

# Economic Outlook

May 2009



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## At a crossroads

Economic trends have worsened further since the January issue of *Economic Outlook*. The global economy is now in the deepest recession since World War II. As a result of the financial meltdown that followed in the wake of Lehman Brothers' bankruptcy on 15 September 2008, world trade and industrial production collapsed. In this environment countries with a relatively large foreign trade and industrial sector were hit the hardest by the downturn.

Only now some six months later do we see tentative signs of a reversal, and that from a very low starting point. In many countries the economy has been set back several years in just a few quarters. This means that it will take a long time before production is back at the pre-crisis level. As a result joblessness in many countries will continue to rise for a long period of time. This, coupled with the currently very low capacity utilisation, makes a sharp economic upswing over the forecast period (up to and including 2010) rather unlikely. Over the past months inventories have been drained, and the many reports of a nascent recovery in industrial production may therefore initially reflect inventory build-up to meet future demand. Not until we see clear signs that final demand, as reflected in consumption and investment data, is on the increase do we dare talk about an actual economic turnaround. So here we are at a crossroads. Economic trends can still go both ways. If final demand does not gain momentum in the coming quarters, there is a risk that the recession will be even deeper and more protracted than envisaged in our baseline scenario, which assumes a contraction of the global economy of 1.4% this year and growth in positive territory of 2.6% in 2010.

### Government stimulus packages help

Our baseline scenario is based on the economic downturn bottoming this year – mainly as a result of significant economic policy easing initiated almost worldwide to counter the effects of the crisis. The G-20 countries have demonstrated a strong will to act in their efforts to implement concerted – although nationally adjusted – fiscal policy easing measures. Combined, the steps taken by the G-20 countries will lift growth by up to 1.3% this year and by 0.3% next year, according to the IMF.

Add to this the easing of monetary policy at an unprecedented pace. The monetary authorities of all the leading countries in the world have cut their policy rates to historically low levels close to zero. And even though the transmission mechanism of monetary policy is still not working effectively following the meltdown in financial markets, there is no doubt that the lower interest rate level to a great extent supports economic activity. Several central banks led by the Fed and the Bank of England have also embarked on quantitative easing.

In practice, this means that the central banks print money to purchase bonds in the market in an attempt to drive down yields. Later in the forecast period, when definite signs have emerged of the individual countries being back on the growth track, monetary policy will likely be tightened again relatively quickly to avoid a repetition of what happened in 2001-2004. During this period monetary policy was too lenient for too long. And the aggressive monetary policy approach at that time laid the ground for the surge in equity and housing prices which, in turn, contributed to lifting indebtedness in many countries to an unsustainable level, as it turned out.

### Affluent countries don't go bankrupt

The economic recession has also resulted in huge budget deficits in many countries. Periodically, this has led to speculation about some countries going bankrupt and worries about the future direction of yields on long government bonds issued to finance the deficits. Let it be clear: for affluent countries and countries that are members of economic and political unions such as the EU the risk of going bankrupt is extremely small. And generally, a country very rarely defaults on its domestic debt. Moreover, at the G-20 meeting in April for instance the IMF was allocated extra resources to help countries having difficulty in meeting their obligations owing to the financial crisis. In our view, there is therefore no need to worry about the risk of state bankruptcy in one of the countries covered in this publication. And that includes the Baltic economies. Also, we do not expect EMU to be dissolved as a result of the financial crisis. The economic and political advantages of EMU are far too great for that, and moreover the loss of political prestige caused by any dissolution would be huge. On the other hand, the crisis is not likely to actually accelerate an expansion of the Euro area to include for instance the Baltic countries. This is not likely to happen until both the applicant countries and the EU are ready for the expansion. In our view, this will not be the case until 2012 at the earliest.

### Focus on public budgets

However, we cannot rule out that the focus in financial markets may quickly shift to public finances (and rightly so) and that this could cause interest rates to rise sharply. In this context notably the US stands out. We expect the US budget deficit to reach an astronomical level of 12.7% of GDP this year, only to decline to 9.5% in 2010.

We also base our forecast of rising long yields over the forecast period on the assumption that risk appetite will gradually return to the financial markets. However, if the deflation theme begins to dominate the market again, the pick-up in interest rates may be less sharp than we forecast or even fail to materialise.

### Huge currency swings

Developments in the currency markets have been characterised by massive swings since the autumn of 2008. The JPY has strengthened markedly versus the other main currencies to the detriment of Japanese exporters, while the USD has strengthened considerably against the EUR. In tandem with the upswing materialising at a more rapid pace in the US than in the Euro area, the USD may strengthen further versus the EUR to around 1.20 on a 12-month outlook. Slightly longer term we expect the USD to weaken again to around the current level of 1.35, driven by mounting uncertainty about US public finances and rising oil prices.

Currency market developments were also to a large extent driven by investor risk appetite. In step with a normalisation of the financial markets we expect the Emerging Markets currencies, which have taken a severe beating since the autumn of 2008, as well as the SEK, the NOK and the GBP to strengthen again. Conversely, typical funding currencies such as the JPY and the CHF should weaken over the forecast period.

### Northern lights

The Danish economy is in the midst of a deep setback. Like all other countries **Denmark** was hard hit by the collapse in world trade in the second half of 2008, and a steep increase in unemployment in the coming years cannot be avoided. This is made worse by the fact that employment initially continued to rise sharply even after economic activity had begun to slow. The good news is that the plunge in economic activity seems to be levelling out. During the second half of the year a cautious upturn in economic activity is expected, which will continue into 2010 thanks to major interest rate declines, lower oil prices and not least the batch of Danish growth packages. Especially the 2009 budget and repayment of special pension funds (SP) will initially lift activity.

The **Finnish** economy contracted sharply during the winter. The downturn was already apparent towards the end of 2008, but it was sharper than even the gloomiest estimates. With the arrival of spring, more definite signs have emerged of the economy gradually stabilising, and the downtrend is expected to level out towards autumn and reverse into a gradual rise. However, GDP will start to recover from a lower level than previously estimated and GDP will therefore this year clearly contract more than forecast in January. Slight economic growth is expected as early as next year. However, the improvement will start from such a low level and be so slow that the outlook for unemployment and public finances will remain weak for years.

In **Norway**, growth in traditional export markets will be considerably weaker than forecast in the latest issue of *Economic Outlook*. This will not only hit exporters but also trigger a deeper-than-expected decline in mainland investment.

Still, much indicates that growth will be more resilient in Norway than in many other countries. The aggressive rate cuts will support a renewed uptick in private consumption, after a clear downward trend. Solid growth in public consumption and investment will also make a positive contribution, as will oil investment this year. Norges Bank has already slashed interest rates, but low inflation and falling capacity utilisation will allow the bank to sanction further cuts. Stable and gradually increasing oil prices coupled with solid public balances suggest that the NOK will gradually strengthen.

The **Swedish** economy ground to a halt at end-2008 when the deep financial crisis paralysed world trade and made the crisis-conscious Swedish consumers increase their savings. Trends in early 2009 remained weak, but signs are emerging that the bottom is near, and an uptick in exports is expected to contribute to a recovery later in the year. However, the labour market, which lags behind in the economic cycle, continues to weaken. As a result households will probably remain reluctant to increase consumption, although those with jobs will actually benefit from fiscal policy easing and significant rate cuts, which will also have an effect on market rates. All in all, weak demand and low capacity utilisation suggest that the Riksbank can leave the current policy rate unchanged well into 2010.

### Lessons learned

On balance, we are fairly comfortable with the outlook for the global economy. The political commitment of world leaders to pull the economies out of the crisis is in this context critical. Clearly, there is also a risk that developments turn out to be less benign than we forecast. Pessimistic consumers owing to sharply rising unemployment are a risk factor, but danger may also emerge from abroad. A clear example of this is the recent risk of a pandemic. However, fortunately things are rarely as black as they are painted. When fears of influenza A were at their highest, the effects of the Spanish disease in 1918-19 were mentioned as a worst-case scenario which according to the World Bank could trim global GDP by nearly 5%.

Things will not turn out this bad. Similarly, the current recession will not evolve into a slide comparable to the Great Depression of the 1930s. Both pathologists and economists have become far more skilled since then.

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**Growth, %**

	2006	2007	2008	2009E	2010E
World <sup>1)</sup>	4.7	4.6	2.6	-1.5	2.6
BIG-3 <sup>2)</sup>	2.7	2.3	0.7	-3.5	1.2
USA	2.8	2.0	1.1	-2.7	1.5
Japan	2.0	2.4	-0.7	-5.8	0.5
Euro area	3.0	2.7	0.7	-3.5	1.0
Germany	3.2	2.6	1.0	-4.5	1.1
France	2.4	2.1	0.7	-2.8	1.0
Italy	2.1	1.5	-1.0	-3.7	0.8
Spain	3.9	3.7	1.2	-3.2	0.0
Netherlands	3.0	3.5	2.0	-2.5	1.2
Belgium	3.0	2.6	1.5	-3.2	1.3
Austria	3.4	3.1	1.5	-2.7	1.5
Portugal	1.4	1.9	0.5	-3.7	0.5
Greece	4.5	4.0	3.0	-0.5	1.2
Finland	4.9	4.2	0.9	-4.5	1.5
Ireland	7.1	6.3	-2.0	-9.0	-2.0
Denmark	3.3	1.6	-1.1	-2.8	1.2
Sweden	4.2	2.6	-0.2	-3.8	1.8
Norway	4.9	6.1	2.4	-0.6	1.6
Iceland	4.5	5.5	-0.9	-11.1	-0.3
UK	2.8	3.0	0.7	-3.7	0.7
Switzerland	3.4	3.3	1.6	-2.8	0.5
Russia	7.7	8.1	5.6	-5.0	1.5
Poland	6.2	6.7	4.8	0.6	2.9
Estonia	10.4	6.3	-3.6	-9.5	-2.0
Latvia	12.2	10.0	-4.6	-12.0	-3.0
Lithuania	7.8	8.9	3.0	-10.0	-3.5
China	11.6	13.0	9.0	7.0	9.0
India	9.7	9.1	7.1	5.2	6.3
Brazil	3.9	5.7	4.9	-0.1	3.9

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	2008	2009E	2010E
World	2.8	3.0	4.6	0.5	1.7
BIG-3	2.4	2.2	3.3	-0.3	1.0
USA	3.2	2.9	3.8	-0.5	1.4
Japan	0.2	0.1	1.5	-1.5	-0.5
Euro area	2.2	2.1	3.3	0.4	1.0
Germany	1.8	2.3	2.8	0.2	1.0
France	1.9	1.6	3.2	0.2	1.0
Italy	2.2	2.0	3.5	0.6	1.6
Spain	3.6	2.8	4.2	0.0	0.8
Netherlands	1.7	1.6	2.2	0.7	1.0
Belgium	2.3	1.8	4.5	0.4	1.0
Austria	1.7	2.1	3.2	0.5	1.4
Portugal	3.0	2.5	2.8	0.0	1.5
Greece	3.3	3.0	4.3	1.5	2.0
Finland	1.6	2.5	4.1	0.3	0.8
Ireland	2.7	2.9	3.1	-0.5	1.0
Denmark	2.1	1.9	3.4	1.6	1.8
Sweden	1.4	2.2	3.4	-0.5	1.1
Norway	2.3	0.8	3.8	1.7	2.3
Iceland	6.7	5.0	12.4	11.0	4.5
UK	2.1	2.3	3.6	0.4	2.3
Switzerland	1.1	0.7	2.4	-0.7	0.8
Russia	9.7	9.0	14.1	11.0	9.0
Poland	1.2	2.6	4.4	3.0	2.1
Estonia	4.4	6.7	10.6	-1.0	1.0
Latvia	6.6	10.1	15.3	3.0	1.0
Lithuania	3.8	5.8	11.1	4.5	1.0
China	1.5	4.8	5.9	-0.5	1.5
India	4.8	4.8	9.1	1.0	4.0
Brazil	4.2	3.6	5.7	4.6	3.7

**Public finances, % of GDP**

	2006	2007	2008	2009E	2010E
BIG-3	-1.6	-1.1	-2.5	-8.6	-7.4
USA	-1.9	-1.2	-3.2	-12.7	-9.5
Japan	-1.4	-2.4	-1.6	-5.4	-5.0
Euro area	-1.3	-0.6	-1.9	-4.5	-5.5
Germany	-1.5	-0.2	-0.1	-3.5	-4.8
France	-2.3	-2.7	-3.4	-6.0	-6.5
Italy	-3.3	-1.5	-2.7	-5.0	-5.5
Finland	4.0	5.2	4.2	-1.0	-2.0
Denmark	4.8	4.5	3.6	-2.0	-3.7
Sweden	2.4	3.8	2.5	-2.5	-4.1
Norway	18.5	17.7	18.8	11.8	16.6
Iceland	6.3	5.4	-1.2	-13.5	-10.5
UK	-2.7	-2.8	-5.5	-9.0	-10.5
Switzerland	1.0	1.3	1.1	-2.0	-3.0
Russia	8.4	6.1	4.1	-8.0	-6.0
Poland	-3.9	-1.9	-3.9	-2.9	-2.9
Estonia	2.9	2.7	-3.0	-3.0	-2.5
Latvia	-0.5	-0.4	-4.0	-7.0	-5.5
Lithuania	-0.4	-1.0	-3.2	-4.0	-5.0
China	-0.8	0.6	-0.4	-2.5	-3.1
India	-6.4	-5.4	-6.0	-6.7	-5.7
Brazil	-2.9	-2.2	-1.5	-2.0	-2.0

**Current account, % of GDP**

	2006	2007	2008	2009E	2010E
BIG-3	-	-	-	-	-
USA	-6.0	-5.3	-4.7	-3.2	-3.2
Japan	3.9	4.8	3.2	1.2	2.2
Euro area	-0.1	0.1	-1.0	-1.1	-0.4
Germany	6.1	7.8	6.6	5.0	4.5
France	-0.5	-1.1	-1.9	-1.0	-1.0
Italy	-2.6	-2.4	-3.5	-3.5	-3.0
Finland	4.6	4.2	2.0	1.0	1.7
Denmark	2.9	0.7	2.1	1.7	2.0
Sweden	8.5	9.0	8.2	4.9	4.8
Norway	17.2	15.9	17.7	9.7	15.9
Iceland	-25.3	-15.4	-34.7	-5.0	5.0
UK	-2.5	-2.9	-1.7	-2.5	-1.2
Switzerland	14.7	10.1	9.3	8.4	8.6
Russia	9.5	5.9	5.9	-1.0	0.0
Poland	-2.7	-4.7	-5.5	-5.2	-4.2
Estonia	-16.7	-18.3	-9.1	-4.0	-2.0
Latvia	-22.5	-22.5	-13.6	-7.0	-3.5
Lithuania	-10.4	-15.1	-12.2	-6.0	-5.0
China	9.5	11.0	10.0	8.1	7.7
India	-1.3	-1.0	-3.2	-3.2	-3.4
Brazil	1.3	0.1	-1.8	-1.1	-1.5

