

# Weathering the storm

## Nordic strength

■ The Nordic economies are still in the lead supported by impressive public and external balances.

## International outlook less certain

■ The alarming increase in commodity prices poses a threat to inflation and economic growth. Even so, no hard landing is in sight and we expect growth to pick up pace next year.

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## World economy weathering the storm

*The headline of our January issue of Economic Outlook was “In smooth waters” – illustrating that the global economic upswing was well on its way to becoming self-sustaining. Now, a few months later, the picture is still positive, but uncertainties are more pronounced than previously. One of the main reasons is that commodity prices have continued to skyrocket. Oil prices have risen partly as a consequence of the tense political situation in the Middle East and North Africa, which is still unresolved. The devastating natural catastrophes in Australia and Japan are also key reasons. At the same time economic policy has been tightened sooner and more aggressively than expected in many countries. The reason why we still expect the world economy to weather the storm is chiefly that the current growth momentum seems even stronger than at the beginning of the year. We therefore still expect the global economy to expand at a pace of around 4% this year, with almost the same growth rate in 2012.*

### USA – Temporary soft patch

The US economy saw a comparatively weak Q1, mainly due to a combination of harsh winter weather and rising commodity prices. However, we think this is a temporary soft patch in the economy. Our baseline scenario does not incorporate additional commodity price increases and economic policy tightening in the US is not on the cards in the near future. Lastly, the outlook for small and medium-sized businesses has brightened significantly compared to a few quarters ago. This is crucial for labour market trends, which are again showing signs of improvement. At the same time, activity indicators for large companies point to continued substantial production increases over the coming quarters, which support our expectations of fairly decent growth in the overall economy during the forecast period. One of the main elements of uncertainty for the US is public finances. If the sovereign debt crisis spreads to the US, a risk scenario that we assign a very low probability, it may have fatal consequences for both economic growth and the financial markets.

### ECB on the move

The growth outlook for the Euro area is relatively subdued with major variations across countries. Germany has definitely taken the lead in terms of economic activity, with the strongest expansion since the unification 20 years ago. The labour market is strong, and activity and confidence indicators for businesses and households point unequivocally upwards. The situation is far more critical in the debt-ridden countries, notably Greece, Portugal and Ireland. The sovereign debt crisis in Europe is thus far from over, and the risk of notably Greece having to undergo a debt restructuring process increases all the time. Although the commitment to cross-country cooperation has been stretched to breaking point lately, we are still convinced that policymakers in the individual mem-

ber countries clearly have the will to keep the system together. But it is also clear that the political – and thus also the economic – agenda is increasingly being set by France and Germany, as most recently demonstrated through the establishment of the Euro Pact which is to address the ailing competitiveness in a number of the more vulnerable Euro-area countries.

The diverse economic trends in the member countries and the at times uncertain political situation complicate the ECB's efforts to determine the optimal monetary policy line for the Euro area. As many countries are effectively unable to access the international capital markets, the ECB has to continue its full allotment for quite a while yet. The bank's interest rate policy is targeted at keeping Euro-area inflation close to but below 2%. But given the recent surge in commodity prices, inflation currently by far exceeds this target. The ECB has therefore had no choice but to tighten its interest rate policy to keep inflation expectations in check. We believe that the ECB will raise its policy rate to 2.25% during the forecast period. This will be somewhat less aggressive than the Fed's interest rate moves. Moreover, we expect the Fed to embark on its tightening cycle in the reverse order – phasing out its QE measures during the summer, but not sanctioning its first rate hike until the end of the year. Subsequently, the Fed will gradually hike the fed funds rate to 3.5% by the end of the forecast period.

### Slowdown in BRIC countries

So far the Asian economies, headed by China and India, have been veritable growth tigers since the big recession ended. However, now much indicates that both countries are facing a controlled economic slowdown. Clear signs of overheating have led to monetary policy tightening in order to avoid high inflation and bubble-like conditions in for instance the housing market. Also economic growth in Brazil seems to have peaked for now, while Russia, on the other hand, has shifted into a higher gear as a result of the recent oil price spike. For the BRIC countries overall we expect growth to abate, but a hard landing will be avoided

### Japan back in recession

In this issue of *Economic Outlook* we have again included Japan, which this year will slide back into recession as a consequence of the devastating earthquake catastrophe. However, the effect on the rest of the world will be limited, as the Japanese economy only accounts for about 5% of the world economy. But the derived effects could be significant. The closure of the Fukushima nuclear power plant will for example postpone the expected renaissance of nuclear power in Europe and the US indefinitely, which near term will boost demand for fossil fuels and longer out pave the way for other renewable energy sources.

### Alarming commodity prices

Over the past year we have seen a massive boom in commodity prices. The reasons are manifold. Firstly, accelerating activity in the global economy has increased demand for commodities for commercial purposes. Secondly, the extremely lenient monetary policy has strengthened investors' appetite for commodities. Thirdly, prices have come under pressure due to uncertainty about the long-term supply and natural catastrophes, like for example in Australia where vast areas of major importance for the country's mining activities were flooded. Consequently, commodity prices are higher than ever overall, resulting in high global inflation and considerable uncertainty about the future strength of the economic upswing. However, in our view the anticipated monetary policy tightening and the high prices in themselves will suffice to curb these trends and may even lead to a correction in commodity prices. At the time of writing, there are signs to that effect. This supports our expectation that the global upswing will continue during the forecast period, but commodity price trends are obviously subject to much uncertainty.

### Higher government yields and USD comeback

The expected monetary policy trend will also have a major impact on long government yields and exchange rates. Our forecast of higher monetary policy rates combined with sovereign debt problems in many countries implies generally higher government yields during the forecast period. Moreover, the Fed's more aggressive rate hikes compared with the ECB later in the forecast period will give the USD a strong comeback in 2012. Under normal circumstances this would also entail falling commodity prices, as they usually correlate negatively with the strength of the USD.

The prospect of Bank of Japan refraining from rate hikes for a long time to come will again make the JPY an attractive funding currency. That is why we expect the JPY to weaken sharply versus the USD during the forecast period when also the CHF is likely to lose terrain to the EUR. In step with the USD firming against the EUR, we also expect the GBP to gain versus the EUR. But that is more due to the historical correlation between the GBP and the USD, as the weak UK economy will make the Bank of England hesitant to raise interest rates despite the currently high inflation in the UK.

### Nordic strength

The Nordic economies are still in the lead. Economic growth in Sweden and Norway looks set to be strong again this year supported by impressive public and external balances. But the Swedish and Norwegian central banks also have to hike interest rates to prevent overheating in the housing and labour markets. Economic growth in Finland is also strong while Denmark is the laggard, but on the right track. Both countries are facing slight fiscal policy tightening, but their public finances are in much better shape than average for the Euro area.

Growth in the **Danish** economy fell surprisingly in Q4 2010 for the first time since mid-2009. But a few negative quarters are not unusual and the latest indicators point to renewed improvement, which is expected to continue during the forecast period. We believe that growth will be sufficiently high to reduce unemployment. Ultimately, this could have a decisive impact on the general election to be held in November this year at the latest.

The **Swedish** economy grew by a record-strong 5.5% in 2010. GDP will continue to increase in 2011 and 2012, but at a somewhat slower pace. Exports benefit from the upswing in global trade and rising demand from Emerging Markets. Despite rising mortgage costs the household economy is in good shape, supporting private consumption. Investment picked up already in 2010 and will increase further. Employment, already at a record-high level, is seen growing sharply in 2011, increasing bottleneck problems. Public finances will strengthen along with rising employment, reaching the target of 1% of GDP in 2011. Inflation will pick up on the back of rising energy prices and higher wages. The Riksbank is expected to continue to raise rates.

We still expect fairly strong growth in the **Norwegian** economy in line with our forecasts in the previous issue of *Economic Outlook*. But we have revised down our unemployment forecast and raised our wage growth forecast for next year. Core inflation has been lower than we expected this year, but we know that retailers' purchase prices have increased sharply. With expected strong growth in consumption, retailers will gradually pass on the costs to consumers. A more rapid uptick in inflation than Norges Bank forecasts is one of the reasons why we think the bank will adopt a more aggressive line than it has signalled. The NOK will hold its own quite well against the EUR going forward, as Norges Bank will hike interest rates more aggressively than the ECB.

The outlook for the **Finnish** economy remains strong, with the economic expansion driven by both foreign trade and domestic demand. Exports, estimated to increase across the board, benefit from the exceptionally strong performance of the German, Swedish and Russian economies, Finland's most important trading partners. Investment growth will accelerate markedly, as machinery and equipment investment follows the rise in the industrial capacity utilisation rate. Consumer prices have risen faster than forecast, so household sector purchasing power will improve less than earlier expected. Consumption growth will slow down towards the end of the forecast period, despite the balancing effects of higher employment and an expected fall in household savings.

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**Growth, %**

	2008	2009	2010	2011E	2012E
World <sup>1)</sup>	2.2	-1.0	4.4	3.7	4.1
BIG-3 <sup>2)</sup>	-0.1	-3.7	2.6	2.0	2.5
USA	0.0	-2.6	2.9	2.7	3.0
Japan	-1.2	-6.3	3.9	-0.1	2.9
Euro area	0.3	-4.0	1.7	1.9	1.8
Germany	0.7	-4.7	3.5	2.8	2.2
France	0.1	-2.5	1.5	1.8	1.9
Italy	-1.3	-5.1	1.2	1.4	1.4
Spain	0.9	-3.7	-0.1	0.8	1.8
Netherlands	1.9	-3.9	1.8	2.0	2.1
Belgium	1.0	-2.8	2.1	2.0	1.9
Austria	2.2	-3.4	2.1	2.0	1.9
Portugal	0.0	-2.6	1.3	-1.5	-0.5
Greece	2.0	-2.3	-4.3	-3.0	1.0
Finland	0.9	-8.2	3.1	3.7	3.0
Ireland	-3.5	-7.6	-1.0	0.8	2.2
UK	-0.1	-4.9	1.3	1.5	2.2
Denmark	-1.1	-5.2	2.1	2.0	1.8
Sweden	-0.6	-5.3	5.5	4.7	2.3
Norway	1.8	-1.3	2.2	3.3	3.1
Russia	5.6	-7.9	4.1	5.4	5.7
Poland	5.1	1.7	3.8	3.7	4.0
Estonia	-5.1	-13.9	3.0	5.7	3.8
Latvia	-4.2	-18.0	-0.1	3.6	4.2
Lithuania	2.9	-14.7	1.3	4.6	4.0
Hungary	0.6	-6.5	0.9	3.2	3.4
Czech Republic	2.3	-4.0	2.5	3.1	3.8
Turkey	0.7	-4.7	7.5	5.1	5.5
China	9.6	9.2	10.3	9.2	8.8
India	4.9	9.1	9.7	7.9	8.1
Brazil	5.2	-0.7	7.6	4.5	4.7

**Inflation, %**

	2008	2009	2010	2011E	2012E
World	4.6	0.7	2.6	3.7	2.7
BIG-3	3.3	-0.2	1.3	2.5	1.7
USA	3.8	-0.3	1.6	3.0	2.0
Japan	1.4		-0.7	-0.1	0.4
Euro area	3.3	0.3	1.6	2.8	1.8
Germany	2.8	0.3	1.2	2.5	1.7
France	3.2	0.1	1.7	2.7	1.8
Italy	3.5	0.6	1.6	2.8	2.1
Spain	4.2	-0.3	2.0	3.4	1.8
Netherlands	2.2	1.0	0.9	2.3	1.6
Belgium	4.5	0.0	2.3	3.3	1.6
Austria	3.2	0.4	1.7	2.9	2.0
Portugal	2.7	-0.9	1.4	3.0	1.6
Greece	4.3	1.3	4.7	2.4	1.0
Finland	4.1	0.0	1.2	3.5	2.5
Ireland	3.1	-1.7	-1.6	1.5	1.0
UK	3.6	2.2	3.2	4.1	2.0
Denmark	3.4	1.3	2.3	2.7	2.0
Sweden	3.4	-0.5	1.2	3.2	3.0
Norway	3.8	2.1	2.5	1.8	2.2
Russia	14.1	11.7	6.9	8.5	7.5
Poland	4.4	3.8	2.7	3.8	1.9
Estonia	10.6	-0.1	3.0	5.0	2.9
Latvia	15.3	3.6	-1.0	4.5	3.0
Lithuania	11.1	4.2	1.3	4.4	3.5
Hungary	6.0	4.2	4.9	2.8	3.0
Czech Republic	6.3	1.0	1.5	2.7	2.3
Turkey	10.4	6.3	8.6	6.0	5.5
China	5.9	-0.7	3.3	5.4	4.0
India	8.7	2.1	9.5	7.5	5.0
Brazil	5.7	4.9	5.0	6.4	5.2

**Public finances, % of GDP**

	2008	2009	2010	2011E	2012E
BIG-3 <sup>2)</sup>	-3.3	-8.4	-7.7	-7.4	-5.8
USA	-4.7	-10.4	-8.7	-8.8	-6.8
Japan	-2.1	-7.1	-7.7	-10.0	-8.0
Euro area	-2.0	-6.3	-6.3	-4.6	-3.6
Germany	0.1	-3.0	-3.3	-2.5	-1.5
France	-3.3	-7.5	-7.0	-6.2	-4.8
Italy	-2.7	-5.4	-4.6	-4.0	-3.2
UK	-5.0	-11.3	-10.5	-8.0	-6.0
Finland	4.2	-2.6	-2.4	-1.2	-0.3
Denmark	3.2	-2.7	-2.7	-3.8	-3.0
Sweden	2.2	-0.9	-0.3	1.0	1.7
Norway	19.1	10.5	10.1	14.6	15.8
Russia	4.1	-5.3	-4.2	-1.5	-1.0
Poland	-3.7	-7.3	-7.9	-6.0	-4.5
Estonia	-2.8	-1.7	0.1	-0.7	-2.7
Latvia	-4.2	-10.2	-7.7	-4.8	-2.6
Lithuania	-3.3	-9.2	-7.1	-5.0	-2.8
Hungary	-3.7	-4.4	-3.8	-2.9	-3.0
Czech Republic	-2.7	-5.8	-5.1	-4.5	-3.5
Turkey	-1.8	-5.5	-5.2	-4.5	-4.0
China	-0.4	-2.1	-1.6	-2.2	-1.9
India	-6.0	-6.5	-5.0	-5.5	-5.0
Brazil	-1.6	-3.2	-2.7	-2.5	-2.0

**Current account, % of GDP**

	2008	2009	2010	2011E	2012E
BIG-3 <sup>2)</sup>	-	-	-	-	-
USA	-4.7	-2.7	-3.2	-3.5	-3.7
Japan	3.2	2.8	3.6	2.6	2.9
Euro area	-1.5	-0.6	-0.6	-0.7	-1.0
Germany	6.7	5.0	5.7	5.2	5.0
France	-2.7	-2.9	-2.1	-2.3	-1.9
Italy	-3.4	-3.2	-3.3	-3.3	-2.7
UK	-1.6	-1.7	-2.5	-2.0	-1.5
Finland	3.5	3.0	3.1	2.9	3.1
Denmark	2.7	3.6	5.4	5.9	5.4
Sweden	8.9	6.8	6.2	5.6	5.8
Norway	17.7	13.1	12.9	16.8	17.2
Russia	6.2	3.9	4.7	4.3	3.5
Poland	-4.8	-2.1	-3.4	-4.7	-4.2
Estonia	-8.8	4.5	3.8	0.9	-0.1
Latvia	-13.1	8.6	4.0	-0.2	-1.0
Lithuania	-13.1	4.3	1.8	-1.0	-1.5
Hungary	-7.3	-0.5	2.2	-0.5	-2.0
Czech Republic	-0.6	-1.0	-2.5	-2.9	-3.5
Turkey	-5.8	-2.3	-5.6	-6.0	-6.0
China	9.6	5.9	5.2	4.1	3.6
India	-2.5	-2.0	-3.1	-2.5	-2.5
Brazil	-1.8	-1.5	-2.5	-3.0	-2.8

1) Weighted average of countries in this table. Accounts for 70.5% of world GDP. Weights calculated using PPP adjusted GDP levels for 2007 according to the IMF's World Economic Outlook

2) US, Japan and the Euro area

### Monetary policy rates

	12.5.11	3M	6M	12M	24M
US	0.25	0.25	0.25	1.25	3.50
Japan	0.10	0.10	0.10	0.10	0.50
Euro area	1.25	1.50	1.75	2.25	2.25
Denmark	1.30	1.55	1.80	2.30	2.50
Sweden	1.75	2.00	2.50	2.75	3.50
Norway	2.00	2.50	2.75	3.25	4.50
UK	0.50	0.50	0.50	1.00	2.25
Switzerland	0.25	0.25	0.50	1.00	2.00
Poland	4.00	4.25	4.50	5.00	5.00
Czech Rep.	0.75	0.75	1.00	1.50	2.25
Hungary	6.00	6.00	6.00	5.50	5.25
Turkey	6.25	6.75	7.25	8.25	8.75
Russia	8.00	8.25	8.50	9.00	9.00
China	6.31	6.81	6.81	6.81	6.81
India	7.25	8.00	8.00	8.00	8.00
Brazil	12.00	12.75	13.00	13.00	9.00

