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ECONOMIC OUTLOOK

AUGUST 2011

Signs of crisis

Nordic economies have peaked

■ The Nordic countries can still boast of solid public finances but the growth engines are running out of steam.

Marked international slowdown

■ The world economy is facing a very uncertain period. Activity has slowed sharply in both the US and the Euro area. However, there are still signs of strong economic growth in the increasingly important Emerging Markets.

Data overview

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Nordic economies

Major economies

Emerging Markets

Commodities

In times of crisis

Since our May issue of Economic Outlook *the signs of crisis in the world economy have become increasingly clearer. The sovereign debt crisis flared up with renewed strength when it spread to large Euro-area countries such as Italy and Spain. And the US received a major blow when S&P downgraded its credit rating of the world's largest economy. The consequence has been dramatically rising volatility in the financial markets across all asset classes. Also the leading economic indicators suggest that the world economy is facing a very uncertain period. Activity has slowed sharply in both the US and the Euro area, and our baseline scenario now factors in very low growth in the "old world" over most of the forecast period (now up to and including 2013). It must be emphasised that the risk of a new recession in both regions is quite high. And unlike the situation in 2008-09 the economic and political tools available to stimulate growth are much more limited today. The room for manoeuvre on fiscal policy is very limited in the debt-ridden countries and interest rates have already been knocked as low as they can get in the large western economies.*

One of the main reasons why we still believe that a new severe recession can be avoided is that the central banks still stand ready to use the printing press to pump out all the liquidity needed to stave off a new collapse of the financial sector. Moreover, falling market rates and commodity prices lend new momentum to households and businesses. Add to this that employment is still adapted to the lower production level that prevailed during the Great Recession and that the private sector is generally much more well-consolidated now than in 2008. So unemployment does not look set to rise drastically again in the years ahead. Lastly, there are still signs of high economic growth in the increasingly important Emerging Markets including China, Russia, India and Brazil. Therefore we are not in the middle of a horror déjà vu from the Great Recession, but "merely" undergoing an extended period of low growth in the "old world" countries. We estimate that growth in the world economy will reach 3.2% this year and 3.3% in 2012 versus 3.7% and 4.1% in our May forecast. In 2013 growth will accelerate to 3.8%.

The US shell-shocked

Compared to the May issue of *Economic Outlook* we have mainly adjusted our expectations for the US economy. Partly because the history of developments so far was fundamentally rewritten when data revisions revealed that growth has been very weak since the end of 2010. Partly because it seems that this summer's stock market collapse has left consumers and businesses virtually shell-shocked. Hopes are now pinned on the Fed's extremely lenient monetary policy propping up the US economy. And it may also turn out to be crucial that the private sector is much better consolidated today than when the sub-prime crisis erupted in 2007.

ECB on stand-by

Whereas Fed Chairman Ben Bernanke has announced that the US central bank will keep its policy rate close to zero until mid-2013, the ECB has refrained from similar bombastic statements. The ECB's mandate is to keep inflation close to or below 2%, which is why the sharp rise in consumer prices in the wake of the skyrocketing commodity prices made the bank raise its policy rate twice this year from a historically low of 1% to currently 1.5%. However, in our view the sovereign debt crisis and the weaker growth outlook combined with the decline in commodity prices will put off further rate hikes until early 2013. Further out the ECB will be able to resume the process of monetary policy normalisation. The exacerbated situation in the money and credit markets also means that the ECB will continue to pursue an extremely easy liquidity policy to prevent a potential meltdown of the financial system.

The growth outlook for the Euro area for the years ahead is also quite meager, but with large geographical variations. Germany, which has in recent years seen an economic renaissance, will still be the frontrunner, although the slowdown has also made its mark here. On the other hand, the debt-ridden countries in southern Europe, where sharp fiscal policy tightening has started, will face a tough period, with the recession ghost rearing its head from time to time.

The sovereign debt crisis has entailed major challenges for the Euro-area cooperation. However, it is increasingly clear that once again the French-German axis needs to be the bearing element of the system. The measures already adopted such as the financial stability mechanism and the pact on competitiveness may in this context be viewed as another step towards further political integration in the Euro area, which could end up resulting in the formulation of a common economic policy. It should also be noted that the object of the modern European cooperation has always been the formation of a political union. Ultimately, the current Euro-area crisis could end up being a catalyst for the union concept.

Credit spreads are back

The extremely lenient monetary policy will in combination with the high level of risk aversion keep long government yields down throughout much of the forecast period. However, as investors have begun to price credit risk on government bonds, yield spreads between the individual countries will periodically fluctuate sharply. We expect long US and German benchmark yields to rise to about 3.5-4% over the forecast period.

Controlled decline

The slowdown has also hit the large BRIC economies China and India, but contrary to trends in the western world, the slowdown here is to a far greater extent initiated by economic policy tightening, which has been imposed to prevent overheating of the economies. The same is to some degree the case in Brazil, whereas the Russian economy is still powering full steam ahead driven by high energy prices and confident consumers. So, seen as a whole, the BRIC countries merely face a controlled growth decline this year and the next.

Commodity prices slipping

Commodity prices fluctuate in step with economic cycles and the clear signs recently of a slowdown in the global economy have combined with investors seeking safe havens driven commodity prices lower across the board. The CRB Spot commodity price index has thus shed just over 5% from the historical peak in the spring of 2011. Prices are still markedly higher than one year ago, though. Given the worsened outlook for the world economy we have revised down our oil price forecast for 2011, although not dramatically. Our baseline scenario is not 2008 revisited, and political uncertainties not only in the Middle East and North Africa but also in places such as Nigeria and Venezuela will keep the risk premium on oil quite sizeable. Prices of most industrial metals are expected to fall further in step with the dampening of industrial production.

