Economic Outlook

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Markets

Contents

Data overview

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The recession is over

In the May issue of *Economic Outlook* we argued that the global economy was at a crossroads. There were budding signs of improvement, but the uncertainty about a possible recovery was extremely high. Now some four months later there is every indication that the spring optimism was justified. Many economies around the world have now emerged from the recession, supported by a highly expansionary and to a large extent coordinated economic policy implemented by governments around the globe.

The Chinese economy is again motoring ahead, and a string of countries including Germany, France, Norway and Japan officially pulled out of recession as early as in Q2, that is, sooner than we had expected. In the US, the epicentre of the crisis, there are also clear signs that the economy will grow in Q3. Meanwhile, a state bankruptcy was avoided in Latvia, and predictions that EMU was doomed to failure proved highly exaggerated, as we also noted in the May issue of *Economic Outlook*.

We therefore see reason to conclude that the determined efforts last autumn by governments and economic policymakers around the world to counter the crisis have been tremendously successful because they have succeeded in fending off economic depression. However, it should be emphasised that it is still too early to celebrate the arrival of a lasting and robust economic upswing. There are still pitfalls ahead, as discussed below.

First, it should be noted that the economic recovery starts from a historically low level. Over a few quarters the manufacturing sectors in many countries have been set back a decade. And even though the outlook is much brighter than a couple of months ago, unemployment globally will still continue to rise going forward. Owing to the low capacity utilisation in the business sector, companies will be cautious about launching new investment projects, and in light of the uncertain labour market situation consumers will show restraint. Add to this the overall tighter credit standards in the global financial sector and a picture of a relatively weak upswing over the forecast period (up to and including 2011) emerges.

However, we may indeed see signs of a more speedy recovery in H2 2009, not least in the manufacturing sector according to recent reports. The decline in production was far bigger than the drop in demand, and this mismatch is now being addressed. Actually, many companies may well start to replenish their stocks on hopes that market conditions will improve.

Still, as noted above there is a risk of new disappointments if final demand does not rise at the same pace. This risk is currently intensified by the sharp pick-up in commodity prices, which has boosted corporate costs and reduced household purchasing power at a very unfortunate time during the incipient upswing. Particularly in the highly energy-intensive USA, there is a risk that this could seriously dampen the recovery.

The countries benefitting from this development are obviously the oil-producing countries. Against this backdrop particularly Russia may recover sooner than previously expected. As the upcoming upswing looks set to be somewhat stronger than envisaged in May, we have decided to raise our forecast for oil prices over the forecast period.

That being said, there is also a chance that the economic upturn proves even stronger than we currently assume. The string of promising economic indicators or so-called green shoots[1] has also made its mark on the financial markets, with sharply rising equity prices and markedly narrower credit spreads on corporate bonds over the past few months. Obviously, this has a cumulative effect on economic activity with cheaper credits more readily available and rising wealth for holders of financial claims, which in turn boosts consumers' propensity to consume. At the same time a stronger-than-expected improvement of the housing market could add fuel to the upswing, resulting in a stronger recovery than we currently anticipate.

Appropriate exit strategy

We base our baseline scenario on a moderate, but lasting recovery. Against this background governments and central banks around the world will have to face the next big challenge in terms of economic policy during the forecast period. They will have to define the appropriate exit strategy away from their current expansionary economic policy line to avoid another financial market collapse and, in the worst case, a new global economic recession.

At this juncture it is obvious that the current very lenient fiscal policy cannot continue. Budget deficits and public debt have risen dramatically in many countries and most G20 countries will likely start to tighten fiscal policy as early as in 2011 or in 2012 at the latest.

Also the central banks will have to embark on a gradual tightening of their very easy monetary policies during the forecast period. In many countries the central bank has not only cut rates to historically low levels, but also launched quantitative easing measures to improve the efficiency of financial markets. We expect the central

[1] The concept of "green shoots" was introduced by former UK Chancellor of the Exchequer Norman Lamont, who used this metaphor during the UK recession in 1991 as a blanket term for the economic indicators that pointed to an economic turnaround. During the current recession US Fed Chairman Ben Bernanke used the term in March during an interview with CBS 60 Minutes. This term has since been adopted by just about every economist around the world.

banks to begin to abandon their quantitative easing measures first and then hike rates, perhaps even at a relatively fast pace to avoid new equity and housing market bubbles. In the Euro area we expect the ECB to start raising rates in the autumn of 2010, while in the US the Federal Reserve may wait longer and perhaps even until early 2011 before hiking its policy rate. In Norway, which has already pulled out of the recession and where house prices have started to pick up, Norges Bank will probably start to hike rates as early as this autumn.

Rising yields and stronger USD over time

We believe that long yields will edge higher during the forecast period, but that we may periodically see declining yields and an actual decoupling between Europe and the US. This may especially be the case if after the initial stock building the US upswing proves to be rather weak as expected. In our view, the risk of this scenario materialising in early 2010 is quite high.

Turning to the currency markets we now expect the USD to weaken further versus the EUR short term in the wake of rising risk appetite and higher oil prices. In the longer term the forecast trend in monetary policy should ensure that the USD strengthens again to around 1.30. In step with the normalisation of financial markets, the Emerging Markets currencies should also strengthen further, thus tracking the appreciation of the SEK, the NOK and the GBP. Typical funding currencies such as the JPY and the CHF, on the other hand, will likely weaken over the forecast period.

Denmark – the Nordic laggard

The storm that has ravaged the **Danish** economy for about 18 months finally seems to peter out. There are increasing signs that the downturn in global trade is being replaced by an upturn, which will also brighten the outlook for Danish exports. The gradual improvement of the financial market situation has also filtered through to Denmark, resulting in lower interest rates. Moreover, in H2 2009 the effect of several of the government's rescue packages will also start to show through. Still, a further sharp increase in unemployment cannot be avoided. The pick-up in unemployment and the past years' housing market slide add to the risk that households will continue to scale up their savings, thus eroding the effect of planned and already implemented tax cuts. At the same time, a drastic deterioration in competitiveness may limit the benefit that Danish exporters will get from the projected upswing in world trade. The formulation of economic policy will thus be very challenging in the years ahead, as the desire to stimulate growth must be weighed against the risk of eroding Danish exporters' competitiveness further.

With its large export sector the **Swedish** economy was hard hit by last year's collapse in world trade. There are now signs that Sweden may emerge relatively quickly from the crisis thanks to the international recovery coupled with highly expansionary conditions at home. Indicators reflect an upswing in the manufacturing industry in H2, while at the same time households' consumption plans are supported by an already fairly high savings ratio. Swedish government finances are adversely affected by a sustained rise in unemployment as well as continued fiscal policy measures going forward, but remain in relatively good shape compared with other economies. All in all, this points to sustained strengthening of the SEK versus the EUR. This – coupled with higher rates when the Riksbank withdraws some of its current stimuli measures – will contribute to a slowdown towards the end of the forecast period.

The recession is over in **Norway**. After two quarters of declining activity in the mainland economy, growth slipped slightly into positive territory again in Q2. Consumption growth is rising sharply driven by substantial rate cuts. Higher export market growth, a sustained high level of investment in the oil sector and strong growth in public sector demand will also contribute to strong GDP growth in the years ahead. Unemployment will follow an uptrend that looks set to flatten in 2010, though. Norges Bank will embark on a gradual normalisation of interest rates, but will do so cautiously, partly as capacity utilisation and price increases will remain at a relatively low level for a longer period of time and partly as a more aggressive approach compared with other central banks could result in excessive NOK appreciation.

The **Finnish** economy contracted sharply during the winter, especially due to the heavy drop in exports. With the advent of spring, there were increasing signs of the economy stabilising, though. In H2 2009 we are set to witness quite a marked turn for the better in the Finnish economy thanks to the pick-up in global trade. Nevertheless, the brisk rise will not last very long because final demand in the export markets will not recover quickly. Economic growth will be reasonable in the next few years, but in the wake of the crash, GDP will clearly be below the potential level. A turn for the better in employment is not to be expected until well into 2010. Overall, the situation is not as bad as feared earlier, but it will take a long time for the recovery to have an impact on a broad front.

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Growth, %

	2007	2008	2009E	2010E	2011E
World[1)]	4.8	2.4	-1.2	3.4	3.4
BIG-3[2)]	2.4	0.3	-3.4	1.8	1.6
USA	2.1	0.4	-2.6	1.7	1.7
Japan	2.4	-0.7	-5.8	1.3	1.2
Euro area	2.7	0.6	-3.5	2.1	1.6
Germany	2.6	1.0	-4.5	2.3	1.7
France	2.3	0.3	-1.8	2.0	1.9
Italy	1.5	-1.0	-4.5	1.8	1.5
Spain	3.7	1.2	-3.2	1.0	1.5
Netherlands	3.5	2.0	-3.5	2.0	1.5
Belgium	2.6	1.5	-3.2	2.3	1.6
Austria	3.1	1.5	-2.7	2.2	1.7
Portugal	1.9	0.5	-3.7	1.0	1.0
Greece	4.0	3.0	-0.5	1.5	1.5
Finland	4.2	1.0	-4.5	2.5	2.0
Ireland	6.3	-2.0	-9.0	-1.0	-2.0
Denmark	1.6	-1.2	-3.0	1.5	1.7
Sweden	2.6	-0.2	-4.2	2.8	2.0
Norway	6.1	2.6	-0.8	2.7	2.5
Iceland	5.5	0.3	-10.1	-1.7	2.4
UK	2.6	0.7	-4.5	1.1	1.7
Switzerland	3.3	1.6	-2.8	1.8	1.5
Russia	8.1	5.6	-7.0	1.5	3.0
Poland	6.8	4.8	1.2	2.7	4.0
Estonia	6.3	-3.6	-14.0	-2.5	1.5
Latvia	10.0	-4.6	-18.0	-3.0	2.0
Lithuania	8.9	3.0	-16.0	-4.0	1.0
China	13.0	9.0	8.8	10.5	10.0
India	9.1	6.1	5.7	7.5	8.4
Brazil	5.6	5.1	0.3	3.6	4.5

Inflation, %

	2007	2008	2009E	2010E	2011E
World	3.1	4.6	0.7	1.9	2.2
BIG-3	2.2	3.3	-0.3	1.2	1.1
USA	2.9	3.8	-0.3	1.6	1.0
Japan	0.1	1.5	-1.5	-0.5	0.5
Euro area	2.1	3.3	0.3	1.3	1.6
Germany	2.3	2.8	0.4	1.4	1.5
France	1.6	3.2	0.2	1.0	1.6
Italy	2.0	3.5	0.6	1.6	1.7
Spain	2.8	4.2	-0.2	1.0	1.5
Netherlands	1.6	2.2	1.3	1.3	1.6
Belgium	1.8	4.5	0.4	1.2	1.7
Austria	2.1	3.2	0.5	1.4	1.5
Portugal	2.5	2.8	-0.3	1.0	1.5
Greece	3.0	4.3	1.5	2.0	2.5
Finland	2.5	4.1	0.0	1.2	1.7
Ireland	2.9	3.1	-1.0	1.0	1.5
Denmark	1.9	3.4	1.6	2.0	1.5
Sweden	2.2	3.4	-0.3	1.6	1.9
Norway	0.8	3.8	2.3	1.9	2.0
Iceland	5.0	12.4	12.0	6.0	2.0
UK	2.3	3.5	1.7	1.4	1.8
Switzerland	0.7	2.4	-0.7	0.6	1.2
Russia	9.0	14.1	12.0	10.0	9.0
Poland	2.6	4.4	3.5	1.9	2.4
Estonia	6.7	10.6	-1.0	-1.5	1.0
Latvia	10.1	15.3	3.5	-4.5	-1.0
Lithuania	5.8	11.1	4.0	-1.0	-0.5
China	4.8	5.9	-0.2	1.5	3.0
India	4.8	9.2	1.0	4.0	5.0
Brazil	3.6	5.7	5.2	4.1	4.5

1) Weighted average of countries in this table. Accounts for 70.5% of world GDP. Weights calculated using PPP adjusted GDP levels for 2006 according to the IMF's World Economic Outlook

2) US, Japan and the Euro area

Public finances, % of GDP

	2007	2008	2009E	2010E	2011E
BIG-3	-1.1	-2.6	-8.8	-7.6	-5.9
USA	-1.1	-3.1	-11.9	-8.8	-6.6
Japan	-2.4	-2.7	-7.8	-8.4	-6.0
Euro area	-0.6	-1.9	-5.0	-5.5	-5.0
Germany	0.4	-0.3	-3.5	-4.8	-3.8
France	-2.7	-3.4	-6.0	-6.5	-6.0
Italy	-1.5	-2.7	-5.0	-5.0	-5.0
Finland	5.2	4.4	-1.1	-2.2	-2.0
Denmark	4.5	3.6	-1.8	-4.5	-3.2
Sweden	3.8	2.5	-2.2	-3.6	-2.6
Norway	17.7	18.8	14.5	15.6	15.7
Iceland	5.4	-14.3	-10.0	-8.0	-5.0
UK	-2.8	-3.8	-9.0	-10.5	-4.5
Switzerland	1.7	2.2	-0.5	-3.0	-3.0
Russia	6.1	4.1	-7.0	-5.0	-3.0
Poland	-1.9	-3.9	-4.8	-4.5	-3.0
Estonia	2.7	-3.0	-4.0	-5.0	-3.0
Latvia	-0.4	-4.0	-10.0	-9.0	-6.0
Lithuania	-1.0	-3.2	-6.0	-5.0	-3.5
China	0.6	-0.4	-3.5	-3.1	-2.5
India	-5.6	-6.1	-7.8	-7.3	-8.2
Brazil	-2.3	-1.8	-2.0	-1.6	-1.2

Current account, % of GDP

	2007	2008	2009E	2010E	2011E
BIG-3	-	-	-	-	-
USA	-5.2	-4.9	-2.8	-2.5	-1.5
Japan	4.8	3.2	2.0	2.0	2.0
Euro area	0.1	-1.0	-0.9	-0.8	-0.7
Germany	7.8	6.6	4.0	5.0	5.0
France	-1.0	-2.3	-1.5	-1.3	-1.0
Italy	-2.4	-3.5	-3.5	-3.3	-3.0
Finland	4.2	2.4	1.0	2.0	2.6
Denmark	0.7	2.3	2.5	2.5	2.5
Sweden	9.0	8.3	6.9	7.4	8.4
Norway	15.9	17.7	15.2	17.2	17.7
Iceland	-20.6	-43.1	-8.0	3.0	5.0
UK	-2.9	-1.7	-0.5	0.5	1.1
Switzerland	10.3	8.4	7.8	8.2	8.4
Russia	5.9	5.9	2.0	3.5	3.0
Poland	-4.7	-5.4	-1.1	-1.8	-2.1
Estonia	-18.3	-9.1	2.0	3.0	1.0
Latvia	-22.5	-13.6	3.0	4.5	2.0
Lithuania	-15.1	-12.2	1.0	2.5	1.5
China	11.0	9.8	6.7	6.1	5.2
India	-1.0	-1.3	-1.4	-1.5	-1.7
Brazil	0.1	-1.8	-1.9	-1.5	-1.0

Monetary policy rates

	26.8.09	3M	6M	12M	24M
US	0.25	0.25	0.25	0.25	2.00
Japan	0.50	0.10	0.10	0.10	0.50
Euro area	1.00	1.00	1.00	1.25	2.25
Denmark	1.45	1.25	1.25	1.50	2.50
Sweden	0.25	0.25	0.25	1.75	3.00
Norway	1.25	1.50	1.75	2.25	3.50
UK	0.50	0.50	0.50	0.50	2.50
Switzerland	0.25	0.25	0.25	0.25	1.00
Poland	3.50	3.50	3.50	3.50	4.50
Czech Rep.	1.25	1.25	1.25	1.25	2.25
Hungary	8.50	7.00	6.25	6.00	6.00

Monetary policy rate spreads vs Euro area

	26.8.09	3M	6M	12M	24M
US	-0.75	-0.75	-0.75	-1.00	-0.25
Japan[1]	0.25	-0.15	-0.15	-0.15	-1.50
Euro area	-	-	-	-	-
Denmark	0.45	0.25	0.25	0.25	0.25
Sweden	-0.75	-0.75	-0.75	0.50	0.75
Norway	0.25	0.50	0.75	1.00	1.25
UK	-0.50	-0.50	-0.50	-0.75	0.25
Switzerland	-0.75	-0.75	-0.75	-1.00	-1.25
Poland	2.50	2.50	2.50	2.25	2.25
Czech Rep.	0.25	0.25	0.25	0.00	0.00
Hungary	7.50	6.00	5.25	4.75	3.75

1) Spread vs US

3-month rates

	26.8.09	3M	6M	12M	24M
US	0.38	0.50	0.50	1.00	2.50
Japan	0.39	0.45	0.45	0.50	0.70
Euro area	0.83	1.00	1.20	1.50	2.50
Denmark	1.91	1.70	1.70	1.95	2.75
Sweden	0.61	0.80	1.00	2.25	3.30
Norway	1.98	2.05	2.25	2.65	3.85
UK	0.70	0.80	0.80	0.90	2.80
Switzerland	0.33	0.35	0.35	0.40	1.20
Poland	4.17	4.00	3.90	3.80	5.00
Czech Rep.	1.86	1.75	1.60	1.50	2.75
Hungary	7.94	8.50	8.00	7.75	7.25
Estonia	5.58	5.20	4.80	4.40	3.80
Latvia	11.44	11.00	10.00	8.00	6.00
Lithuania	7.62	7.00	6.50	5.50	4.00

3-month spreads vs Euro area

	26.8.09	3M	6M	12M	24M
US	-0.45	-0.50	-0.70	-0.50	0.00
Japan[1]	0.01	-0.05	-0.05	-0.50	-1.80
Euro area	-	-	-	-	-
Denmark	1.07	0.70	0.50	0.45	0.25
Sweden	-0.23	-0.20	-0.20	0.75	0.80
Norway	1.15	1.05	1.05	1.15	1.35
UK	-0.13	-0.20	-0.40	-0.60	0.30
Switzerland	-0.51	-0.65	-0.85	-1.10	-1.30
Poland	3.34	3.00	2.70	2.30	2.50
Czech Rep.	1.03	0.75	0.40	0.00	0.25
Hungary	7.11	7.50	6.80	6.25	4.75
Estonia	4.75	4.20	3.60	2.90	1.30
Latvia	10.61	10.00	8.80	6.50	3.50
Lithuania	6.79	6.00	5.30	4.00	1.50

1) Spread vs US

10-year government benchmark yields

	26.8.09	3M	6M	12M	24M
US	3.45	4.00	3.75	4.00	4.75
Japan	1.32	1.50	1.55	1.65	1.80
Euro area	3.24	3.60	3.60	3.75	4.25
Denmark	3.55	3.90	3.85	4.00	4.50
Sweden	3.42	3.70	3.75	3.90	4.40
Norway	4.24	4.40	4.40	4.60	5.10
UK	3.53	3.95	3.95	4.25	4.80
Switzerland	1.97	2.30	2.45	2.60	3.15
Poland	6.08	5.75	5.50	5.25	5.50
Czech Rep.	5.08	4.75	4.50	4.25	4.50
Hungary	8.04	9.00	8.50	8.00	7.50

10-year yield spreads vs Euro area

	26.8.09	3M	6M	12M	24M
US	0.21	0.40	0.15	0.25	0.50
Japan[1]	-2.14	-2.50	-2.20	-2.35	-2.95
Euro area	-	-	-	-	-
Denmark	0.30	0.30	0.25	0.25	0.25
Sweden	0.18	0.10	0.15	0.15	0.15
Norway	0.99	0.80	0.80	0.85	0.85
UK	0.29	0.35	0.35	0.50	0.55
Switzerland	-1.27	-1.30	-1.15	-1.15	-1.10
Poland	2.84	2.15	1.90	1.50	1.25
Czech Rep.	1.83	1.15	0.90	0.50	0.25
Hungary	4.80	5.40	4.90	4.25	3.25