**Monetary policy rates**

	5.5.09	3M	6M	12M	24M
US	0.25	0.25	0.25	0.25	2.00
Japan	0.50	0.10	0.10	0.10	0.50
Euro area	1.25	1.00	1.00	1.00	2.00
Denmark	2.00	1.50	1.35	1.25	2.25
Sweden	0.50	0.50	0.50	0.50	2.50
Norway	2.00	1.25	1.25	1.25	2.50
UK	0.50	0.50	0.50	0.50	2.50
Switzerland	0.25	0.25	0.25	0.25	1.00
Poland	3.75	3.75	3.75	4.00	4.50
Czech Rep.	1.75	1.75	1.75	2.00	2.25
Hungary	9.50	9.00	8.00	6.00	5.00

**3-month rates**

	5.5.09	3M	6M	12M	24M
US	0.99	0.95	0.70	1.00	2.50
Japan	0.54	0.55	0.50	0.50	0.70
Euro area	1.34	1.20	1.20	1.30	2.25
Denmark	2.85	2.40	2.00	1.75	2.50
Sweden	0.94	1.00	1.00	1.00	2.80
Norway	2.63	2.00	2.00	1.75	2.90
UK	1.44	1.30	1.10	1.10	2.80
Switzerland	0.41	0.35	0.35	0.40	1.20
Poland	4.38	4.20	4.10	4.25	4.80
Czech Rep.	2.49	2.30	2.25	2.30	2.50
Hungary	9.69	9.00	7.25	5.75	5.30
Estonia	6.27	5.70	5.50	5.00	4.00
Latvia	12.84	11.00	9.00	8.00	6.50
Lithuania	6.84	6.00	5.50	5.00	4.00

**10-year government benchmark yields**

	5.5.09	3M	6M	12M	24M
US	3.17	3.50	3.60	4.00	4.75
Japan	1.40	1.45	1.50	1.65	1.80
Euro area	3.21	3.25	3.50	3.75	4.25
Denmark	3.50	3.65	3.75	4.00	4.35
Sweden	3.35	3.30	3.50	3.80	4.30
Norway	4.00	3.85	4.10	4.35	4.90
UK	3.55	3.60	3.80	4.25	4.80
Switzerland	2.17	2.45	2.60	2.80	3.40
Poland	6.18	6.00	5.75	5.50	5.50
Czech Rep.	5.48	5.25	5.00	4.75	4.80
Hungary	10.05	10.00	9.50	8.00	6.00

**Exchange rates vs EUR**

	5.5.09	3M	6M	12M	24M
EUR/USD	1.334	1.350	1.300	1.200	1.350
EUR/JPY	131.9	135.0	135.0	138.0	143.0
EUR/DKK	7.448	7.460	7.460	7.460	7.460
EUR/SEK	10.606	10.600	10.000	9.600	9.500
EUR/NOK	8.760	8.500	8.400	8.200	7.900
EUR/GBP	0.884	0.880	0.880	0.860	0.800
EUR/CHF	1.509	1.520	1.520	1.540	1.560
EUR/PLN	4.374	4.400	4.250	3.750	3.500
EUR/CZK	26.61	27.00	26.50	26.00	25.00
EUR/HUF	283.0	290.0	280.0	270.0	260.0
EUR/RUB	43.80	43.88	41.60	36.00	37.80
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.709	0.700	0.700	0.700	0.700
EUR/LTL	3.453	3.453	3.453	3.453	3.453
EUR/CNY	9.095	9.248	8.905	8.100	8.978

**Monetary policy rate spreads vs Euro area**

	5.5.09	3M	6M	12M	24M
US	-1.00	-0.75	-0.75	-0.75	0.00
Japan <sup>1</sup>	0.25	-0.15	-0.15	-0.15	-1.50
Euro area	-	-	-	-	-
Denmark	0.75	0.50	0.35	0.25	0.25
Sweden	-0.75	-0.50	-0.50	-0.50	0.50
Norway	0.75	0.25	0.25	0.25	0.50
UK	-0.75	-0.50	-0.50	-0.50	0.50
Switzerland	-1.00	-0.75	-0.75	-0.75	-1.00
Poland	2.50	2.75	2.75	3.00	2.50
Czech Rep.	0.50	0.75	0.75	1.00	0.25
Hungary	8.25	8.00	7.00	5.00	3.00

<sup>1)</sup> Spread vs US

**3-month spreads vs Euro area**

	5.5.09	3M	6M	12M	24M
US	-0.36	-0.25	-0.50	-0.30	0.25
Japan <sup>1</sup>	-0.44	-0.40	-0.20	-0.50	-1.80
Euro area	-	-	-	-	-
Denmark	1.50	1.20	0.80	0.45	0.25
Sweden	-0.41	-0.20	-0.20	-0.30	0.55
Norway	1.29	0.80	0.80	0.45	0.65
UK	0.09	0.10	-0.10	-0.20	0.55
Switzerland	-0.94	-0.85	-0.85	-0.90	-1.05
Poland	3.04	3.00	2.90	2.95	2.55
Czech Rep.	1.15	1.10	1.05	1.00	0.25
Hungary	8.35	7.80	6.05	4.45	3.05
Estonia	4.93	4.50	4.30	3.70	1.75
Latvia	11.50	9.80	7.80	6.70	4.25
Lithuania	5.50	4.80	4.30	3.70	1.75

<sup>1)</sup> Spread vs US

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

	5.5.09	3M	6M	12M	24M
US	-0.04	0.25	0.10	0.25	0.50
Japan <sup>1</sup>	-1.77	-2.05	-2.10	-2.35	-2.95
Euro area	-	-	-	-	-
Denmark	0.29	0.40	0.25	0.25	0.10
Sweden	0.14	0.05	0.00	0.05	0.05
Norway	0.79	0.60	0.60	0.60	0.65
UK	0.34	0.35	0.30	0.50	0.55
Switzerland	-1.05	-0.80	-0.90	-0.95	-0.85
Poland	2.97	2.75	2.25	1.75	1.25
Czech Rep.	2.26	2.00	1.50	1.00	0.55
Hungary	6.84	6.75	6.00	4.25	1.75

<sup>1)</sup> Spread vs US

**Exchange rates vs USD**

	5.5.09	3M	6M	12M	24M
-					
USD/JPY	98.9	100.0	103.9	115.0	105.9
USD/DKK	5.584	5.526	5.738	6.217	5.526
USD/SEK	7.952	7.852	7.692	8.000	7.037
USD/NOK	6.568	6.296	6.462	6.833	5.852
GBP/USD	1.508	1.534	1.477	1.395	1.688
USD/CHF	1.132	1.126	1.169	1.283	1.156
USD/PLN	3.280	3.259	3.269	3.125	2.593
USD/CZK	19.95	20.00	20.38	21.67	18.52
USD/HUF	212.1	214.8	215.4	225.0	192.6
USD/RUB	32.84	32.50	32.00	30.00	28.00
USD/EEK	11.73	11.59	12.04	13.04	11.59
USD/LVL	0.532	0.519	0.538	0.583	0.519
USD/LTL	2.589	2.558	2.656	2.878	2.558
USD/CNY	6.819	6.850	6.850	6.750	6.650

## Strong shot in the arm for ailing economy

- Danish economy in historically deep setback
- Significant economic policy easing
- Still potential for narrower interest rate differential

The Danish economy is in the midst of a deep setback. Like all other countries Denmark was hard hit by the collapse of international trade in H2 2008. The impact of the downturn in export markets came at a time when the economy had actually already begun to contract as a consequence of recent years' severe slowdown in the housing market. 2008 was thus the poorest growth year since the oil crisis in the early 1970s. And given the likelihood of further declines in economic activity in 2009 the current crisis looks set to be the deepest since World War II. A setback this severe will inevitably lead to sharply rising unemployment in the years ahead. This is exacerbated by the fact that employment initially continued to surge when the economy started to slow.

### Economy regains footing

The good news is that the plunge in economic activity seems to be nearing an end. This forecast is underpinned by the latest business and consumer confidence readings; after hovering at record-low levels over the past six months both figures have become less downbeat. Our very negative growth forecast for FY 2009 thus reflects the overhang from the weak Q4 2008 as well as the fact that activity also contracted sharply in Q1. During H2 we look for a tentative pick-up in economic activity, which will continue into 2010. Notably in 2010 we see a good chance of positive surprises as a result of the significant interest rate declines, lower oil prices and not least the batch of Danish stimulus packages. Oil prices and interest rate declines alone could boost economic activity by

nearly 2% points next year, and the fiscal policy measures should have largely the same effect. As regards the latter, notably the 2009 budget already adopted and the repayment of special pension savings (SP) could boost activity, corresponding to a lift in employment of almost 60,000 persons relative to a situation without these measures.

The effect of the SP repayments is somewhat uncertain, but this extra cash could definitely provide a very significant boost to consumption and economic activity. The falling home prices and nose-diving stock prices have sharply eroded household wealth – with rising savings as a natural consequence. The same goes for unemployment fears. Still, we see a good chance of a moderate increase in private consumption this year, as households' disposable income will grow sharply, making room for both increased savings and consumption. With respect to the effect of the SP repayments we have cautiously assumed that only half of the repaid pension savings will be channelled into increased private consumption. That is why we consider it best to await the effect of these measures before adding more fuel to the fire.

It should be underlined that economic policy measures always take effect with a lag of up to two years. Moreover, it is worth bearing in mind that an open economy such as Denmark relies heavily on trends in export markets – and thus cannot escape the global downturn completely unscathed. Nor is it realistic that Denmark could act as a growth engine for the whole world or even Europe for that matter. That was tested in the 1970s – with very limited success.

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

	2005 (DKKbn)	2006	2007	2008	2009E	2010E
Private consumption	760	4.4	2.4	-0.1	-1.2	1.5
Government consumption	401	2.1	1.3	1.1	1.7	2.0
Fixed investment	307	13.3	3.1	-3.6	-9.7	-0.5
- government investment	27	16.5	-10.0	5.2	9.6	8.5
- residential investment	93	11.2	4.8	-9.8	-12.7	-3.5
- business fixed investment	187	13.2	4.4	-1.9	-11.7	-1.9
Stockbuilding*	4	-0.3	-0.3	0.1	-0.2	0.0
Exports	762	9.1	2.2	2.2	-6.2	1.9
Imports	685	13.9	2.8	3.7	-5.8	1.9
GDP		3.3	1.6	-1.1	-2.8	1.2
Nominal GDP (DKKbn)	1,548	1,628	1,687	1,740	1,719	1,770
Unemployment rate, %		3.8	2.7	1.8	3.4	5.5
Unemployment level, '000 persons		109.1	77.6	50.0	95	150
Consumer prices, % y/y		2.1	1.9	3.4	1.6	1.8
Hourly earnings, % y/y		3.1	3.9	4.6	3.7	2.8
House prices, one-family, % y/y		21.6	4.5	-4.3	-11.0	-3.5
Current account (DKKbn)		47.0	12.0	35.7	30.0	35.0
- % of GDP		2.9	0.7	2.1	1.7	2.0
General govt. budget balance (DKKbn)		79.4	76.5	62.1	-35.0	-65.0
- % of GDP		4.8	4.5	3.6	-2.0	-3.7
Gross public debt, % of GDP		30.4	26.3	32.8	35.2	37.8

\* Contribution to GDP growth (% points)

**Loss of competitiveness hampers exports**

The budding signs of a tentative reversal in activity in Denmark’s export markets also suggest that the plunge in exports will be replaced by a slight pick-up later this year. However, the significant depreciation of the SEK, the GBP and to a lesser degree the NOK has eroded Danish companies’ competitiveness through a considerably stronger trade-weighted DKK exchange rate, and this will dampen export growth during most of the forecast period.

The substantial downturn in industrial production will naturally cause business investment to contract as well. In addition, residential investment will decline as a consequence of the large overhang of homes for sale and lower prices. But the housing market will receive a helping hand from lower interest rates – and the declining home prices will make it more affordable to buy homes. Despite the pick-up in unemployment we therefore expect housing market turnover to increase to a more normal level next year when prices should stabilise.

**Slowly easing inflation pressure**

The drop in commodity prices has sent inflation significantly down from its peak at 4.4% in August last year. This trend will remain intact until the summer. However, due to the after-effects of recent years’ comparatively strong wage growth, inflation adjusted for energy and food will only ease slowly in coming years. That is why we expect overall inflation to climb again once the effect of the lower commodity prices drops out of the index during the autumn. However, longer out there is no doubt that the rapidly growing unemployment will push inflation lower. Given our expectations that 130,000 people will be without jobs at the end of the year, with the figure rising to 175,000 by end-2010, wage growth will clearly be much weaker in future. This trend is already evident in construction, which is one of the most cyclically-sensitive sectors.

**Still room for narrower interest rate gap**

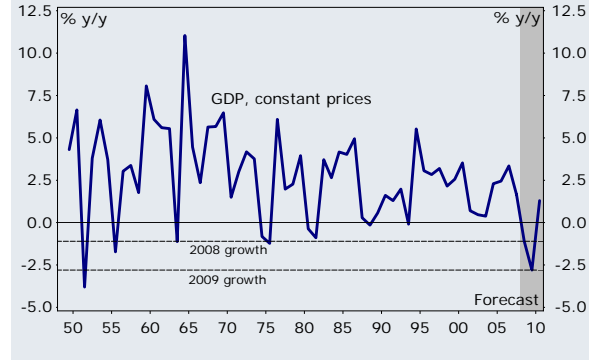
The differential between the Danish central bank’s lending rate and the ECB’s repo rate has narrowed sharply since the DKK came under pressure last autumn because of the financial crisis. We expect the Danish central bank to continue to narrow the interest rate differential during the rest of the year, but probably at a more sedate pace. The exact timing of further narrowing depends entirely on the central bank’s currency inflows. At the long end of the yield curve we expect further narrowing of the yield spread to Germany, with the increase in Danish long government yields being more subdued. Long mortgage bond yields may not even increase in the near future as the spread versus government yields will probably narrow again once the credit crisis draws to an end.

