis. Monetary policy all over the world has been eased at a historically fast pace, and so far this has resulted in record-low interest rates in for instance China, the US and the UK. Incidentally, as a curiosity it could be mentioned that since the formation of the Bank of England in 1694 interest rates have never before been below 2%.

The increased room for manoeuvre in monetary policy is underpinned by nose-diving commodity prices. Until September last year accelerating inflation was the cause of deep concern at the central banks which saw the crisis coming, but still had to employ inflation targeting as the framework for their monetary policy decisions. Now the collapse of commodity prices will justify a clear focus on setting the economies back on firm ground. In many countries more rate cuts may therefore be in the pipeline for the months ahead. When there are no shots left in the central banks' lockers, some may decide to follow in the footsteps of the US Federal Reserve and carry out quantitative easing policies. In practice, this means that the central banks will run the printing press and buy bonds in the market to drive down interest rates.

On the other hand, monetary policy may also be tightened again relatively quickly once clear signs of a recovery emerge – perhaps even towards the end of this year. Consequently, over the forecast horizon we may see an end to quantitative easing and a renewed increase in central bank policy rates.

### Rescue packages and fiscal easing

Over the past months a whole batch of financial sector rescue packages has been introduced, and some countries led by the US have announced massive fiscal easing. Despite the strict fiscal policy requirements of the Maastricht treaty this also includes the EU as budget overshoots in case of a major economic downturn are allowed.

Note also that most of the packages aimed at kick-starting the global economy contain elements that support environmental policies. However, in times of crisis many companies will obviously try to avoid new investment in environmental technology. The reason is that it has become more difficult to raise capital and that the low energy prices make it more profitable to use energy based on fossil fuels.

The packages aimed at the troubled banking sector reduce the risk of an actual collapse of the financial sector and of households and companies being caught in a credit squeeze. However, it should be emphasised that these packages constitute a necessary but not sufficient precondition for preventing a credit crunch. Government capital injections will therefore not ease the now overall much tighter credit standards in many countries, but they will obviously contribute to preventing a cutback in lending solely due to sudden solvency problems.

### Nose-diving commodity prices

Lastly, the past few months' sharp drop in commodity prices provides a boost to household purchasing power and reduces corporate costs. This also supports our expectations of a reversal in H2 2009. In 2008 oil prices peaked at around USD 150/barrel, but now prices are down at around USD 40/barrel. This unprecedented sharp fall is mainly attributable to declining demand for oil in the wake of the global economic slowdown, but the steepness of the fall also illustrates that oil and other commodities in general have been subject to significant speculative demand. Longer term, we expect oil prices to rise again driven by further output trimming. Still, over the forecast horizon prices are nowhere near the USD 100/barrel mark in our baseline scenario.

But the sharp drop in commodity prices may also jeopardise the economic progress of commodity-producing countries, which over the past few years have benefited from a strong economic boom and a significant increase in their currency reserves.

### Wild currency swings

During the spring the currency market saw wide exchange rate fluctuations. The USD strengthened markedly over the summer from some 1.60 versus the EUR to 1.25 in mid-November. At the time of writing EUR/USD is trading around 1.35. We look for a gradual appreciation of the USD over the forecast period to around 1.15. However, as long as the uncertainty about economic developments remains pronounced, the cross will likely also fluctuate sharply in the period ahead. Other currencies have also been subject to wild swings. The JPY and the CHF have strengthened dramatically versus the EUR, while the GBP, the NOK, the SEK and a string of EM currencies have weakened markedly. In step with the gradual, though slow, return of risk appetite in the financial markets we expect renewed weakening of the traditional funding currencies, while the high-yield currencies may strengthen again.

### Government yields about to bottom out

Also developments in the fixed income markets have been quite dramatic, to put it mildly. Government bond yields have declined to new record lows, while spreads to credit bonds have widened in tandem with investors' flight to safety. US 10-year Treasury yields dropped as low as 2% over the turn of the year, but have since edged up slightly. In our view government bond yields are about to bottom out despite continued low inflation (periodic negative inflation) and overall weak economic indicators in the coming period. Later in the forecast period when the economy recovers and risk appetite slowly returns, yields will gradually rise. However, there is a risk that the severe deterioration of US public finances could trigger somewhat higher long yields than currently assumed in our forecast. Also, a very sharp pick-up in yields in the event of a strong increase in financial market risk appetite cannot be ruled out.

### Nordic downturn

The outlook for the **Danish** economy has worsened significantly. The reason is partly the downturn in several important export markets and partly the more direct effect of tighter credit standards on investment. In our new forecast for 2009 we expect Denmark to experience the steepest drop in economic activity since the oil crisis in the first half of the 1970s. In 2010 growth will gradually resume, but unemployment will continue to rise and likely reach almost 5% over the next two years. On the other hand, inflation is projected to be considerably lower in the years ahead and the current account surplus will be somewhat higher. Public finances now look set to slide into deficit, but there will still be room for economic policy easing if the economic slowdown in Denmark turns out to be unexpectedly severe.

Momentum in the **Finnish** economy slowed sharply in 2008. GDP continued to grow until the autumn, but during the winter the steep downturn in the export markets will send the Finnish economy into recession. After sev-

eral years of substantial growth, the economy will hardly grow at all over the next couple of years on average. Unemployment will naturally increase quite markedly, even though the labour force will shrink exceptionally as a large number of people will retire. The actual contraction phase will probably be over in the summer and then the economy will start to recover gradually, albeit so slowly that the labour market will not rebound during the forecast period.

The **Norwegian** economy is facing lean years following a tremendous boom. Exports will be squeezed due to the international recession and at the same time Norges Bank's survey of banks' credit standards indicates that a relatively sharp tightening is underway. Pessimism among consumers and businesses has also grown noticeably. The correction of imbalances in the Norwegian economy (low consumer savings, high level of residential and non-residential construction) will thus be much stronger than expected early last autumn. Sharp rate cuts, NOK weakness and a more expansionary fiscal policy will to some extent alleviate the adverse effects, but will not entirely offset these. We have therefore markedly revised down our growth forecasts since the September issue of *Economic Outlook*.

After showing a weak trend in early 2008 the **Swedish** economy hit the wall in H2 2008. Particularly exports have declined significantly, but also activity in the domestic economy has become more subdued. Uncertainties are rife. There is a risk that weak demand at home and abroad, tighter credit standards and declining employment will trigger a vicious spiral that will dramatically slow down Swedish economic activity.

However, there are factors that will mitigate the downturn and eventually help break the negative trend. An expansionary fiscal and monetary policy, rapidly declining inflation and weak SEK will support the economy and create the foundation for a gradual recovery over time. Particularly the Riksbank's aggressive rate cuts have lowered mortgage rates and thus eased the interest burden for households.

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**Growth, %**

	2006	2007	2008E	2009E	2010E
World <sup>1)</sup>	5.4	5.1	3.4	0.6	2.9
BIG-3 <sup>2)</sup>	2.7	2.3	0.9	-1.6	0.9
USA	2.8	2.0	1.2	-1.7	0.7
Japan	2.0	2.4	-0.1	-1.9	1.2
Euro area	3.0	2.6	0.9	-1.3	1.0
Germany	3.2	2.6	1.0	-1.5	0.9
France	2.4	2.1	0.9	-1.0	1.1
Italy	1.9	1.4	-0.4	-1.3	0.9
Spain	3.9	3.8	1.2	-2.3	0.0
Netherlands	3.0	3.5	2.0	-0.8	1.0
Belgium	3.0	2.6	1.5	-1.1	1.1
Austria	3.4	3.1	1.5	-1.5	1.5
Portugal	1.4	1.9	0.5	-1.6	0.5
Greece	4.5	4.0	3.0	0.7	2.0
Finland	4.9	4.5	1.5	-1.3	1.5
Ireland	7.1	6.3	-2.0	-3.3	0.0
Denmark	3.3	1.6	-0.7	-1.0	0.2
Sweden	4.2	2.5	0.7	-1.5	1.3
Norway	4.8	6.2	2.2	-0.1	1.7
Iceland	4.4	4.9	0.1	-11.9	-0.2
UK	2.9	3.1	0.8	-2.0	1.0
Switzerland	3.4	3.3	1.7	-0.5	0.8
Russia	7.4	8.1	6.0	1.0	2.5
Poland	6.2	6.7	5.0	0.9	2.6
Estonia	10.4	6.3	-2.2	-4.5	-1.0
Latvia	12.2	10.3	-1.8	-6.0	-2.0
Lithuania	7.8	8.9	3.3	-3.0	-0.5
China	11.6	11.9	9.2	6.7	8.4
India	9.7	8.9	7.2	5.2	6.3
Brazil	3.9	5.7	5.8	2.0	3.3

1) Weighted average of countries in this table. Accounts for 72,0% of world GDP. Weights calculated using PPP adjusted GDP levels for 2005 according to the IMF's World Economic Outlook

2) US, Japan and the Euro area

**Inflation, %**

	2006	2007	2008E	2009E	2010E
World	4.0	3.6	5.3	2.2	2.9
BIG-3	2.4	2.2	3.2	0.7	1.6
USA	3.2	2.9	3.7	1.0	2.0
Japan	0.2	0.1	1.5	0.0	0.5
Euro area	2.2	2.1	3.3	0.5	1.5
Germany	1.8	2.3	2.8	0.5	1.3
France	1.9	1.6	3.2	0.2	1.4
Italy	2.2	2.0	3.3	0.6	1.6
Spain	3.6	2.8	4.2	0.6	1.5
Netherlands	1.7	1.6	2.2	0.7	1.6
Belgium	2.3	1.8	4.5	0.4	1.5
Austria	1.7	2.1	3.2	0.5	1.4
Portugal	3.0	2.5	2.8	0.7	1.5
Greece	3.3	3.0	4.3	2.0	2.5
Finland	1.6	2.5	4.1	0.8	1.3
Ireland	2.7	2.9	3.1	0.5	1.6
Denmark	2.1	1.9	3.4	1.2	2.2
Sweden	1.4	2.2	3.4	-0.1	1.1
Norway	2.3	0.8	3.8	1.6	2.5
Iceland	6.7	5.1	13.2	12.1	4.5
UK	2.1	2.3	3.5	0.4	2.3
Switzerland	1.1	0.7	2.5	0.5	1.0
Russia	9.7	9.0	14.2	10.0	8.0
Poland	1.2	2.6	4.4	1.7	2.3
Estonia	4.4	6.7	10.4	4.5	3.0
Latvia	6.6	10.1	15.6	7.0	4.0
Lithuania	3.8	5.8	11.0	6.0	3.5
China	1.5	4.8	6.4	1.5	3.0
India	4.8	4.8	9.0	3.7	4.0
Brazil	4.2	3.6	5.8	5.5	4.5

**Public finances, % of GDP**

	2006	2007	2008E	2009E	2010E
BIG-3	-1.8	-1.2	-2.7	-6.6	-4.4
USA	-1.9	-1.2	-3.2	-9.8	-5.5
Japan	-2.9	-2.8	-4.5	-5.0	-4.0
Euro area	-1.3	-0.6	-1.2	-3.0	-3.2
Germany	-1.5	-0.2	0.2	-2.5	-2.7
France	-2.4	-2.7	-3.0	-4.0	-4.0
Italy	-3.4	-1.6	-2.5	-3.7	-4.0
Finland	4.1	5.3	4.5	1.5	1.0
Denmark	4.8	4.5	3.1	-0.5	-1.5
Sweden	2.4	3.7	2.3	-1.4	-2.9
Norway	18.5	17.7	22.1	13.5	19.3
Iceland	6.3	5.5	-0.2	-13.5	-10.5
UK	-3.6	-2.9	-3.8	-6.5	-5.5
Switzerland	1.9	1.3	0.6	-1.0	-1.2
Russia	7.5	5.5	6.5	-2.0	-3.0
Poland	-3.8	-2.0	-2.7	-2.7	-2.5
Estonia	2.9	2.7	-1.5	-3.0	-2.5
Latvia	-0.2	0.1	-3.0	-6.0	-5.5
Lithuania	-0.4	-1.2	-2.5	-3.5	-4.0
China	-0.8	0.6	-1.0	-1.5	-1.5
India	-6.7	-5.6	-5.3	-6.0	-5.0
Brazil	-3.0	-2.3	-1.4	-1.9	-1.6

**Current account, % of GDP**

	2006	2007	2008E	2009E	2010E
BIG-3	-	-	-	-	-
USA	-6.0	-5.3	-4.5	-2.8	-2.8
Japan	3.9	4.8	3.2	2.1	2.2
Euro area	0.0	0.3	-0.5	-0.2	-0.1
Germany	6.1	7.6	7.0	6.2	6.2
France	-0.7	-1.2	-1.9	-2.0	-1.6
Italy	-2.6	-2.4	-3.0	-2.7	-2.5
Finland	4.5	4.1	2.9	3.4	3.9
Denmark	2.9	0.7	1.8	1.7	2.0
Sweden	8.5	8.4	7.0	6.5	6.4
Norway	17.3	15.4	17.2	8.9	15.0
Iceland	-25.5	-14.6	-18.2	3.4	5.4
UK	-2.5	-3.7	-3.1	-2.5	-2.2
Switzerland	14.7	16.8	17.0	16.2	16.3
Russia	9.5	5.8	6.0	-3.0	-2.5
Poland	-2.7	-4.7	-4.8	-5.2	-4.8
Estonia	-17.0	-18.5	-11.0	-7.5	-6.0
Latvia	-22.5	-22.9	-14.0	-8.0	-7.0
Lithuania	-10.4	-15.1	-13.0	-7.0	-6.0
China	9.4	11.3	9.0	8.5	9.5
India	-1.3	-1.0	-2.5	-3.2	-3.4
Brazil	1.3	0.1	-1.8	-1.9	-1.5

**Monetary policy rates**

	15.1.09	3M	6M	12M	24M
US	0.25	0.25	0.25	0.75	2.50
Japan	0.50	0.10	0.10	0.10	0.50
Euro area	2.50	1.50	1.50	1.50	2.50
Denmark	3.75	2.25	2.00	1.75	2.75
Sweden	2.00	1.25	1.00	1.00	1.50
Norway	3.00	2.25	2.00	2.00	3.50
UK	1.50	1.00	1.00	1.00	2.50
Switzerland	0.50	0.30	0.30	0.30	1.00
Poland	5.00	3.75	3.75	4.00	4.50
Czech Rep.	2.25	1.00	1.00	1.50	2.00
Hungary	10.00	8.50	7.00	5.00	5.00

**3-month rates**

	15.1.09	3M	6M	12M	24M
US	1.08	0.95	0.70	1.35	3.00
Japan	0.75	0.60	0.50	0.50	0.70
Euro area	2.57	2.10	2.00	2.00	2.80
Denmark	4.76	3.25	2.60	2.30	3.05
Sweden	2.23	1.60	1.35	1.35	1.85
Norway	3.47	2.85	2.50	2.25	3.75
UK	2.28	1.80	1.60	1.60	2.80
Switzerland	0.56	0.45	0.40	0.40	1.20
Poland	5.65	4.50	4.25	4.40	4.80
Czech Rep.	3.32	2.00	1.70	1.90	2.30
Hungary	9.89	8.25	6.90	5.40	5.30
Estonia	7.43	6.20	5.70	5.50	5.80
Latvia	12.64	11.00	9.00	8.00	8.00
Lithuania	8.52	6.50	6.00	5.50	5.80

**10-year government benchmark yields**

	15.1.09	3M	6M	12M	24M
US	2.17	2.50	3.00	3.50	4.50
Japan	1.21	1.40	1.60	1.80	2.10
Euro area	2.90	3.20	3.40	3.80	4.30
Denmark	3.27	3.55	3.70	4.05	4.40
Sweden	2.75	2.80	3.00	3.60	4.20
Norway	3.59	3.90	4.00	4.40	5.00
UK	3.12	3.35	3.70	4.20	4.60
Switzerland	2.15	2.30	2.40	2.80	3.10
Poland	5.34	5.00	5.10	5.40	5.75
Czech Rep.	3.97	4.00	4.10	4.40	5.00
Hungary	9.05	8.00	7.00	6.00	6.00

**Exchange rates vs EUR**

	15.1.09	3M	6M	12M	24M
EUR/USD	1.316	1.350	1.300	1.200	1.150
EUR/JPY	116.8	115.0	122.0	125.0	130.0
EUR/DKK	7.451	7.460	7.460	7.460	7.460
EUR/SEK	11.134	10.400	10.000	9.500	9.200
EUR/NOK	9.565	9.200	8.700	8.200	7.900
EUR/GBP	0.900	0.880	0.860	0.840	0.800
EUR/CHF	1.469	1.480	1.500	1.520	1.550
EUR/PLN	4.233	3.900	3.850	3.750	3.500
EUR/CZK	27.22	26.00	25.75	25.50	25.00
EUR/HUF	280.6	265.0	255.0	245.0	240.0
EUR/RUB	42.74	46.64	47.06	45.84	40.80
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.704	0.700	0.700	0.700	0.700
EUR/LTL	3.453	3.453	3.453	3.453	3.453
EUR/CNY	8.994	9.248	8.905	8.100	7.648

**Monetary policy rate spreads vs Euro area**

	15.1.09	3M	6M	12M	24M
US	-2.25	-1.25	-1.25	-0.75	0.00
Japan <sup>1)</sup>	0.25	-0.15	-0.15	-0.65	-2.00
Euro area	-	-	-	-	-
Denmark	1.25	0.75	0.50	0.25	0.25
Sweden	-0.50	-0.25	-0.50	-0.50	-1.00
Norway	0.50	0.75	0.50	0.50	1.00
UK	-1.00	-0.50	-0.50	-0.50	0.00
Switzerland	-2.00	-1.20	-1.20	-1.20	-1.50
Poland	2.50	2.25	2.25	2.50	2.00
Czech Rep.	-0.25	-0.50	-0.50	0.00	-0.50
Hungary	7.50	7.00	5.50	3.50	2.50

1) Spread vs US

**3-month spreads vs Euro area**

	15.1.09	3M	6M	12M	24M
US	-1.49	-1.15	-1.30	-0.65	0.20
Japan <sup>1)</sup>	-0.33	-0.35	-0.20	-0.85	-2.30
Euro area	-	-	-	-	-
Denmark	2.19	1.15	0.60	0.30	0.25
Sweden	-0.34	-0.50	-0.65	-0.65	-0.95
Norway	0.90	0.75	0.50	0.25	0.95
UK	-0.30	-0.30	-0.40	-0.40	0.00
Switzerland	-2.01	-1.65	-1.60	-1.60	-1.60
Poland	3.08	2.40	2.25	2.40	2.00
Czech Rep.	0.75	-0.10	-0.30	-0.10	-0.50
Hungary	7.32	6.15	4.90	3.40	2.50
Estonia	4.86	4.10	3.70	3.50	3.00
Latvia	10.07	8.90	7.00	6.00	5.20
Lithuania	5.95	4.40	4.00	3.50	3.00

1) Spread vs US

**10-year yield spreads vs Euro area**

	15.1.09	3M	6M	12M	24M
US	-0.73	-0.70	-0.40	-0.30	0.20
Japan <sup>1)</sup>	-0.96	-1.10	-1.40	-1.70	-2.40
Euro area	-	-	-	-	-
Denmark	0.37	0.35	0.30	0.25	0.10
Sweden	-0.15	-0.40	-0.40	-0.20	-0.10
Norway	0.69	0.70	0.60	0.60	0.70
UK	0.22	0.15	0.30	0.40	0.30
Switzerland	-0.75	-0.90	-1.00	-1.00	-1.20
Poland	2.44	1.80	1.70	1.60	1.45
Czech Rep.	1.07	0.80	0.70	0.60	0.70
Hungary	6.15	4.80	3.60	2.20	1.70

1) Spread vs US

**Exchange rates vs USD**

	15.1.09	3M	6M	12M	24M
-	-	-	-	-	-
USD/JPY	88.8	85.2	93.8	104.2	113.0
USD/DKK	5.664	5.526	5.738	6.217	6.487
USD/SEK	8.463	7.704	7.692	7.917	8.000
USD/NOK	7.270	6.815	6.692	6.833	6.870
GBP/USD	1.461	1.534	1.512	1.429	1.438
USD/CHF	1.117	1.096	1.154	1.267	1.348
USD/PLN	3.217	2.889	2.962	3.125	3.043
USD/CZK	20.69	19.26	19.81	21.25	21.74
USD/HUF	213.2	196.3	196.2	204.2	208.7
USD/RUB	32.49	34.55	36.20	38.20	35.48
USD/EEK	11.89	11.59	12.04	13.04	13.61
USD/LVL	0.535	0.519	0.538	0.583	0.609
USD/LTL	2.625	2.558	2.656	2.878	3.003
USD/CNY	6.837	6.850	6.850	6.750	6.650

## Facing storm

- Sharpest drop in economic activity in several years
- Risk of sharp acceleration in unemployment
- Lower inflation and taxes stabilise spending

The outlook for the Danish economy has worsened significantly. The reason is partly the downturn in several important export markets and partly the more direct effect of tighter credit standards on investment. In our new forecast for 2009 we expect Denmark to experience the steepest drop in economic activity since the oil crisis in the first half of the 1970s. In 2010 growth will gradually resume, but unemployment will still continue to rise and likely reach almost 5% over the next two years. On the other hand, inflation is projected to be considerably lower in the years ahead and the current account surplus will be somewhat higher. Public finances now look set to slide into deficit, but there will still be room for economic policy easing if the economic slowdown in Denmark turns out to be unexpectedly severe. Given that the financial crisis has reached a scale that statistically only occurs once every century, this risk is definitely present. However, falling commodity prices, lower interest rates and tax cuts constitute stabilising factors that will prevent any permanent damage from the somewhat hard landing for the Danish economy.

