Economic Outlook

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Markets

Data overview

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Economic springtime

2010 has so far been a year with much drama on the economic front; not least Europe has attracted a great deal of attention. The serious debt problems in a string of EU countries, with Greece as the worst example, have set the agenda. Add to this that Europe has been in the grip of one of the coldest winters on record and that the ash from the volcanic eruption in Iceland has not yet left the European airspace.

Against this background, it is even more encouraging that several economic data now indicate that Europe is finally sensing the dawn of better things to come. Strangely enough supported by the "Greek tragedy", which has sharply weakened the EUR and this has indirectly helped easing the financial conditions in the Euro area further. The improvement of competitiveness in the Euro area could be crucial for the export outlook. We therefore maintain our relatively optimistic view on economic growth in the Euro area this year, although trends in Q1 were definitely disappointing.

The same can certainly not be said for South East Asia, headed by China: supported by a lenient economic policy the Asian countries again deserve to be called tiger economies. Industrial production in the region has long been back at the pre-crisis long-term growth track and progress currently seems unstoppable. Also the Japanese economy, which was hit the hardest by the crisis, is currently benefiting from the Chinese recovery, which buoys the country's beleaguered exporters. Moreover, the expansion in China has led to rising commodity prices and renewed economic activity in the commodity-producing countries, including Brazil and Russia. Also the last BRIC country, India, is currently enjoying solid economic growth. Combined these four countries now represent an economic and political unity that holds joint summits, thus challenging the power of the established western institutions. Despite these new markets' growing economic and political importance, we still do not think they can take over the role as growth engine for the world economy, though.

The US is still the growth engine

This role is still played by the US. So it is very good news indeed that signs of an economic springtime are also emerging in "God's own country". The last months of 2009 were very strong and the first months of 2010 also saw solid growth and tentative signs of employment growth. So, it looks increasingly likely that the litmus test that we mentioned in our latest issue of *Economic Outlook* seems to have been passed. The economic upswing is on track and the world will not slide back into a new recession.

Nevertheless, we forecast only a moderate upswing in coming years. We must not forget that the world economy plummeted into a deep hole in the autumn of 2008 and that global industrial capacity utilisation is still weak. This constrains the investment requirement and makes the labour market situation difficult. In turn, this makes consumers reluctant to spend, although we have lately seen more signs that labour markets are gradually improving in many countries. Moreover, the years leading up to the crisis were characterised by a huge construction boom, and several countries still have a large overhang of vacant homes and office premises. We are not yet convinced that property prices in the US and a number of Southern European countries are done falling.

Policy tightening in sight

The expected and needed economic policy tightening will also be all-decisive for the economic outlook. The European Commission has in accordance with its procedure for excessive budget deficits recommended sharp fiscal policy tightening in most EU countries starting as early as this year. The Southern European countries, notably Greece, are therefore facing dramatic austerity measures that will inevitably lead to several years of very weak or perhaps even negative growth. It seems that the old Biblical prophecy that seven fat years will be followed by seven lean years will be fulfilled under any circumstances in the Euro area where capacity utilisation will probably not be back to full speed until 2015. There will be significant national variance, though. Whereas national fiscal policy easing was concerted and the dosage was roughly the same, the tightening will be asymmetrical both in terms of timing and size. The countries that put the most aside during the fat years will get through the austerity period more easily – and the Nordic countries are definitely among these. Even the Baltic countries which are currently undergoing an incredibly steep economic nosedive with huge public finance deficits have considerably better debt ratios than the Southern European countries.

One problem that all the "old world" countries share is that aging populations will place major demands on public finances. None of the countries will be able to avoid hiking taxes or scaling back public expenditure if the socio-economic budget is to balance in the long term. In this connection it is worth pointing out that tightening of public spending has a higher success rate, as it implies stronger credibility in terms of the future budget situation with resultant lower interest rates, which will stimulate growth as well as reduce future interest payments on the public debt.

The focus on the Greek sovereign debt crisis – which we incidentally do not see as a real threat to either the EU or EMU – has lately overshadowed similar problems in the US. But the fact is that the US also currently struggles with double-digit public budget deficits. California, which is about the size of France in economic terms, is just as close to the brink of bankruptcy as Greece. Financial market participants could therefore quickly turn their attention from the European budget woes to the problems in the US once a tangible solution to the situation in Greece has been found in collaboration with the IMF and the EU.

Moderate interest rate increases

The Greek crisis has caused the EUR to weaken sharply versus the other major currencies since the beginning of the year. Consequently, the European Central Bank (ECB) is now facing an additional dilemma as regards its future interest rate policy. It is clear that the quantitative easing that the bank has generously dispersed since the recession broke out will slowly but surely be withdrawn. But the big question is when the ECB will sanction its first rate hike. We believe that it will not be until some time in Q1 2011. It could be both sooner or later, though. The heralded fiscal policy tightening could result in lower economic growth than would otherwise have been the case, which could make the ECB postpone the first rate hike. On the other hand, the weakening of the EUR could increase the risk of it happening sooner. Partly because imported inflation will rise faster and partly because growth could surprise on the upside if exporters get extra tailwind. This could prompt the ECB to act sooner than assumed in our baseline scenario. This would also help the ECB counter the risk of the lenient monetary policy creating new equity and housing markets bubbles.

However, under any circumstances the interest rate increases should be moderate over the forecast horizon, because the economic upswing will be moderate. Thus, we only expect the ECB to raise its policy rate to 2% over the coming 24 months. We believe that the Fed will not hike its policy rate until 2011, but that it will then act slightly more aggressively than the ECB. We thus also look for a fed funds rate of 2% in two years.

The expected monetary policy tightening will also make long yields move higher over the forecast horizon, albeit also at a moderate pace, as we do not consider the underlying inflationary risk to be significant near term. Longer out, the inflation outlook will rely heavily on the ability to exit the expansionary economic policy line in time.

Nordic progress

After last year's historically sharp GDP contraction of 4.9%, the **Danish** economy is again heading for brighter times. Interest rates are low, confidence indicators are high, the housing market has stabilised and the main export markets are showing positive growth trends. At the same time private consumption has been stimulated by tax cuts and low interest rates, and higher government consumption is still providing quite a boost to economic growth. However, these positive factors are accompanied by a number of challenges. Unemployment has risen sharply, productivity is still sluggish and the growth contribution from the government's stimulus measures is slowly but surely petering out. Overall, this paints a picture of 2010 as a year when moderate growth will slowly pull the Danish economy towards brighter times. We believe this trend will continue into 2011 and therefore look for economic growth of 1.7% in both forecast years.

It has become increasingly clear that the recovery of the **Swedish** economy is relatively strong. Employment has already started to grow, public finances are close to balancing and house prices are rising rapidly. The GDP performance was admittedly weak in 2009, but conditions are in place for healthy growth figures this year, particularly in the latter part. As the stimulus effects fade in the rest of world and to some extent also in Sweden, and many countries still struggle with imbalances, growth will slow somewhat in 2011. We expect GDP to grow by just under 3% this year and around 2.5% in 2011. Despite moderate cost pressures the Riksbank seems ready to hike its policy rate this year. We look for the first rate hike this summer and expect a repo rate of 1.75% at end-2010.

Growth in the second half of 2009 and early 2010 looks set to be weaker in **Norway** than expected in the January issue of *Economic Outlook*. With lower output at the beginning of the year and prospects of lower real wage growth – and thus weaker spending growth – we have cut our forecast for mainland economic growth to just 2% in 2010. Interest rates could rise less in 2010 than we anticipated, implying a lower level in 2011 than assumed in January. Partly for this reason we have revised up our growth forecast for 2011. Another factor pulling in the same direction is that we have less confidence in the government's commitment to tightening the budget in 2011. Even so, strong growth is not on the cards for 2011. Growth should be broadly in line with the 2010 level instead of somewhat lower as projected in January

The **Finnish** economy started to pick up in H2 2009 and the recovery is set gain strength going forward. We continue to expect reasonable 2.7% GDP growth this year. Growth depends a bit more on domestic demand than in the earlier forecast. The outlook for 2011 is slightly brighter than we expected previously mainly owing to private consumption. Since the recession was mainly caused by a drop in exports and domestic markets were affected much less, the unemployment rate is set to peak at a relatively modest level this summer. This helps to keep the public deficit at about 3% of GDP. Consequently, the future challenges to balanced public finances will be moderate compared to the other Euro- area countries.

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Growth, %

	2007	2008	2009	2010E	2011E
World[1)]	4.8	2.3	-1.2	4.1	3.8
BIG-3[2)]	2.4	0.2	-3.4	2.2	2.0
USA	2.1	0.4	-2.4	2.9	2.2
Japan[3)]	2.3	-1.2	-5.2	1.9	2.0
Euro area	2.7	0.5	-4.0	1.4	1.7
Germany	2.6	1.0	-4.9	1.6	1.9
France	2.3	0.3	-2.2	1.5	1.6
Italy	1.5	-1.0	-5.1	1.3	1.3
Spain	3.7	1.2	-3.6	-0.3	1.4
Netherlands	3.5	2.0	-4.0	1.6	1.8
Belgium	2.6	1.5	-3.2	1.8	2.0
Austria	3.4	2.0	-3.6	1.6	2.1
Portugal	1.9	0.5	-2.7	0.7	1.0
Greece	4.0	3.0	-2.0	-2.5	-1.0
Finland	4.9	1.2	-7.8	2.7	3.0
Ireland	6.3	-2.0	-7.1	-0.5	1.5
Denmark	1.7	-0.9	-4.9	1.7	1.7
Sweden	2.5	-0.2	-4.9	2.8	2.6
Norway	5.6	2.2	-1.5	2.1	2.2
Iceland	5.6	1.3	-7.3	-4.9	2.3
UK	2.6	0.5	-4.9	1.2	2.2
Switzerland[3)]	3.6	1.8	-1.5	1.5	1.8
Russia	8.1	5.6	-7.9	6.0	4.5
Poland	6.8	5.0	1.8	3.5	3.8
Estonia	7.2	-3.6	-14.1	1.2	4.0
Latvia	10.0	-4.6	-18.0	-2.0	3.0
Lithuania	9.8	2.8	-14.9	0.5	3.0
China	13.0	9.6	8.7	10.4	9.5
India	9.6	5.1	6.8	9.0	8.8
Brazil	6.1	5.1	-0.2	6.3	5.1

Inflation, %

	2007	2008	2009	2010E	2011E
World	3.1	4.6	0.7	2.5	2.2
BIG-3	2.2	3.3	-0.2	1.4	1.2
USA	2.9	3.8	-0.3	1.9	1.3
Japan[3)]	0.1	1.5	-1.3	-0.5	0.0
Euro area	2.3	3.3	0.3	1.6	1.6
Germany	2.3	2.8	0.3	1.3	1.5
France	1.6	3.2	0.1	1.7	1.6
Italy	2.0	3.5	0.6	1.7	1.6
Spain	2.8	4.2	-0.3	1.2	1.5
Netherlands	1.6	2.2	1.0	1.7	1.6
Belgium	1.8	4.5	0.0	1.8	1.6
Austria	2.1	3.2	0.4	1.7	1.5
Portugal	2.5	2.8	-1.0	1.3	1.2
Greece	3.0	4.3	1.3	2.2	1.2
Finland	2.5	4.1	0.0	1.0	2.5
Ireland	2.9	3.1	-1.6	-1.0	0.0
Denmark	1.7	3.4	1.3	1.8	1.7
Sweden	2.2	3.4	-0.3	1.2	2.3
Norway	0.8	3.8	2.1	2.0	1.5
Iceland	5.0	12.4	12.0	6.0	2.0
UK	2.3	3.6	2.2	2.6	1.8
Switzerland[3)]	0.7	2.4	-0.4	0.7	1.0
Russia	9.0	14.1	11.7	7.0	7.2
Poland	2.6	4.4	3.9	2.4	2.2
Estonia	6.7	10.6	-0.1	0.5	1.5
Latvia	10.1	15.3	3.6	-2.2	-0.5
Lithuania	5.8	11.1	4.2	-1.0	0.5
China	4.8	5.9	-0.7	3.5	3.0
India (WPI)	4.8	9.1	1.5	6.5	5.3
Brazil	3.6	5.7	4.9	5.4	4.8

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

3) Source: IIMF WE O April 2010

Public finances, % of GDP

	2007	2008	2009	2010E	2011E
BIG-3	-1.1	-2.7	-8.6	-9.1	-7.9
USA	-1.1	-3.2	-9.9	-10.7	-9.0
Japan[3)]	-2.5	-2.7	-10.3	-9.8	-9.1
Euro area	-0.6	-2.0	-6.2	-6.7	-5.8
Germany	-0.2	0.0	-3.3	-5.0	-4.8
France	-2.7	-3.3	-7.5	-8.2	-6.9
Italy	-1.5	-2.7	-5.3	-5.5	-4.8
Finland	5.2	4.2	-2.2	-3.0	-2.5
Denmark	4.8	3.4	-3.0	-5.6	-4.5
Sweden	3.8	2.5	-0.8	-0.5	0.5
Norway	17.7	19.1	9.7	12.3	16.5
Iceland	5.4	-13.6	-15.0	-10.0	-5.0
UK	-2.3	-4.9	-11.9	-13.0	-11.5
Switzerland[3)]	2.1	1.0	1.4	-1.0	-0.9
Russia	6.1	4.1	-6.3	-6.0	-4.0
Poland	-1.9	-3.9	-7.1	-6.5	-5.5
Estonia	2.6	-2.7	-1.7	-2.5	-2.2
Latvia	-0.3	-4.1	-9.0	-8.0	-6.0
Lithuania	-1.0	-3.2	-8.9	-8.0	-6.8
China	0.6	-0.4	-2.1	-3.2	-2.2
India	-2.7	-6.2	-8.0	-7.5	-7.2
Brazil	-2.2	-1.6	-3.2	-2.7	-2.0

Current account, % of GDP

	2007	2008	2009	2010E	2011E
BIG-3	-	-	-	-	-
USA	-5.2	-4.9	-2.9	-3.0	-3.0
Japan[3)]	4.8	3.2	2.8	2.8	2.4
Euro area	0.2	-1.6	-0.6	-0.3	-0.5
Germany	7.8	6.6	5.0	6.5	7.0
France	-1.0	-2.3	-2.0	-1.5	-1.8
Italy	-2.4	-3.4	-3.4	-3.0	-3.0
Finland	4.3	3.1	1.3	1.5	1.6
Denmark	1.5	2.2	4.0	2.4	2.1
Sweden	9.1	9.5	7.2	6.6	6.5
Norway	15.9	17.7	13.8	16.4	20.5
Iceland	-20.6	-42.2	-10.0	3.0	5.0
UK	-2.7	-1.5	-1.3	-1.1	-1.0
Switzerland[3)]	10.4	1.4	8.7	9.5	9.6
Russia	5.9	6.2	3.9	5.0	4.5
Poland	-4.7	-5.1	-1.6	-1.6	-1.2
Estonia	-17.9	-9.1	4.6	4.0	2.0
Latvia	-22.5	-13.0	9.4	7.0	5.0
Lithuania	-15.0	-11.9	3.8	3.0	2.5
China	10.7	9.6	5.8	6.0	4.3
India	-1.0	-1.2	-1.6	-1.6	-1.8
Brazil	0.1	-1.8	-1.5	-2.5	-3.0

Monetary policy rates

	28.4.10	3M	6M	12M	24M
US	0.25	0.25	0.25	0.75	2.00
Japan	0.10	0.10	0.10	0.10	0.50
Euro area	1.00	1.00	1.00	1.25	2.00
Denmark	1.05	1.00	1.00	1.35	2.25
Sweden	0.25	0.50	1.25	2.25	3.00
Norway	1.75	2.00	2.25	2.50	3.25
UK	0.50	0.50	0.50	1.00	2.50
Switzerland	0.25	0.25	0.25	0.50	1.00
Poland	3.50	3.50	4.00	4.25	4.75
Czech Rep.	1.00	1.00	1.00	1.25	2.25
Hungary	5.50	5.00	5.25	5.75	6.50

Monetary policy rate spreads vs Euro area

	28.4.10	3M	6M	12M	24M
US	-0.75	-0.75	-0.75	-0.50	0.00
Japan[1]	-0.15	-0.15	-0.15	-0.65	-1.50
Euro area	-	-	-	-	-
Denmark	0.05	0.00	0.00	0.10	0.25
Sweden	-0.75	-0.50	0.25	1.00	1.00
Norway	0.75	1.00	1.25	1.25	1.25
UK	-0.50	-0.50	-0.50	-0.25	0.50
Switzerland	-0.75	-0.75	-0.75	-0.75	-1.00
Poland	2.50	2.50	3.00	3.00	2.75
Czech Rep.	0.00	0.00	0.00	0.00	0.25
Hungary	4.50	4.00	4.25	4.50	4.50

1) Spread vs US

3-month rates

	28.4.10	3M	6M	12M	24M
US	0.33	0.30	0.40	1.25	2.50
Euro area	0.65	0.70	0.90	1.50	2.25
Denmark	1.28	1.35	1.35	1.70	2.60
Sweden	0.54	1.00	1.70	2.50	3.25
Norway	2.40	2.43	2.60	2.80	3.55
UK	0.66	0.65	0.90	1.40	2.80
Poland	3.86	3.90	4.40	4.75	5.25
Czech Rep.	1.40	1.40	1.50	1.75	2.50
Hungary	5.24	5.30	5.60	6.25	7.00
Estonia	1.80	1.50	1.20	1.50	2.25
Latvia	2.14	1.70	1.20	1.80	2.00
Lithuania	1.45	1.20	1.00	1.40	1.80