1) Spread vs US

Exchange rates vs EUR

	26.8.09	3M	6M	12M	24M
EUR/USD	1.427	1.400	1.500	1.400	1.300
EUR/JPY	134.4	140.0	142.5	147.0	150.0
EUR/DKK	7.443	7.460	7.460	7.460	7.460
EUR/SEK	10.144	9.850	9.750	9.400	9.400
EUR/NOK	8.637	8.400	8.300	8.200	7.900
EUR/GBP	0.879	0.850	0.870	0.820	0.800
EUR/CHF	1.519	1.550	1.520	1.570	1.580
EUR/PLN	4.091	3.900	3.900	3.900	3.700
EUR/CZK	25.41	25.00	25.00	25.00	24.00
EUR/HUF	267.7	265.0	270.0	270.0	268.0
EUR/RUB	44.92	46.20	45.75	41.30	36.40
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.702	0.700	0.700	0.700	0.700
EUR/LTL	3.453	3.453	3.453	3.453	3.453
EUR/CNY	9.748	9.590	10.275	9.380	7.930

Exchange rates vs USD

	26.8.09	3M	6M	12M	24M
-					
USD/JPY	94.2	100.0	95.0	105.0	115.4
USD/DKK	5.216	5.329	4.973	5.329	5.738
USD/SEK	7.110	7.036	6.500	6.714	7.231
USD/NOK	6.053	6.000	5.533	5.857	6.077
GBP/USD	1.624	1.647	1.724	1.707	1.625
USD/CHF	1.065	1.107	1.013	1.121	1.215
USD/PLN	2.867	2.786	2.600	2.786	2.846
USD/CZK	17.81	17.86	16.67	17.86	18.46
USD/HUF	187.6	189.3	180.0	192.9	206.2
USD/RUB	31.48	33.00	30.50	29.50	28.00
USD/EEK	10.97	11.18	10.43	11.18	12.04
USD/LVL	0.492	0.500	0.467	0.500	0.538
USD/LTL	2.420	2.466	2.302	2.466	2.656
USD/CNY	6.832	6.850	6.850	6.700	6.100

Storm easing but still high seas for the Danish economy

- Tentative signs that the economy has bottomed out
- Continued increase in unemployment unavoidable
- Still scope for narrowing of interest rate differential

The storm that has ravaged the Danish economy for about 18 months finally seems to be easing. We see increasingly clear signs that the downturn in global trade is being replaced by an upturn, which will also brighten the outlook for Danish exports. The gradual improvement of the situation in the financial markets has also filtered through in Denmark with resultant lower interest rates. Lastly, several of the government's economic rescue packages will start to work in the second half of 2009 – not least this summer's repayments from the special pension fund (SP). Although we anticipate positive growth during the coming year, unemployment is bound to rise further. Activity has simply contracted too sharply. The rising unemployment and last year's housing market slide add to the risk that households will continue to scale up their savings, thus eroding the effect of planned and already implemented tax cuts. At the same time, a drastic deterioration in competitiveness may limit the benefit that Danish exporters' will get from the projected upswing in world trade. Finding the right stance of economic policy will thus be very challenging in the years ahead, as the desire to stimulate growth must be weighed against the risk of eroding Danish exporters' competitiveness further.

Still no tangible signs of reversal

Although confidence indicators for both businesses and consumers suggest that the nosedive in economic activity is over, tangible signs of more robust economic progress have yet to emerge. The latest industrial production data showed continued declines, while retail sales revealed only a stabilisation in private consumption after last autumn's plunge. Our forecast of a more definite improvement in the second half of 2009 is based on the expectation that the increasingly promising signs of an economic reversal in Germany and Sweden, Denmark's two key export markets, will also brighten the outlook for Danish companies and that consumer spending will begin to increase at a decent clip. Interest in reclaiming special pension fund contributions (SP) has been overwhelming. Since 1 June a total amount of DKK 36bn, or DKK 22bn after tax, has been repaid. If only half this amount is channelled into spending, private consumption will be lifted by about 1.25%.

The outlook for consumer spending will still be favourable later on the forecast horizon. Despite a sharp slowdown in wage growth and a continued decline in employment, the introduction of the tax reform in 2010 will boost disposable income quite nicely. In addition, comparatively moderate inflation will help ensure growth in real wages. Lastly, lower interest rates will ease household finances in the years ahead. However, households may still channel a large chunk of the disposable income gains into savings. House price declines and recent years' stock market slide have made substantial inroads into households' net assets and the rapidly growing unemployment may provide added incentive to save. Note, however, that household savings reached a record-high level already in Q1 this year, so the propensity to save is unlikely to increase further. In the latter part of the forecast period we even see a chance of consumer spending going up as a result of falling savings despite the prospect that mortgage interest relief above the DKK 100,000 threshold per household will be gradually phased out from 2012.

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

	2006 (DKKbn)	2007	2008	2009E	2010E	2011E
Private consumption	793	2.4	-0.2	-3.5	2.1	1.7
Government consumption	423	1.3	1.5	1.8	1.8	1.2
Fixed investment	350	3.1	-5.1	-7.2	-3.7	0.6
- government investment	32	-10.0	4.5	13.9	9.0	-2.5
- residential investment	107	4.8	-9.8	-13.6	-9.1	-4.9
- business fixed investment	211	4.4	-4.0	-6.6	-2.2	2.7
Stockbuilding*	14	-0.3	0.2	-0.4	0.3	0.0
Exports	847	2.2	2.2	-6.7	4.1	4.1
Imports	797	2.8	3.4	-7.3	4.3	3.6
GDP		1.6	-1.2	-3.0	1.5	1.7
Nominal GDP (DKKbn)	1,629	1,687	1,734	1,709	1,769	1,826
Unemployment rate, %		2.7	1.8	3.7	5.7	6.0
Unemployment level, '000 persons		77.6	50.0	104.1	157.9	167.5
Consumer prices, % y/y		1.9	3.4	1.6	2.0	1.5
Hourly earnings, % y/y		3.9	4.6	3.7	2.8	2.3
House prices, one-family, % y/y		4.5	-4.3	-15.0	-3.0	2.0
Current account (DKKbn)		12.0	39.8	42.5	45.0	47.0
- % of GDP		0.7	2.3	2.5	2.5	2.5
General govt. budget balance (DKKbn)		75.1	63.2	-30.0	-80.0	-60.0
- % of GDP		4.5	3.6	-1.8	-4.5	-3.2
Gross public debt, % of GDP		26.8	33.3	35.5	38.8	40.9

* Contribution to GDP growth (% points)

Housing market still a drag on the economy

The housing market downturn is one of the key reasons why the upswing in the Danish economy will be more subdued than in the other Nordic countries. In addition to the sharp increase in household savings that has already taken place, we expect an additional plunge in housing starts. The supply of homes for sale admittedly appears to be declining in Greater Copenhagen and Århus, but nationwide there are still many unsold homes on the market and this of course limits the need for housing starts. However, the lower construction activity will also contribute to limiting the supply of homes and thus help stabilise prices later in the forecast period. This stabilisation will probably occur first in Greater Copenhagen and Århus, where prices have declined the most, and only spread to the rest of the country later on.

Sharp focus on cost reductions

The plunge in economic activity has not yet led to a corresponding drop in employment and this has lifted companies' unit labour costs sharply. The higher costs can probably not be offset by increased production, as GDP at the end of our forecast period in 2011 will still be more than 1% below the level at end-2007. At the same time the significant weakening of the SEK and GBP, the currencies of two of Denmark's key export markets, has put Danish companies under increased competitive pressure. Considering that productivity trends in the last 12 months before the crisis were already quite weak, the companies are bound to focus sharply on reducing costs via additional layoffs. This will of course translate into a further increase in unemployment, which we expect to reach 135,000 by the end of this year and peak at around 175,000 at end-2010. The drastic deterioration of labour market conditions since last summer has already put quite a damper on wage growth in the construction and manufacturing sectors, and this trend is likely to persist and spread in step with the spike in unemployment. We therefore forecast a continued decline in inflation, excluding energy and food, although the commodity-based price decline has been replaced by fresh price growth.

Interest rate differential back at pre-crisis level

During the summer the Danish central bank was able to narrow the interest rate differential versus the ECB's repo rate further thanks to a persistent inflow of foreign currency and already swelling currency reserves. We still see scope for an additional, moderate narrowing of the interest rate differential to 25 bp by the end of the year reducing the lending rate to 1.25%. At the long end of the yield curve we expect the spread versus Germany to be largely unchanged despite a substantial increase in the issuance of government bonds over the coming years.

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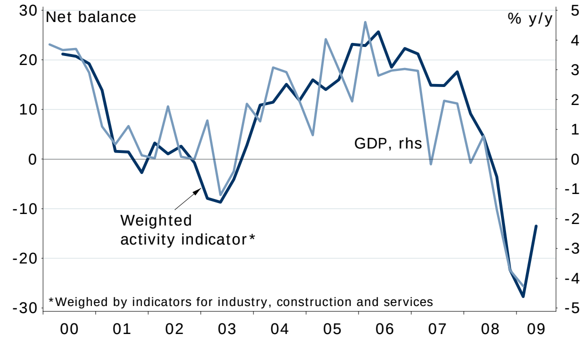
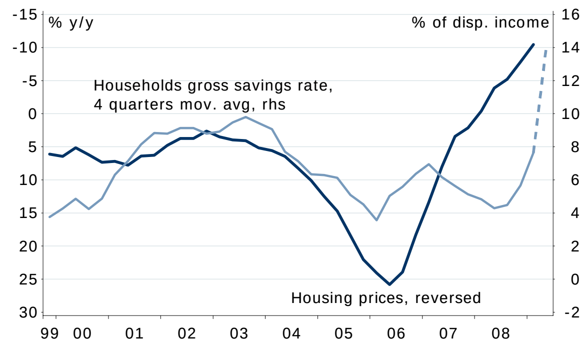
Business confidence reversal suggests stabilisation



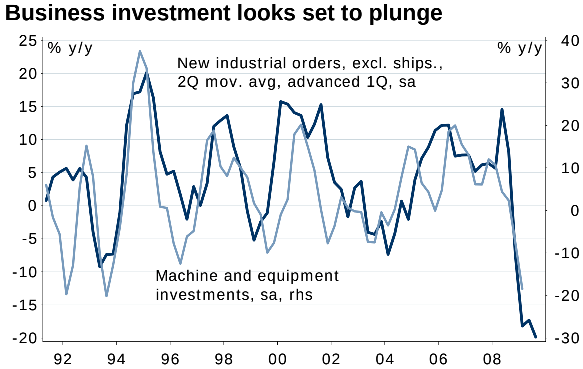
Source: Statistics Denmark and own calculations

Household savings at record level



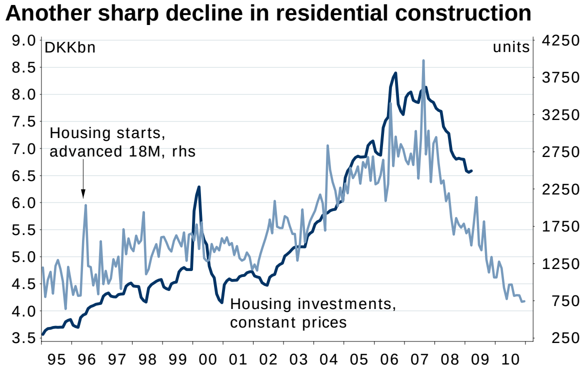
Source: Statistics Denmark and own calculations

Business investment looks set to plunge



Source: Statistics Denmark and own calculations

Another sharp decline in residential construction



Source: Statistics Denmark and own calculations

Recovery

- Strong growth in H2 2009
- The decline in employment is levelling out
- The Riksbank will revise up its forecasts …
- … and hike the repo rate in H1 2010

Expansionary climate facilitates growth

GDP seems to have stabilised in Q2 following the dramatic plunge at the turn of the year. The outlook for the remainder of the year is brighter. We expect the Swedish economy to recover sufficiently in the coming quarters for Q4 GDP to be higher than last year.

The onset of a recovery largely hinges on the success of the measures launched by central banks and governments. Not least measures taken on the financial markets, which have now improved markedly from their previously frozen state. This is of vital importance for the recovery. Moreover, the banking system in Sweden is in relatively good shape. Few signs have been detected of a more severe credit tightening than normally seen during an economic downturn. The low interest rates have therefore to a large extent benefited households and businesses.

The almost synchronised fiscal policy stimulus in many countries is also starting to take effect. In Sweden the expansionary fiscal policy corresponds to about 1.5% of GDP this year and is believed to rise to about 1% of GDP next year. Trends in share prices and the weak SEK also contributes to the expansionary economic climate in Sweden. The substantial stock market gains this year have bolstered household finances and eased companies' access to funding. Given the weak SEK, exporters will be well positioned once demand starts to pick up.

Brighter export outlook

The business cycle is also affected by fluctuations in inventories. Over the past six months there has been a need for destocking both among Swedish companies and globally, which has resulted in production falling more steeply than underlying demand. Now that inventories appear to have been adjusted to more desired levels, the stronger demand will be met through increased production rather than destocking.

Indicators for Swedish industry clearly show a much better balance between new orders and inventories, which suggests that production will soon be scaled up. Based on the very low production and export levels, we look for high growth figures during the coming quarters. However, industrial production has not yet started to pick up, and in our view production and exports are not likely to rise significantly until later in the autumn, notably in Q4.

The export outlook for the latter part of 2010 and for 2011 is more uncertain. Improved conditions mainly in Asia but also in the economies of key trading partners such as Norway and the Euro-area countries bode well for a pick-up in demand for Swedish exports. The remaining imbalances, mainly in the US household sector, make the global recovery more difficult and will in turn also put a damper on global demand. Combined with a stronger SEK, export growth is therefore forecast to subside somewhat later in the forecast period. Although some improvement is anticipated, export and production levels will remain low. Capacity utilisation will thus stay low for a long time yet. The manufacturing industry, like many other sectors, will therefore be forced to scale back investment next year, too. Investment activity is not likely to pick up until 2011.

Sweden: macroeconomic indicators (% annual change unless otherwise stated

	2006 (SEKbn)	2007	2008	2009E	2010E	2011E
Private consumption	1,373	3.0	-0.2	-0.7	2.5	2.0
Government consumption	762	0.4	1.5	0.9	1.1	0.7
Fixed investment	528	7.5	2.7	-16.0	-5.3	3.2
- industry	83	11.4	2.2	-25.0	-11.8	4.0
- residential investment	92	8.7	-5.4	-24.4	-7.4	3.6
Stockbuilding*	0	0.8	-0.6	-0.8	0.8	0.0
Exports	1,494	5.8	1.8	-13.5	6.3	4.0
Imports	1,257	9.4	3.0	-15.1	4.1	4.0
GDP		2.6	-0.2	-4.2	2.8	2.0
Nominal GDP (SEKbn)	2,901	3,064	3,157	3,128	3,219	3,319
Unemployment rate, %		6.1	6.2	8.6	10.2	9.9
Employment growth		2.6	1.2	-2.4	-2.0	0.3
Consumer prices, % y/y		2.2	3.4	-0.3	1.6	1.9
Underlying inflation (CPIF), % y/y		1.5	2.7	1.9	1.6	1.1
Hourly earnings, % y/y		3.1	4.4	3.1	2.3	2.5
Current account (SEKbn)		275.0	262.0	216.0	238.0	280.0
- % of GDP		9.0	8.3	6.9	7.4	8.4
Trade balance, % of GDP		4.6	4.0	3.9	4.8	5.4
General govt budget balance (SEKbn)		116	79	-69	-116	-86
- % of GDP		3.8	2.5	-2.2	-3.6	-2.6
Gross public debt, % of GDP		40.5	34.8	41.8	44.2	44.9

* Contribution to GDP growth (% points)

Spending revived despite weak labour market

Households were quick to save up more, first as a consequence of the Riksbank's rate hikes and later in response to the more uncertain outlook. Savings are therefore already comparatively high, and at the same time the stock market is recovering and the expansionary fiscal policy has ensured decent income growth. Low interest rates have provided significant relief and helped along the housing market stabilisation. So, household finances are generally in good shape, which explains why consumer spending has already accelerated and indicates sustained growth despite the weak labour market trends. The Riksbank is expected to start hiking its policy rate next year, which will curb consumption growth longer out.

Signs have emerged that the drop in employment is levelling out. Fewer layoffs are announced, the number of reported new vacancies is not dwindling as quickly and businesses' hiring plans are not quite as pessimistic as before. With a recovery in production, employment could pick up again in H2 2010 when unemployment is forecast to peak at above 10%. The development in the local governments is vital to the forecast for employment. We expect local governments to receive further government grants in the autumn budget, which should break the pattern of decline in employment in this sector. Despite these subsidies and other economic stimulus measures, the financial savings deficit will be limited to about 3% of GDP per annum. Not least receipts from capital gains taxation will increase during this period.

The Riksbank in hiking mode in H1 2010

Growing unemployment will prepare the ground for low wage growth in coming years. As productivity will recover, cost pressures will be moderate. Inflation will thus be low over the forecast horizon, although the weak SEK will drive inflation higher for a while yet. Despite low cost pressures we expect the Riksbank to take its foot off the gas pedal and sanction a string of rate hikes beginning in H1 2010. The reason is that the Riksbank will have to reassess the situation and lift its forecasts for GDP and capacity utilisation, which means that today's close-to-zero-rate is too low. If inflation remains low, as we forecast, the Riksbank can cease hiking rates at a level that is still expansionary.

The Riksbank will hike its policy rate somewhat earlier than the ECB, which indicates that the SEK will strengthen going forward. The expected recovery phase in Sweden as well as globally should also fuel risk appetite and facilitate a more favourable environment for the currency. We look for a EURSEK exchange rate of 9.40 on a 12-month outlook.

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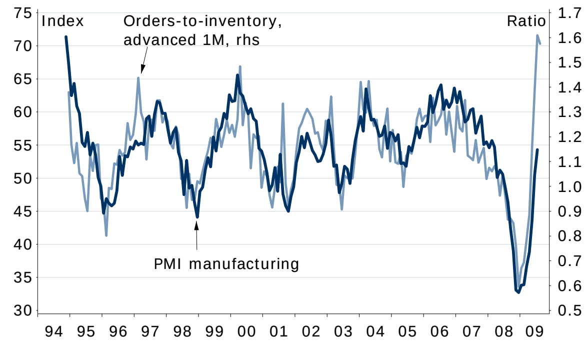
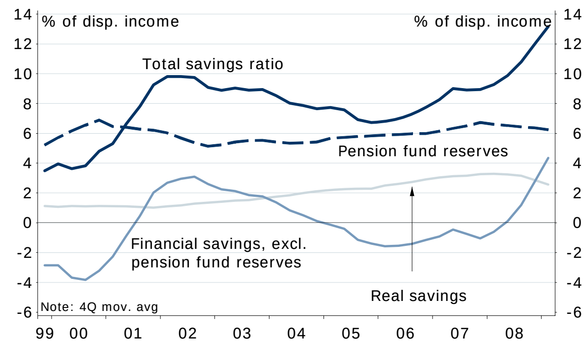
Indicators point to manufacturing sector recovery

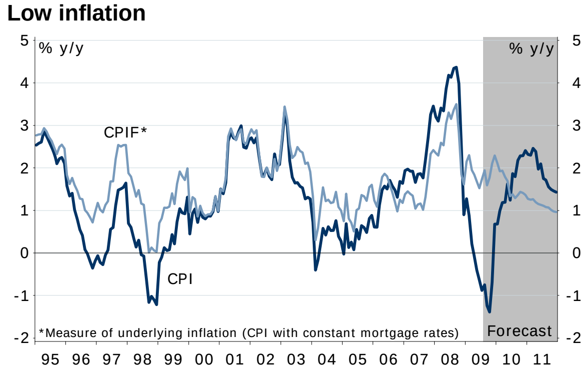


Households have increased savings



Unemployment to peak in 12 months

Low inflation



Labour market in better shape than expected

- Clear turnaround in the mainland economy
- Norges bank will hike slowly
- Quicker than other central banks and NOK will firm

We were a bit too pessimistic in May

Much indicates that the picture we painted of the Norwegian economy in the May issue of *Economic Outlook* was a bit too pessimistic. Since then international economic indicators have turned out to be better than feared and the financial markets have recovered sooner than expected. Last, but not least, Norwegian key data have been on the positive side – especially labour market figures. They are somewhat mixed, though: registered unemployment shows a sharper increase than LFS unemployment. But registered unemployment is rising less than feared.