### Financial crisis hits exports and investment

It has long been obvious that 2009 will mark a low point for the Danish economy in terms of growth. The chief reason is the past two years' downturn in the housing market, which dampens construction and private consumption. However, the unexpected worsening of the credit crisis since mid-September has practically sent the outlook for the Danish economy into a tailspin. Follow-

ing the disastrous development in the financial markets, growth prospects for several of Denmark's key export markets such as the UK, Sweden and Germany have deteriorated drastically. In addition, the sharp depreciation of the SEK, GBP and NOK has eroded Danish companies' competitiveness through a significantly strengthened trade-weighted DKK exchange rate. Both these factors will of course hurt Danish exports and investment activity. We expect the SEK, GBP and NOK to firm somewhat later in the forecast period, which coupled with a stronger USD will help recover some of the lost ground and trigger renewed export growth.

The credit crisis has also dealt the Danish economy a more direct blow. In the autumn the central bank thus had to widen the interest rate differential versus the European Central Bank (ECB) from 35 bp to 175 bp. The central bank has subsequently narrowed the interest rate differential to 125 bp. At the same time, intra-bank lending risk premiums rose markedly and mortgage bond yield spreads widened sharply versus government bonds. In response, the government and the central bank have implemented a string of stabilising measures aimed at banks and pension funds, which to some extent have helped reduce risk premiums again. Still, the strong turbulence in the financial markets during the autumn has no doubt exacerbated the downturn in the housing market and caused a sharp decline in non-residential construction.

### Risk of sharply accelerating unemployment

Although the economy started to slow down as early as the beginning of 2007, employment continued to rise, resulting in a substantial drop in productivity over the past two years. This productivity drop heightens the risk

### Denmark: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (DKKbn)	2006	2007	2008E	2009E	2010E
Private consumption	760	4.4	2.4	0.8	0.2	1.2
Government consumption	401	2.1	1.3	1.1	1.8	1.5
Fixed investment	307	13.3	3.1	-1.5	-5.9	-4.5
- government investment	27	16.5	-10.0	-3.7	6.0	9.0
- residential investment	93	11.2	4.8	-4.5	-11.3	-9.7
- business fixed investment	187	13.2	4.4	0.3	-5.0	-3.5
Stockbuilding*	4	-0.3	-0.3	-0.3	0.0	0.2
Exports	762	9.1	2.2	3.2	-0.5	3.4
Imports	685	13.9	2.8	5.5	-0.1	2.0
GDP		3.3	1.6	-0.7	-1.0	0.2
Nominal GDP (DKKbn)	1,548	1,628	1,687	1,733	1,737	1,779
Unemployment rate, %		3.8	2.7	1.8	2.8	4.3
Unemployment level, '000 persons		109.1	77.6	50.0	78.0	118.0
Consumer prices, % y/y		2.1	1.9	3.4	1.2	2.2
Hourly earnings, % y/y		3.1	3.9	4.6	4.4	3.8
House prices, one-family, % y/y		21.6	4.5	-4.0	-7.0	-3.0
Current account (DKKbn)		47.0	12.0	32.0	30.0	35.0
- % of GDP		2.9	0.7	1.8	1.7	2.0
General govt. budget balance (DKKbn)		79.4	75.6	53.0	-8.0	-26.0
- % of GDP		4.8	4.5	3.1	-0.5	-1.5
Gross public debt, % of GDP		30.4	26.2	30.5	28.5	27.0

\* Contribution to GDP growth (% points)

of a quite rapid decline in employment over the forecast period. The contraction in employment is expected to mainly hit the construction sector, which has experienced activity levels much higher than the historical average in recent years. In addition to the cyclical downturn in employment a structural shift from construction to other industry groups will also be needed. Empirical evidence suggests that a structural shift of this nature will temporarily increase unemployment. However, the overall rise in unemployment will not quite match the drop in employment due to a demographic contraction of the labour force. In our baseline scenario we look for an unemployment rate of almost 5% or 135,000 persons by the end of 2010. Unemployment will thus have reached a sufficiently high level to seriously start dampening wage growth.

### Helping hand for households

The financial crisis has also offered some positive side effects. Commodity prices have fallen sharply, for example. This has had a direct positive influence on household finances via a drop in the prices of petrol, electricity and heating. And the surge in food prices is almost over, although there is little likelihood of outright price declines on this front. Moreover, this year households will benefit from tax cuts of about DKK 9bn or about 1.2% of disposable income. Hence, combined with the agreed wage increases of about 4%, households' real disposable income should improve significantly. The drop in employment will of course pull in the opposite direction, but the social security network will to some degree reduce the income losses.

All in all, there is still a chance of a moderate increase in private consumption this year, although the ailing housing market and the stock market slide suggest a considerable increase in household savings. We do not think that the expected monetary policy easing will have a positive effect on private consumption until 2010, and the lower interest rates can hardly prevent a further increase in household savings. On the other hand, lower interest rates will help to stabilise the situation in the housing market. The reason is that the combination of nominal price declines of an additional 10% and rising disposable incomes will most likely significantly reduce the mortgage burden<sup>1</sup>, and gradually lift the number of home sales to a more normal level.

### Inflation down – and the current account up

The decline in commodity prices has already significantly lowered inflation from the peak of 4.4% in August 2008. This trend will continue until the summer when inflation is expected to be as low as around 1.0%. However, adjusted for energy and food, inflation will decline only gradually in step with the slowing activity.

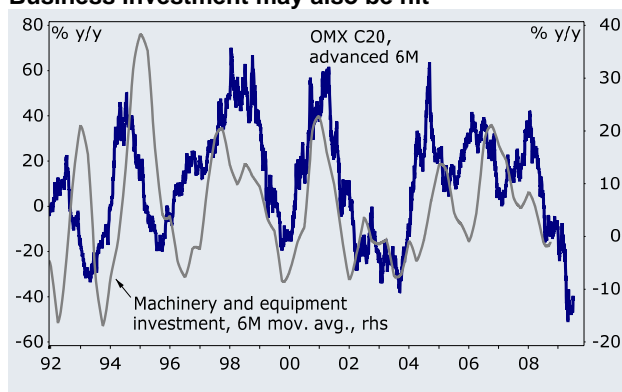
<sup>1</sup> The mortgage burden measures the post-tax share of disposable income that a first-time buyer needs to buy an average home financed through a 30-year fixed-rate loan.

### Financial crisis hits Denmark via exports



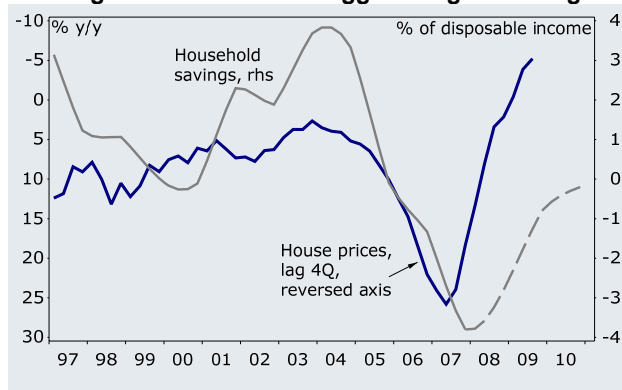
Source: Statistics Denmark and own calculations.

### Business investment may also be hit



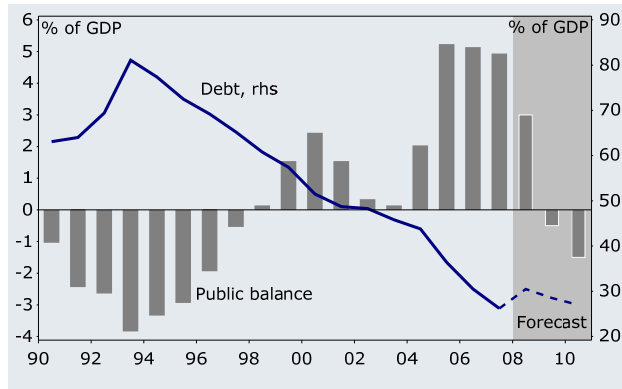
Source: Statistics Denmark and Reuters Ecowin.

### Housing market downturn suggests higher savings



Source: The Association of Danish Mortgage Banks, Statistics Denmark and own calculations.

### Public finances look set to slide into deficit



Source: The Ministry of Finance, Statistics Denmark and own calculations.

We therefore expect headline inflation to edge higher again when the effect of the lower commodity prices drops out of the price index during the autumn.

Despite the none too bright outlook for Danish exports we expect a noticeable increase in the current account surplus. The surplus thus looks set to be considerably larger in 2008 compared to the year earlier. However, the chief reason is a steep increase in the surplus in relation to wage and dividend payments, which were very low in 2007. Going forward, weak import trends will be the main contributor to the current account surplus increase, while the lower oil prices and a decline in freight rates will reduce the surplus on Denmark's trade in energy and net income from sea transport.

**Tax reform may be underfinanced**

The all-important item on the government's political agenda in the spring of 2009 is expected to be a tax reform negotiated on the basis of a proposal from the government's tax commission. The commission has been charged with the task of proposing a tax reform aimed at significantly easing the tax burden on labour. The reform must also support the government's ambitions in relation to energy and the climate, socially balanced and financially viable. Despite these goals we still consider it possible that the reform will be underfinanced at its implementation in 2010, to halt the rise in unemployment. In our opinion, this will still be feasible in spite of the likelihood of a budget deficit in the coming years.

**Narrowing of interest rate gap versus the ECB**

The pressure on the DKK and widening of the interest rate differential between the Danish central bank and the ECB have rekindled the political debate on Denmark's EUR opt-out. But we do not expect a possible EMU referendum until the autumn of 2009, with EMU entry from 1 January 2011 at the earliest in case of a Yes vote. However, if the outcome is a No vote, it will not change Denmark's long-standing policy of a fixed exchange rate within the ERM-II framework. Otherwise we expect the central bank to continue to narrow the interest rate differential versus the ECB during 2009. The exact timing depends on the currency inflow to the central bank. However, judging from the bank's moves last autumn, it will not hesitate to sanction a unilateral rate hike in case of renewed pressure on the DKK. At the long end of the yield curve, the turmoil in the financial markets has caused the Danish-German yield spread to widen. This spread will probably also narrow again once the markets start to calm down.

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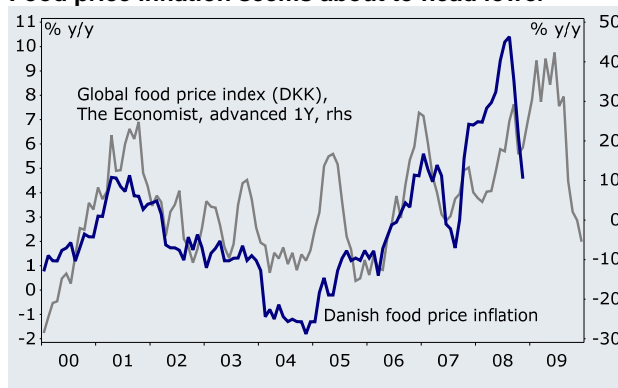
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**Tax cuts boost disposable income next year**

	2008	2009
Earned income tax credit	3.9	0.3
Higher threshold for taxable income	0.7	1.2
Higher threshold for median tax	0.0	3.9
Municipal taxes	-2.0	0.0
Compensatory tax cut	0.0	4.0
Total tax cut	2.6	9.4
In percent of disposable income	0.3	1.2

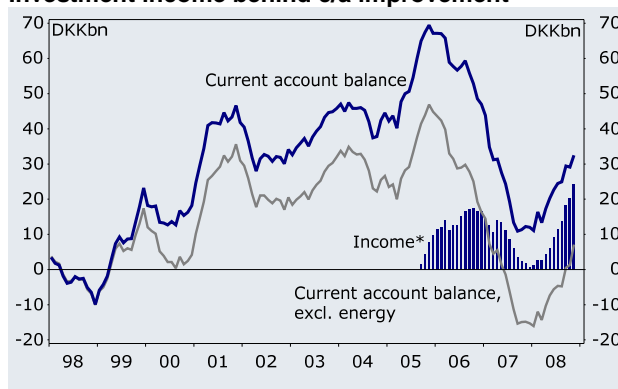
Source: The Ministry of Finance.

**Food price inflation seems about to head lower**



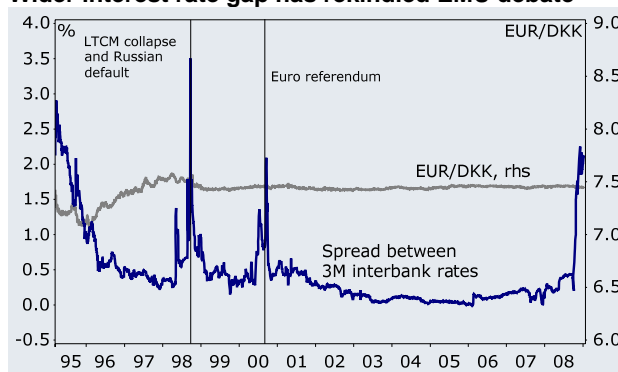
Source: Statistics Denmark and The Economist.

**Investment income behind c/a improvement**



Note: 12-month sum; \* only from 2005. Source: Statistics Denmark and own calculations.

**Wider interest rate gap has rekindled EMU debate**



Source: The Association of Danish Mortgage Banks and own calculations.

## Sharp drop and moderate rise

- The economy will contract strongly during winter ...
- ... but start to rebound in the summer
- Unemployment will continue to rise in 2010, though
- Consumer prices to decline temporarily

Momentum in the Finnish economy slowed sharply in 2008. GDP continued to grow until the autumn, but during the winter the steep downturn in the export markets will send the Finnish economy into recession. After several years of substantial growth, the economy will hardly grow at all over the next couple of years on average. Unemployment will naturally increase quite markedly, even though the labour force will shrink exceptionally as a large number of people will retire.

The economy is in the midst of a severe decline this winter. The actual contraction phase will probably be over in the summer and then the economy will start to recover gradually, albeit so slowly that the labour market will not rebound during the forecast period.

In the near future the risks continue to be on the downside. So far, there are few signs of the economy picking up in the summer. The conditions for a rebound are forming quickly, though. Inflation will be falling and will drop below 1% in 2009. Real wages will increase exceptionally strongly, interest rates will fall at a record-breaking pace and the economy will be revitalised in a number of ways. Consequently, there is light at the end of the tunnel, even though it looks distant at the moment.

### Record-steep decline in exports

The outlook for the export market deteriorated quickly in the autumn when Emerging Markets, which had grown

briskly previously, started to falter too. Finnish export growth fluctuates rather heavily, and exports will decrease significantly in 2009. According to our estimates, exports will decline by about 4%, which is the sharpest drop since 1975; the one exception being 1991 when exports to the Soviet Union crashed to one third. At the same time exports to other markets stagnated. From a Finnish perspective, the collapse of the Soviet export market is a disruption not easily surpassed. In 1990 the Soviet Union accounted for 12.7% of Finnish exports. Now Russia is Finland's biggest single export market, accounting for 11.5%. Growth in Russia will slow severely, but imports are expected to continue to increase markedly. We are nowhere near the hardships of 1991.

Other factors will also alleviate the impact of the recession in developed economies on Finnish exports. A relatively large percentage of exports goes to Emerging Markets, which will continue growing despite the recession. In several industries the large export companies' order books for years ahead are in good shape. The electronics industry went through a substantial structural change at the beginning of the decade and the output outlook is consequently relatively stable. Despite these mitigating factors, the plunge in exports will be deep but the actual contraction phase will not last very long. We expect the heaviest fall to be over in the autumn, but the recovery will be slower than usual and is naturally still on rather shaky ground, as no definite signs of a rebound are yet visible.

### Investment to decrease sharply

Investment will decline in 2009 even more than exports. The biggest drop will be seen in construction investment. Residential investment started to diminish as early as 2007 and in the autumn of 2008 plans of new projects

### Finland: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (EURbn)	2006	2007	2008E	2009E	2010E
Private consumption	81	4.1	3.2	2.2	1.0	1.5
Government consumption	35	0.6	1.3	1.5	2.0	1.5
Fixed investment	30	4.7	8.5	2.6	-4.5	-2.5
Stockbuilding*	5	-0.5	-0.3	-0.7	-0.3	0.0
Exports	66	11.8	8.2	2.3	-4.0	3.5
Imports	59	7.8	6.6	0.6	-3.0	2.0
GDP		4.9	4.5	1.5	-1.3	1.5
Nominal GDP (EURbn)	157	167	180	189	192	196
Unemployment rate, %		7.7	6.9	6.4	7.2	8.0
Industrial production, % y/y		10.5	8.6	2.0	-3.0	1.0
Consumer prices, % y/y		1.6	2.5	4.1	0.8	1.3
Hourly wages, % y/y		2.9	3.4	5.3	4.6	3.5
Current account (EURbn)		7.5	7.3	5.4	6.6	7.7
- % of GDP		4.5	4.1	2.9	3.4	3.9
Trade balance (EURbn)		9.1	8.7	7.5	8.8	9.0
- % of GDP		5.4	4.8	4.0	4.6	4.6
General govt budget balance (EURbn)		6.7	9.5	8.5	2.9	2.0
- % of GDP		4.1	5.3	4.5	1.5	1.0
Gross public debt (EURbn)		65.5	62.9	61.4	65.4	68.7
- % of GDP		39.2	35.0	32.5	34.0	35.0

\* Contribution to GDP growth (% points)

were in short supply. Hence, the correction in residential investment will be sharp and the percentage of GDP will sink to the lowest level since the mid-1990s. Other construction activity will follow the trend in residential construction with a delay. Existing projects will keep up the momentum well into early 2009, but towards the end of the year activity will decrease markedly. Investment in machinery and equipment will decrease in the wake of the industrial downturn with a delay, although machine deliveries to the nuclear power plant project will cushion the fall.

On the investment front, prospects will first start to brighten for residential investment, which is currently declining quickly. In the wake of lower interest rates and house prices, the housing affordability of households will next autumn have improved to the highest levels in decades. As sentiment in the economy starts to pick up gradually, people will once again become interested in buying a home. So, 2010 appears brighter for residential investment, but the same cannot yet be said for other investment.

### Consumption may surprise on the upside

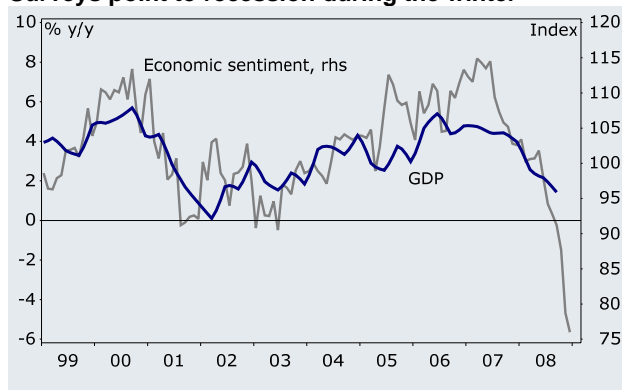
At present, the outlook for consumption is brighter than for exports and investment, albeit ambiguous. In 2008 the inflation spike significantly eroded purchasing power. Inflation and higher interest rates weakened consumer sentiment markedly as early as in the spring. Later in the year the plunge in economic sentiment was naturally reflected in consumption as well, and consumption growth came to a standstill.

In 2009 consumption will be dampened by increasing unemployment, which will not only decrease disposable income but also undermine consumer confidence. Consequently, the savings ratio will continue to rise. Still, income growth will be exceptionally brisk since the current wage agreements guarantee an increase in nominal wages of over 4%. Real wages will rise nearly as much as 4% and lighter taxation will increase purchasing power by 1% point. Falling interest rates will also improve the financial position of an average family nicely.

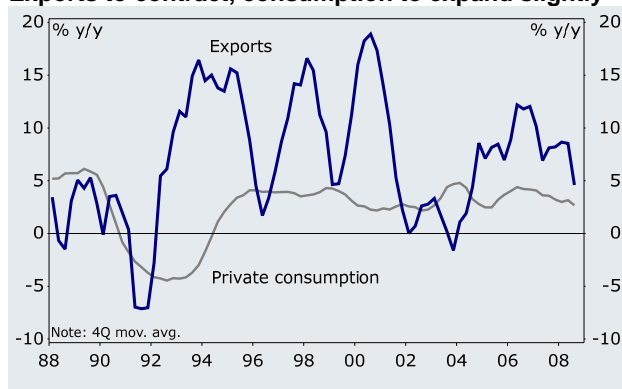
Overall, the increase in wage earners' real income will be record high, which will enable a marked rise in the savings ratio even though consumption will continue to increase. Private consumption will be supported by public spending. The situation of municipalities will still be good in 2009 and the government's revitalisation measures may also slightly speed up public spending.

In 2010 the increase in real income will slow but sentiment will already be on the mend, which will enable a slight decrease in the savings ratio. Consumption growth will be reasonable, but below average.

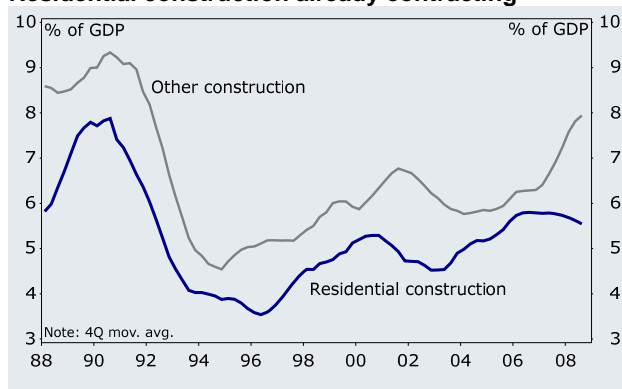
### Surveys point to recession during the winter



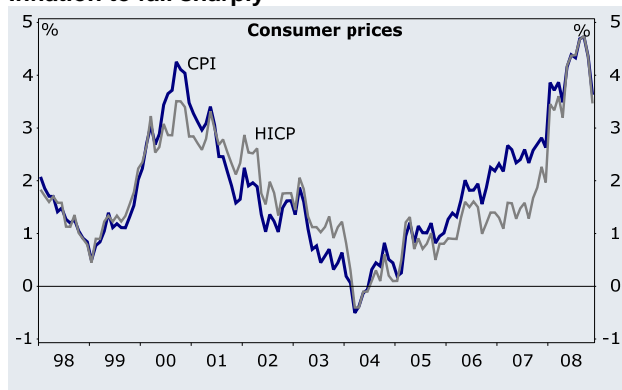
### Exports to contract, consumption to expand slightly



### Residential construction already contracting



### Inflation to fall sharply



Growth in public spending will slow down, which will curb the pace of total consumption.