3-month spreads vs Euro area

	28.4.10	3M	6M	12M	24M
US	-0.32	-0.40	-0.50	-0.25	0.25
Euro area	-	-	-	-	-
Denmark	0.63	0.65	0.45	0.20	0.35
Sweden	-0.11	0.30	0.80	1.00	1.00
Norway	1.75	1.73	1.70	1.30	1.30
UK	0.02	-0.05	0.00	-0.10	0.55
Poland	3.21	3.20	3.50	3.25	3.00
Czech Rep.	0.75	0.70	0.60	0.25	0.25
Hungary	4.59	4.60	4.70	4.75	4.75
Estonia	1.15	0.80	0.30	0.00	0.00
Latvia	1.49	1.00	0.30	0.30	-0.25
Lithuania	0.80	0.50	0.10	-0.10	-0.45

10-year government benchmark yields

	28.4.10	3M	6M	12M	24M
US	3.79	3.85	3.85	4.20	4.50
Euro area	3.02	3.30	3.45	3.60	4.00
Denmark	3.26	3.55	3.70	3.85	4.20
Sweden	2.98	3.40	3.55	3.70	4.00
Norway	3.69	3.99	4.20	4.33	4.59
UK	4.01	4.25	4.35	4.50	4.80
Poland	5.59	5.40	5.50	5.60	5.75
Czech Rep.	3.65	3.75	4.00	4.25	4.50
Hungary	6.50	6.75	7.00	7.25	7.50

10-year yield spreads vs Euro area

	28.4.10	3M	6M	12M	24M
US	0.77	0.55	0.40	0.60	0.50
Euro area	-	-	-	-	-
Denmark	0.24	0.25	0.25	0.25	0.20
Sweden	-0.04	0.10	0.10	0.10	0.00
Norway	0.67	0.69	0.75	0.73	0.59
UK	0.99	0.95	0.90	0.90	0.80
Poland	2.57	2.10	2.05	2.00	1.75
Czech Rep.	0.63	0.45	0.55	0.65	0.50
Hungary	3.48	3.45	3.55	3.65	3.50

Exchange rates vs EUR

	28.4.10	3M	6M	12M	24M
EUR/USD	1.319	1.350	1.350	1.300	1.200
EUR/JPY	123.0	124.2	124.2	130.0	138.0
EUR/DKK	7.442	7.443	7.455	7.455	7.455
EUR/SEK	9.655	9.450	9.250	9.100	9.100
EUR/NOK	7.866	7.800	7.800	8.000	8.000
EUR/GBP	0.866	0.900	0.900	0.840	0.800
EUR/CHF	1.433	1.390	1.390	1.440	1.470
EUR/PLN	3.941	3.800	3.900	3.900	3.700
EUR/CZK	25.63	25.00	25.50	25.50	24.00
EUR/HUF	270.1	255.0	260.0	265.0	270.0
EUR/RUB	38.73	38.61	38.21	36.01	32.40
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.708	0.707	0.700	0.700	0.700
EUR/LTL	3.453	3.453	3.453	3.453	3.453
EUR/CNY	9.001	9.113	9.045	8.450	7.260

Exchange rates vs USD

	28.4.10	3M	6M	12M	24M
-					
USD/JPY	93.3	92.0	92.0	100.0	115.0
USD/DKK	5.644	5.513	5.522	5.735	6.213
USD/SEK	7.321	7.000	6.852	7.000	7.583
USD/NOK	5.965	5.778	5.778	6.154	6.667
GBP/USD	1.522	1.500	1.500	1.548	1.500
USD/CHF	1.087	1.030	1.030	1.108	1.225
USD/PLN	2.988	2.815	2.889	3.000	3.083
USD/CZK	19.43	18.52	18.89	19.62	20.00
USD/HUF	204.8	188.9	192.6	203.8	225.0
USD/RUB	29.37	28.60	28.30	27.70	27.00
USD/EEK	11.87	11.59	11.59	12.04	13.04
USD/LVL	0.537	0.524	0.519	0.538	0.583
USD/LTL	2.618	2.558	2.558	2.656	2.878
USD/CNY	6.826	6.750	6.700	6.500	6.050

Heading for brighter times

- Prospect of moderate economic growth
- Falling interest rates to make large impact this year
- Business and residential investment under pressure
- Bright outlook for private consumption

After last year's historically sharp GDP contraction of 4.9%, the economy is again heading for brighter times. Interest rates are low, confidence indicators are high, the housing market has stabilised and the main export markets are showing positive growth trends. At the same time private consumption has been stimulated by tax cuts and higher government consumption is still providing quite a boost to economic growth. However, these positive factors are offset by a number of challenges. Unemployment has risen sharply, productivity is still sluggish and the growth contribution from the government's stimulus measures is slowly but surely petering out. Overall, this paints a picture of 2010 as a year when moderate growth will slowly pull the Danish economy towards brighter times. We believe this trend will continue into 2011 and therefore look for economic growth of 1.7% in both forecast years.

Low rates to have major impact this year

Since end-2008 falling interest rates have eased interest expenditure burdens considerably for households and businesses alike. It seems likely that 2010 will be the year when lower interest rates will really make a difference to budgets – one of the reasons being that mortgage borrowers have only recently felt the benefit of low rates on adjustable-rate loans. Households may look forward to a reduction of interest expenses before tax of around DKK 24bn, while non-financial businesses may shave around DKK 10bn off their interest expenses. In 2011 interest expenses will probably be higher due to rising market rates. However, the uptick should be moderate, so interest expenses will likely still be relatively low in 2011.

Investment under pressure

In addition to making the economic backdrop more favourable for businesses and households, low interest rates are (all else equal) also a bonus for the investment climate. The latest surveys suggest that companies will scale up investment activity already this year. On the other hand, the outlook for residential investment is still very gloomy. Residential construction has been hit by a setback of historical dimensions – in 2009 the number of housing starts was the lowest since 1955. This means continued negative pressure on residential investment in 2010.

Bright private consumption outlook

Danish consumers' assessment of the coming 12 months' economic trends has been historically high for several months. A sharp decline in home equity values and financial assets has now been replaced by an increase. At the same time tax cuts and falling interest rates have boosted disposable incomes and private consumption thus looks set to rise quite significantly in 2010 – although growing unemployment and a higher savings ratio will curtail this increase. Based on the latest available private consumption data – retail sales and payment card sales – the icy winter put a damper on spending in January and February, while payment card sales rose markedly in March. Combined with rising car sales, this could be a sign that consumption is finally shifting into a faster gear again.

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

	2006 (DKKbn)	2007	2008	2009	2010E	2011E
Private consumption	787	2.4	-0.2	-4.6	2.9	2.7
Government consumption	423	1.3	1.6	2.5	1.2	0.5
Fixed investment	356	2.9	-4.7	-12.0	-4.2	-0.8
- government investment	32	-3.3	-2.9	20.1	12.0	-10.0
- residential investment	108	3.4	-14.2	-16.8	-6.1	-1.4
- business fixed investment	216	3.5	-0.4	-14.2	-6.3	1.6
Stockbuilding*	15	-0.3	0.3	-1.7	1.1	0.3
Exports	850	2.2	2.4	-10.4	1.9	4.3
Imports	798	2.6	3.3	-13.2	4.1	4.4
GDP		1.7	-0.9	-4.9	1.7	1.7
Nominal GDP (DKKbn)	1,632	1,691	1,737	1,676	1,694	1,770
Unemployment rate, %		2.7	1.7	3.3	4.6	4.9
Unemployment level, '000 persons		74.1	48.1	92.2	128.0	138.0
Consumer prices, % y/y		1.7	3.4	1.3	1.8	1.7
Hourly earnings, % y/y		4.0	4.5	2.9	2.1	2.0
House prices, one-family, % y/y		4.6	-4.5	-12.5	4.0	2.0
Current account (DKKbn)		25.0	38.0	66.3	40.0	38.0
- % of GDP		1.5	2.2	4.0	2.4	2.1
General govt. budget balance (DKKbn)		80.6	59.8	-50.3	-94.4	-79.0
- % of GDP		4.8	3.4	-3.0	-5.6	-4.5
Gross public debt, % of GDP		26.8	33.4	38.4	42.6	46.8

* Contribution to GDP-growth (% points)

Government stimulus will peter out next year
Government spending will be tightened to comply with the government's convergence programme. Growth in public spending thus looks set to be considerably lower already next year. But in 2010 public spending and investment should still make a significant contribution to economic growth.

Current account surplus shrinking
In step with accelerating activity with our main trading partners, Danish exports are seen rising. But the improvement will probably be quite modest in light of the continued problems of higher wage growth in Denmark affecting Danish competitiveness. In 2009 the current account surplus was very substantial. One of the main reasons was that imports fell more sharply than exports, which also nosedived. In 2010 and 2011 imports are likely to rise more than exports, with growing private consumption as one of the main drivers. The current account surplus will therefore probably shrink a bit again.

Bright spots in the labour market
Since the turn of the year unemployment has stabilised at around 120,000 (full-time jobs). At the same time the number of job vacancies has risen in recent months as economic activity has picked up pace. We see this as a tentative sign of gradually improving labour market conditions towards the end of the year – although job vacancies are still so few that they will not prevent unemployment from rising further. However, it is important to emphasise that although the latest official jobless numbers suggest stabilising unemployment, gross unemployment (including job seekers and those on retraining programmes) is still on the rise. At the same time, many have left the labour market over the past year. We estimate that up to 75,000 persons have left the labour market entirely and are therefore no longer included in the official unemployment statistics.

With economic growth of 1.7% annually in both 2010 and 2011, we can expect employment to shrink by an additional 50,000 persons until the end of 2010. The declining labour force will account for about half, while continued growing unemployment will account for the other half. We therefore expect unemployment to rise to 4.6% of the labour force in 2010, with a gross unemployment rate of 6.2%.

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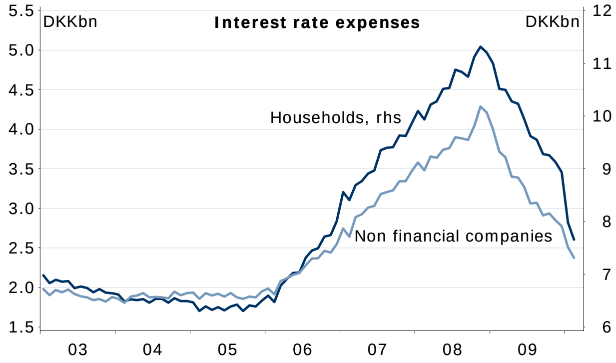
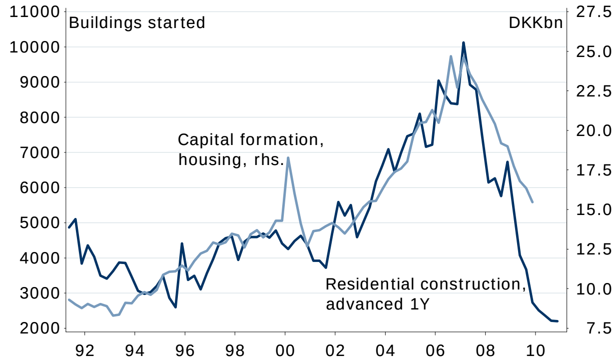
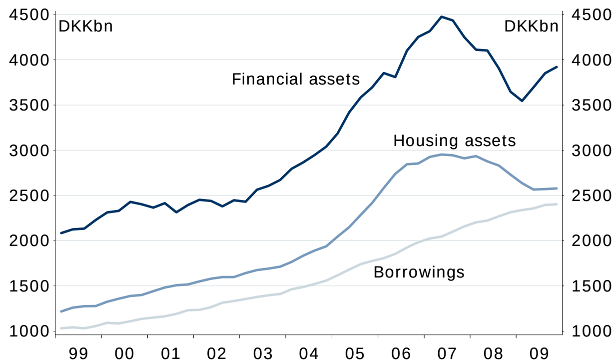
Falling interest rates now having major impact



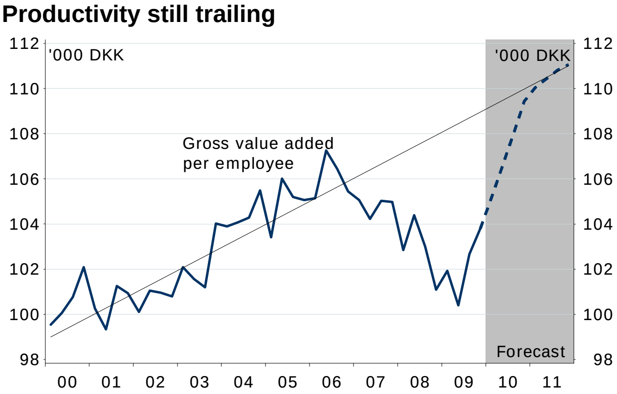
Construction sector suffers historical setback



Gradual recovery of household assets



Productivity still trailing



A message of strength

- Sharp GDP increase in 2010
- Government finances almost balanced
- Riksbank repo rate hike to 1.75% this year

It has become increasingly clear that the recovery in the Swedish economy is relatively strong. Employment has already started to grow, public finances are close to balancing and house prices are rising rapidly. The GDP performance was admittedly weak in 2009, but conditions are in place for healthy growth figures this year, particularly in the latter part. As the stimulus effects fade in the rest of world and to some extent also in Sweden, and many countries still struggle with imbalances, growth will slow somewhat in 2011. We expect GDP to grow by just under 3% this year and around 2.5% in 2011.

Improved domestic economy

Household consumption rose already in Q2 2009. Consumption has thus mitigated the economic downturn and is one of the reasons why employment has already picked up. Consumption will continue to be a key driver, as household demand will continue to be stimulated from several fronts. Interest rates are still record low, lifting house prices and strengthening real wealth. Income taxes were cut also this year and rising equity markets imply that financial wealth has recovered sharply. Moreover, households' savings ratio is high; with strong consumer confidence savings probably will decline somewhat over the forecast horizon.

The improved labour market outlook is the key reason why household consumption will show healthy growth going forward. The stimulus measures will fade somewhat next year, not least due to higher interest rates and a less expansionary fiscal policy, which contributes to curbing the increase in household demand somewhat. The tax cuts for households coincide with 2010 being an election year. The municipalities have also been allocated additional funds. Much therefore indicates that government consumption will grow briskly this year as is generally the case in election years. The adopted fiscal policy implies that the additional funds to the municipalities will be reduced by some SEK 10bn in 2011. However, we expect that additional funds will be announced ultimately result in an unchanged government contribution.

Growth more broadly based

The export sector is lagging and has so far slowed the recovery of the Swedish economy. However, new orders have risen markedly, particularly from export markets, while other indicators paint a bright picture of the current situation. And much suggests that the Swedish manufacturing industry will also increasingly benefit from the ongoing recovery in world trade. Exports are thus expected to become an even more important growth engine.

With improved production, investment activity will also gradually gain momentum. As capacity utilisation in several sectors is already low, investment activity will probably not pick up until next year. This view is supported by the cautious investment plans for 2010 among companies in for example the manufacturing industry. Residential construction was very low at the end of 2009 and is unlikely to increase until next year when total investment is projected to rise by some 5%. Inventories are important in the economic cycle. Last year's significant destocking contributed to dampening GDP. Note that our forecast assumes further destocking this year. As the reduction is much more moderate than last year, inventories will still have a major positive effect on this year's GDP performance.

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

	2006 (SEKbn)	2007	2008	2009	2010E	2011E
Private consumption	1,373	3.0	-0.2	-0.8	2.8	2.2
Government consumption	762	0.3	1.4	2.1	1.9	0.9
Fixed investment	528	7.5	2.6	-15.3	-1.2	4.5
- industry	83	11.4	2.2	-21.8	-3.1	6.2
- residential investment	92	8.7	-5.2	-20.5	0.5	8.7
Stockbuilding*	0	0.8	-0.6	-1.5	1.1	0.4
Exports	1,494	5.8	1.9	-12.5	4.7	4.6
Imports	1,257	9.4	3.0	-13.4	5.4	5.1
GDP		2.5	-0.2	-4.9	2.8	2.6
Nominal GDP (SEKbn)	2,901	3,063	3,155	3,057	3,182	3,310
Unemployment rate, %		6.1	6.2	8.3	9.0	8.9
Employment growth		2.5	1.2	-2.1	0.5	0.7
Consumer prices, % y/y		2.2	3.4	-0.3	1.2	2.3
Underlying inflation (CPIF), % y/y		1.5	2.7	1.9	1.9	1.2
Hourly earnings, % y/y		3.1	4.4	3.2	2.3	2.7
Current account (SEKbn)		279.0	299.0	222.0	210.0	217.0
- % of GDP		9.1	9.5	7.2	6.6	6.5
Trade balance, % of GDP		4.6	4.0	3.6	3.2	3.3
General govt budget balance (SEKbn)		116	80	-25	-16	17
- % of GDP		3.8	2.5	-0.8	-0.5	0.5
Gross public debt, % of GDP		40.9	38.3	42.3	41.1	39.4

* Contribution to GDP growth (% points)

Improved labour market but low inflation

The decline in the number of people employed levelled out already in Q3 2009 and reversed in Q4. The uptrend remained intact in the first months of 2010. All indicators suggest that employment will continue to rise, while unemployment has peaked and is on the decline.

Labour market trends are pivotal for inflation in the medium term, as higher resource utilisation normally implies faster wage increases. However, short term we believe that underlying inflation pressures will ease. The reason is that the ongoing pay talks will by all accounts result in considerably lower wage increases than the previous round of pay talks. Moreover, the SEK has appreciated and is likely to gain further strength going forward, resulting in lower import prices.

Higher interest rates

Our view on underlying inflation is in line with the Riksbank's forecasts. Despite easing cost pressures the bank is inclined to hike its policy rate this year, as it has changed focus from handling a financial crisis to managing an economy in a recovery phase. The surprisingly early labour market reversal is not just a sign that the recovery has gained a firm foothold but also that economic activity is rising at a healthy clip. Add to this rising asset prices and a risk of overheating in the housing market. Against this background, a repo rate close to zero is too low. We therefore look for the first rate hike in the summer, with the repo rate reaching 1.75% at end-2010.