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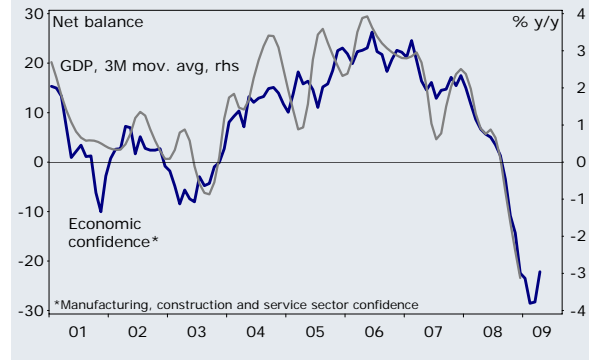
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**Historically deep setback in Danish economy**



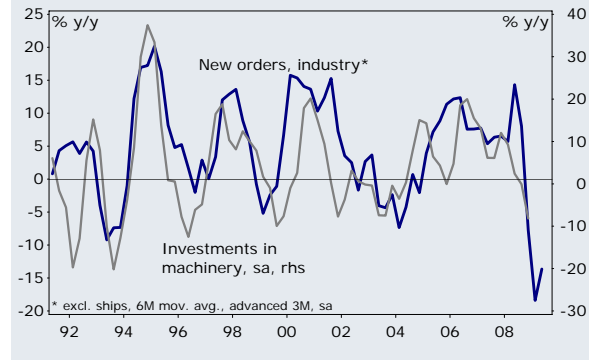
Source: Statistics Denmark and own calculations

**Business confidence reversal suggests stabilisation**



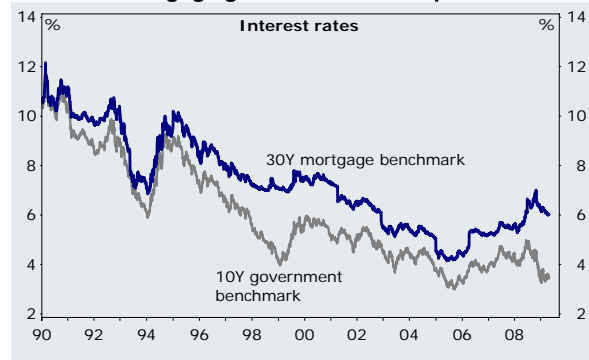
Source: Statistics Denmark and own calculations

**Business investment set to plunge**



Source: Statistics Denmark and own calculations

**Still wide mortgage/government bond spread**



Note: Borrowers’ access to redeem mortgage loan at par makes 30-year mortgage bond yields very sensitive to coupon rate shifts. Source: Reuters Ecowin

## Near the bottom, but it is a long way up

- GDP contracted sharply in early 2009 ...
- ... but the bottom is near
- It is a bumpy road ahead
- Unemployment will rise for a long time

The Finnish economy contracted sharply during winter. The downturn was already apparent towards the end of 2008, but it was sharper than even the gloomiest estimates. With the arrival of spring, more definite signs have emerged of the economy gradually stabilising; we expect the downtrend to level out towards autumn and reverse into a gradual rise.

Then again, the development will hardly be linear. As inventories have become empty, trade and production may witness an even more marked temporary growth spurt since the level has dropped much more than end-demand. Nonetheless, end-demand will recover only slowly and the rebound phase will consequently be followed by a slow recovery.

GDP will start to recover from a lower level than previously estimated and hence GDP will this year clearly contract more than forecast in January. As before, we expect slight economic growth as early as next year. However, the improvement will start from such a low level and be so slow that the outlook for unemployment and public finances will remain weak for years.

### Plunge in exports will take years to correct

Finnish exports simply collapsed in the winter, as did foreign trade all over the world. Nearly all export areas were affected. A relatively large percentage of Finnish exports goes to Emerging Markets, especially Eastern

European countries. Their difficulties weighed heavily on Finnish exports in the winter, albeit foreign trade declined substantially everywhere.

Finnish exports will recover in the wake of global trade. We expect the situation to stabilise gradually and a recovery to take place already towards the end of the year. We anticipate export growth next year, but an increase of a few percentage points will be very slow after the collapse of historical proportions.

### Lower investment; consumption quite stable

In the wake of faltering exports, industrial production also diminished sharply during winter. The plunge in industry has also led to a deep downturn in machinery and equipment investment. Sizeable expansion investments will be few for a while. Office and business premises construction will also plummet.

Residential construction started to decline already in 2008 and in 2009 starts of new owner-occupied residential buildings will be very few and far between. Then again, construction of rental flats will pick up during the year, and next year we are also likely to see a recovery in owner-occupied residential projects. In addition, renovation construction, which covers about half of all construction, will gain momentum this year as a result of fiscal resuscitation, for instance. Low interest rates and increasing confidence will gradually lift demand for new housing and we expect residential investment to pick up in 2010.

The culmination of the financial crisis last autumn scared consumers, and consumption declined markedly. Based on data for the early part of the year, consumption has increased slightly from the deepest bottom at end-2008.

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

	2005 (EURbn)	2006	2007	2008	2009E	2010E
Private consumption	81	4.1	3.3	2.0	-0.5	1.0
Government consumption	35	0.6	0.8	1.7	2.0	1.0
Fixed investment	30	4.8	8.7	1.0	-11.5	-3.5
Stockbuilding*	4	-0.5	-0.3	-0.4	-0.1	0.0
Exports	66	11.8	8.1	-1.1	-16.5	4.5
Imports	59	7.8	6.5	-1.3	-15.5	2.0
GDP		4.9	4.2	0.9	-4.5	1.5
Nominal GDP (EURbn)	157	167.0	179.7	186.2	182.3	186.4
Unemployment rate, %		7.7	6.9	6.4	8.8	9.4
Industrial production, % y/y		10.5	8.6	0.3	-10.0	1.0
Consumer prices, % y/y		1.6	2.5	4.1	0.3	0.8
Hourly wages, % y/y		2.9	3.4	5.3	4.6	2.8
Current account (EURbn)		7.6	7.5	3.8	1.9	3.2
- % of GDP		4.6	4.2	2.0	1.0	1.7
Trade balance (EURbn)		9.1	8.7	6.2	4.0	5.0
- % of GDP		5.4	4.8	3.3	2.2	2.7
General govt budget balance (EURbn)		6.7	9.4	7.8	-1.8	-3.7
- % of GDP		4.0	5.2	4.2	-1.0	-2.0
Gross public debt (EURbn)		65.5	63.0	62.1	73.0	80.0
- % of GDP		39.2	35.1	33.4	40.0	43.0

\* Contribution to GDP growth (% points)

Consumer confidence has improved slightly and consumers' opinion of the affordability of big purchases has become notably more optimistic. Nevertheless, the threat of unemployment will increase savings despite the low interest rates. Real income will rise nicely, though, and we expect household consumption to remain relatively stable this year.

Disposable income growth will slow down in 2010, but confidence in the economic outlook will improve, and we therefore expect household consumption to climb slightly. Overall consumption will increase in 2009 as well as in 2010 since public expenditure will grow moderately in 2009 but decelerate in 2010 due to municipalities' financial difficulties.

**Unemployment rises throughout 2010**

Unemployment started to increase already in autumn 2008. Unemployment will inevitably increase in 2009 as well as next year. In the absence of positive surprises we may therefore not see a turn for the better until well into 2011.

Wages will increase strongly in 2009, but next year increases will be moderate, as wage agreements have to be renegotiated this year. Inflation has slowed quickly due to the fall in energy and food prices. Increases in prices of other goods have been modest or even declining the whole time, and the rise in service prices will also decelerate when wage increases slow. In addition, VAT on food will be cut in the autumn, which will push inflation temporarily below zero. Inflation will return to positive territory in 2010, but price growth will be moderate. The threat of actual deflation is limited, and inflation threats are very distant.

**Relatively small-scale government revitalisation**

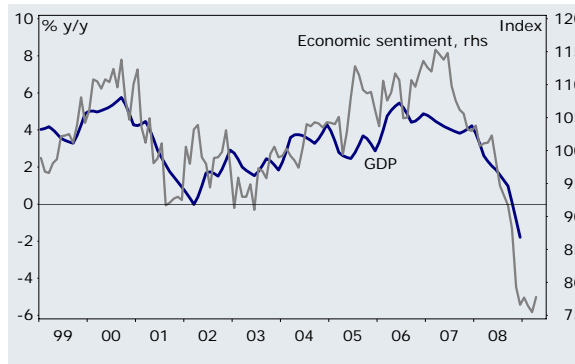
The government has announced a fiscal stimulus package worth 1.7% of GDP for this year, but this amount mainly consists of tax cuts that have been agreed earlier. Increases in expenditure only amount to about 0.5% of GDP. The government has also drafted a support package for banks, covering potential capital support in the amount of EUR 4bn and guarantees of EUR 50bn. So far, banks have not utilised the possibility for support. The government has also improved special credit institutions' possibilities to provide counter-cyclical loans and trade finance.

Central government finances will deteriorate in 2009 and 2010 mostly due to smaller tax revenues and higher income transfers as automatic stabilisers are functioning. According to our estimates, the whole public sector deficit will still remain below 3% of GDP underpinned by the social security fund surplus.

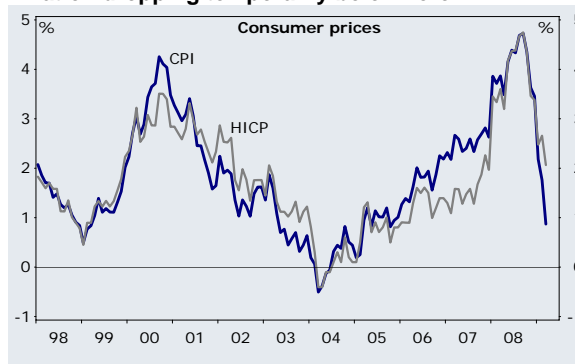
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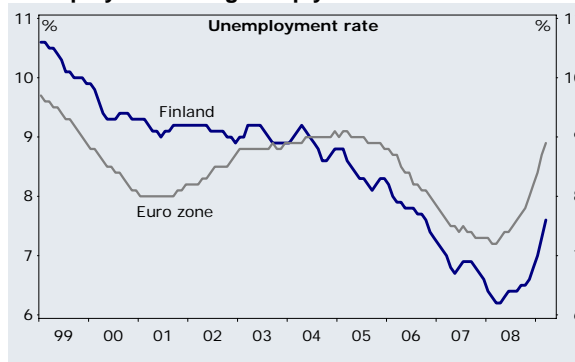
**GDP continued to fall in H1 2009**



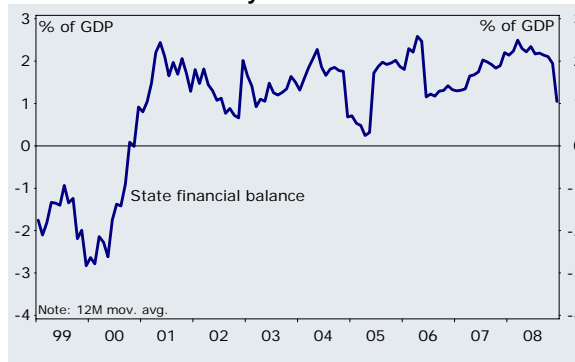
**Inflation dropping temporarily below zero**



**Unemployment rising sharply**



**State finances hit badly**



## Consumers decide the direction

- Exports and mainland investment to drop sharply
- Public demand and oil investment curb the downturn
- Rate cuts could lift consumption slightly
- Norges Bank aims to cut rates further ...
- ... but not enough to prevent gradual NOK firming

### Even weaker global trends

Growth in Norway's traditional export markets will be considerably weaker than we forecast in our January issue of *Economic Outlook*. Consequently, not only production, employment and profitability in the traditional export industries will be lower than we envisaged – service suppliers to the export sector will also be hit, and demand for capital goods such as buildings and machinery will deteriorate further.

### And even lower mainland investment

We now look for a steeper drop in mainland economy investment than we did in January. Note, though, that the decline in mainland investment will be from a very high starting point. But lower capacity utilisation, major uncertainty about the economic outlook and persistently tight credit markets for corporate borrowers are expected to result in significantly weaker investment activity. Strong stimuli via public budgets, particularly aimed at the building and construction sectors, will to some extent counter the effect of the decline in private-sector investment.

### Oil investment to break the fall, at least this year

Oil companies' investments in 2009 are largely planned already, and the outlook is for a cautious increase. That is one of the reasons why growth in the Norwegian economy, particularly the manufacturing industry, this

year looks set to be less in negative territory this year than in most other countries. The outlook for 2010 is more uncertain. If oil prices remain reasonably high as we expect, the level of oil investment may well be high, although somewhat lower than in 2009. But if oil prices move sharply lower, oil investment could contract significantly and the outlook for Norway's offshore-related industries would weaken dramatically. If so, 2010 could be a worse year for the Norwegian economy than for Norway's trading partners.

### Rate cuts are working

Norges Bank has slashed interest rates aggressively and we expect the policy rate to bottom at 1.25%. Money market rates will remain considerably higher, but the gap will likely shrink. The mortgage market functions relatively well given that the lower money market rates translate into lower mortgage rates. Sharply lower mortgage rates and households' relatively easy access to credits have supported the stabilisation of home prices. We expect home prices to pick up somewhat beyond the current year, and residential construction should consequently recover somewhat during 2010.

### Household savings the decisive factor

The sharp rate cuts will underpin solid growth in households' disposable real income, although wage growth will be moderate and fewer will have jobs. Much of the income growth will be channelled into savings, but we think there will be room for some consumption growth. The latest consumption figures have, however, been weaker than expected and we have therefore lowered our forecast for consumption growth this year.