**Inflation temporarily in negative territory**

A central element in the reasonable consumption outlook is the sharp drop in inflation. In 2009 energy prices will decrease considerably and food prices will also drop towards the end of the year when the VAT on food is cut. Prices of industrial goods are on the decline, so only service prices will lift inflation in late 2009. Service inflation will decelerate slowly due to relatively strong wage growth. The domestic consumer price index is also impacted by housing loan interest, the fall of which will slow inflation next year by about half a percentage point. On the whole, inflation will be less than 1% and the price level will drop towards the end of the year. The inflation outlook for 2010 remains moderate.

**Public sector remains slightly in surplus**

As a result of the recession, employment will decline markedly in 2009 and 2010, but unemployment will increase less. The labour force will be more flexible than before, as an increasing number of baby boomers will retire. The labour force has reacted more and more to fluctuations in demand in other respects as well, for example in terms of acquiring education.

The decline in employment will naturally hit central government finances as well. The starting point is good, but the recession combined with the fiscal stimulus measures will push general government finances into the red. The government has decided to cut income tax and VAT on food. In addition, spending will be increased. The anticipated tax cuts and increases in spending add up to about 1% of GDP. The revitalisation expenses are likely to increase even from this amount, and central government finances will end up in deficit. Due to the sizeable surplus of the social security funds, the public sector will still remain in surplus overall. However, central government debt will start to increase, but the level will remain low by international standards.

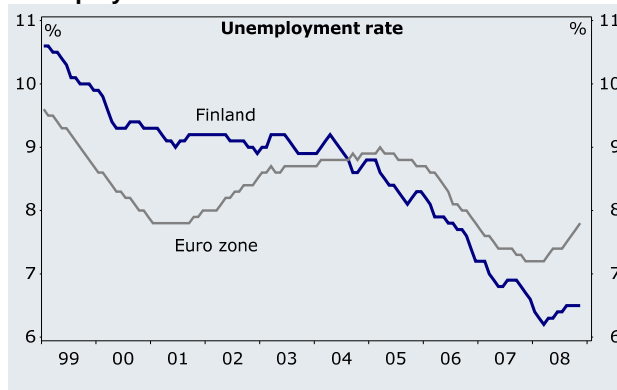
Due to Finland's relatively small amount of debt, it has more room for manoeuvre in terms of fiscal revitalisation than many other countries. Private sector balance sheets are also in fairly good condition. Households have not run up debt to the same extent as households in many other countries, and house prices have risen moderately. Of course, the uptrend has brought about some excesses, but on the whole, there is no need for a bigger correction than during an ordinary recession. If the economic downturn becomes prolonged, Finland will be well placed to withstand it and be in a good position when the export markets rebound.

Reijo Heiskanen

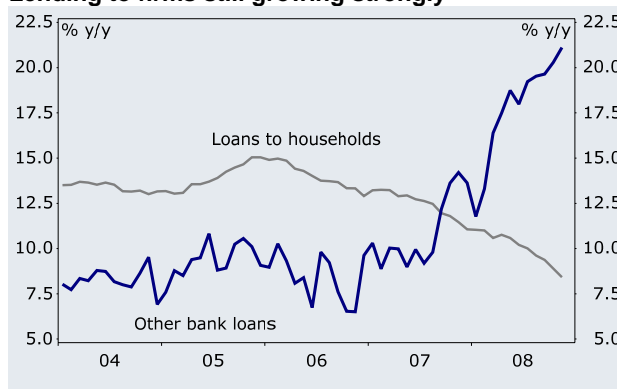
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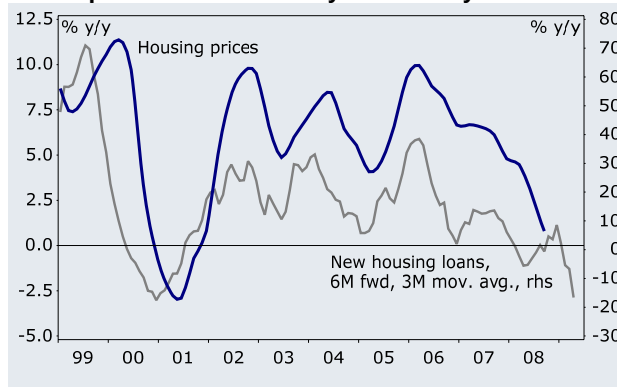
**Unemployment to rise also in 2010**



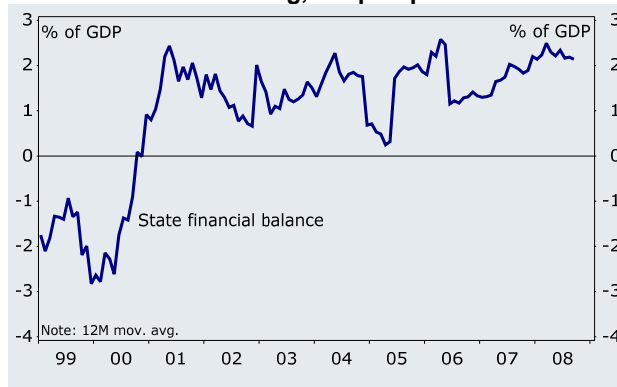
**Lending to firms still growing strongly**



**House prices to fall relatively moderately**



**State finances still strong, but prospects bleak**



## Stimuli dampen impact

- Sharp drop in mainland investment and weak exports
- Downturn curbed by sharp rate cuts, NOK weakness and expansionary fiscal policy
- Inflation below target and low capacity utilisation imply very low interest rates
- NOK appreciation could take time

### Weak global growth, tight credit market

There is little doubt that growth in the global economy will be very weak in 2009 and 2010. At the same time, Norges Bank's survey of banks' credit standards indicates that a relatively sharp tightening is underway. Pessimism among consumers and businesses has also grown noticeably. The correction of imbalances in the Norwegian economy (low consumer savings, high level of residential and non-residential construction) will thus be much stronger than expected early last autumn. We have sharply revised down our growth forecasts from the September 2008 issue of *Economic Outlook*. Sharp rate cuts, NOK weakness and a more expansionary fiscal policy will to some extent alleviate the adverse effects, but will not entirely offset these. Norges Bank is thus set to cut interest rates rapidly to around 2%.

### Weaker global economy

Slower growth in the global economy will hit Norwegian exports, and we have revised down growth in traditional exports both this year and next year. However, the downturn will be curbed by a weak NOK. Prices of many Norwegian exports will drop significantly despite the weaker NOK. Weakness in imports cushions the negative impact from exports on growth in the mainland economy.

### Oil sector limits downturn

Oil prices have come down sharply, and we see oil staying near the USD 40 mark for most of 2009. Prices could move back higher in 2010. With lower oil prices, oil investment will be significantly lower than previously assumed. But many projects are difficult to postpone or scale back short term. We therefore expect sustained growth in oil investment this year. For 2010, however, we see some deceleration in oil investment although oil prices are set to edge higher by then. The growth in oil investment will offset some of the negative effects of the international downturn on the Norwegian manufacturing industry in 2009. If oil prices remain at current levels for an extended period or fall further than expected, the downturn in 2010 and beyond could prove even more dramatic.

### Mainland investment to drop sharply

Business investment in the mainland economy has been scaled back sharply since the latest issue of *Economic Outlook*. Investment was initially at a high level. With a weaker growth outlook and greater uncertainty about the economy, businesses will dramatically trim their capital expenditure. As credit becomes harder to obtain, and with a poorly functioning bond market, it may also prove more difficult to finance even necessary investments.

Also residential construction will drop sharply. Admittedly, we have not become significantly more pessimistic about house prices since last autumn. Much lower interest rates will to a large extent offset the impact of unemployment accelerating more than previously anticipated. Residential construction may nevertheless fall further than expected early last autumn as the overhang of new homes for sale should continue to increase for some months and developers will put new projects on hold

### Norway: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (NOKbn)	2006	2007	2008E	2009E	2010E
Private consumption	826	4.7	6.4	1.5	1.4	2.5
Government consumption	387	2.9	3.6	3.5	4.0	3.5
Fixed investment	314	7.3	9.3	2.8	-6.7	-3.0
- gross investment, mainland	230	7.6	9.4	2.0	-10.5	-1.6
- gross investment, oil	74	3.8	4.1	5.0	5.0	-7.5
Stockbuilding*	34	0.7	-0.3	0.0	0.0	0.0
Exports	733	0.4	2.8	1.7	0.2	2.0
- crude oil and natural gas	337	-6.6	-2.8	-2.0	2.0	2.0
- other goods	210	6.2	9.0	5.5	-1.0	1.8
Imports	498	8.1	8.7	4.9	-0.7	1.4
GDP	1,743	2.5	3.7	1.2	0.3	1.7
GDP, mainland	1,355	4.8	6.2	2.2	-0.1	1.7
Unemployment rate, %		3.4	2.5	2.6	3.7	4.6
Consumer prices, % y/y		2.3	0.8	3.8	1.6	2.5
Core inflation, % y/y		0.8	1.4	2.6	2.3	2.1
Annual wages (incl. pension costs), % y/y		4.3	5.6	5.8	3.5	4.0
Current account (NOKbn)		373.4	350.6	420.9	197.9	377.6
- % of GDP		17.3	15.4	17.2	8.9	15.0
Trade balance, % of GDP		18.2	15.7	17.5	8.8	14.9
General govt budget balance (NOKbn)		399.1	402.4	540.0	300.0	485.0
- % of GDP		18.5	17.7	22.1	13.5	19.3

\* Contribution to GDP growth (% points)

pending stronger signs of a housing market turnaround. Banks should also remain cautious about financing new major housing projects for some time.

**Spending not as soft as might be feared**

Given the weak performance of exporters and companies reliant on mainland investment (building and construction), employment will drop sharply. But the extent of this decline will largely depend on consumer spending. Further worries about the labour market and the economy have made consumers more cautious. Much lower interest rates and falling energy prices will on the other hand contribute to sharply improved purchasing power in 2009 despite moderate pay rises and falling employment. We have lowered our spending growth forecast from the latest issue of *Economic Outlook*. However, with Norges Bank's turnaround, the downward revision is more moderate than would otherwise have been the case.

**Expansionary fiscal policy**

We expect public investment and government consumption to grow strongly in the years ahead. For our forecasts for public investment to prove accurate, an additional package of at least NOK 5bn-10bn is needed in 2009. Moreover, we expect that the government will increase municipal transfers in order to compensate for lower tax receipts.

**Zero growth in 2009**

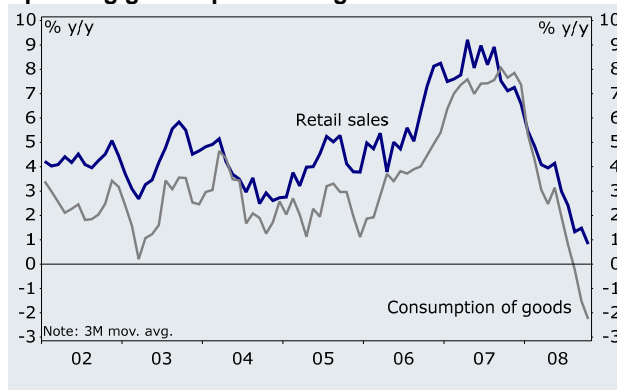
Overall, we look for zero growth in mainland GDP this year. This implies a sharp drop in employment although declining average working hours will limit the decline. Unemployment will rise steeply despite a much weaker increase in the labour supply than suggested by demographics. Many immigrants will leave the country, students will study longer and more will apply for early retirement. LFS unemployment should reach 4% in the summer of 2009 and 4.5% by early 2010.

**Lower wage growth, gradually lower inflation**

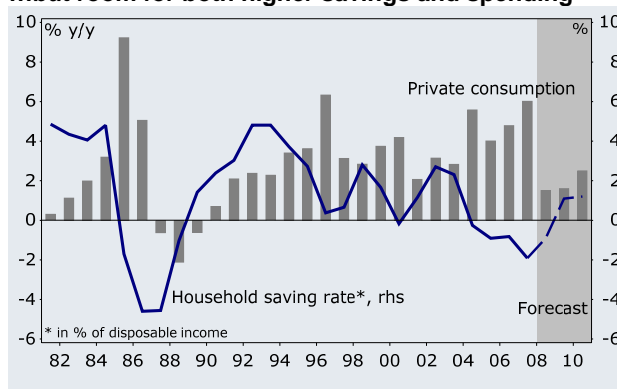
Next year's pay deals will be very moderate, partly as a consequence of the weak economic outlook and partly because they are interim deals. The wage drift will also be weak. Due to a large overhang (wage level at the beginning of the year relative to the year-earlier average) wage growth from 2008 to 2009 may nevertheless average about 3.5%.

Core inflation is edging lower. Recently prices of international commodities including food have dropped sharply also in NOK terms. Combined with lower energy prices and much lower wage growth, this will help to dampen cost increases for businesses. Also, relatively weak demand growth will drive down margins, especially in retailing. That means that core inflation may fall sharply. In the first half of the year we see inflation below target. However, NOK weakness will gradually push up price increases for imported goods and halt the de-

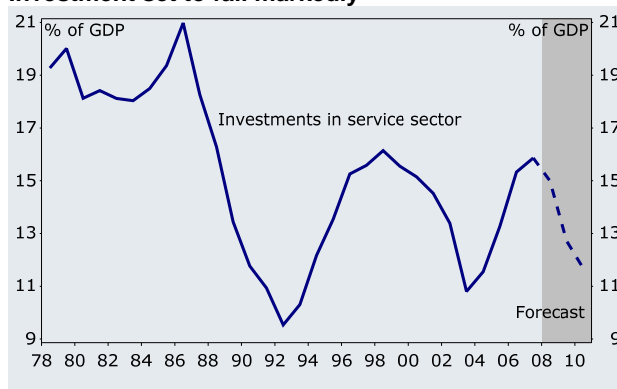
**Spending growth plummeting...**



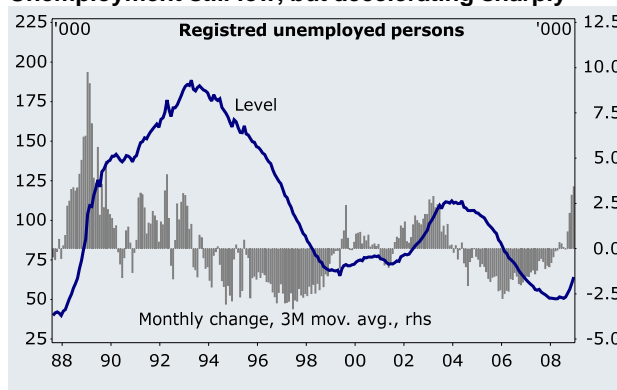
**...but room for both higher savings and spending**



**Investment set to fall markedly**



**Unemployment still low, but accelerating sharply**



cline in core inflation. With sharply lower petrol prices and gradually lower electricity prices this year, headline CPI inflation year on year will drop well below core inflation, while the pattern will largely reverse in 2010.

**Sharp rate cuts**

In its October monetary policy report Norges Bank expected inflation to remain a good deal above the 2.5% target well into 2011. In its revised forecast from December inflation was set to drop below target this year. Also according to the bank the output gap (actual versus potential output) will be negative. Hence, the bank reasons that there is only one thing to do: cut rates aggressively. We now see rates bottoming around 2.00%, not far from the bottom of its latest forecast.

**Narrower interest rate differential to Euro area**

Short Norwegian swap rates have dropped sharply, also relative to comparable Euro-area rates, and are now close to these rates. Longer-term swap rates remain well above comparable Euro-zone rates, and government bond yields are high relative to Euro-area equivalents, both at the short and long end. We expect the spread between longer-term Norwegian swap rates and government yields and their Euro-zone equivalents to narrow as Norges Bank cuts its policy rate further.

**NOK needs risk appetite**

Since last summer the NOK has seen a considerable erosion. Lack of risk appetite and a flight to more liquid investments are the main reasons. But lower oil prices have probably also played a role. With Norges Bank's massive easing moves and signals that rates will come down further, the final buy argument for the NOK disappeared. We therefore expect persistent NOK weakness, but the currency should appreciate eventually. But this requires that risk appetite returns to the currency market. Oil prices stabilising and possibly moving higher in 2010 also points to NOK appreciation.

**Not just downside risk**

There are still downside risks to our interest rate view. Inflation could fall further and the international setting could weaken more than we assume. Also the NOK may appreciate faster than anticipated.

However, interest rates may not fall as far as we expect or may rise faster again. Strong stimuli in the form of record-low interest rates and fiscal measures may reverse spending growth and house prices more quickly than expected. In this scenario the central bank may disregard the fact that current inflation remains low. Given the risk of new bubbles longer term, it may raise rates at a faster pace than last time rates were low although this implies a period of inflation below target and a negative output gap.

Erik Bruce

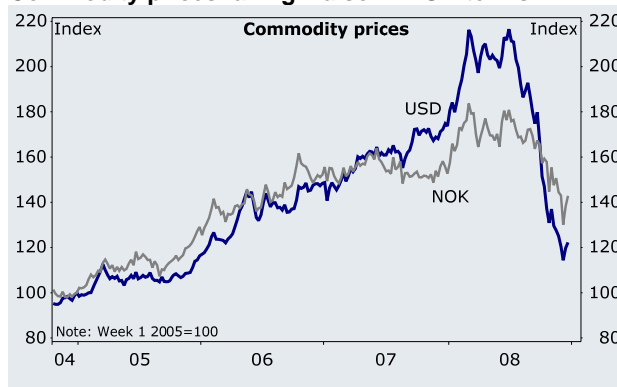
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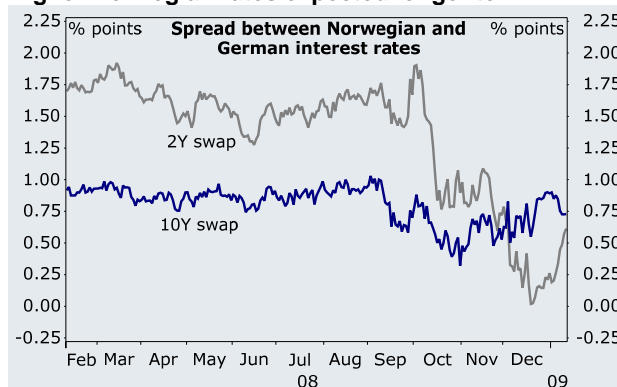
**Unemployment to rise sharply**



**Commodity prices falling – also in NOK terms**



**Higher Norwegian rates expected longer term**



**NOK weakness especially against EUR**



## There is hope after all!

- Sharp drop in GDP in 2009; gradual rise in 2010...
- ...driven by economic policy, SEK and low inflation
- Riksbank to cut rates to at least 1.0%

### Turnaround eventually

After showing a weak trend in early 2008 the Swedish economy hit the wall in H2 2008. GDP fell by 0.1% q/q in Q3 2008 and indicators suggest that it contracted by approximately 1% in Q4. Particularly exports have declined significantly, but also activity in the domestic economy has become more subdued.

Uncertainties are rife. There is a risk that weak demand at home and abroad, tighter credit standards and declining employment will trigger a vicious spiral that will dramatically slow down Swedish economic activity.

However, there are factors that will mitigate the downturn and eventually help break the negative trend. An expansionary fiscal and monetary policy, rapidly declining inflation and weak SEK will support the economy and create the foundation for a gradual recovery over time. Particularly the Riksbank's aggressive rate cuts have lowered mortgage rates and thus eased the interest burden for households.

### More action is needed

But the financial crisis still keeps a stranglehold on the business sector. The financial market turmoil has had an adverse effect on the transmission mechanisms for businesses and as a result the Riksbank's rate cuts are not fully passed on to corporate borrowers. Our forecast is based on the assumption that governments and central banks in Sweden and internationally will take further measures to ease credit standards for businesses. That

would prevent the Swedish economy from sliding into even deeper trouble. Despite various stimulus packages the year 2009 will be a "lost" year, but the Swedish economy will likely escape the very bleak scenario that most indicators currently point to.

### Focus on investment

Especially investment has been hit by the financial crisis as it relies heavily on the availability of capital. Swedish exports are to a large extent made up of capital goods. So in addition to being hit by declining demand in Swedish export markets for the first time since the early 1980s, Sweden will therefore in 2009 also be hit due to the unfavourable composition of Swedish exports.

The sharp SEK depreciation will act as a shock absorber, though. The lower SEK rate thus helps Swedish exporters maintaining their market share and to some extent dampen the downturn in exports. In 2010 the global economy will start to recover slowly, a trend that will also support Swedish exporters.

The financial crisis and the ensuing uncertainty will also feed through to domestic investment activity. Activity in the housing market slowed down noticeably during the autumn, resulting in a declining turnover and lower prices. Residential construction has dropped to the lowest level in many years, and the number of housing starts will halve during the 3-year period from 2008 through 2010. Home renovations and extensions should increase, though, among other things driven by the newly reintroduced special tax allowance.

Other parts of the business sector are also likely to witness a marked downturn. As a result of shrinking capac-

### Sweden: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (SEKbn)	2006	2007	2008E	2009E	2010E
Private consumption	1,328	2.3	3.0	0.9	-0.6	1.5
Government consumption	723	2.0	0.4	1.1	0.4	1.1
Fixed investment	476	9.1	7.5	3.7	-4.9	-3.0
- industry	84	-1.2	11.4	0.3	-11.2	-9.8
- residential investment	77	15.0	8.7	-4.7	-17.4	-6.9
Stockbuilding*	-4	0.2	0.8	-0.3	-0.3	0.2
Exports	1,333	8.9	5.7	2.2	-3.0	2.5
Imports	1,121	8.7	9.4	3.6	-3.3	1.3
GDP		4.2	2.5	0.7	-1.5	1.3
Nominal GDP (SEKbn)	2,735	2,901	3,061	3,161	3,175	3,260
Unemployment rate, %		7.1	6.2	6.1	7.7	8.7
Employment growth		1.8	2.4	1.0	-1.7	-1.2
Consumer prices, % y/y		1.4	2.2	3.4	-0.1	1.1
Underlying inflation (CPIF), % y/y		1.4	1.5	2.7	1.4	1.4
Hourly earnings, % y/y		3.3	3.1	4.2	3.8	3.4
Real disposable income, % y/y		3.3	3.9	3.3	2.8	2.2
Current account (SEKbn)		247.0	257.0	221.0	205.0	210.0
- % of GDP		8.5	8.4	7.0	6.5	6.4
Trade balance, % of GDP		5.6	4.6	4.1	4.5	4.5
General govt budget balance (SEKbn)		70	115	73	-45	-97
- % of GDP		2.4	3.7	2.3	-1.4	-2.9
Gross public debt, % of GDP		45.9	40.7	38.6	38.8	41.0

\* Contribution to GDP growth (% points)

ity utilisation, uncertainty and tighter credit standards, investment is expected to contract across the board. With the expected subdued output trend the downturn will probably drag out, with overall investment dropping 5% in 2009 and 3% in 2010 despite government infrastructure spending.