Interest rates thus largely seem to have bottomed. Some factors will curb the rise in interest rates in the longer term, though. The sovereign debt crisis in the Euro area will prompt the ECB to embark on a hiking cycle much later than the Riksbank and it will proceed much more cautiously. Given the Riksbank's relatively early hikes and the stronger confidence in the Swedish economy, the SEK is likely to firm against the EUR to 9.25 on a 6m horizon. A more significant strengthening of the SEK could reduce the need for rate hikes longer out. Swedish households increasingly prefer adjustable-rate mortgage loans. Consequently, consumption and house prices could be impacted by even minor interest rate changes.

For long yields, trends in the US economy are crucial. Uncertainties over the US economy and the forecast of moderate growth next year reduce the likelihood of a stronger uptrend in yields. In addition, public finances in Sweden are in surprisingly good shape. Public sector financial savings could balance as early as this year and we look for a minor surplus next year despite the additional SEK 20bn of unfunded reforms. The solid public finances limit the supply of bonds and hold back yield increases.

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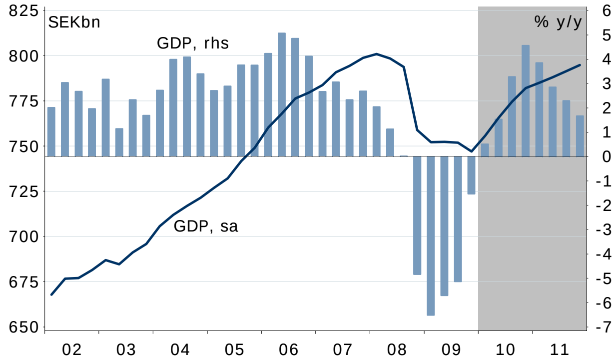
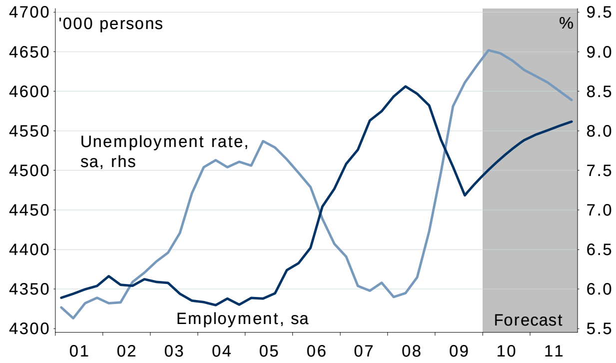
Robust GDP growth in 2010

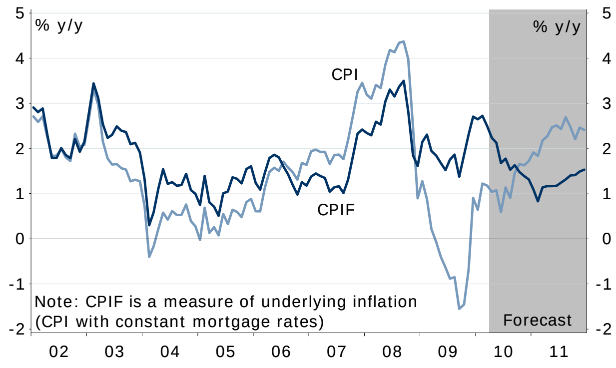


New orders point to recovery

Unemployment has peaked



Easing underlying inflation



Moderate growth and low inflation

- Growth will be moderate and inflation low
- Tightening moves will be cautious
- This will prevent significant NOK appreciation

Growth disappointing – moderate rate rises

Growth in the second half of 2009 and early 2010 looks set to be weaker than expected in the January issue of *Economic Outlook*. With lower output at the beginning of the year and prospects of lower real wage growth – and thus weaker spending growth – we have cut our forecast for mainland economic growth to just 2% in 2010.

Interest rates could rise less in 2010 than we anticipated, implying a lower level in 2011 than assumed in January. Partly for this reason we have revised up our growth forecast for 2011. Another factor pulling in the same direction is that we have less confidence in the government's commitment to tightening the budget in 2011. Even so, strong growth is not on the cards for 2011. Growth should be broadly in line with the 2010 level instead of somewhat lower as projected in January.

Annual growth in the mainland economy of 2% over the next couple of years is not enough to prevent further labour market weakness. Given that the NOK has appreciated more than expected and this year's more moderate pay deals, we have lowered our core inflation forecasts for the years ahead. Lower inflation, slower wage growth and a stronger currency are the main reasons why we expect Norges Bank to proceed with caution

Robust spending growth slowing

The large rate cuts in late 2008 and in 2009 helped to boost household incomes. Initially, consumers chose to save the additional money and spending was thus unchanged from 2008 to 2009.

During last year, however, spending growth accelerated sharply and we expect this strong growth to continue this year. Income growth is set to be very modest this year driven by low wage growth and somewhat higher interest rates. Yet with the high savings level, people are able to finance additional spending by saving less. Rising interest rates point to another slowdown in consumer spending growth in 2011.

Oil investment to remain high

Oil companies' investment plans and a gradual rise in oil prices suggest that investment activity offshore in 2010 and 2011 could end up close to last year's record level. This is good news at least for parts of the mainland industry producing capital goods for the offshore sector. Growing international competition and excess capacity in parts of the oil service sector nevertheless mean that demand for ships and vessels could be rather weak. The production of vessels and platforms peaked last spring and has dropped nearly 10% since then. Weak order inflows indicate further declines going forward.

Business investment in the mainland economy has dropped sharply but is still at a relatively high level. Current statistics suggest that we are close to the bottom, and from 2010 to 2011 a slight rise in investment by mainland businesses is likely. The turnaround in residential investment will be more marked. House prices have accelerated quite sharply and should rise further over the year given the continued relatively low interest rates and low unemployment. With available capacity in the construction sector, higher house prices point to solid growth in residential investment going forward.

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

	2006 (NOK bn)	2007	2008	2009E	2010E	2011E
Private consumption	882	5.4	1.3	0.0	3.5	2.5
Government consumption	413	3.0	4.1	5.2	3.0	2.0
Fixed investment	424	12.5	1.4	-7.9	-1.7	2.2
- gross investment, mainland	308	15.7	1.0	-12.1	-2.3	3.1
- gross investment, oil	99	7.2	-1.0	6.8	0.0	0.0
Stockbuilding*	51	-1.3	0.5	-1.9	0.0	0.0
Exports	1,003	2.3	0.9	-4.3	2.8	1.7
- crude oil and natural gas	498	-2.4	-2.0	-1.3	1.0	1.0
- other goods	272	8.5	4.3	-7.8	5.0	3.0
Imports	613	8.6	2.2	-9.7	4.2	2.8
GDP	2,160	2.7	1.8	-1.5	1.8	1.9
GDP, mainland	1,581	5.6	2.2	-1.5	2.1	2.2
Unemployment rate, %		2.5	2.6	3.2	3.4	3.6
Consumer prices, % y/y		0.8	3.8	2.1	2.0	1.5
Core inflation, % y/y		1.4	2.6	2.6	1.2	1.5
Annual wages (incl. pension costs), % y/y		5.6	6.0	4.1	3.4	4.0
Current account (NOKbn)		320.7	473.2	332.7	428.7	597.6
- % of GDP		15.9	17.7	13.8	16.4	20.5
Trade balance, % of GDP		15.3	19.2	14.4	16.8	20.5
General govt budget balance (NOKbn)		402.6	486.7	232.9	320.0	480.0
- % of GDP		17.7	19.1	9.7	12.3	16.5

* Contribution to GDP growth (% points)

Export growth slowing

Traditional goods exports rose rapidly in the second half of last year and we see further growth in future. As economic growth among Norway's main trading partners remains relatively weak and competitiveness continues to erode, the rise in exports should however be moderate.

Low inflation despite low unemployment

Mainland economic growth in 2010 and 2011 will hardly be strong enough to prevent unemployment from rising over the forecast period. But unemployment will remain low, at 3.5%. Local wage increases could thus be relatively favourable. Moderate central pay rises imply, though, that average wage growth from 2009 to 2010 could be as low as 3.5%. While this matches the 2004 and 2005 levels, at that time unemployment was 4.5%. Last year's NOK appreciation will contribute to bringing down core inflation towards 1% during the year. While a stabilisation of the NOK rate in 2010 suggests core inflation accelerating again in 2011, low wage growth will help to keep core inflation well below the target. For parts of 2010, headline inflation will be much higher than core inflation due to a sharp rise in energy prices.

Cautious tightening moves

Our forecasts for wage growth and core inflation are below Norges Bank's projections. We expect the bank to proceed rather more cautiously when setting interest rates than outlined in the March monetary policy report. We see two more tightening moves of 25 bp each in 2010 and three in 2011. Norwegian long yields should rise gradually in line with their Euro-area equivalents. Over time the rise in Norway could be somewhat less pronounced than in the Euro area. As short-term rates start to rise internationally, we expect markets to discount a sharper rise in the Euro area than in Norway. Chiefly because the Euro-area level is lower at the moment.

NOK relatively stable

The NOK appreciated sharply in the second half of 2009 and going into 2010, to some extent because Norges Bank is one of a handful of central banks to raise policy rates and announce further tightening moves. As a result Norwegian both short-term and long-term market rates have moved much higher relative to the Euro-area level.

Norges Bank will also be almost alone in raising rates over the rest of 2010, and the NOK may appreciate further short term. Slightly longer term, the NOK should be pretty stable. As market rates will also rise elsewhere, the market rate differential will not change significantly. In the EMU money market rates will rise before the policy rate is raised. The significant liquidity measures have brought money market rates below the policy rate; this will have to normalise before the policy rate is raised.

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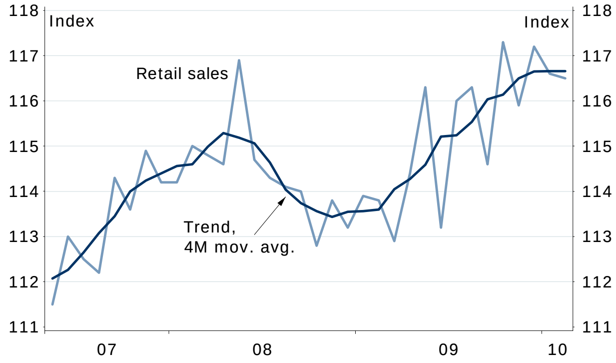
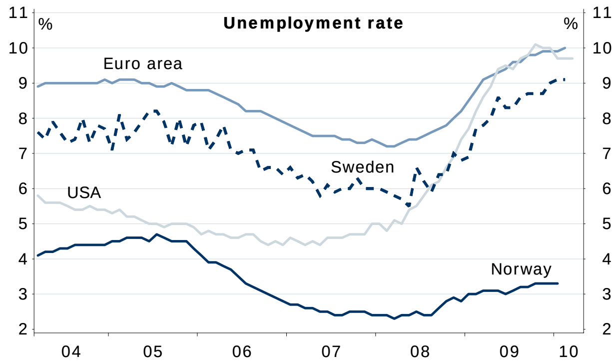
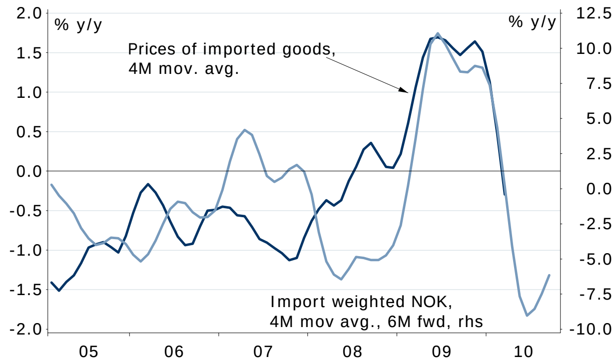
Retail sales growth slowing



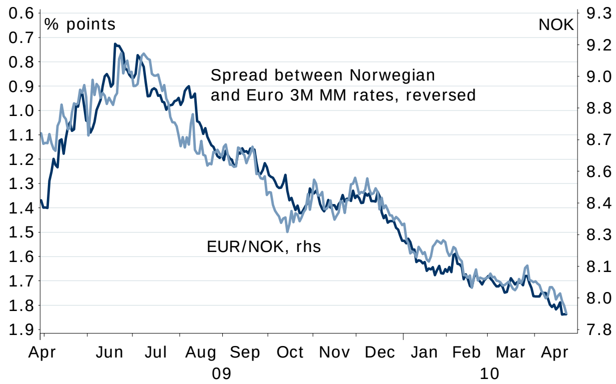
Unemployment low in Norway



Stronger NOK will imply lower imported inflation



NOK stronger on higher rate expectations in Norway



Recovery gains strength

- Strengthening GDP growth
- Unemployment starting to decline
- Inflation to continue its roller coaster ride
- General government deficit within allowed limits

Driven by retail trade and industrial production, the Finnish economy started to pick up in H2 2009. In the first months of 2010, GDP started to grow compared to the previous year as well. In the winter, though, performance was undermined by temporary factors such as strikes and harsh weather conditions. The statistics for the winter will hardly do justice to the actual pace of recovery.

The leading indicators have reinforced the view that the economy has gained momentum during spring. Consequently we continue to expect a reasonable GDP growth rate of 2.7% this year. Growth relies a bit more on domestic demand than in the earlier forecast. The outlook for 2011 is slightly brighter than we previously expected mainly owing to private consumption.

Exports will pick up speed during the year

The collapse in exports halted already in the summer of 2009, but since then recovery has been modest. In March the strike at ports also strained the performance. However, order books became clearly fuller as of the year-end and various preliminary figures are positive. There is no doubt that exports will increase considerably this year. The export outlook is supported by the general revitalisation of the global market and the vigorous recovery in Russia, for instance. Exports to Russia contracted more than on average last year, but this year the increase in the Russian market is bound to be sharper than elsewhere. EUR depreciation in relation to Finland's trading partners will also boost the performance

Residential construction growing briskly

In addition to exports, construction contracted the most last year, but not as much as feared. The fiscal stimulus fuelled renovation construction and also construction of new homes to some extent. The outlook for residential construction is quite positive this year and the next. The housing market rebounded already in the spring of 2009 thanks to the low interest rate level. In 2010 low rates and strong consumer confidence have kept up the housing market momentum.

Residential construction has also started to speed up quickly, and the market will grow rapidly in 2010 and 2011. Other new construction as well as machinery and equipment investment will continue to contract. As a result, investment on the whole will not start to increase until next year.

New peak in consumption already this year

Consumption demand started to pick up earlier than exports in the spring of 2009. In early 2010 retail trade had already climbed above the level prevailing a year ago. Sales of durable consumer goods have recovered the most, boosted by the low rates and solid consumer confidence. Despite the contraction in employment, households' disposable income increased last year thanks to wage increases, income transfers and lower rates. Thus, the savings ratio rose by several percentage points.

This year growth in real disposable income will gain pace and as a result of the strong confidence and favourable interest rates, the savings ratio will decrease. The recent developments indicate that private consumption will increase more this year than estimated earlier. The level from which consumption started to

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

	2006 (EURbn)	2007	2008	2009	2010E	2011E
Private consumption	86	3.4	1.7	-2.1	2.4	2.6
Government consumption	37	1.1	2.7	0.7	0.5	0.5
Fixed investment	33	10.6	-0.2	-13.4	-1.5	4.2
Stockbuilding*	2	-0.5	-0.7	-0.4	0.7	0.0
Exports	75	7.9	6.5	-24.3	7.0	7.0
Imports	68	6.0	6.6	-22.3	5.5	6.3
GDP		4.9	1.2	-7.8	2.7	3.0
Nominal GDP (EURbn)	165.6	179.5	184.2	171.0	179.0	189.0
Unemployment rate, %		6.9	6.4	8.2	9.6	9.3
Industrial production, % y/y		8.6	0.1	-20.0	4.0	5.0
Consumer prices, % y/y		2.5	4.1	0.0	1.0	2.5
Hourly wages, % y/y		3.4	5.5	3.9	2.7	2.0
Current account (EURbn)		7.6	5.8	2.3	2.7	3.0
- % of GDP		4.3	3.1	1.3	1.5	1.6
Trade balance (EURbn)		9.1	6.9	3.5	3.6	4.2
- % of GDP		5.1	3.7	2.0	2.0	2.2
General govt budget balance (EURbn)		9.3	7.7	-3.7	-5.4	-4.7
- % of GDP		5.2	4.2	-2.2	-3.0	-2.5
Gross public debt (EURbn)		63.2	63.0	75.2	85.0	94.0
- % of GDP		35.2	34.2	44.0	47.5	50.0

* Contribution to GDP growth (% points)

shrink in H1 2008 will be exceeded already in H2 2010. In 2011 the gradually recovering labour market should keep consumer confidence solid, and consumption can continue to grow faster than disposable income.

Unemployment not as bad as feared

One reason for the pick-up in consumer confidence is that unemployment has not increased as much as feared. The relatively moderate rise in unemployment can be explained by a bigger reduction in the labour force than during previous recessions, primarily because the baby boomers have reached retirement age. Then again, employment has not deteriorated as much as the GDP figures might suggest at first glance, because the recession has mainly hit the export sector, which employs fewer people than the Finnish service sector. We expect unemployment to start to decline in H2 2010.

Inflation became positive again in the first months of the year. As the year progresses, inflation measured by national CPI will accelerate, approaching a couple of per cent towards the end of the year after VAT is hiked in the summer and interest rates on housing loans no longer decline. Fundamentally, there is minor inflation pressure. Excluding energy and housing loan interest rates, inflation will slow further in the course of the year. Consequently, inflation will be either low or moderate in the next few years, depending on the selected indicator.