### Idle capacity, low wage and price growth

Production growth will be very weak throughout 2009

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

	2005 (NOKbn)	2006	2007	2008	2009E	2010E
Private consumption	826	4.8	6.0	1.5	0.9	2.5
Government consumption	387	1.9	3.4	3.7	4.0	3.5
Fixed investment	314	11.7	8.4	3.3	-8.6	-3.1
- gross investment, mainland	276	11.9	9.3	1.9	-12.4	-1.7
- gross investment, oil	95	4.1	2.9	6.0	3.0	-7.5
Stockbuilding*	50	0.0	-0.6	0.8	0.0	0.0
Exports	1,002	0.0	2.5	0.9	-2.5	2.0
- crude oil and natural gas	533	-6.5	-2.6	-2.3	0.0	2.0
- other goods	256	6.2	8.7	4.8	-7.0	1.8
Imports	565	8.4	7.5	4.2	-4.5	1.3
GDP	2,111	2.3	3.1	2.0	-0.4	1.7
GDP, mainland	1,507	4.9	6.1	2.4	-0.6	1.6
Unemployment rate, %		3.4	2.5	2.6	4.2	5.1
Consumer prices, % y/y		2.3	0.8	3.8	1.7	2.3
Core inflation, % y/y		0.8	1.4	2.6	2.4	1.9
Annual wages (incl. pension costs), % y/y		4.3	5.6	6.0	3.5	4.0
Current account (NOKbn)		372.1	362.3	448.9	222.2	411.9
- % of GDP		17.2	15.9	17.7	9.7	15.9
Trade balance, % of GDP		18.0	16.0	18.3	9.7	15.8
General govt budget balance (NOKbn)		399.1	402.4	477.6	270.0	430.0
- % of GDP		18.5	17.7	18.8	11.8	16.6

\* Contribution to GDP growth (% points)

and partly in 2010. Unemployment will continue to grow and capacity utilisation will decline further. Coupled with weak corporate profitability this means that wage growth will be moderate both this year and the next. Domestic price growth will consequently slow down. Near term the NOK depreciation at end-2008 will contribute to keeping up inflation. However, this effect will gradually abate, particularly if the NOK strengthens as we expect it will. At the same time international price growth is low. Low price increases of imported goods and declining domestic inflation will ensure that core inflation in Norway will fall well below the 2.5% target.

**Room for lower interest rates**

With lower price and wage growth, much lower capacity utilisation and prospects of persistently low production growth, Norges Bank is likely to cut its policy rate further. But we think the central bank will stop at 1.25 % this summer or early autumn. At that time signs will be emerging that the strong fiscal and monetary policy stimuli are starting to work. And signs will also be visible that trading partners' production declines are slowing down. It cannot be ruled out that stronger-than-expected domestic demand will make Norges Bank stop cutting rates before reaching the 1.25% level. But the room for downside surprises is probably quite large. Price growth could for example fall more than expected simultaneously with sharp NOK appreciation.

Prospects of a relatively prolonged period of low capacity utilisation, low price growth and low international interest rates suggest that the policy rate will remain low for quite some time also in Norway. Short bond yields could thus drop further as they currently discount relatively swift interest rate increases. But trends in international bond yields will be decisive, particularly for long Norwegian government yields.

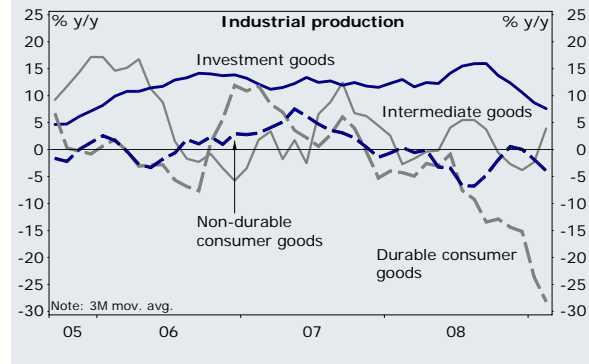
**Gradually stronger NOK**

The NOK has recovered from the record-weak levels at the turn of the year, mainly on the back of a renewed pick-up in market players' risk appetite. But Norges Bank's low interest rate forecast in March and its rhetoric that was interpreted to signal that the bank wanted a weak NOK has to some degree curbed the strengthening. The NOK is still relatively weak. Further normalisation of investor risk appetite coupled with a market that will focus more on countries with solid financial balances suggest additional NOK firming. If the Norwegian policy rate bottoms at 1.25% as we predict, the interest rate differential towards other countries per se is unlikely to affect the NOK much. An interest rate decline to that level is already largely discounted. If Norges Bank is keener to prevent the NOK from strengthening than we presume, the bank will probably cut the policy rate further.

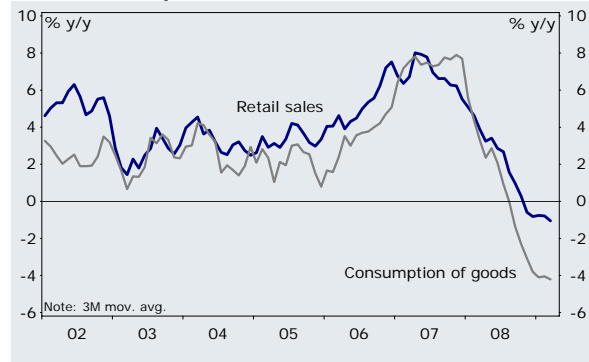
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**Industrial sector – mixed picture**



**Weak consumption trends**



**Fewer building starts, but level still high**



**NOK still weak**



## Ongoing stabilisation

- World trade collapse triggers GDP decline this year
- Repo rate has bottomed but will stay low
- SEK strengthening once risk appetite recovers

The Swedish economy ground to a halt at end-2008. The reason was that the worsening financial crisis in the wake of Lehmann Brothers' bankruptcy triggered a collapse in world trade, and crisis-conscious Swedish consumers increased their savings. Trends in early 2009 remained weak, but signs are emerging that the bottom is near, for example for exports. However, the labour market, which lags somewhat behind in the economic cycle, continues to weaken, which means that the Swedish economy is facing a couple of weak years.

### Exports close to bottoming

In Q4 2008 and Q1 2009 one-fourth of Swedish goods exports evaporated when heightened uncertainty and financing difficulties even made customers cancel orders already placed. Swedish exports are largely made up of investment goods and given the declining activity in export markets coupled with very weak investment activity, the outlook is undeniably very bleak for Swedish exports this year. At the same time we are seeing early signs that the downturn is slowing. In recent months the drop in new export orders has for example stabilised and the PMI has increased.

One factor that will support the development going forward is Swedish companies' swift production cutbacks, which means that they have avoided building up excess stocks. When demand stabilises – presumably in the US, the Euro area and Asia during the coming year – and later increases, production can be scaled up relatively quickly. A weaker SEK is another factor helping Swed-

ish exporters. A third factor is that the situation in Nordic markets such as Denmark and especially Norway looks relatively good on a 2-year horizon. But it is also important to bear in mind that the current level is so low that even a very modest pick-up in demand will generate relatively high growth figures. Despite quite high growth next year our baseline scenario for the next two years does not include a return to the level of goods exports seen in 2005, though (see chart).

### Labour market continues to deteriorate

The steep drop in production output has left many companies with surplus capacity. This suggests very weak investment activity in the years ahead and a definite worsening of the labour market, which is now clearly reflected in jobless figures. However, the jobless number is slightly boosted by the recent broadening of the definition of both unemployment and the labour force. Looking at historical data we believe that labour market conditions over the next two years probably will be considerably worse than during the downturn early in this millennium, but not quite as bad as in the early 1990s. The decline in employment in 2008-2010 will for example only be half as large as during the crisis in the 1990s.

### Fiscal and monetary policy measures take effect

Given the gloomier labour market conditions we expect weak consumption trends in the coming years – although people with jobs will actually experience quite decent income growth. Households will for example benefit from an expansionary fiscal policy this year and probably also during the 2010 election year. Real incomes will also increase thanks to coming years' low inflation.

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

	2005 (SEKbn)	2006	2007	2008	2009E	2010E
Private consumption	1,328	2.3	3.0	-0.2	-1.6	1.5
Government consumption	723	2.0	0.4	1.3	0.3	0.7
Fixed investment	476	9.1	7.5	3.5	-9.8	-6.3
- industry	84	-1.2	11.4	2.8	-18.9	-16.9
- residential investment	77	15.0	8.7	-5.4	-16.6	-8.2
Stockbuilding*	-4	0.2	0.8	-0.7	-0.3	0.5
Exports	1,333	8.9	5.8	1.7	-13.9	6.2
Imports	1,121	8.7	9.4	3.0	-14.2	3.5
GDP		4.2	2.6	-0.2	-3.8	1.8
Nominal GDP (SEKbn)	2,735	2,901	3,064	3,158	3,088	3,144
Unemployment rate, %		7.1	6.1	6.2	8.6	10.4
Employment growth		2.0	2.5	1.2	-2.8	-2.4
Consumer prices, % y/y		1.4	2.2	3.4	-0.5	1.1
Underlying inflation (CPIF), % y/y		1.4	1.5	2.7	1.6	1.4
Hourly earnings, % y/y		3.3	3.1	4.4	3.5	2.8
Current account (SEKbn)		247.3	275.4	260.2	154.0	157.9
- % of GDP		8.5	9.0	8.2	4.9	4.8
Trade balance, % of GDP		5.6	4.6	4.0	3.5	3.8
General govt budget balance (SEKbn)		70	116	80	-76	-127
- % of GDP		2.4	3.8	2.5	-2.5	-4.1
Gross public debt, % of GDP		45.9	40.5	38.0	43.2	46.5

\* Contribution to GDP growth (% points)

**Negative inflation but no deflation**

CPI inflation will decline during the year and bottom at about -1.5% during the autumn according to our estimates. Paradoxically, the chief reason is the Riksbank's own rate cuts, but also the decline in energy prices. Inflation excluding energy and mortgage rates is much more stable. CPIF inflation, which excludes the effect of the Riksbank's rate cuts, will fluctuate between 1% and 2% throughout the forecast period (see chart).

The weak SEK is one of the reasons why inflation will not drop further. The sharp SEK weakening is due to several factors. One is the very significant and synchronised contraction in industrial output worldwide, which for example prompted many companies that had hedged the currency risk associated with future export revenues to buy back these instruments, thus triggering currency outflows. Another is the Riksbank's repo rate cuts which were larger than in the Euro area and Norway, for example. A third key explanation is investors' risk aversion in a generally uncertain environment, which often hurts a small currency such as the SEK. However, going forward we consider it likely that the SEK will firm versus the EUR when risk appetite continues to stabilise and the monetary and fiscal policy stimulus measures start to improve the growth outlook.

Hence, there will probably be no signs of deflation to fight by means of zero interest rates and quantitative easing during the forecast period. Declining resource utilisation will allow the Riksbank to remain on hold well into 2010, however.

**Growing budget deficit**

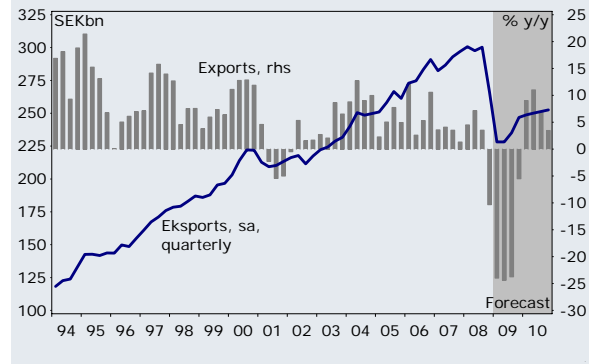
Long yields both in Sweden and abroad are expected to be underpinned by an increased borrowing requirement in order to finance growing budget deficits. In Sweden the central government budget balance is forecast to reverse from a surplus of SEK 135bn in 2008 to a deficit of SEK 170bn in 2009 in step with the rapidly deteriorating labour market, lower consumption and unfinanced fiscal policy measures. However, compared to many other countries Sweden's starting point is relatively good with consolidated government debts of less than 40% of GDP in 2008.

When we start to see more definite signs of an economic recovery, we think that the debate will heat up on when and how the central bank should scale back its stimulus measures. The markets must then gradually get used to the idea that the central banks, once they enter into hiking mode again, will proceed at a relatively swift pace. Interest rates could then increase relatively sharply. As short rates are expected to remain low during the coming year, yield curves will remain steep.

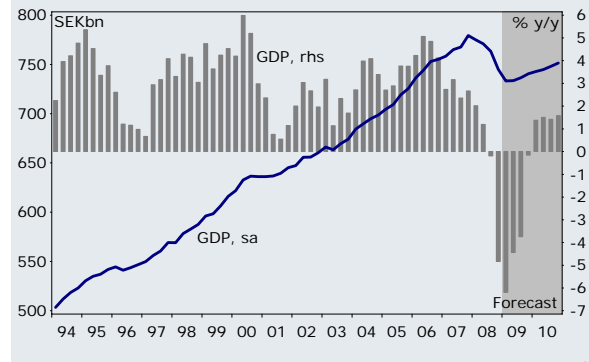
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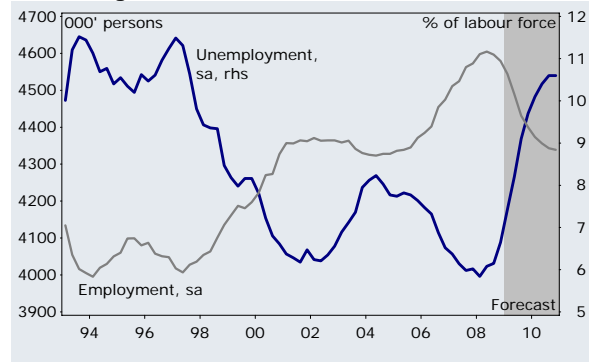
**Pick-up in goods exports ...**



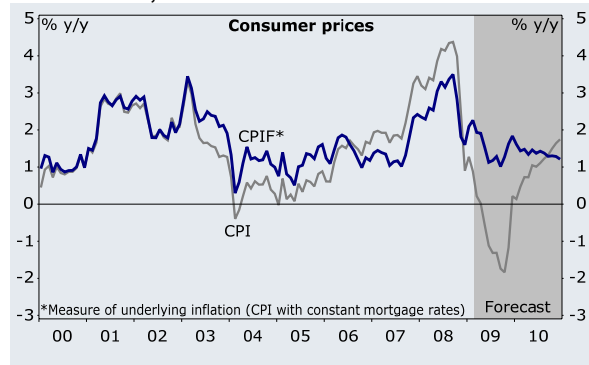
**... contributes to GDP growth recovery**



**Worsening labour market conditions**



**Low inflation, but not deflation**



## Recession nearing an end

- The worst of the recession is probably behind us
- Persistent uncertainty – prospect of slight upswing
- Deflation is a larger risk than high inflation
- First rate hike in H2 2010 at the earliest

We maintain our cautiously optimistic expectation that the worst of the recession is behind us. After having contracted 6.3% (annual rate) during the last three months of 2008 in the wake of the Lehmann Brothers collapse, the economy shrank at a 6.1% annual rate in Q1 this year. By all accounts the drop in production will continue this quarter, but the pace is estimated to have slowed. More specifically we expect GDP to decline 3% in Q2.