Consumption stronger than expected

Next year economic growth in Norway will be driven by consumer spending. This year consumers will experience major income gains due to the sharp interest rate cuts. Accelerating wage growth, lower inflation and gradually more people in work will fuel income growth also next year. In H1 2009 much of the income growth was channelled into savings. However, the latest consumer spending statistics indicate that consumers now believe that they can also afford to spend more. We have had a positive view on consumption trends throughout the year, but as the labour market now looks set to reverse sooner than expected, we have revised up our 2010 forecast for consumer spending. In 2011 we expect consumption growth to slow somewhat again. By then interest rates will have increased quite sharply and income growth will therefore be much more moderate than in 2009 and 2010.

Investment activity will take longer to reverse

Mainland businesses' investments have contracted markedly over the past year and we expect this trend to continue for a while yet. The investment level was very high before it started falling last year, so many companies have ample idle production capacity. Uncertain prospects in many sectors and continued relatively restrictive credit standards suggest that investment activity may drop further in 2010. In 2011 we expect that capacity utilisation has increased enough for investment growth to resume. It is quite normal that business investment takes longer to reverse when business cycles change.

Oil investment has risen sharply in recent years and oil companies' plans for this year and 2010 suggest an additional increase. Given our relatively optimistic view on oil prices, we anticipate oil investment to increase somewhat also in 2011.

Both imports and exports to rise quite sharply

Norway's export-oriented mainland industry has been hit relatively hard by the international downturn. In most countries the decline in exports and imports has been larger than the decline in demand would suggest. The reason is unclear, but part of the explanation may be export financing problems. Going forward, both imports and exports are therefore likely to increase more than implied by domestic demand growth. Our forecasts therefore incorporate a fairly strong increase in traditional exports (excluding oil), although we expect the NOK to strengthen and wage growth to remain relatively high. Due to robust growth in goods imports, net exports will not contribute significantly to growth in the mainland economy.

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

	2006 (NOK bn)	2007	2008	2009E	2010E	2011E
Private consumption	882	6.0	1.4	-0.3	3.5	2.0
Government consumption	413	3.4	3.8	5.5	3.5	3.5
Fixed investment	424	8.4	3.9	-6.6	0.6	2.5
- gross investment, mainland	308	9.3	2.4	-9.5	-1.4	2.8
- gross investment, oil	99	2.9	5.6	9.0	6.0	2.0
Stockbuilding*	51	-0.6	0.7	-0.3	0.0	0.0
Exports	1,002	2.5	1.4	-5.9	2.0	1.7
- crude oil and natural gas	498	-2.6	-1.5	-3.0	1.0	1.0
- other goods	271	8.7	4.8	-11.0	3.5	3.0
Imports	613	7.5	4.4	-9.6	3.0	2.5
GDP	2,160	3.1	2.1	-0.5	2.3	2.1
GDP, mainland	1,581	6.1	2.6	-0.8	2.7	2.5
Unemployment rate, %		2.5	2.6	3.3	4.0	3.8
Consumer prices, % y/y		0.8	3.8	2.3	1.9	2.0
Core inflation, % y/y		1.4	2.6	2.6	1.8	2.0
Annual wages (incl. pension costs), % y/y		5.6	6.0	3.8	4.3	4.5
Current account (NOKbn)		362.3	496.4	377.7	462.7	506.8
- % of GDP		15.9	17.7	15.2	17.2	17.7
Trade balance, % of GDP		16.0	19.3	15.2	17.0	17.6
General govt budget balance (NOKbn)		402.4	478.3	360.0	420.0	450.0
- % of GDP		17.7	18.8	14.5	15.6	15.7

* Contribution to GDP growth (% points)

Clear turnaround in the mainland economy

Private demand is expected to rise sharply in the years ahead. Next year consumption will be the growth engine, while investment activity will help drive growth in 2011 when private consumption growth starts to wane. With public demand expected to grow quite sharply, albeit not as much as this year, and continued growth in oil investment, the mainland economy will show good momentum in the coming two to three years. Unemployment is projected to rise somewhat in H2 2009 but will probably peak at just over 4% much sooner than we forecast in May. In 2011 unemployment could decline slightly again.

Moderate wage growth; below-target inflation

With an unemployment rate of about 4% and decent growth in the mainland economy, we expect wage growth to accelerate somewhat from this year's low level – but to remain well below the levels in 2007 and 2008. Moderate wage growth will help curb domestic inflation. Imported price growth will also ease, initially because the effect of the past NOK weakening will fade and longer out because we expect the NOK to firm. Core inflation will run at just under 2% over most of the forecast horizon.

Tentative rate hikes in the pipeline

Despite lower inflation, economic expansion not far from what Norges Bank considers the potential growth rate and initially somewhat higher unemployment, we expect the bank to embark on rate hikes in the autumn. The bank would characterise hikes from today's low level as a scale-back of stimulus rather than a tightening move. First and foremost due to the more upbeat view on the labour market, we believe that Norges Bank will hike interest rates sooner and more swiftly than suggested in its June monetary policy report.

Norges Bank will hike its policy rate sooner and more aggressively than most other central banks. Coupled with higher oil prices and a generally solid economy, this indicates that the NOK will keep strengthening. However, during periods of market unrest and reduced risk appetite the NOK could weaken periodically.

Norwegian long government yields have backed up sharply versus Euro-area yields during 2009. Near term the 10-year government yield spread versus Euro-area equivalents may seem to have widened too much. But a rapid pace of hikes in short rates in Norway indicates that the spread will remain relatively wide.

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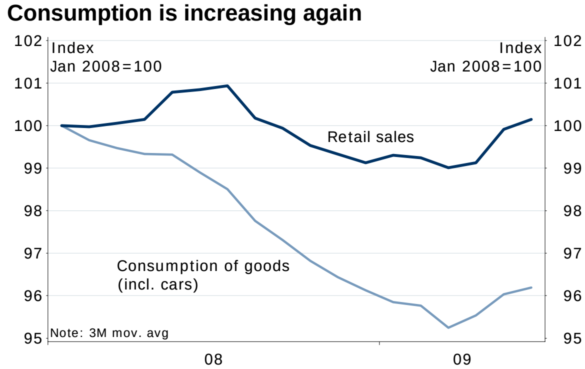
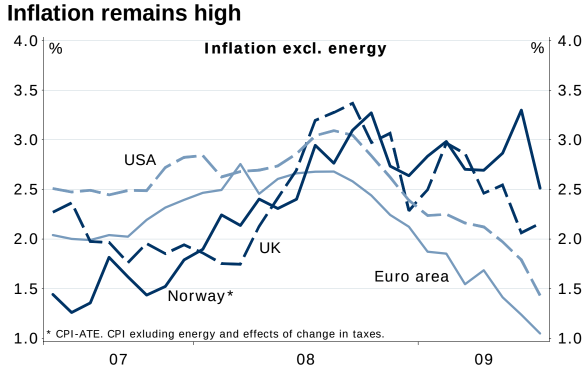
The labour market not as bad as expected

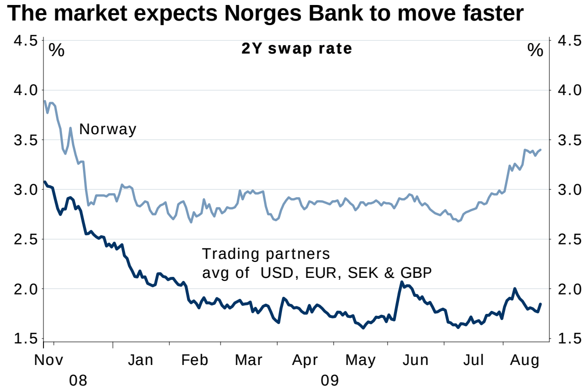
Consumption is increasing again



Inflation remains high



The market expects Norges Bank to move faster



Economy jumps to reasonable growth

- GDP rises from the bottom in the autumn
- Economic growth remains reasonable in 2010
- Employment will not rebound until after 12 months
- Inflation positive again next winter

The Finnish economy contracted sharply in the winter, especially due to the heavy decline in exports and inventories. With the advent of spring, there were increasing signs of the economy stabilising, and global trade started to pick up. In H2 2009 we are set to witness fairly strong turn for the better because the Finnish economy is very sensitive to global fluctuations. Last winter showed it quite clearly. Nevertheless, the brisk rise will not last very long, as final demand will not recover quickly. When exports have, in the aftermath of the collapse, adjusted to a level corresponding to final demand, economic growth will continue at a more moderate rate.

Economic growth will be reasonable in the next few years, although after the crises GDP will remain below the potential level. A rebound in the economy may lead to cancellation of lay-offs, but a turn for the better in employment is not to be expected until well into 2010. Overall, the situation is not as bad as has been feared, but it will take a long time before the recovery will have an impact on a broad front. In many industries things will get worse before they get better, and there are still plenty of risks. But the outlook is becoming much brighter than could be foreseen by looking at the bleak growth figures of H1.

Exports swing upwards

In H1 the value of Finnish exports of goods contracted by over one third year-on-year. Anyway, the dive in exports halted in April-June and a notable rebound is to be expected in H2. German statistics and preliminary data, among other things, support this. Finnish exports fluctuate at the same pace as the Euro area, but the fluctuations are more severe and the recent crash is not an exception. The good news is that the same also applies when exports start to pick up. Finnish exports will rise clearly from the deepest bottom in the autumn, although in annual comparison we will not see positive growth until late 2009. After the brisk rebound, growth will become slower and it will take years to reach the level prevailing before the crash.

Consumption is also improving

A typical view is that consumption follows the fluctuations in exports with a delay in line with the movements of the labour market. The current recession deviates clearly from this scenario. As a result of high inflation and interest rates, consumption started to weaken already before exports did. In the autumn of 2008, the dreadful news about the economy made households postpone their acquisitions and consumption contracted markedly. The situation began to mend in the spring when consumers started regaining their confidence. The drop in retail sales has stopped and there are signs of a turn for the better.

When confidence dropped, the savings ratio went notably up, which can partly be seen as a welcome development. The savings ratio is likely to decrease slightly during the remainder of 2009 and in 2010. Still, growth in disposable income is slackening, so consumption growth will remain relatively small next year as well.

Investment started to decline sharply last winter, and the outlook is also weak in 2010. Under the surface, though, the development is rather mixed. The housing market has

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

	2006 (EURbn)	2007	2008	2009E	2010E	2011E
Private consumption	86	3.3	1.9	-1.0	1.2	1.7
Government consumption	37	0.8	2.0	1.5	0.5	0.0
Fixed investment	32	8.7	0.3	-11.7	-3.6	2.3
Stockbuilding*	4	-0.3	-0.9	-0.3	0.5	-0.2
Exports	75	8.1	7.3	-17.1	7.0	5.0
Imports	67	6.5	7.0	-17.8	4.2	3.6
GDP		4.2	1.0	-4.5	2.5	2.0
Nominal GDP (EURbn)	167.0	179.7	184.7	181.1	184.5	190.6
Unemployment rate, %		6.9	6.4	8.6	9.4	9.2
Industrial production, % y/y		8.6	0.1	-12.0	5.0	3.5
Consumer prices, % y/y		2.5	4.1	0.0	1.2	1.7
Hourly wages, % y/y		3.3	5.6	4.3	3.0	2.5
Current account (EURbn)		7.5	4.4	1.9	3.6	5.0
- % of GDP		4.2	2.4	1.0	2.0	2.6
Trade balance (EURbn)		8.7	6.0	4.1	4.9	5.9
- % of GDP		4.8	3.2	2.3	2.7	3.1
General govt budget balance (EURbn)		9.4	8.1	-2.0	-4.0	-3.8
- % of GDP		5.2	4.4	-1.1	-2.2	-2.0
Gross public debt (EURbn)		63.2	63.1	72.4	83.0	92.0
- % of GDP		35.2	34.1	40.0	45.0	48.0

* Contribution to GDP growth (% points)

picked up recently and the number of unsold homes does not exceed the normal level. Hence residential construction will start to increase in 2010. Business and office construction continues to decline. The public sector support boosts infrastructure and rental housing construction. The rebound in manufacturing activity provides some support to machinery and equipment investment, but expansion investment will be in short supply in the coming years. On the whole, investment will decrease also in 2010.

Employment on a long decline

Unemployment has risen to the highest level since 2004, and employment will hardly start to improve before H2 2010. The labour force has not contracted very much so far. However, it is likely that the contraction of the labour force will accelerate in the next 12 months, as e.g. studies are continued. This will slow the rise in unemployment to some extent.

The recession has clearly reduced the wage drift, so the weak labour market has already had an impact on wage development. New wage negotiations will start in the autumn. In the previous round the agreements were concluded at the peak of an uptrend and the increases were excessive. This time wage increases will remain modest.

In the summer inflation dropped into negative territory measured by the domestic CPI, and it will not become positive until 2010. The rise in prices has been curbed by the lower price of energy as well as households' decreased interest expenses. During 2010 the lower energy prices and interest rates will begin to raise prices and therefore inflation will become positive again. Still, the cut of VAT on food will keep food prices on a decline next year, and the rise in service prices will also decelerate when the increase in wages weakens. Overall, inflation will be moderate in the next few years.

Plenty of time to fine-tune fiscal policy

The government's fiscal policy package for the current year was 1.7% of GDP. Income tax cuts took place already at beginning of the year, but spending measures will not have an impact until next winter. No significant stimulus measures in view of the whole economy are planned for next year. The focus is already on how public finances can be balanced when the economy recovers. It will undoubtedly require strict cost control as well as tighter taxation. In our view the need to hike taxes is not as big as has been feared. In the next few years there will also be plenty of time to consider how policy could be tightened sensibly. Anyway, at this stage it is not sensible policy to scare people with huge tax hikes.

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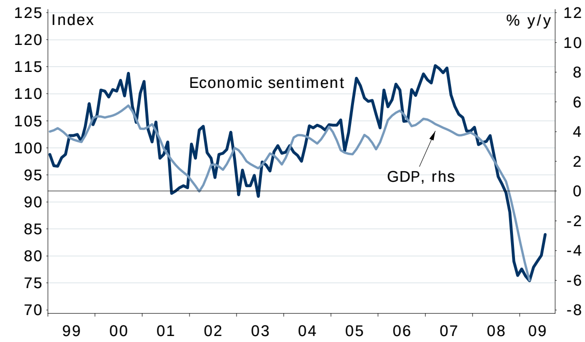
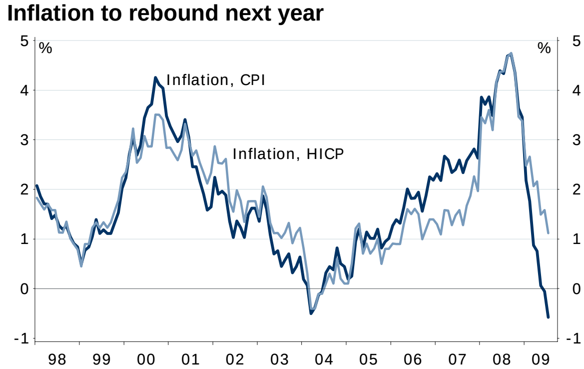
GDP has bottomed out



Finnish exports fluctuate relatively sharply

Inflation to rebound next year



Unemployment peaks late next year

Euro membership not a possible rescue plan short term

Following the collapse of the financial sector, domestic demand has plummeted even more than elsewhere. Households are now also strained by sky-rocketing unemployment and falling real wages, on top of the direct effect from the collapse of the ISK in the form of steeply rising import prices and larger repayments and outstanding balances on loans denominated in foreign currency. Also investments are suffering from the general pessimism and the still dysfunctional financial system.

Looking forward, one milestone on the way to normalisation of the economy would be completion of the restructuring of the capsized banks, a process that weighs heavily on public finances. Tourism is set to gain from the weaker ISK, but the main export sectors fishing and aluminium smelting are despite some relief still struggling with lower global prices than in the pre-crisis heyday.

The severe situation has made the country turn to the EU, and a membership application was sent in mid-July. Formally, Iceland could fairly easily become a member as much of the legislation is already in place thanks to the membership of the European Economic Area. One hurdle is Iceland's reluctance to join the EU's common fishing policy and let others fish in Icelandic territory. Another is British and Dutch depositors' losses related to the financial sector meltdown. EU membership will not happen before 2011 at the very earliest.

The fragile ISK has been stabilised through intervention and very strict currency restrictions. Without these restrictions, the ISK would most likely weaken further also on the domestic FX market. Though both the national authorities and the IMF intend to relax these restrictions, only little progress has been made yet in this manner. The plan is to let restrictions on capital *inflow* go during the autumn. Only later will capital *outflow* limitations be lifted. Once EU membership is in place, adoption of the euro could be on the table. But that seems very far away, not least because both public deficits and debt will by far exceed the Maastricht criteria in the years to come.

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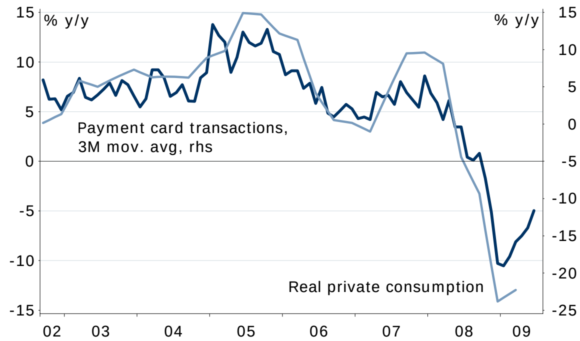
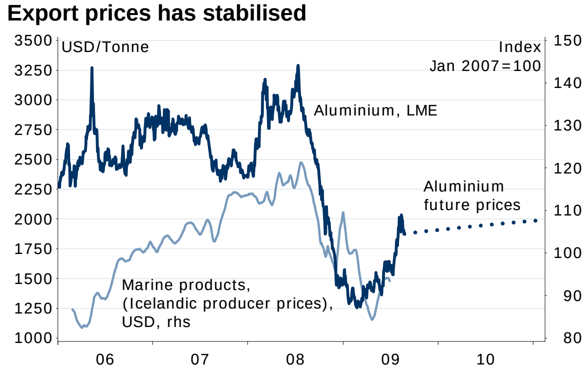
Private consumption remains depressed



Households strained

Export prices has stabilised



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

	2006 (ISKbn)	2007	2008	2009E	2010E	2011E
Private consumption	682.3	5.6	-7.7	-18.7	-5.3	4.1
Government consumption	285.4	4.2	2.8	-1.8	-6.3	-6.1
Fixed investment	397.6	-12.8	-21.8	-57.5	-5.3	7.4
Stockbuilding*	13.5	-0.6	-0.4	0.6	0.0	0.0
Exports	374.1	17.7	7.1	-0.1	2.3	5.8
Imports	584.6	-1.0	-18.0	-27.3	-3.5	5.1
GDP		5.5	0.3	-10.1	-1.7	2.4
Nominal GDP (ISKbn)	1,168	1,339	1,597	1,437	1,564	1,775
Unemployment rate, %		1.0	1.6	9.1	10.3	9.9
Consumer prices, % y/y		5.0	12.4	12.0	6.0	2.0
Current account - % of GDP		-20.6	-43.1	-8.0	3.0	5.0
General govt. budget balance, % of GDP		5.4	-14.3	-10.0	-8.0	-5.0

* Contribution to GDP growth (% points)

The recession is over

- Prospect of strong growth near term
- But weak growth in 2010 and 2011
- High inflation not an immediate threat
- The first rate hike is a long way off

As predicted in our May issue of *Economic Outlook*, the US economy seems to have emerged from the recession around mid-2009. The question is how strong the ongoing upswing will be and how long it will last? Production looks set to make a strong comeback from a very low level towards the end of this year and we expect positive growth in 2010 and 2011. However, due to weak household fundamentals, which are still strained by high indebtedness and weak income growth, the upswing is likely to lose momentum after the anticipated rather strong end to 2009 in terms of growth. A permanent drop in unemployment is thus not expected until end-2010 at the earliest and most likely not until 2011 – for the same reason the first rate hike from the Fed is a long way off.