General government deficit within allowed limits

Balancing of central government finances is one of the great challenges after the recession. In Finland it requires relatively moderate efforts by European standards. Excluding the challenges resulting from the ageing population, the need for structural correction is a couple of per cent of GDP, but the target should certainly be more ambitious. The Ministry of finance’s plan to balance central government finances by the mid-2010s is well founded. It would mean a surplus of a couple of per cent in general government finances due to the pension fund surplus.

Last year the general government deficit was 2.2% and we expect it to hover around 3% this year. The balance of general government finances is improved by the pension fund surplus, which is about 3% of GDP. As pension funds diversify their investments, the general government gross debt will increase more than can be estimated on the basis of the overall general government finance deficit. However, even measured by the central government deficit, the balance of Finnish general government finances is still in the top league and the amount of debt is quite small. Not to mention the fact that including the investments of pension funds, general government net assets amount to 63% of GDP.

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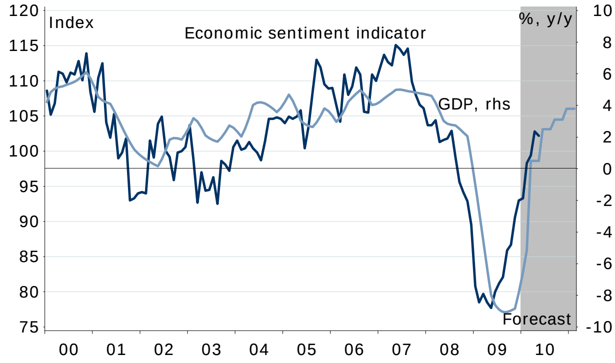
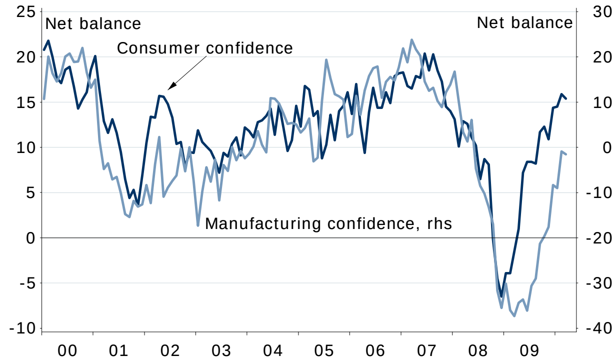
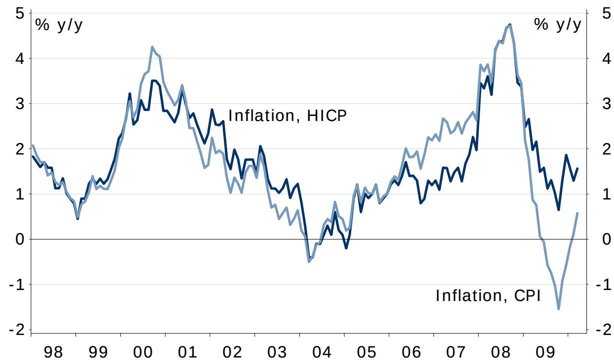
Indicators point to reasonable growth



Households upbeat on future prospects



Inflation rising again



Unemployment set to peak soon

Upswing continues in lower gear

- Surprisingly brisk start to 2010
- But fading stimuli from fiscal policy and inventories
- Consumer spending likely to lose momentum …
- … as home prices will probably drop again

The upswing in the US economy that started in mid-2009 continued with surprising strength in the first months of the year. The improvement was mainly driven by a very expansionary fiscal policy stance, which has also boosted consumer spending, and the end of the massive destocking that took place when businesses were hit by the crisis. The first budding signs of spring are for example emerging in the labour market where employment has stabilised and in the housing market where prices have trended higher for almost a year.

The economy is forecast to keep expanding throughout the forecast period. Growth looks set to remain high this quarter, but in H2 we expect the momentum to fade somewhat and in 2011 growth is estimated to be only moderate. Fiscal policy measures will continue to stimulate activity for some months yet, but the effect will gradually fade, actually turning negative in 2011. The reasons are that some of the federal initiatives to promote growth will expire and that taxes for the highest income brackets will be hiked next year. Also pressures on state budgets will curb public demand, as most states are required to run balanced budgets.

With inventories now much better aligned with sales, further economic expansion will rely on continued growth in private final demand. Recent months' uptick in consumer spending has surprised on the upside, fuelling hopes of a self-sustaining upswing. A drop in households' savings ratio from around 6.5% in mid-2009 to 3% according to the latest data has led to an unexpected boost to demand. Against this background, we now forecast somewhat higher GDP growth this year relative to our January forecast. More specifically, we now expect GDP growth to come out at 2.9% this year and 2.2% in 2011 (versus 2.2% and 2.0% in January).

However, trends in households' propensity to save are highly uncertain longer term. Our baseline scenario, where home prices will soon start falling again, incorporates a rise in the savings ratio to 6- 7% at end-2011. For every percentage point that the savings ratio increases, GDP will weaken some 0.7%. The size of households' net worth relative to disposable income points to a savings ratio of 6-7%. Moreover, savings patterns in the Nordic countries in the early 1990s also point to a strong and sustained increase in the savings ratio in the wake of a severe financial crisis.

Moreover, consumers will have to brace themselves for weak wage growth given the unfavourable labour market conditions and their purchasing power will be eroded by high energy prices. As many potential borrowers are not eligible for bank loans and consumer confidence is still at a recession-like level, we consider it most likely all in all that consumer spending will lose momentum after a brisk start to the year.

Companies' continued low capacity utilisation points to generally weak business investment. However, larger-than-expected investment activity among large companies could lead to a positive surprise in terms of economic growth. Large companies are still doing much better than small businesses thanks to easier access to the capital markets and often larger benefits from the ongoing improvement in exports underpinned by the weak USD.

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

	2006 (USDbn)	2007	2008	2009	2010E	2011E
Private consumption	9,323	2.7	-0.2	-0.6	2.4	2.3
Government consumption and investment	2,518	1.7	3.1	1.8	0.4	0.0
Private fixed investment	2,267	-2.1	-5.1	-18.3	0.5	3.5
- residential investment	762	-18.5	-22.9	-20.5	-2.1	8.2
- equipment and software	1,072	2.6	-2.6	-16.6	8.0	3.4
- non-residential structures	434	14.9	10.3	-19.8	-12.8	-1.0
Stockbuilding*	60	-0.3	-0.3	-0.6	1.1	0.1
Exports	1,471	8.7	5.4	-9.6	9.6	7.9
Imports	2,240	2	-3	-14	7	6
GDP		2.1	0.4	-2.4	2.9	2.2
Nominal GDP (USDbn)	13,398.9	14,077.7	14,441.4	14,256.3	14,953.1	15,471.8
Unemployment rate, %		4.6	5.8	9.3	9.6	9.7
Industrial production, % y/y		1.5	-2.2	-9.7	4.2	2.9
Consumer prices, % y/y		2.9	3.8	-0.3	1.9	1.3
Consumer prices ex. energy and food, % y/y		2	2	2	1	0
Hourly earnings, % y/y		4.0	3.8	3.0	2.0	1.8
Current account (USDbn)		-726.6	-706.1	-419.9	-448.6	-464.2
- % of GDP		-5.2	-4.9	-2.9	-3.0	-3.0
Federal budget balance (USDbn)		-160.7	-458.6	-1413.6	-1600.0	-1400.0
- % of GDP		-1.1	-3.2	-9.9	-10.7	-9.0

* Contribution to GDP growth (% points)

Labour market recovering but still weak

Employment will be briefly boosted by a sharp rise in public sector employment in connection with this year's census. This will require manpower of over 1m persons in the public sector, but the jobs will be scrapped from July this year. With prospects of a moderate upswing the unemployment rate is likely to remain around 9.5-10% at the end of 2011. Over 40% of today's job seekers have been unemployed for six months or longer, so that is another reason why it will take several years to restore employment to pre-crisis levels. Over the past two years 8¼m jobs have disappeared. Given the prospect of continued high unemployment, inflation is expected to decline further. Core inflation is forecast to drop close to zero at end-2010 without noticeable changes in 2011.

Double dip in home prices

Supported by a tax credit for first-time buyers, home prices have trended higher since May last year. However, the tax credit scheme expired at the end of April this year, and at the same time mortgage rates have risen since the Fed suspended its purchase of mortgage-backed securities at the end of March. Measured in terms of mortgage applications, the demand for homes is back at the lowest level since 1997 and at the same time the supply is still impacted by a large number of foreclosures. Almost 25% of homeowners with mortgage loans have negative home equity values. Moreover, as home prices seem relatively high compared to rents, which have even fallen recently, a further drop in home prices by 5-10% from the current level is considered likely.

Focus on public debt

The adoption of the health care reform was a major political triumph for President Obama. However, the reform is not enough to bring public debt back on a sustainable path. In December a commission will submit recommendations for how to eliminate the primary budget deficit from 2015. But heavier market pressure may ultimately be the only thing that can really make policy-makers take the debt problem seriously.

First rate hike a long way off

The first fed funds hike is expected to be sanctioned in early 2011. At that time unemployment will probably still be high and inflation low. But to counter the risk of new bubbles and excessive risk-taking, the Fed may still at that point take its foot slightly off the accelerator by hiking the fed funds rate from the extremely low level that it was slashed to in order to reduce the risk of an economic depression. The fed funds rate is not expected to exceed 2% during the forecast period, though. Prior to the first rate hike we expect the Fed to start absorbing some of the extra liquidity that it has injected in order to stimulate the economy.

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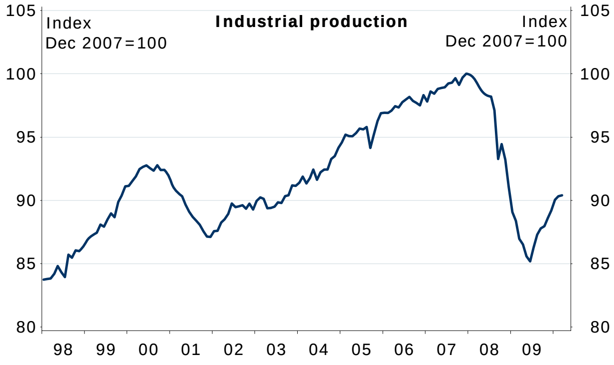
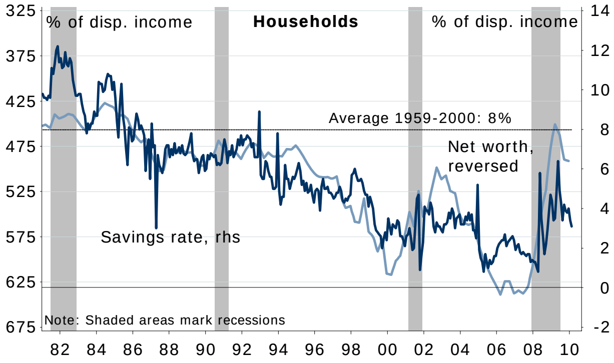
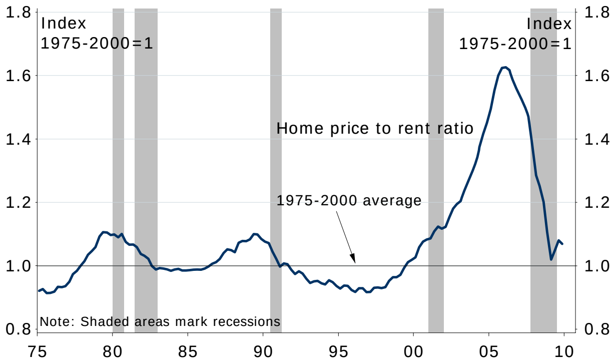
Conditions are recovering, but still a long way to go



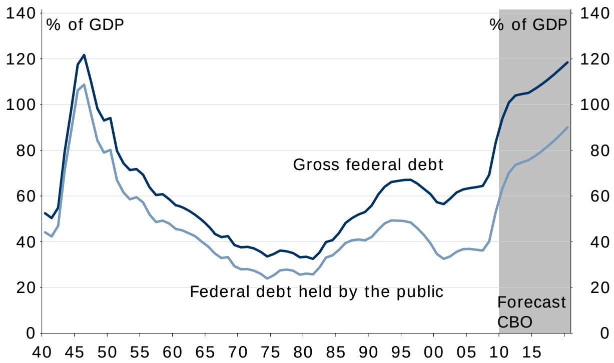
Household savings are low relative to net worth



A double dip in home prices seems likely



Unsustainable fiscal policy



Debt crisis masks a strengthening recovery

- Debt crisis highlights need for fiscal consolidation
- Indicators suggest the recovery is accelerating
- Ample spare capacity keeps inflation in check
- The ECB to withdraw liquidity in Q4 this year

Fiscal consolidation to restrain growth

Since the end of last year, the Euro area has been engulfed in an ever escalating debt crisis, which has reflected considerable scepticism over the sustainability of public finances in Greece and other Southern European member states. Greece is by far the most egregious case where several instances of misreporting about the true state of public finances completely have undermined the credibility of fiscal policy. This situation has forced the Euro group to draw up a contingency plan, which promises to extend loans from the IMF and the other Euro-area members. At the time of writing Greece has asked for the plan to be activated and an IMF team is in Athens to negotiate the terms.

The debt crisis has illustrated that many Euro-area member states face several years of tight fiscal policy and wrenching structural changes. However, only Ireland is facing cuts of a similar magnitude as Greece and these two countries constitute less than 5% of Euro-area GDP. Consequently, the sharp fiscal tightening in these two countries will only have a fairly limited impact on the rest of the Euro area. Among the bigger Euro-area members, France and Spain also need to undertake significant consolidation of public budgets over the coming years, while Germany, Austria and Finland are only facing a fairly mild tightening of fiscal policy beginning next year. Hence, the tightening of fiscal policy should only begin to weigh on growth towards the end of the year, while we expect fiscal tightening to subtract as much as 1% point from growth in 2011.

Meanwhile, short-term indicators point to an acceleration in economic growth over the coming quarters. In particular the manufacturing sector seems to be benefiting from the rebound in global trade and the positive impact from the inventory cycle. Germany, which saw one of the sharpest contractions in activity during the crisis, is the primary beneficiary of the rebound in manufacturing, but manufacturing activity is also expanding in France and Italy, albeit at a slower pace. The main reason for the fairly moderate growth forecast for 2010 is thus the disappointing outcome for growth in Q4 last year and the unusually cold winter, which may have put a significant damper on activity in the construction sector during Q1.

The recovery still has a long way to go

Even though the growth outlook is fairly bright for the next couple of quarters, we still expect growth to moderate towards the end of the year, as the growth impulse from inventories begins to fade and fiscal policy turns contractive. With moderate growth foreseen over the next two years, economic activity will remain below the peak seen at the beginning of 2008. Thus, we do not expect any significant drop in unemployment over the forecast horizon, even though short-term indicators suggest that labour markets are stabilising, and this should keep a firm lid on underlying inflationary pressures.

Obviously, the prospect of a significant tightening of fiscal policy adds considerable downside risk to the outlook for growth over the coming years. This is compounded by the risk that a rapid rise in energy prices will once again sap the purchasing power of households, restraining growth in consumption. However, the rebound in financial wealth and the low level of interest rates both suggest that household savings could decline from the current peak, and this will provide some growth in private consumption. Paradoxically, the debt crisis has also increased the chances of a more robust recovery, since

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

	2006 (EURbn)	2007	2008	2009	2010E	2011E
Private consumption	4,962	1.6	0.4	-1.0	0.5	0.8
Government consumption	1,733	2.3	2.1	2.3	1.2	0.8
Fixed investment	1,832	4.7	-0.9	-10.8	-1.1	3.0
Stockbuilding*	25	0.0	0.1	-0.9	0.3	0.2
Exports	3,452	6.3	0.8	-12.8	6.8	5.8
Imports	3,354	5.5	0.9	-11.4	5.9	5.3
Net exports*	97	0.4	0.0	-0.8	0.4	0.3
GDP		2.7	0.5	-4.0	1.4	1.7
Nominal GDP (EURbn)	8,558	9,007	9,255	8,975	9,251	9,566
Unemployment rate, %		7.5	7.6	9.5	10.3	10.3
Industrial production, % y/y		3.2	-2.4	-13.8	7.0	2.0
Consumer prices, % y/y (HICP)		2.3	3.3	0.3	1.6	1.6
- core inflation		2.0	2.4	1.3	0.8	0.7
Hourly labour cost, wages and salaries % y/y		2.5	3.2	1.5	1.5	1.5
Current account (EURbn)		16	-152	-58	-25	-50
- % of GDP		0.2	-1.6	-0.6	-0.3	-0.5
General govt budget balance, % of GDP		-0.6	-2.0	-6.2	-6.7	-5.8
Gross public debt, % of GDP		66.0	69.4	78.7	83.1	86.1

* Contribution to GDP growth (% points)

the recent weakening of the EUR will make it easier for Euro-area exporters to hold onto their market shares. Looking forward, we expect the EUR to weaken further next year, which should provide additional support to exports even as export demand slows down.

Deleveraging continues

Even though the recovery in industrial production and orders has brightened the prospects for business investment, the fact that capacity utilisation remains near record lows, suggests that investment growth will be fairly moderate. This seems to be the primary reason why bank lending to non-financial companies is still declining. The lingering effects of the credit crisis could also hamper investment growth, even though Euro-area banks seem to be less keen on tightening credit conditions further and spreads for corporate bonds have narrowed considerably. Lending for house purchases is actually increasing, indicating that the low level of interest rates is beginning to stimulate economic activity. However, the development in housing markets is still highly diverse, where Spain and other member states are still struggling with large inventories of unsold homes.