The economy (GDP) is still expected to stabilise at around mid-2009 ahead of a slight recovery in the latter part of the year and into 2010. Economic growth is not projected to reach a level equal to the estimated annual growth potential of 2½-2¾% until end-2010 at the earliest. Until then unemployment will continue to rise. At end-2010 we expect an unemployment rate of 10%.

The US economy has now been stuck in a recession for 17 months running. This is a long time from a historical perspective and the gravity of the situation is exacerbated by the fact that it is now part of a global downturn triggered by a financial crisis that is not yet over. And it is always difficult to predict reversals of economic cycles. Uncertainties are rife but we still see good arguments for expecting improvements in 2009. Not least thanks to the massive fiscal and monetary policy stimuli and the rescue packages for the financial sector, which are starting to filter fully through to the economy. In addition, the decline in energy prices equal to tax cuts of 2% of consum-

ers' income will boost activity.

The effect of the political stimulus measures is still uncertain. But the huge fiscal policy easing of nearly USD 800bn from 2009 to 2019, corresponding to 5½% of GDP, passed by Congress in February is estimated to lift GDP growth by 3-4% points in Q2 and Q3 this year.

Coupled with the lower energy prices and borrowing costs, the tax cuts, which are part of the fiscal stimulus package, should pave the way for an increase in households' purchasing power this year and in 2010 despite falling employment and weaker wage growth. After the sharp erosion of consumer spending in H2 2008, the increase in real disposable income is expected to make room for a slight pick-up in consumption in the coming quarters although the savings ratio will rise. This forecast is based on an expected increase in the savings ratio from the current 4% to a historical average of 8%. A year ago the ratio was close to zero. Slumping home prices and growing unemployment are key arguments for expecting a further increase in the propensity to save. Particularly the propensity to save is seen as a major factor of uncertainty in the forecast. The longer the banks tighten their credit standards, the greater the risk will be of a strong correction in savings and demand.

### Finally signs of housing market stabilisation

After the deep dive following the Lehmann Brothers collapse, home sales have stabilised in recent months. This may be the first tentative signs that the housing market slump that started in 2006 is finally coming to an end. But home prices will probably decline further. Demand for new homes is still very low and about half of existing home sales now represent foreclosure sales at much reduced prices. The excess supply of homes on the market

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

	2005 (USDbn)	2006	2007	2008	2009E	2010E
Private consumption	8,694	3.0	2.8	0.2	-0.3	1.7
Government consumption and investment	2,355	1.7	2.1	2.9	2.8	5.5
Private fixed investment	2,043	2.0	-3.1	-5.0	-20.7	-5.5
- residential investment	770	-7.1	-17.9	-20.8	-21.8	-0.1
- equipment and software	936	7.2	1.7	-3.0	-21.3	-5.8
- non-residential structures	338	8.2	12.7	11.2	-18.3	-9.5
Stockbuilding*	43	0.0	-0.4	-0.2	-0.2	0.3
Exports	1,312	9.1	8.4	6.2	-14.9	1.6
Imports	2,025	6.0	2.2	-3.5	-13.8	3.7
GDP		2.8	2.0	1.1	-2.7	1.5
Nominal GDP (USDbn)	12,422	13,178	13,808	14,265	14,159	14,664
Unemployment rate, %		4.6	4.6	5.8	8.9	9.8
Industrial production, % y/y		2.3	1.5	-2.2	-10.0	-0.5
Consumer prices, % y/y		3.2	2.9	3.8	-0.5	1.4
Consumer prices ex. energy and food, % y/y		2.5	2.3	2.3	1.3	0.6
Hourly earnings, % y/y		3.9	4.0	3.8	2.8	2.0
Current account (USDbn)		-788.1	-731.2	-673.3	-453.1	-469.3
- % of GDP		-6.0	-5.3	-4.7	-3.2	-3.2
Federal budget balance (USDbn)		-248.2	-161.5	-454.8	-1,800.0	-1,400.0
- % of GDP		-1.9	-1.2	-3.2	-12.7	-9.5
Gross public debt, % of GDP		66.0	67.0	75.2	89.2	97.5

\* Contribution to GDP growth (% points)

has shrunk somewhat but remains at a level that points to lower prices (see chart).

All in all, we expect a tentative stabilisation of home prices at end-2009 – not least because the financial burden of buying a home is at a 35-year low. The political commitment to easing the interest burden for beleaguered homeowners is also believed to play an important part in stabilising the housing market and the crisis in a broader sense.

After a reduction of almost 80% from the peak level, housing starts and thus residential investment are estimated to be close to the bottom. A mere stabilisation would boost GDP growth noticeably, as the decline in residential investment has pulled growth lower by about 1% point on average during the past three years.

**Further drop in business investment**

Business investment is now hard hit by the collapse of domestic and global demand. Given the broadly based decline in companies’ capacity utilisation to about 70% and plummeting earnings, investment activity looks set to decline further during most of the forecast period. Companies’ destocking, which was initiated last year, sharply accelerated in Q1 this year. This adjustment is likely to result in a substantial positive growth contribution from stocks in the coming quarters.

**No immediate risk of high inflation**

Despite the very expansionary fiscal and monetary policy measures the underlying inflation pressure is expected to ease throughout the forecast period. The reason is the large amount of idle production resources. The output gap – the difference between actual production and the level attainable at full employment – is thus estimated to be close to -10% at the end of 2010 (see chart). Against this backdrop deflation is seen as a greater risk than high inflation in the next few years.

**First rate hike from the Fed a long way off**

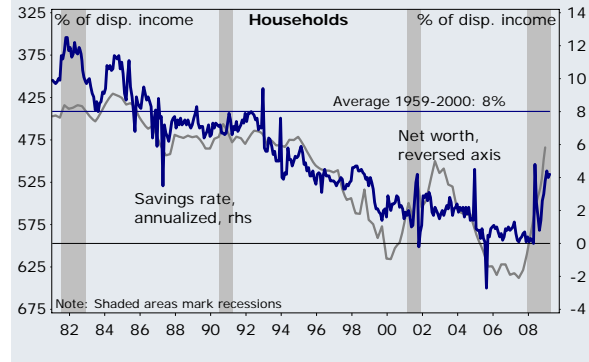
Given the inflation outlook the Fed is not expected to hike interest rates until H2 2010 at the earliest. Once the normalisation process finally starts, interest rates are likely to be hiked relatively swiftly, though. But before the first rate hike the Fed is likely to initiate measures to absorb the extra liquidity that has been pumped into the economy since last autumn.

In step with the economic recovery long yields are expected to back up relatively steeply and the USD is likely to firm versus the EUR. However, near term increased risk appetite could weaken the USD. Towards the end of the forecast period, the ballooning US budget deficit, which is forecast to surpass 10% of GDP this year, is expected to weaken the USD versus the EUR again.

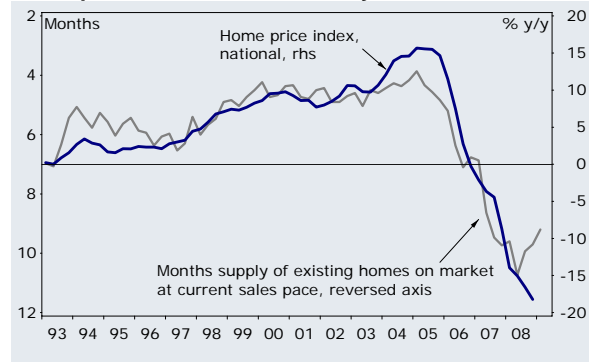
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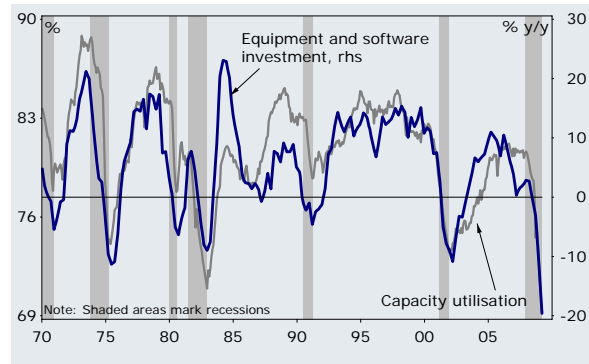
**Rising savings ratio**



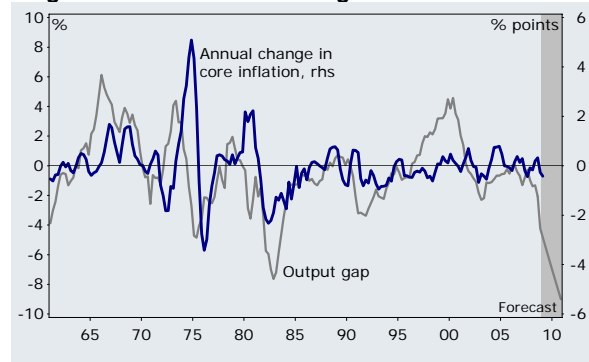
**Home prices have not bottomed yet**



**Business investment set to decline further**



**Larger risk of deflation than high inflation**



## Economic activity to bottom out later this year

- Trough for GDP in sight
- Unemployment will continue to rise through 2010
- CPI to fall this summer and rise slightly in 2010
- ECB will introduce further unconventional measures

### Only gradual export recovery after rebound

The Euro-area economy fell into the deepest post-war recession last winter. The collapse in global trade and manufacturing activity hit hard in practically all Euro-area countries. Only Cyprus is anticipated to show growth, whereas Ireland is hit sharply by recession in export markets, the burst of the housing bubble and the freeze in financial markets.

The deep recession in Germany is clearly the most severe for the Euro area as a whole. The German export machine choked badly due to overall weakness in global trade and the hard landing for the central and eastern European economies. So far, France seems to suffer the least among the largest countries, whereas Spain is contracting less than many other countries despite a severe housing market recession.

The Euro-area economy as a whole is expected to have contracted even more in Q1 than in Q4. The economy will likely continue to shrink also in Q2 albeit at a slower pace. Yet more positive signs have emerged lately. Manufacturing expectations have started to increase and export markets are set to stabilise over the summer. Also in the Euro area exports and industrial production have fallen more sharply than actual final demand as inventories have been reduced. Hence, it seems that the export industry is heading towards a rebound in activity along

with the global economy. Yet, we anticipate only a cautious increase in exports after the major fall in 2009 as final demand in export markets is set to recover only gradually and continues to be surrounded by major uncertainties. External competitiveness will also be under pressure from the trade-weighted exchange rate, which is still quite strong despite the strengthening of the USD. Thus, the currencies of many major trading partners have depreciated sharply, not least the GBP. However, this situation is likely to reverse in the H2 2010, supporting a more robust export recovery.

### Divergent outlook for domestic demand

Just as the fall in global trade has hit Germany more than other Euro-area countries, the situation in the domestic markets is also quite varied. Spain and Ireland are labouring under a housing market collapse, which has spilled over to construction activity. At the other end of the spectrum, conditions in the German housing market remain relatively stable and German consumers are not burdened by debt due to high savings ratios. The government has also adopted one of the largest growth packages in the Euro area, including an attractive scrapping premium, which has led to a substantial boost in car sales.

The sharp drop in industrial activity, falling profits and tighter credit standards point towards a similar drop in capital expenditure across the Euro area. In addition, the reduction in inventories is likely to continue until next year, although the pace is likely to slow down as early as this summer.

Private consumption was hit at the beginning of last year by the spike in inflation and the relatively high level of interest rates, but also here the culmination of the finan-

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

	2005 (EURbn)	2006	2007	2008	2009E	2010E
Private consumption	4,671	2.1	1.6	0.4	-0.6	0.7
Government consumption	1,665	1.9	2.2	2.0	2.5	2.0
Fixed investment	1,686	5.9	4.4	-0.1	-10.1	-1.5
Stockbuilding*	6	0.1	0.0	-0.1	-0.7	0.1
Exports	3,113	8.6	6.0	1.2	-12.4	3.3
Imports	2,995	8.5	5.3	1.3	-11.2	2.4
Net exports*	118	0.2	0.3	0.0	-0.8	0.4
GDP		3.0	2.7	0.7	-3.5	1.0
Nominal GDP (EURbn)	8,149	8,594	8,992	9,274	9,099	9,330
Unemployment rate, %		8.2	7.4	7.6	9.2	10.6
Industrial production, % y/y		4.0	3.5	-1.9	-10.0	1.0
Consumer prices, % y/y (HICP)		2.2	2.1	3.3	0.4	1.0
- core inflation**		1.5	2.0	2.5	1.5	0.8
Hourly earnings, % y/y		2.2	2.2	3.5	2.5	1.5
Current account (EURbn)		-10	11	-93	-100	-70
- % of GDP		-0.1	0.1	-1.0	-1.1	-0.4
Trade balance (EURbn)		-20	50	-39	-50	-24
- % of GDP		-0.2	0.6	-0.4	-0.5	-0.1
General govt budget balance, % of GDP		-1.3	-0.6	-1.9	-4.5	-5.5
Gross public debt, % of GDP		68.3	66.0	69.3	75.1	78.8

\* Contribution to GDP growth (% points)

\*\* HICP excl. energy and unprocessed food

cial crisis in the autumn aggravated the situation. Lately, confidence has rebounded somewhat, as interest rates and inflation have fallen to record lows. Going forward, wage gains from the boom years allow for a considerable increase in disposable income despite the fall in employment. Tax cuts and social transfers will also help bolster income. Considering the already high savings ratio, the increase in disposable income will support relatively stable household spending and a slight upturn next year, when improved confidence will lead to a slightly lower savings ratio.

**Deflation not yet a serious threat**

Inflation has dived sharply this spring due to the retraction in energy and food prices. As noted earlier, inflation is heading towards negative territory this summer, but this will only be temporary, as expected by the ECB. When the favourable base effects of falling commodity prices fade, inflation is set to bounce back to moderately positive figures. The deep recession will naturally put strong downward pressures on wages and hence core inflation. In the rigid European labour markets it takes time before wage growth starts to slow down. Thus, wage growth and core inflation will only ease more substantially in 2010. We expect core inflation to fall to levels not yet seen during the euro era. However, there is not any harmful deflation spiral in sight.