**Cautious households contribute to GDP drop**

Household consumption accounts for approximately half of GDP. Households' behaviour therefore has a significant bearing on economic activity. Household savings have been rather low over the past few years. A return to a higher savings rate will thus help mitigate consumption, which did indeed start to drop already in Q3 2008. The labour market is arguably the most important factor for household consumption and savings. And the outlook for the labour market is certainly not benign. In light of this and the fragile housing market we therefore expect household consumption to decline further over the coming year.

However, there are also some bright spots. Tax cuts, lower interest rates and sharply falling inflation will benefit households' finances and considerably strengthen their purchasing power. Even though the unfavourable trend in asset prices and the labour market will dampen households' propensity to spend, other factors will pull in the opposite direction. We look for a decline in consumer spending of some 0.5% in 2009 followed by a minor increase in 2010 of around 1.5%.

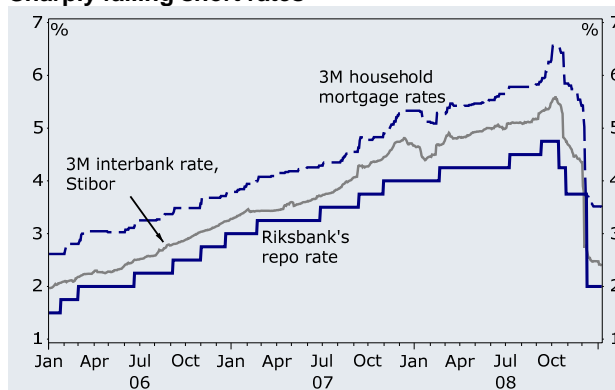
All in all, as noted above uncertainties are rife. What is certain is that 2009 will be a difficult year for the economy. However, there are factors that will break the fall and as a result there is reason to expect a minor recovery in 2010. We expect GDP to drop by around 1.5% in 2009 and then rise by close to 1.5% in 2010.

**High unemployment and budget deficit**

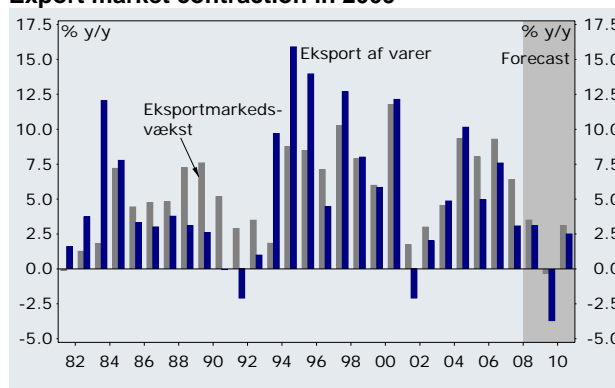
The weak GDP trend has already taken its toll on the labour market. Employment has been on a downtrend since the turn of the year; a trend which will most likely accelerate in the period ahead. The decline is broadly based, but one of the few exceptions is the municipalities, which we expect will receive further stimulus to the tune of SEK 10bn per year in 2009 and 2010. This will boost both consumption and employment. We see overall employment down by 1.7% in 2009 and by 1.2% in 2010, translating into an increase in joblessness from just under 6% in early 2008 to around 9% at the end of 2010, a post-1998 high.

Fiscal stimulus packages are estimated to amount to about 1.5% of GDP in both 2009 and 2010. Consequently, the fiscal boost from the government in 2009 and 2010 is expected to total approximately SEK 80bn. As a result of this and the ongoing economic downturn the 2007 budget surplus high of 3.7% of GDP

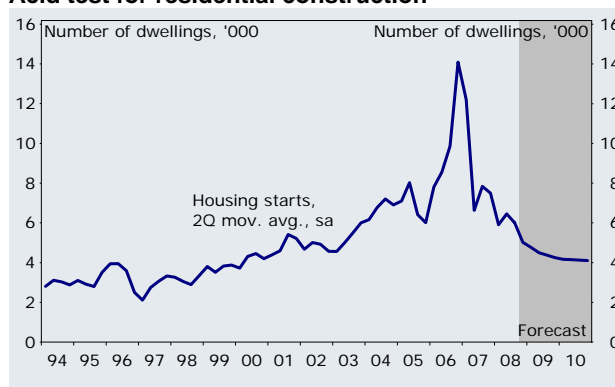
**Sharply falling short rates**



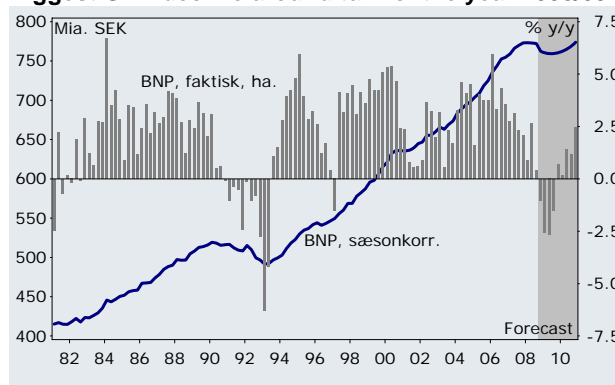
**Export market contraction in 2009**



**Acid test for residential construction**



**Biggest GDP decline around turn of the year 2008/09**



will be transformed into a deficit of 1.4% in 2009 and 2.9% of GDP in 2010.

**Consumer prices to edge lower**

Productivity looks set to gradually increase going forward mainly as a result of declining employment. Meanwhile, wage growth will slow, leading to a drop in overall costs. Still, owing to the 3-year pay deals wage growth will remain relatively high for this stage of the economic cycle.

Inflation is expected to decline significantly from last year's record high of 4.4% and slide into negative territory in 2009. The sharp fluctuations in inflation are driven by massive up- and downturns in oil prices and mortgage rates. Another factor is that the uptrend in food prices has stopped. Meanwhile, prices of other goods and services have increased only marginally and will continue to do so going forward.

The SEK has weakened markedly over the past few months, and this will have a noticeable effect on inflation, slowing the decline, but not preventing a temporary slide into negative territory over the coming year. When the effect of falling oil prices and interest rates drops out of the 12-month index, inflation will edge higher again towards the end of 2009 and in early 2010, but it will not reach the 2% target level.

**Still more to do for the Riksbank**

The weak economic trend is the focal point of the Riksbank and the sharp fall in inflation will widen its room for manoeuvre in monetary policy. To dampen the decline in GDP and slow down the increase in unemployment the Riksbank will likely cut rates by 75 bp to 1.25% as early as in February and then cut rates again by 25 bp to 1.0% in April, at which level the policy rate should bottom in this rate cycle. However, there is a risk that the Riksbank will cut rates even further.

In 2010 growth should start to pick up slowly. But the labour market will continue to deteriorate and inflation will remain below the 2% target. Based on experience from previous years, central banks will likely try to avoid keeping rates at these low levels for too long. We therefore expect rates to be hiked again relatively early. We see the Riksbank's repo rate at 1.5% by end-2010.

**SEK environment to improve**

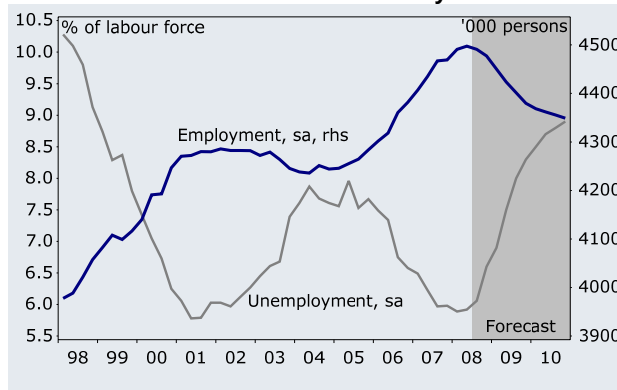
During the autumn the SEK has largely been in a free fall versus the EUR. We expect the SEK to remain undervalued at least in the coming 12 months. But particularly driven by growing risk appetite and some normalisation of the financial markets the SEK may regain some of the ground lost. We see the SEK trading at 9.50 versus the EUR in one year's time.

Torbjörn Isaksson

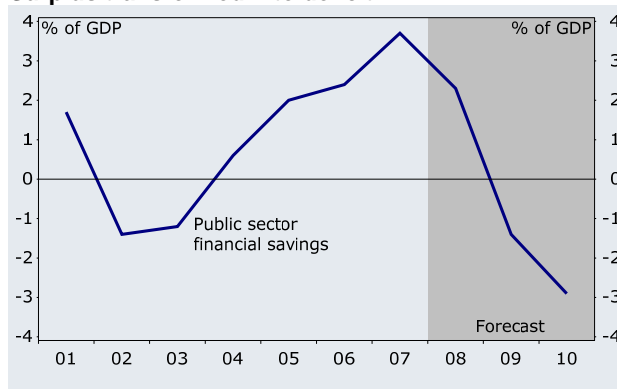
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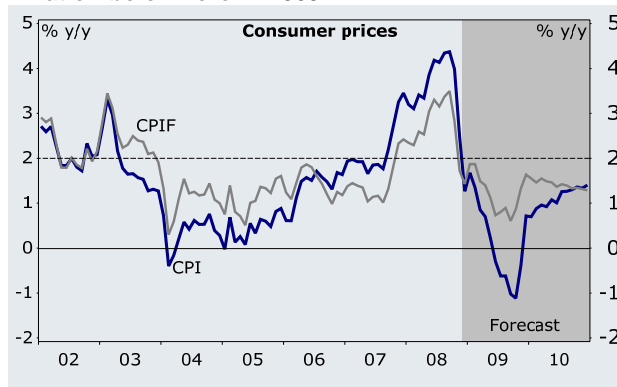
**Labour market to deteriorate markedly**



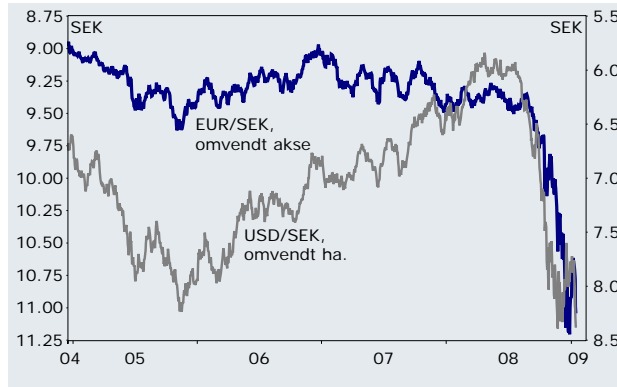
**Surplus transformed into deficit**



**Inflation below zero in 2009**



**The SEK in free fall**



## Entirely new order of the day after financial meltdown

After the almost total meltdown of the financial sector in October 2008 the economy is facing a very deep recession and we look for a GDP decline of up to 12% this year. A rescue package from the IMF solved Iceland's acute problems of access to foreign currency and should help restore confidence in the economy. Private consumption will decline sharply, as households are strained by steeply rising import prices, higher interest rates (not least on inflation-indexed loans) and larger repayments and outstanding balances on loans denominated in foreign currency.

Due to the financial breakdown Iceland will in future have to focus on the country's two main sectors: marine products and aluminium. The aluminium smelting capacity and hence the scope for exports have increased significantly lately, but this has coincided with sharp declines in aluminium prices since the summer of 2008. The price decline threatens planned future capacity investment. Marine product prices have also fallen somewhat recently, and although fuel for the fishing fleet has become cheaper despite the weakening of the ISK, the fishing industry, just like the aluminium sector, is facing a tough time. Hence, there is little hope that these two sectors can prevent unemployment from rising sharply.

The relatively healthy public finances until the financial collapse are now a thing of the past. The IMF estimates that the government takeover and reconstruction of the ailing banks and the substantial loans from the IMF and individual countries will swell Iceland's net general government debt from 7% in 2007 to as much as 97% of GDP in 2009. The surplus on public finances is expected to turn into a deficit of more than 10% of GDP in 2009.

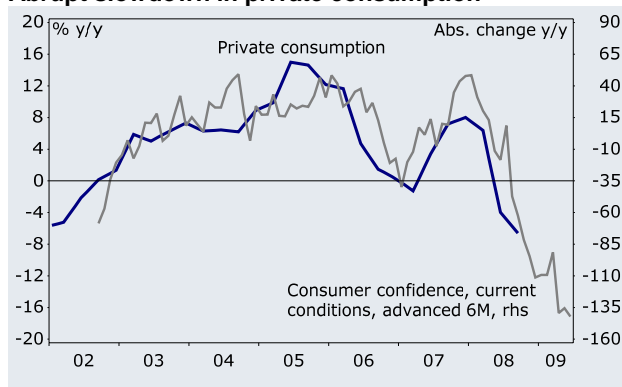
After the breakdown of all trade in the ISK, the currency market is starting to revive again, but mainly internally in Iceland. A string of capital restrictions are still in place to prevent capital flight from Iceland.

**Bjarke Roed-Frederiksen**

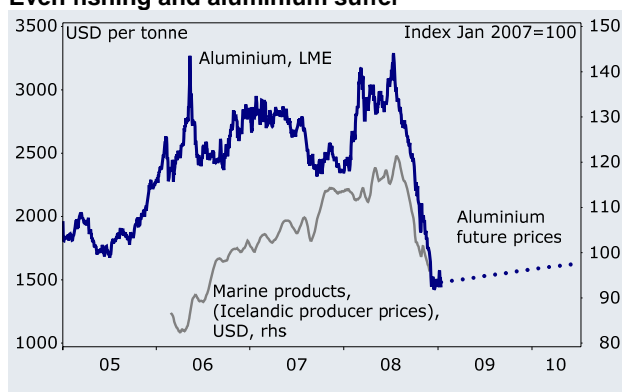
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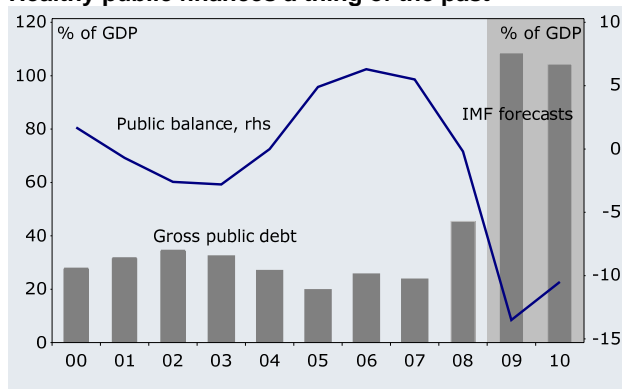
### Abrupt slowdown in private consumption



### Even fishing and aluminium suffer



### Healthy public finances a thing of the past



### Iceland: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (ISKbn)	2006	2007	2008E	2009E	2010E
Private consumption	611	4.4	4.3	-4.6	-18.2	-4.6
Government consumption	253	4.0	4.2	3.4	2.1	1.4
Fixed investment	291	20.4	-13.7	-21.1	-35.6	-5.3
Stockbuilding*	-1	1.1	-0.6	0.4	0.3	0.0
Exports	324	-5.0	18.1	4.3	0.3	4.3
Imports	452	10.2	-1.4	-10.5	-13.6	-2.8
GDP		4.4	4.9	0.1	-11.9	-0.2
Nominal GDP (ISKbn)	1,026	1,168	1,328	1,424	1,323	1,391
Unemployment rate, %		1.3	1.0	1.7	7.2	8.4
Consumer prices, % y/y		6.7	5.1	13.2	12.1	4.5
Current account - % of GDP		-25.5	-14.6	-18.2	3.4	5.4
General govt. budget balance, % of GDP		6.3	5.5	-0.2	-13.5	-10.5

\* Contribution to GDP growth (% points)

## Still going down, but the parachute is now open

- The economy has not bottomed yet
- Strong commitment to stabilise the economy
- The Fed's new weapon: the printing press
- Uncertainty about size of Obama's rescue package

In early 2009 the good news is that the worst of the slide in US economic activity is probably over. As things stand now, it seems realistic to expect that the economy (GDP) will stabilise around mid-2009. The bad news is that the recession that started in December 2007 is not over yet, and because it has now spread to all vital parts of the economy, the foundation is exceptionally fragile. If monetary conditions do not improve in the months ahead and the announced massive fiscal policy easing fails to materialise, the recession may continue well into 2010.

Our baseline scenario is that economic activity will continue to fall in H1 2009 with broad-based declines in consumer spending, housing and business investment as well as exports. However, in our view the expected drop in GDP in the first two quarters of the year will likely take place at a slightly slower pace than in the last three months of 2008 when the economy presumably contracted by 4-5% (annual rate).

After the highly dramatic escalation of the financial crisis in the wake of the collapse of US investment bank Lehman Brothers in September there are now signs that financial market conditions are gradually improving. One example is the money market where the spread between uncollateralised and collateralised money market rates has narrowed slightly. However, the improvement is even more evident in the mortgage bond market. Thanks to the Federal Reserve's (Fed) announcement of its inten-

tion to purchase agency debt and mortgage-backed securities for up to USD 600bn, the yield spread between these mortgage bonds and the much safer Treasuries has narrowed markedly. Also yields on corporate bonds have edged lower, albeit from a high level, as a result of expectations of further quantitative monetary policy easing.

This improvement in monetary conditions will likely be sustained in the months ahead, and coupled with lower commodity prices and the expected massive fiscal kick-start this will probably pave the way for a stabilisation of the economy in H2 2009 followed by marginally positive growth in 2010.

### Economy still has not bottomed

However, until then economic news may turn even worse. At end-January the recession has lasted 13 months and as we expect it to continue until at least end-May, it looks set to become the longest recession since the Depression of the 1930s. If our forecast of a rise in unemployment to above 8.5% is on the mark, it will also be the strongest increase in joblessness since the 1930s. We see unemployment at 9% towards year-end, a post-1983 high. By comparison unemployment was nearly 25% during the Depression. Lastly, we expect GDP in constant prices to drop by 2¼% from peak to bottom. If we are right, it will be the biggest contraction since the recession in 1981-1982.

In our view, the risk of a deeper recession than envisaged in our baseline scenario outweighs the chance of it becoming less pronounced. This risk is mainly related to household savings. Our forecast is based on an expected increase in the savings ratio from an estimated 2.5% in Q4 2008 to 5% in one year's time. But the consolidation process to reduce household indebtedness may prompt an

### USA: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (USDbn)	2006	2007	2008E	2009E	2010E
Private consumption	8,694	3.0	2.8	0.3	-1.9	0.8
Government consumption and investment	2,355	1.7	2.1	2.8	1.4	3.2
Private fixed investment	2,043	2.0	-3.1	-4.5	-10.0	-3.1
- residential investment	770	-7.1	-17.9	-20.7	-10.4	3.6
- equipment and software	936	7.2	1.7	-1.8	-11.5	-4.2
- non-residential structures	338	8.2	12.7	11.1	-5.0	-6.4
Stockbuilding*	43	0.0	-0.4	-0.3	0.1	0.1
Exports	1,312	9.1	8.4	7.9	1.9	2.7
Imports	2,025	6.0	2.2	-2.8	-2.9	3.1
GDP		2.8	2.0	1.2	-1.7	0.7
Nominal GDP (USDbn)	12,422	13,178	13,808	14,297	14,330	14,649
Unemployment rate, %		4.6	4.6	5.7	8.4	9.3
Industrial production, % y/y		2.2	1.7	-2.0	-8.0	1.0
Consumer prices, % y/y		3.2	2.9	3.7	1.0	2.0
Consumer prices ex. energy and food, % y/y		2.5	2.3	2.3	1.5	1.2
Hourly earnings, % y/y		3.9	4.0	3.4	2.8	2.0
Current account (USDbn)		-788.1	-731.2	-643.4	-401.2	-410.2
- % of GDP		-6.0	-5.3	-4.5	-2.8	-2.8
Federal budget balance (USDbn)		-248.2	-161.5	-454.8	-1,400.0	-800.0
- % of GDP		-1.9	-1.2	-3.2	-9.8	-5.5
Gross public debt, % of GDP		66.0	67.0	68.0	78.0	83.0

\* Contribution to GDP growth (% points)

even bigger increase in the propensity to save. A pick-up in the savings ratio to the historical average of some 7% will all else equal shave off another 1½% of GDP relative to our forecast, and an even stronger rise in the propensity to save cannot be ruled out. The longer it takes before bank lending to households and businesses accelerates, the bigger the risk of a sharp correction in savings and hence demand.

A positive surprise could come from fiscal policy. Our forecast is based on fiscal easing to the tune of USD 150bn-200bn or around 1% of GDP in both 2009 and 2010. But President-elect Barack Obama's advisers have advocated fiscal easing of no less than 5-6% of GDP over two years.

### House prices have yet to bottom

A stabilisation of house prices is still considered a vital precondition for an end to the financial and economic crisis. Although we do see some bright spots in this area, we still expect prices to drop by a further 10-15%, thereby extending the 20% decline from the 2006 peak which has already taken place. The reasons are that the markets for both new and existing homes are still characterised by massive oversupply and that banks have drastically tightened mortgage credit standards. Declining house prices coupled with rising joblessness are one of the key factors behind our expectations of a rising propensity to save among households.