The ECB is inching towards exit strategy

Headline inflation has moved considerably higher in recent months. The depreciation of the EUR and the relatively high level of oil prices have lifted energy prices measured in EUR to levels not far below the peak seen in the summer of 2008. We expect energy prices to pull headline inflation further upwards and peak just around the ECB's definition of price stability by the end of this year. The rise in inflation should not be of much concern to the ECB, however, as core inflation will remain subdued over the forecast horizon. The ECB has nevertheless begun a roll-back of the extraordinary liquidity support provided during the credit crisis. So far this has not led to any significant draining of liquidity, but this could change, when the EUR 442bn 12-month long-term refinancing operation expires at the beginning of July. At first we only expect a modest rise in money market rates, since the ECB has promised full allotment, at the weekly and monthly refinancing operations until the beginning of the fourth quarter, but we do see a significant change of increased volatility in money market rates after 1 July. A more pronounced rise in money market rates is likely in Q4, when we expect the ECB to scale back the provision of liquidity at the weekly and monthly refinancing operations. This process is then likely to be followed by a series of four quarterly rate hikes of 25 bp beginning in March next year and ending with 2.00% in December. In our view, this can be considered "the normal trough" for ECB rates in a situation with ample spare capacity, and given the prospect of significant fiscal policy tightening, this level could well be maintained for an extended period.

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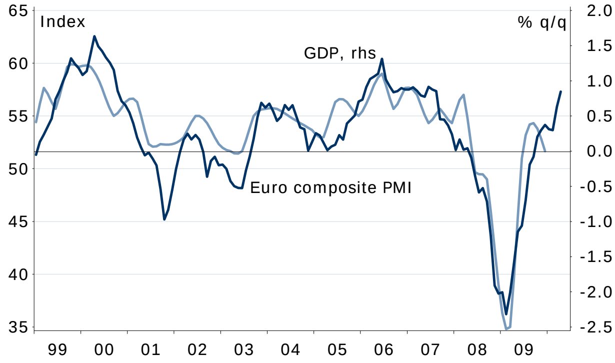
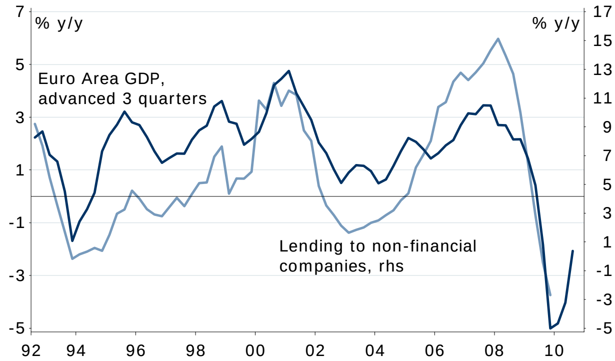
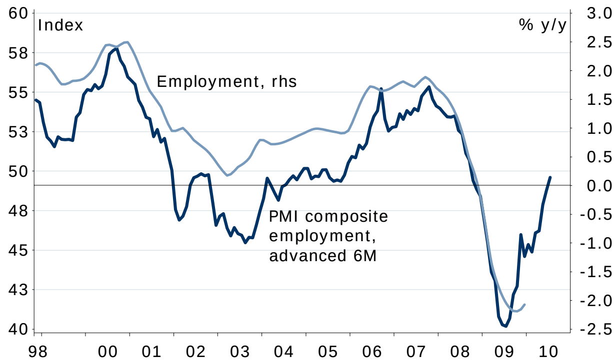
Surveys point to growth acceleration after winter lull



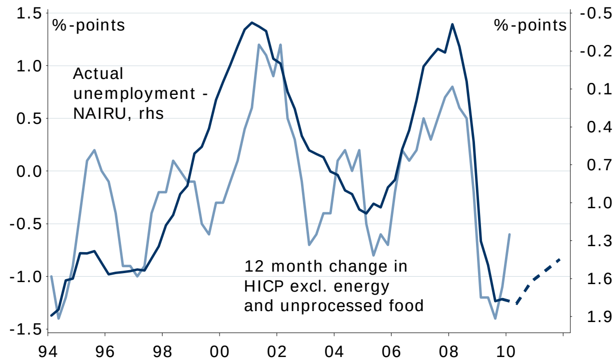
History suggests lending could soon rebound



Labour markets seem to be stabilising, but …



…downward pressure on core inflation to continue



A good start to the year, but major headwinds remain

The British economy had an encouraging start to the year. After the economy finally emerged from recession in the final quarter of 2009, a further expansion in Q1 this year has alleviated concerns of a double-dip recession. But the output level is still more than 5% below its pre-recession peak, suggesting that some spare capacity is likely to persist over the forecast period.

A continued weak recovery is in prospect, driven by the considerable stimulus from economic policy and supported by global growth and the past depreciation of the GBP. The economy faces major headwinds, however. The combination of weak income growth and restricted credit supply continues to be a drag on spending. Also the need to strengthen public finances will weigh on demand over the forecast period.

Following the general elections on 6 May we expect the new government to embark on a rough fiscal consolidation programme, although its eventual nature and pace are uncertain. An election outcome with a hung parliament, where no political party has an outright majority of seats, could delay and possibly weaken efforts to cut the public budget deficit. With a deficit running close to 12% of GDP, the absence of a credible plan to restore public finances could lead to investors demanding a much larger risk premium for UK sovereign debt, and the country would risk losing its AAA credit rating.

With the restoration of the standard rate of VAT to 17.5%, higher energy prices and the weak GBP, inflation has been soaring over the past months, breaking the Bank of England's 3% upper limit. Nevertheless, given the spare capacity in the economy, and particularly in the labour market, this trend should be short-lived. Thus, we expect inflation to fall sharply later this year and to stay below the 2% target for much of the forecast horizon. Therefore, we do not expect the BoE to hike the bank rate before early 2011.

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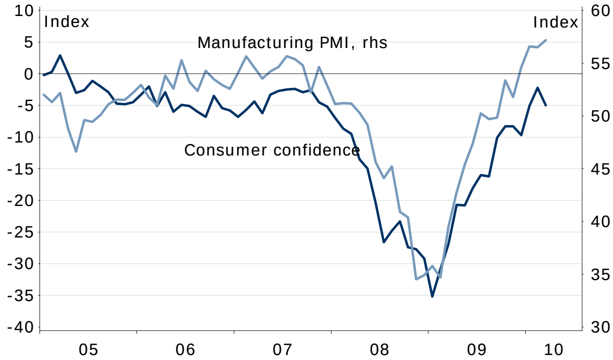
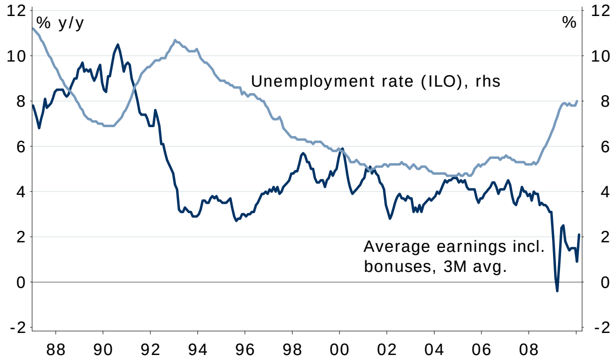
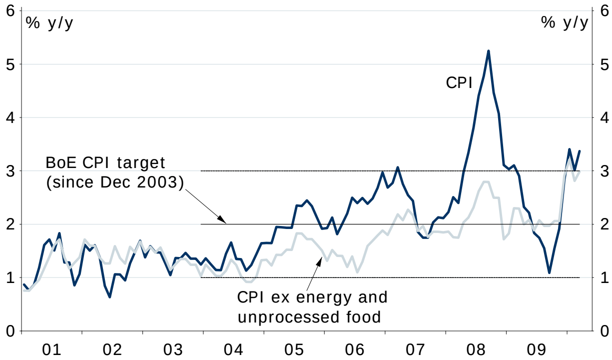
Consumers and businesses stepping out of the dark



Unemployment stabilisation is likely temporary



A temporary peak in inflation



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

	2006 (GBPbn)	2007	2008	2009	2010E	2011E
Private consumption	850	2.1	0.9	-3.2	0.1	1.6
Government consumption	285	1.2	2.6	2.2	1.8	-1.0
Fixed investment	227	7.8	-3.5	-14.9	-3.3	4.7
Stockbuilding*	5	0.2	-0.4	-1.2	0.6	0.0
Exports	378	-2.8	1.1	-10.6	7.5	8.0
Imports	419	-0.7	-0.5	-11.9	4.6	5.2
GDP	5	2.6	0.5	-4.9	1.2	2.2
Nominal GDP (GBPbn)	1326	1398.9	1448.4	1395.9	1449.5	1513.0
Unemployment rate, %		5.4	5.7	7.6	8.4	8.7
Consumer prices, % y/y		2.3	3.6	2.2	2.6	1.8
Current account, % of GDP		-2.7	-1.5	-1.3	-1.1	-1.0
General govt budget balance, % of GDP		-2.3	-4.9	-11.9	-13.0	-11.5
Gross public debt, % of GDP		42.7	52.0	68.4	78.5	86.0

* Contribution to GDP growth (% points)

Domestic economy to start recovering

- Labour market closer to its weakest point
- No major shifts in policy after tragic plane crash …
- … but fiscal policy could be tightened a bit earlier
- Low interest rates for a bit longer

The recovery continues at a quite decent pace. Exports have shown strong momentum starting from the middle of last year, while the domestic economy has suffered from a weakening labour market and has not yet started to recover in earnest. However, we expect that the labour market is close to its weakest point and that the domestic economy will gradually start to pick up speed during the second half of the year, which will help broaden the base of the recovery and make it more sustainable. Still, growth is likely to remain moderate both this year and in 2011.

Risks remain above average, but roughly balanced. The main negative risks are in our view the international outlook and the upcoming presidential and parliamentary elections amid the concurrent need to tighten fiscal policy to ensure fiscal sustainability. On the other hand, we are not as worried about household spending as others. Stabilisation and a subsequent slight downtrend in the unemployment rate, as we expect, could unlock a lot of positive dynamics in credit conditions, housing markets, investment etc.

Labour market closer to its weakest point

Private consumption was weak throughout 2009, as the unemployment rate increased, wage growth slowed, house prices fell and credit conditions were tightened. Weak numbers for retail sales and the labour market suggest that the early part of this year probably has not shown much improvement.

However, there are some early signs that the unemployment rate is approaching its weakest point. Indeed, recent months have shown an increase in manufacturing employment and a pick-up in unfilled vacancies. Moreover, business surveys show a significant improvement in the balance between businesses expecting to hire and businesses expecting to lay off, though the gap remains slightly in negative territory.

Investment is still some way from recovering, though. Low capacity utilisation, tight credit conditions and uncertainties regarding the outlook for demand mean that businesses are holding back. For the same reasons we do not see a significant pick-up in investment until 2011.

No major shifts in policy after tragic plane crash

The tragic death of President Kaczynski, Central Bank Governor Skrzypek and a number of high-ranking political and military persons will not prompt major shifts in economic policies in the near term, in our view.

Presidential elections will be moved forward to late June/early July from October, and parliamentary speaker Komorowski, who is also the Civic Platform’s presidential candidate and the favourite to become the next president according to polls, will be acting president until then.

The earlier date for presidential elections could move tightening of fiscal policy just a bit forward. Indeed, the late President Kaczynski had threatened to veto large-scale austerity measures, whereas the next president – assuming it will be acting President Komorowski – is likely to support proposals from his own government to tighten. We therefore expect to see some tightening measures implemented shortly after the new president is in place and perhaps also a slightly lower budget deficit for 2011 than previously expected.

The junior coalition partner in the Civic-Platform-led government, the Peasants’ Party, is likely to agree only to modest expenditure cuts, and the government will also have to think about the general elections, which are likely to be held in the spring of 2011. Therefore, large-scale austerity measures and structural reforms are unlikely until the latter half of 2011 or perhaps even 2012, and only if the Civic Platform gets a much stronger mandate at the general elections.

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

	2006 (PLNbn)	2007	2008	2009	2010E	2011E
Private consumption	653	4.9	5.9	2.3	1.7	3.6
Government consumption	194	3.6	7.2	2.8	3.0	0.3
Gross fixed capital formation	208	17.2	8.2	-0.3	1.6	3.4
Stockbuilding*	15	1.7	-1.1	-2.7	0.9	1.1
Exports	428	9.1	5.8	-7.3	6.7	4.6
Imports	447	13.7	6.1	-12.1	5.0	3.4
GDP		6.8	5.0	1.8	3.5	3.8
Nominal GDP (PLNbn)	1,115	1,177	1,273	1,343	1,422	1,506
Unemployment rate, %		12.7	9.8	11.0	12.3	11.1
Consumer prices, % y/y		2.6	4.4	3.9	2.4	2.2
Current account, % of GDP		-4.7	-5.1	-1.6	-1.6	-1.2
General government budget balance, % of GDP		-1.9	-3.9	-7.1	-6.5	-5.5

* Contribution to GDP growth (% points)

EMU in 2014-15

Baring a different election outcome than what is suggested by current polls, we still see a possibility of EMU entry in 2014. Poland no longer has an official target date for joining, but various government officials have said that 2015 seems to be the most likely year of membership. Bringing the government budget deficit below 3% of GDP will be the most difficult hurdle to overcome.

Low interest rates for a bit longer

First Deputy Governor of the National Bank of Poland (NBP) Wiesiolek will act as temporary central bank chief until a replacement has been appointed. Interest rates are set by the monetary council in which the central bank chief has only one vote out of ten and hence there is no reason to expect major changes in the interest rate outlook. The central bank chief may have a more decisive role in daily operations like FX interventions, but when the central bank in early April – for the first time since its independence in 1999 – intervened directly in the FX market to weaken the PLN, the decision was said to be backed by the monetary council and the government.

However, the NBP's decision to intervene in the FX market means that the outlook for the monetary policy rate has become more dependent on the PLN. Interest rate hikes will therefore not be on the cards as long as market sentiment is in favour of a stronger PLN.

Still, we believe that interest rates will have to be hiked once the concerns about excessive PLN strength abate. Inflation is expected to trend lower in the coming months, but will start to creep upwards again already in the second half of the year and even the NBP's own inflation projection sees inflation significantly exceeding the upper band of its target towards the end of 2012.

Weaker PLN

The PLN seems to be close to the strongest it will get for now. The NBP's decision to intervene will definitely limit the potential in the short term. Moreover, we do see some risk that markets are now expecting a too strong recovery in the global economy. Thus, we could see a few quarters of moderate weakening. However, fundamentals are very strong, interest rates remain well above their Euro-area counterparts and EMU convergence means that any weakness will be temporary.

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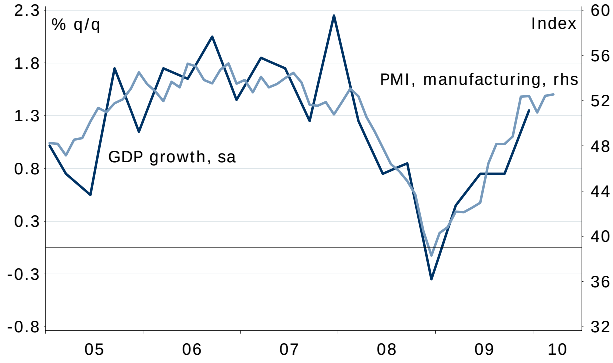
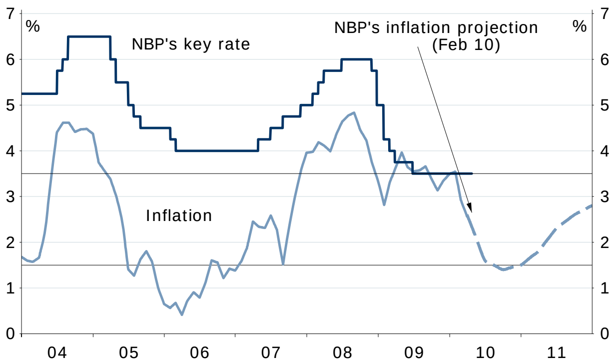
Recovery continues

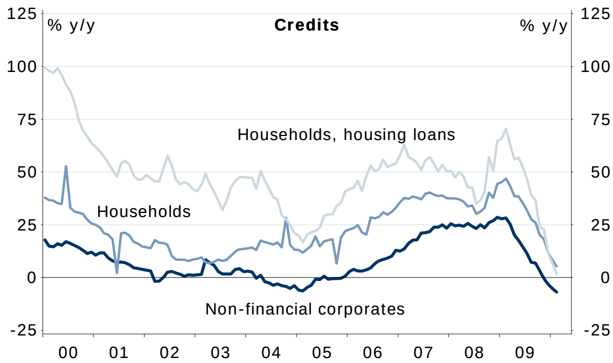


Labour market closer to its weakest point

Inflation to fall before rising



Credit conditions remain tight



Brisk upswing in 2010

- Exports leading the recovery in 2010
- Private spending to strengthen gradually
- RUB expected to appreciate further in the long term

Economy rebounding strongly

The economy strengthened clearly in Q4, but for 2009 as a whole the economy declined more than initially expected. Most notably after declining for four consecutive quarters exports grew by a surprisingly strong 8.2% y/y. The rise in oil prices boosts the value of Russian exports significantly, but as no significant decline in commodity prices is expected, they will continue to offer support for the economy. The recovery in the world economy will also support export volumes further this year. Growth prospects for 2010 are thus strong, and we see the economy recovering briskly this year, with GDP growth reaching 6% y/y.

Especially at the beginning of the year the recovery is expected to be largely dependent on exports, but towards the end of the year we also see a revival in private consumption. Although household spending has so far remained subdued, positive signs have emerged in for example disposable income and real wages, which have both reached positive growth territory. In addition, the indebtedness of households is low. Albeit still relatively high, unemployment is expected to turn slowly, supporting a recovery in consumption.

Growth potential endangered in the long term

Although growth potential is significant short term, momentum is expected to fade. Already in 2011 we see growth slowing to 4.5% y/y as various challenges restrict growth. Short-term growth is affected by for example increased protectionism and government control of the economy, which has increased during the downturn.