### Monetary policy rate spreads vs Euro area

	12.5.11	3M	6M	12M	24M
US	-1.00	-1.25	-1.50	-1.00	1.25
Japan <sup>1</sup>	-0.15	-0.15	-0.15	-1.15	-3.00
Euro area	-	-	-	-	-
Denmark	0.05	0.05	0.05	0.05	0.25
Sweden	0.50	0.50	0.75	0.50	1.25
Norway	0.75	1.00	1.00	1.00	2.25
UK	-0.75	-1.00	-1.25	-1.25	0.00
Switzerland	-1.00	-1.25	-1.25	-1.25	-0.25
Poland	2.75	2.75	2.75	2.75	2.75
Czech Rep.	-0.50	-0.75	-0.75	-0.75	0.00
Hungary	4.75	4.50	4.25	3.25	3.00
Turkey	5.00	5.25	5.50	6.00	6.50
Russia	6.75	6.75	6.75	6.75	6.50
China	5.06	5.31	5.06	4.56	4.56
India	6.00	6.50	6.25	5.75	5.75
Brazil	10.75	11.25	11.25	10.75	6.75

1) Spread vs US

### 3-month rates

	12.5.11	3M	6M	12M	24M
US	0.26	0.50	0.60	1.60	3.85
Euro area	1.42	1.85	2.10	2.50	2.50
Denmark	1.45	2.00	2.30	2.70	2.90
Sweden	2.46	2.70	2.95	3.45	3.75
Norway	2.64	2.91	3.10	3.69	4.94
UK	0.82	0.80	0.90	1.45	2.35
Poland	4.42	4.50	4.75	5.25	5.25
Czech Republic	1.22	1.25	1.40	1.80	2.50
Hungary	6.10	6.25	6.25	5.75	5.50
Russia	4.06	4.30	4.55	5.00	6.00
Latvia	0.79	0.90	1.00	1.50	2.00
Lithuania	1.66	1.80	2.00	2.20	2.30

### 3-month spreads vs Euro area

	12.5.11	3M	6M	12M	24M
US	-1.16	-1.35	-1.50	-0.90	1.35
Euro area	-	-	-	-	-
Denmark	0.03	0.15	0.20	0.20	0.40
Sweden	1.04	0.85	0.85	0.95	1.25
Norway	1.22	1.06	1.00	1.19	2.44
UK	-0.60	-1.05	-1.20	-1.05	-0.15
Poland	3.00	2.65	2.65	2.75	2.75
Czech Republic	-0.20	-0.60	-0.70	-0.70	0.00
Hungary	4.68	4.40	4.15	3.25	3.00
Russia	2.64	2.45	2.45	2.50	3.50
Latvia	-0.63	-0.95	-1.10	-1.00	-0.50
Lithuania	0.24	-0.05	-0.10	-0.30	-0.20

### 10-year government benchmark yields

	12.5.11	3M	6M	12M	24M
US	3.18	3.65	3.75	3.90	4.35
Euro area	3.10	3.60	3.70	3.75	3.75
Denmark	3.11	3.65	3.80	3.90	4.00
Sweden	3.04	3.50	3.80	3.95	4.05
Norway	3.46	3.92	4.10	4.33	4.75
UK	3.38	3.70	3.75	3.80	4.05
Poland	6.05	6.00	5.80	5.70	5.60
Czech Rep.	3.76	3.80	3.90	4.00	4.25
Hungary	7.03	7.25	7.50	7.75	8.00

### 10-year yield spreads vs Euro area

	12.5.11	3M	6M	12M	24M
US	0.08	0.05	0.05	0.15	0.60
Euro area	-	-	-	-	-
Denmark	0.01	0.05	0.10	0.15	0.25
Sweden	-0.05	-0.10	0.10	0.20	0.30
Norway	0.36	0.32	0.40	0.58	1.00
UK	0.28	0.10	0.05	0.05	0.30
Poland	2.96	2.40	2.10	1.95	1.85
Czech Rep.	0.67	0.20	0.20	0.25	0.50
Hungary	3.93	3.65	3.80	4.00	4.25

### Exchange rates vs EUR

	12.5.11	3M	6M	12M	24M
EUR/USD	1.430	1.45	1.35	1.30	1.25
EUR/JPY	116.2	122	116	120	123
EUR/DKK	7.456	7.46	7.46	7.46	7.46
EUR/SEK	8.976	8.75	8.75	9.00	9.20
EUR/NOK	7.813	7.80	7.80	7.80	7.60
EUR/GBP	0.870	0.87	0.88	0.84	0.83
EUR/CHF	1.265	1.30	1.30	1.35	1.37
EUR/PLN	3.894	3.90	3.80	3.70	3.60
EUR/CZK	24.24	24.3	24.0	23.5	23.0
EUR/HUF	264.4	265	270	275	270
EUR/TRY	2.26	2.15	2.10	2.00	2.00
EUR/RUB	39.66	37.1	35.1	33.7	32.9
EUR/LVL	0.709	0.71	0.71	0.71	0.71
EUR/LTL	3.453	3.45	3.45	3.45	3.45
EUR/CNY	9.288	9.32	8.56	8.00	7.24
EUR/INR	63.92	65.3	60.8	57.9	55.0
EUR/BRL	2.310	2.25	2.23	2.08	1.88

### Exchange rates vs USD

	12.5.11	3M	6M	12M	24M
-	-	-	-	-	-
USD/JPY	81.21	84.0	86.0	92.0	98
USD/DKK	5.212	5.14	5.52	5.73	5.96
USD/SEK	6.275	6.03	6.48	6.92	7.36
USD/NOK	5.462	5.38	5.78	6.00	6.08
GBP/USD	1.645	1.67	1.53	1.55	1.51
USD/CHF	0.884	0.90	0.96	1.04	1.10
USD/PLN	2.723	2.7	2.8	2.8	2.9
USD/CZK	16.95	16.7	17.8	18.1	18.4
USD/HUF	184.8	183	200	212	216
USD/TRY	1.58	1.50	1.47	1.40	1.40
USD/RUB	27.72	25.6	26.0	25.9	26.3
USD/LVL	0.496	0.49	0.52	0.54	0.56
USD/LTL	2.414	2.38	2.56	2.66	2.76
USD/CNY	6.493	6.43	6.34	6.15	5.79
USD/INR	44.69	45.0	45.0	44.5	44.0
USD/BRL	1.615	1.55	1.65	1.60	1.50

## Record year in the labour market

- GDP growth slowing from high levels
- Above normal capacity utilisation as early as this year
- Repo rate to reach 2.50% this year

### The economy is heating up

The Swedish economy continues to develop favourably. Both exports and domestic demand are rising at a healthy clip and employment beats all records both in terms of level and growth. Public finances are in surplus although further reforms are on the cards next year.

However, after a strong start to 2011 growth is slowing as the initial sharp upward move from the depressed levels after the crisis is over and economic policy is becoming less expansionary. Mortgage rates have risen more than expected and the government's fiscal policy line is growth neutral this year compared to its highly accommodative line last year. In addition, the SEK strengthening adversely affects export companies' profits and, in turn, equity prices.

Next year the economy stands to receive a boost from tax cuts and other reforms worth a total of SEK 30bn, while additional rate hikes and labour market bottlenecks will have an opposite effect. The deceleration in GDP growth is taking place from very high levels, though. Despite the economy's shift into a lower gear, growth is still expected to be above both the potential level and the long-term trend over the forecast period. As a result, resource utilisation, already above normal this year, should increase further.

### Exports a key driver

Demand for Swedish export goods has increased sharply

during the past year. Despite a growing public debt burden in many countries, global trade has recovered after the financial crisis, and Swedish exporters have benefited from this trend. Especially the pick-up in Emerging Markets growth has contributed to this recovery. Note in this context that Swedish companies' trade with Emerging Markets has increased. Recently, total exports to the BRIC countries have outstripped Swedish exports to the US, a long-term key export market for Sweden. Indicators and the global economic outlook suggest that Swedish exports will continue to rise, although growth is expected to slow in tandem with the expected slowdown in Sweden's export markets especially next year.

### Labour market offsets higher household costs

Household expenses have risen sharply during the past six months. Most importantly, mortgage rates have increased as a result of the Riksbank's rate hikes, the new financial sector regulations and the increased supply of mortgage bonds. Also electricity prices were very high during the winter, and fuel prices have risen to record levels.

The sharp pick-up in mortgage rates is the key factor behind the sooner-than-expected tightening. Households appear to have reacted to the higher costs. Credit growth has flattened and retail sales have been weak over the past few months. Also the housing market, which usually has a strong bearing on household spending and savings, show signs of a slowdown.

But the positive trend in the labour market remains intact, contributing to higher income and increased confidence. Despite elevated interest rates and higher energy prices, household real disposable incomes look set to rise by

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

	2007 (SEKbn)	2008	2009	2010	2011E	2012E
Private consumption	1,460	0.0	-0.4	3.5	2.8	2.5
Government consumption	797	1.0	1.7	2.6	2.8	0.4
Fixed investment	612	1.4	-16.3	6.3	10.0	5.8
- industry	95	-0.2	-22.2	-7.5	12.1	8.6
- residential investment	121	-13.1	-23.3	16.0	17.2	7.7
Stockbuilding*	23	-0.5	-1.5	2.1	0.2	-0.4
Exports	1,621	1.7	-13.4	10.7	9.1	5.7
Imports	1,388	3.5	-13.7	12.7	8.9	5.8
GDP		-0.6	-5.3	5.5	4.7	2.3
GDP, calendar adjusted		-0.9	-5.2	5.3	4.8	2.7
Nominal GDP (SEKbn)	3,126	3,204	3,089	3,301	3,500	3,657
Unemployment rate, %		6.2	8.3	8.4	7.3	6.8
Employment growth		1.1	-2.1	1.0	2.7	1.1
Consumer prices, % y/y		3.4	-0.5	1.2	3.2	3.0
Underlying inflation (CPIF), % y/y		2.7	1.7	2.0	1.7	1.9
Hourly earnings, % y/y		4.6	3.0	0.9	3.6	4.2
Current account (SEKbn)		284	209	205	196	213
- % of GDP		8.9	6.8	6.2	5.6	5.8
Trade balance, % of GDP		3.6	3.2	2.4	2.2	2.5
General govt budget balance (SEKbn)		71	-29	-11	35	63
- % of GDP		2.2	-0.9	-0.3	1.0	1.7
Gross public debt, % of GDP		37.7	42.1	39.8	36.0	32.6

\* Contribution to GDP growth (% points)

about 3% in both 2011 and 2012, thus setting the scene for good consumption growth going forward. Our forecast factors in a rising savings ratio over the coming years as a result of more stable wealth growth after the past few years' sharp pick-up. The rising savings ratio indicates that consumption growth could turn out higher than expected.

**Sharply rising employment**

The sharply rising economic activity shows clearly through in the labour market, with employment rising markedly over the past six quarters. As a result, the number of people employed was at an all-time high in the beginning of 2011. There is every indication that the strong labour market trend will continue in most of 2011, resulting in an increase in the number of people in employment of no less than 2.7% this year, also a record high. However, next year the labour market will slow somewhat in tandem with the more moderate production growth.

Also the labour supply has risen sharply in recent years. The government's reforms have for example resulted in more people entering the labour market. Consequently, despite record-high employment, joblessness is still higher than before the crisis. There are signs that structural unemployment has increased and that it has become more difficult for businesses to hire staff with the required skills. The tighter labour market situation, coupled with compensation claims for previous crisis deals and record-high corporate earnings in many sectors, suggests that wages will rise faster going forward. We expect hourly wages to rise by over 4% in 2012, which is somewhat above the historical 15-year average of 3.7%.

Rising inflation expectations may also contribute to higher wage demands during this autumn's pay talks. The rising inflation expectations reflect the increase in commodity prices and household expenses on energy and housing. CPI inflation will likely remain high, i.e. above the 2% target, both this year and next year, while core inflation remains below target. With rising capital utilisation, rising labour costs and a stabilisation of import prices, core inflation should move higher going forward.

**Interest rate hikes and still strong SEK**

Accordingly, there is every indication that the Riksbank will continue to raise its repo rate in the period ahead. We see the repo rate at 2.50% by end-2011 and at 3.50% in two years' time. Despite the expected deceleration in growth the Swedish economy will still remain strong compared to so many other countries in the years ahead. This, coupled with the Riksbank's rate hikes, will support the SEK, while rate hikes in other countries will have the opposite effect. On a 1-year horizon we see the SEK trading at 6.92 versus the USD and at 9.0 versus the EUR.

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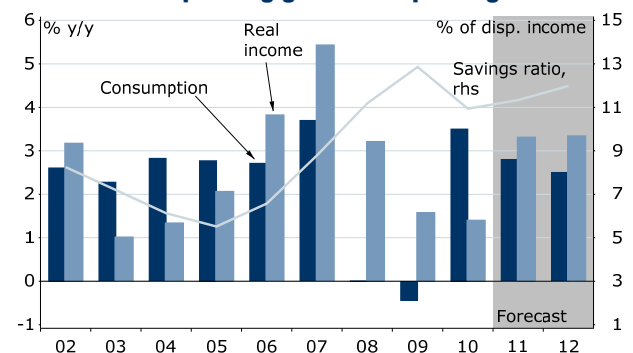
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**Sharply rising exports**



Source: Nordea Markets and Reuters Ecowin

**Still room for spending growth despite higher rates**



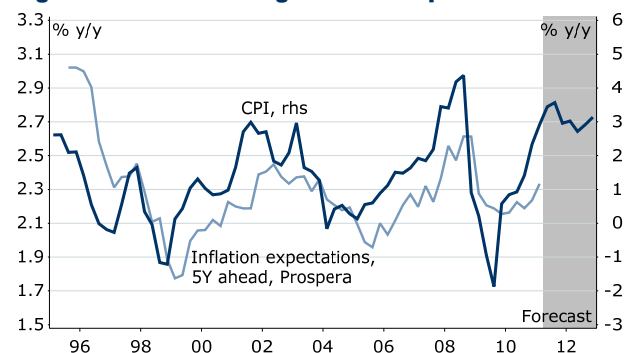
Source: Nordea Markets and Reuters Ecowin

**Employment at a record high**



Source: Nordea Markets and Reuters Ecowin

**High inflation and rising inflation expectations**



Source: Nordea Markets and Reuters Ecowin

## Strong growth and higher inflation equal higher interest rates

- Strong growth but no overheating
- Inflation to rise more than Norges Bank expects
- Rates rising more than Norges Bank expects this year
- Strong NOK vs EUR, weaker import-weighted NOK

Demand and production in the mainland economy look set to develop roughly as forecast in our January issue of *Economic Outlook*. However, recent labour market figures have been somewhat stronger than expected and it would appear that unemployment may decline more rapidly than previously assumed.

Underlying inflation has been lower than we expected this year, but we have nonetheless only slightly downgraded our forecast of the average level in 2011. Definite signs have now emerged that the sharp uptick in all commodity prices is translating into higher purchase prices of finished products for retailers. So far this has not driven consumer prices higher, but we think this will happen gradually. As we look for somewhat higher inflation going forward than Norges Bank has estimated, we expect interest rates to be hiked at a slightly faster pace this year than the central bank has indicated so far.

### Strong increase in consumer demand

Consumption growth rose sharply last autumn, but seems to have declined again in Q1 2011. This is probably a temporary lull caused by high electricity prices. But with fairly strong growth in real wages and employment, we think consumption growth will accelerate again. Home prices have increased significantly and we expect this trend to remain intact well into 2012. Low interest rates, a favourable economic outlook and high labour immigration point to strong growth in housing demand.

However, during the forecast period interest rates will rise enough to probably halt home price growth and we eventually expect a downward correction.

Residential construction has picked up slightly lately and with rising home prices we expect housing investment to accelerate further. We also expect corporate investment activity to revive after the past few years' decline. Low interest rates, easier access to credits and benign economic prospects bode well for higher investment activity. The increase will be curbed by a continued high level of idle capacity, though.

Oil companies' investment plans for 2011 show a significant increase in offshore investment in Norway. We expect the good times for the supplier industry to continue in 2012 as oil prices are likely to remain high. Prospects for Norwegian exporters are also good thanks to fairly strong growth in their key markets. But for some companies the strong NOK and high cost growth will hamper expansion opportunities.