In H2 2009 we expect average GDP growth of 3% (annual rate) after a decline of 3½% during the first six months of the year. The improvement is mainly expected to be driven by three factors. Firstly, slower destocking of business inventories than in previous quarters is expected to boost growth short term. Secondly, fiscal policy easing, including the government's successful Cash for Clunkers car allowance rebate system, will make a positive growth contribution and so will the expected moderate pick-up in residential construction from an extremely low level. The expectation of a sharp increase in production in the coming months is supported by a string of manufacturing activity indicators, which for example show an increase in new orders.

However, the upswing is expected to lose steam in 2010 when the temporary effects from stock investment and the Cash for Clunkers programme fade. There are still no signs of a sustained upswing in final demand, and in 2010 and 2011 demand is expected to rise only moderately. The reason is households' need to scale up savings; at the same time wage trends will be very weak because of the labour market situation. More specifically, we expect the household savings ratio to rise from 4½% at present to the historical average of 8% by end-2010 driven by the erosion of households' wealth and the uptick in unemployment. Moreover, the high level of idle capacity in businesses and in the housing market will curb private investment. Lastly, a continued tightening of US banks' credit standards may hamper the increase in demand.

The driving forces behind the upswing until end-2007 – consumer spending, the housing market and easy access to credit – will in other words remain under pressure although the recession has now ended. GDP growth is consequently expected to be lower than the estimated annual potential growth rate of about 2½% throughout most of 2010 and 2011.

The fragile household fundamentals still imply a risk of the economy sliding back into recession in 2010. The probability of such a scenario will increase if high unemployment leads to a prolonged decline in nominal wages. Conversely, if households show a weaker propensity to save, for example as a result of an unexpectedly positive trend in house prices and employment, growth could be higher than forecast. Exports may also surprise on the upside on the back of continued USD weakness. The USD is not expected to strengthen versus the EUR until the latter part of the forecast period.

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

	2006 (USDbn)	2007	2008	2009E	2010E	2011E
Private consumption	9,322.7	2.7	-0.2	-0.9	0.9	1.0
Government consumption and investment	2,518.4	1.7	3.1	2.9	5.2	1.1
Private fixed investment	2,267.2	-2.1	-5.1	-19.6	-3.2	4.7
- residential investment	761.9	-18.5	-22.9	-23.2	4.8	11.1
- equipment and software	1,071.7	2.6	-2.6	-19.2	-3.7	3.0
- non-residential structures	433.7	14.9	10.3	-17.8	-9.1	2.5
Stockbuilding*	60.0	-0.3	-0.3	-0.5	0.6	0.1
Exports	1,471.1	8.7	5.4	-13.7	2.1	7.8
Imports	2,240.4	2.0	-3.2	-16.2	3.0	4.8
GDP		2.1	0.4	-2.6	1.7	1.7
Nominal GDP (USDbn)	13,398.9	14,077.7	14,441.4	14,260.3	14,721.8	15,203.8
Unemployment rate, %		4.6	5.8	9.2	10.2	10.0
Industrial production, % y/y		1.5	-2.2	-11.0	2.0	3.0
Consumer prices, % y/y		2.9	3.8	-0.3	1.6	1.0
Consumer prices ex. energy and food, % y/y		2.3	2.3	1.6	0.6	0.2
Hourly earnings, % y/y		4.0	3.8	2.8	2.0	1.8
Current account (USDbn)		-726.6	-706.1	-399.3	-368.0	-228.1
- % of GDP		-5.2	-4.9	-2.8	-2.5	-1.5
Federal budget balance (USDbn)		-161.5	-454.8	-1,700.0	-1,300.0	-1,000.0
- % of GDP		-1.1	-3.1	-11.9	-8.8	-6.6
Gross public debt, % of GDP		65.7	74.3	90.2	99.0	105.6

* Contribution to GDP growth (% points)

Unemployment to peak at above 10% in 2010

The decline in employment has slowed sharply since early 2009 when more than half a million jobs were lost per month on average. The pace is likely to slow further in the coming months, but positive employment growth is not expected until H1 2010. Owing to the demographics of the labour force, job creation must reach about 100,000 per month to stabilise unemployment, which is estimated to peak at around 10¼% next year.

Given the continued weak labour market outlook, a new fiscal policy growth package is likely to be launched in 2010. However, a federal measure of this kind must be expected to some extent to be counterbalanced by tightening in the individual states, which are currently struggling with large budget deficits.

High inflation not an immediate threat

Despite the very expansionary fiscal and monetary policy there is no danger of high inflation the next few years because of the ample idle capacity in the labour market and in businesses. The year-on-year rate of increase in overall consumer prices will admittedly rise from currently -2% to about +2% in early 2010, but this is due to the fallout of the favourable base effects of last year's high commodity prices. Core inflation, which excludes food and energy, will on the other hand drop sharply over the forecast horizon when ample capacity will make it difficult to raise wages and prices. More specifically, core inflation is projected to approximate zero at end-2010 without any appreciable changes in 2011.

No rate hikes in the near future

Given the unemployment and underlying inflation forecasts we consider it most likely that the Fed will leave its policy rate at the current level of 0-0.25% throughout 2010. The central bank will probably not embark on a normalisation of interest rates until clear signs emerge that unemployment has peaked. Such a pattern would be consistent with the bank's previous behaviour. But once the normalisation starts, the bank will probably hike its policy rate at a relatively swift pace. However, this is not expected to happen until 2011.

In August the Fed announced the extension of some of its extraordinary loan programmes until end-June next year. This in itself suggests that the first rate hike will not be sanctioned until H2 2010 at the earliest. Prior to the first rate hike we expect the Fed to start absorbing some of the extra liquidity that it has pumped out in order to stimulate the economy. But given the prospect of a weak economic upswing and downward pressure on inflation, the withdrawal of liquidity will most likely be gradual.

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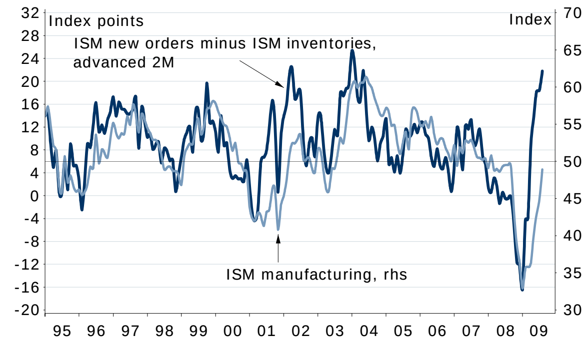
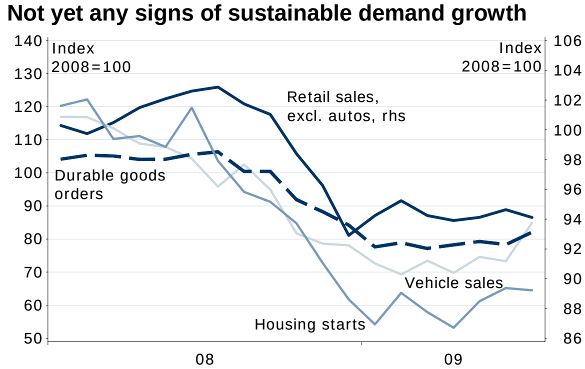
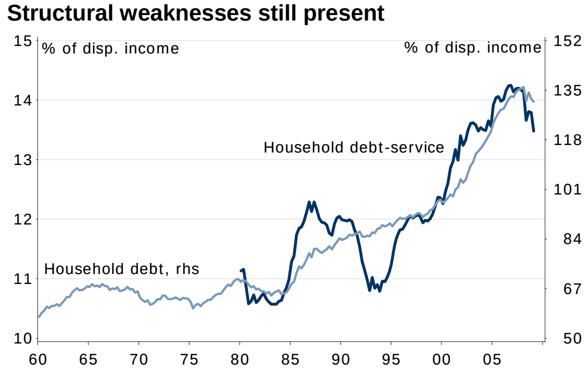
Promising short-term outlook



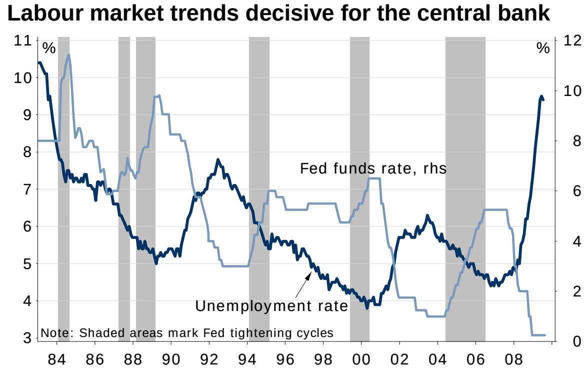
Not yet any signs of sustainable demand growth



Structural weaknesses still present



Labour market trends decisive for the central bank



Bounce from the abyss followed by gradual ascent

- GDP has started to rebound
- Peak in unemployment still far off
- Headline inflation to bounce, core well contained
- ECB in no hurry to tighten

The Euro-area economy bottomed out in the summer after GDP had been contracting for five consecutive quarters. The fall in activity almost came to an end in Q2 after the huge drop during the winter. This drop was largely caused by a sharp fall in world trade and massive inventory reductions. Conversely, we expect a brisk rebound in the Euro area during the fall as global trade and manufacturing activity catch up to final demand, and the easing of monetary and fiscal policy begin to stimulate growth.

After the initial bounce in activity, the pace of the recovery will be more moderate as it takes much longer for especially investments to recover. Nevertheless, a shift from a downward free fall to even a moderate recovery trend is a huge change from the depressive sentiment earlier this year. Many problems and risks remain, such as the lingering effects of the credit crisis and a further rise in unemployment, but the risk of a protracted deep recession threatening the whole economic structure has faded.

Exports remain key driver

The current recession has again proved that the Euro area is very export sensitive. The huge drop in world trade, which followed in the wake of Lehman Brothers' collapse, had a severe impact on the most export dependent Euro-area countries such as Germany. This led to a sharp fall in economic activity, but in the near future the effect will be opposite, with Germany leading the rest of the Euro-area out of recession. The rebound is already well under way in many Asian countries and there are clear signs that a similar bounce is under way in the Euro area. Thus, business surveys indicate renewed expansion during the fall as sharply reduced inventories prompt companies to ramp up production to fill new orders.

The outlook for exports next year is more nuanced, particularly with respect to demand from the US and the UK, where prospects for domestic demand are fairly modest. On the other hand, the trade-weighted exchange rate of the Euro area is likely to remain at fairly benign levels, as an expected strengthening of the EUR against the USD next spring will be countered by a strengthening of other currencies. The competitiveness of Euro-area exports may even get a boost later next year, as we expect the USD and other major currencies to strengthen against the EUR over the remaining forecast horizon.

Final demand recovering slowly

Prospects for consumption and especially investment are much more moderate than for exports. There are signs that household spending has started to recover, with the surge in German car sales resulting from a generous scrappage subsidy as a prominent example. Last winter households were discouraged by the overall decline in economic sentiment, and the household savings ratio rose to 15.6% of disposable income, a record high since the introduction of the euro. As there are no obvious debt problems in the Euro area as a whole, consumption will most likely be supported by a slight decline in household savings as sentiment improves. However, the continuing decline in employment and slower growth in real wages will keep purchasing power in check, hampering more robust growth in private consumption. Investments have suffered heavily from the global downturn.

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

	2006 (EURbn)	2007	2008	2009E	2010E	2011E
Private consumption	4,871	1.6	0.3	-0.6	1.0	1.2
Government consumption	1,732	2.2	2.0	2.5	2.3	1.5
Fixed investment	1,832	4.7	-0.3	-10.4	-1.0	2.7
Stockbuilding*	17	0.0	0.1	-0.7	0.7	0.0
Exports	3,469	5.9	1.0	-12.2	6.6	4.9
Imports	3,368	5.3	0.9	-11.0	5.5	4.8
Net exports*	101	0.3	0.0	-0.8	0.5	0.1
GDP		2.7	0.6	-3.5	2.1	1.6
Nominal GDP (EURbn)	8,553	8,992	9,274	9,084	9,408	9,701
Unemployment rate, %		7.4	7.6	9.5	10.6	10.6
Industrial production, % y/y		3.7	-1.8	-12.0	4.0	1.5
Consumer prices, % y/y (HICP)		2.1	3.3	0.3	1.3	1.6
- core inflation**		2.0	2.5	1.3	0.9	1.5
Hourly earnings, % y/y		2.2	3.5	2.5	1.5	1.5
Current account (EURbn)		11	-93	-90	-74	-70
- % of GDP		0.1	-1.0	-0.9	-0.8	-0.7
Trade balance (EURbn)		50	-39	-30	-20	-24
- % of GDP		0.6	-0.4	-0.3	-0.2	-0.2
General govt budget balance, % of GDP		-0.6	-1.9	-5.0	-5.5	-5.0
Gross public debt, % of GDP		66.0	69.3	75.7	78.6	81.3

* Contribution to GDP growth (% points)

There are some signs of stabilisation in the construction sector, notably in Germany, and some machinery investments may pick up with manufacturing activity. Yet, it will take a long time before there is a need to expand capacity or build new office premises. Also financing of new projects will still be on uncertain ground as the ECB's bank lending survey still reports a tightening of credit standards. Thus, investment will be the last train to come out of the tunnel.

Weak labour market dents core inflation

Unemployment has increased sharply this year and we do not foresee a stabilisation until late next year. Naturally, this will pull wage growth down both next year and in 2011. Core inflation pressures will therefore remain largely absent in the next couple of years, and core inflation is likely to gradually drift to somewhat below 1%, the lowest level in the euro era.

Headline inflation will live its own life, though. The current negative rates are mainly the result of the drop in energy and food prices last fall. As these base effects subside, headline inflation will move quite quickly above 1%. If oil prices surprise on the upside there is even a risk that headline inflation could move closer to 2% already this winter. This would surely hurt purchasing power and increase the downside risk to growth. However, the ECB has usually ignored these short-term swings in headline inflation and focused more on medium-term prospects.

Substantial policy easing still in the pipeline

Both monetary and fiscal policies were eased substantially in response to the crisis. In addition to the specific growth packages adopted by the various Euro- area member countries, transfers and lower taxes will also support the economy. In fact, the largest impact of the growth packages is only likely to be felt in the course of the next 12 months. Budgets for 2010 will most likely still be expansive or at least neutral but after that fiscal policy is likely to be focused on budget consolidation.

We expect the ECB to maintain the current easy monetary policy stance throughout the rest of this year, where actual money market rates trade well below the main refi rate of 1.00%. Next spring, the ECB will most likely initiate a normalisation of monetary policy, beginning with a withdrawal of the extraordinary liquidity provisions to the Euro-area banking sector, and this should lift money market rates above the refi rate. When that process is completed next summer, we expect the ECB to undertake its first rate hike of 25 bp in September next year and continue hiking until rates reach 2%, the low for interest rates in the last cycle.

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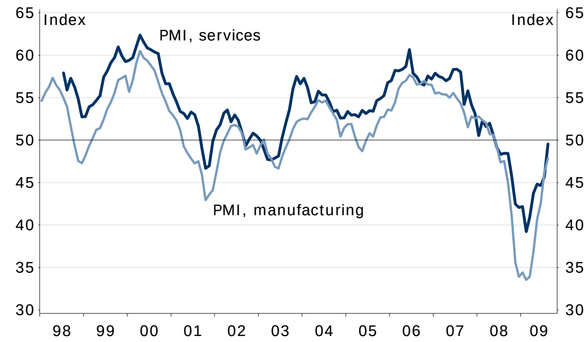
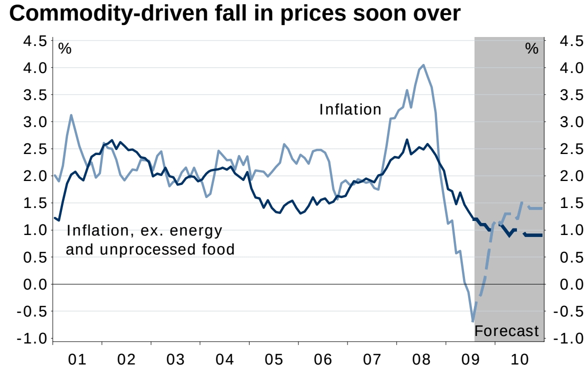
Activity indicators are recovering fast

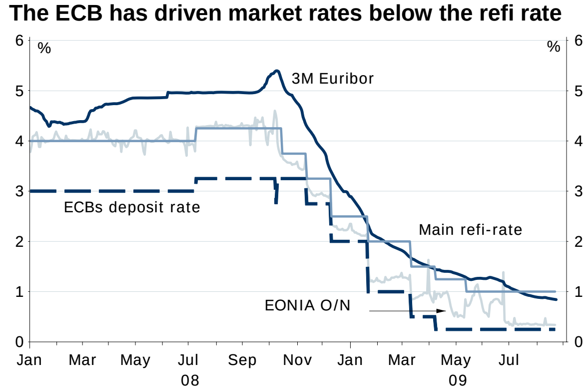


More moderate growth in sight after brisk rebound

Commodity-driven fall in prices soon over



The ECB has driven market rates below the refi rate



Temporary strong rally

The temperature of the economy dropped to far below freezing point in late 2008 and early 2009. Exports and investment plummeted and consumers cut back on spending. But clear signs of improvement have now emerged. Since March industrial production has risen quite significantly – mainly due to noticeable progress in exports and public investment activity. Higher activity in China coupled with tax discounts on car purchases in the US and the Euro area has boosted exports of machinery and cars. In addition, the generally more favourable trend in global inventories has a positive spill-over effect on exports. Against this background, we expect impressive economic growth rates in the remaining quarters of 2009.

If the global economy continues to improve, the potential for brisk export growth will remain in the next few years. However, there is a major risk that a scale-back of global government stimulus and the end of the stockpiling phase will hamper the recovery. Domestic demand is also in great danger of freezing up again. A cocktail of rising unemployment and declining nominal wage growth is putting a damper on consumption. Still, we look for positive, albeit weak, private consumption growth lifted by stimulus injections in the shape of increased public spending aimed at consumers. A survey conducted by the central bank in June clearly showed that investment activity does not look set to improve. The businesses interviewed reported major cutbacks in planned investments relative to a similar survey in March. This kind of survey was first conducted in 1984 and it was the first time that investment plans were not revised up in June. Overall, the growth potential is very weak in 2010 and 2011 and there is a major risk of new setbacks.