The sharp drop in economic activity will cause unemployment to rise sharply not only this but also next year. This will obviously undermine purchasing power and confidence. Consequently, even a nice rebound in GDP growth on a quarterly basis will not reverse the adverse trend in the labour market for quite some time. Measured by unemployment the end of this recession is still far ahead.

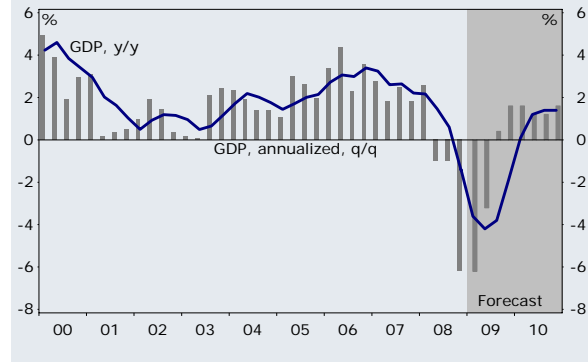
**The ECB will keep rates low for long**

The ECB has already cut interest rates to record low levels, and ECB officials have clearly signalled that they would not be comfortable with interest rates being too close to zero. Thus, based on our central scenario, we do not expect the ECB to cut rates further after the main refinancing rate reaches 1% this spring, although rates are likely to stay at very low levels during most of the forecast horizon. Instead, markets have focused on unconventional measures from the ECB. Here, the ECB has clearly indicated that it prefers a more cautious approach of extending the maturity of ECB refinancing facilities for banks and later on perhaps direct purchases of commercial paper. More aggressive measures such as the outright purchase of government securities would require a drastic increase in the probability of deflation.

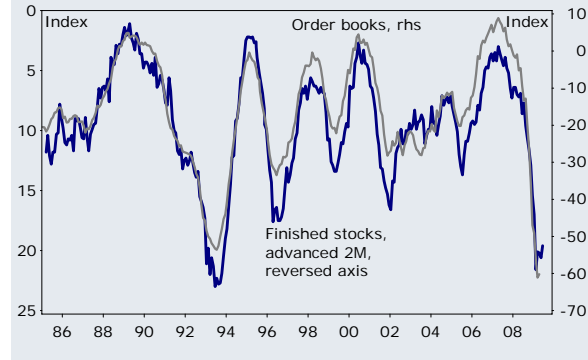
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**Economic activity should expand moderately in H2**

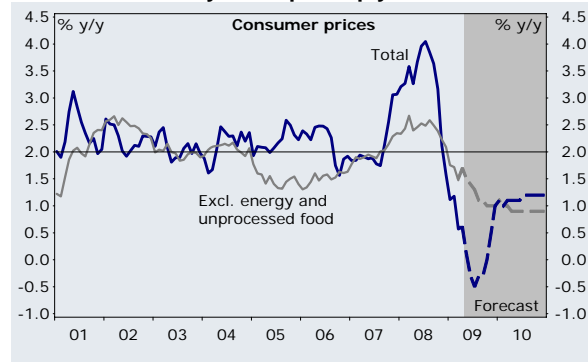


**Nascent signs that inventory correction is underway**

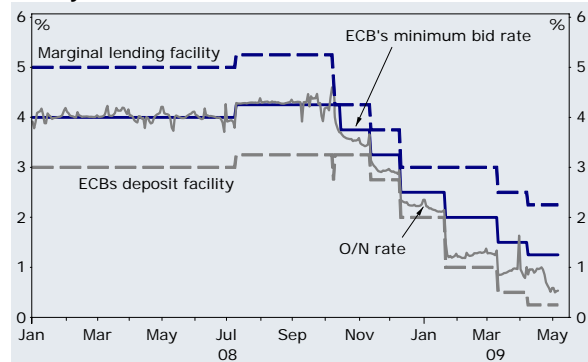


Source: European Commission

**Core inflation likely to drop sharply in 2010**



**Money market rate well below the ECB's refi rate**



## Recovering from a deep recession

Since mid-2008 Japanese exports have been in free-fall, and this severely impacted the economy, which has slowed markedly over the past quarters. Declining sales have given rise to concern among the major manufacturing businesses, and industrial production has dropped sharply. The key Tankan business confidence indicator has dropped to historical lows. The major companies are, however, now taking a slightly less downbeat view of the future, which could be a sign that the worst is over. The past few months' export data suggest that exports have bottomed and may be rising. Particularly exports to Asian countries are showing progress, as is container traffic to the US. As the global economy emerges from the recession, we expect to see a pick-up in Japanese exports. Also, as stocks have been reduced, the scene is set for rising industrial production in the coming quarters. But the pace of economic activity will still be very slow.

The government has presented a new fiscal policy stimulus package comprising massive government investment in H2 2009. The stimulatory effect of the package, which follows in the wake of two smaller packages in 2008, is estimated to be around 3% of GDP. This could pull the economy out of recession. However, there is a risk that the effect of the resuscitation of the economy will be temporary and that the pace will slow again in 2010. And further fiscal stimulus is restricted by Japan's huge public debt of close to 170% of GDP.

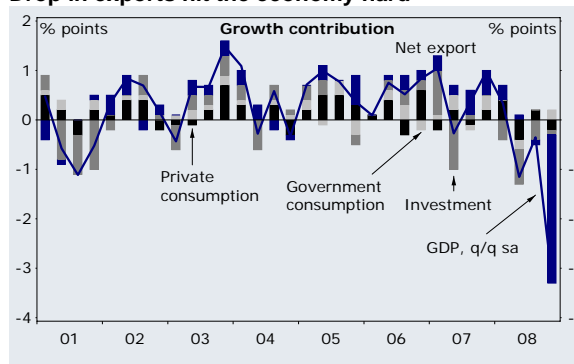
The Japanese central bank has cut its policy rate to 0.1% and used extraordinary means to bring the economy back on track. There is a significant risk of deflation too. The unconventional measures include purchases of short-term corporate debt and government bonds. There is indication that the central bank will keep its policy rate unchanged at 0.1% until end-2010. Also, the bank may very likely step up its use of unconventional measures. Further purchases of government bonds seem the most obvious option, particularly in light of the future large supply of government bonds that could push up long yields.

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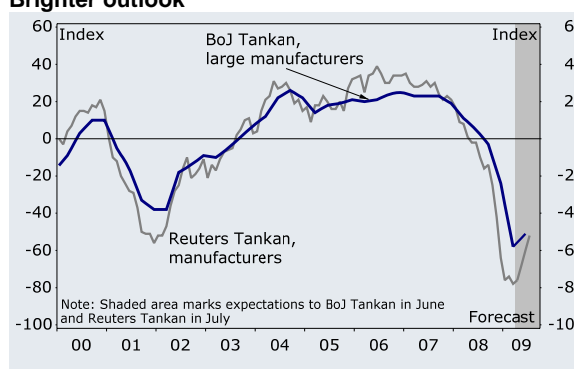
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Drop in exports hit the economy hard



Brighter outlook



Signs of stabilising exports



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

	2005 (JPYtm)	2006	2007	2008	2009E	2010E
Private consumption	286	1.5	0.7	0.5	-1.3	0.3
Government consumption	91	0.4	2.0	0.9	1.8	1.2
Gross fixed capital formation	117	0.6	1.2	-4.7	-7.5	-2.6
Stockbuilding*	1	0.1	0.3	-0.1	-0.6	0.0
Exports	72	9.7	8.4	1.9	-31.2	6.4
Imports	65	4.2	1.5	1.1	-15.0	1.4
GDP		2.0	2.4	-0.7	-5.8	0.5
Nominal GDP (JPYtrn)	502	508	516	524	513	521
Unemployment rate, %		4.1	3.9	4.1	5.0	5.8
Consumer prices, % y/y		0.2	0.1	1.5	-1.5	-0.5
Current account, % of GDP		3.9	4.8	3.2	1.2	2.2
General government budget balance, % of GDP		-1.4	-2.4	-1.6	-5.4	-5.0

\* Contribution to GDP growth (% points)

## The hangover will clear

For the UK the economic hangover is severe. But there is plenty of evidence that the worst headache is over following the past two quarters' sharply negative data on economic growth. The UK PMI readings, normally a good gauge of GDP growth, have moved a good deal up from the November 2008 low. In addition, mortgage rates are coming down, and according to the Bank of England the funding situation of businesses is improving. Much therefore suggests that the bank's very aggressive actions combined with the fiscal stimulus package and the GBP weakening are starting to have a positive effect on the economy. Consumer spending will be held back by rising joblessness and higher household savings, though, and the economic outlook remains very weak.

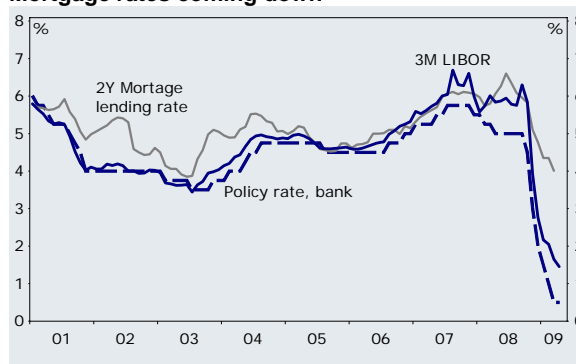
Since October 2008 the Bank of England has been very aggressive in its attempt to alleviate the economic problems. The policy rate has been lowered from 5.0% to 0.5% and several measures have been introduced to boost the liquidity of the banking system. Furthermore, the bank has embarked on quantitative easing, purchasing corporate bonds and gilts for GBP 75bn funded by printing money. Signals from the bank are clear: the policy rate has reached bottom. Governor Mervyn King has also hinted at fears of overdoing the expansionary measures, as this may lead to inflationary problems in future. We expect the bank to remain sidelined in coming quarters. In case of a new severe jolt to financial markets or new negative surprises from economic data, further quantitative easing moves seem very likely. Governor King has stated that the bank should be ready to raise rates quickly once growth improves to stave off inflation. But we do not expect the UK economy to improve so dramatically that rate hikes will become relevant before late 2010.

Our model indicates that the GBP is sharply undervalued. As the economy recovers, we expect the GBP to appreciate. The deterioration of public finances and large guarantees to the banking sector could put renewed pressure on the currency, though.

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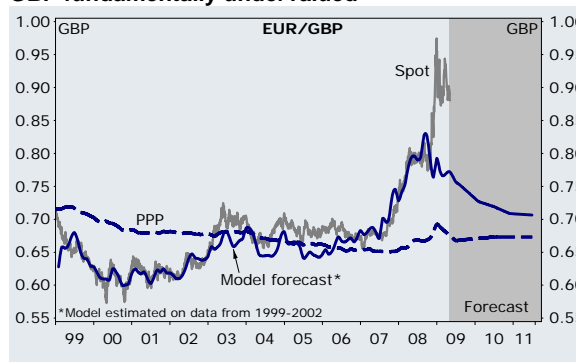
Mortgage rates coming down



House prices no longer in free fall



GBP fundamentally undervalued



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

	2005 (GBPbn)	2006	2007	2008	2009E	2010E
Private consumption	810.7	2.1	3.1	1.4	-2.5	0.2
Government consumption	268.6	1.6	1.5	3.4	4.5	1.2
Fixed investment	211.3	6.0	6.8	-3.1	-12.4	-3.1
Stockbuilding*	4.6	0.0	0.2	-0.4	-1.2	0.7
Exports	331.0	11.0	-4.1	0.1	-6.3	3.2
Imports	-373.7	9.6	-1.5	-0.6	-6.8	2.6
GDP		2.8	3.0	0.7	-3.7	0.7
Nominal GDP (GBPbn)	1,253	1,322	1,402	1,445	1,392	1,433
Unemployment rate, %		2.8	2.9	2.8	4.7	6.5
Consumer prices, % y/y		2.1	2.3	3.6	0.4	2.3
Current account, % of GDP		-2.5	-2.9	-1.7	-2.5	-1.2
General govt budget balance, % of GDP		-2.7	-2.8	-5.5	-9.0	-10.5
Gross public debt, % of GDP		42.1	43.9	52.0	64.0	76.5

\* Contribution to GDP growth (% points)

## Deep in recession valley

Switzerland has taken a severe blow from the global recession. This, coupled with a strong CHF, has put the important export sector under massive pressure. Add to this the negative impact of the financial crisis on the huge financial services sector. The leading business confidence indicator (KOF) has been on a roller-coaster ride towards new record lows. This paints a very bleak picture of economic growth, which usually tracks the KOF indicator. Corporate scepticism is a forewarning of decelerating investment activity in 2009 and 2010. It also suggests a further pick-up in unemployment, which has started to accelerate in recent months, acting as a drag on higher private consumption. Nascent signs in the global economy underpin hopes of growing sales potential in export markets.

Declining commodity prices, low economic activity and a strengthened CHF have sent inflation below zero. The risk of recession and deflation has caused the Swiss central bank (SNB) to make some aggressive moves. At the March monetary policy meeting rates were shaved to 0.25%, and the SNB moreover announced purchases of bonds and foreign currency to stop the CHF from firming further. Several central bank members have subsequently said that additional CHF appreciation would lead to intervention.

The historically close correlation between share prices and EUR/CHF has not been strong in recent months primarily due to statements from the SNB and the ECB. In the coming quarters risk appetite should gradually grow. This will weaken the CHF versus the EUR. But as interest rates in most countries are close to zero, CHF funding will not skyrocket, and the potential of significant CHF depreciation is relatively limited. In the event of a surprising new wave of financial market turbulence, the CHF could firm. However, the SNB seems so determined to act that a sharp strengthening seems a very unlikely scenario.