### Strong demand growth but moderate wage growth

Following some years with strong public stimulus, government consumption increased less than private consumption last year. The government has signalled that moderate public consumption growth must be expected also in the next few years. However, strong growth in private demand will ensure good production growth in the mainland economy. This will lead to solid employment growth with a risk that the labour markets may tighten to a degree triggering renewed wage and cost growth. But strong growth in the working-age population, well aided by high immigration, will ease the pressure. We look for wage growth of 4 and 4 ¼% in 2011 and 2012.

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

	2007 (NOK bn)	2008	2009	2010	2011E	2012E
Private consumption	940	1.6	0.2	3.6	3.3	3.0
Government consumption	447	4.1	4.7	2.2	2.0	2.0
Fixed investment	504	2.0	-7.4	-8.9	9.4	5.3
- gross investment, mainland	376	-1.4	-11.7	-4.4	7.9	4.5
- gross investment, oil	113	5.5	9.9	-18.8	15.0	8.0
Stockbuilding*	33	-0.3	-2.6	3.3	-0.4	0.0
Exports	1,040	1.0	-4.0	-1.3	1.3	1.5
- crude oil and natural gas	480	-2.0	-1.2	-6.5	-2.0	-0.6
- other goods	302	4.2	-8.2	5.0	3.0	4.3
Imports	691	4.3	-11.4	8.7	5.2	3.7
GDP	2,272	0.8	-1.4	0.4	2.2	2.3
GDP, mainland	1,724	1.8	-1.3	2.2	3.3	3.1
Unemployment rate, %		2.6	3.2	3.6	3.0	2.8
Consumer prices, % y/y		3.8	2.1	2.5	1.8	2.2
Core inflation, % y/y		2.6	2.6	1.4	1.4	2.3
Annual wages (incl. pension costs), % y/y		6.3	4.2	3.6	4.0	4.7
Current account (NOKbn)		449.1	311.8	322.1	471.3	515.2
- % of GDP		19.7	13.1	12.9	16.8	17.2
Trade balance, % of GDP		19.1	14.8	13.7	16.8	17.2
General govt budget balance (NOKbn)		480.4	249.6	253.5	410.0	475.0
- % of GDP		19.1	10.5	10.1	14.6	15.8

\* Contribution to GDP growth (% points)

### Costs passed through to consumers

Although we expect moderate growth in wage costs, underlying inflation may rise quite sharply from the current low level. The strong growth in energy and commodity prices now filters through to growth in prices at the producer/importer level for key products such as clothing and food. We think the growth trend will continue on the back of accelerating cost growth in low-cost countries such as China.

So far growth in consumer prices has been surprisingly low considering retailers' higher purchase costs. In times of weak spending growth, price competition intensifies to retain customers, and margins come under pressure. However, we think it is only a question of time before consumer prices go up. Relatively brisk consumption growth going forward will make it easier for retailers to hike prices during the year.

### Higher inflation equals higher interest rates

Our growth outlook does not differ markedly from that of Norges Bank, but our forecast of underlying price growth this year is considerably higher. That is a key reason why we expect the central bank to hike its policy rate more rapidly than implied in its March interest rate forecast. The presumed continued uptick in home prices also suggests that Norges Bank will hike interest rates at a more aggressive pace this year.

Since mid-February the NOK has firmed in terms of the import-weighted I44 exchange rate index, while the NOK has been relatively stable versus the EUR. The import-weighted strengthening reflects the fact that the NOK has largely kept pace with the EUR during a period when the EUR has generally firmed sharply. We also expect the NOK to hold its own against the EUR going forward. As Norges Bank according to our forecasts will hike interest rates more sharply than the ECB, we will occasionally see a stronger NOK versus the EUR. In import-weighted terms and versus currencies such as the GBP and the USD, the NOK is expected to weaken as we consider the current EUR strength to be temporary.

### Risk of strong wage and price growth

Unemployment has dropped quite steeply lately. Even if our growth forecast turns out to be accurate, a combination of weaker productivity growth and lower labour immigration could lead to labour market tightening and a stronger-than-expected acceleration of wage growth. Bottlenecks in parts of the labour market could also result in generally stronger wage growth. In such a scenario Norges Bank will hike its policy rate also faster than we expect, and the NOK will occasionally be stronger than assumed in our forecasts. However, the NOK strengthening will limit the upturn in interest rates.

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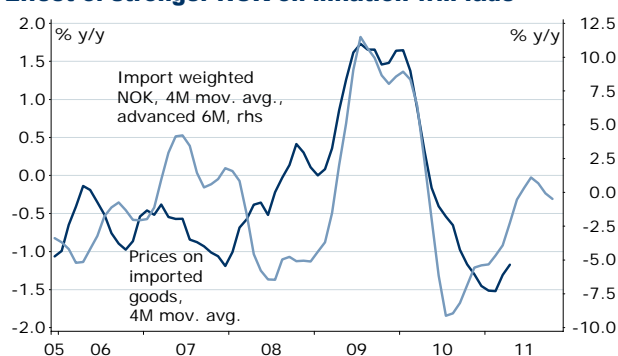
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### Spending on pause at the beginning of the year



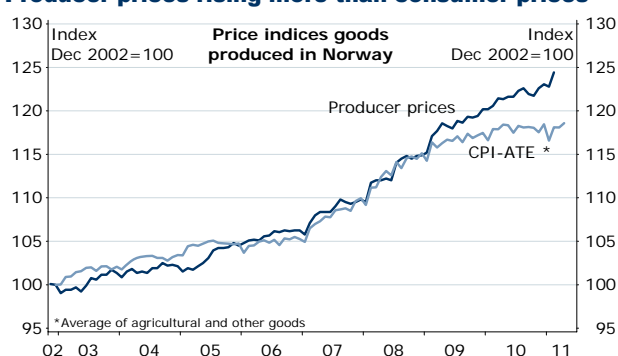
Source: Nordea Markets and Reuters Ecowin

### Effect of stronger NOK on inflation will fade



Source: Nordea Markets and Reuters Ecowin

### Producer prices rising more than consumer prices



Source: Nordea Markets and Reuters Ecowin

### NOK is strong given rate differential



Source: Nordea Markets and Reuters Ecowin

## Moving forward in tough terrain

- Prospect of falling unemployment
- Productivity challenge remains
- Inflation looms
- Housing market facing headwinds this year

Growth in the Danish economy declined surprisingly in Q4. It was the first setback registered since the low in mid-2009. But a single negative quarter is not unusual and the latest indicators suggest a renewed upturn that is expected to remain intact throughout the forecast period.

### Labour market about to reverse

Danish labour market indicators have surprised on the upside over the past few months. Unemployment has declined slightly, seasonally adjusted employment expectations in both the manufacturing industry and the service sector are back in positive territory and the number of job vacancies is trending higher. At the same time we have seen a prolonged period of rising demand. This strongly suggests that private-sector employment has finally reversed. But employment in the public sector will still be dominated by the ongoing budget consolidation. All in all, we expect employment to increase moderately over the coming quarters, unemployment to edge lower and this favourable development to gather momentum towards the end of the year and in 2012.

### Brief productivity boost

Since growth recovered during 2009 the downward productivity trend has been broken thanks to increased added value without a major intake of labour. However, our expectation of rising private-sector employment also implies that most of the “low-hanging fruit” of

productivity gains has now been harvested. Therefore we expect productivity to fall back towards an annual growth rate of around 1% towards 2012. Once again, this underscores the need to focus on generating the necessary productivity boost in coming years that is a key prerequisite for the sustainability of the government’s 2020 plan.

### Inflation surprises on the upside

Despite continued low capacity utilisation in the Danish economy inflation looks set to come out closer to 3% than 2% in 2011. This is largely due to surging oil prices at the beginning of the year and expectations of persistently high oil prices during the remainder of the year combined with a strengthening of the USD versus the DKK. In addition, the sharp postage rate hikes with effect from April and the introduction of a new tax on saturated fats in the autumn will contribute to the higher inflation.

### Consumption under pressure, but hope in sight

Consumer spending has again come under pressure. Following a sharp increase in disposable incomes in 2010 on the back of substantial tax cuts, falling interest rates and rising real wages, trends in 2011 have reversed. Notably rapidly growing inflation and very modest nominal wage increases have put households’ room for manoeuvre under pressure. Moreover, consumers are still very nervous about the outlook for the labour market and the housing market, and this coupled with significant political uncertainty puts a damper on their spending. However, given the prospect of rising employment and a clarification of the political situation during the autumn at the latest (when a general election must be held), we expect 2011 to be a year with reasonable consumer spending levels and 2012 to be even better.

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

	2007 (DKKbn)	2008	2009	2010	2011E	2012E
Private consumption	820	-0.6	-4.5	2.2	1.8	1.9
Government consumption	440	1.6	3.1	1.0	-0.3	0.5
Fixed investment	371	-3.2	-14.3	-4.0	1.9	2.3
- government investment	32	0.8	4.6	7.3	11.5	-7.6
- residential investment	107	-10.9	-16.9	-9.4	3.4	3.8
- business fixed investment	233	-0.6	-15.3	-1.4	-0.7	4.0
Stockbuilding*	25	-0.5	-1.4	0.6	0.3	0.0
Exports	885	2.8	-9.7	3.6	5.0	4.4
Imports	847	2.7	-12.5	2.9	4.4	4.5
GDP		-1.1	-5.2	2.1	2.0	1.8
Nominal GDP (DKKbn)	1,695	1,741	1,656	1,746	1,783	1,869
Unemployment rate, %		1.9	3.5	4.2	4.0	3.8
Unemployment level, '000 persons		51.1	96.2	114.1	108.9	103.9
Gross unemployment level, '000 persons		74.2	129.0	164.9	162.0	153.4
Consumer prices, % y/y		3.4	1.3	2.3	2.7	2.0
Hourly earnings, % y/y		4.5	2.9	2.5	2.0	2.5
Nominal house prices, one-family, % y/y		-4.5	-12.0	2.4	-1.0	1.0
Current account (DKKbn)		46.2	59.0	94.8	105.0	100.0
- % of GDP		2.7	3.6	5.4	5.9	5.4
General govt. budget balance (DKKbn)		56.1	-45.0	-47.4	-68.0	-56.0
- % of GDP		3.2	-2.7	-2.7	-3.8	-3.0

\* Contribution to GDP growth (% points)

**Danish companies more optimistic**

While consumers are still sitting on the fence, companies have become more optimistic in recent months. Notably sentiment in the manufacturing industry has shifted since the turn of the year, especially driven by growing demand in Danish export markets. But with the likelihood of more subdued growth momentum in Denmark's key export markets in Sweden and Germany in 2012, it is crucial for continued growth in the Danish economy that consumer spending regains momentum.

**Central bank ready to sanction new rate hikes**

In early April the Danish central bank sanctioned the first hikes of the lending rate and the discount rate since October 2008. The hike of 0.25% point came after a similar hike from the ECB. We expect the Danish central bank to mirror the ECB's interest rate moves until end-2011, lifting the lending rate up to 1.80%. On a 2-year horizon we look for a lending rate of 2.50%, partly as a result of the expected rate hikes in the Euro area and partly because we expect the Danish central bank to normalise the interest rate differential to the Euro area to 0.25% point.

**Housing market taking a breather this year**

Housing prices are still lower than at the peak in 2007 and many homeowners have therefore bought their home at a higher price that they will be able to sell it for today. This puts a damper on transaction activity, as many of the technically loss-making homeowners cannot or will not sell their home at a lower price than they paid for it. Still, home sales rose in 2010 compared to 2009 supported by low interest rates and fairly decent increases in disposable incomes. But based on the trend in the number of loan offers as well as net lending at the beginning of this year, it seems that home sales got off to a tentative start to 2011.

Despite an increase in long mortgage rates, housing affordability is still at roughly the same level as during the housing market boom in 2003-2005. And as the expected increase in long rates is offset by modest income gains, housing affordability this year and next year will most likely remain at largely the same level as during the boom years. A family's housing expenses the first time they are buying a house will therefore constitute the same share of its income as then. Moreover, rising employment will lend a helping hand to the housing market, but as employment growth will probably not accelerate until the end of this year and in 2012. We expect price declines this year to be followed by price increases next year.

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**Spring is on its way**



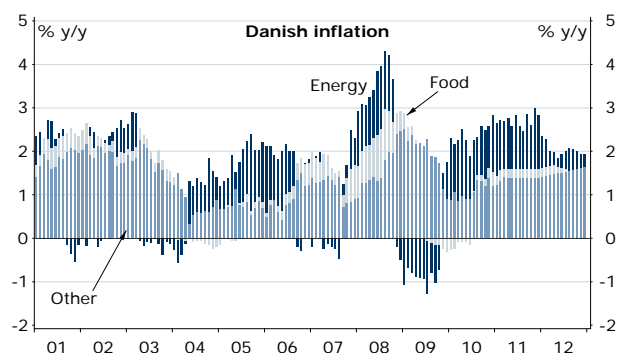
Source: Statistics Denmark, Nordea Markets and Reuters Ecowin

**Still major productivity challenges**



Source: Statistics Denmark, Nordea Markets and Reuters Ecowin

**Inflation on the rise**



Source: Statistics Denmark, Nordea Markets and Reuters Ecowin

**Dwellings worth less than when they were bought**



Kilde: Realkreditforeningen, Nordea Markets og Reuters Ecowin

## Brisk rise continues

- No slowdown in growth before 2012
- Inflation weakens household purchasing power
- Increase in exports, investment and consumption
- Public deficit will decrease markedly

In 2010 the Finnish economy recovered clearly faster than most of the euro countries. Both total production and total demand, measuring the general economic activity, increased 3.1% from last year. Growth accelerated towards the year-end, and in Q4 total production increased more than 5% from the previous year.

This year's outlook remains good in Finland and rather strong growth is expected to continue. A special benefit for us is the fact that the economies of our most important export countries, Germany and Sweden, are growing exceptionally briskly. Rising crude oil prices and the stronger rouble will boost Russia's export income, adding to the country's possibilities to increase its imports, also from Finland.

With regard to 2012, the outlook has, however, become more uncertain. The rising prices of oil and other commodities will increase corporate costs globally. In addition, consumer prices have risen faster than forecasted, improving the purchasing power of households less than expected. All this dampens the growth outlook of both the world and Europe as well as Finland.

Total production is estimated to increase 3.7% in 2011 and 3% in 2012. Both years, growth is driven by foreign trade and domestic demand (consumption and investment). The growth estimate for this year has been

raised with a good half a percentage point, mainly due to corrected historical statistics. Then again, the growth estimate for 2012 has been lowered to make it consistent with the weaker global growth outlook.

### Strong rise in exports continues

Goods exports will grow somewhat slower than last year during the forecast period. Service exports will take an upward turn after a couple of years' decline and contribute to faster growth of total exports than in 2010. Exports are estimated to increase across the board, as all main industrial sectors have received a lot of new orders. The pick-up of investment demand indicates that export growth relies more heavily than last year on the manufacture of machinery and equipment as well as on the electro-technical industry.

### Restart of machinery and equipment investment

There was only a slight improvement in investment last year. Construction investment picked up clearly, as residential construction returned briskly to its pre-recession peak levels. However, machinery and equipment investment only started rising in late 2010. During the forecast years, investment growth will accelerate markedly. Machinery and equipment investment will grow along with the rising industrial capacity utilisation rate. Growth in construction investment will wane somewhat. The level of residential construction will stabilise and the growth rate decelerate, but non-residential construction will increase.

### Much higher inflation than expected

In Q1 2011, consumer prices rose 3.2% compared to one year ago. This is much more than expected. Rising energy and commodity prices have lifted primarily housing, food and transport prices. The significance of

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

	2007 (EURbn)	2008	2009	2010	2011E	2012E
Private consumption	91	1.7	-2.1	2.6	2.6	2.3
Government consumption	39	2.4	1.0	0.4	1.0	1.0
Fixed investment	38	-0.4	-14.6	0.8	5.6	4.7
Stockbuilding*	3	-0.8	-1.3	0.2	0.0	0.0
Exports	82	6.3	-20.1	5.1	7.7	7.1
Imports	73	6.5	-17.6	2.6	6.6	7.0
GDP		0.9	-8.2	3.1	3.7	3.0
Nominal GDP (EURbn)	179.7	184.6	171.2	180.3	190.3	200.6
Unemployment rate, %		6.4	8.2	8.4	7.7	6.9
Industrial production, % y/y		-0.1	-19.9	5.4	6.0	5.0
Consumer prices, % y/y		4.1	0.0	1.2	3.5	2.5
Hourly wages, % y/y		5.6	4.0	2.6	2.7	3.0
Current account (EURbn)		6.4	5.1	5.5	5.5	6.3
- % of GDP		3.5	3.0	3.1	2.9	3.1
Trade balance (EURbn)		6.9	3.4	3.4	2.4	3.6
- % of GDP		3.7	2.0	1.9	1.3	1.8
General govt budget balance (EURbn)		7.8	-4.5	-4.4	-2.3	-0.7
- % of GDP		4.2	-2.6	-2.4	-1.2	-0.3
Gross public debt (EURbn)		63.0	75.0	87.2	94.7	100.8
- % of GDP		34.1	43.8	48.4	49.8	50.2

\* Contribution to GDP growth (% points)

these sectors is high, as their share of the consumer price index is about 50%. It is likely that consumer price growth will accelerate even more, as prices may not yet totally reflect the actual rise of commodity prices. The rising market rates start to gradually raise the costs of owner-occupied housing. In addition, the euro is expected to weaken, which will add somewhat to the upward pressure on import prices. Consequently, consumer prices are estimated to rise 3.5% in 2011 and 2.5% in 2012.