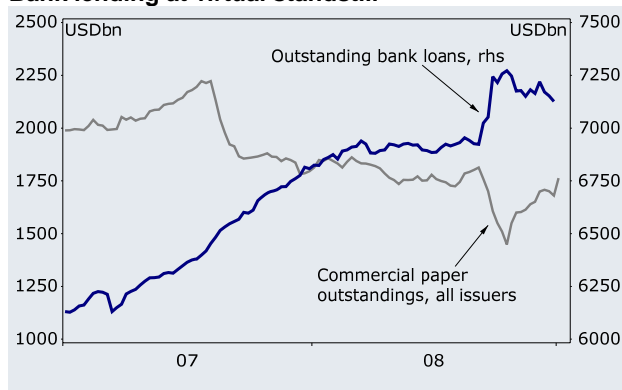
At the end of Q3 2008 10% of outstanding mortgages were either delinquent or in foreclosure. Declining house prices and rising unemployment *per se* point in the direction of more non-performing loans, which in turn will intensify the downward pressure on house prices. However, President-elect Obama has pledged to give high priority to stemming the foreclosure wave. No concrete plans have been presented yet, but imminent efforts to modify existing loans and sharply ease the interest burden on hard-pressed homeowners may contribute considerably to a stabilisation of the housing market and hence the overall crisis.

All in all, we see scope for a stabilisation of house prices in the latter part of 2009. The main reason is that the declining house prices and the recent drop in mortgage rates have reduced the financial burden of buying your own home to the lowest level in more than 35 years, measured in relation to income.

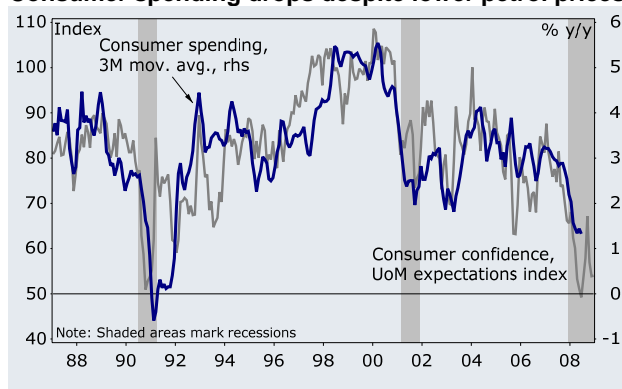
### Strengths turned into weaknesses

One of the main reasons for the worsening economic outlook is that the recession has spread from Wall Street to Main Street. A clear example of how previous strengths have now turned into weaknesses is the trend in exports, which after a sharp increase is now falling rapidly. The turnaround was triggered partly by the USD appreciation in H2 2008 and partly by weaker export

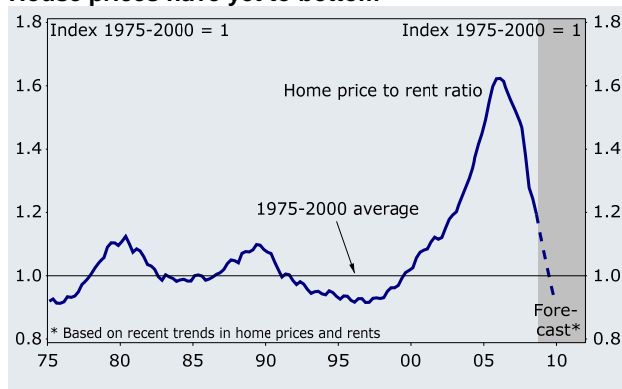
### Bank lending at virtual standstill



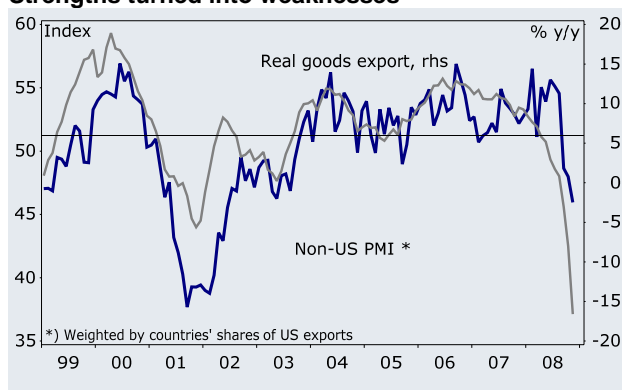
### Consumer spending drops despite lower petrol prices



### House prices have yet to bottom



### Strengths turned into weaknesses



market demand. With large parts of the world in recession the export sector will hardly be able to lift the US economy out of recession.

Towards the end of 2008 business investment fell sharply, and we expect further declines in the coming quarters driven by lower earnings and tighter credit standards. However, with overall healthy corporate finances outside the financial sector investment should recover later in the forecast period in step with a normalisation of credit standards and sales expectations.

The labour market clearly demonstrates that the recession has hit all vital parts of the economy. With the broadest based decline in employment in more than 30 years joblessness has so far increased from 4.4% to 7.2%. At end-2009 unemployment is forecast to be 9%, and further increases may be expected well into 2010.

**Disinflation, but not deflation**

Particularly due to the nose-diving commodity prices inflation is expected to move briefly into negative territory in 2009. The drop in consumer prices will underpin household demand. Actual deflation with a persistent, broad-based decline in consumer prices is, however, not very likely as core inflation is expected to remain in positive territory, albeit declining from 2% at present to around 1% towards the end of the forecast horizon.

**The Fed's new weapon: the printing press**

With its policy rate close to zero the Federal Reserve (Fed) has fired all shots in its traditional armoury. As noted earlier the central bank already has announced its intent to purchase agency debt and mortgage-backed securities, and further quantitative monetary policy easing, including direct purchases of Treasuries by the Fed, is likely in 2009. This will contribute to bringing down interest rates and easing the pressure on households and businesses.

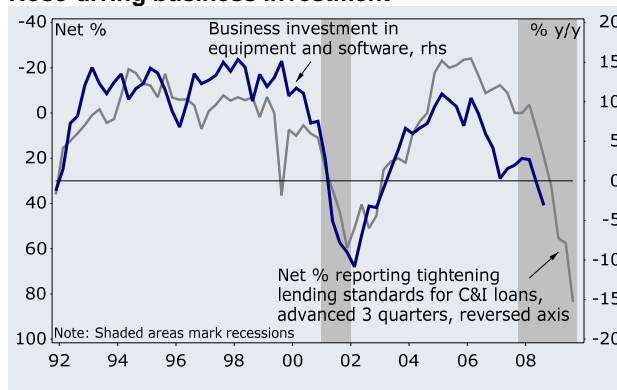
Once the financial markets begin to normalise, the Fed is expected to absorb the extra liquidity injected into the markets as quickly as possible to avoid high inflation in the longer term. However, the first rate hike is not expected until in about a year at the earliest.

In late 2008 pressure on the USD resumed as a result of the Fed's efforts to increase the money supply and the prospect of a titanic US federal budget deficit. The budget deficit will likely approach 10% of GDP in 2009. Short term these factors could put the USD under renewed pressure, but longer term we see renewed USD strengthening in step with further ECB rate cuts.

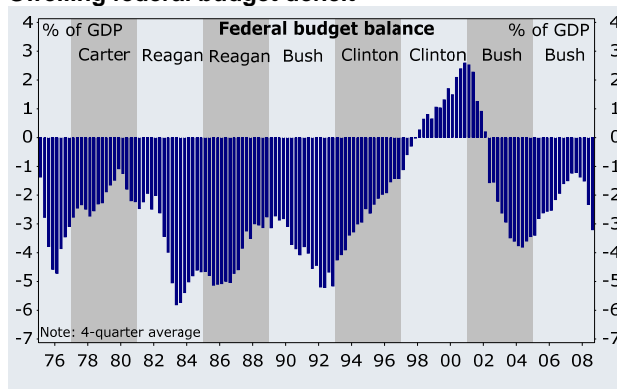
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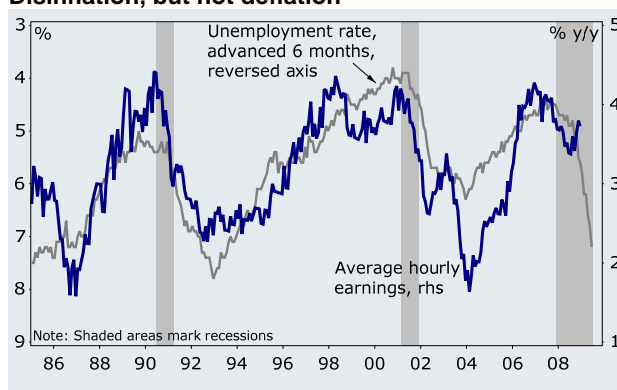
**Nose-diving business investment**



**Swelling federal budget deficit**



**Disinflation, but not deflation**



**Wild swings in USD**



## Economy in reverse

- Exports hit by global downturn
- Strong JPY also puts pressure on exporters
- Investments cancelled or postponed
- Recovery hinges on global economy and risk appetite

### Downward revision of economic growth

We have revised down our growth forecast for Japan since the latest issue of *Economic Outlook*. This downgrade chiefly reflects a marked deceleration in international economic growth, which is hurting exporters. In addition, the JPY has appreciated sharply and owing to the financial crisis companies have restricted access to credit.

### Exports and investment moving lower

Japanese exports have been hit by headwinds in export markets where consumers as well as businesses trim spending. At the same time the waning appetite for risk has led to massive unwinding of loans in JPY, and the resulting capital inflows have triggered significant appreciation of the JPY against key export currencies. Competitiveness has deteriorated as a result, further eroding sentiment among Japanese exporters. Thus the previous driving force behind Japan's economic growth is under pressure, and exports to key markets have slowed sharply over the past two quarters. With the gloomy picture for the US economy over the coming quarters, much suggests that exports will continue to deteriorate until the middle of 2009.

The financial crisis is also showing its ugly face in Japan, where especially small and medium-sized businesses are finding it more expensive and difficult to secure financing. With reduced earnings and lower expectations for the future, this implies lower investment activity in businesses.

The national accounts for Q2 and Q3 show negative investment growth and we are likely to see sharp declines in the coming quarters. Machinery orders, which are a good leading indicator of investment, fell by a hefty 10.4% q/q in Q3, suggesting that many companies are

scaling back or postponing their investment plans.

Overall, the business sector has been dealt a difficult hand, and the important Tankan confidence indicator has plummeted along with other business confidence indicators over the past few quarters. The latest Tankan survey for Q4 also indicates that sentiment will deteriorate further in Q1 2009.

### Consumer spending flat

Lower activity and the erosion of corporate earnings are hitting employment and the size of consumers' pay packets. However, with the sharp drop in oil prices and the economic deceleration, there are prospects of lower inflation. That may help to underpin purchasing power in the coming quarters. Households will furthermore receive a helping hand from the government, which will pay out JPY 2trn in benefits, or around 0.7% of consumer spending, as part of the rescue package. Against this background we look for a flat trend in consumer spending.

### Rescue packages on the agenda

Since the summer the government has introduced several rescue packages. In addition to subsidies to households, these rescue packages include an extension of public loan guarantees to small businesses, tax advantages for investments as well as the recapitalisation of financial institutions.

While the government has indicated that further measures could be in the pipeline, a large-scale rescue package could prove difficult to implement. Firstly, the scope for action is hampered by the large government debt which accounts for some 180% of GDP. Secondly, it is doubtful whether the government coalition, which holds a majority in the lower house of parliament, can bring a rescue package through the upper house, which is dominated by the opposition.

### Recession likely to end by mid-2009

Commodity prices saw a steep rise until the summer of 2008 and that put a strain on businesses and consumers. Since then, however, prices have come back down

### Japan: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (JPYtrn)	2006	2007	2008E	2009E	2010E
Private consumption	285.9	1.5	0.7	0.7	0.5	1.1
Government consumption	90.6	0.4	2.0	0.5	0.9	0.9
Gross fixed capital formation	116.9	0.6	1.2	-3.8	-4.2	0.4
Stockbuilding*	1.4	0.1	0.3	-0.3	-0.3	0.0
Exports	71.9	9.7	8.4	3.5	-8.8	3.9
Imports	65.0	4.2	1.5	0.1	-3.0	2.0
GDP	-	2.0	2.4	-0.1	-1.9	1.2
Nominal GDP (JPYtrn)	501.7	507.5	515.8	523.5	513.0	521.3
Unemployment rate, %		4.1	3.9	4.1	4.7	4.9
Consumer prices, % y/y		0.2	0.1	1.5	0.0	0.5
Current account, % of GDP		3.9	4.8	3.2	2.1	2.2
General government budget balance, % of GDP		-2.9	-2.8	-4.5	-5.0	-4.0

\* Contribution to GDP growth (% points)

sharply and this should eventually alleviate the pressure on businesses and consumers. Also the government's rescue packages will help to boost spending. In addition, an improvement in the economies of Japan's export markets from mid-2009 will help exporters get back on their feet. A gradual return of risk appetite during 2009 will also bring the sharp JPY appreciation to an end. With these four factors the economy could be back on the mend and reach positive growth rates again towards the end of 2009.

**Bank of Japan eased rates**

After having stayed sidelined since the beginning of 2007 the Bank of Japan has now sanctioned two rate cuts, bringing interest rates down from 0.5% to 0.1% since October. Measures to boost liquidity have also been introduced. With prospects of very low inflation in 2009, we do not expect tightening moves to be on the agenda until 2010.

**Risk appetite crucial for JPY**

Risk appetite is set to remain weak in the months ahead. Combined with our expectations of further easing moves by the Federal Reserve and the ECB, this should have a strengthening effect on the JPY short term. Longer term, however, we expect the turmoil in the wake of the financial crisis to gradually abate. Combined with expectations of higher interest rates in the US and the Euro zone, this will contribute to JPY weakness against the EUR and the USD towards the end of our forecast period.

Martin Ipsen

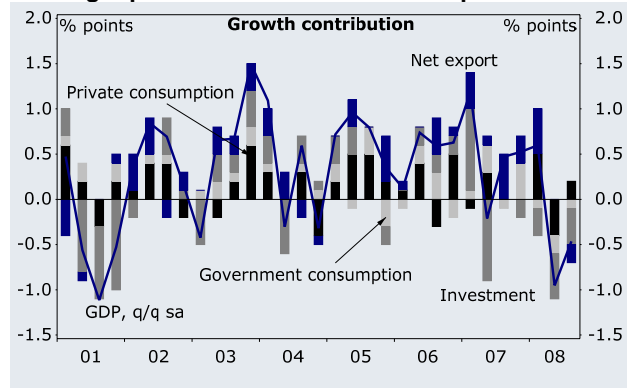
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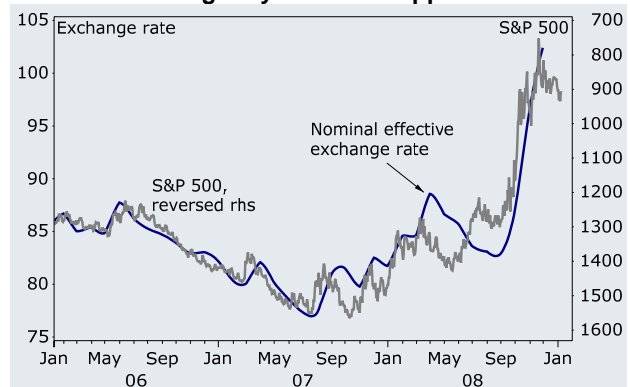
**Setback in exports to all key markets**



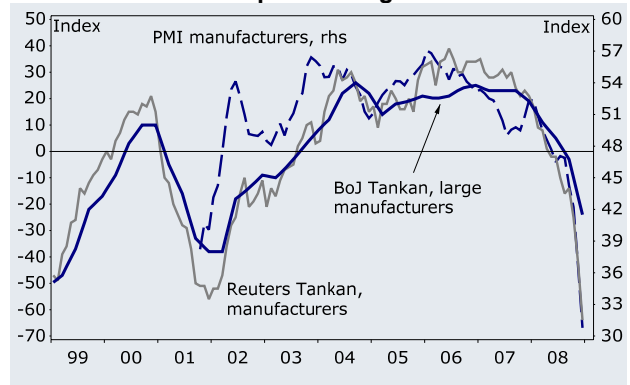
**No longer positive contribution from exports**



**JPY driven stronger by lower risk appetite**



**Business confidence plummeting**



## Headed for a deep recession

- The economy will contract severely in the winter
- Contraction period over in the summer
- Inflation will slow sharply
- The ECB will cut rates to an exceptionally low level

The Euro-area economy sank into a deep recession towards the end of 2008. The slowdown started already in the spring as a result of an inflation spike and rising rates. In the autumn the culmination of the financial crisis exacerbated the downturn and GDP shrunk considerably towards the end of the year. No instant relief can be expected according to economic surveys and other leading indicators. On the contrary, they indicate that the economy will decline further in the near future.

So, it appears that this year will be the weakest since World War II. We have not seen a downturn on this scale since the oil crises and the tumult in the early 1990s, but the outlook is not entirely gloomy. The conditions for a recovery have started to improve, even faster than earlier expected. Inflation will decelerate and interest rates drop, and the EUR has already peaked. Furthermore, fiscal revitalisation is exceptionally intense.

But it will take some time for the positive impact of these factors to show. The recovery of the financial market has just begun and the export market will not show any improvement until H2 2009 at the earliest. So, a turn for the better is still on the drawing board and the risks continue to be on the downside in the near future. Later the risks will become markedly more balanced, and the longer it takes before the rebound materialises, the stronger the recovery will be. In our baseline scenario, economic growth in 2010 will be distinctly weaker than normal,

even though the situation will improve gradually.

### Record-steep decline in exports

The cyclical turns in the Euro area are typically export-driven. This is also the case this time: exports slowed markedly already in the first half of 2008 but still grew resiliently, contrary to private consumption and residential investment. In the autumn the slump in exports worsened significantly when companies were simultaneously hit by the upward spike in the EUR and the faltering export market. The outlook for the near future is exceptionally gloomy, as demand has diminished sharply also in Emerging Markets, which have become significantly more important to Euro-area exports in recent years. In addition, the financial crisis has hampered exporters' business operations, as it has been difficult to obtain even normal export finance.

So far, the only positive factor in terms of exports has been the cheaper EUR, which typically boosts exports with a delay of about six months. This time the weaker EUR will only alleviate the distress of exporters in the near future and any hopes of a gradual pick-up in exports are focused towards the end of 2009.

### Investment on a long downward track

Investment will also decrease sharply. Residential investment will drop markedly in a number of countries. On average, residential investment has not been exceptionally strong in the Euro area, but the lame construction activity in Germany has been balanced by robust residential construction in many other countries. No improvement is to be expected in Germany, but residential construction will decline in other countries. Other construction activity will cool down in the wake of funding difficulties, and other investment activity will also suffer

### Euro area: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (EURbn)	2006	2007	2008E	2009E	2010E
Private consumption	4,650	2.0	1.6	0.3	0.3	0.9
Government consumption	1,659	2.0	2.3	1.9	2.5	2.0
Fixed investment	1,672	5.8	4.2	1.0	-6.7	-1.2
Stockbuilding*	16	0.1	0.0	-0.1	-0.4	0.1
Exports	3,076	8.1	6.1	3.1	-2.2	2.1
Imports	2,967	7.8	5.3	2.8	-2.0	1.8
Net exports*	109	0.2	0.3	0.1	-0.1	0.3
GDP		3.0	2.6	0.9	-1.3	1.0
Nominal GDP (EURbn)	8,110	8,504	8,928	9,145	9,189	9,417
Unemployment rate, %		8.2	7.4	7.5	8.5	9.5
Industrial production, % y/y		4.0	3.5	-1.5	-4.0	0.0
Consumer prices, % y/y (HICP)		2.2	2.1	3.3	0.5	1.5
- core inflation**		1.5	2.0	2.5	1.6	1.2
Hourly earnings, % y/y		2.2	2.2	3.5	2.5	2.0
Current account (EURbn)		0	25	-46	-16	-7
- % of GDP		0.0	0.3	-0.5	-0.2	-0.1
Trade balance (EURbn)		-15	22	-41	-11	-2
- % of GDP		-0.2	0.2	-0.5	-0.2	-0.1
General govt budget balance, % of GDP		-1.3	-0.6	-1.2	-3.0	-3.2
Gross public debt, % of GDP		68.4	66.3	65.9	68.6	70.1

\* Contribution to GDP growth (% points)

\*\* HICP excl. energy and unprocessed food

from the industrial recession and the tightness of the financial market. So, investment will decrease sharply this year and on average will not return to the growth track in the following year either.

**Consumption outlook ambiguous**

The Euro area plunged into a recession in the wake of declining household consumption and partly households' diminishing residential investment. The sharp inflation peak eroded purchasing power and the higher rates dampened the willingness to make new acquisitions. Confidence deteriorated sharply and the savings ratio started to rise. As a result, consumption dwindled. Certainly, the turmoil during the autumn has weighed down consumer confidence further and the decline in employment will adversely affect the household sector's ability to spend going forward.

However, the consumption outlook is not unambiguously negative. The sharp drop in inflation and interest rates will improve the outlook. The working population will see the fastest rise in real wages ever in the Euro area. The fall in interest rates is also extraordinary despite the difficulties in the financial market. Private consumption is likely to increase slightly this year even though the savings ratio will go up. Consumption will probably accelerate further in 2010, although growth continues to be slower than average.

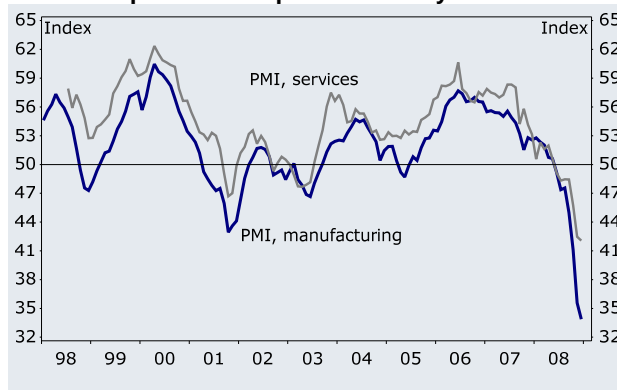
This year the strongest factor supporting demand will be public spending, which typically lags somewhat behind economic changes. In addition, the economy will be re-suscitated with exceptional intensity. The revitalisation will mainly be transmitted through the private sector, increasing households' disposable income and alleviating the downhill slide of investment. Still, a part of the large fiscal stimulus packages will be allocated to public spending as well.