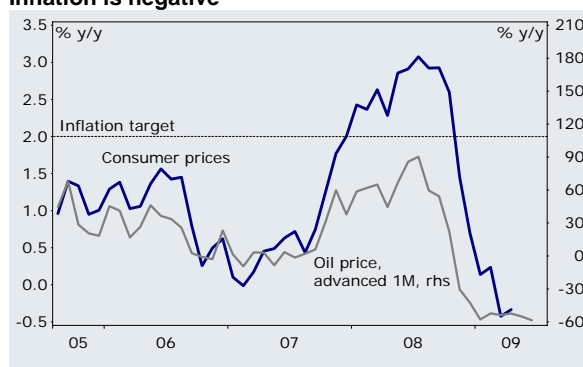
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**Economic growth storm in the offing**



**Inflation is negative**



**CHF not driven by share prices since November**



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

	2005 (CHFbn)	2006	2007	2008	2009E	2010E
Private consumption	279	1.6	2.1	1.7	-0.5	0.0
Government consumption	54	-0.9	-1.1	0.0	2.0	1.4
Fixed investment	98	4.7	5.4	-1.7	-7.0	-1.0
Stockbuilding*	2	-0.1	-1.3	-1.7	-1.3	0.2
Exports	226	9.9	9.4	2.3	-8.0	1.4
Imports	196	6.5	5.9	-0.2	-6.4	1.1
GDP		3.4	3.3	1.6	-2.8	0.5
GDP nominal (CHFbn)	463	487	509	529	510	516
Unemployment rate, %		3.3	2.8	2.6	4.2	5.0
Consumer prices, % y/y		1.1	0.7	2.4	-0.7	0.8
Current account, % of GDP		14.7	10.1	9.3	8.4	8.6
General govt. budget balance, % of GDP		1.0	1.3	1.1	-2.0	-3.0

\* Contribution to GDP growth (% points)

## Not so bad

The outlook for the Polish economy remains bleak as we see almost no expansion during 2009 and only a moderate recovery in 2010. We still expect that a near-term recession will be barely avoided and in comparison with most other countries in Europe that is not so bad. However, it does not change the fact that unemployment will be on the rise throughout 2009 and well into 2010.

Consumer spending has been a major driver of the economy in recent years, with a 5.0% annual growth rate in the very difficult Q4 2008. Going forward, real disposable incomes will increase at a much slower pace than last year despite the tax reductions implemented at the beginning of the year, as the labour market will continue to weaken gradually. However, real disposable incomes will still be increasing and thereby support some growth in consumer spending. Investment and exports will be the main drag on growth as we expect contraction at least throughout the first half of this year.

Inflation has not fallen as fast and as much as expected due to rising food and energy prices and the weakening of the PLN. Thus, the monetary easing cycle has been put on hold and will only be resumed if inflation starts moving closer to the 2.5% target. We see the current interest rate level as close to the bottom.

Global risk appetite will be the main driver of the PLN in the coming quarters. That means risk of renewed PLN weakening, though the USD 20bn flexible credit line with the IMF seriously reduces the risk. However, we are fairly convinced that the PLN will strengthen towards year-end and during 2010. A key event for the PLN is the possibility of ERM-2 membership during the summer, which is a prerequisite for EMU membership on 1 January 2012 according to schedule. At this point, ERM-2 does not seem realistic given the weak PLN and high volatility. However, should the PLN move towards the equilibrium range of 3.7-4.1, we see a risk that Poland will join the ERM-2. In that case the PLN should strengthen significantly.

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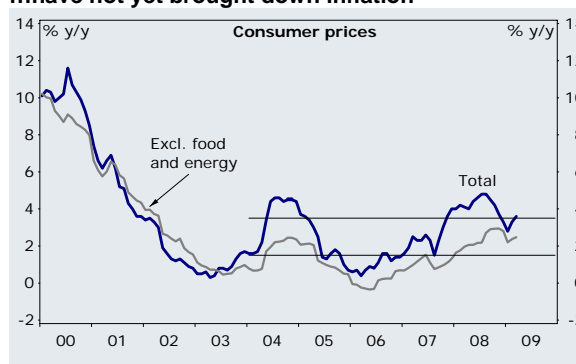
Stimuli from weak PLN and low interest rates



Labour market weakening...



...have not yet brought down inflation



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

	2005 (PLNbn)	2006	2007	2008	2009E	2010E
Private consumption	609	5.0	5.0	5.4	3.5	2.2
Government consumption	178	6.0	3.8	0.2	2.7	2.4
Gross fixed capital formation	179	14.9	17.3	7.9	-4.8	6.3
Stockbuilding*	10	0.4	1.7	0.2	-0.3	0.0
Exports	365	14.6	9.1	5.8	-6.7	5.1
Imports	372	18.6	13.6	6.2	-1.6	3.1
GDP		6.2	6.7	4.8	0.6	2.9
Nominal GDP (PLNbn)	983	1,060	1,175	1,272	1,317	1,382
Unemployment rate, %		16.2	12.7	9.8	10.5	12.1
Consumer prices, % y/y		1.2	2.6	4.4	3.0	2.1
Current account, % of GDP		-2.7	-4.7	-5.5	-5.2	-4.2
General government budget balance, % of GDP		-3.9	-1.9	-3.9	-2.9	-2.9

\* Contribution to GDP growth (% points)

## Recession has tightened its grip

The Estonian economy plummeted heavily towards the end of 2008 when the steep downturn in the world economy worsened the already ongoing recession. In Q4 2008 the economy shrunk by nearly 10% y/y, and in Q3 2008 GDP had already contracted by 3.6% y/y.

The economy is now declining on all fronts. Household consumption has sunk at a rapid pace and will remain weak for a long time. Consumer confidence has eroded to its lowest level in over 15 years. Consumption is burdened especially by the surging unemployment and sharply decreased wages. The labour market will be weak for a long time and the only bright spot for the development in purchasing power is the rapidly slowing inflation. Investment has also dropped considerably, as debt-driven growth ended in a belly-landing. The situation in consumption or investment is not made any easier by the difficulties caused by the financial crisis.

The sharp downtrend in the export markets also hit Estonia last autumn, speeding up the economic crash considerably. We expect that global trade will start to gradually pick up towards the end of 2009 but the situation in Estonia's key export areas will improve slower than on average.

We foresee the Estonian economy to contracting sharply by 9.5% in 2009. The trough in the cycle is set to be in 2010, but on average GDP will still shrink next year, too. As the recovery is largely dependent of the revival of the world economy, any setbacks in the export markets could further postpone the recovery.

Estonia's EMU membership has been a popular topic of discussion recently. After inflation moderated in March to approximately 2% from a peak of over 10% last spring, Estonia should fulfil the inflation criterion this year. A real challenge is reducing the public sector deficit to below the 3% target level. At present Estonia's aim is to adopt the euro in January 2011.

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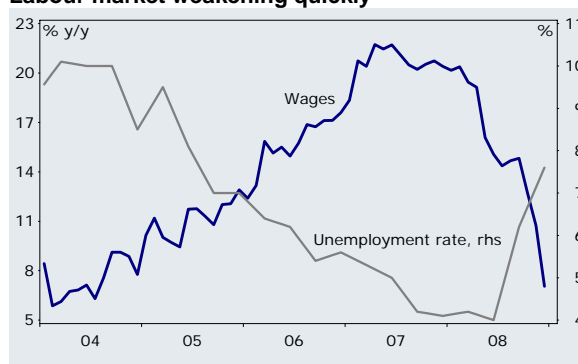
Bottom not in sight yet



Consumption and confidence have dived



Labour market weakening quickly



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

	2005 (EEKmn)	2006	2007	2008	2009E	2010E
Private consumption	93,835	12.7	7.9	-3.8	-11.5	-3.0
Government consumption	29,942	1.8	3.9	4.4	-5.0	-0.5
Fixed investment	53,742	19.5	4.8	-8.6	-22.5	-4.5
Exports	138,550	11.6	0.0	-1.1	-13.0	-1.0
Imports	149,560	20.4	4.2	-7.9	-15.0	-2.0
GDP		10.4	6.3	-3.6	-9.5	-2.0
Nominal GDP (EEKmn)	173,530	205,038	238,929	255,176	228,383	226,099
Unemployment rate, %		5.9	4.7	5.5	12.0	15.0
Consumer prices, % y/y		4.4	6.7	10.4	-1.0	1.0
Current account, % of GDP		-16.7	-18.1	-9.2	-4.0	-2.0
General govt budget balance, % of GDP		3.8	2.9	-3.0	-3.0	-2.5

## Economic tailspin worsens

The Latvian economy began to crash already in 2008 and the tailspin is not yet stabilising. The economy contracted almost 5% in Q3, and in Q4 the GDP statistics were dismal: the economy had shrunk by over 10%. During the full year of 2008 GDP contracted 4.6%, which was worse than expected.

Inflation has slowed considerably from last summer's peak. The trend is still clearly downward, and as a result of the deteriorating economy, inflation is likely to decelerate further this year, too.

The outlook is even gloomier than historical figures. In Q1 both exports and domestic demand continued to fall sharply. We expect the economy to contract by 12% in 2009. A global recovery is a prerequisite for restoring the Latvian economy to the growth track. So, even in the best case we will have to wait for positive GDP figures at least until 2010.

Latvia's political atmosphere has been problematic in the early part of the year, as the old government had to resign due to internal problems and the civil commotion caused by budget cuts. In addition, credit rating institutions have cut Latvia's rating during the spring, which increases borrowing costs.

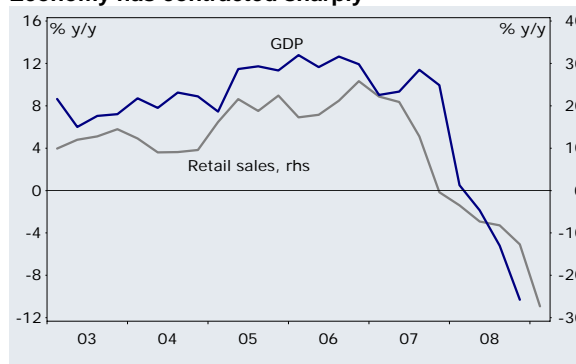
In order to qualify for an IMF loan, Latvia has undertaken not to let the budget deficit exceed 5% of GDP, but the steep economic slump has made things even more difficult than before for the new government. Furthermore, substantial public sector wage cuts erode consumers' purchase power, weakening the domestic economy further. It is representative of IMF's strict policy that it did not forward the promised funds to Latvia in March because the required budget cuts had not been made. Consequently, Latvia's short-term challenge is to fulfil IMF's requirements.

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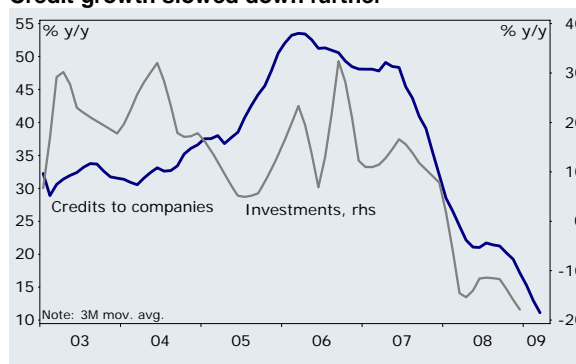
Economy has contracted sharply



Unemployment rising sharply



Credit growth slowed down further



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

	2005 (LVLmn)	2006	2007	2008	2009E	2010E
Private consumption	5,666	21.2	14.8	-11.0	-20.0	-4.5
Government consumption	1,581	4.9	3.7	1.5	-5.5	-3.0
Fixed investment	2,774	16.4	7.5	-13.2	-18.5	-5.0
Exports	4,335	6.5	10.0	-1.3	-7.0	-2.0
Imports	5,638	19.4	14.7	-13.6	-19.5	-5.0
GDP		12.2	10.0	-4.6	-12.0	-3.0
Nominal GDP (LVLmn)	9,059	11,172	13,957	15,450	14,060	13,779
Unemployment rate, %		6.8	6.0	7.5	12.5	14.0
Consumer prices, % y/y		6.6	10.1	15.3	3.0	1.0
Current account, % of GDP		-22.5	-22.5	-13.6	-7.0	-3.5
General govt budget balance, % of GDP		-0.5	-0.4	-4.0	-7.0	-5.5

## Economic slump just starting

The economy has declined deeply, contracting by over 12.6% in Q1 2009. Economic indicators suggest that the situation has remained weak in Q2 2009, and this year is expected to be clearly weaker than the end of 2008.

The recovery is heavily dependent on the revival of the global economy and Lithuania's trading partners. Domestic consumption and investment are going downhill and it is difficult to turn the direction unless exports start to pick up, improving confidence in general and alleviating the situation in the financial markets.

We expect the economy to contract 10% in 2009 when the recession in Lithuania and abroad continues to intensify. In 2010 the situation should start to improve, but growth will probably remain negative.

Inflation has moderated from the peak levels of last summer and this trend should continue in 2009. The economic decline, decrease in wages and moderation of energy and food prices are pushing prices down, as in other parts of the world. We believe that inflation will slow considerably during 2009.

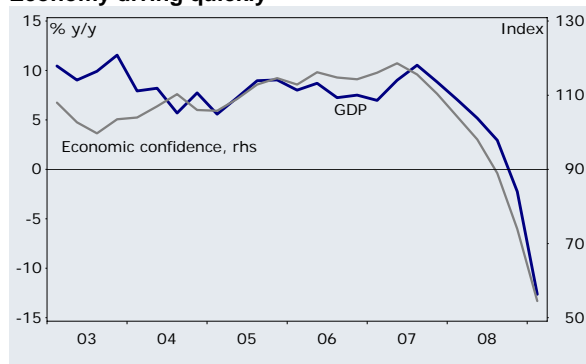
The global recession has weighed heavily on Lithuania. Standard & Poor's and Moody's have cut the country's credit rating, as they did Latvia's. The bigger than expected economic contraction strains government revenue and swells expenditure, which has made the government adjust the 2009 budget. VAT, for example, was raised in early 2009, but as the budget deficit has continued to grow, the government will probably have to cut its expenditure considerably. Lithuania has so far announced that it can withstand the crisis without support from abroad.