**Improving employment and smaller savings ratio supporting private consumption**

Private consumption surpassed the pre-recession peak in Q4 2010. During the forecast period, consumption growth will slow down, as the purchasing power of an average household will not improve much due to higher inflation. However, improved employment will enable higher consumption as it increases the disposable income of the household sector. The unemployment rate is expected to decrease to around 7% on average in 2012. We are also assuming that households will save a smaller portion of their income than in the past two years when the savings ratio was exceptionally high. The most rapid growth will be seen within demand for durable goods.

**Public sector deficit to decrease markedly**

The fairly brisk economic growth will not be quite enough to generate a public financial surplus. The deficit is estimated to decrease to a little more than 1% of GDP in 2011 and to a little less than 0.5% of GDP in 2012. These figures give, however, too rosy an image, as the public finances include the pension system with its ample surplus. The central government finances will continue to have a clear deficit, and the government borrowing, in particular, will raise the public debt to more than 50% of total production. One of the most important tasks of the new government will be to get the central government finances into shape, despite the fact that Finland already now clearly meets the requirements of the Stability and Growth Pact. At first, this may require public expenditure cuts and tax increases. What is even more important, though, is to reinforce the ground for growth in the longer term. Without strong growth, it will be very painful to finance the prospective growing public expenditure, which will become due with the ageing population. In practice, it is simply a question of how much we Finns will work during our lifetime and how productive we are.

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**Value of exports in double digit growth**



Source: Nordea Markets and Reuters Ecowin

**Economic recovery strengthens employment**



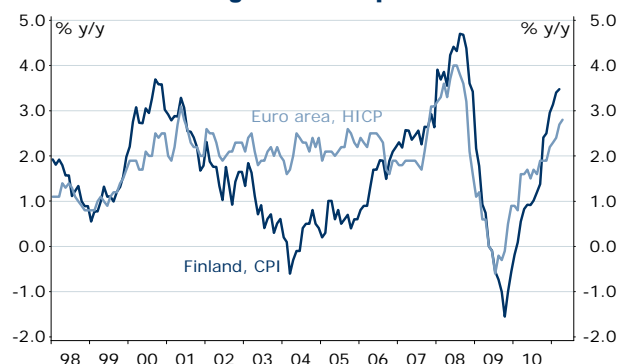
Source: Nordea Markets and Reuters Ecowin

**Consumer confidence leads GDP expansion**



Source: Nordea Markets and Reuters Ecowin

**Inflation is much higher than expected**



## Still grounds for optimism

- Soft patch in Q1, but upswing intact ...
- ... despite high commodity prices
- Fiscal policy creating uncertainty
- Higher interest rates in sight

The outlook for the US economy in 2011 is still quite bright, although the unexpectedly high commodity prices contributed to a sharp downturn in growth in Q1. After solid progress in GDP of 3.1% in Q4 2010, growth decelerated to 1.8% in Q1 this year. However, in our view this is a soft patch in the ongoing recovery: in addition to the high commodity prices, activity was also held back by the unusually harsh winter weather in the early months of the year. This alone points to a renewed upturn in activity as early as this quarter.

Moreover, in the coming quarters commodity prices are not expected to curb growth to the same extent as in Q1. One of the reasons is that the oil price spike is believed to be nearly over. But more fundamentally, the economy seems to be well bolstered against the high commodity prices owing to the temporary tax cuts this year, the now high household savings ratio and robust earnings growth particularly among large companies.

Small companies are closer to the danger zone due to the pressure on input prices. But so far they are still hiring at a rapid pace supported by further easing of banks' credit standards also towards this segment. It is the small companies that account for the strongest job growth at the moment, which indicates that they will be able to withstand the blow from the high commodity prices at least in the foreseeable future.

All in all, we therefore believe that the upswing is still on track. But as growth in the first months of the year was weaker than estimated and oil prices are now expected to remain at a higher level than assumed so far, we have made some adjustments to our growth forecast notably for this year. Following GDP growth of 2.9% last year, we now look for an increase of 2.7% in 2011 and 3 % in 2012. In our January issue of *Economic Outlook* the forecast was 3.3% for both 2011 and 2012.

The increase in employment is projected to accelerate slightly more during the forecast period in step with a faster increase in banks' corporate lending and a slow-down in the so far strong productivity growth. Unemployment is therefore likely to be reduced to 8½% by end-2011 and to just below 8% by end-2012.

### Heavier underlying inflation pressure

In early 2011 core inflation reversed and the now upward trend is expected to remain intact, particularly driven by higher rents and some spill-over effect from the higher commodity prices. The headline inflation rate, which is forecast to peak at around 3½% in mid-2011, should remain above 2% throughout most of the forecast period. Households' purchasing power should therefore increase about 2½% this year and the next.

### Fiscal policy also source of uncertainty

Fiscal policy has been given extra attention after Standard & Poor's in April downgraded the AAA rating of the US from stable to negative outlook. The reason cited was a lack of strategy to bring public budgets back on track. However, the political debate seems to have shifted in a more positive direction lately, as both parties now finally want to reduce public debt long term. But there is still political strife on which means to employ to achieve

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

	2007 (USDbn)	2008	2009	2010	2011E	2012E
Private consumption	9,806.3	-0.3	-1.2	1.7	3.1	3.0
Government consumption and investment	2,674.3	2.8	1.6	1.0	-0.4	0.4
Private fixed investment	2,266.1	-6.4	-18.3	3.9	5.1	6.1
- residential investment	628.6	-24.0	-22.9	-3.0	-2.8	4.3
- equipment and software	1,112.6	-2.4	-15.3	15.3	11.2	7.2
- non-residential structures	524.9	5.9	-20.4	-13.7	-4.8	3.2
Stockbuilding*	29.1	-0.5	-0.6	1.4	-0.1	0.1
Exports	1,661.7	6.0	-9.5	11.7	6.8	7.0
Imports	2,375.7	-2.6	-13.8	12.6	4.2	6.0
GDP		0.0	-2.6	2.9	2.7	3.0
Nominal GDP (USDbn)	14,061.8	14,369.1	14,119.1	14,660.4	15,337.8	16,117.1
Unemployment rate, %		5.8	9.3	9.6	8.7	8.3
Industrial production, % y/y		-3.7	-11.2	5.3	5.0	5.0
Consumer prices, % y/y		3.8	-0.3	1.6	3.0	2.0
Consumer prices ex. energy and food, % y/y		2.3	1.7	1.0	1.2	1.6
Hourly earnings, % y/y		3.8	3.0	2.4	2.0	2.5
Current account (USDbn)		-668.9	-378.4	-470.2	-536.8	-596.3
- % of GDP		-4.7	-2.7	-3.2	-3.5	-3.7
Federal budget balance (USDbn)		-680.5	-1,471.3	-1,275.1	-1,350.0	-1,100.0
- % of GDP		-4.7	-10.4	-8.7	-8.8	-6.8
Gross public debt, % of GDP		75.6	86.4	94.5	103.3	110.1

\* Contribution to GDP growth (% points)

this debt reduction. The Democrats still want large tax increases for the rich, while the Republicans only want spending cuts.

So we do not consider it very likely that political agreement on significant fiscal policy tightening in 2011 and 2012 will be reached, apart from the expiry next year of the current stimulus measures (tax cuts and extended unemployment benefit period). But there is reason to hope that policymakers will agree to tighten fiscal policy sharply beyond this time horizon during the ongoing negotiations. A long-term strategy will reduce the risk of a sovereign debt crisis in the US as well as the risk that a fiscal policy austerity package will dampen the upswing over the next couple of years.

**Monetary policy tightening at the end of the year**

Given our expectation that fiscal policy will not be tightened significantly until after the presidential election in 2012, monetary policy will most likely be the main tool for tightening economic policy over the next few year, reducing the risk of high inflation and new bubbles.

We still do not expect the first rate hike until December this year. The Fed will probably signal its coming rate hike move in the autumn, maybe August or September. Owing to the banks' huge excess reserves and the low starting point for interest rates, we expect the Fed to proceed quite aggressively when it finally starts to normalise the interest rate level. On a 2-year horizon we expect the fed funds rate to be hiked to 3.50%. The Fed's rate hikes should lead to a strengthening of the USD versus the EUR throughout most of the forecast period.

**Risks on both sides**

As always the growth forecast is subject to both upside and downside risks. On the *upside* the main risk is still that we underestimate the extent of pent-up demand in both households and companies. With the continued uplift from global demand it cannot be ruled out that the well-consolidated companies expand capacity and hire more new employees than currently estimated. An unexpectedly sharp rise in bank lending activity will likewise result in an even stronger upswing.

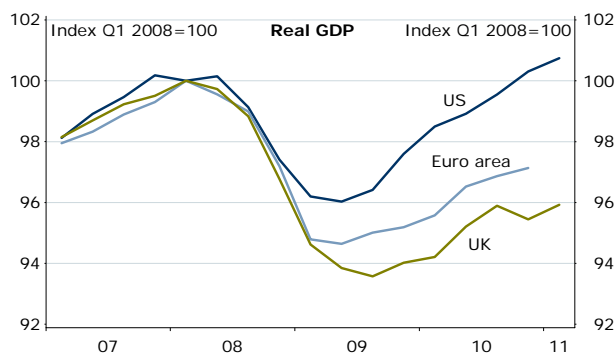
On the *downside* there is also still a risk that an additional sharp decline in housing prices will hit consumer spending hard. The economy should be able to absorb an expected further decline in housing prices of around 2-5% from the current level given the now high level of household savings. But an even steeper price drop cannot be ruled out. High commodity prices could also lead to significantly weaker growth than in our baseline scenario. And lastly fiscal policy also constitutes an important downside risk.

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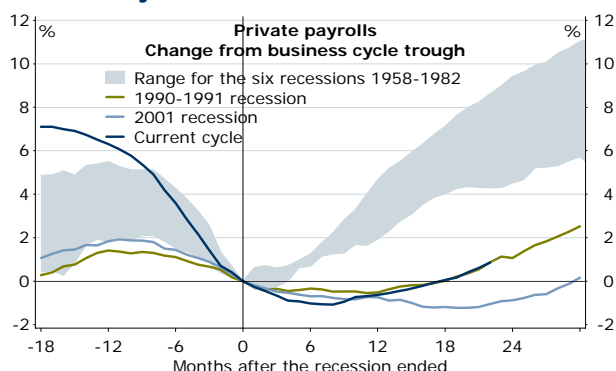
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**The US is back**



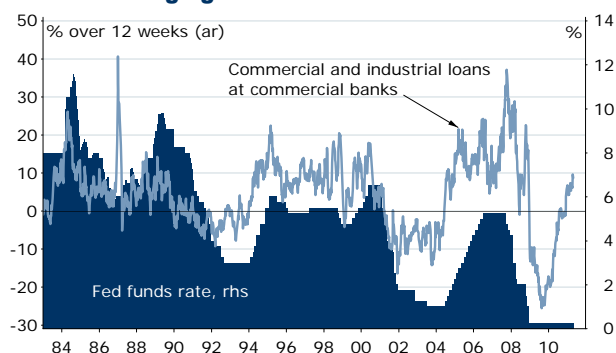
Source: Nordea Markets and Reuters Ecowin

**Economic dynamics normalised**



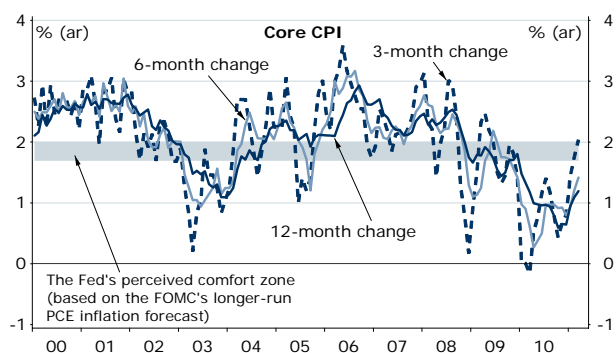
Source: Nordea Markets and Reuters Ecowin

**Credits flowing again**



Source: Nordea Markets and Reuters Ecowin

**Core inflation on the rise**



Source: Nordea Markets and Reuters Ecowin

## High commodity prices to keep the ECB on rate hiking path

- Resilient growth in spite of debt crisis
- Higher commodity prices likely to dampen growth
- High inflation leads to a more aggressive ECB stance
- We still expect the ECB to pause at 2.25%

### High commodity prices to dampen growth

The recovery in the Euro area has been surprisingly resilient in the face of the sovereign debt crisis, and this has led us to adjust our growth forecast for 2011 upwards once again. Activity indicators have continued to indicate strong growth in the first half of this year, and so far there is little evidence of any substantial negative impact from the Japanese earthquake or the higher oil prices. However, the surge in prices of oil and other commodities is the main reason why we have downgraded our growth forecast for 2012. In addition to the direct impact on consumer spending and business investment, the high level of commodity prices has also provoked a more aggressive stance on monetary policy at the ECB, which also could weigh slightly on growth in 2012. Indeed a renewed surge in oil prices represents one of our main risk scenarios on the downside, while stronger global growth represents our main upside risk scenario for the Euro area.

### Debt crisis mainly affects peripheral countries

At the EU summit at the end of March, EU leaders agreed to increase the lending capacity of the European Financial Stabilisation Fund (EFSF). This ensures that the EFSF can borrow up to EUR 440bn in financial markets without jeopardising its AAA rating, as it was originally intended. This has effectively ensured that even Spain would be able to get a bailout package if the need should arise. In addition, EU leaders agreed that the EFSF and the ESM will be allowed to buy sovereign debt from Euro-area member states in primary markets. This

gives the EU an option to extend the current lending package to Greece. Thus, according to the agreement with the EU and the IMF Greece has so far been supposed to return to financial markets in 2012 raising EUR 40 bn, something which looks increasingly unrealistic.

These steps are all useful, but they do not fundamentally alter the strategy chosen so far; it is still the hard slog of fiscal austerity and structural reform that offers the best prospect of curbing the debt crisis. This is unlikely to bring immediate results, and market jitters are highly likely to recur, as it happened at the beginning of April when Portugal was forced to seek help from the EU and the IMF.

With regards to fiscal policy, we expect the tightening of fiscal policy to subtract about 0.8% point from Euro-area growth in 2011 and 0.5% point in 2012. The fiscal tightening will be concentrated in some of the more vulnerable member states, while the fiscal tightening planned in Germany will be fairly mild. Thus, the growth performance of the individual member states is likely to be quite uneven, with a high risk of further declines in economic activity in the more vulnerable member states, while Germany will still experience fairly robust growth.

The sovereign debt crisis still provides considerable downside risk for the Euro area. A Greek debt restructuring would most likely cause most of the Greek banks to become insolvent, while specific banks in Germany and France could also face significant losses. The uncertainty created by such a scenario could lead to renewed tightening of credit conditions, which could choke the recovery. Secondly, the tightening of fiscal policy could still have a larger effect on growth than estimated.

### Inflation to weigh on consumption growth

The surge in energy and food prices has already pushed

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

	2007 (EURbn)	2008	2009	2010	2011E	2012E
Private consumption	5,184	0.4	-1.1	0.7	1.1	1.4
Government consumption	1,807	2.3	2.5	0.7	0.3	0.0
Fixed investment	1,971	-1.0	-11.3	-0.8	3.0	4.1
Stockbuilding*	39	-0.2	-0.8	0.4	0.0	0.0
Exports	3,741	0.7	-13.1	10.6	7.4	6.0
Imports	3,606	0.6	-11.8	8.7	6.2	6.0
Net exports*	135	0.1	-0.8	0.9	0.6	0.1
GDP		0.3	-4.0	1.7	1.9	1.8
Nominal GDP (EURbn)	9,030	9,243	8,954	9,179	9,504	9,825
Unemployment rate, %		7.6	9.6	10.1	9.9	9.5
Industrial production, % y/y		-2.4	-13.8	4.0	3.5	3.0
Consumer prices, % y/y (HICP)		3.3	0.3	1.6	2.8	1.8
- core inflation		2.4	1.3	0.9	1.4	1.4
Hourly labour cost, wages and salaries % y/y		3.2	1.6	1.5	1.6	2.0
Current account (EURbn)		-134	-52	-56	-70	-100
- % of GDP		-1.5	-0.6	-0.6	-0.7	-1.0
General govt budget balance, % of GDP		-2.0	-6.3	-6.3	-4.6	-3.6
Gross public debt, % of GDP		69.7	79.1	84.7	86.4	87.2

\* Contribution to GDP growth (% points)

Euro-area consumer prices significantly higher, and this will most likely dampen consumption growth over the coming quarters. With unemployment still at elevated levels in most Euro-area member states, it seems unlikely that households will be fully compensated for the rising energy prices, even though some member states still have inflation claw-back clauses embedded in wage agreements. Nevertheless, Euro-area households are still likely to benefit from a gradual improvement in Euro-area labour markets. Furthermore, growth in private consumption will most likely be supported by a further decline in the savings rate. Thus, we still expect consumption to accelerate in 2012, supporting a self-sustained recovery.