As a result of the robust fiscal revitalisation, the public sector deficit will rise to over 3% of GDP on average. However, the recession makes it possible to relax the Maastricht criteria. Consequently, the size of the public budget deficits will not be a concern in the next couple of years. At present, a bigger cause for worry is the increasing unemployment. Economic growth will not yet be robust enough in 2010 to stop the rise in unemployment. So, a turn for the better in the labour market is not in the cards during the forecast period.

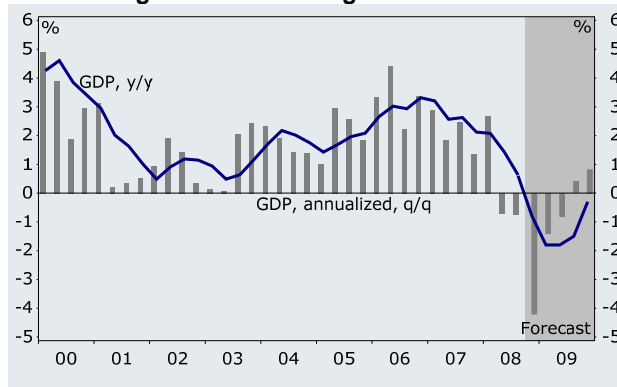
**Inflation temporarily into negative territory**

After the surprising spike during the summer, inflation slowed sharply. Consumer prices have increased mainly due to the higher prices of energy and food, but energy prices have already tumbled and the rise in food prices is slowing rapidly. Inflation will continue to slow considerably and consumer prices will drop in the summer of 2009 compared to the summer of 2008 when energy

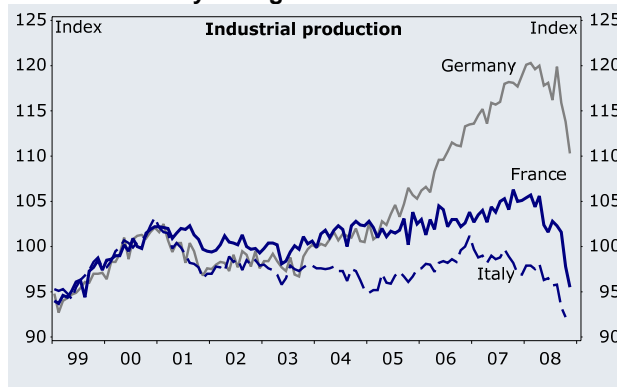
**Indicators point to sharp fall in activity**



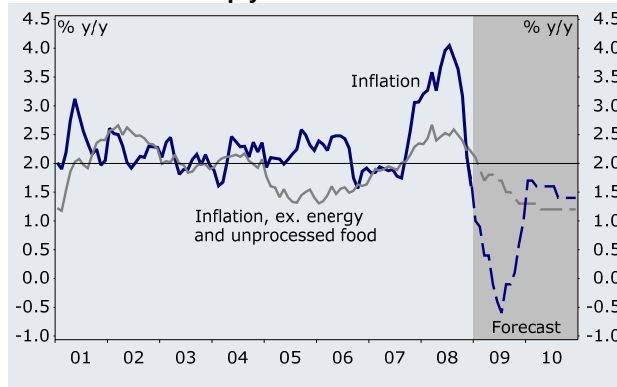
**Record-long contraction in sight**



**Industrial activity diving in all countries**



**Inflation dives sharply**



prices peaked. The decline in prices will be temporary, but the inflation outlook is very moderate also in the medium term. The recession will push prices of industrial products down and service inflation will also start to slow gradually. According to our estimates, inflation will be below the central bank's target also in 2010.

**Central bank's unusual challenges will persist**

The central bank responded quickly to the rapid changes to the economic outlook in the autumn. By ECB standards the policy rate was cut exceptionally fast by 1.75% points. Then again, the ECB's cuts so far pale in comparison with those of other central banks. The ECB is concerned that lowering the policy rate to an exceptionally low level might trigger new problems, as it may be difficult to hike the rate to a more normal level. With the recession becoming deeper, these concerns seem distant, and we expect the ECB to follow in the footsteps of other central banks and lower the policy rate to a record-low level.

How much the central bank will ultimately cut the policy rate largely depends on developments in the money market. Central bankers have eagerly emphasised that after the sizeable cuts their primary concern is to get the cuts transmitted through to market rates. We assume that the market situation will continue to improve gradually and that the ECB does not need to lower the policy rate below 1.5%.

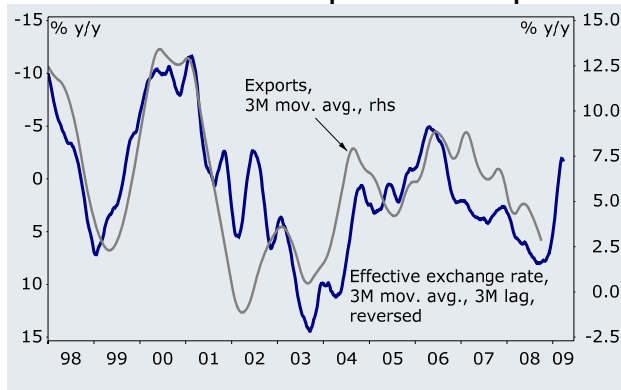
The financial sector still represents a major risk to the macroeconomic outlook, however. The losses suffered by the Euro area's major banking groups as a result of the financial turmoil have forced many of them to contain risks by reducing the leverage of their balance sheets. Until the collapse of Lehman Brothers in September this was mostly achieved through the injection of fresh capital in excess of losses. Since then, banks have found it much harder to raise fresh capital, and this increases the risk of a substantial fall in lending to businesses and households.

In such a situation, it may become relevant for the ECB to embark on a policy of quantitative easing in the same fashion as the US Federal Reserve. According to ECB officials, the statutes of the ECB do not exclude such a policy, but the decentralised nature of Euro-area financial markets and fiscal authorities still make such a move unlikely. Furthermore, the risk of a credit crunch will also be alleviated by the various government schemes adopted at the height of the financial turmoil, and we find it more likely that these schemes will be further expanded before quantitative easing is considered.

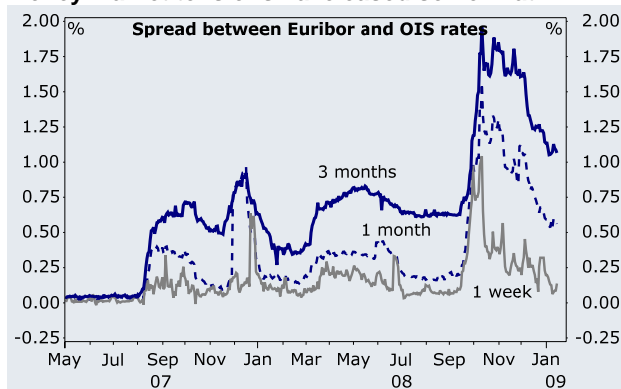
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**Weaker EUR could alleviate pressures on exports**



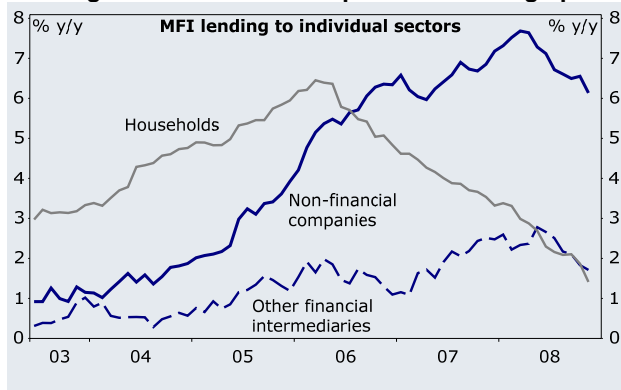
**Money market tensions have eased somewhat**



**Corporate credit spreads remain elevated**



**Lending to non-financial companies is holding up**



## Hangovers!

- Households and businesses under pressure
- Bank of England and government responded
- GBP severely weakened against most currencies
- Hope ahead

### The party is over

The UK has been in a party mood for many years. Interest rates were low and borrowing was easy as the level of risk tolerance in financial markets was high. Households were particularly eager to borrow, and the UK is among the countries topping the international league tables measured by household debt as a percentage of disposable income. Also, the optimism and the desire to borrow contributed to the surge in house prices until early 2007.

Since the middle of 2007 when the credit crisis erupted and the Bank of England eased rates, banks have put a brake on lending and tightened credit standards, thereby triggering a reversal of skyrocketing house prices and causing a good deal of housing wealth to evaporate. With accelerating energy and commodity prices putting pressure on household budgets, the consumer spending spree gave way to hangovers and consumer confidence readings have dropped sharply since then.

In an international perspective the UK has a very large percentage of people employed within the troubled financial services sector. That constitutes a threat of severe job losses. It is positive, though, that the government has provided a safety net for banks, partly by injecting capital into the sector, which has had a stabilising effect.

But the problems have spread to most of the corporate sector, which generally experiences restricted access to credit. Households have scaled back on spending, and with the slowdown in the global economy exporters face a deterioration in demand. Surveys by the Confederation of British Industry further indicate that the high costs of and the restricted access to financing are starting to adversely affect corporate investment plans.

Following two quarters of negative growth the economy slipped into recession in Q3 2008. Forward-looking indicators suggest that the economy will suffer from these hangovers well into 2009. The PMI readings, normally a good indicator of GDP growth, are at record lows.

### Government rescue package

In response to the weak economic outlook the government presented an economic rescue package in November, with the aim of kick-starting the sluggish economy. The package consists of tax cuts and an increase in public spending totalling GBP 20bn (1.4% of GDP) in the period until April 2010. The key element of the package is a temporary VAT cut from 17.5% to 15% from 1 December 2008 until 31 December 2009. Another important element is to bring forward public investment projects to the tune of GBP 3bn.

We expect positive effects from the rescue package on consumer spending and corporate earnings. However, the rescue package is relatively small and the scope for additional measures is limited as the UK is already running considerable public deficits. The slowdown in activity will also generate lower tax receipts, while expenditure for unemployment benefits will increase. That leaves a hole in the budget, which looks set to show a large deficit this year.

### Bank of England cut rates very aggressively

From the end of 2007 until the autumn of 2008 the UK, like most other countries, saw markedly higher inflation driven by surging commodity prices. However, with recent months' falling commodity prices, severe deterioration of the economy and the government's temporary VAT reduction, there are prospects of significantly lower inflation over the course of 2009.

Until the beginning of October the spectre of inflation kept the Bank of England from cutting interest rates although the economy was showing signs of weakness. With recent months' further deterioration of the economy and fears that inflation could turn negative, the bank has felt compelled to use the interest rate weapon. Since

### UK: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (GBPbn)	2006	2007	2008E	2009E	2010E
Private consumption	811	2.0	3.2	2.0	-1.1	0.7
Government consumption	269	1.7	1.9	2.4	2.2	1.4
Fixed investment	211	7.6	6.0	-4.6	-10.9	1.7
Stockbuilding*	5	0.0	0.2	-0.2	0.0	0.0
Exports	331	10.7	-5.1	1.0	-1.6	2.8
Imports	-374	9.8	-2.4	0.7	-2.2	2.6
GDP		2.9	3.1	0.8	-2.0	1.0
Nominal GDP (GBPbn)	1,253	1,322	1,401	1,451	1,430	1,477
Unemployment rate, %		2.8	2.9	2.8	4.7	6.5
Consumer prices, % y/y		2.1	2.3	3.5	0.4	2.3
Current account, % of GDP		-2.5	-3.7	-3.1	-2.5	-2.2
General govt budget balance, % of GDP		-3.6	-2.9	-3.8	-6.5	-5.5
Gross public debt, % of GDP		42.1	43.9	46.2	53.4	57.2

\* Contribution to GDP growth (% points)

8 October the bank has aggressively trimmed rates to the lowest-ever level in the history of the Bank of England, which dates all the way back to 1694. Even so, we do not believe the bank is done cutting rates. The outlook for the economy is simply too bleak.

The temporary VAT cut will expire on 1 January 2010. Combined with an improvement in the economy, that will contribute to lifting inflation again. We thus expect the bank to raise rates again from the beginning of 2010.

**Hope ahead**

At this juncture the clouds over the UK are very dark, but there are hopes that the economy will again be on the mend. One type of medicine is the rate cuts already introduced, as these are now starting to feed through to 3-month Libor rates and thereby bank funding costs. And together with pressure from the government to make banks pass on the lower interest rates to borrowers, there are prospects that both private individuals and businesses will once again see lower rates on their loans. Another boost to the economy could come from the GBP, which has weakened sharply against most currencies in recent months. That improves the competitiveness of exporters. Also the government's rescue package will help to underpin the economy.

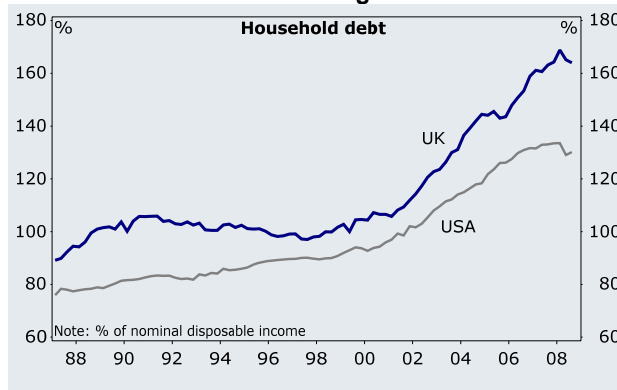
Recent months' sharp GBP erosion is attributable to the aggressive rate cuts and expectations that interest rates will come even closer to zero. In addition, the gigantic budget deficit involves a risk of a massive sell-off of UK government bonds.

With the market focusing on the weak economy, continued GBP weakness is very likely short term. However, we believe that the currency already discounts a lot of bad news. With the gradual economic recovery we see the GBP once again appreciating against the EUR longer term.

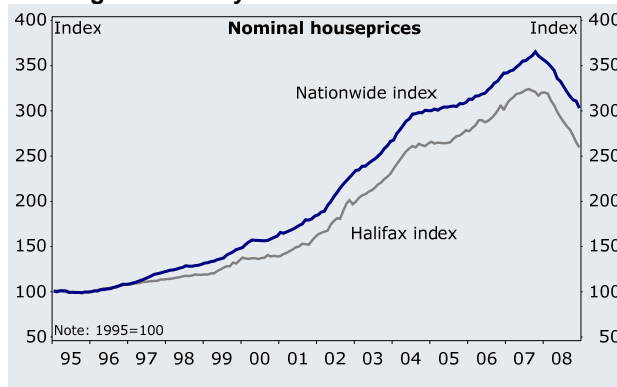
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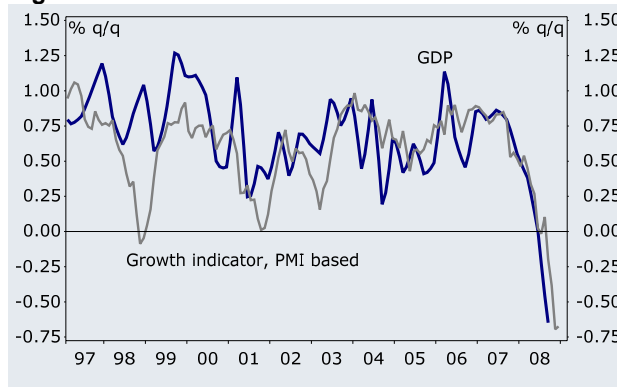
**Households strained under huge debt burden**



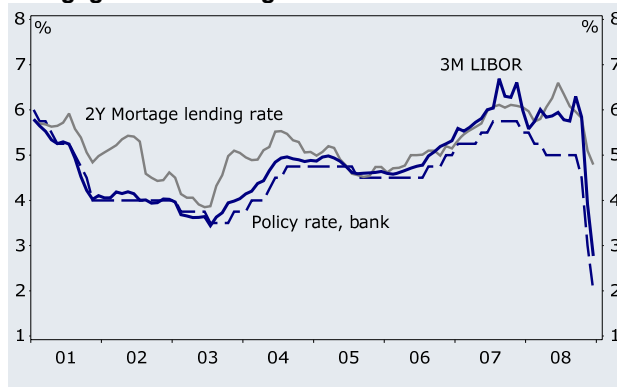
**Housing market rally over**



**Signs of continued downturn**



**Mortgage rates starting to come down**



## Economy sliding downhill

Economic growth in Switzerland is decelerating – one of the reasons being the global recession, which looks set to continue into 2009. Moreover, the CHF has generally been strong. The important export sector, which in terms of size makes up about 50% of GDP, is thus under pressure. And the financial crisis is negative for the large financial sector. Consumers and businesses alike take a very gloomy view on the economic situation: consumer confidence and the KOF indicator, Switzerland’s leading economic barometer, have plunged. Combined with the uncertain market conditions this suggests that many investment plans have either been scrapped or put on the backburner. We therefore look for declining investment activity in 2009 and 2010. Moreover, the weaker economy will likely cause unemployment to rise, albeit from a very low level, and the declining inflation will help to support consumption.

The Swiss national bank (SNB) pursues a monetary policy that aims to keep annual consumer price inflation just below 2% with due regard to the country’s economic growth. Given the falling commodity prices and low economic activity, inflation is now approaching 0%, and the SNB has been proactive, lowering its policy rate sharply from 2.75% to 0.5% since 8 October. At the same time the 1-week repo rate has also been slashed. We expect that the policy rate will be brought closer to 0% in early 2009.

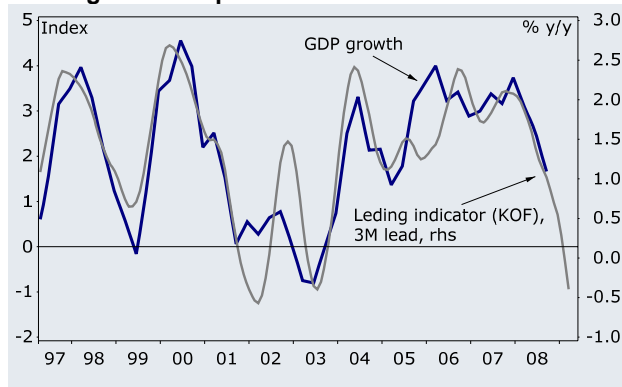
The historically close correlation between share prices and the performance of the CHF versus the EUR has not been evident since November. One of the reasons is the SNB’s aggressive rate cuts. Over the coming months we expect the interest rate differential between the Euro area and Switzerland to narrow, which coupled with persistently low risk appetite will cause the CHF to appreciate versus the EUR. However, longer out we expect the fall-out from the current financial crisis to gradually abate. This will again contribute to weakening the CHF versus the EUR.

Martin Ipsen

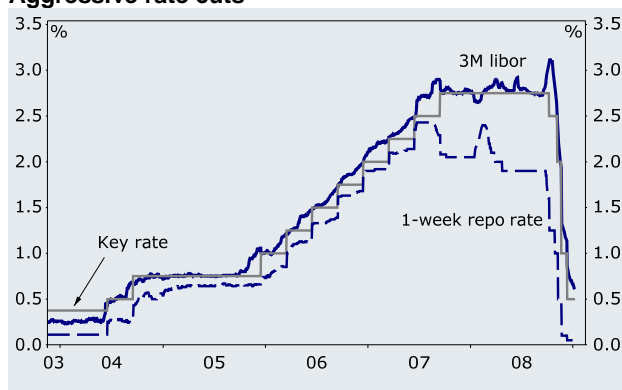
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Leading indicator points to further downturn



Aggressive rate cuts



CHF not driven by share prices since November



### Switzerland: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (CHFbn)	2006	2007	2008E	2009E	2010E
Private consumption	279	1.6	2.1	1.9	1.1	0.9
Government consumption	54	-0.9	-1.1	-0.7	1.2	1.4
Fixed investment	98	4.7	5.4	-2.5	-4.5	-1.0
Stockbuilding*	2	1.1	-0.1	-0.3	0.0	0.3
Exports	226	9.9	9.4	3.6	-2.6	2.4
Imports	196	9.5	5.9	1.2	-1.0	2.3
GDP		3.4	3.3	1.7	-0.5	0.8
GDP nominal (CHFbn)	463	487	509	530	529	538
Unemployment rate, %		3.3	2.8	2.5	3.2	3.7
Consumer prices, % y/y		1.1	0.7	2.5	0.5	1.0
Current account, % of GDP		14.7	16.8	17.0	16.2	16.3
General govt. budget balance, % of GDP		1.9	1.3	0.6	-1.0	-1.2

\* Contribution to GDP growth (% points)

## Barely avoiding recession

The economy is slowing down fast. Exports and investment are now contracting due to the global financial crisis, which has significantly affected foreign demand and domestic credit conditions. Meanwhile, growth in manufacturing is in free fall. The steepest decline was probably in Q4 last year, but the contraction is likely to continue at least throughout Q1 2009. The weak PLN and the interest rate cuts from the National Bank of Poland (NBP) will help eventually, but will hardly be enough to generate positive momentum before the global environment improves.

The labour market remains fairly tight, though, and is – together with the temporary boost from the tax cuts implemented from 1 January – supporting decent growth in private consumption. Falling activity in the export-oriented sectors have led to some easing of the labour market pressure, and we expect seasonally adjusted employment to start falling in Q2, implying that wage growth will come down further. Still, consumers’ real disposable incomes may increase decently in 2009 and hence we expect private consumption to hold up quite well during the year despite falling house prices, limited credit availability and a gradual easing of labour market conditions. This is why we still expect that an outright recession can be avoided, although barely so. We expect the economy to start recovering gradually in Q2, leaving growth at just below 1% for 2009 and just below 3% next year.

Inflation concerns have more or less disappeared with the falling energy prices and deteriorated economic outlook and this has allowed the NBP to embark on an easing cycle. We expect interest rates to be cut to around 4% rather quickly. The PLN has weakened substantially and is now undervalued. We expect a gradual strengthening in the medium term. EMU membership is now targeted for 1 January 2012, though we see some risk of delays due to political challenges and the financial crisis.