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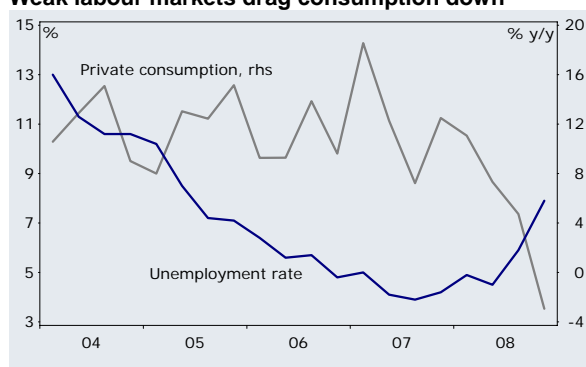
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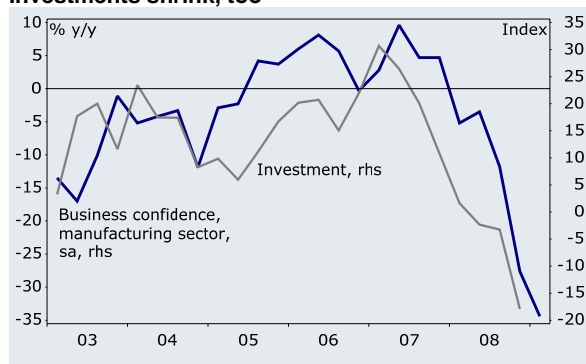
### Economy diving quickly



### Weak labour markets drag consumption down



### Investments shrink, too



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

	2005 (LTLmn)	2006	2007	2008	2009E	2010E
Private consumption	46,453	10.6	12.4	4.7	-7.5	-3.0
Government consumption	12,231	3.7	3.3	4.3	-0.5	0.0
Fixed investment	16,302	19.4	20.8	-6.1	-18.5	-7.5
Exports	41,440	12.0	4.3	11.3	-3.5	0.0
Imports	46,667	13.7	11.6	10.0	-5.0	-1.0
GDP		7.8	8.9	3.0	-10.0	-3.5
Nominal GDP (LTLmn)	71,380	81,905	96,739	110,379	104,308	101,701
Unemployment rate, %		5.6	4.3	7.9	11.0	14.0
Consumer prices, % y/y		3.8	5.8	11.1	4.5	1.0
Current account, % of GDP		-10.6	-14.6	-11.6	-6.0	-5.0
General govt budget balance, % of GDP		-0.4	-1.2	-2.9	-4.0	-5.0

## Robust growth turns into recession

Strong growth continued until Q3 2008. Towards the end of the year, however, it became apparent that the economy was going markedly downhill and actually deteriorated at a rapid pace in Q4 and Q1.

As a consequence of the financial crisis and the decline in oil prices, the economy has dived deeper than expected. Investment has shrunk due to lack of financing and the lower oil price has eaten away at exports. The financial crisis has made it more difficult to obtain consumer and housing loans. In addition, unemployment has increased significantly in the wake of the recession, while wages have dropped sharply. Household consumption has suffered badly.

The slump will continue this year. We expect that the economy will contract 5% in 2009 but start to grow once again in 2010. Economic growth is largely dependent on developments in the global economy and oil prices. We estimate that oil prices will begin to rise in 2010, but progress is also needed in other areas if the brisk growth of the past few years is to be reached. The government's revitalisation measures mainly aim at stabilising the financial sector, which was granted RUB 1,500bn last year, according to the Ministry of Finance. There are other plans to resuscitate the real economy, but the details have not yet been published.

Inflation has not slowed much from last summer's double-digit peak. Nonetheless, we expect inflation to moderate clearly this year when wage increases decelerate and the weaker currency no longer fuels price pressures.

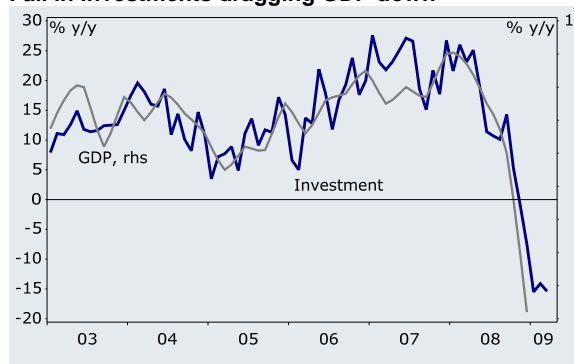
The severe depreciation of the RUB has stopped and the central bank has announced that devaluation has come to an end. In January, it was announced that the new fluctuation range of the RUB basket is 26-41. Market players have raised doubts as to whether the cap of the RUB basket will hold, but further devaluation would erode the central bank's credibility and therefore any devaluation is not likely at least in the near future.

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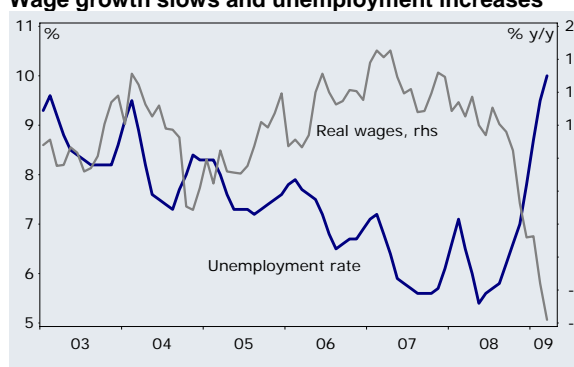
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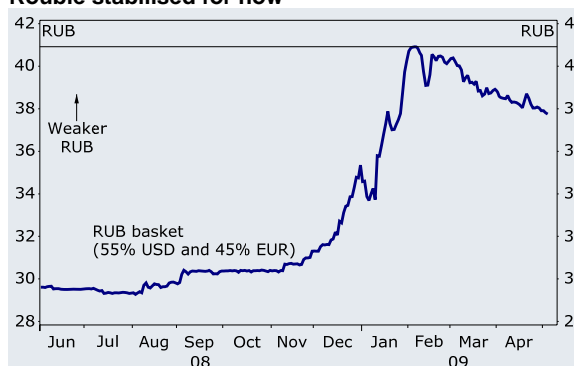
Fall in investments dragging GDP down



Wage growth slows and unemployment increases



Rouble stabilised for now



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

	2005 (RUBbn)	2006	2007	2008	2009E	2010E
Private consumption	10,728	11.2	12.8	11.5	-5.0	1.0
Government consumption	3,591	2.5	5.0	2.4	0.5	2.5
Fixed investment	3,837	17.7	20.8	12.8	-12.0	-1.5
Exports	7,607	7.3	6.4	0.9	-8.5	1.0
Imports	4,648	21.9	27.3	15.7	-9.0	2.0
GDP		7.4	8.1	5.8	-5.0	1.5
Nominal GDP (RUBbn)	21,625	26,880	32,987	39,551	41,924	46,327
Unemployment rate, %		7.2	6.1	6.4	12.0	13.0
Consumer prices, % y/y		9.7	9.0	14.1	11.0	9.0
Current account, % of GDP		9.5	5.8	6.1	-1.0	0.0
Central govt budget balance, % of GDP		8.4	6.1	4.8	-8.0	-6.0

## The first country to pull out of the crisis

Unlike many other countries China is already showing clear signs of improvement following last year's profound slowdown. Activity in the export industries remains subdued, though, while momentum particularly in the construction sector is rising again driven by the many government investment projects launched as part of last autumn's huge fiscal policy stimulus package. The economic progress is evidenced in investment activity and industrial production numbers. Just as the pick-up in investment activity is driven by public investment, the increase in industrial production is driven by production of especially construction materials and other products related to infrastructure investment.

Another good sign of the reversal of the economy is the high credit growth. This is driven partly by the funding of government investment projects. But it is worth noting that unlike in many other countries, the monetary policy easing measures have in fact significantly boosted credit growth in China. In addition to cutting rates the authorities have lowered the bank reserve requirements and abolished the credit quotas imposed a couple of years ago to dampen housing market activity. Another contributing factor could be that a majority of the banks are still state-owned and therefore more prone to comply with the authorities' request to increase lending. But this has also sparked growing fears of a future pick-up in the number of non-performing loans and defaults.

Despite increased government aid to the export industries we do not expect this sector to contribute much to the overall economy until global demand gradually regains momentum later this year. Meanwhile, however, the positive momentum in the domestic economy will continue and any signs of renewed weakness will most likely be met by new economic stimulus measures from the authorities.

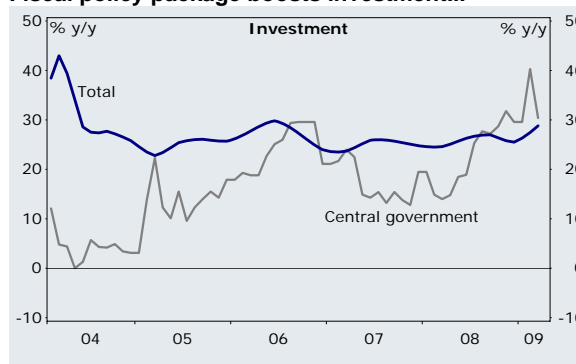
We expect the CNY to be kept stable versus the USD short term and gradually strengthen again longer term.

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### Fiscal policy package boosts investment...

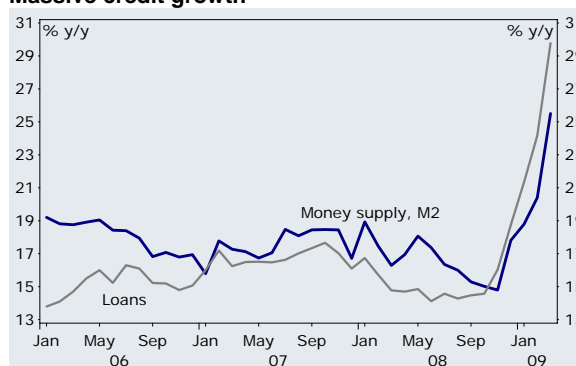


### ...and industrial production



Note: Data not adjusted for Chinese New Year, which creates noise in January and February.

### Massive credit growth



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

	2005 (CNYbn)	2006	2007	2008	2009E	2010E
Private consumption	7,122	11.3	9.6	9.5	8.5	9.5
Government consumption	2,661	11.5	13.7	11.0	12.0	11.0
Fixed investment	7,730	14.9	12.3	10.0	12.0	12.0
Stockbuilding*	334	-2.1	0.2	-0.5	-1.0	0.0
Exports	6,858	14.2	15.8	7.7	-12.0	8.0
Imports	5,835	12.6	13.4	2.4	-13.0	12.0
GDP		11.6	13.0	9.0	7.0	9.0
Nominal GDP (CNYbn)	18,869	22,117	26,324	30,760	32,452	34,237
Unemployment rate, %		4.1	4.0	4.2	4.5	4.7
Consumer prices, % y/y		1.5	4.8	5.9	-0.5	1.5
Current account, % of GDP		9.5	11.0	10.0	8.1	7.7
General government budget balance, % of GDP		-0.8	0.6	-0.4	-2.5	-3.1

\* Contribution to GDP growth (% points)

## Demand recovers gradually, but supply may be squeezed

Momentum in underlying oil prices is expected to trend upwards in H2. A gradual reduction in high long-term crude oil inventories will improve the supply/demand balance as OPEC supply cuts will finally outweigh the fall in demand. Increasing optimism on the back of better readings of macroeconomic indicators is expected to support an upturn in oil prices. Price volatility hit a long-time high in January, triggered by the credit market crisis and fragile political stability in major oil and gas producing regions. Volatility has come down markedly since the start of the year, but is still above the historical average.

Low oil prices are expected to put adequate investment in needed medium-term capacity at risk. Drying-up financing is aggravating the situation. The cut in upstream spending is expected to be less significant for the oil majors and many national oil companies (NOCs) as years with increasing oil prices have improved their balance sheets significantly. Higher cuts are expected among smaller and independent companies. Liquidity problems and a deteriorating economic environment may even lead to spending cuts by some NOCs. Years with high oil prices have made heavy public spending programmes and fuel subsidies possible. Lower oil prices make it increasingly difficult for some NOCs to balance the budgets and new project investments are at risk. Growth in non-OPEC supply is expected to remain subdued over the forecast horizon.

OPEC surplus capacity is expected to increase markedly as some new capacity has come on stream and OPEC output has been cut. We expect spare capacity to be at comfortable levels for the forecast horizon, but may come under pressure again in the medium term as investment in new capacity is cut and demand for oil is expected to pick up.

Global economic activity is a vital driver for oil demand. Energy-intensive sectors have been hit hard by the economic downturn. Oil demand continued to decelerate in Q1. However, we expect to see a gradual recovery in the world economy during the next 18 months. Growth will probably not be back to normal levels again until the end of 2010 or early 2011. This will in turn increase the demand for oil and oil products. As we move closer to the Copenhagen Climate Conference in December, we expect the focus on fuel efficiency to increase. We do not expect new efficiency standards to have significant impact on fuel demand in major fuel consuming countries until some years into the future.

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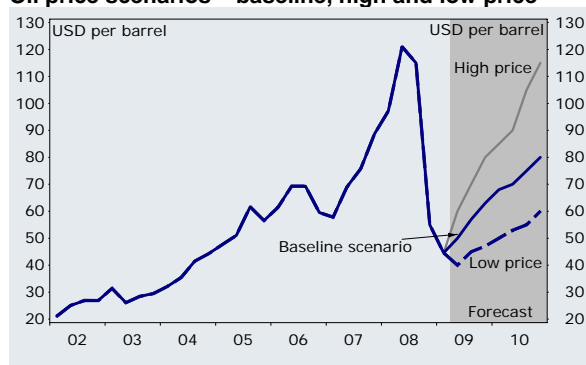
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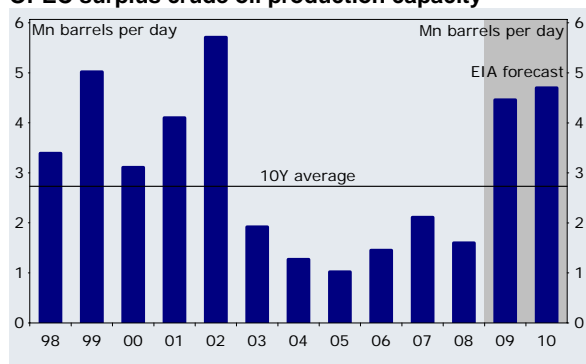
Oil price forecast – baseline (Brent spot – USD/barrel)

	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	44.6	50.0	57.0	63.0	53.7
2010E	68.0	70.0	75.0	80.0	73.3

Oil price scenarios – baseline, high and low price

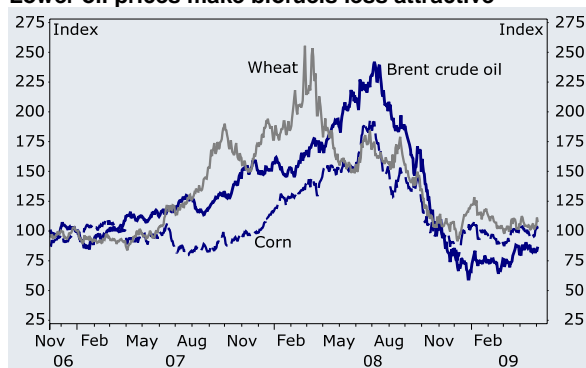


OPEC surplus crude oil production capacity



Source: Energy Information Administration (EIA)

Lower oil prices make biofuels less attractive



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