While domestic demand is likely to pick up speed, exports are expected to fade as a growth driver. Export demand is likely to continue growing, albeit at a more moderate pace as the catch-up in world trade is fading out. The recent relatively sharp appreciation of the EUR could also weigh on export growth, but this situation should be reversed in 2012 when we expect the EUR to weaken again.

**ECB has begun a normalisation of policy**

With headline inflation running well above its target of close to but just below 2%, the ECB decided to hike interest rates by 25 bp at its meeting in April. The ECB is clearly concerned that the current high level of inflation will become entrenched, and the ECB has repeatedly called for the abolition of inflation indexation in wage contracts. In addition to hiking interest rates it has also sought to anchor inflation expectations by verbally emphasising its commitment to its price stability mandate.

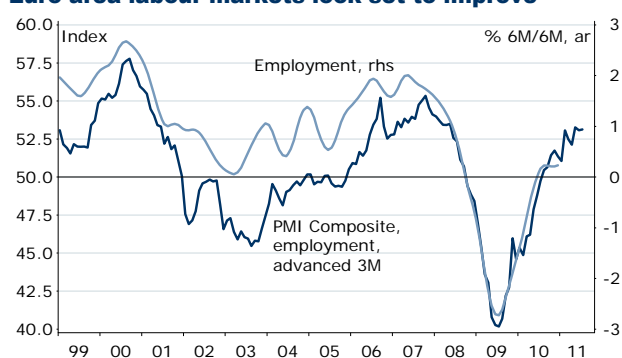
Looking forward we expect the high level of oil prices to keep inflation at elevated levels well into the second half of 2011. Given our expectation of a stabilisation in commodity prices, we expect inflation to fall below 2% early next year. However, with increasing signs that high commodity prices are spilling over to core inflation, we expect the ECB to maintain a hawkish stance for the rest of 2011. Thus, we now expect the ECB to hike rates by 25 bp again already in July, followed by another 25 bp hike in October. In addition, we expect the ECB to normalise liquidity policy towards the end of 2011, causing EONIA rates to move back above the ECB's refi-rate by the end of the year. We still expect the ECB to go on hold after bringing interest rates to 2.25% in Q1. Euro-area labour markets have only recently begun to improve, and credit to the private sector is still growing at a moderate pace. This suggests that inflationary pressures are still well contained over the medium term.

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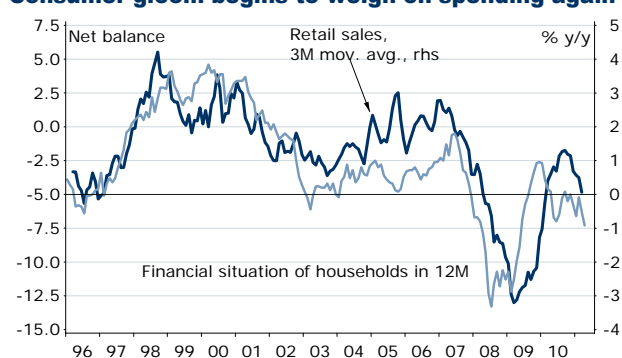
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**Euro-area labour markets look set to improve**



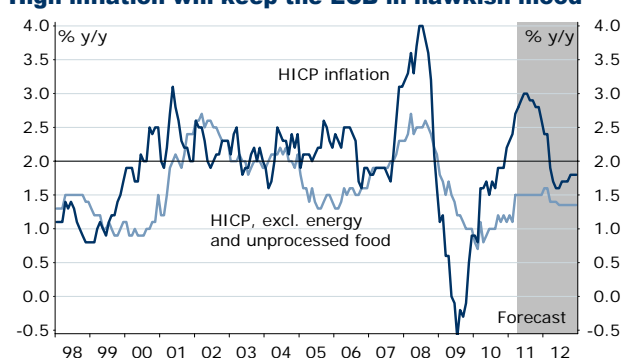
Source: Nordea Markets and Reuters Ecowin

**Consumer gloom begins to weigh on spending again**



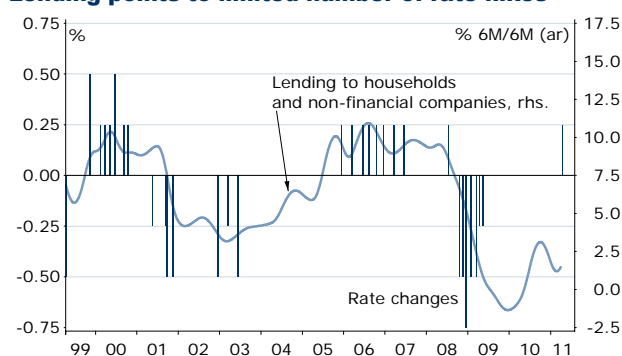
Source: Nordea Markets and Reuters Ecowin

**High inflation will keep the ECB in hawkish mood**



Source: Nordea Markets and Reuters Ecowin

**Lending points to limited number of rate hikes**



Source: Nordea Markets and Reuters Ecowin

## Rebalancing at the expense of growth near term

The UK economy is caught in a critical transition phase. Domestic demand is under severe pressure owing to negative real wage trends and continued high unemployment. At the same time the very ambitious austerity programme launched by the new government to reduce the public budget deficit is squeezing consumers' purchasing power. The programme aims to strengthen public budgets by GBP 126bn by 2015. The goal is to rebalance the UK economy towards greater focus on investment and net exports and less reliance on government and private consumption.

In recent years the weakening of the GBP has strengthened corporate competitiveness markedly: in trade-weighted terms the value of the GBP has dropped more than 15% below the 1998-2008 average. Combined with the significant improvement in key export markets, this has given UK exporters a strong tailwind over the past few years. However, going into 2012 there is a risk that export growth may decline in the wake of the expected setback in economic growth, notably in the Euro area. But we expect these waning growth rates to be offset by a renewed increase in consumer spending during 2012, which overall will ensure acceleration in economic growth during the forecast period.

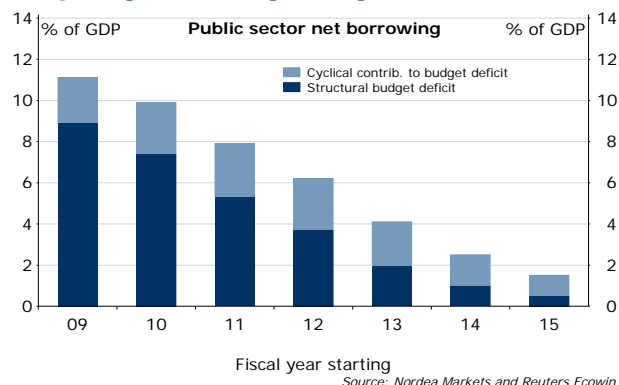
Despite major internal strife the Bank of England has maintained its extremely lenient monetary policy. Even against the backdrop of sharply rising consumer prices that are currently increasing at twice the official target of 2%. We expect inflation to remain very high over the coming months and quarters, chiefly driven by base effects from the higher commodity prices and the upturn in consumer prices resulting from the VAT. Into 2012 we expect inflation to fall back in step with the base effects losing momentum. That is why we do not expect the BoE to follow in the ECB's footsteps in the near term but to wait until early 2012 before embarking on the upcoming normalisation of monetary policy.

Jan Størup Nielsen

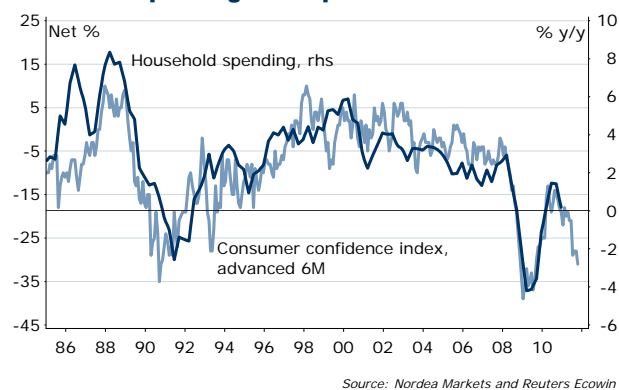
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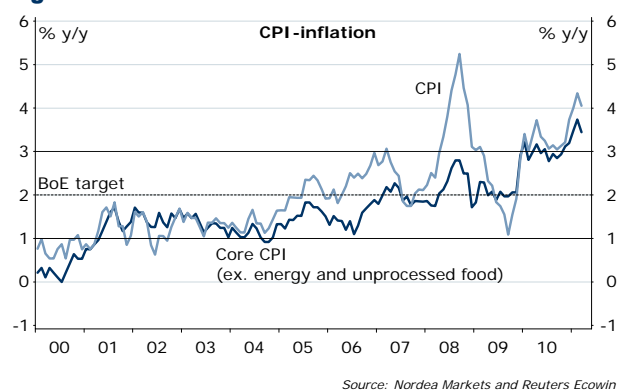
### Sharp budget deficit tightening



### Household spending under pressure



### High inflation but no imminent rate hikes



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

	2007 (GBPbn)	2008	2009	2010	2011E	2012E
Private consumption	896.0	0.4	-3.2	0.6	0.4	1.7
Government consumption	296.1	1.6	1.0	0.8	-0.6	-1.1
Fixed investment	249.5	-5.0	-15.4	3.0	3.1	4.5
Stockbuilding*	5.8	-0.4	-1.2	1.4	0.6	0.0
Exports	374.0	1.0	-10.1	5.3	7.0	6.3
Imports	417.0	-1.2	-11.9	8.5	5.4	3.7
GDP		-0.1	-4.9	1.3	1.5	2.2
Nominal GDP (GBPbn)	1,404.8	1445.6	1395.0	1453.6	1522.9	1599.1
Unemployment rate, %		5.7	7.6	7.8	8.2	8.0
Consumer prices, % y/y		3.6	2.2	3.2	4.1	2.0
Current account, % of GDP		-1.6	-1.7	-2.5	-2.0	-1.5
General govt budget balance, % of GDP		-5.0	-11.3	-10.5	-8.0	-6.0
Gross public debt, % of GDP		52.1	68.2	78.7	86.7	92.7

\* Contribution to GDP growth (% points)

## Catastrophe will have severe economic impact

The tragic earthquake and tsunami and nuclear catastrophe are chiefly a human tragedy, but though too early to gauge fully, the economic consequences are also set to be very severe, with GDP growth likely slowing to a little below 0% this year. The government has estimated that the direct damage amounts to JPY 25trn or 5% of GDP. Industrial production fell a nasty 15% from March to April and is likely to continue falling due to the destroyed production capacity. Also the lack of electricity and the rolling black-outs lower industrial production and postpone the reconstruction process, and supply chain problems also act as a drag. On top of the supply side problems comes the demand side. Households are depressed and refrain from discretionary spending. The consequence is the already observable steep drop in retail sales that will translate into very weak private consumption figures. Overall economic growth will get a strong boost once the rebuilding process gathers momentum later this year, especially via public spending and investment. This will push GDP growth back up to close to 3% in 2012. Note that some production capacity especially in the export sector will probably never be rebuilt due to permanently lost market shares abroad and offshoring to neighbouring low-cost countries.

The rebuilding costs will weigh on the already huge public debt (currently above 200% of GDP gross), which surely increases the risk of funding problems. Note, however, that a funding crisis is not imminent because the private sector in Japan has a huge saving surplus and most government bonds are held domestically.

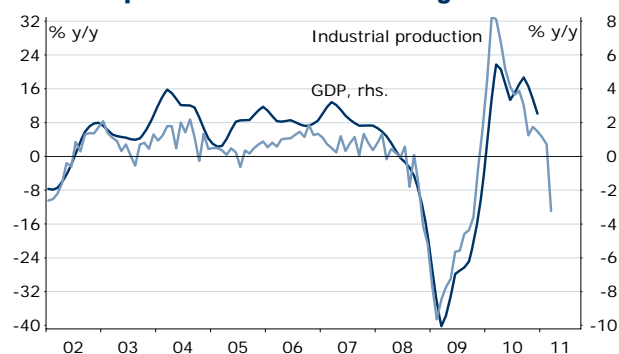
The Bank of Japan expanded its quantitative easing programme as the crisis unfolded and is likely to remain accommodative throughout the forecast period. Any marked JPY strengthening is likely to be met by further intervention. Once the other mature economies' central banks hike their interest rates in earnest, Japan will again become a low-interest rate country, implying a weaker JPY. This should support the hard-pressed export sector.

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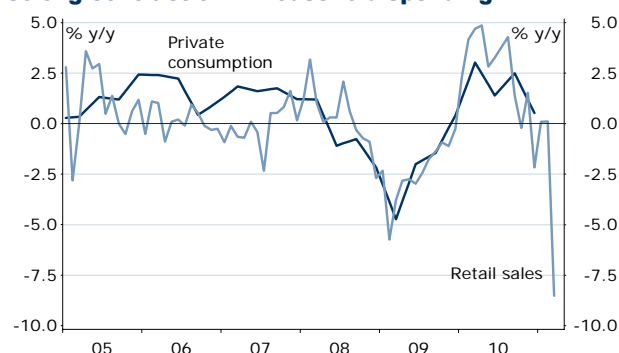
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### Industrial production to suffer for long



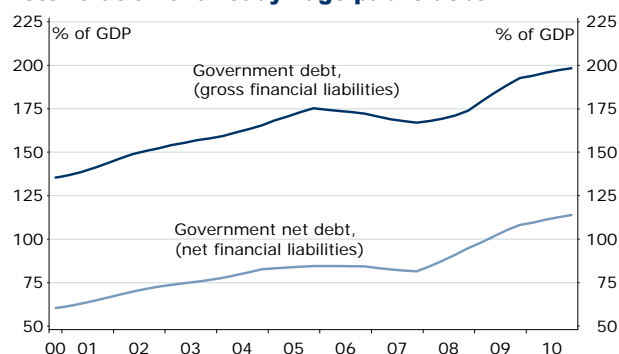
Source: Nordea Markets and Reuters Ecowin

### Strong contraction in household spending



Source: Nordea Markets and Reuters Ecowin

### Deterioration of already huge public debt



Source: Nordea Markets and Reuters Ecowin

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

	2007 (JPYbn)	2008	2009	2010	2011E	2012E
Private consumption	292,523	-0.7	-1.9	1.8	-0.9	1.7
Government consumption	92,218	0.5	3.0	2.3	3.5	1.0
Gross fixed capital formation	118,237	-3.6	-11.7	-0.2	3.5	5.0
Stockbuilding*	3,910	-0.3	-1.4	0.6	0.2	0.1
Exports	90,830	1.6	-23.9	24.0	-3.5	7.5
Imports	82,198	0.4	-15.3	9.8	5.0	4.0
GDP		-1.2	-6.3	3.9	-0.1	2.9
Nominal GDP (JPYbn)	515,520	504,378	470,937	479,179	478,021	493,812
Unemployment rate, %		4.0	5.1	5.1	4.8	4.5
Consumer prices, % y/y		1.4	-1.3	-0.7	-0.1	0.4
Current account, % of GDP		3.2	2.8	3.6	2.6	2.9
General government budget balance, % of GDP		-2.1	-7.1	-7.7	-10.0	-8.0

\* Contribution to GDP growth (% points)

## Slowing just a bit

- Weaker momentum
- Tighter economic policies
- Consumers are getting more pessimistic
- Elections also important to keep EMU as an anchor

The economy continued at a fairly strong pace around 4.5% y/y in the first quarter of 2011, but as expected the underlying momentum slowed somewhat at the end of 2010 and going into 2011. Indeed, the annualised quarterly growth rates have probably been just above 3% in each of the two most recent quarters. This means that we keep our slightly below consensus call for growth for the whole of 2011 of just below 4% followed by slightly higher growth in 2012.