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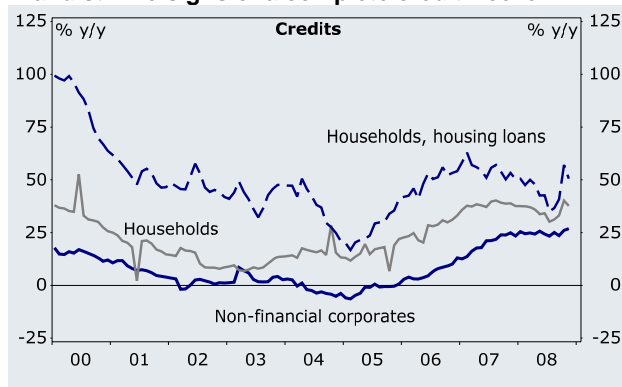
### PMI points to recession...



### ...but the labour market remains tight...



### ...and still no signs of a complete credit freeze



### Poland: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (PLNbn)	2006	2007	2008E	2009E	2010E
Private consumption	609	5.0	5.0	5.3	3.4	2.3
Government consumption	178	6.1	3.7	0.1	3.1	3.1
Gross fixed capital formation	179	14.9	17.3	7.1	-3.1	6.6
Stockbuilding*	10	0.4	1.7	0.4	0.2	0.0
Exports	365	14.6	9.1	5.1	-6.4	4.8
Imports	372	18.6	13.6	5.7	-1.3	2.5
GDP		6.2	6.7	5.0	0.9	2.6
Nominal GDP (PLNbn)	983	1,060	1,175	1,273	1,306	1,370
Unemployment rate, %		16.2	12.7	9.8	10.5	11.9
Consumer prices, % y/y		1.2	2.6	4.4	1.7	2.3
Current account, % of GDP		-2.7	-4.7	-4.8	-5.2	-4.8
General government budget balance, % of GDP		-3.8	-2.0	-2.7	-2.7	-2.5

\* Contribution to GDP growth (% points)

## Deep in recession

The Estonian economy drifted into a deep recession last year. The economy began to contract already in Q2 relative to the previous year. Retail sales and industrial production are declining, as is output in the main export industries, such as wood products – electronic products being an exception. Household and business confidence in the economy is record low, and the outlook for production and consumption is extremely weak.

The external environment is expected to be exceptionally challenging, as the US-led slowdown is forecast to stretch well into 2010. The economies of Estonia's biggest trading partners Finland and Sweden are also expected to contract this year, so Estonia's export outlook is clearly weakening.

We expect GDP to decline about 4.5% in 2009, which is considerably more than in 2008. The correction in the housing market is likely to continue throughout 2009, and a sharp decline is expected in investment. The rise in unemployment figures will further weaken private consumption. Estonia will not return to the growth track until export demand recovers, which will not happen until well into 2010.

Inflation peaked at over 11% at the beginning of last summer. Inflation began to slow in mid-2008 when the year-on-year changes in food and energy prices declined sharply. Especially the falling fuel prices reduced inflation. Inflation is currently around 8% and we expect a quick deceleration while the economic recession deepens and the softening labour market curbs wage growth.

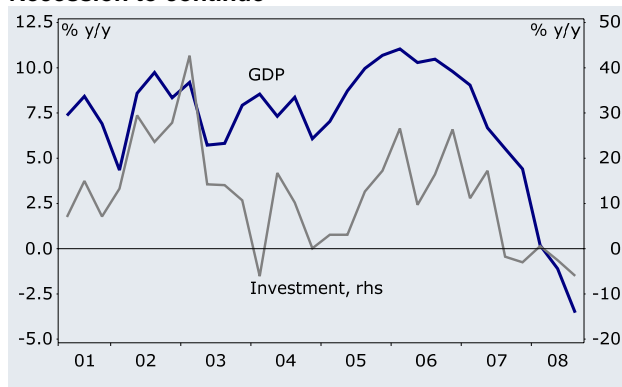
Despite spending cuts and postponed tax cuts, the public budget deficit is forecast to increase, as recession reduces tax revenues. However, public finances are quite strong because Estonia is practically debt-free and it has accumulated rather large reserves during the fat years, covering about 10% of GDP.

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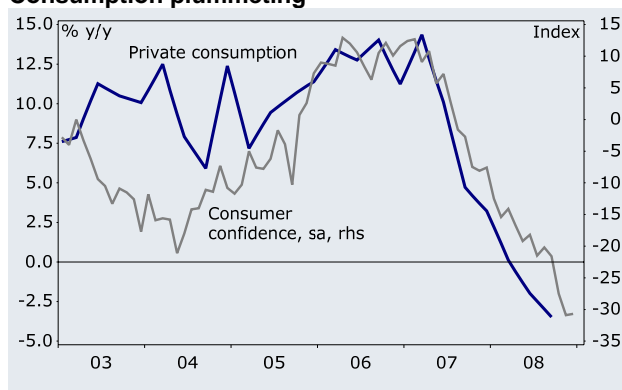
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**Recession to continue**



**Consumption plummeting**



**Labour markets cooling quickly**



**Estonia: Macroeconomic indicators (% annual real changes unless otherwise noted)**

	2005 (EEKmn)	2006	2007	2008E	2009E	2010E
Private consumption	93,835	12.7	7.9	-2.1	-5.5	0.5
Government consumption	29,942	1.8	3.9	3.8	-3.5	0.0
Fixed investment	53,742	19.5	4.8	-4.8	-10.0	-1.0
Exports	138,550	11.6	0.0	-1.3	-3.0	0.0
Imports	149,560	20.4	4.2	-6.0	-5.0	1.0
GDP		10.4	6.3	-2.2	-4.5	-1.0
Nominal GDP (EEKmn)	173,530	205,038	238,929	258,521	258,521	263,692
Unemployment rate, %		5.9	4.7	5.5	8.5	9.5
Consumer prices, % y/y		4.4	6.7	10.4	4.5	3.0
Current account, % of GDP		-17.0	-18.5	-11.0	-7.5	-6.0
General govt budget balance, % of GDP		2.9	2.7	-1.5	-3.0	-2.5

## Plunging deeper

The Latvian economy plunged deep into recession very quickly last year. In early 2008, the economy was still growing, but in Q3 it had already contracted by almost 5% relative to the year before. Private consumption and investment have declined more than 10%.

The boom in the housing market has turned into bust. Developments in the housing market will have a negative impact on residential investment and private consumption. The employment outlook has deteriorated quickly and we expect considerable growth in unemployment in 2009. The global recession weakens the export outlook, as the growth outlook is very gloomy in Estonia, Lithuania and Russia, Latvia's main trading partners. Consequently, we predict that the Latvian economy will contract about 6% in 2009.

The fast economic decline and the resulting weakening of the balance of public finances and the need to stabilise the financial market drove the Latvian government to ask for financial support from the IMF and EU. In order to receive financing, Latvia was required to issue an extensive reform package with the purpose of restoring the economy and improving Latvia's competitiveness. The Latvian parliament has decided to cut income taxes but raise VAT, so that overall tax revenues are expected to increase. The government is hoping that the income tax cut will support employment in the difficult financial situation and slow down wage growth in the private sector. In the public sector, wage cuts of 15% have been announced. We expect the public deficit to grow to 6% of GDP despite the announced tightening of fiscal policy.

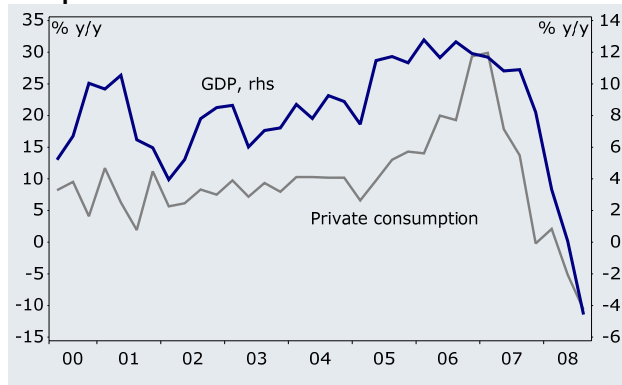
Inflation in Latvia skyrocketed in 2008, led by soaring food and energy prices and administered prices. Now inflation is decelerating quite rapidly due to the deep economic recession. We expect the currency peg to remain unchanged. The funding package granted by international players will probably cool down the market and ease the pressure on the currency.

Reijo Heiskanen

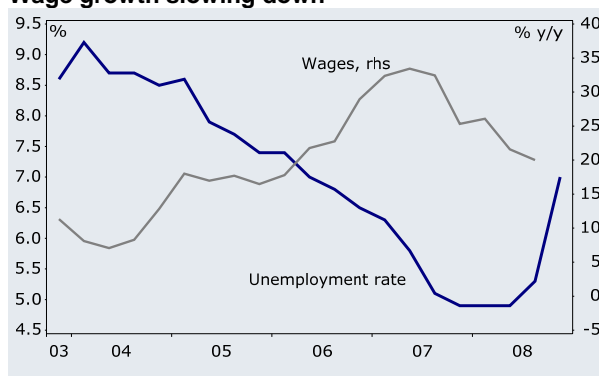
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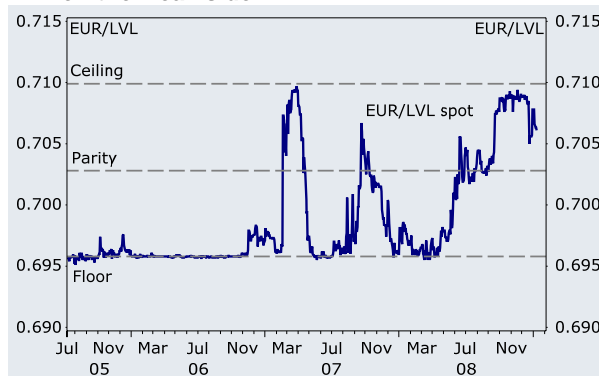
Sharp slowdown



Wage growth slowing down



LVL on the weak side



### Latvia: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (LVLmn)	2006	2007	2008E	2009E	2010E
Private consumption	5,666	21.2	14.2	-6.1	-10.0	-2.5
Government consumption	1,581	4.9	4.8	2.8	-5.0	-2.0
Fixed investment	2,774	16.4	8.4	-7.8	-9.0	-2.6
Exports	4,335	6.5	11.1	2.7	-2.0	0.0
Imports	5,638	19.3	15.0	-7.5	-9.0	-1.0
GDP		12.2	10.3	-1.8	-6.0	-2.0
Nominal GDP (LVLmn)	9,059	11,172	13,957	15,883	16,042	16,363
Unemployment rate, %		7.0	5.7	5.3	9.5	11.0
Consumer prices, % y/y		6.6	10.1	15.6	7.0	4.0
Current account, % of GDP		-22.5	-22.9	-14.0	-8.0	-7.0
General govt budget balance, % of GDP		-0.2	0.1	-3.0	-6.0	-5.5

## Recession just round the corner

The Lithuanian economy is on the brink of recession. Production grew robustly in the first half of 2008, as income tax cuts boosted consumption. Investment growth, however, has already been on a downtrend for quite a while. Weak confidence indicators reflect a less benign outlook for both households and corporates. GDP growth has been slowing for a year already, and there are no signs of the fall levelling out.

The recovery of oil refining capacity in the latter part of 2007 helped exports and imports grow briskly in 2008. In terms of value added, the impact of oil refining is, however, limited. Industrial production excluding oil refining has grown modestly. Export demand is exceptionally subdued both in Russia and Germany this year. Moreover, the economic crisis in Latvia weighs down export growth in Lithuania. We forecast a contraction of 3% in the Lithuanian economy in 2009.

The new government's programme for balancing public finances supports financial stability in the longer term but the direct effect on growth is negative. Tax cuts directed at earned income will support employment and curb wage demands, but the VAT hike and planned rise in aggregate tax revenues will erode consumers' purchasing power. Despite belt-tightening, the public deficit threatens to grow throughout the forecast period, and the government must increase borrowing in order to finance the deficit.

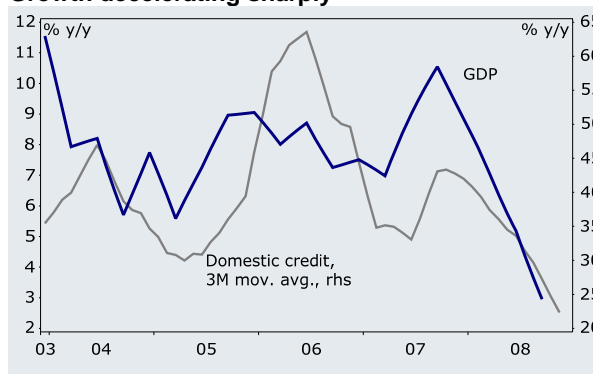
Similarly to many other countries, Lithuania experienced an inflation spike last year. Now that the economy is cooling down, the inflation trend is clearly downwards. The most significant risk threatening the positive inflation trend is the closing down of the Ignalina nuclear power plant at the end of 2009, as agreed with the EU. If the plant is closed down as planned, inflation will accelerate at least 2-3% points in 2010 in the wake of the energy price rise, making growth in 2010 underperform the baseline scenario by at least 2% points.

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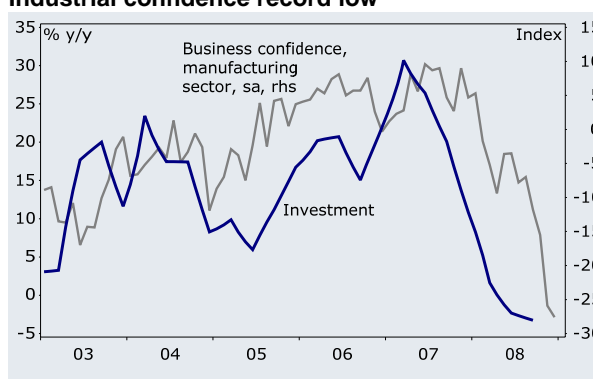
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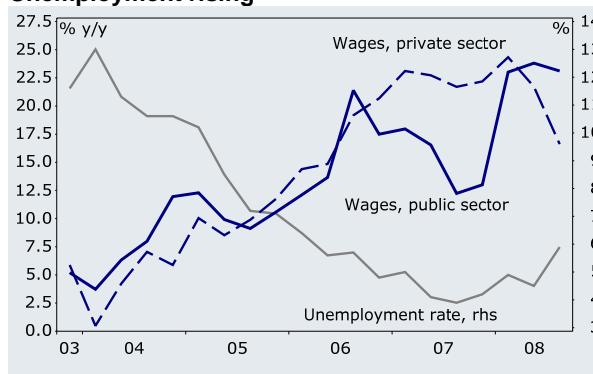
Growth decelerating sharply



Industrial confidence record low



Unemployment rising



### Lithuania: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (LTLmn)	2006	2007	2008E	2009E	2010E
Private consumption	46,453	10.6	12.4	6.8	-3.5	-1.0
Government consumption	12,231	3.7	3.3	5.0	-1.0	0.0
Fixed investment	16,302	19.4	20.8	-3.1	-6.0	-2.0
Exports	41,440	12.0	4.3	12.1	-2.0	1.0
Imports	46,667	13.7	11.6	12.5	-3.5	0.0
GDP		7.8	8.9	3.3	-3.0	-0.5
Nominal GDP (LTLmn)	71,380	81,905	96,739	110,573	113,890	117,307
Unemployment rate, %		5.6	4.3	5.6	8.0	9.0
Consumer prices, % y/y		3.8	5.8	11.0	6.0	3.5
Current account, % of GDP		-10.4	-15.1	-13.0	-7.0	-6.0
General govt budget balance, % of GDP		-0.4	-1.2	-2.5	-3.5	-4.0

## In the midst of a financial crisis

Growth in Russia slowed down clearly in the latter half of 2008. The brisk growth of 8% in early 2008 eased to 6% in Q3. Recent figures for retail sales, investment and industrial production suggest a marked slowdown in growth in Q4 2008.

The reasons for the slowdown are the sharp decline in oil prices after the summer and the arrival of the financial crisis in Russia during the autumn. The funding problems of companies have reversed investment growth to a sharp decline. Especially construction growth has stagnated. Private consumption growth has also dropped because the availability of consumer credits decreased last autumn. Especially car sales have declined due to financing problems.

The Russian authorities reacted quickly to the problems in the financial market. The financial stimulus package includes several actions to calm down the interbank money market and ease the financing problems of companies and banks. In total, the stimulus actions amount to more than 10% of GDP.

Despite these actions, we expect growth to slow down markedly in 2009 to around 1%. Companies' financing situation will remain very tight and investment is expected to contract. The oil price is expected to stay low, dragging both the current account and public budget balance into the red already during 2009.

The inflation trend reversed downwards in mid-2008, as the effect of food and energy prices on accelerating inflation receded. We expect inflation to slow further, as growth wanes and the softening labour market subdues upward pressures on wages.

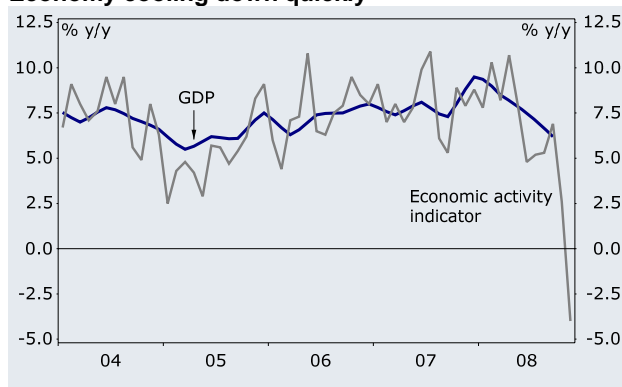
The RUB has already weakened more than 12% against the twin currency basket since last August. We expect the central bank to continue the gradual devaluation of the RUB so that at the end of 2009 the RUB will be approximately 15% weaker than at the beginning of 2009.

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**Economy cooling down quickly**



**Financial crisis hurts investment**



**RUB has weakened**



**Russia: Macroeconomic indicators (% annual real changes unless otherwise noted)**

	2005 (RUBbn)	2006	2007	2008E	2009E	2010E
Private consumption	10,728	11.2	12.8	10.8	5.0	6.0
Government consumption	3,591	2.5	5.0	2.7	4.5	4.0
Fixed investment	3,837	17.7	20.8	10.3	-2.0	2.0
Exports	7,607	7.3	6.4	6.7	-2.0	1.0
Imports	4,648	21.9	27.3	20.5	8.0	10.0
GDP		7.4	8.1	6.0	1.0	2.5
Nominal GDP (RUBbn)	21,625	26,880	32,987	39,650	44,012	48,633
Unemployment rate, %		7.2	6.1	6.2	8.0	9.0
Consumer prices, % y/y		9.7	9.0	14.2	10.0	8.0
Current account, % of GDP		9.5	5.8	6.0	-3.0	-2.5
Central govt budget balance, % of GDP		7.5	5.5	6.5	-2.0	-3.0

## Lowest growth since 1990

- Significant slowdown ahead
- Exports and housing market hit particularly hard
- Help from fiscal and monetary policy measures
- Stable CNY expected

### An end to double-digit economic growth

After five years with double-digit growth, the economy has now slowed down abruptly. In 2008 economic growth was probably close to 9% and we now expect a decline to a paltry 6.7% this year – a level that normally indicates an economy in recession. If so, this will be the weakest growth rate since 1990! However, towards the end of the year we expect momentum to build gradually and in 2010 growth should exceed 8% again.

For several years the economy has benefited from the world's big appetite for inexpensive Chinese products, and exports have gradually made up an increasingly large part of the economy. The reliance on exports means that China will now mirror global cyclical trends more closely than before, which will of course put a damper on the economy under the current circumstances with most industrialised economies in recession. Weaker international demand is already reflected in production as well as exports. Industrial production is now increasing at a single-digit pace annually and is likely to decline further in the months ahead. The PMI activity indicator actually points to zero growth in industrial production, which would be a first since the early 1990s. Similarly, annual export growth was negative in November for the first time in ten years. We forecast persistently weak export trends throughout 2009, as there is little prospect of the global economy picking up pace again until H2 at the earliest.

Investment activity is another source of worry. Manufacturing companies are expected to be cautious until the outlook for demand brightens again. And the slowing business investment activity has already given rise to redundancies. The slowdown in the housing market and consequent slump in construction have also had a relatively strong adverse impact on employment both di-

rectly and through lower activity in related sectors such as building materials. The large cities where the housing market was previously red hot will probably suffer the steepest price declines and the largest increase in unemployment. It is estimated that more than 10 million people have already lost their jobs in the cities. The contribution from investment in residential construction is expected to be close to zero this year.

Private consumption has held up relatively well so far; retail sales rose more than 20% y/y in November. However, there is little prospect of private consumption taking over the role of growth engine near term. Rising unemployment, the downturn in the housing market and falling stock markets have weakened consumer confidence considerably and will over time most likely reduce growth in private consumption.

### Huge fiscal stimulus package

The authorities have not looked on passively while the economic outlook has worsened; a huge fiscal stimulus package was announced in early November. The package is said to include aid measures to the tune of CNY 4,000bn (or almost 14% of GDP). However, some of these measures were due to be implemented anyway or have just been brought forward. The stimulus primarily consists of public infrastructure investment, including railways, roads, airports and energy. Moreover, there are plans to cut taxes and increase spending on public services, for example education. Lastly, a string of measures are aimed at the ailing export companies and the housing market. The rescue package is expected to boost domestic demand towards mid-year and thus gradually help rebuild economic momentum.

If the economic outlook darkens further or the rising unemployment starts to cause more widespread social unrest, additional packages and rescue measures cannot be ruled out. The annual congress of the Communist Party, which is held in March, will be an important forum in this connection. On that occasion it will also be clear how much the public budget deficit will be allowed to swell this year.