The Japanese central bank (BoJ) has cut its policy rate to 0.1% and used extraordinary measures, such as buying short-dated corporate and government bonds, to bring the economy back on the right track. Based on our forecasts for inflation and growth, we expect an unchanged interest rate level throughout the forecast period.

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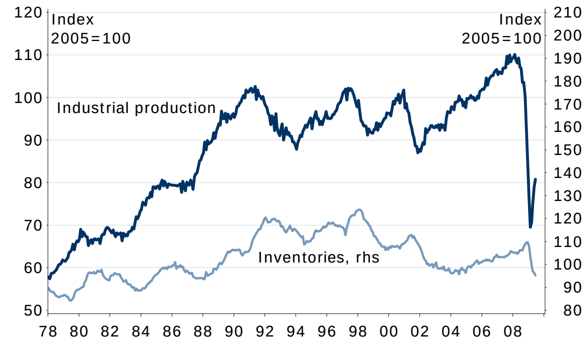
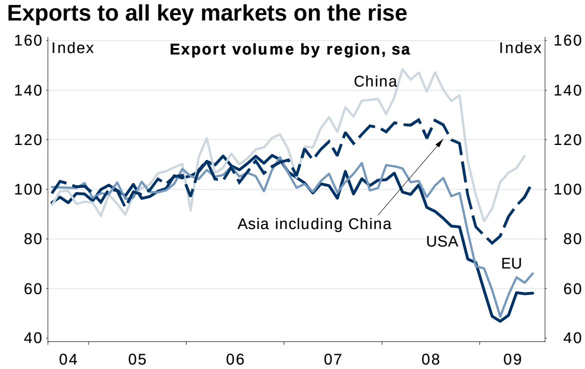
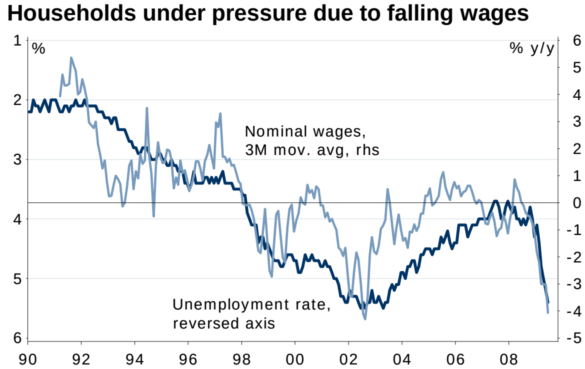
Industrial production set to rise again



Exports to all key markets on the rise



Households under pressure due to falling wages



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

	2006 (JPYtrn)	2007	2008	2009E	2010E	2011E
Private consumption	289.6	0.7	0.6	-1.3	0.3	1.1
Government consumption	90.7	1.9	0.8	1.9	3.9	2.8
Gross fixed capital formation	118.6	1.0	-5.1	-13.4	-4.4	0.9
Stockbuilding*	2.3	0.3	-0.2	0.3	0.1	0.1
Exports	81.6	8.4	1.9	-28.8	8.1	4.0
Imports	75.3	1.5	0.9	-15.3	1.5	4.4
GDP	-	2.4	-0.7	-5.8	1.3	1.2
Nominal GDP (JPYtrn)	501.1	507.0	506.6	484.3	488.2	496.5
Unemployment rate, %		3.9	4.1	5.5	5.8	5.6
Consumer prices, % y/y		0.1	1.5	-1.5	-0.5	0.5
Current account, % of GDP		4.8	3.2	2.0	2.0	2.0
General government budget balance, % of GDP		-2.4	-2.7	-7.8	-8.4	-6.0

* Contribution to GDP growth (% points)

Exports to drive weak upswing

After four quarters with a bad hangover the UK economy now seems to be on the road to recovery. British purchasing managers' view on economic trends (the PMI), which is usually a good indicator of GDP growth, has improved sharply and now hints at positive growth rates in the coming quarters. Moreover, the housing market is starting to show signs of stabilising and coupled with rising stock markets, the debt-ridden households will now get a bit of much-needed relief. However, several factors erode the potential for a spending spree: unemployment is skyrocketing, wage growth is stalling, petrol prices are rising and on 1 January 2010 the temporary VAT reduction from 17.5% to 15% will expire. And given the substantial surplus production capacity, hopes should not be pinned on investment activity, so the UK will have to rely on exports acting as a growth engine. Luckily, there is every reason to expect noticeably progress on the back of an improved global economy and a relatively weak GBP. Hence, exports will probably be the main driver of what overall looks set to be a weak upswing.

The UK central bank has acted very forcefully in its bid to save the economy from deflation. The policy rate has been slashed to 0.5% and the bank has launched a GBP 175bn programme for purchasing government and corporate bonds. The BoE's August inflation report does not suggest any rate hikes in the near future – inflation expectations are simply too low. We do not think that rate hikes will feature on the agenda until some time in 2011 – but at that point the hikes are likely to be implemented at a rapid pace.

Our model indicates that the GBP is still fundamentally undervalued. As the economy gradually shifts into a higher gear, the GBP will therefore firm versus the EUR. However, near term the GBP could come under renewed pressure if attention again starts to focus on the high public debt or if the economy does not recover as much as expected. On a 3- to 6-month outlook, a USD softening against the EUR will also contribute to weakening the GBP versus the EUR.

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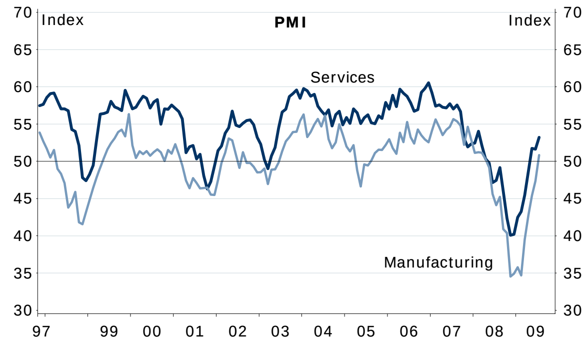
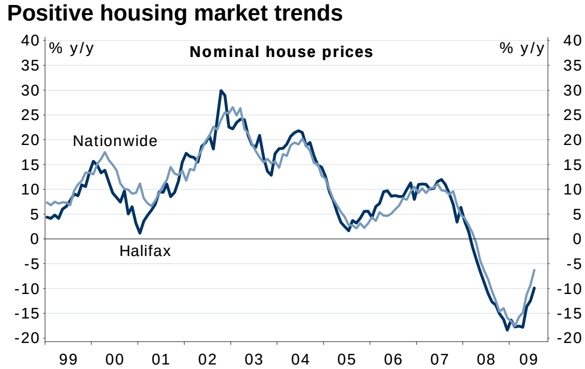
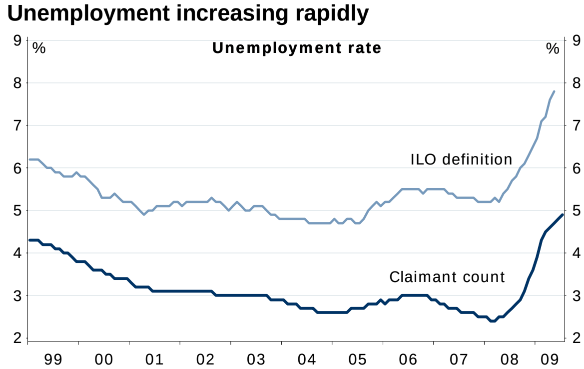
PMI improving sharply



Positive housing market trends



Unemployment increasing rapidly



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

	2006 (GBPbn)	2007	2008.0	2009E	2010E	2011E
Private consumption	828	2.1	1.2	-3.1	-0.2	1.2
Government consumption	272	1.2	2.8	1.9	1.2	-0.4
Fixed investment	223	7.8	-2.8	-16.8	-4.7	1.6
Stockbuilding*	5	0.2	-0.4	-1.0	1.0	0.5
Exports	368	-2.8	0.8	-9.1	4.5	4.0
Imports	406	-0.7	-0.6	-11.5	1.7	2.7
GDP		2.6	0.7	-4.5	1.1	1.7
Nominal GDP (GBPbn)	1,328	1,369	1,373	1,406	1,444	1,478
Unemployment rate, %		2.9	2.8	4.9	6.2	6.0
Consumer prices, % y/y		2.3	3.5	1.7	1.4	1.8
Current account, % of GDP		-2.9	-1.7	-0.5	0.5	1.1
General govt budget balance, % of GDP		-2.8	-3.8	-9.0	-10.5	-4.5
Gross public debt, % of GDP		43.9	52.0	64.0	76.5	80.5

* Contribution to GDP growth (% points)

Out of recession valley driven by the Euro area

The global recession and financial crisis propelled the Swiss economy steeply downhill. The double blow of reduced demand in export markets and a strong CHF sent the export sector reeling. At the same time the financial crisis hit the comprehensive banking sector very hard.

The leading business confidence indicator (KOF) has picked up in recent months. This is in line with sharp increases in the equivalent indicators for the Euro area, which absorbs nearly 50% of Swiss exports. Much indicates relatively solid import growth in the Euro area in the years ahead. This would boost Swiss exports in 2010 and 2011. However, the outlook for consumer spending and investment activity is not quite as bright. Consumption is curbed by rising unemployment, and major surplus capacity in the manufacturing industry definitely does not suggest any remarkable upturn in investment.

In order to limit CHF appreciation and avoid deflation, the Swiss central bank (SNB) lowered its policy rate to 0.25% in March and announced purchases of bonds and foreign currency. Since then the SNB has on several occasions intervened in the currency market. This has helped avoid further strengthening of the CHF versus the EUR and since March the exchange rate has remained within the 1.50-1.54 range. As the inflation outlook is still moderate, we do not look for rate hikes until some time in 2011.

As risk appetite grows and the interest rate differential between the Euro area and Switzerland widens, we expect the CHF to weaken against the EUR. However, on a 3- to 6-month outlook we see renewed strengthening of the CHF as a consequence of disappointing trends in the US economy, which may adversely affect risk appetite. But a significant strengthening of the CHF does not seem very likely, as the SNB appears to be ready to buy more foreign currency if need be. The likelihood of a sharp depreciation is also limited, as the interest rate level in most countries is close to zero. That makes the CHF less attractive as a funding currency.

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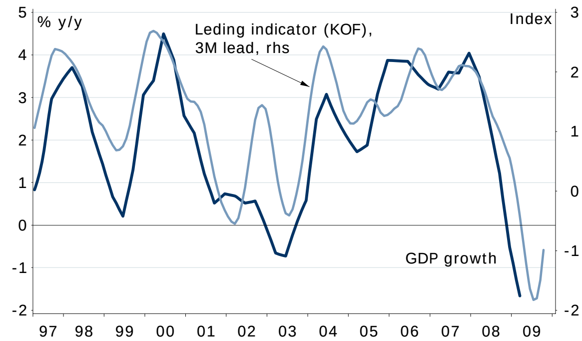
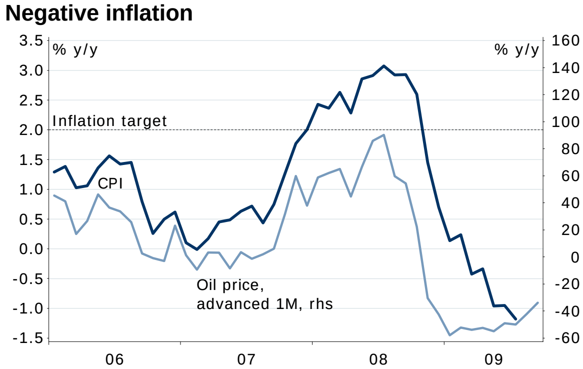
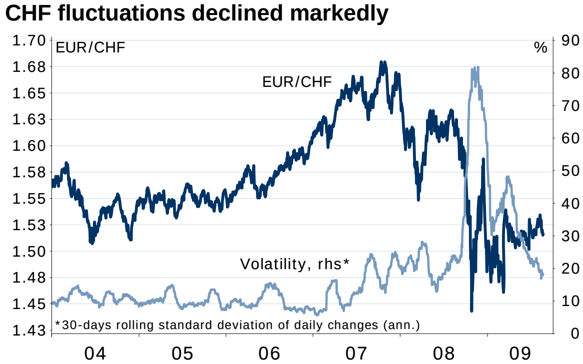
Improved growth outlook



Negative inflation



CHF fluctuations declined markedly



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

	2006 (CHFbn)	2007	2008	2009E	2010E	2011E
Private consumption	286.7	2.1	1.7	-0.5	0.5	1.0
Government consumption	54.6	-1.1	0.0	2.0	0.8	0.6
Fixed investment	104.3	5.4	-1.7	-7.0	-1.5	0.8
Stockbulding*	0.0	-1.3	-1.7	-1.3	-0.1	0.1
Exports	255.3	9.4	2.3	-8.0	3.2	3.8
Imports	217.9	5.9	-0.2	-6.4	2.8	3.4
GDP		3.3	1.6	-2.8	1.8	1.5
GDP nominal (CHFbn)	487.0	512.1	532.1	543.3	550.3	551.9
Unemployment rate, %		2.8	2.6	4.2	5.0	4.7
Consumer prices, % y/y		0.7	2.4	-0.7	0.6	1.2
Current account, % of GDP		10.3	8.4	7.8	8.2	8.4
General govt. budget balance, % of GDP		1.7	2.2	-0.5	-3.0	-3.0

* Contribution to GDP growth (% points)

EMU postponed due to increasing budget deficit

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

Recovery from a decent starting point

It seems clear that the recovery has begun and that recession has been avoided. The speed of the expected recovery is uncertain, but the starting point is certainly decent. We are most inclined to believe in a strong recovery in the remainder of the year driven by exports and rebuilding of inventories followed by a more gradual but also more sustainable recovery during 2010 driven by final domestic demand. In 2011, the economy is expected to have more or less overcome the crisis.

We now expect that growth will be somewhat stronger in this quarter and in the final quarter of the year compared with earlier forecasts. This is because of the faster-than-expected recovery in the Euro-area economies, and in the German economy in particular, and because of the weak PLN that is helping the competitiveness of exporters. The effect is visible eg in the PMI manufacturing activity index and in industrial production. Thus, we expect annual growth in industrial production to turn positive in the coming months after having been down 15% at the low point in January. Moreover, the ratio of orders to inventories in the corporate sector in general has improved significantly and points to a need to start rebuilding inventories, which would also add to the near-term momentum in the economy. Going into 2010, the temporary boost from exports and inventories is expected to fade, but domestic demand will start to pick up.

Consumer spending is weakening fast at the moment, as indicated by eg retail sales and consumer confidence indicators. Moreover, unemployment will probably increase throughout next year, peaking around 12%, and real wages are expected to increase at a moderate pace. Lastly, the banks will probably be reluctant to ease credit conditions towards households as long as unemployment is rising. Thus, consumer spending will only gradually become the needed key driver to set off a sustainable upswing.

Investment may also start to pick up next year. A low level of capacity utilisation means that production can be increased to meet an increase in demand without large-scale investment in the near term, though. Small and medium-sized companies may also find it difficult to attain financing for investment projects, as banks are tightening credit conditions. Public investment, co-financed by EU funds, should continue at a steady pace, though.

Government budget risks

In terms of domestic risk factors, the rapidly increasing government budget deficit stands out. Thus, during the summer, the government revised upwards this year’s deficit target to PLN 27bn from 18bn earlier, as revenues dropped significantly due to the economic downturn and the tax reductions implemented prior to the downturn.

There are several reasons why the increased budget deficit is problematic. The first reason is that the general government budget deficit now significantly exceeds the Maastricht criteria, which means that the government has had to give up the planned membership of the EMU in 2012. A new convergence programme will be released in September, but may not even contain a new entry target. We now expect membership in 2014.

The second reason is the risk of pro-cyclical fiscal policy, ie that the government will be forced to tighten fiscal policy during the downturn and thereby significantly worsen the situation. Indeed, the constitution sets three thresholds for the level of government debt as a percentage of GDP (50%, 55% and 60%), which, for each threshold breached, put tougher strains on fiscal policy the year after. If no action is taken, the first threshold would probably be breached later this year and the second threshold late next year thereby forcing tighter fiscal policy. The third and related reason is the risk that strains on government expenditures could prevent the utilisation of EU funds, which usually requires 25% local co-financing. Note also that 2010 is a presidential election year, while 2011 is a general election year.

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

	2006 (PLNbn)	2007	2008	2009E	2010E	2011E
Private consumption	653	4.9	4.9	3.5	2.2	3.8
Government consumption	194	3.9	7.5	-3.7	-1.8	2.0
Gross fixed capital formation	208	17.2	8.2	0.0	3.5	6.5
Stockbuilding*	15	1.7	-0.7	-2.4	0.8	0.1
Exports	428	9.1	5.8	-6.6	6.1	4.9
Imports	447	13.7	6.0	-9.2	7.9	5.4
GDP		6.8	4.8	1.2	2.7	4.0
Nominal GDP (PLNbn)	1,115	1,177	1,272	1,333	1,394	1,484
Unemployment rate, %		12.7	9.8	11.0	11.9	11.6
Consumer prices, % y/y		2.6	4.4	3.5	1.9	2.4
Current account, % of GDP		-4.7	-5.4	-1.1	-1.8	-2.1
General government budget balance, % of GDP		-1.9	-3.9	-4.8	-4.5	-3.0

* Contribution to GDP growth (% points)

The good thing about the budget situation is that is has put the government's previous privatisation plans back on track. Indeed, the government plans to get one-off privatisation receipts of PLN 37bn by selling minority stakes at the stock exchange, which can be used to finance the budget deficit without having to increase the public debt. The general opinion seems to be that it could be possible to realise most of this plan.

No need to worry about inflation

Despite the economic crisis, inflation remains near the upper limit of the central bank's (NBP) inflation target of 2.5% +/-1% point. The NBP expects core inflation, which excludes food and energy prices, to remain almost unchanged throughout the forecast horizon despite a significant weakening of the labour market. We do not agree with this view. Rather, we see core inflation falling significantly, as the labour market weakens and the PLN strengthens. Food and energy prices, on the other hand, could continue to increase. Based on this view and taking our expectations for a gradual recovery in the economy into account, we no longer expect additional rate cuts, though we still see it as the most likely risk scenario in the near term.

The timing of the first rate hike seems rather uncertain, but could be sometime during H2 2010, depending on the speed of the recovery and possibly also on the action taken by the ECB and the Fed. It is worth noting that some of the Monetary Policy Committee (MPC) members will be replaced early next year and notably all the perceived hawks. Thus, a more dovish MPC could be slightly slower to hike and perhaps even slightly faster to warn about the possibility of FX interventions in case of too rapid PLN appreciation.

Stronger PLN

We still see the PLN as undervalued and expect a strengthening. The potential for speeding up the privatisation process points to the possibility of a further strengthening towards the end of this year. Strong activity indicators in Poland as well as from the world's major economies, a more or less balanced current account and relatively high interest rates also point to currency strengthening. Finally, the constraints on the level of public debt could make local government bonds relatively more attractive compared with the regional peers.

Going into 2010, we are somewhat more sceptical and expect continued high volatility around an almost sideways trend, as markets could be disappointed about the speed of the global and local recovery and may also worry about the budget situation and the upcoming elections.