At just below 4% growth, Poland will still be one of the best performing economies in Central and Eastern Europe, which is even more impressive when considering that the country has suffered relatively less than other countries in the region during the crisis and hence that the comparison base is less favourable. In our forecasts only Turkey and Russia in Central and Eastern Europe will see significantly higher growth than Poland this year.

### Weaker momentum in exports

The main reason for the slowing momentum seems to be exports. Exports have showed a broad-based slowdown, but with a certain variety across Europe. Indeed, exports to some of Poland's key foreign markets such as France and Italy have weakened in particular, whereas exports to Germany, the largest destination by far for Polish exports, are holding up rather well as are exports to Russia. We expect slowing foreign demand growth during the year, which should lead to a further weakening of the momentum in exports, followed by some improvement in 2012.

### Tighter economic policies

Another reason for the weaker growth momentum is in our view the tightening of economic policies. The 1% point VAT hike and other fiscal tightening measures

have had some dampening effect on household spending and we expect additional fiscal tightening after the autumn's elections. The full effect of the tightening of monetary policy so far, with reserve requirement hikes as of 1 January and interest rate hikes in January and April, will not be seen until late in the year and during next year. The weakening of the PLN would normally be thought of as an easing of monetary conditions, but this effect is likely to be partly offset due to the significant share of FX loans among households.

The Monetary Policy Committee (MPC) of the National Bank of Poland (NBP) seems to have made an effort to communicate clearer with the markets, but significant disagreements within the MPC may be the reason why it is still not entirely clear what the big plan is. We choose to listen to NBP President Belka, who seems reluctant to hike too fast. The latest indication of Mr Belka's dovish stance was the agreement with the Ministry of Finance that the Ministry may exchange parts of its EUR flows from the EU, which could amount to EUR 13-14bn this year, in the markets. The justification is that excess liquidity in the money market reduces the effect of the NBP's interest rate hikes and hence conversion of EU funds can be used to reduce PLN liquidity to make monetary policy more effective. Moreover, a stronger PLN as a consequence of the intervention may alleviate some of the pressure to hike interest rates. However, it does not fit well with the communication from Mr Belka since he took office almost a year ago, where he has tried to communicate that the NBP has no target for the PLN and will not intervene in the FX market unless the distortions constitute a risk to the inflation target.

We expect a total of five interest rate hikes this year and a gradual appreciation of the PLN due primarily to the interest rate hikes, the Ministry of Finance's intervention in the FX markets and the still sound economic fundamentals.

### Consumers are getting more pessimistic

The key uncertainty regarding the growth outlook is consumer spending. Consumer spending growth surprised positively during most of last year and only showed

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

	2007 (PLNbn)	2008	2009E	2010	2011E	2012E
Private consumption	702	5.7	2.1	3.2	2.6	3.2
Government consumption	211	7.4	2.0	3.5	3.2	0.1
Gross fixed capital formation	254	9.6	-0.8	-2.0	8.5	9.8
Exports	480	7.0	-8.5	10.2	5.6	7.0
Imports	513	8.1	-12.5	10.7	9.7	6.1
GDP		5.1	1.7	3.8	3.7	4.0
Nominal GDP (PLNbn)	1,177	1,275	1,344	1,416	1,521	1,611
Unemployment rate, %		9.8	11.0	12.1	11.8	10.1
Consumer prices, % y/y		4.4	3.8	2.7	3.8	1.9
Current account, % of GDP		-4.8	-2.1	-3.4	-4.7	-4.2
General government budget balance, % of GDP		-3.7	-7.3	-7.9	-6.0	-4.5

\* Contribution to GDP growth (% points)

slowing momentum in the final quarter. Tighter economic policies will have a negative effect in the forecast period, but the labour market continues to improve and will provide solid support to real disposable incomes. Employment growth hovers around 1% y/y, but indicators for the larger companies suggest a faster pace at the beginning of 2011. Wage growth remains moderate and with the recent increase in inflation real wage growth is close to zero. Still, we expect real wage growth to increase gradually during the coming two years, as wage growth picks up speed and inflation slows. The consumers are getting more pessimistic, though. Indeed, according to the consumer confidence survey, more households now see their financial situation deteriorating over the coming 12 months. As a consequence, the savings rate jumped towards the end of 2010 according to our calculations.

**Investment growth to increase**

Investment has not recovered in earnest from the crisis and has potential to provide some upside surprise. Next year's European Soccer Championship, which Poland co-hosts with Ukraine, is likely to require additional investment during the next year or so, though everything should be running according to the plan. Moreover, business investment is likely to accelerate with the increase in the capacity utilisation rate.

**Elections also important to keep EMU as an anchor**

General elections are scheduled for October at the latest. Currently, the leading party of the incumbent government, the Civic Platform (PO), looks set to secure another victory and is most likely to lead the next government also. However, as the polls look at present the PO will not be able to form a majority government on its own. Moreover, it will be important for the EMU road map that two-thirds of the parties in the next government back a change of the constitution to allow EMU membership. Public support for EMU membership is at an all-time low, which is most likely because of the current state of the EMU. However, the EMU is a very important anchor for economic policies and real convergence, as we see it.

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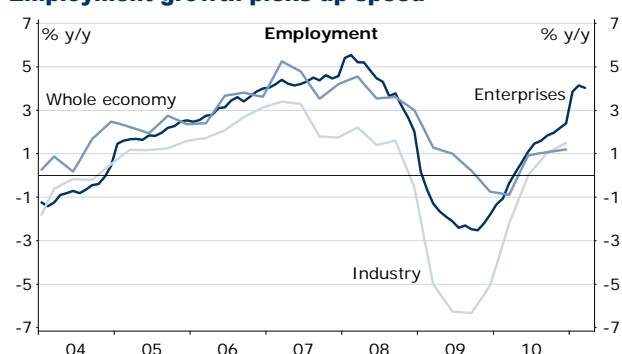
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**Exports losing momentum**



Source: Nordea Markets and Reuters Ecowin

**Employment growth picks up speed**



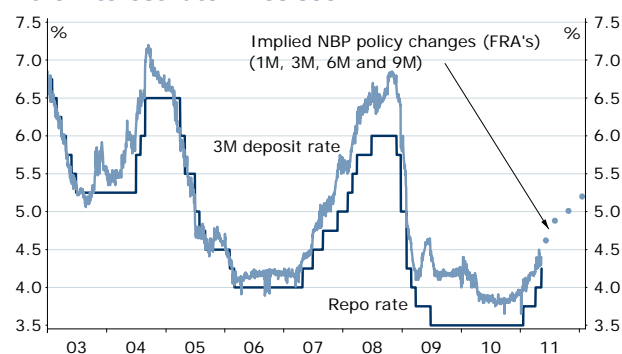
Source: Nordea Markets and Reuters Ecowin

**Consumers are getting more pessimistic**



Source: Nordea Markets and Reuters Ecowin

**More interest rate hikes seen**



Source: Nordea Markets and Reuters Ecowin

## Two steps forward, one step back

- Moderate recovery in Q1 led by consumers
- Investments to rebound in the coming quarters
- Monetary policy focus on inflation increases

The economy has slowly regained momentum after the shock last summer. As expected, consumers remained in the driver's seat in the recovery process in Q1. Russia's statistics agency (Rosstat) revised upward retail sales figures recently, and this makes room for upward revision of consumption in Q4 and Q1 2011. The only concerning thing is inflation, which has eroded real wage growth. Yet a rather fast drop in unemployment to below 7% on the back of strong employment growth makes room for more bargaining power for consumers in the coming quarters. Moreover, given the momentum in retail sales, we believe consumers might be getting additional support from non-official/"shadow" compensation, which could have risen after the increase in business social contribution taxes from 26% to 34% this year.

Other indicators also suggest recovering consumption: deposit growth has finally slowed down and the savings rate has fallen from nearly 16% in early 2010 to just above 10% now, implying that consumers opt for more spending rather than saving. This is not surprising, given the improvement in labour market, as well as lack of incentive to save with inflation of above 9.5% and average time deposit rates of just above 6%.

### Capex disappointment temporary

Another component of domestic demand – fixed capital investment – did not develop as well as expected, according to monthly capex statistics. After the 10.6% y/y growth in Q4 2010, fixed capital investment contracted 1.8% y/y in Q1. Yet coincident and leading indicators for investment – interest rates, business confidence, imports of machinery etc – all point toward higher investment growth in future. Industrial production is back at a pre-crisis growth pace of 5-6% y/y, and the forward-looking PMI indicators suggest strong momentum at least for H1 2011 – for example, the PMI manufacturing new orders index is at 3-year highs. Moreover, construction, which constitutes the bulk of fixed capital investment, has re-

bounded at the end of Q1, and strong growth in housing starts points toward more activity in the pipeline.

Conditions are favourable for financing new investments, since domestic average lending rates in RUB for companies have fallen to below 9%, the lowest level on record, and bank lending to companies has accelerated further. Even though the Central Bank of Russia (CBR) has started raising interest rates, anecdotal evidence suggests that commercial banks are not in a rush to raise their lending rates as bank excess liquidity is still ample and the "competitive margin" may be reduced further.

### Budget flourishes on oil

One of the major changes over the past quarter has been the revisions to the oil forecast, which are expected to help boost government revenue by nearly 20% more than budgeted for this year. In principle, with our oil price forecast of above USD 110/bbl for 2011, the government budget should be in balance, in contrast to the 3.6% deficit budgeted in late 2010. Yet significant risks are related to pre-election spending, and additional spending will likely leave the fiscal balance negative in 2011, albeit with a big chance of zero balance in 2012. So far the government intends to "save" excess oil reserves by re-summing refilling the Oil Reserve Fund: the current plan is to double the fund from the current RUB 760bn. But political will and legislative changes are needed first.

There are both pros and cons to higher oil prices. Needless to say, consumption will be bolstered by the direct and indirect effect of higher oil prices – private companies will have the capacity to raise wages and the government will most likely carry out a second round of wage indexation in the early autumn. However, strong current account inflows, coupled with private capital inflows, will put pressure on the CBR and its monetary policy. If not properly sterilised, as has been the case in pre-crisis times, strong inflows will likely translate into excess domestic liquidity - and double-digit inflation.

### Inflation: from food to core

Food price inflation, having peaked in January, has decelerated in Q1, helped by global food price develop-

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

	2007 (RUBbn)	2008	2009	2010	2011E	2012E
Private consumption	16,193	11.2	-7.6	4.3	5.8	6.5
Government consumption	5,745	2.5	2.0	1.2	1.8	2.0
Fixed investment	6,984	10.0	-16.5	4.4	7.8	7.0
Exports	10,029	0.5	-4.6	8.8	5.6	5.8
Imports	7,138	15.0	-30.2	20.0	15.5	8.0
GDP		5.6	-7.9	4.1	5.4	5.7
Nominal GDP (RUBbn)	33,258	41,445	39,064	45,300	51,805	58,864
Unemployment rate, %		5.6	7.5	7.5	6.5	5.8
Consumer prices, % y/y		14.1	11.7	6.9	8.5	7.5
Current account, % of GDP		6.2	3.9	4.7	4.3	3.5
Central govt budget balance, % of GDP		4.1	-5.3	-4.2	-1.5	-1.0

\* Contribution to GDP growth (% points)

ments and domestic measures – from sales of grain from reserve funds to monetary policy tightening. Headline inflation remained nearly unchanged at around 9.5% in Q1. The government expects to reduce inflation to 4-5% by 2014. The CBR’s goal for 2011 is to keep inflation within 6-7%. Yet this is a difficult task – even though food price inflation decelerates, non-food prices have ticked up. The labour market has tightened recently, causing core inflation to accelerate to nearly 8% y/y, with more upside expected.

The CBR has acknowledged the risks and tightened its monetary policy further in Q1. The priorities seem to have shifted from keeping the RUB from strengthening to maintaining inflation targets, as heard from recent comments from government officials. This is just the beginning of the gradual policy tightening cycle, using all tools – higher reserve requirements, interest rates and a stronger RUB – to return inflation to the target range. As for interest rates, the CBR will attempt to lift the deposit rates higher in order to narrow the operating interest rate corridor and thus reduce volatility in the domestic inter-bank market.

**RUB appreciation intact**

The RUB basket strengthened visibly in Q1, as the RUB became a favoured currency in the Emerging Markets universe. The CBR has facilitated RUB movements recently, further widening the RUB floating band from 4 RUB to 5 RUB in March 2011, leaving the range at 32.45-37.45. According to the CBR’s foreign exchange intervention mechanism, the CBR moves the floating band by five kopeck in the direction of the RUB move each time they have bought/sold a cumulative USD 600m in the foreign exchange market. The latter amount was reduced from USD 700m in September as yet another sign that the CBR is allowing more RUB flexibility.

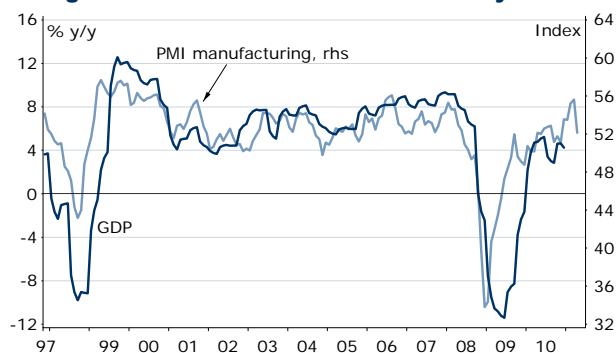
Given our new oil price forecast of above USD 110/bbl for this year, we believe the basket will strengthen to 32 by the end of the year, with risks skewed toward an even stronger RUB. The key risk is any uncertainty or turmoil over the outcome of the upcoming elections. For example, if President Medvedev and Prime Minister Putin fall out and one of them leave the “tandem”, domestic firms may see this as sign of political tension raising the risk of capital outflows.

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**Strong momentum for GDP from PMI surveys**



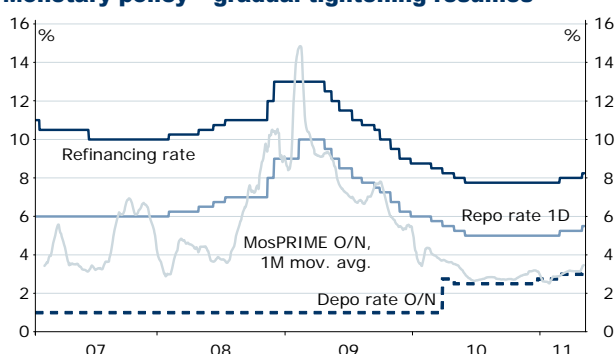
Source: Nordea Markets and Reuters Ecowin

**Wages to catch up on rising employment**



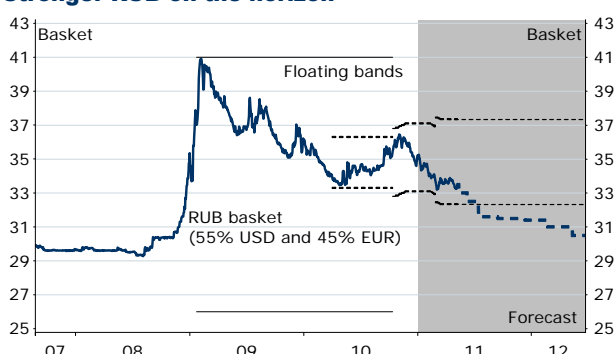
Source: Nordea Markets and Reuters Ecowin

**Monetary policy – gradual tightening resumes**



Source: Nordea Markets and Reuters Ecowin

**Stronger RUB on the horizon**



Source: Nordea Markets and Reuters Ecowin

## Recovery spreading to the domestic economy

The recovery has proceeded faster than initially anticipated, and the encouraging signs from the domestic economy which materialised during the second half of last year have largely continued this year. Together with still good momentum in exports, this is expected to support the economy to a brisk recovery this year.

The cautious strengthening in retail sales is supported by a faster-than-anticipated decline in unemployment and a modest rise in wages. However, the acceleration in inflation weighs on consumers' purchasing power, with inflation still largely above wage gains. In addition, the unemployment rate is still in double digits and likely to stay elevated in the near future. Reducing structural and long-term unemployment remains one of the main challenges of the authorities in the medium term. The recovery is thus still dependent on foreign demand, and a slowdown in demand in Europe and especially the Nordic countries would have adverse effects on the recovery.

Inflation has continued to accelerate, with food and energy prices the main culprits. However, as the acceleration in food prices seems to have stabilised also the inflation rate has levelled out, albeit remaining at a high level. The support from higher global commodity prices is seen as temporary, and with domestic demand still fragile and pressure from for instance wages still modest, we expect some moderation in inflation towards the end of the year. The government budget posted a tiny surplus in 2010. Especially the sale of emission allowance units boosted revenues, but the investments to be made with the revenues will weigh on the deficit going forward. Overall government finances nevertheless remain strong. As the recovery has continued government finances have turned out better than expected and the financial markets have calmed down, reflecting increasing confidence in the economy. This supports expectations of upgrades to Estonia's single A credit rating.