### China: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (CNYbn)	2006	2007	2008E	2009E	2010E
Private consumption	7,122	11.3	9.6	10.0	9.0	10.0
Government consumption	2,661	11.5	13.7	12.0	12.0	12.0
Fixed investment	7,730	14.9	12.3	10.0	9.0	9.0
Stockbuilding*	334	-1.3	-1.2	-0.2	-1.0	0.0
Exports	6,858	12.6	17.2	9.0	4.0	10.0
Imports	5,835	13.2	13.9	12.0	9.0	13.0
GDP		11.6	11.9	9.2	6.7	8.4
Nominal GDP (CNYbn)	18,869	22,117	24,662	28,515	30,867	34,374
Unemployment rate, %		4.1	4.0	3.9	4.2	5.4
Consumer prices, % y/y		1.5	4.8	6.4	1.5	3.0
Current account, % of GDP		9.4	11.3	9.0	8.5	9.5
General government budget balance, % of GDP		-0.8	0.6	-1.0	-1.5	-1.5

\* Contribution to GDP growth (% points)

**Also help from monetary policy measures**

Inflation is declining rapidly and is expected to continue to do so in the coming months – even briefly reaching negative territory during the spring. Most of the decline is initially due to lower prices of food, which constitutes by far the largest expense for an average household. But the authorities are still keeping energy prices relatively high and a correction towards the declining global commodity prices could be another way to stimulate the economy in the coming months. We do not expect to see an effect on inflation from the economic slowdown and the rising unemployment until at a later point in time.

The improved outlook for inflation has extended the central bank’s (PBoC) room for manoeuvre to help stimulate the economy rather than curbing economic overheating and inflationary pressure. The PBoC has thus considerably eased the credit quotas allocated to the banking sector and which were particularly aimed at cooling the housing market. In addition, the PBoC has reduced the banks’ reserve requirements and (by the time of writing) cut interest rates five times, reducing the interest rate level to just over 5%. We look for additional rate cuts and easing of reserve requirements in the months ahead.

**Stable CNY expected**

The CNY has been held relatively stable against the USD since mid-year and this suggests a return to the fixed exchange rate regime versus the USD. The markets expect a weakening over the coming year. We believe that the authorities would prefer a relatively stable CNY or at any rate a very gradual and moderate weakening. The reason is that expectations of a sharper depreciation of the CNY could lead to massive capital outflows. Conversely, a stable or slightly weaker CNY could support the hard-pressed export sector. US President-elect Barack Obama is believed to take a harder line with China to force through further currency strengthening and the rhetoric could become sharper as unemployment increases in the US. However, it is doubtful whether this will have any major effect on the Chinese authorities, which will also be facing rising unemployment. The horror scenario is American protectionism, which Obama is generally thought to be more open towards than President Bush.

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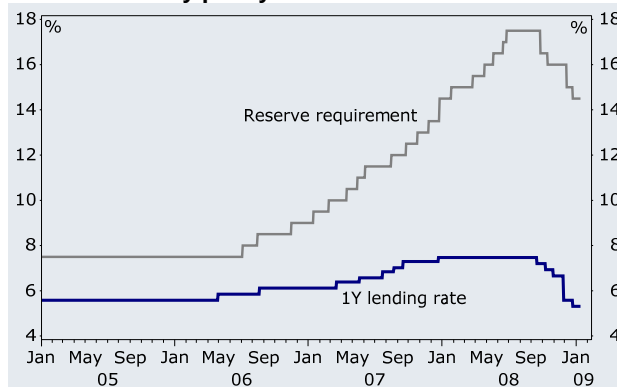
**Persistently weak export trends**



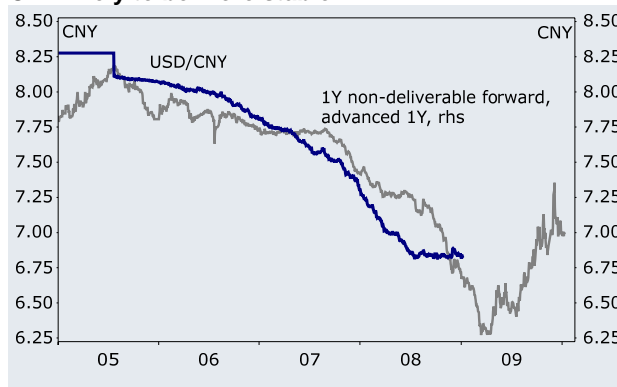
**The housing market has slowed down**



**Easier monetary policy**



**CNY likely to be more stable**



## Reasons for optimism, but not in the near term

The near-term economic outlook is bleak at the moment, and we have revised down our growth forecast to just above 5% for this year. Economic activity probably slowed significantly in Q4 last year to well below the previous 4-year trough for growth of 7%. Exports slowed due to waning foreign demand and we expect a further slowdown in the coming quarters as the global economy will be struggling to overcome the financial crisis. Manufacturers are currently adapting to the deteriorating outlook by cutting down on production and investment. Indeed, commercial vehicle production was reduced by almost 60% y/y in November. Parts of the service sector are also showing weakness, especially sectors related to construction and tourism.

There are several reasons to be optimistic about the outlook a bit further ahead, though, and the economy is expected to show decent growth again in 2010. Indeed, the INR has weakened more than 20% vis-à-vis the USD during 2008 and this will give a major boost to competitiveness once foreign demand returns. Further weakening is even likely until global risk appetite returns. Indeed, the Reserve Bank of India (RBI) had to use USD 70bn of its currency reserves to support the INR in the second half of last year. Moreover, the RBI has acted very decisively during the financial crisis to secure liquidity and support lending, lowering the cash reserve requirement 3.5% points and the repo rate 350 bp so far. Thus, there are no signs of a credit freeze at this point. The government has also done its part for the economy with a stimulus package worth some USD 6.4bn (0.6% of GDP) and the lowering of administered energy prices. However, with public finances in a dire state, monetary policy will be the main policy tool going forward. We expect further monetary easing in the near term to support the economy. With the collapse of energy prices, the pressure on public balances will ease, and inflation is no longer a major concern for monetary policy.

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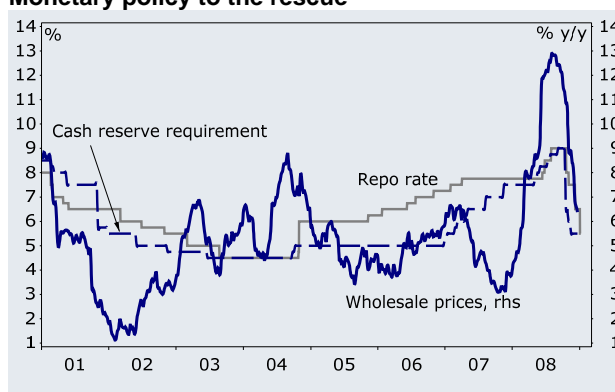
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Slowing down, especially industry



Monetary policy to the rescue



Reserves are now falling



### India: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (INRbn)	2006	2007	2008E	2009E	2010E
Private consumption	20,554	6.6	9.4	6.5	4.5	5.5
Government consumption	3,731	2.2	-2.3	10.5	8.0	5.0
Fixed investment	11,092	15.7	14.3	11.0	8.8	10.0
Exports	7,121	15.8	10.3	13.1	6.2	9.0
Imports	8,135	21.3	14.2	18.2	9.5	10.0
GDP		9.7	8.9	7.2	5.2	6.3
Nominal GDP (INRbn)	35,803	41,458	47,131	54,766	59,640	65,783
Wholesale prices, % y/y		4.8	4.8	9.0	3.7	4
Current account, % of GDP		-1.3	-1.0	-2.5	-3.2	-3.4
General government budget balance, % of GDP		-6.7	-5.6	-5.3	-6.0	-5.0

\* Contribution to GDP growth (% points)

## The good times lasted longer than in other places

The economic slowdown was not visible until quite recently, but there is no longer any doubt that Brazil will not escape unscathed. We have therefore lowered our 2009 growth forecast from 3.3% to 2.0%. In Q3 2008 the economy was actually still growing at a healthy clip (1.8% q/q, 6.8% y/y), as the domestically-driven upswing was not noticeably affected by the problems in the rest of the world due to Brazil's relatively moderate exports. But as the economic expansion was to a large extent supported by the high credit growth, the flare-up of the credit crisis in the autumn of 2008 obviously hit both households and businesses. Private consumption and notably car sales fell sharply and business confidence nosedived. Times will also be tough for private sector investment. Meanwhile, exports of commodities and particularly agricultural products are hit by the large commodity price declines since the summer.

Public consumption and investment has been a key source of recent year's strong growth but has also threatened to heat up the already overheated labour market. This threat is not quite as serious now and with the presidential election in 2010 there is reason to expect continued strong economic stimulus from fiscal policy.

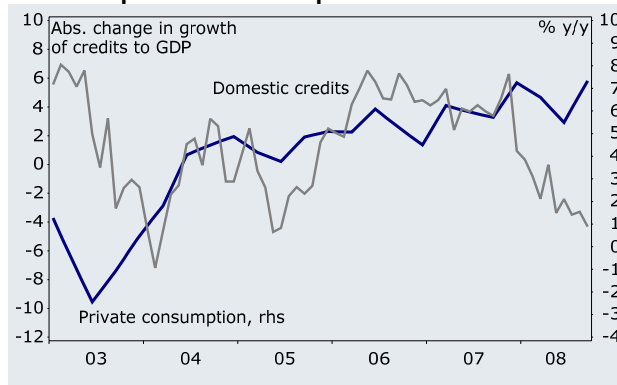
The weakening of the BRL and persistent domestic inflation pressure, which is expected to gradually abate, though, will overshadow the effect from falling commodity prices near term, implying that inflation will not decline significantly in H1 2009. However, the central bank (BCB) is still expected to ease monetary policy throughout the year. Despite the BCB's regular intervention in the market, the BRL depreciated sharply in line with all other Emerging Markets currencies in H2 2008. The current account has entered negative territory and the economic downturn is not enough to counteract this. On the other hand, the BRL will be underpinned by continued high interest rates despite cuts, and we thus expect the currency to regain some of the strength lost when the dust settles following investors' flight to safe haven.

**Bjarke Roed-Frederiksen**

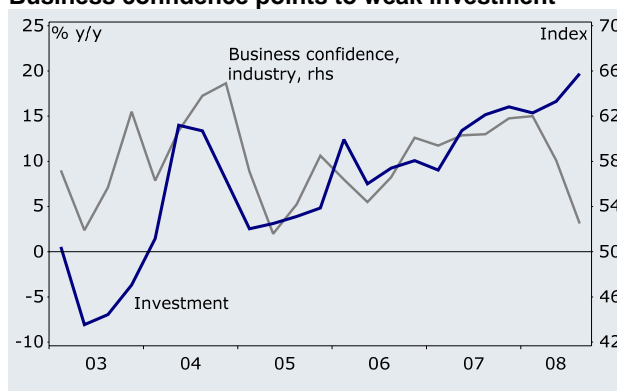
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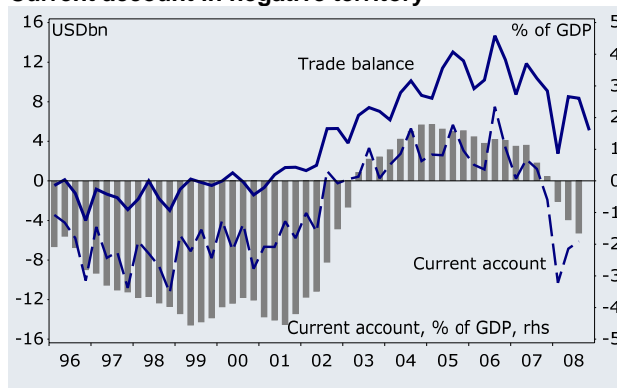
**Credit stop will hit consumption**



**Business confidence points to weak investment**



**Current account in negative territory**



**Brazil: Macroeconomic indicators (% annual real changes unless otherwise noted)**

	2005 (BRLbn)	2006	2007	2008E	2009E	2010E
Private consumption	1,294.2	5.2	6.3	6.3	2.0	2.4
Government consumption	427.6	2.6	4.7	5.7	3.7	2.9
Gross fixed capital formation	342.2	9.8	13.5	16.8	-0.7	6.3
Stockbuilding*	5.7	0.1	-0.1	-3.8	-0.1	0.0
Exports	324.8	5.0	6.7	0.7	-4.8	1.8
Imports	247.4	18.4	20.8	21.4	-6.2	1.0
GDP		3.9	5.7	5.8	2.0	3.3
Nominal GDP (BRLbn)	2,147.2	2,369.8	2,747.0	2,864.2	3,038.8	3,264.6
Unemployment rate, %		10.0	9.3	8.1	8.4	8.5
Consumer prices, % y/y		4.2	3.6	5.8	5.5	4.5
Current account, % of GDP		1.3	0.1	-1.8	-1.9	-1.5
General government budget balance, % of GDP		-3.0	-2.3	-1.4	-1.9	-1.6

\* Contribution to GDP growth (% points)

## Supply cuts will eventually balance the fall in demand

Short term underlying oil prices are expected to continue their downward trend in H1 2009. The price pressure is expected to ease further as demand continues to weaken at a faster pace than oil-producing countries can manage to tighten supply. When the sharp contraction in demand fades, production cuts will have a more marked effect on prices. With a slowdown in investment activity and restricted access to financing, capacity is expected to come under pressure again when demand finally recovers in late 2010. When momentum turns and the need for energy picks up, this may in a worst-case scenario trigger strong upward pressure on prices.

Financial turmoil, the credit crisis and a world economy in recession have led to a sharp drop in oil prices of about 70% from the peak in July. Massive sell-offs by hedge funds as well as index and investment funds have reduced liquidity in the financial market for oil significantly over the past months. Risk aversion has increased significantly, reflecting the deterioration in financial conditions and a weaker outlook for the real economy.

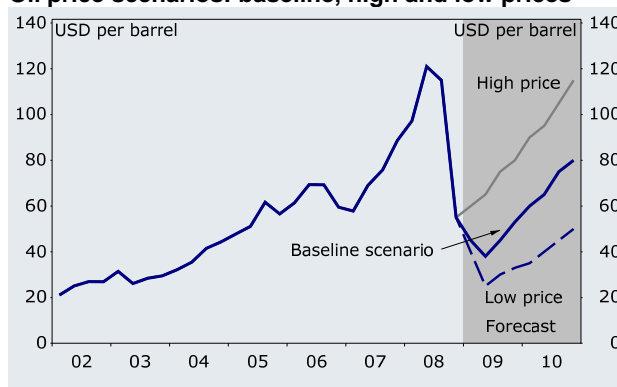
Demand destruction has been worse than expected, especially in the OECD. Three out of four of the world's biggest oil consumers – the US, the EU and Japan – are now in recession. Economic growth in China, the third-biggest oil consumer in the world, has weakened markedly in the last few months and so has the state of other oil-craving emerging economies.

The world is running out of accessible oil as growing resource nationalism and political unrest restrict investments in more than 75% of the world's conventional oil-fields. Growth in non-OPEC supply is expected to remain subdued over the forecast horizon. From 1 January OPEC has cut production three times by a total of 4.2m bpd. But production cuts are expected to continue to lag the fall in demand in the short term and further production cuts may be needed to balance prices. OPEC spare capacity is expected to improve somewhat in 2009 and 2010. Low prices will put adequate investment in long-term capacity growth at risk. Aggravating the situation, project financing is drying up. This may in the worst case lead to a sharp drop in investments in the coming period. At prices below USD 75/barrel, high-cost margin projects such as sour gas, deepwater projects and oil sand may be cancelled or put on hold. Already ongoing assets will still be producing, whereas planned projects would need to be abandoned. A weaker investment climate and the risk that decline rates at mature fields may be higher than previously anticipated will make it even more difficult to maintain existing capacity and to build capacity for future demand growth.

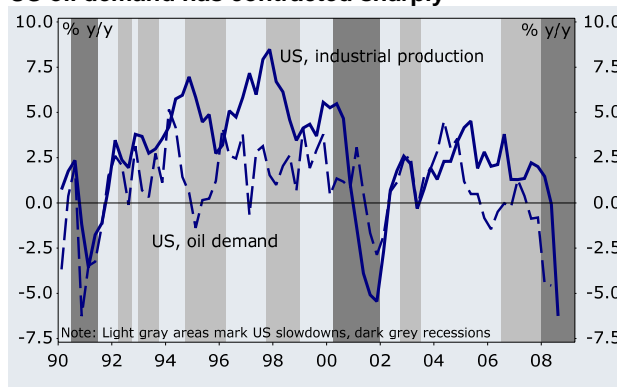
Oil price forecast: baseline (Brent spot USD/barrel)

	Q1	Q2	Q3	Q4	Year
2007	57.8	69.0	75.8	88.7	72.8
2008	97.2	121.0	115.0	55.0	97.0
2009E	45.0	38.0	45.0	53.0	45.3
2010E	60.0	65.0	75.0	80.0	70.0
2009 High	60.0	70.0	75.0	85.0	72.5
2010 High	90.0	95.0	105.0	115.0	101.3
2009 Low	40.0	25.0	30.0	33.0	32.0
2010 Low	35.0	40.0	45.0	50.0	42.5

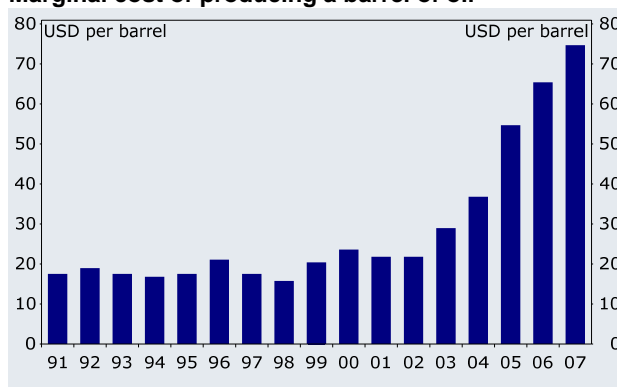
Oil price scenarios: baseline, high and low prices



US oil demand has contracted sharply



Marginal cost of producing a barrel of oil



Source: International Monetary Fund, World Economic Outlook, October 2008

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## Base metal prices continue to decline

The price increase on industrial metals during the global economic boom had evaporated in the autumn. Metals hovered close to the peak level until global industrial output declined sharply. The LME index of the London Stock Exchange lost almost half of its value during Q4. A similar fall is unprecedented in post-war history.

The crash in metal prices was caused by the steep downturn in the industrial cycle, and especially the slump in economic growth in emerging countries. In recent years China has created most of the growth in the demand for metals, but now the Chinese industry has clearly slowed down, too. The global industrial outlook for H1 2009 is poor. Towards the end of the year the situation will probably start to improve gradually, but the pace will not be good even in 2010.

As a consequence of the slowdown in demand growth, inventories have started to increase. After several years of robust growth, demand will increase only slightly next year. On the supply side, high-cost production plants are closed down, but at the same time new plants built during the economic boom are starting operations. On the whole, inventories will continue to increase. Despite the sharp decline, metal prices are still close to the historical average. The prices of most metals have already dropped below the highest production cost levels.

In spite of the massive correction, metal prices have probably not yet bottomed. Inventories will continue to grow and investors will be considerably less interested than before. Prices will likely continue to fall, especially in the early part of the year. The situation will not stabilise until towards the end of the year. At the moment an increase in prices is a far way off.

There is a risk that the financial crisis and the decline in prices will put a halt to investment, and prices will increase sharply again when the global economy eventually recovers. The longer and the deeper the recession is, the more likely the realisation of this scenario is as Emerging Markets will continue to grow strongly in the future and require a lot of commodities. Then again, the risks of the commodity market have become a reality for many investors and it will take quite a while to reduce inventories. According to our baseline scenario, the economy will recover slowly, which means that when the tide eventually turns, the increase in metal prices will be more moderate than during the previous upswing.

Reijo Heiskanen

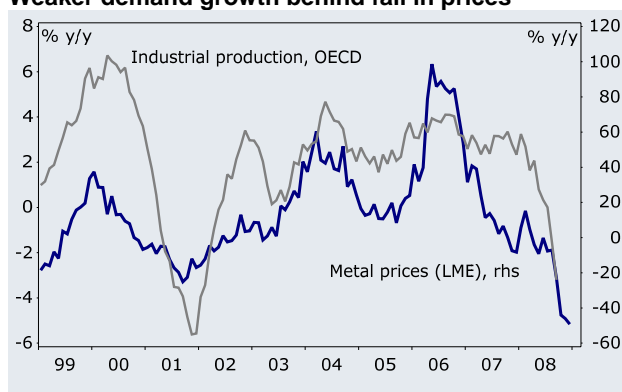
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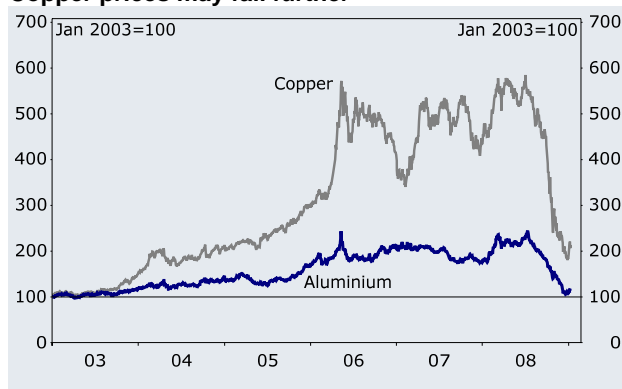
Metal prices may not have hit the bottom yet



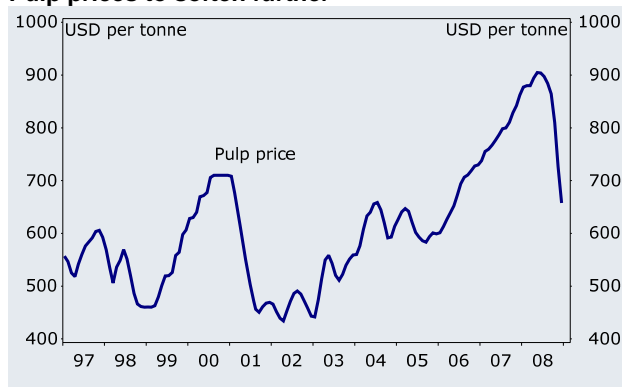
Weaker demand growth behind fall in prices



Copper prices may fall further



Pulp prices to soften further



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