Protectionism has increased in various industries, complicating the WTO negotiations further. Russia's accession to the WTO is still clouded by uncertainty, especially as Russia formed a new customs union with Belarus and Kazakhstan in January 2010. It is still unclear when and with whom Russia wishes to join. In general, the government's anti-crisis measures have been criticised for supporting old and inefficient structures and companies as well as promoting protectionism. Thus, the crisis has not been taken as an opportunity to modernise the economy and move resources to more productive industries, further weighing on the growth potential.

In addition, the previously ample oil funds, hosting the tax revenues from oil production and exports, are declining. The Reserve Fund, 64% lower in March 2010 than a year earlier, is used for plugging the hole in the federal budget and is expected to be almost depleted in 2010. The National Wealth Fund is seen declining due to support for the pension fund. Hence, a budget deficit of around 6% is expected in 2010 and Russia will be forced to turn to the international markets to finance its spending.

In the long term growth potential is also limited. The long-lasting problems of the economy – raw material dependence and corruption – will remain central themes. Russia has continued to score weakly on the international corruption ratings despite pledges of anti-corruption policies already during Putin's presidency. The lack of investment in the oil and gas sectors in recent years put new investment in a crucial position, as increasing production potential is a relatively slow process. Foreign investment would be welcome both in terms of increased financing and newer technology, but laws limiting foreign investment in for example the oil and gas industries are a barrier to this development.

Government budget to remain in deficit

Government finances deteriorated clearly as commodity prices fell sharply and the economy was supported by various anti-crisis measures. Last year's government deficit has been estimated at 5.9% of GDP, and a 6.8% deficit is targeted in 2010. Tax revenues from crude oil have amounted to around 30-35% of the total budget over the past couple of years, and lower oil prices mean that spending must be adjusted to lower tax revenues.

The anti-crisis measures will continue this year, supporting especially domestic companies and industries such as the car industry. A return to the prudent fiscal policy ex-

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

	2006 (RUBbn)	2007	2008	2009	2010E	2011E
Private consumption	13,041	13.6	11.2	-7.6	4.5	5.0
Government consumption	4,589	3.4	2.5	2.0	3.0	2.0
Fixed investment	4,981	21.1	10.0	-16.5	4.5	5.5
Exports	9,079	6.3	0.5	-4.6	9.0	8.0
Imports	5,657	26.5	15.0	-30.2	8.0	7.0
GDP		8.1	5.6	-7.9	6.0	4.5
Nominal GDP (RUBbn)	26,904	33,111	41,668	43,251	48,874	54,592
Unemployment rate, %		5.6	5.6	7.5	7.5	6.8
Consumer prices, % y/y		9.0	14.1	11.7	7.0	7.2
Current account, % of GDP		5.9	6.2	3.9	5.0	4.5
Central govt budget balance, % of GDP		6.1	4.1	-6.3	-6.0	-4.0

ercised earlier this decade is expected, helped by expectations of rising commodity prices. However, many of the recent spending increases have increased social spending such as pensions permanently and are thus difficult to reverse.

Interest rates declining

The high inflation seen during the past couple of years has slowed down clearly. Inflation reached 6.4% y/y in March 2010 – the lowest since 1998. However, the rising money supply, the accommodative fiscal policy and improving income development are expected to create price pressures in the second half of the year.

Interest rates have also declined quickly. The Mosprime 3M rate has fallen rapidly from its peak of almost 30% to around 4%, thus reducing interest rates to pre-crisis levels. The central bank has continued cutting the main refinancing rate in the wake of slowing inflation. Altogether the cuts have amounted to 475 bp since April 2009, but the effect on bank lending has been subdued. The central bank's easing cycle is seen close to the end, but rate hikes are not expected until 2011.

RUB on an appreciating trend

The rouble has been on a firming trend this year, as the oil price has risen and global risk sentiment has remained positive. We believe that the gradual appreciation will continue throughout this year on the back of the improving economy, positive risk-taking appetite, the still significant interest rate differential to the US and the Euro area as well as the firming oil price.

The rouble has gained a lot of flexibility in recent years. However, the central bank has continued to slow down the rouble appreciation by frequent interventions on the currency markets, shifting down the intervention band gradually. So far the central bank has kept to the rule of shifting down the intervention band after purchases of USD 700m on the currency markets. Although measures curbing the inflow of speculative capital have been discussed, the central bank is not expected to use drastic measures to limit speculation.

Despite the outlook for a strengthening rouble, short-term volatility should not be overlooked. The rouble is a very volatile currency, vulnerable to changes in global investor sentiment, leading to possibly sharp movements in the currency. Currently the improved sentiment has increased capital inflows to Russia significantly, which poses one of the main risks to the currency. A reversal in risk sentiment could lead to a sudden withdrawal of capital, and thus the risk of short-term weakness in the rouble should not be underestimated.

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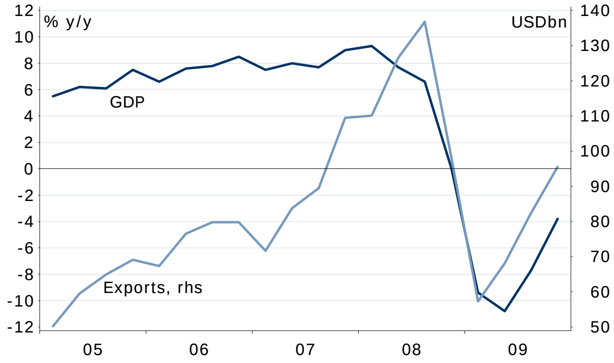
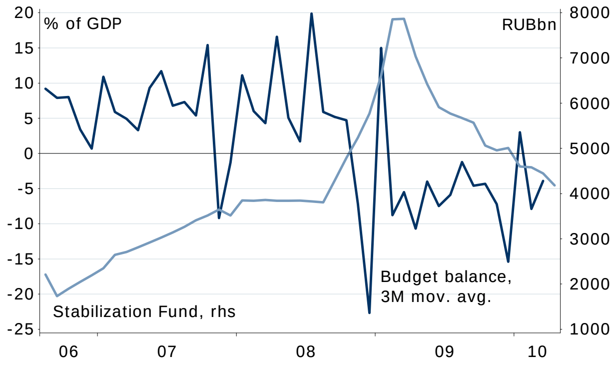
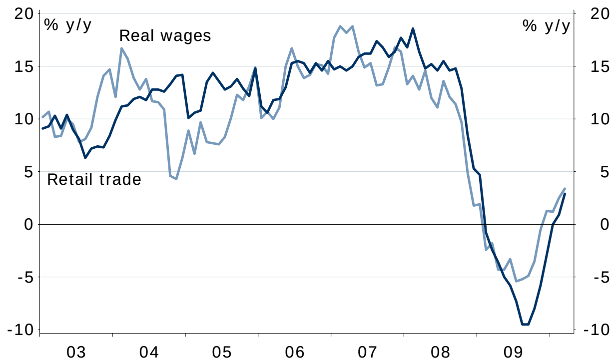
Exports have reversed much of their gain



Oil funds declining swiftly



Consumption returning to growth



High oil price supports the rouble

EMU membership in focus

The Estonian economy stabilized in the second half of last year, with quarter-on-quarter growth seen for the first time in Q4. However, some main components of GDP, such as private consumption and investment, continue to decline, highlighting the weakness of the recovery. So far the main boost to the economy has come from slowly improving exports and inventory rebuilding. Although the revival in exports is still modest, the recovery will be export-led, as especially demand from the Nordic countries recovers.

Domestic demand will still squeeze the economy, as unemployment remains elevated and wages continue to decline. Bringing down unemployment will be one of the main challenges facing Estonia in the next couple of years. All in all, we expect modest GDP growth this year, mainly due to a recovery in exports. However, growth will remain below the rates seen a couple of years ago.

The main focus is currently on Euro area membership. Government debt in 2009 rose to 7.2% of GDP and the deficit reached 1.7% of GDP, both clearly fulfilling the Maastricht criteria. Inflation is also expected to remain subdued for the foreseeable future. The main interest is now turned towards mid-May when the European Commission will release its recommendation regarding Estonia's admittance to the Euro area. The final confirmation will take place in July, but the EC's report in May will shed additional light on the sustainability of the consolidation measures and it is the most important guidepost for the decision.

We consider the risk of a "no" to be unlikely if the EC is satisfied that all the criteria are fulfilled, and thus believe in euro-adoption in 2011. EMU membership is seen boosting confidence in the economy, supporting foreign investment and thus growth. However, the euro will not solve all the problems in the economy, particularly as regards improvement in competitiveness. Therefore, the process of reducing costs to improve competitiveness must continue.

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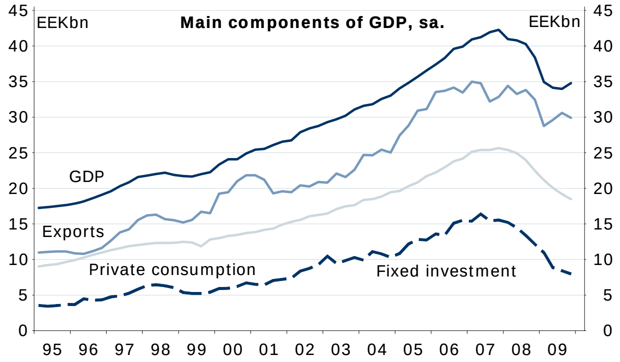
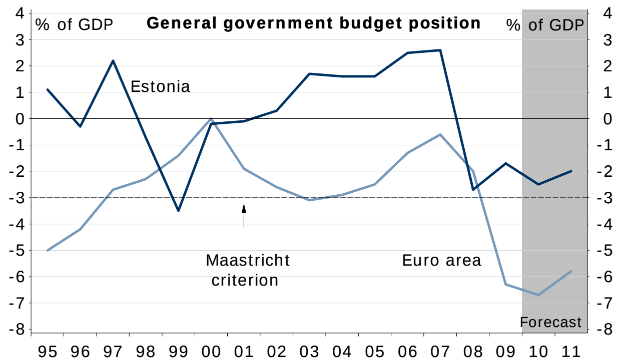
GDP growing but spending and investment falling



Stronger confidence indicates stronger spending

Government deficit below Maastricht criteria



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

	2006 (EEKmn)	2007	2008	2009	2010E	2011E
Private consumption	113,272	9.0	-4.7	-18.4	-2.5	4.0
Government consumption	33,839	3.7	4.1	-0.5	-1.0	0.5
Fixed investment	69,462	9.0	-12.1	-34.4	-4.0	6.0
Exports	165,888	0.0	-0.7	-11.3	6.0	6.3
Imports	189,517	4.7	-8.7	-26.7	4.2	4.8
GDP		7.2	-3.6	-14.1	1.2	4.0
Nominal GDP (EEKmn)	205,038	238,929	248,149	212,912	216,531	228,441
Unemployment rate, %		4.7	5.5	13.8	17.0	16.2
Consumer prices, % y/y		6.7	10.6	-0.1	0.5	1.5
Current account, % of GDP		-17.9	-9.1	4.6	4.0	2.0
General govt budget balance, % of GDP		2.6	-2.7	-1.7	-2.5	-2.2

Uncertainty in the economy still high

The worst decline in the economy is clearly over and various indicators have stabilised or started to increase again. GDP has, however, not yet turned towards growth (in seasonally adjusted terms), highlighting the widespread weakness especially in the domestic economy. Whereas exports have grown for two consecutive quarters, private consumption and investment are still contracting. Although consumer confidence has improved, weak labour markets and wage developments restrain consumption. The main hope is thus pinned on the export sector where a slow recovery has already started.

The government has undertaken significant fiscal consolidation measures, restraining the 2010 deficit below 8.5% of GDP. Latvia has received new loan tranches from international lenders, altogether EUR 800m. Thus, the State Treasury has enough funds to cover the budget deficit and roll over maturing debt obligations until the end of 2010. However, political friction escalated as the People's Party left the ruling coalition in March. The minority government is supported by an opposition party, but political uncertainty remains high.

Attention is gradually turning towards the 2011 budget. However, it is unlikely that specific measures will be agreed before the parliamentary elections in October, as further cuts become politically increasingly difficult. Households and companies have already been hit hard by the expenditure cuts, and measures targeted at consumers or businesses would be a political suicidal before the elections. The next round of reforms will thus likely be postponed until after the elections. However, bringing the deficit below 3% of GDP in 2012 will be difficult, unless the economy recovers faster than currently anticipated.

Devaluation speculation could re-emerge in 2010, in particular ahead of the parliamentary elections. However, the central bank's reserve position is strong and we do not expect the central bank to choose to abandon the peg. Thus, we see the internal adjustment continuing in 2010.

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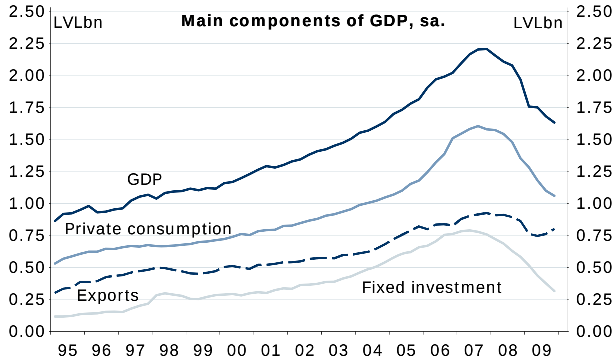
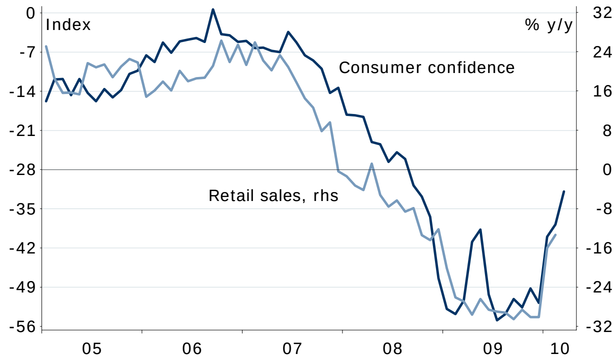
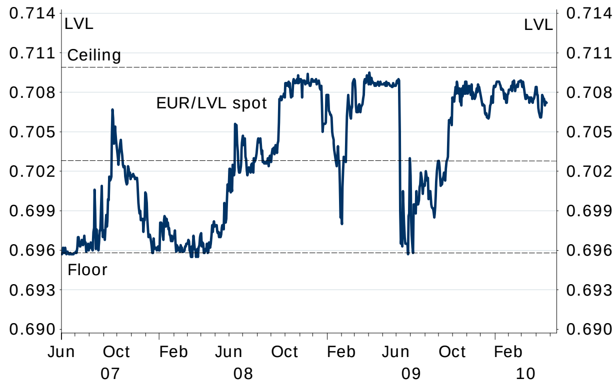
Domestic demand still declining



Consumer confidence up from bottom levels



LVL firmly within its fluctuation band



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

	2006 (LVLmn)	2007	2008	2009	2010E	2011E
Private consumption	7,281	14.8	-5.4	-22.2	-6.0	2.8
Government consumption	1,855	3.7	1.5	-8.7	-5.0	-1.0
Fixed investment	3,644	7.5	-15.6	-37.5	-5.0	4.5
Exports	5,014	10.0	-1.3	-13.8	5.5	5.8
Imports	7,412	14.7	-13.6	-34.0	3.5	4.5
GDP		10.0	-4.6	-18.0	-2.0	3.0
Nominal GDP (LVLmn)	11,172	14,780	16,243	13,244	12,688	13,005
Unemployment rate, %		6.0	7.5	17.2	22.5	20.5
Consumer prices, % y/y		10.1	15.3	3.6	-2.2	-0.5
Current account, % of GDP		-22.5	-13.0	9.4	7.0	5.0
General govt budget balance, % of GDP		-0.3	-4.1	-9.0	-8.0	-6.0

* Contribution to GDP growth (% points)

Gradual recovery in sight

The economy grew quarter-on-quarter (in seasonally adjusted terms) both in Q3 and Q4 last year, indicating an end to the recession. However, the improvements have been extremely modest, and the decline in both private consumption and investment has continued to steepen throughout the year. The improving GDP is mainly due to a cautious improvement in exports and a rise in inventories. Despite the gradual recovery we expect 2010 to be a difficult year, as especially domestic demand remains fragile. Thus, hopes largely rely on the export sector, as demand from some of Lithuania's main export partners has grown briskly in recent months. Although modest GDP growth is expected this year, it will take several years for the economy to reach pre-recession levels.

Consumer confidence has improved slowly but steadily and the decline in retail sales has abated, indicating firming household demand. However, the high unemployment and weak wage development will remain a drag on consumption. The measures taken to curb the growing budget deficit, such as the VAT hike and wage cuts, continue to weigh on spending.

Due to the high budget deficit EMU membership is postponed at least until 2014. Estonia's possible euro adoption has been feared to hurt the other Baltic countries through e.g. foreign investment moving to Estonia. However, Estonia's euro adoption could also reflect positively on the other Baltic countries through increased confidence in the possibility of the Baltics joining the EMU.

Lithuania has been able to raise funding in the international markets throughout the recession, avoiding turning to the IMF. Lithuania is likely to be able to continue borrowing without external support as long as its debt remains under control and the economic recovery remains on track. Falling government revenues increase the need to cut expenditures further to keep the deficit at a reasonable level. Government debt is seen rising sharply in the next couple of years, but still fulfilling the Maastricht criteria of remaining below 60% of GDP.