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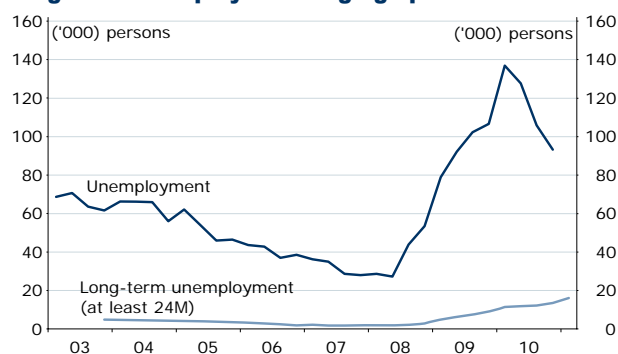
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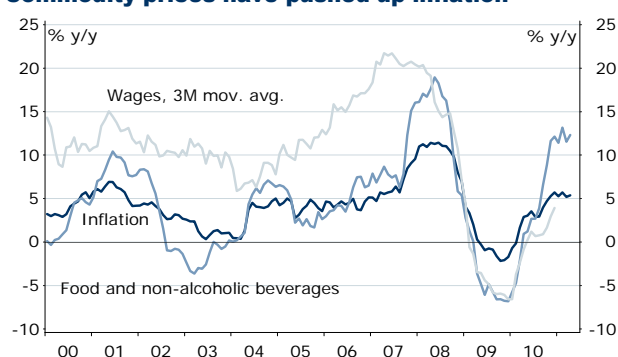
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### Long-term unemployment edging up



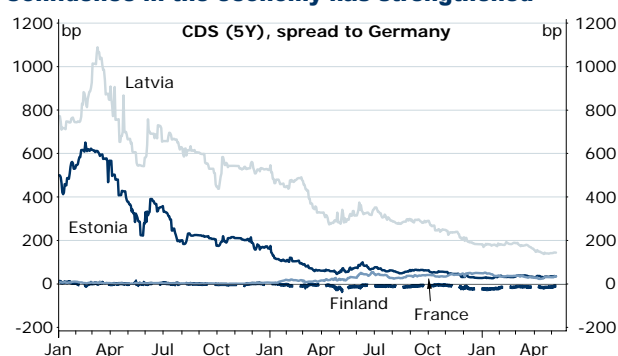
Source: Nordea Markets and Reuters Ecowin

### Commodity prices have pushed up inflation



Source: Nordea Markets and Reuters Ecowin

### Confidence in the economy has strengthened



Source: Nordea Markets and Reuters Ecowin

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

	2007 (EURbn)	2008	2009	2010	2011E	2012E
Private consumption	8.7	-5.4	-18.4	-1.9	4.5	4.5
Government consumption	2.6	3.8	0.0	-2.1	1.3	1.7
Fixed investment	5.5	-15.0	-32.9	-9.1	14.2	7.0
Exports	10.7	0.4	-18.7	21.2	17.8	5.2
Imports	12.4	-7.0	-32.6	20.9	16.6	6.3
GDP		-5.1	-13.9	3.0	5.7	3.8
Nominal GDP (EURbn)	15.8	16.1	13.9	14.5	16.1	17.2
Unemployment rate, %		5.5	13.8	16.9	12.4	10.7
Consumer prices, % y/y		10.6	-0.1	3.0	5.0	2.9
Current account, % of GDP		-8.8	4.5	3.8	0.9	-0.1
General govt budget balance, % of GDP		-2.8	-1.7	0.1	-0.7	-2.7

\* Contribution to GDP growth (% points)

## Recovery gradually gaining momentum

The focus is increasingly shifting to growth, as the financial markets have remained calm and the budget gap is being closed even faster than required by the IMF/EU. After an already promising 2010 we see the recovery gaining strength this year, as the export-led upturn is being supported by firming domestic demand. The faster-than-anticipated decline in unemployment has contributed to the dawning recovery of household demand. Overall, consumer confidence is improving and especially unemployment expectations are optimistic. However, gains in employment could remain modest due to high structural unemployment and the continued emigration of the active population.

Inflation has sped up due to global price trends and indirect tax hikes. With the effects from higher food and energy prices expected to be temporary and domestic demand-driven price pressure still modest, we see inflation moderating gradually. Nevertheless, accelerating inflation erodes the purchasing power of those consumers who do not see matching income growth. A risk is also connected to fulfilling the Maastricht criterion for inflation in 2012, putting euro adoption in 2014 at risk. Concerning the budget deficit Latvia is aiming at 2.5% of GDP in 2012. With financial markets calm and the economy recovering, confidence in the economy is improving, and thus further credit ratings upgrades are expected from the current low levels. Latvia will start refinancing its public debt on the financial markets next year and higher ratings would contribute to lower funding costs.

The key upcoming political event is the presidential election in late May/early June. With the governing coalition not unified in its support for the current president, the opposition is likely to play an important role. Election of an alternative candidate might result in considerable political uncertainty. However, we see a low probability of this derailing the economic recovery.

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### Especially unemployment expectations optimistic



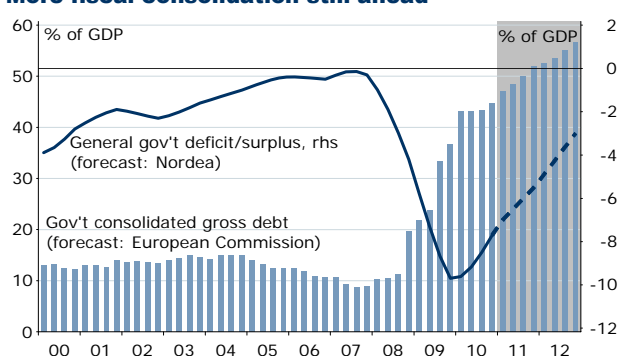
Source: Nordea Markets and Reuters Ecowin

### Inflation accelerating mainly on food prices



Source: Nordea Markets and Reuters Ecowin

### More fiscal consolidation still ahead



Source: Nordea Markets and Reuters Ecowin

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

	2007 (LVLmn)	2008	2009	2010	2011E	2012E
Private consumption	9,196	-5.2	-24.1	-0.1	3.0	4.2
Government consumption	2,575	1.5	-8.7	-11.0	-1.0	-0.5
Fixed investment	4,975	-13.6	-37.1	-20.4	14.2	8.0
Exports	6,259	2.0	-13.9	10.1	8.8	5.1
Imports	9,220	-11.2	-33.3	8.4	9.8	5.4
GDP		-4.2	-18.0	-0.1	3.6	4.2
Nominal GDP (LVLmn)	14,780	16,188	13,083	12,736	13,750	14,740
Unemployment rate, %		7.5	17.1	19.4	16.0	14.8
Consumer prices, % y/y		15.3	3.6	-1.0	4.5	3.0
Current account, % of GDP		-13.1	8.6	4.0	-0.2	-1.0
General gov't budget balance, % of GDP		-4.2	-10.2	-7.7	-4.8	-2.6

\* Contribution to GDP growth (% points)

## Entering a new growth cycle

The outlook for the economy has continued to brighten. Q1 GDP growth reached close to 7% y/y as all sectors expanded in the first quarter, leading also to brisk growth from the previous quarter. In addition to base effects, the solid expansion in Q1 also highlights the spreading of the recovery from the export sector, which has continued to perform well, to the domestic economy. Nevertheless, after the initial bounce economic growth is seen moderating, as domestic demand and investments remain fragile.

The economy, and especially the industrial sector, has continued to benefit from strong demand from its trading partners. With exports already above pre-crisis levels the domestic economy has slowly started to gain a foothold. Recently retail sales expanded rapidly, but were mainly supported by growing sales of motor vehicles.

Household demand is thus still facing headwinds from high structural unemployment especially in the construction sector, weak wage trends, modest consumer confidence and accelerating inflation. As the economy is shifting from manufacturing to a growing service sector, reducing structural unemployment is one of the main challenges. Another challenge is posed by the elevated inflation rate. In order to enable euro adoption in 2014 it needs to be kept within the Maastricht criterion in 2012. However, the main price pressure comes from the most likely temporary food and energy price rises, which indicates that inflation will moderate slightly going forward. The budget deficit is expected to fall to 2.8% of GDP in 2012, a significant improvement from 7.1% in 2010. Cutting the deficit to below 3% of GDP in 2012, and thus adopting the euro in 2014, still requires significant fiscal consolidation, but at least the year began with signs of a strong economic recovery, helping Lithuania to reach the target. The stabilising economy and encouraging prospects for government finances are helping to increase confidence in the economy.

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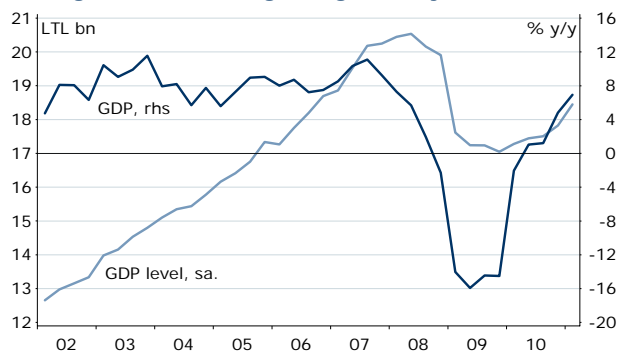
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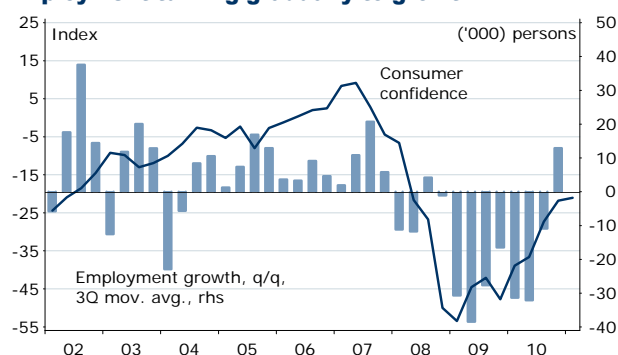
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### Brisk growth in the beginning of the year



Source: Nordea Markets and Reuters Ecowin

### Employment turning gradually to growth



Source: Nordea Markets and Reuters Ecowin

### Inflation accelerating but wage gains still modest



Source: Nordea Markets and Reuters Ecowin

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

	2007 (LTLmn)	2008	2009	2010	2011E	2012E
Private consumption	63,736	3.7	-17.7	-4.5	4.8	5.0
Government consumption	17,638	7.3	-1.9	-3.4	0.0	1.0
Fixed investment	27,919	-5.2	-40.0	0.0	13.8	8.0
Exports	53,371	11.6	-12.7	17.4	12.5	5.0
Imports	66,537	10.3	-28.4	17.9	14.3	6.0
GDP		2.9	-14.7	1.3	4.6	4.0
Nominal GDP (LTLmn)	98,669	111,482	91,525	94,641	102,500	110,085
Unemployment rate, %		5.8	13.7	17.8	15.7	14.2
Consumer prices, % y/y		11.1	4.2	1.3	4.4	3.5
Current account, % of GDP		-13.1	4.3	1.8	-1.0	-1.5
General govt budget balance, % of GDP		-3.3	-9.2	-7.1	-5.0	-2.8

\* Contribution to GDP growth (% points)

## Growth will slow down as authorities fight inflation

Economic growth stayed stronger than expected at the beginning of the year, and we have therefore adjusted our GDP forecast for 2011 upwards although we expect growth to slow in the coming quarters as the already implemented monetary policy tightening measures will start to pass through to the economy. Not least construction investment and spending related to housing will slow down going forward. This is because the authorities seem keen on avoiding further inflating the likely housing bubble. New measures in order to dampen speculation and excessive price increases could well be taken, including further purchase restrictions and lending regulation tightening. The construction activity slowdown should to some extent be offset by the government's massive programme to build social and low-cost housing.

With both wages and goods prices increasing strongly, the coming slowdown is not necessarily a bad thing. We do not foresee any collapse of the economy and expect growth to remain relatively solid around 9% with the process towards a more balanced economy gradually gaining momentum. The underlying long-term trend of increased wealth from productivity gains amid urbanisation and industrialisation remains intact and should not be hampered by the other very important long-term factor, namely demographics, which not yet but in some years' time will act as a drag on the economy.

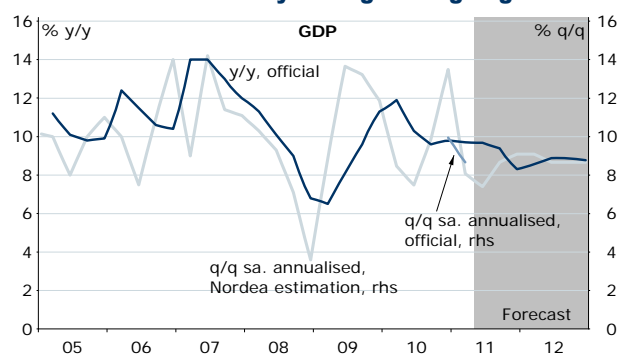
Inflation will likely continue upwards and peak at close to 6% during the summer. Both the direct and indirect measures taken to control price increases will then kick in and in combination with base effects send inflation down again. Inflation will, however, end above the upward revised target for 2011 of 4%. A few more interest rate hikes are likely during the summer and the gradual revaluation of the renminbi is set to continue in an attempt to dampen inflation. If inflation and especially food price increases do not subside, much more drastic economic tightening could prove necessary, posing a risk to our main scenario of still relatively solid growth.

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### Lower but still relatively solid growth going forward



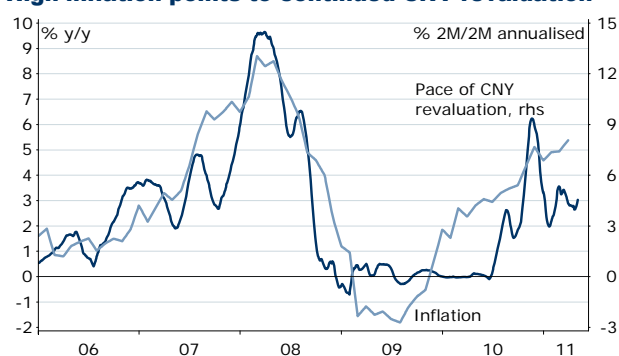
Source: Nordea Markets and Reuters Ecowin

### Inflation to peak at close to 6% during summer



Source: Nordea Markets and Reuters Ecowin

### High inflation points to continued CNY revaluation



Source: Nordea Markets and Reuters Ecowin

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

	2007 (CNYbn)	2008	2009	2010	2011E	2012E
Private consumption	9,561	8.4	9.3	9.8	10.0	10.0
Government consumption	3,590	9.0	6.1	7.5	9.5	9.0
Fixed investment	10,395	9.8	24.2	11.3	10.0	9.5
Stockbuilding*	699	0.8	-0.7	-0.5	0.1	0.0
Exports	10,210	13.9	-9.1	15.8	10.0	10.0
Imports	7,872	15.2	-2.7	12.0	12.0	12.0
GDP		9.6	9.2	10.3	9.2	8.8
Nominal GDP (CNYbn)	26,583	31,490	34,502	39,798	45,609	51,446
Unemployment rate, %		4.2	4.3	4.1	4.1	4.0
Consumer prices, % y/y		5.9	-0.7	3.3	5.4	4.0
Current account, % of GDP		9.6	5.9	5.2	4.1	3.6
General government budget balance, % of GDP		-0.4	-2.1	-1.6	-2.2	-1.9

\* Contribution to GDP growth (% points)

## Less bright economic outlook due to price pressure

The until recently very bright outlook for India's economy has become a little bleaker and we have adjusted down our GDP growth forecast by roughly 1% point to around 8% in 2011 and 2012. The main reason is the persistently high inflation that is eroding households' purchasing power and forcing the central bank to tighten monetary conditions even more. This tightening will eventually dampen economic activity. Especially investment growth will be subdued going forward due to the higher interest rates. But also the many corruption scandals in the political system and the lack of functioning governance are dampening especially public investment. A hard landing of the economy will, however, most likely be avoided due to private consumption that will remain strong as urban households will prosper from strong wage increases. Despite the expected slowdown in economic growth in the near term, the underlying long-term trend remains encouraging, among other factors due to favourable demographics and the big pool of labour.

Public finances are chronically in bad shape, and the deficit is set to once again breach the budget and end at above 5% of GDP. Not least the cost of subsidising fertilisers and fuels is growing following the surge in the global oil price.