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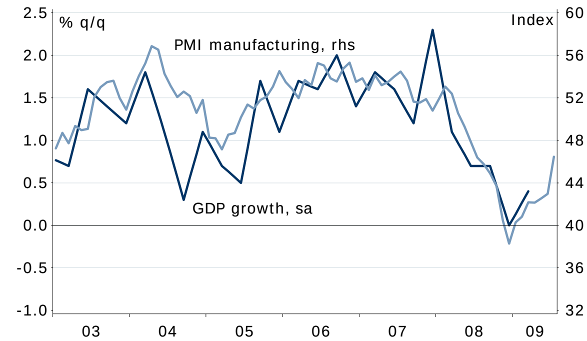
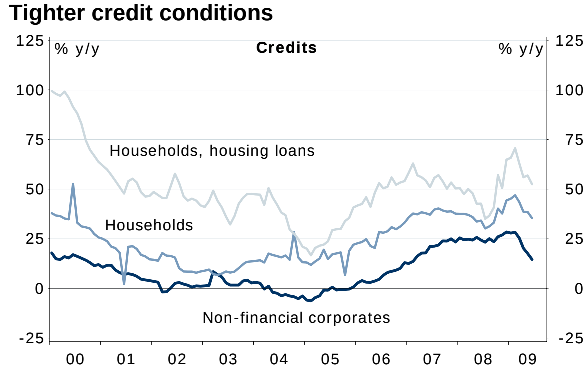
The recovery has begun …

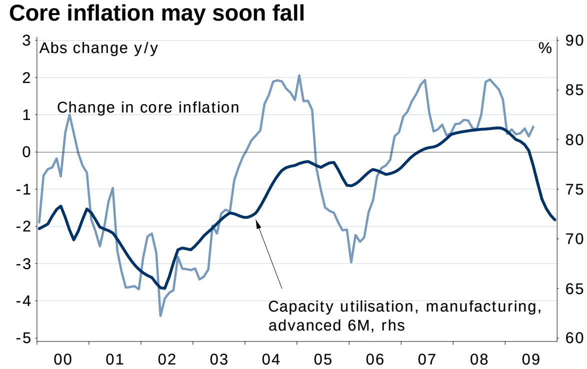


… but the labour market will weaken for some time

Tighter credit conditions



Core inflation may soon fall



Waiting for better times

- Sharpest contraction in GDP seems to have passed
- Cautious signs of stabilisation in the economy
- RUB likely to appreciate in the long term

The steep contraction of the Russian economy continued in Q2 (-10.9% y/y). After the over 10% drop in H1 the steepest decline during the recession is expected to be history, and we believe that GDP will contract by 7% in 2009. An upswing is expected as early as in 2010, although the development during the next few years will be more modest than in the past couple of years. Its reliance on natural resources weakens the economy, and the uncertainty created by unforeseeable political decisions will continue to dampen investment in production. Oil prices will not necessarily rise as rapidly as during the past decade and the recovery of the global economy alone will not guarantee a return to strong growth. A return to previous years' growth figures would require investment in oil production capacity as well as diversification of the export sector, by lessening the dependency on natural resources.

Cautious signs of a stabilisation of the economy are already visible. For instance, the sharply accelerating downtrend in exports has stabilized – at over 40% y/y, though – and the fall in industrial production has fluctuated around 15%. The purchasing manager indices for both the manufacturing and service sectors have clearly strengthened since the beginning of the year. Although the economy is still in deep recession, the stabilisation of the decline in some macroeconomic figures bodes well for a stronger performance in H2.

Despite the sharp weakening of the economy and the more moderate development in wages, inflation has decelerated only slightly. However, inflation is expected to continue decelerating in 2010 despite the inflationary pressures created by the government's expansionary fiscal policy.

Is recovery around the corner?

The almost doubled oil prices since early this year, the government's stimulus measures and the recovery of the global economy support a positive development of the economy. Because of the Stabilisation Fund the impact of oil prices on the economy is not straightforward. The higher oil prices increase export revenue and support public finances through increased tax income. The government's revitalisation measures include support for the banking sector as well as the real economy, supporting for example investments which boost demand for domestic products.

Consumption has continued to weaken as the tight credit conditions, high unemployment and declining wage growth have eroded domestic consumption. The prevailing labour market situation is uncertain, and especially purchases of durable goods are easily postponed. But the government has promised to continue the disbursement of social benefits, which will support consumption among the lowest social classes. The financial crisis put a stop to the increasing affluence of the middle class, but when economic growth regains momentum middle-class consumption growth is expected to resume. Thus the increase in consumption may at times be quite robust, although there will be no return in the near future to the double-digit growth figures of recent years.

The clear fall in the 3-month Mosibor rate from its peak in early 2009 also speaks in favour of a stabilising economy. However, interest rates are still about twice as high as before the crisis. The central bank has cut the refinancing rate five times this year in an attempt to revitalise the economy and reduce borrowing costs. But the central bank is still worried about the high interest rates for borrowers, so further rate cuts are anticipated.

Although there are signs of a stronger economic outlook, the recovery is expected to be slow and tough. In addition to slower-than-expected growth in the global economy or lower-than-anticipated oil prices, higher-than-expected credit losses could impede the recovery. The number of non-performing loans could increase during H2, which would add to the uncertainty about the growth forecast and the development of the rouble. The government has promised to support the banking sector, but as it is difficult to estimate the amount of credit losses, it remains to be seen whether the amount of subsidies reserved will be enough.

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

	2006 (RUBbn)	2007	2008	2009E	2010E	2011E
Private consumption	13,041	13.5	9.0	-5.0	2.0	4.0
Government consumption	4,589	3.4	4.5	1.0	2.5	3.0
Fixed investment	4,981	20.8	12.8	-10.0	2.0	3.0
Exports	9,079	6.4	3.0	-8.0	2.5	3.0
Imports	5,657	26.6	13.2	-25.0	1.0	2.0
GDP		8.1	5.6	-7.0	1.5	3.0
Nominal GDP (RUBbn)	26,904	33,111	41,668	43,751	48,783	54,637
Unemployment rate, %		5.6	5.9	13.0	14.0	13.5
Consumer prices, % y/y		9.0	14.1	12.0	10.0	9.0
Current account, % of GDP		5.9	5.9	2.0	3.5	3.0
Central govt budget balance, % of GDP		6.1	4.1	-7.0	-5.0	-3.0

* Contribution to GDP growth (% points)

Surplus turning into a deficit

As a result of a tight fiscal policy the government has had significant budget surpluses in recent years. The budget is, however, turning into a 7.5% deficit in 2009 according to the most recent budget proposal. Oil price estimates in the budget are traditionally moderate, at present USD 55 per barrel, indicating that the deficit could prove smaller than budgeted. Furthermore, revenues from oil exports and production have been accumulated to the Stabilisation Fund, divided into the National Welfare Fund and the Reserve Fund. The oil export tax is steeply progressive, so the higher the oil prices the faster the growth of the Fund. The Reserve Fund, intended to even out the business cycle, could even be exhausted by the end of 2010 as the funds are used for stimulating the economy. However, the Reserve Fund still amounted to over USD 88bn in August.

Rouble likely to appreciate in the long term

During the winter the RUB depreciated strongly against the basket (EUR/RUB 45%, USD/RUB 55%), and has since then remained at the weaker end of its fluctuation band. The volatility in the exchange rate during recent months has shown that the central bank (CBR) is still willing to support the RUB. Especially during the winter the foreign exchange reserves for supporting the RUB have been maintained at about USD 400bn, so there are still plenty of funds to defend the stability of the RUB.

The market may want to test the CBR's willingness to support the rouble during the autumn, and the fears of an increase in the number of non-performing loans may also cause weakening pressures on the RUB towards the end of the year. However, fluctuations in the speculation-sensitive RUB are expected to be temporary and are likely to slow down as the fears subside. The high oil prices and the economic recovery suggest an appreciation of the RUB in the long term.

The wider fluctuation range announced in January is a step towards a floating currency, and the CBR has stated that it is targeting a floating RUB within the next two years. A floating RUB would increase the attractiveness of the currency in the international FX markets. However, as this would require the CBR to change its currency-oriented policy to an inflation-targeting one, the change is unlikely to take place until the political and economic climate allows it.

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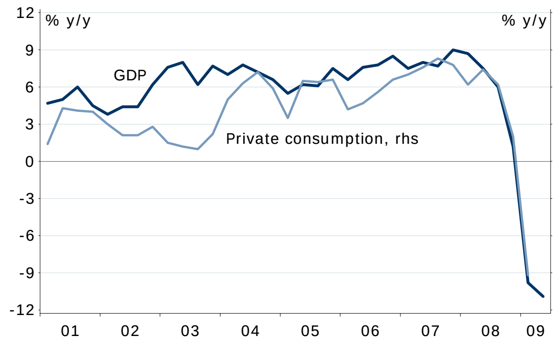
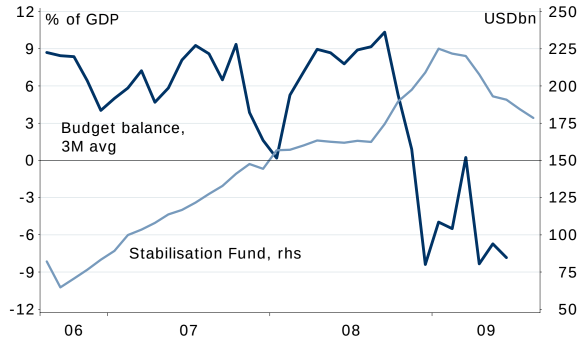
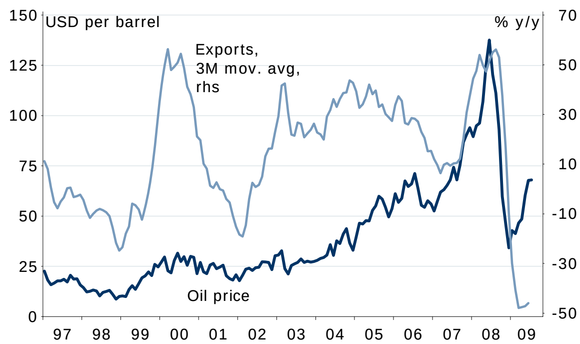
No signs of a turn-around in consumption



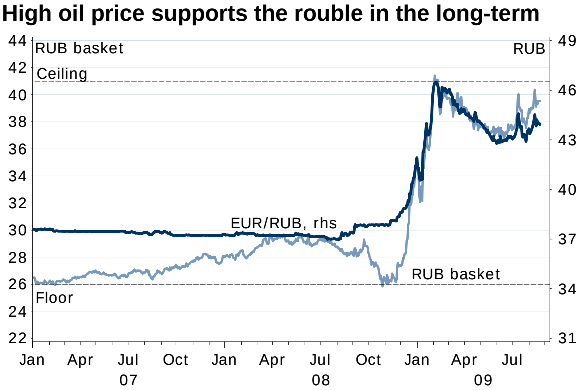
Budget surplus to turn into a considerable deficit



Export income supported by higher oil prices



High oil price supports the rouble in the long-term



Bottom already close, but still a long way to recovery

The economy plunged into an ever deeper recession with GDP falling by 16.6% in Q2, as expected. For instance, domestic demand and exports continued to drop sharply in Q2. Despite the steepening contraction the pace of decline accelerated less than in previous quarters. Nevertheless, GDP is likely to decrease by as much as 14% y/y in 2009. We expect GDP to contract further in 2010, but the recession will ease when for instance export demand recovers. Even if the global upturn proves more rapid than anticipated, domestic demand and investment will remain subdued in the next few years. The economy is expected to turn to growth in 2011, but at a notably weaker pace than in the past few years.

Consumer confidence has risen from its lows, but it still remains at a weak level, which demonstrates the still long and bumpy road to recovery for consumption. Even though the fall in wages dampens consumption, the correction to recent years' brisk wage growth has been necessary. Rising unemployment and the difficulties on the credit markets will also slow down the recovery in consumption. After the quick deceleration inflation will continue to moderate, with the drop in consumer prices strengthening purchasing power.

Uncertainty about the Latvian economy, its financial conditions and especially the currency has also cast a shadow over Estonia during the summer. Although the risk of devaluation in Latvia has subsided, the neighbouring countries will continue to monitor the situation as devaluation could prove disastrous to the currencies of the other Baltic countries as well.

The government's support measures, such as the VAT hike and cuts in public sector wages, are aimed at keeping the budget deficit below 3% of GDP, which would enable EMU membership in 2011. However, after the gloomy H1 this goal is becoming increasingly hard to reach, and thus the plans of euro adoption seem to be postponed at least until 2013.

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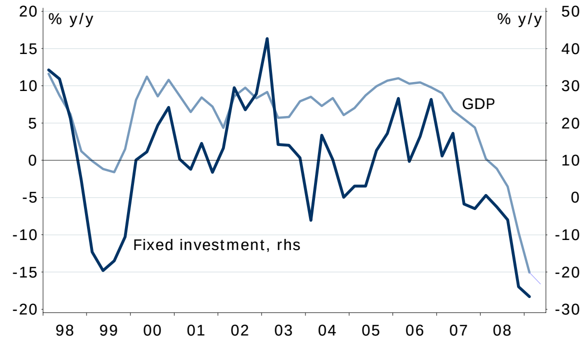
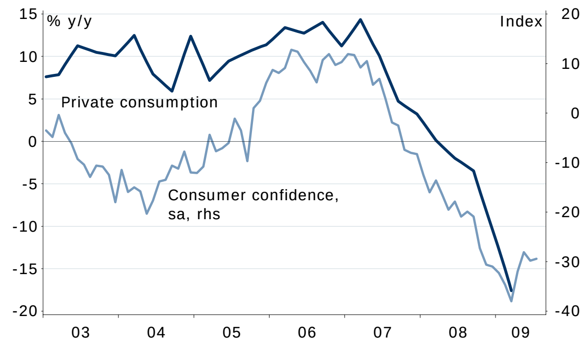
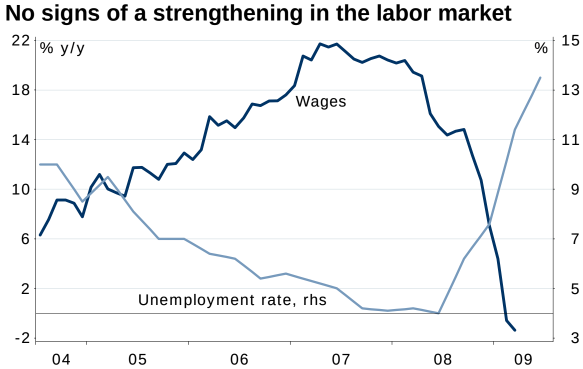
The bottom of the economy has not yet been passed



Firmer confidence indicates turn-around in spending



No signs of a strengthening in the labor market



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

	2006 (EEKmn)	2007	2008	2009E	2010E	2011E
Private consumption	113,272	7.9	-3.8	-16.0	-5.0	2.0
Government consumption	33,839	3.9	4.4	-4.0	-2.0	1.0
Fixed investment	69,462	7.6	-8.1	-24.5	-7.0	1.5
Exports	165,888	0.0	-1.1	-14.0	1.0	2.0
Imports	189,517	4.2	-7.9	-22.0	-2.0	2.0
GDP		6.3	-3.6	-14.0	-2.5	1.5
Nominal GDP (EEKmn)	205,038	238,929	248,149	210,927	202,490	207,552
Unemployment rate, %		4.7	5.5	15.0	18.0	17.5
Consumer prices, % y/y		6.7	10.6	-1.0	-1.5	1.0
Current account, % of GDP		-18.3	-9.1	2.0	3.0	1.0
General govt budget balance, % of GDP		2.7	-3.0	-4.0	-5.0	-3.0

Difficult autumn ahead

The deeper-than-expected dive in the economy has continued as the drop of 19.6% in Q2 sealed a weak first half of 2009. The rest of the year will remain fragile as the impact of the government's austerity measures will start to show through and domestic as well as foreign demand will remain modest. Still, 2010 is likely to be brighter as the recovery of the global economy supports the export sector. Compared to this year's dismal figures, 2010 might even prove surprisingly strong.

Although demand for Latvian exports could start to pick up, the recovery in domestic demand will be delayed. Consumer confidence, which strengthened in the early part of the year, has sunk again to new lows. The drop in confidence spells tough times for consumption, reflecting Latvia's poor financial conditions as well as the drastic austerity measures, which erode household consumption.

During the summer speculation about further international aid has kept fears of a devaluation and state bankruptcy alive. However, the devaluation speculations subsided when the second tranche of the EU loan was confirmed. Future loan disbursements are important for the stability of the LVL, but the devaluation speculations are not expected to be entirely over. Focus is especially on the budget cuts required for 2010. A reform of the tax system also lies ahead – a capital gains tax has already been introduced and also the possibility of a progressive income tax has been considered.

The unsustainable pace of wage growth in the previous years has been reversed and inflation has quickly moderated from its peak last year. The aim of this internal devaluation is to avoid a devaluation of the currency. We consider a currency devaluation an unlikely option if wages and prices continue to correct downwards and Latvia manages to receive further funding from international donors.

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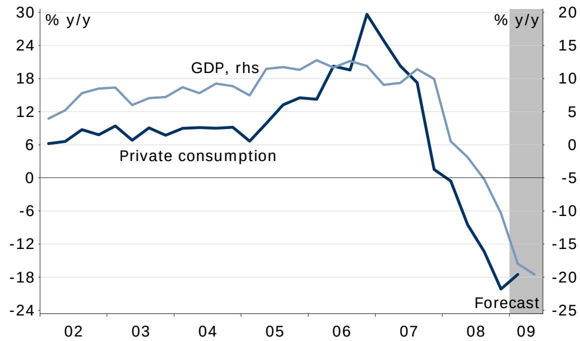
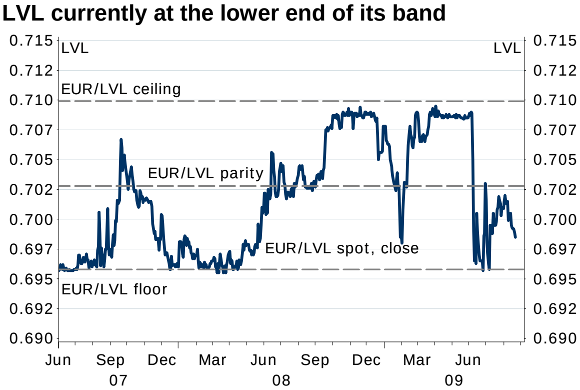
Only cautious signs of a strengthening



New dip in confidence indicates weaker consumption

LVL currently at the lower end of its band



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

	2006 (LVLmn)	2007	2008	2009E	2010E	2011E
Private consumption	7,281	14.8	-11.0	-20.0	-7.0	1.0
Government consumption	1,855	3.7	1.5	-5.0	-3.0	1.0
Fixed investment	3,644	7.5	-13.2	-23.0	-8.0	1.0
Exports	5,014	10.0	-1.3	-16.0	1.0	2.0
Imports	7,412	14.7	-13.6	-25.0	-4.0	2.0
GDP		10.0	-4.6	-18.0	-3.0	2.0
Nominal GDP (LVLmn)	11,172	14,780	16,243	13,888	12,846	12,975
Unemployment rate, %		6.0	7.5	16.0	18.5	18.0
Consumer prices, % y/y		10.1	15.3	3.5	-4.5	-1.0
Current account, % of GDP		-22.5	-13.6	3.0	4.5	2.0
General govt budget balance, % of GDP		-0.4	-4.0	-10.0	-9.0	-6.0

Economic tailspin has steepened

The contraction of the economy accelerated to 20.2% y/y in Q2 as Lithuania caught up with its Baltic neighbours, which had moved into recession earlier. Despite the dramatic annual drop, the level of GDP is still around the levels at the beginning of 2005. We see the contraction continuing in 2010, albeit at a more composed pace than in 2009, while a return to growth is expected in 2011.