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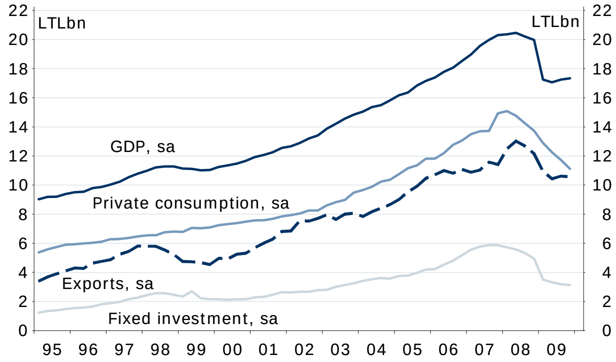
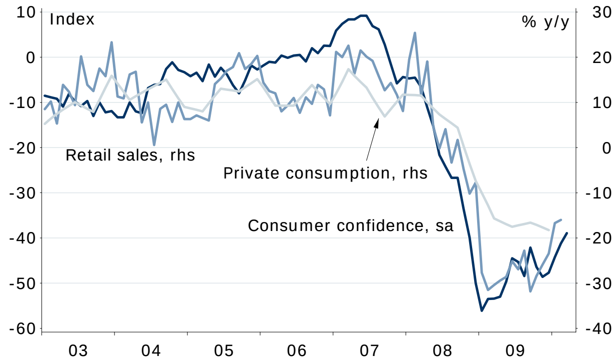
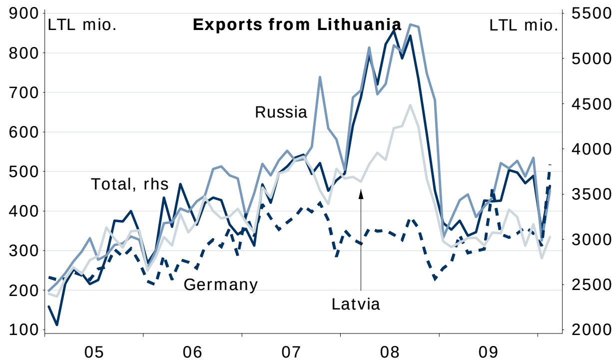
GDP turning slowly, but domestic economy still weak



Decline in sales abating along with rising confidence



Exports to Germany and Russia have revived



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

	2006 (LTLmn)	2007	2008	2009	2010E	2011E
Private consumption	53,449	12.1	3.6	-17.0	-4.0	3.0
Government consumption	15,966	3.2	7.9	-2.1	-3.5	0.5
Fixed investment	20,841	23.0	-6.5	-39.0	-4.5	5.0
Exports	48,917	3.0	12.2	-15.3	5.0	5.5
Imports	57,343	10.7	10.5	-28.9	3.8	4.0
GDP		9.8	2.8	-14.9	0.5	3.0
Nominal GDP (LTLmn)	82,792	98,138	111,498	99,568	99,070	102,537
Unemployment rate, %		4.3	5.8	13.7	17.0	16.5
Consumer prices, % y/y		5.8	11.1	4.2	-1.0	0.5
Current account, % of GDP		-15.0	-11.9	3.8	3.0	2.5
General govt budget balance, % of GDP		-1.0	-3.2	-8.9	-8.0	-6.8

Economy to keep up momentum

We expect strong economic growth to continue in the near term. The recovery is becoming sustainable and not solely reliant on public investment and lax credit conditions. The outlook for both household expenditure and private investment is bright, though reported growth in these indicators will likely decrease throughout this year due to base effects from last year.

Recently, also exports have rebounded to pre-Lehman levels, and as global demand picks up further, the export sector will regain further strength despite the expected revaluation of the CNY. In 2011 overall growth will likely slow somewhat as the effect from the monetary and fiscal stimuli fades, but growth will remain very strong in comparison with most other countries.

One risk to the main scenario of continued healthy growth is the bursting of the bubble that might exist in the property market. Despite many plausible explanations for the high property price levels, we cannot rule out that prices could correct downwards. But due to relatively low household leverage and the authorities' ability to manage the situation properly by for instance imposing a property tax and appropriate tightening of credit conditions, we expect a gradual deflation of the bubble (and not a burst) with limited negative consequences for household consumption. The banks might suffer from losses on loans to developers, but that should be handled too since most banks are publicly owned.

Consumer price inflation will likely climb above the government's 3% inflation target for 2010 amid renewed regional labour shortages and strong wage increases and despite the fact that food price inflation seems to have peaked. Looming inflationary pressure is one of the key reasons why we expect both continued monetary tightening in the form of reserve requirement hikes and interest rate hikes and a gradual revaluation of the CNY versus the USD throughout the forecast period.

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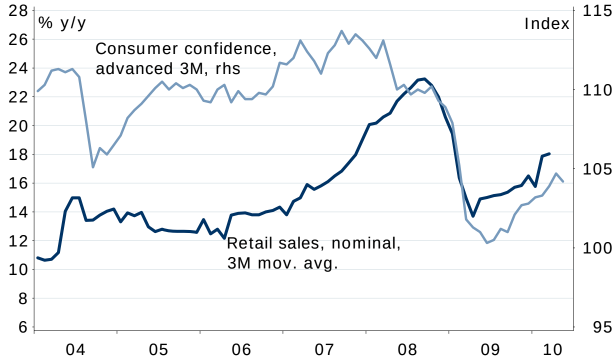
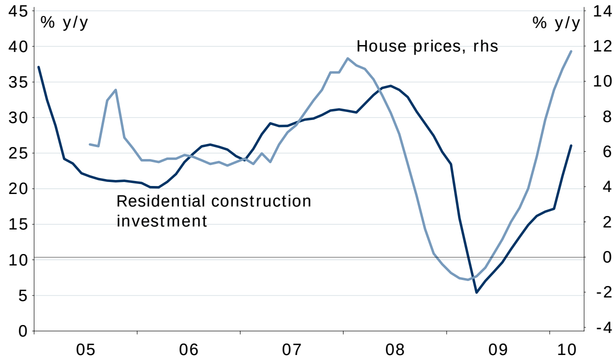
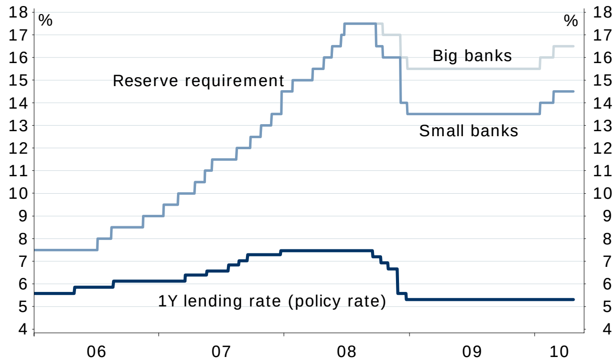
Retail sales one of many indicators pointing upwards



Property prices in bubble-like territory



Gradual monetary tightening set to continue



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

	2006 (CNYbn)	2007	2008	2009	2010E	2011E
Private consumption	8048	10.4	8.4	9.3	9.6	10.0
Government consumption	3012	10.9	8.3	10.1	10.8	9.5
Fixed investment	9015	11.9	9.4	18.4	13.0	11.5
Stockbuilding*	425	0.4	0.5	0.3	0.0	0.0
Exports	8465	20.4	13.9	-9.0	9.0	10.0
Imports	6799	18.5	15.2	-3.4	10.0	12.0
GDP		13.0	9.6	8.7	10.4	9.5
Nominal GDP (CNYbn)	22165	26309.0	30686.0	33535.0	38196.4	42970.9
Unemployment rate, %		4.0	4.2	4.3	4.2	4.0
Consumer prices, % y/y		4.8	5.9	-0.7	3.5	3.0
Current account, % of GDP		10.7	9.6	5.8	6.0	4.3
General government budget balance, % of GDP		0.6	-0.4	-2.1	-3.2	-2.2

* Contribution to GDP growth (% points)

Ready to take advantage of revaluation in neighbouring China

Being less affected by the global crisis than most others economies, India had a favourable starting point for the current recovery. Having taking adequately advantage of this, the economy is now fully up to speed again. This can easily be seen from industrial production growth that has soared to close to 20% y/y. Due to negative base effect, this figure will decrease going forward, but monthly industrial production growth will hardly lose momentum.

The service sector is also recovering, reflecting the revival of domestic demand. But also the vital software service exports are now showing signs of improvement and with the global recovery on track despite some possible bumps on the road, the outlook for exports remain bright. A revaluation of the CNY would mean additional support for exports via increased competitiveness.

The most important sector especially in terms of its share of total employment remains agriculture. Here the economic outlook is heavily dependent on the unpredictable weather. Food prices are still elevated following last year's deficient monsoon, and inflation is therefore running at double-digits. Wholesale price inflation, the preferred inflation measure, has most likely peaked (at 9.9% y/y in March) and is set to decelerate slightly from here. But food comprises a much larger share of the consumer price index than of the wholesale price index, explaining why consumer price inflation is even higher than wholesale price inflation. Add to this that also general inflationary pressure is building up amid the strong domestically driven recovery.

In order to dampen inflation, the monetary policy rate and reserve requirement rate have been raised, and we expect more to come throughout 2010. The high inflation in combination with a likely Chinese revaluation should also lead the central bank to allow more appreciation of the effective exchange rate. This should in combination with our view of a stronger USD versus the EUR mean that the INR could strengthen further versus the EUR but not necessarily versus the USD.

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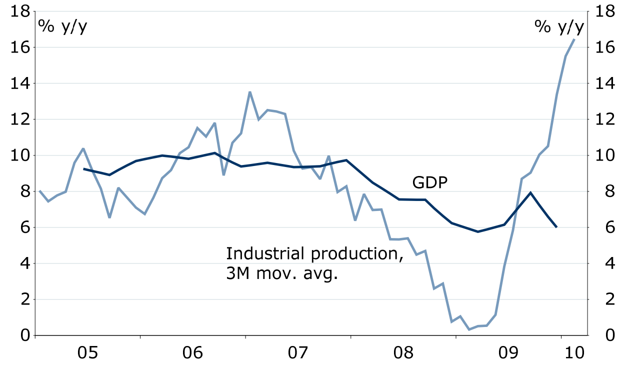
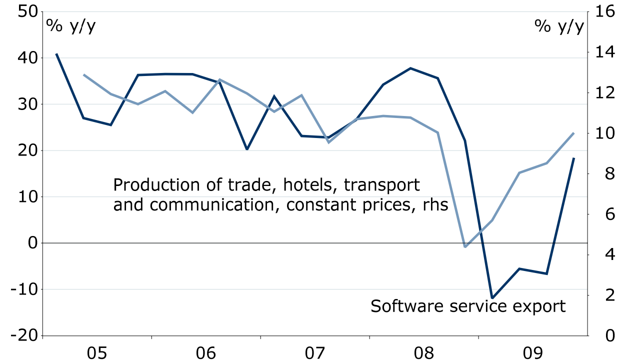
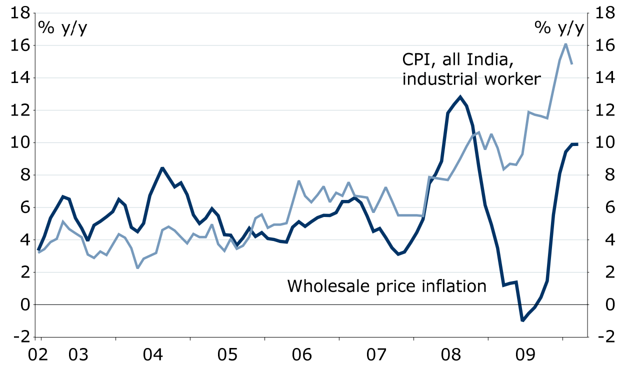
Industrial production has soared



Software service exports have joined the bandwagon



Inflation has likely peaked – but what a peak!



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

	2006 (INRbn)	2007	2008	2009E	2010E	2011E
Private consumption	24,652	9.2	8.2	3.9	6.0	6.5
Government consumption	37,556	5.5	7.4	20.2	8.0	7.0
Fixed investment	13,471	15.2	4.0	5.2	12.0	13.5
Exports	8,716	6.8	20.9	-9.4	13.0	15.0
Imports	10,440	7.1	31.7	-8.5	10.0	12.0
GDP	42,840	9.6	5.1	6.8	9.0	8.8
Nominal GDP (INRbn)	42,840	49,479	55,744	60,348	69,702	79,530
Wholesale prices, % y/y		4.8	9.1	1.5	6.5	5.3
Current account, % of GDP		-1.0	-1.2	-1.6	-1.6	-1.8
General government budget balance, % of GDP		-2.7	-6.2	-8.0	-7.5	-7.2

Presidential elections take centre stage

Economic growth in 2010 is expected to be very healthy at a little above 6%, though partly thanks to an overhang from the very strong recovery in H2 2009. 2011 will likely see more modest but still decent trend-like growth. The domestic economy has already recovered amid lower interest rates and fiscal stimuli with especially car purchases as the main growth driver. Going forward, investment becomes key. And luckily indicators point to a strong rebound in investment activity supported by easier credit conditions and better business sentiment. In addition to improving growth immediately, the improved capital flow from the accelerated investment pace bodes well for the coming years. The economy will soon be running at full capacity again, and the labour market is tightening with unemployment again trending downwards, recently reaching a new record.

The value of the important commodity exports increased with global commodity prices. And now also real exports seem buoyed by the pick-up in global demand. Unfortunately, this will likely be more than offset by the surge in imports, meaning that the monthly surplus on the trade balance could soon turn into deficit again. This will further worsen the current account deficit.

The presidential election is due in October, and President Lula is not eligible for re-election. He probably intends to stay beloved by the people and to try to let his popularity spill over to his preferred candidate, Dilma Rousseff. Thus, fiscal policy will probably remain loose throughout 2010. The opposition's main candidate Jose Serra's lead in the polls is shrinking. He is seen by most observers as being more market friendly than Rousseff. On the other hand, victory to Rousseff should likely ensure continued strong public support for growth in the short term.

Interest rates will likely be hiked throughout this year, soon bringing the policy rate back to double-digit figures. This should support the BRL, though worries about the presidential elections and the strength of the global recovery could weigh on the BRL in H2 2010.

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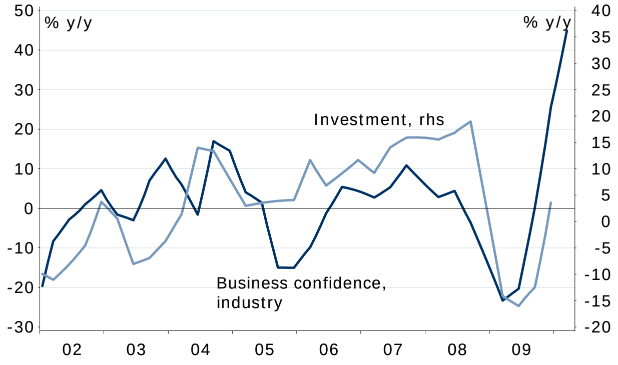
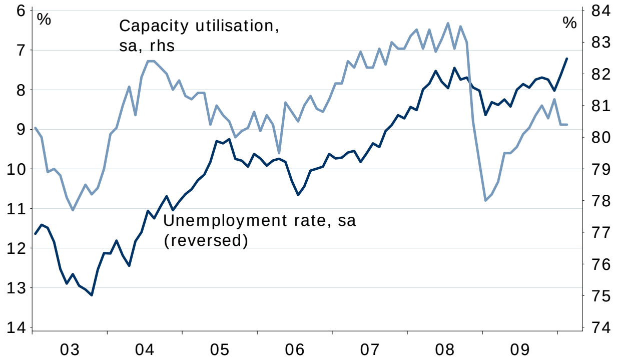
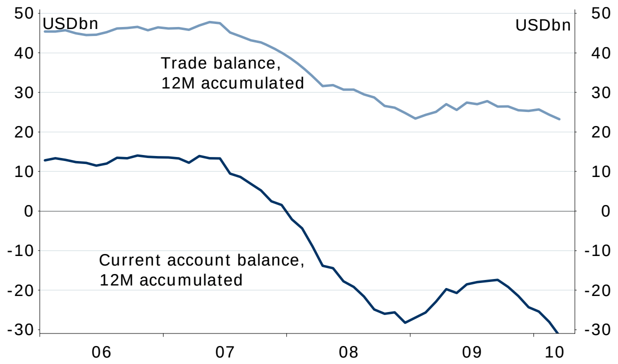
Bright outlook for investment



Economy soon running at full capacity again



Trade balance surplus set to disappear



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

	2006 (BRLbn)	2007	2008	2009	2010E	2011E
Private consumption	1,428.9	6.1	7.0	4.1	6.0	5.2
Government consumption	474.8	5.1	1.6	3.7	4.0	3.5
Gross fixed capital formation	389.3	13.8	13.4	-10.0	16.0	8.8
Stockbuilding*	7.7	0.7	0.5	-1.5	0.2	0.0
Exports	340.5	6.3	-0.8	-10.3	6.3	6.5
Imports	271.7	19.8	18.0	-11.5	16.5	9.5
GDP		6.1	5.1	-0.2	6.3	5.1
Nominal GDP (BRLbn)	2,369.5	2,661.3	3,004.9	3,242.4	3,680.5	4,130.2
Unemployment rate, %		9.3	7.9	8.1	7.2	7.1
Consumer prices, % y/y		3.6	5.7	4.9	5.4	4.8
Current account, % of GDP		0.1	-1.8	-1.5	-2.5	-3.0
General government budget balance, % of GDP		-2.2	-1.6	-3.2	-2.7	-2.0

* Contribution to GDP growth (% points)

Oil fundamentals gradually tighten

Our oil price forecasts have not changed much since our January issue of *Economic Outlook*. Oil prices are expected to continue on an upward trend and pick up pace at the end of the forecast period as the world economy recovers and oil fundamentals gradually tighten. Financial investors' appetite for oil is expected to increase as the oil supply/demand balance continues to improve. However, short term there is a risk that prices may correct down somewhat before continuing on the upward trend.