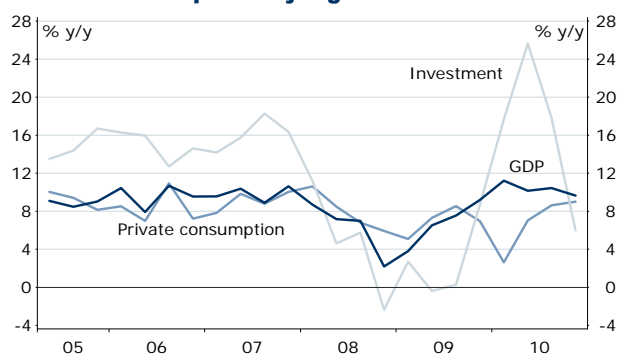
Both consumer price inflation and the central bank's preferred measure, wholesale price inflation, have after falling slightly in H2 2010 stabilised at a still very elevated level around 9% and are not expected to fall meaningfully soon. As everywhere else, the high inflation is led by surging food and energy prices. But in India the high food price inflation seems to have become structural. One explanation is that the improved living standards of part of the population have changed the consumption pattern structurally to include a more protein-rich diet, the production of which is far more soft commodity-intensive. This year's harvest was good due to a normal monsoon last summer. Should rainfall during this summer's monsoon be deficient, it will pose a series threat to the outlook for both inflation and the overall economy.

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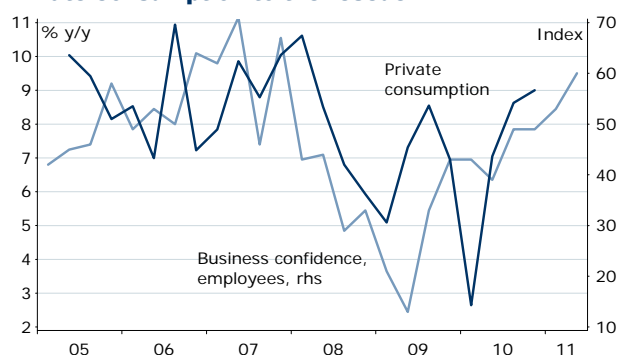
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### Investment dampened by higher interest rates



Source: Nordea Markets and Reuters Ecowin

### Private consumption to the rescue



Source: Nordea Markets and Reuters Ecowin

### High inflation will not go away



Source: Nordea Markets and Reuters Ecowin

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

	2007 (INRbn)	2008	2009	2010	2011E	2012E
Private consumption	28,157	7.9	7.0	6.9	7.0	7.5
Government consumption	5,130	10.7	16.4	2.6	6.0	7.0
Fixed investment	16,415	1.5	7.3	8.4	10.0	12.0
Exports	9,843	16.4	-7.4	14.6	15.0	13.0
Imports	12,198	31.2	-7.0	3.5	11.0	13.0
GDP		4.9	9.1	9.7	7.9	8.1
Nominal GDP (INRbn)	49,864	55,826	62,082	74,013	84,279	95,304
Wholesale prices, % y/y		8.7	2.1	9.5	7.5	5.0
Current account, % of GDP		-2.5	-2.0	-3.1	-2.5	-2.5
General government budget balance, % of GDP		-6.0	-6.5	-5.0	-5.5	-5.0

\* Contribution to GDP growth (% points)

## Balancing between excess inflation and "hard landing"

The economy has started to show some signs of slowing down. The recent retail sales data point toward slower consumption growth already in H1, and business surveys indicate deceleration in fixed capital investments growth as well. That being said, credit growth is still remarkable – at a pace above 20% y/y it is still early to call for any kind of “landing” of the economy, as expansion is still above historic average rates. And the labour market has tightened further, with unemployment falling to historic lows of 6.5%.

Growth above potential has translated into inflationary pressures, which have been of concern recently. Headline inflation has reached the upper limit of the central bank target (6.5%), thus raising the question of monetary policy credibility. We believe inflation will rise further to 7% in the coming months, thus for some months staying above the central bank’s comfort zone. Even if commodity prices decelerate, there are signs that core inflation will accelerate – capacity utilisation levels are at historic highs and the labour market is the tightest ever.

The policymakers have employed “macro prudential” measures to curb credit growth, such as taxes on consumer credit and foreign investments in bonds. It appears that the government has become concerned over a potential slowdown, as seen from the recent decision to reduce the pace of monetary policy tightening. Instead of two final 50 bp SELIC rate hikes by mid-2011, we thus expect to see a prolonged cycle of 25 bp hikes well into the year.

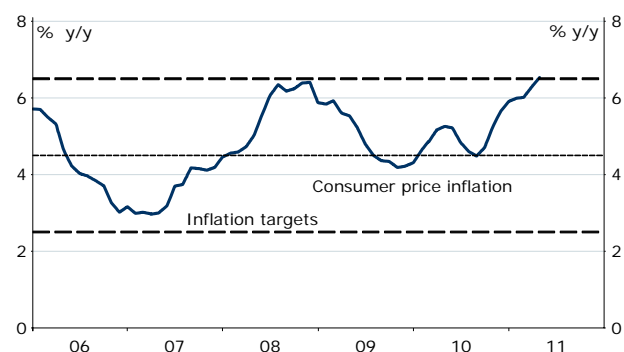
The BRL has strengthened in recent months, responding to strong commodity price momentum. The appeal of one of the most attractive interest rate levels in the Emerging Market universe has boosted capital inflows despite the measures taken. The excessive inflows recently make BRL particularly vulnerable to sudden increases in risk aversion globally and monetary policy tightening from the Fed starting late this year.

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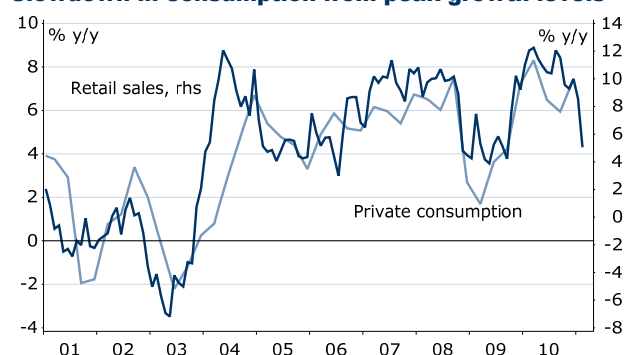
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### Inflation nears the out-of-comfort zone



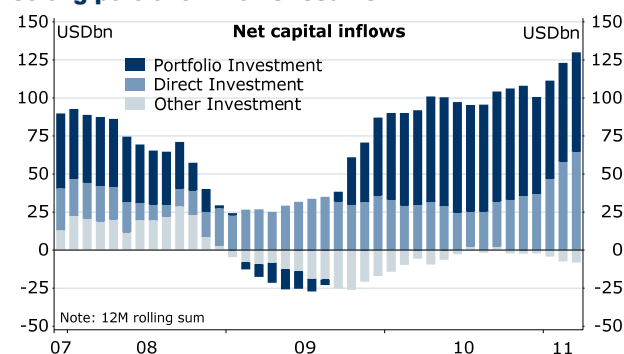
Source: Nordea Markets and Reuters Ecowin

### Slowdown in consumption from peak growth levels



Source: Nordea Markets and Reuters Ecowin

### Strong portfolio inflows resume



Source: Nordea Markets and Reuters Ecowin

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

	2007 (BRLbn)	2008	2009	2010	2011E	2012E
Private consumption	1,594	5.7	4.2	7.0	4.8	4.6
Government consumption	539	3.1	3.9	4.0	3.0	3.5
Gross fixed capital formation	464	13.6	-10.4	26.0	7.0	6.5
Stockbuilding*	24	0.9	-2.0	0.2	0.0	0.0
Exports	356	0.4	-10.3	10.0	9.0	7.0
Imports	315	15.3	-11.5	30.0	13.0	7.0
GDP		5.2	-0.7	7.6	4.5	4.7
Nominal GDP (BRLbn)	2,661	3,032	3,257	3,722	4,136	4,556
Unemployment rate, %		7.9	8.1	6.7	6.5	6.4
Consumer prices, % y/y		5.7	4.9	5.0	6.4	5.2
Current account, % of GDP		-1.8	-1.5	-2.5	-3.0	-2.8
General government budget balance, % of GDP		-1.6	-3.2	-2.7	-2.5	-2.0

\* Contribution to GDP growth (% points)

## Political risk in the limelight

Political unrest in North Africa and the Middle East (MENA) and the devastating earthquake/tsunami in Japan have changed the oil market outlook markedly. Mounting political unrest in the MENA region and Libya's production outages pushed the "fear premium" and oil prices significantly higher. The "fear premium" has contracted markedly in Q2. From H2 2011 the underlying oil price trend is again expected to move higher driven by tighter fundamentals. Libyan production outages have deflated the OPEC supply cushion significantly and global oil demand is anticipated to outpace non-OPEC supply growth as world economic growth continues to gain momentum.

The supply outlook has tightened sharply following the recent development in the MENA region. The region accounts for 35% of global oil production, 50% of total world oil exports and holds around 60% of the world's proven oil reserves. Oil's unique property and low substitutability especially as fuel for transportation leaves the world highly dependent on the MENA region as a persistent and secure supplier of oil in future. The recent wave of political unrest has increased the risk of oil supply disruptions and scarcity of oil in the world market. Large-scale investments are needed to increase production capacity from newly discovered areas to compensate for declining production from mature fields. Political unrest and resource nationalism challenge investments in new production capacity to meet future demand growth. Higher oil prices are expected to increase investments of higher cost oil reserves outside OPEC such as ultra-deepwater production and unconventional resources.

Future oil demand growth will to a large extent depend on the impact of continued economic growth, increasing living standards and population growth in emerging economies, especially China, India and the Middle East. We expect that oil demand will continue to grow at a healthy rate in 2011 and then slow down somewhat in 2012. The removal of fuel subsidies could reduce oil demand significantly and dampen oil prices, but popular discontent across the Middle East, Latin America and Asia is raising pressure on governments to maintain fuel subsidy programme. The tsunami that hit Japan in March has had a profound impact on the country's power generation as a significant share of the country's nuclear power generators has been damaged or destroyed. Although oil demand is expected to fall in Q2 as oil refineries have been shut and economic activity slowed, we expect a total increase in oil demand as oil will substitute lost nuclear capacity in power generation.

Thina M. Saltvedt

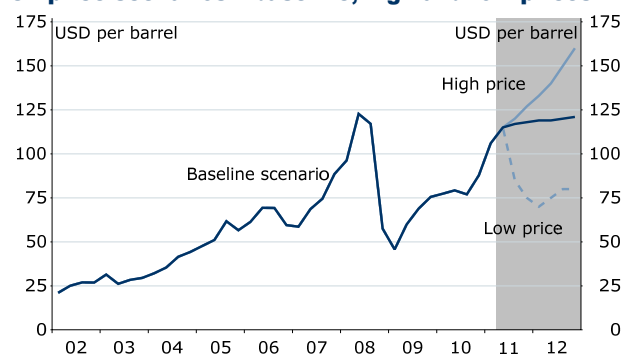
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### Oil price forecast – baseline (Brent – USD/barrel)

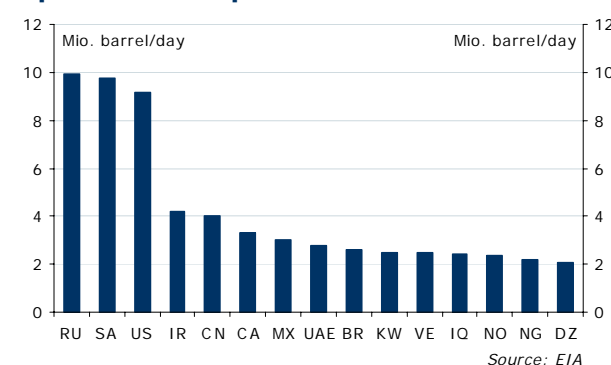
	Q1	Q2	Q3	Q4	Year
2008	96.3	122.8	117.2	57.5	98.4
2009	45.7	59.9	68.9	75.5	62.5
2010	77.4	79.3	77.0	87.8	80.4
2011E	106.0	115.0	117.0	118.0	114.0
2012E	119.0	119.0	120.0	121.0	119.8

### Oil price scenarios – baseline, high and low prices



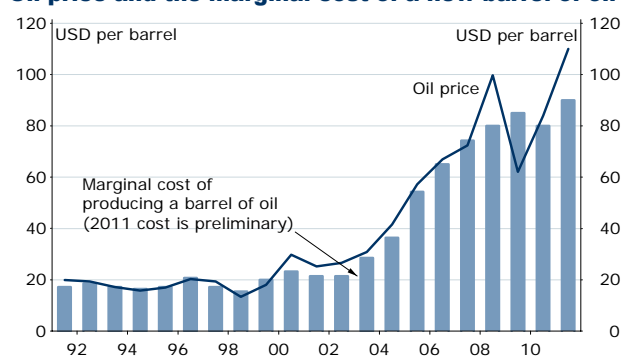
Source: Nordea Markets and Reuters Ecowin

### Top 15 world oil exporters 2009



Source: EIA

### Oil price and the marginal cost of a new barrel of oil



Source: Nordea Markets, IMF and Reuters Ecowin

## Metal prices taking a breather at high levels

Base metal markets have experienced a turbulent ride since the previous edition of *Economic Outlook*. Prices generally rose in January and continued upwards until mid-February when the conflict in Libya escalated and sent oil prices sharply up. Since then base metal prices, with the exception of energy price-sensitive aluminium, have been under pressure with increased volatility as a result.

On the back of a constructive outlook for oil and energy prices, we believe aluminium prices will be relatively well supported. We expect demand growth to slow from the record rate of 2010, but to remain above trend in 2011 and 2012. China is expected to remain the engine of demand growth. Supply capacity is still ample and expected to grow more slowly than demand, thereby increasing operating rates. China's curbs on both energy use and expansion of production capacity are expected to be supportive of the aluminium market, forcing China to become a net importer of primary aluminium again. In our base scenario, prices are expected to average higher levels over the next couple of years.

We remain fairly bullish on the copper market, as supply growth continues to fall short of demand. Mine supply is expected to increase faster amid record-high prices as new projects will come on stream over the next two to three years. Risks are nevertheless on the downside for mining output. Demand is still expected to outstrip supply, but the expected deficit is highly sensitive to global GDP growth. We expect prices to stay high and volatile.

Strong stainless steel production has supported the nickel market recently. Demand growth is expected to remain robust, but slow from last year's rate. In theory, the supply additions announced are plentiful, but the history of delays could repeat itself. We believe in a fairly balanced market this year and a gradually less tight market over the outlook period. Prices are expected to moderate from current levels.

Zinc has the weakest current fundamentals of the base metals complex, but we expect fundamentals to strengthen over the outlook period. Driven by China, demand is expected to grow, albeit more slowly than in previous cycles. Mine supply growth is dependent on a few large projects which could disappoint. We forecast a market surplus for 2011 which turns into a small deficit next year. Prices are expected to edge higher over the next couple of years.

### Base metal price forecasts (USD/tonne)

	Aluminium	Copper	Nickel	Zinc
2011E	2,630	9,525	25,460	2,470
2012E	2,760	10,000	24,000	2,700

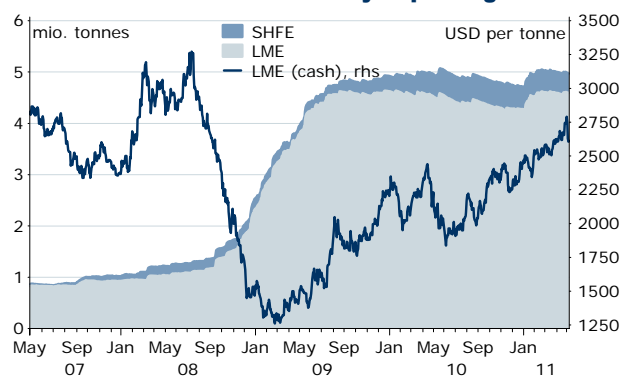
Source: Nordea Markets

### Metal prices close to all-time highs



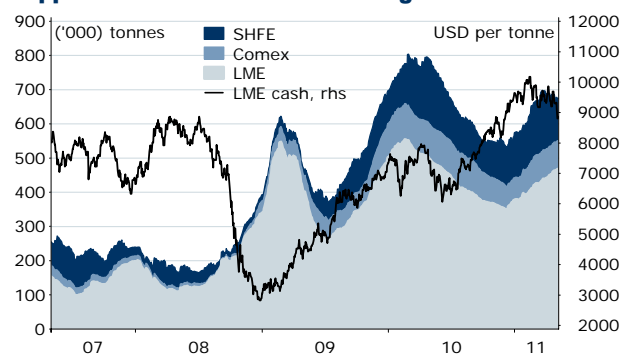
Source: Nordea Markets and Reuters Ecowin

### Aluminium fundamentals finally improving



Source: Nordea Markets and Reuters Ecowin

### Copper fundamentals to remain tight



Source: Nordea Markets and Reuters Ecowin

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