The deterioration in the economy has remained broad-based as exports have plunged by nearly 30% year-to-date while domestic demand has weakened further. Nevertheless, it appears that confidence indicators for both consumers and the industrial sector have started to rise, which supports expectations of improving demand.

The government has had to make tough decisions in order to curb the growing budget deficit. The support measures include a VAT hike and public sector cost reductions, including wage cuts. Hence, the road towards an improvement in spending is long and winding, as rising unemployment and slowing wage growth strain consumption. This autumn focus will turn towards Lithuania's next Eurobond placement, as the confidence of private sector lenders would support the notion that no rescue package from the IMF is necessary.

The Ignalina nuclear power plant will be closed at the end of 2009. Inflation is currently declining briskly, but the need to import more expensive energy at the beginning of next year will support inflation. Also production and exports are likely to drop. A cause for concern is also the stability of the Latvian currency, but fears have recently subsided as the risk of a devaluation has diminished.

EMU membership is still on the horizon in a few years, although the swelling budget deficit is of concern. Euro adoption in 2013 would be a realistic target provided that there are no negative surprises during the recovery, the price level drops sufficiently as a result of the internal devaluation and the government is able to keep budget deficit growth under control.

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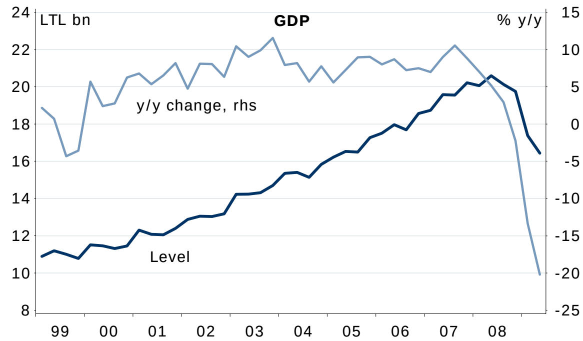
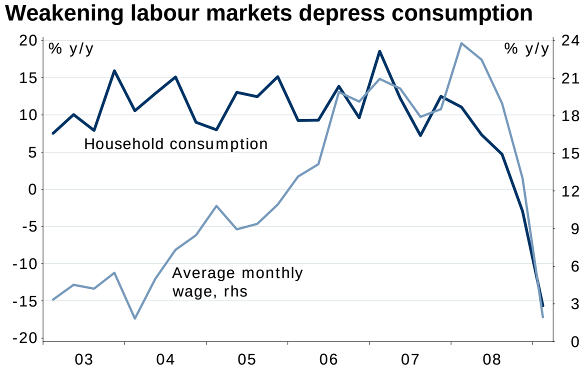
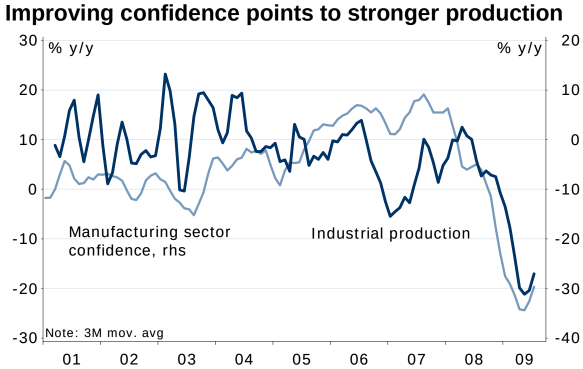
GDP still around the 2005 level



Weakening labour markets depress consumption



Improving confidence points to stronger production



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

	2006 (LTLmn)	2007	2008	2009E	2010E	2011E
Private consumption	53,449	12.4	4.7	-17.0	-6.0	1.0
Government consumption	15,966	3.3	4.3	-3.0	-2.0	0.5
Fixed investment	20,841	20.8	-6.0	-29.0	-7.0	1.0
Exports	48,917	4.3	11.3	-15.0	0.5	1.0
Imports	57,343	11.6	10.0	-26.0	-1.0	2.5
GDP		8.9	3.0	-16.0	-4.0	1.0
Nominal GDP (LTLmn)	82,792	98,138	111,498	98,118	93,212	93,678
Unemployment rate, %		4.3	5.8	15.0	17.0	17.5
Consumer prices, % y/y		5.8	11.1	4.0	-1.0	-0.5
Current account, % of GDP		-15.1	-12.2	1.0	2.5	1.5
General govt budget balance, % of GDP		-1.0	-3.2	-6.0	-5.0	-3.5

Long tough haul to get out of the recession

Economic growth in Hungary turned increasingly negative during Q1 and Q2 this year and the economy is stuck in a deep recession. Exports have been hit by the downturn across the globe, but particularly in Europe, causing production to grind to a halt. In October 2008 the central bank had to hike the policy rate by as much as 300 bp to defend the currency, and it was thus not possible to use the interest rate weapon to shore up the economy. Subsequently, a couple of rate cuts were sanctioned, followed by a pause of nearly six months. Against the backdrop of a relatively stable currency performance and the prospect of maintaining the inflation target of 3% (+/- 1%-point) in the medium term, the central bank again used the interest rate weapon in July to kick-start the economy. In the autumn the IMF granted a record-large loan with ensuing budget size requirements relative to the country's GDP. The government thus threw the towel in the ring, and a new government took office in April, introducing a string of fiscal policy tightening moves, which will only hurt the economy in the short run.

Hungary is thus mired in a deep crisis which it will take a very long time to overcome. When a new government presumably takes over the helm after the general regular government election in April 2010, additional fiscal policy tightening will very likely be necessary to meet the IMF and EU's requirements and fulfil the criteria for ERM-2 participation. Inflation is expected to continue to edge higher due to the VAT hike in July, which will erode incomes and further dampen consumer spending. The first bright spot will therefore be a reversal of the Euro Area, lifting exports. Another one will be more rate cuts down to a bottom level of 6% during Q1 2010. The HUF is expected to strengthen vis-à-vis EUR in the medium term on improvements in global markets and the persistent wide interest rate differential vis-à-vis other European countries. We thus expect growth to stagnate in 2010, followed by acceleration only in 2011.

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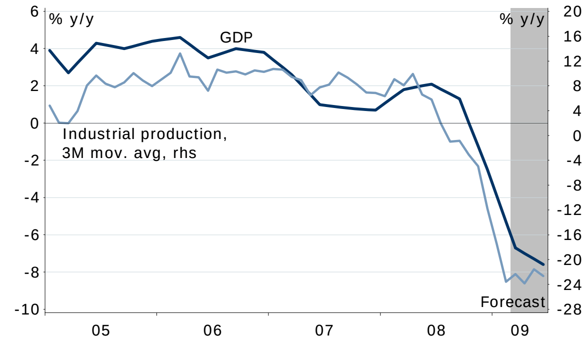
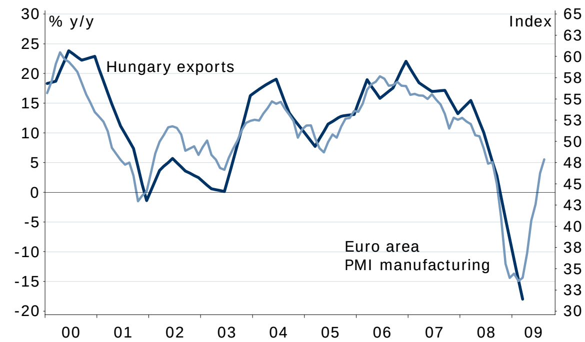
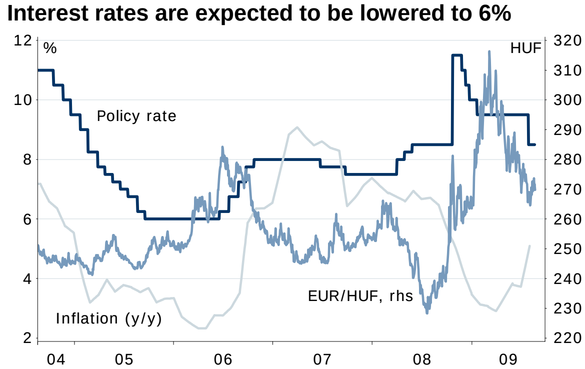
Growth is going to be less negative



Economic recovery is very export dependent



Interest rates are expected to be lowered to 6%



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

	2006 (HUFbn)	2007	2008	2009E	2010E	2011E
Private consumption	12,384	0.5	-0.5	-6.0	-4.0	2.0
Government consumption	2,430	-4.5	-1.9	-4.0	-2.0	0.5
Fixed investments	5,131	1.8	-2.6	-10.0	-4.5	3.0
Stockbuilding*	826	-0.1	0.2	-2.9	0.7	0.0
Exports	18,330	16.4	4.8	-15.0	5.0	5.0
Imports	18,495	13.4	4.7	-18.0	2.0	4.0
GDP		1.2	0.6	-6.2	0.0	2.6
Nominal GDP, HUFbn	23,775	25,479	26,621	24,970	24,966	25,605
Unemployment rate, %		7.4	7.8	10.8	11.2	10.7
Consumer prices, % y/y		8.0	6.1	4.6	4.0	5.0
Current account, % of GDP		-6.5	-8.4	-4.0	-3.9	-3.7
General government budget balance, % of GDP		-9.2	-4.9	-3.4	-3.9	-3.5

* Contribution to GDP growth (% points)

Early elections ahead

The low point in terms of growth has probably been passed and we see potential for a sharp recovery during the remainder of this year. Thus, being one of the most open economies in the world and heavily exposed to the recovering automotive sector, the Czech Republic is in a very good position to enjoy a fast upswing. Moreover, the rebuilding of inventories domestically and abroad should help boost industrial production in the near term.

Private consumption, on the other hand, looks set to weaken before gradually improving again next year. This is due to the weakening of the labour market, with unemployment continuing higher and wage growth slowing further, which will continue for some time before the recovery of the export sector starts generating new jobs. The weak CZK has provided a cushion for exporters, but is now half-way back to the pre-Lehman level.

All in all, we expect something like a 3% contraction this year followed by almost the same positive growth number next year.

Early elections are scheduled for the middle of October. At present, polls do not give a decisive victory to either political side, but it seems that fewer parties will make the 5% threshold. The political situation means that the rapidly rising government budget deficit will not be tackled this year and perhaps not even next year. Thus, EMU membership is not an option until, say, 2014.

Inflation will probably remain low for a long time, but the central bank (CNB) has already cut interest rates significantly. Thus, we do not see any rate changes before end-2010 with risks being tilted towards later rather than sooner, as the CNB is perceived to be reluctant to hike.

The CZK has appreciated significantly due to the prospects of a strong recovery and low fundamental risks. Politics is usually not a driver of currency movements, so downside risks to the currency are mostly related to the labour market and to external events.

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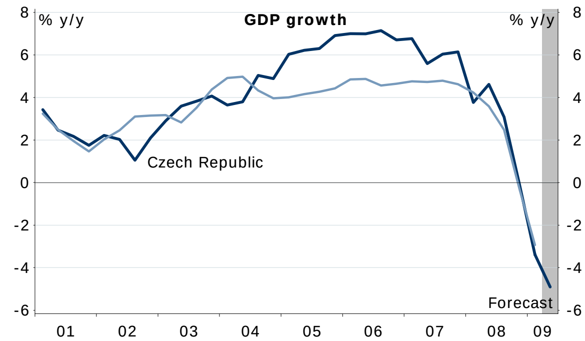
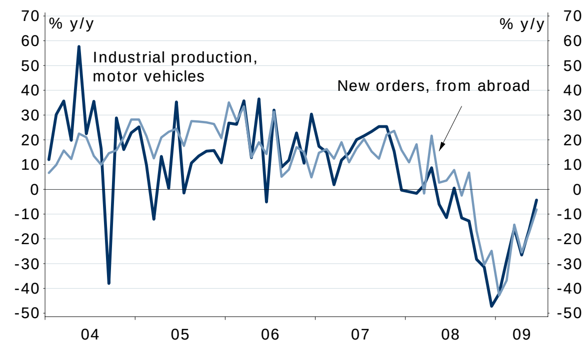
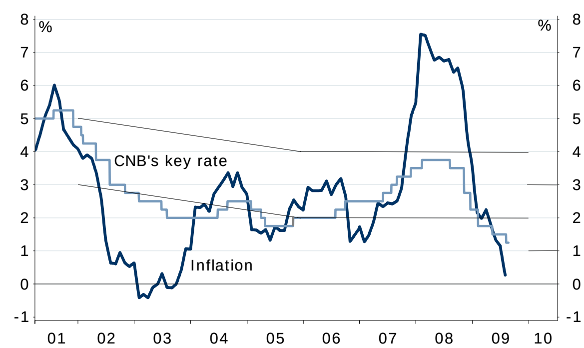
Sharp contraction



Main risk is weaker demand from abroad



Low inflation and low rates



Czech Republic: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2006 (CZKbn)	2007	2008	2009E	2010E	2011E
Private consumption	1562	4.9	2.6	1.2	1.5	3.0
Government consumption	687	0.7	1.7	1.5	0.5	0.5
Fixed investments	796	10.8	-0.1	-4.5	1.0	6.0
Stockbuilding*	64	-0.2	-0.6	-1.0	0.0	0.0
Exports	2462	15.1	6.0	-13.5	9.0	7.5
Imports	2352	14.2	4.2	-12.0	7.5	7.0
GDP		6.1	2.8	-2.8	2.5	3.7
Nominal GDP (CZKbn)	3222	3535	3706	3649	3811	4031
Unemployment rate, %		6.6	5.4	8.5	9.0	8.4
Consumer prices, % y/y		2.9	6.3	1.3	1.5	2.0
Current account, % of GDP		-3.1	-3.1	-2.5	-2.0	-2.5
General government budget balance, % of GDP		-0.6	-1.5	-5.5	-5.0	-3.5

* Contribution to GDP growth (% points)

Stimuli to continue until growth is sustainable

The public investment led recovery continues and GDP growth has rebounded remarkably. The authorities' strong and successful response to the fallout of exports confirms that they are willing to go a long way to make the overall growth target become reality. The outlook for the economy therefore to a very large extent depends on the authorities' desire to continue the fiscal and monetary easing. We expect the stimuli to persist until more clear signs of both stronger household spending and external demand emerge. From early next year we might see some gradual scaling back of the economic policy loosening, but economic growth will nevertheless pick up further in 2010 and 2011. There are already signs of both households' optimism increasing, stronger car sales and increasing residential investments. And also exports seem to have stabilised and are set to increase from next year on as the global economy recovers.

As a consequence of the monetary easing, credits have continued to expand strongly, and this has naturally lead to worries of overinvestment, new asset bubbles, an increasing number of non-performing loans (NPLs) and bank failures. We find these worries a little overdone but admit that we could see more NPLs and defaults in the future, hurting the banks. Remember, however, that a majority of the banks are still state-owned and these banks will most likely not be allowed to collapse. Instead, it might pose problems for the government later on.

China has on several occasions argued for a stronger role for the CNY and other currencies at the expense of the USD in global trade and financial markets. But apart from agreements with a chosen few countries on settling trade in CNY and not USD, the rhetoric has not been followed by real action. And the CNY is still not a fully convertible currency. When the export sector shapes up, the CNY might again be allowed to strengthen gradually, perhaps as early as spring next year. Until then we expect it to be kept stable versus the USD as it has been since mid-2008.

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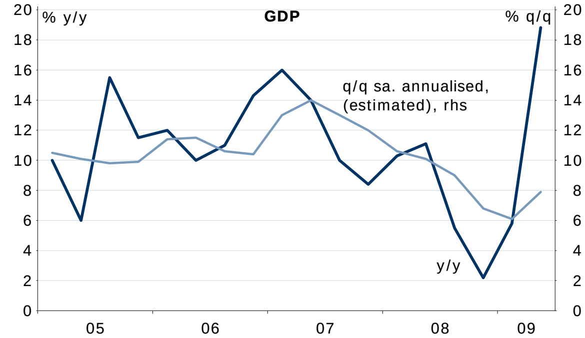
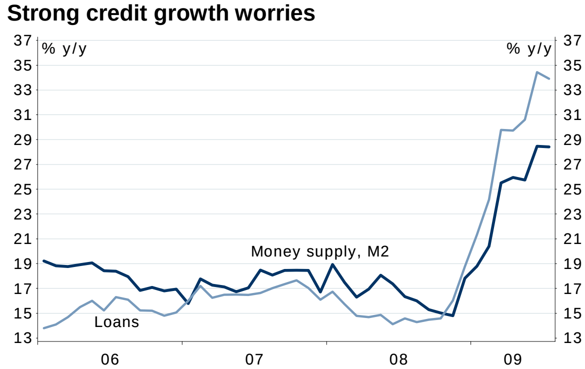
GDP growth has rebounded strongly



Exports set to recover going forward

Strong credit growth worries



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

	2006 (CNYbn)	2007	2008	2009E	2010E	2011E
Private consumption	8,048	9.6	9.5	8.8	9.5	10.0
Government consumption	3,012	13.7	11.0	12.0	11.0	10.5
Fixed investment	9,015	12.3	10.0	14.2	12.0	12.5
Stockbuilding*	425	0.2	-1.9	-1.0	0.0	0.0
Exports	8,465	15.8	7.4	-8.2	8.0	9.0
Imports	6,799	13.4	4.6	-7.5	13.0	14.0
GDP		13.0	9.0	8.8	10.5	10.0
Nominal GDP (CNYbn)	22,165	26,324	30,686	33,325	37,324	42,176
Unemployment rate, %		4.0	4.2	4.5	4.2	4.0
Consumer prices, % y/y		4.8	5.9	-0.2	1.5	3.0
Current account, % of GDP		11.0	9.8	6.7	6.1	5.2
General government budget balance, % of GDP		0.6	-0.4	-3.5	-3.1	-2.5

Lack of rainfall will have severe but temporary impact

The economy has gradually shifted into a higher gear and not least the investment climate has improved considerably since last autumn. Firstly, financial conditions have improved markedly since the credit crisis has abated. Secondly, the convincing election victory to the Congress party in May this year has eliminated much of the political uncertainty.

Households, notably among the large rural population, have emerged relatively unscathed from the financial crisis. At the same time many of the fiscal policy rescue packages are aimed at this population group. On the other hand, this group is exposed to fluctuations in agricultural production and this summer's partial draught could have severe repercussions. Most of the annual rainfall is from June to the end of September, but much indicates that this year's rainfall will be far lower than normal. This will mean a sharp drop in especially sugar and soya production, which threatens to postpone the upswing also in the rest of the economy. The authorities have built up strategic inventories, though. And the favourable economic outlook in the slightly longer term is still intact.

A poor harvest could drive up prices of agricultural products, which will put upward pressure on inflation. The central bank does not operate with an inflation target, but has announced that the loose monetary policy will be tightened once the upswing really takes hold. Hence, we expect gradual rate hikes throughout 2010 and 2011.

Another way to tighten the monetary conditions would be to allow the currency to strengthen. Although the INR has been allowed to float more freely than previously, the central bank still intervenes from time to time. The INR has been boosted by renewed capital inflows as a result of reduced political uncertainty, the scrapping of a string of capital restrictions and improved global risk appetite. This has also allowed some restoration of currency reserves. As the economy gradually recovers and shakes off the negative effects of the lack of rainfall, we expect the INR to strengthen further.