The investment climate has improved from a year ago. Capital costs have fallen by 12-15% from the peak in 2008 and oil prices have more than doubled from last year's low, reducing margin pressure. Further consolidations along the supply chain are expected this year, as companies may exploit the opportunities from the current down cycle. Appetite for investments in new projects is expected to pick up in 2011 as the price trend continues up. Oil production is struggling with accelerating decline rates and an aging production base. Timely and sufficient investments in all parts of the supply chain are vital to secure sufficient production capacity for the years to come. Limited potential to expand non-OPEC production capacity increases the pressure on OPEC-countries to invest, as the cartel holds around 75% of the world's oil reserves. Aggravating the risk of underinvestment in the oil-rich parts of the world is increasing sovereignty over oil reserves, national protectionism and political unrest. Capacity potential has improved in Russia, Brazil, Iraq and the US coastal waters. Russia removed taxes in East Siberia to encourage investments in new oil fields, to counterbalance stagnating output and to meet the export potential of the ESPO pipeline to China finished by 2012. Spurred by technology breakthroughs, the shale gas fever is spreading rapidly from the US to other parts of the world. Technological, political and economic challenges remain manifold. Shale gas is expected to influence the energy mix in the medium and long term as large discoveries may change the price trend for natural gas and alter inter-energy competition.

Global economic activity, industrial production and world trade are vital drivers for oil demand. Solid economic growth in oil-intensive emerging economies, urbanisation and increasing living standards in populous countries is expected to support oil demand in the forecast period. Crude oil imports to China have showed remarkable strength as a rapidly increasing car fleet boosts demand for transportation fuels. Increasing refinery capacity may turn China into a net oil product exporter.

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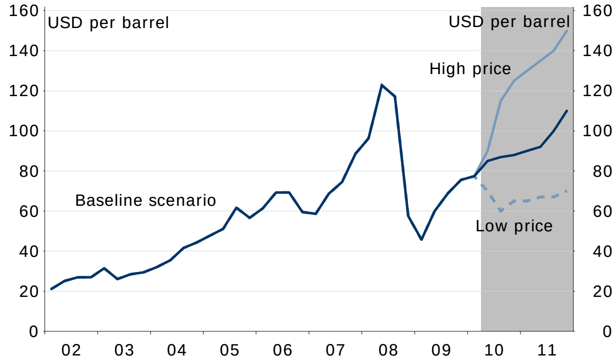
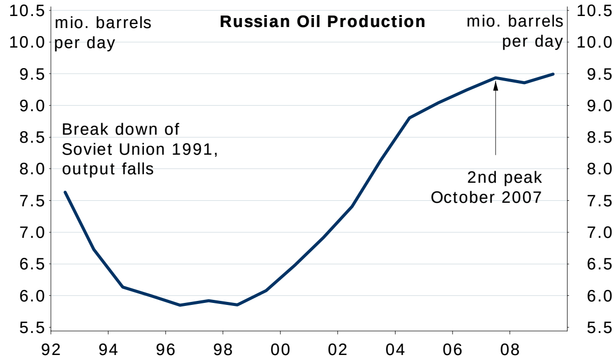
Oil price forecast – baseline (Brent – USD/barrel)

	Q1	Q2	Q3	Q4	Year
2007	58.6	68.7	74.6	88.5	72.6
2008	96.3	122.8	117.2	57.5	98.4
2009E	45.7	59.9	68.9	75.5	62.5
2010E	77.4	85.0	87.0	88.0	84.3
2011E	90.0	92.0	100.0	110.0	98.0

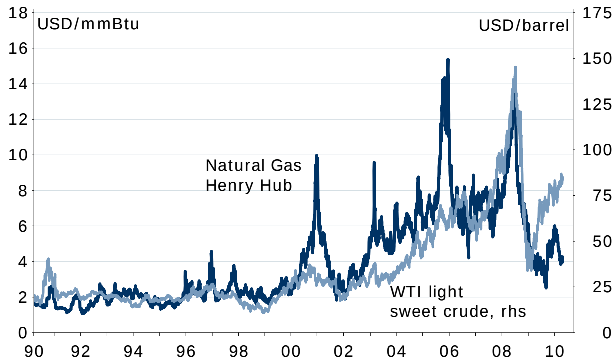
Oil price scenarios – baseline, high and low price



Russian oil production



WTI oil price and Henry hub natural gas price, 1-pos



Metal prices volatile, but on the rise

Despite the marked downswing in February, prices of base metals continued to rise in the first months of the year. Besides the relatively brisk pick-up in industrial output, the rise is explained by individual factors, such as the earthquake in Chile. The close-to-zero interest rate level is also driving investors to seek more attractive investment opportunities. The insatiable appetite of China and other industrialising countries for raw materials, coupled with long-term inflation fears, makes the environment opportune for investors.

Previously sizeable inventories and surplus in the market in the next few years would have curbed prices. Now a large proportion of inventories is tied into investment activity and the slight surplus in the market does not indicate a drop in prices, since surprisingly brisk demand or declining supply may lift prices all of a sudden. In contrast, there is a risk that the market may run into deficit in a few years' time unless prices remain sufficiently high to fuel new investment.

The metal price outlook is dual. We expect the pace of the global recovery to decelerate towards the end of the year when China will tighten its fiscal policy and the inventories cycle will fail to boost industrial activity in the way it used to. USD appreciation and more scarce liquidity in the financial markets could also push prices down. When inventories are high, investors' waning interest might lower prices quickly. Yet, tighter market balance as a result of better-than-expected economic growth, combined with late tightening of monetary policy, could keep metal prices surging surprisingly sharply.

The extremes of the price scenarios are rather far apart, which intensifies the risk of sharp price fluctuations. Nickel might prove the most volatile metal by far since there is marked short-term upward pressure on its price. If the market dips, the decline could be quite as sharp. As to other metals, the supply of copper is among the most stretched and hence copper prices might soar quickly if demand picks up.

The recession showed that demand recovers quickly when prices dip. The long-term demand outlook is solid and if prices do not remain sufficiently high to encourage investment, the market will become considerably tighter in a couple of years. Consequently, the price level of base metals seems to be sustainable in a longer perspective and the basic price trend is slightly upwards after the huge surge last year, even though there is reason to expect anything but stable performance.

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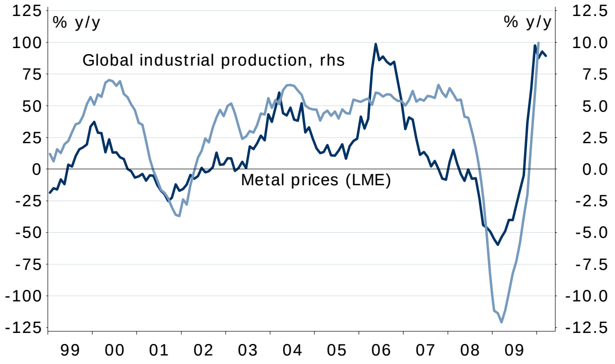
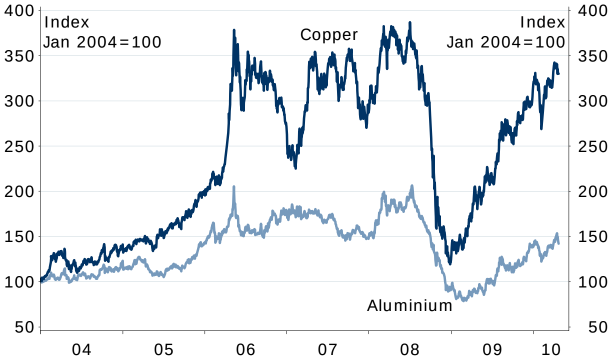
Milder but volatile rise

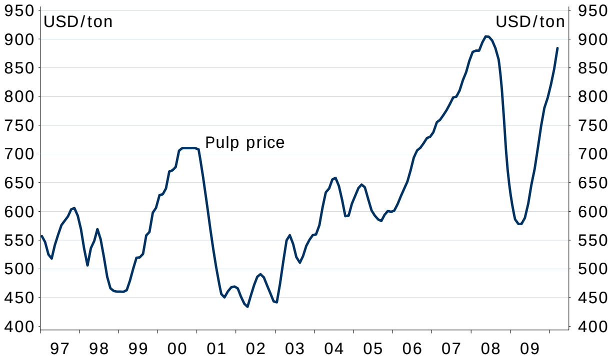
Demand has risen sharply



Copper supply will be tight



Pulp prices close to peak?



Public debt could hold the seeds of the next financial crisis

- The Greek debt crisis could easily become contagious
- Public debt challenge not confined to the Euro area
- Small fiscal adjustment need in the Nordic countries
- No alternative to tightening of fiscal policy

Greece is the comatose canary in the coalmine

The crisis over Greek public finances has grabbed headlines for several months with significant fluctuations in financial markets. This has led some observers to question whether Greece can solve its fiscal and structural problems without restructuring its debt. The other Euro-area member states were eventually forced to design an unprecedented contingency plan, which promises a combination of loans from the IMF and the other Euro-area members. Although policymakers were clearly hoping that the mere commitment to offer financial assistance to Greece would be enough to calm market concerns, the plan was not able to instil calm in financial markets. Hence, with yields on Greek 2-year bonds reaching 10%, the Greek government found it necessary to ask for the loan package to be activated. At the time of writing, an IMF team is in Athens to negotiate the terms of the loan package, and it is expected that an agreement can be reached in the first half of May.

As noted by the IMF, there is a considerable risk that, if unchecked, market concerns about sovereign liquidity and solvency in Greece could turn into a full-blown and contagious sovereign debt crisis. This could easily affect other Euro-area member states where debt appears to be on an unsustainable path, such as Portugal, Ireland and Spain. However, for the Euro area as a whole, public deficits are expected to constitute less than 7% of GDP in 2010, significantly lower than in the US, the UK and Japan. Thus, the risk of an unsustainable debt path is by no means confined to the Euro-area members, and the increasingly urgent need to deal with this situation is likely to have a significant impact on nearly all advanced economies over the next decade.

Fiscal crisis intensified after the recession

The great recession of 2008-09 has led to a sharp deterioration in government budgets in nearly all OECD countries. Following the financial crisis, which sharply curtailed private borrowing in most countries, the public sector in nearly all countries has seen a sharp rise in borrowing needs over the past couple of years. This development is well justified, as the big deterioration in public balances is the natural result of both automatic stabilisers and fiscal packages aimed at stimulating economic activity. Nevertheless, the big deficits have resulted in dramatic increases in government debt since 2007 in many OECD countries, elevating public debt to the highest levels seen since World War II.

Given that part of the deterioration in government balances is explained by discretionary loosening of fiscal policy, many countries will not be able to stabilise, let alone reduce, public debt by simply relying on economic activity to return to pre-crisis levels. Furthermore, to the extent that the credit crunch has reduced potential output, structural borrowing will have risen even without any active decision to spend more or cut taxes. The sharp rise in debt ratios will also lead to higher interest expenditures. Thus, the OECD estimates that cyclically adjusted net lending by the general government in 2010 will reach 4.5% of GDP in the Euro area, over 7% of GDP in Japan and nearly 9% of GDP in the US. Meanwhile, the need for fiscal adjustment in the Nordic countries is relatively limited due to strong fiscal positions before the crisis.

In addition to the big current deficits, nearly all of the advanced economies are facing sharply rising public expenditure for health and pensions as a result of the ongoing demographic change. Hence, a recent BIS study argues that the debt-to-GDP ratio, without a change in policy, could reach 450% in the US by 2040, 250% in Italy, 300% in Germany, 400% in France, 500% in the UK and 600% in Japan.

The problem with high levels of debt

With public debt levels reaching new post-war highs, many observers worry about the negative fall-out from this development. An influential study by Reinhart and Rogoff concluded that once central government debt reaches 90% of GDP, annual growth rates tend to fall by 1%-point[1]. Risks related to sovereign debt could depress output for a variety of reasons. They could prompt premature withdrawal of fiscal stimulus that undermines recovery or limits the scope of new stimulus in response to new adverse shocks. As activity weakens, households and investors could lose confidence in governments' ability to design and implement sound consolidation plans and in response could sharply reduce their spending because of concerns that taxes will increase or that prospects for growth, wages and investment returns will diminish. Lastly, higher levels of debt could lead to higher interest rates, which would restrain investment activity.

Even though debt levels are approaching post-war highs in many advanced economies, the IMF believes that a widespread public debt scare is unlikely, because to-

[1] Carmen Reinhart and Kenneth Rogoff, Growth in a time of debt, 2010. According to the convergence criteria of the Maastricht Treaty government debt must not exceed 60% of GDP. However, there is no evidence to support this threshold as crucial. With annual nominal GDP growth of 5% and deficits of 3% of GDP, debt would be stable at 60% of GDP. However, with nominal GDP growth in the Euro area around 3.8%, deficits can only be 2.1% of GDP for debt to remain stable at 60% of GDP. In the US nominal GDP growth is higher, and here debt could be stable at 60% with deficits of 2.6% of GDP and annual nominal GDP growth of 4.5%.

gether these economies have broad tax and investor bases. However, even here, investors are likely to increasingly differentiate among economies, showing greater sensitivity to deteriorating budgetary outlooks.

For example, Japan's gross debt is now close to 190% of GDP, far above the debt of nearly 116% of GDP seen in Greece at the end of 2009. Yet Japan is still able to borrow at 1.6% interest on 10-year bonds. Several factors may explain this. First, it should be mentioned that Japanese net debt is just 96% of GDP, not far above net financial liabilities in Greece. Secondly, analysts often point to the fact that Japan has its own monetary policy, and should therefore always be able to meet its obligations by letting the central bank print money to buy the debt, although such a policy would effectively amount to a real depreciation of outstanding debt due to the inflation created by such a policy. A third and perhaps more important reason is that Japan still has a big current account surplus, while Greece has a big current account deficit. Thus, Japan still has a big domestic investor base for government debt, while Greece has to rely on foreign investors, who tend to be far more sensitive to the outlook for public finances.

The combination of big public deficits and reliance on foreign capital inflows also characterise the US, and foreign investors own almost half of the publicly held federal debt. So far the US has enjoyed the benefit of being the world's reserve currency, but China has already fretted about the fiscal course of the US and recurring rumours that China wants to reduce its Treasury holdings is a reminder that the US could face difficulties financing its runaway public deficit.

No easy way to reduce the deficits

Fiscal consolidation will certainly not be easy from a political viewpoint, and there is a substantial risk that many countries will not tackle the issue unless an outright crisis leads to a sharp rise in funding costs. This has led some observers to suggest that countries could be tempted to inflate themselves out of debt. However, if government bond investors demand a constant real return, increasing inflation would actually result in higher public deficits, preventing a lasting stabilisation of public debt. Thus, it is quite clear that nearly all countries will have to undertake a substantial tightening of fiscal policy in order to stabilise debt, not to speak of reducing debt to pre-crisis levels. In this relation, historical experience shows that some of the biggest fiscal consolidations primarily have relied on expenditure reductions. Moreover, most of the big fiscal consolidations have occurred at a time when interest rates were falling sharply, reducing the drag on growth. With interest rates already close to historical lows, such an effect is unlikely this time round.

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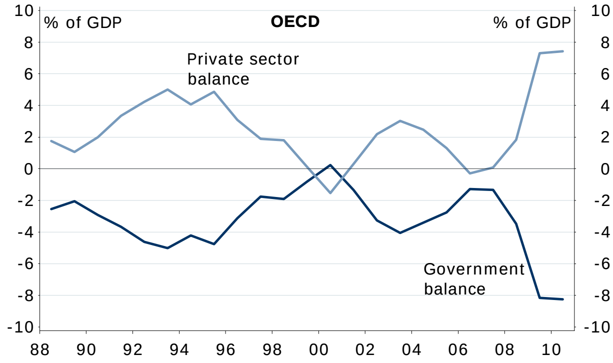
Higher public borrowing as private borrowing fell



Public debt at highest levels since World War II

Source: The IMF, based on PPP weights.

Adjustment need in Nordic countries relatively small

	Gross puclic debt, % of GDP, IMF forecast for 2010	Structural primary balance, % of GDP, IMF forecast for 2010	Required fiscal adjustment 2010-2020 to bring debt to 60% of GDP in 2030, % of GDP
Greece	129.5	-6.4	15.5
Ireland	74.5	-8.7	13.5
Japan	228.6	-6.7	13.4
United States	91.8	-6.4	10.6
United Kingdom	79.6	-6.2	10.4
Spain	63.7	-6.1	9.4
Portugal	83.3	-3.7	7.5
France	84.9	-2.1	6.0
Belgium	100.9	-1.1	5.8
Austria	72.9	-2.7	5.7
Netherlands	63.9	-3.3	5.3
Italy	117.6	0.5	4.9
Germany	77.3	-1.7	4.4
Iceland	131.2	0.1	3.8
Norway	67.4	4.4	2.2
Sweden	44.7	-1.5	1.9
Finland	48.1	-0.2	0.7
Denmark	46.0	0.6	-0.1

Biggest fiscal adjustments focused on expenditures

Country (End-Year)	Size	Of which: Revenue Increase	Of which: Primary Expenditure Reduction	Length (Years)	Cyclically-Adjusted Primary Balance at end year
Ireland (1989)	20.0	8.1	11.8	11.0	4.4
Sweden (2000)	13.3	3.0	10.4	7.0	3.8
Finland (2000)	13.3	2.6	10.7	7.0	7.1
Sweden (1987)	12.5	7.2	5.3	7.0	4.8
Denmark (1986)	12.3	6.3	6.0	4.0	6.6
Greece (1995)	12.1	9.9	2.3	6.0	4.8
Israel (1983)	11.1	-0.1	11.2	3.0	2.6
Belgium (1998)	11.1	0.4	10.7	15.0	6.7
Canada (1999)	10.4	4.0	6.4	14.0	5.6
United kingdom (2000)	8.3	3.2	5.1	7.0	2.9

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