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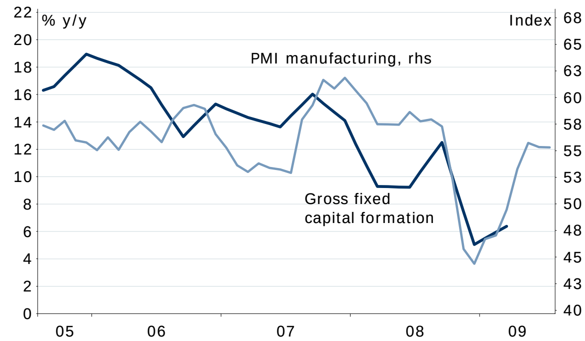
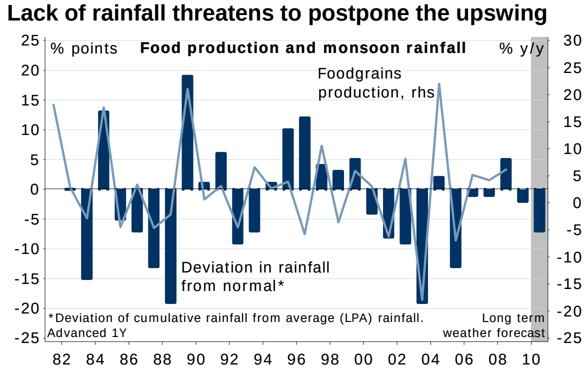
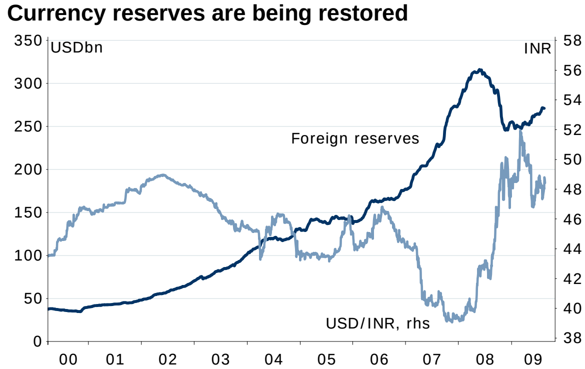
Investments growth set to increase again



Lack of rainfall threatens to postpone the upswing



Currency reserves are being restored



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

	2006 (INRbn)	2007	2008	2009E	2010E	2011E
Private consumption	23,078	8.5	2.9	4.5	5.5	6.0
Government consumption	4,215	7.4	20.2	8.0	6.0	5.0
Fixed investment	13,438	12.9	8.2	8.8	11.0	13.0
Exports	6,747	9.0	30.3	6.2	12.0	15.0
Imports	7,830	12.0	41.0	9.5	10.0	12.0
GDP	41,292	9.1	6.1	5.7	7.5	8.4
Nominal GDP (INRbn)	41,292	47,234	53,217	56,766	63,273	71,742
Wholesale prices, % y/y		4.8	9.2	1.0	4.0	5
Current account, % of GDP		-1.0	-1.3	-1.4	-1.5	-1.7
General government budget balance, % of GDP		-5.6	-6.1	-7.8	-7.3	-8.2

Service sector keeps the economy afloat

The economy is already well on its way to recovery after being hit by the recession last autumn. Economic growth is back in positive territory, not least bolstered by fiscal policy easing. Car sales have recovered particularly swiftly to the levels from last autumn as vehicle taxation has been temporarily reduced. Car production as well as manufacturing production overall looks set to increase further as the sharply depleted inventories are gradually restocked and demand picks up. The economy is also supported by renewed credit growth, particularly via the government-owned banks, and lower interest rates.

Consumer spending has not contracted markedly during the crisis and households are also likely to do their bit to keep the economy going in future. The crisis mainly hit the capital-intensive manufacturing industry, while the impact on the labour-intensive service sector was less severe. Unemployment has thus only risen slightly and appears to have stabilised at a still fairly low level by Brazilian standards.

A risk factor in coming years will be public finances. The budget balance will come under pressure both from declining tax receipts and the string of expansionary government measures. Expenditure may escalate further up to the October 2010 presidential elections, although President Lula is not eligible for re-election.

Inflation has been safely reduced to the middle of the central bank's target range, but fresh inflationary pressure could build, as the labour market, notably the service sector as noted above, is still relatively tight. This is why we expect rate hikes from H2 2010, when the economy will again be running at full capacity.

The BRL has already gained significantly since the turn of the year, but we expect the currency to benefit further from the global recovery. It will be underpinned by stronger capital inflows, and further increases in global commodity prices will boost the trade balance.

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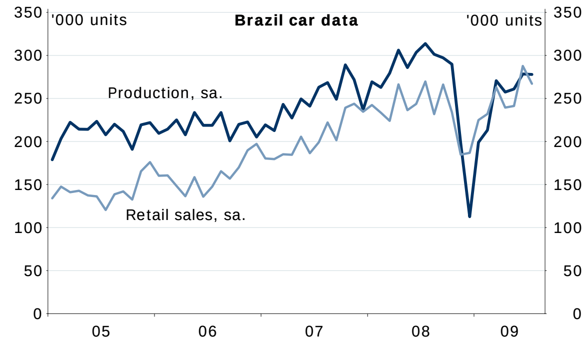
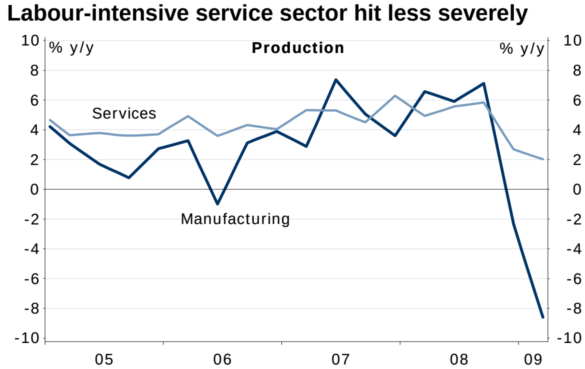
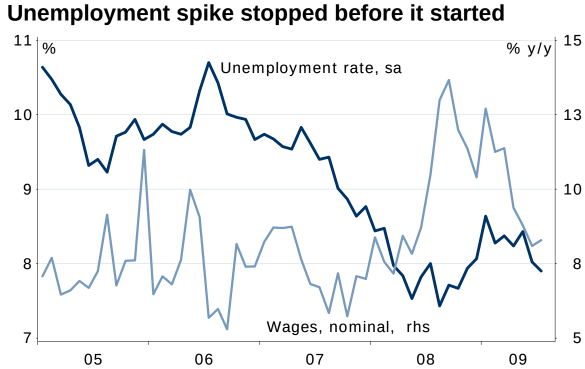
Car sales back at pre-crisis level



Labour-intensive service sector hit less severely



Unemployment spike stopped before it started



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

	2006 (BRLbn)	2007	2008	2009E	2010E	2011E
Private consumption	1,428.9	6.3	5.4	0.5	3.4	4.5
Government consumption	474.8	4.7	5.6	2.5	3.5	3.8
Gross fixed capital formation	389.3	13.4	13.7	-0.6	5.9	12.9
Stockbuilding*	8.0	-0.1	-0.3	-0.4	0.4	0.0
Exports	340.5	6.8	-0.7	-17.8	7.5	4.8
Imports	271.7	20.7	18.6	-13.2	13.9	15.0
GDP		5.6	5.1	0.3	3.6	4.5
Nominal GDP (BRLbn)	2,369.8	2,747.0	2,988.6	3,073.1	3,401.0	3,801.3
Unemployment rate, %		9.3	7.9	9.2	8.7	8.2
Consumer prices, % y/y		3.6	5.7	5.2	4.1	4.5
Current account, % of GDP		0.1	-1.8	-1.9	-1.5	-1.0
General government budget balance, % of GDP		-2.3	-1.8	-2.0	-1.6	-1.2

* Contribution to GDP growth (% points)

The worst is over – time to look ahead

The Turkish economy recorded the biggest quarterly contraction ever in Q1 2009. But the worst now seems to be over, with a few green shoots of recovery evident in the economy.

Both consumer spending and industrial production show signs of improvement. This should be seen against the backdrop of government measures in the form of tax cuts, rate cuts by the central bank and record-low inflation. Recently, the government extended the period of tax relief in an attempt to further stimulate domestic demand. It is extremely important that private consumption is improving as more than half of the contribution to GDP growth comes from household consumption. Obviously, the risk is that these measures will have a temporary effect only, but increased momentum in the global economy and the financial markets should also start to spill over to the Turkish economy. Especially a rebound in the European economy where Germany is the biggest trading partner is going to support exports and in turn boost growth in coming quarters. Still, we do not see growth in positive territory until late this year as it will take time to get the economy back on track. Consequently, growth is not expected to reach the potential level and thus set the scene for the first rate hike until end-2010.

The Turkish economy is still facing challenges, the first being possible Turkish EU admission. One aspect in this context is whether Turkey should relinquish its control over part of Cyprus. Another challenge is a new loan deal with the IMF. For now, an agreement with the IMF is not crucial but if uncertainty again hits financial markets, an agreement could prove essential.

Despite the political challenges, the TRY will likely strengthen versus the EUR in the medium term in step with the economic recovery and improving global and financial conditions.

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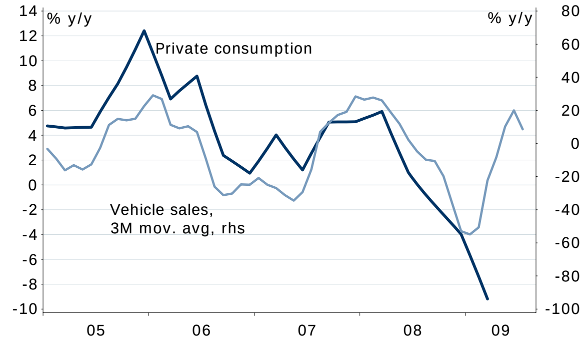
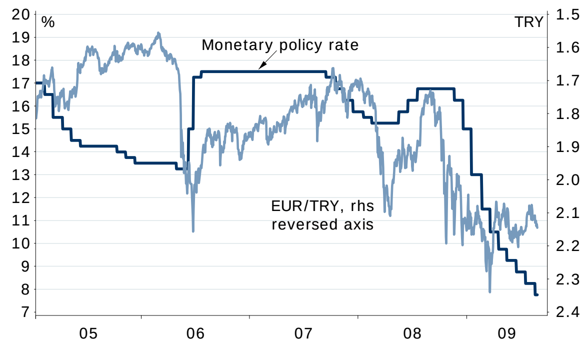
Economic contraction beat all records in Q1

Tax cuts underpin private consumption



TRY to strengthen; no policy rate hike until H2 2010



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

	2006 (TRYbn)	2007	2008	2009E	2010E	2011E
Private consumption	564.9	3.9	0.1	-5.5	2.5	3.5
Government consumption	93.5	6.5	1.8	2.5	2.5	2.5
Fixed investments	169.0	5.4	-4.6	-18.0	10.0	11.0
Exports	172	7.3	2.6	-18.0	4.5	5.0
Imports	209	10.7	-3.1	-20.0	6.0	8.0
GDP		4.7	1.1	-6.0	3.6	4.0
Nominal GDP, TRYbn	758	843	950	894	926	963
Unemployment rate, %		9.9	10.7	15.0	14.8	13.0
Consumer prices, % y/y		8.8	10.4	6.5	6.7	6.9
Current account, % of GDP		-5.9	-5.7	-1.9	-2.5	-4.0
Public sector balance, % of GNP		-1.6	-1.8	-5.8	-5.0	-4.0

Investment cuts may set the stage for a future price rally

The underlying oil price is expected to trend upwards and the price increase is expected to accelerate at the end of the forecast period. In the short term there is a risk that prices may fall below the underlying trend because of weak demand, high stocks and ample idle production capacity in OPEC.

Oil prices have more than doubled since the lows at the end of December 2008, but they are still below the level to ensure adequate investments to meet future supply requirements. A weak financing environment, lower profitability (lower oil prices) and uncertainty about future demand growth have increased fears of a crash in investment both in new capacity and to counter steep production declines in mature fields. Projects in high-cost regions have been cut markedly. Especially tar sand projects in Canada have been hit hard. Lower costs will to some extent counterbalance the fall in investment, but with a lag. Non-OPEC supply is expected to account for only a minor share of total supply growth over the forecast horizon. OPEC will account for the lion's share of future supply growth, as the cartel accounts for two thirds of the proven oil reserves in the world (British Petroleum). OPEC surplus capacity is at comfortable levels after the cut in production quotas since 1 January 2009, but new capacity needs to come on stream to be able to meet future demand growth. Lower oil prices and reduced output volumes have put the balance of some OPEC members under pressure. Despite years with high oil revenues, high public spending programmes and fuel subsidies have put additional investments in new capacity for a few national oil companies at risk. Amplifying the risk of future supply growth are the many obstacles to investments in many OPEC countries such as increasing national protectionism and political instability.

Global economic activity is a vital driver for oil demand. We expect to see a gradual recovery in the demand for oil as the pace of the world economic activity accelerates. The speed at which more oil-intensive emerging economies such as China will return to sustainable growth levels will be vital. Growth will probably not be back at pre-crisis levels until 2011 or 2012 – around the time current cuts in oil investment are expected to materialise as a fall in the production of petroleum. A huge setback in oil investment today can set the stage for a future price rally. The current weak investment environment has hit the full energy spectre. Especially investments in more capital-intensive projects with longer lead time and uncertain technology such as clean energy are at stake. This will add to the risk of an energy supply squeeze in the medium term.

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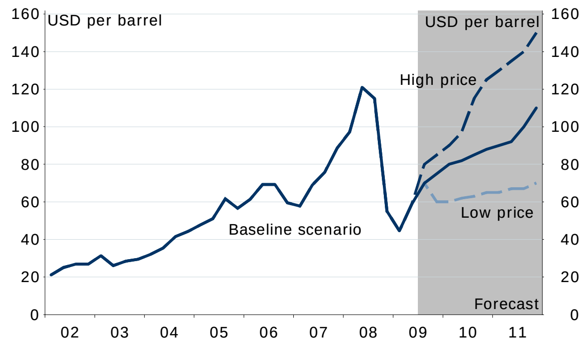
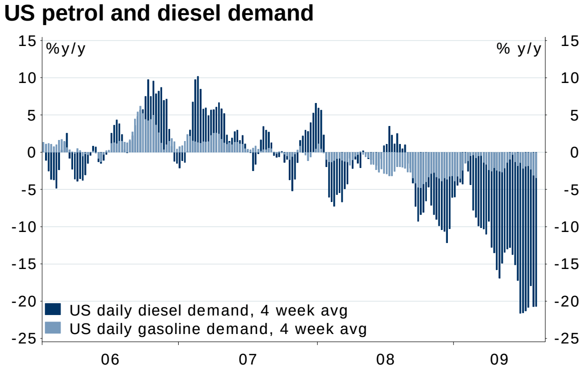
Oil price forecast – baseline (Brent spot – USD/barrel)

	Q1	Q2	Q3	Q4	Year
2007	57.8	69.0	75.8	88.7	72.8
2008	97.2	121.0	115.0	55.0	97.0
2009E	44.6	58.9	70.0	75.0	62.1
2010E	80.0	82.0	85.0	88.0	83.8
2011E	90.0	92.0	100.0	110.0	98.0

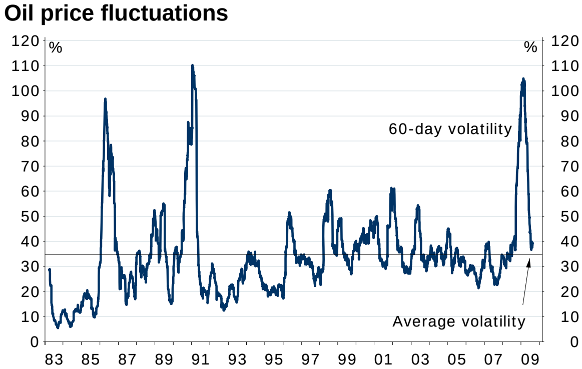
Oil price scenarios – baseline, high and low price



US petrol and diesel demand



Oil price fluctuations



Surge in base metal prices to cool down

Industrial metal prices have increased this year more than anyone could have suspected at the beginning of the year. There are clear fundamental reasons behind the rise. For instance, copper inventories in the London Metal Exchange have decreased notably as demand from China has been strong. Naturally, there have been fears that Chinese demand could weaken suddenly after a certain restocking period. So far this has not been the case, and as global manufacturing has started to recover broadly, it may well offset any softening in Chinese purchases at least in H2 this year.

The importance of China and other emerging markets for commodity prices has been evident and generally known for years. The role of the US economy has clearly diminished sharply. Historically, an increase in metal prices has been a sign that capacity utilisation in the US economy (and elsewhere in the western hemisphere) was rising and that it was time for the central bank to consider policy tightening. Now the developed economies are still quite far from that kind of situation.

Recently, metal prices have been among the best leading indicators for the global economy. They have gauged the recovery in Asian emerging markets better than any other analysis or indicator. Currently, metal prices point to a continued rebound in manufacturing activity in the near future. Unfortunately, that means that there are not many leading indicators for metal prices. The strong rise in prices is a sign that global manufacturing activity is set to surprise positively this autumn. Still, industrial recovery is not necessarily followed by a further surge in metal prices.

We foresee a brisk rebound in global manufacturing activity during H2 this year. The recent rise in metal prices is much in line with our view. Nevertheless, we anticipate that the initial rebound in activity in order to better meet the level of final demand will be followed by only a moderate recovery. Consequently our view on the global economy does not support a sharp, continuous increase in metal prices.

The rise in prices may also lead to increasing supply as there is capacity available for all types of metals. The rise in base metal prices may well be extended into coming months driven by strengthening sentiment and a rebound in manufacturing activity. Yet, a corrective drop in the price level may well take place next year unless the rise in prices slows down already during the autumn.

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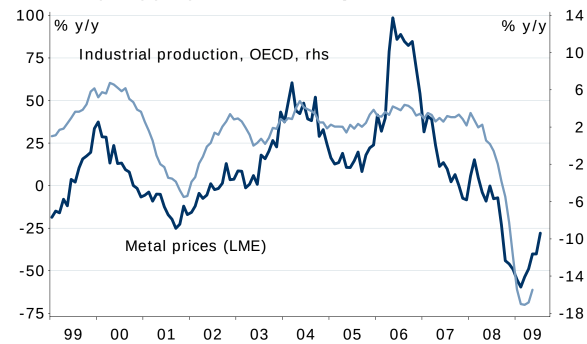
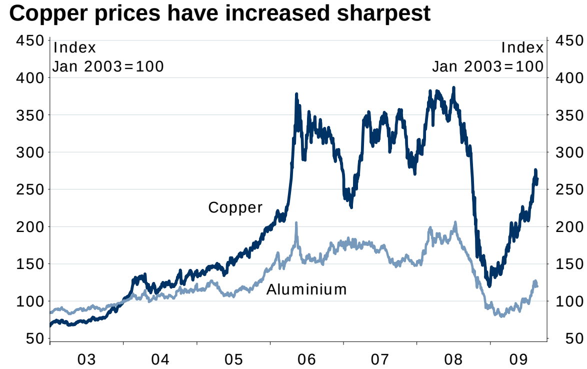
Metal prices have neatly doubled this year

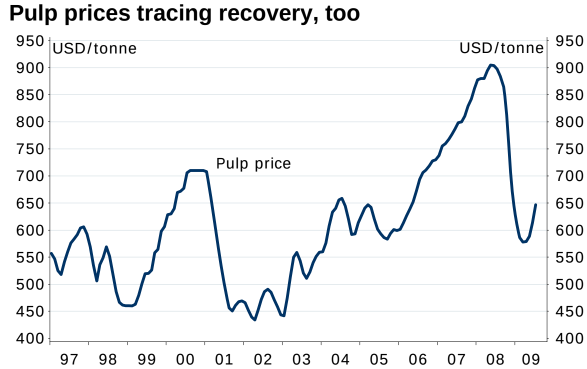
Recovery lagging rise in metal prices



Copper prices have increased sharpest



Pulp prices tracing recovery, too



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