New chapter in the currency tug of war

The growing risk aversion has dramatically strengthened the historical funding currencies, the CHF and the JPY. The central banks in both Switzerland (SNB) and Japan (BoJ) have tried to weaken their currencies through sharp monetary policy easing and on the part of the BoJ also through intervention in the market. In combination with the latest liquidity measures from the Fed and the ECB, the contours are emerging of a new round in the currency tug of war that broke out in the autumn of 2010. Not until late in the forecast period when risk appetite returns to the financial markets do we expect the CHF and the JPY to weaken more substantially. And we expect the USD to firm versus the other main currencies, because the Fed will proceed more aggressively with hiking rates than the ECB. That is also why we expect to see a more historically based appreciation of the GBP against the EUR, although the Bank of England will keep its policy rate low for a long time owing to the UK's weak economic performance.

Nordic economies have peaked

The **Danish economy** is still feeling the aftermath of the downturn in the housing market and the Great Recession. Economic improvement since the end of 2009 has not been convincing and Denmark is again in a technical recession. Domestic demand growth has been lacklustre and many factors of uncertainty are at play, including the outcome of the upcoming parliamentary election and international economic trends. Against this background, we have revised down our growth forecast for both 2011 and 2012. In both years we now expect economic growth to be just around 1%. But growth will accelerate during the period, rising to 1.5% in 2013.

After vigorous growth in H1 2011 the **Swedish economy** is losing steam. Economic growth will be sluggish in 2012 as a result of the global slowdown. Export growth has already been affected and is seen slowing further. Despite higher energy prices and rising mortgage costs private consumption has held up fairly well. However, the recent fall in the stock market and a weaker labour market will hamper consumption in 2012. Investment is also affected by the financial unrest and will grow slowly next year. Employment is record high, but is seen falling in 2012, pushing unemployment higher. Public finances are balancing and will even improve slightly despite weak growth. Inflation is in line with the 2% target. Financial unrest will keep the Riksbank on hold this year. A deteriorating labour market will result in a lowering of the repo rate in 2012.

Weaker growth prospects internationally and financial unrest have weakened the outlook for the **Norwegian economy**. Still, there is reason to believe that Norway will be less hit than many other countries. Oil companies will increase investment activity sharply both in Norway and abroad. With low unemployment and decent wage growth, consumption growth will keep up, although the turmoil and stock market slide could dampen the pace. Given unchanged interest rates with Norway's trading partners, Norges Bank will only hike interest rates gradually and slowly, but still hike rates more than in other countries. Combined with the very strong public finances, this will help keep the NOK strong.

The economic outlook in **Finland** has turned gloomier. Growth forecasts for important trading partner economies – especially Germany, Sweden and the US – are being revised sharply downwards, which suggests that Finnish exports are going to be much weaker than expected earlier. Companies are thus likely to postpone investment projects. A fall in consumer confidence puts brakes on both private consumption and housing investment. We have almost halved our GDP growth forecast for 2012 from 3% to 1.6%. With such modest growth, employment hardly improves, and the new government will be forced to strike a balance between growth stimulating and public deficit narrowing policy actions. The outlook for 2013 is brighter, following that of key export markets, and total production is expected to increase by 2.7%.

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Growth, %

	2009	2010	2011E	2012E	2013E
World[1]	-0.9	4.4	3.2	3.3	3.8
USA	-3.5	3.0	1.3	1.6	2.7
Euro area	-4.1	1.7	1.6	0.6	1.8
China	9.2	10.3	9.1	8.5	8.1
Japan	-6.3	4.0	-0.2	2.5	1.2
Denmark	-5.2	1.7	1.0	1.3	1.5
Norway	-1.8	2.1	2.6	2.5	3.0
Sweden	-5.3	5.7	4.2	0.8	2.5
UK	-3.4	0.0	1.2	2.1	2.6
Switzerland	-1.9	2.6	2.1	1.8	2.3
Germany	-4.7	3.6	2.9	1.2	2.1
France	-2.6	1.6	1.5	1.0	1.8
Italy	-5.2	1.3	0.7	0.2	0.9
Spain	-3.7	-0.1	0.8	0.2	1.5
Netherlands	-3.9	1.8	1.8	0.9	2.3
Austria	-3.9	2.0	2.1	1.1	1.9
Portugal	-2.5	1.3	-2.2	-1.8	0.8
Greece	-2.0	-4.5	-4.9	-1.0	0.5
Finland	-8.2	3.6	3.4	1.6	2.7
Ireland	-7.6	-1.0	0.6	0.5	1.8
Estonia	1.7	0.0	7.5	3.6	4.8
Poland	1.7	3.8	3.3	3.4	4.0
Russia	-7.6	4.0	4.9	5.3	5.6
Lithuania	-14.7	1.3	6.0	3.7	4.8
Latvia	-18.0	-0.3	4.6	3.6	4.9
Czech Republic	-4.1	2.3	2.3	2.0	2.9
Hungary	-6.7	1.2	2.2	2.0	3.0
Kazakhstan	1.2	7.0	6.0	6.5	6.3
Romania	-7.1	-1.3	1.6	3.1	3.8
Turkey	-4.8	8.9	5.5	3.5	4.0
South Africa	-1.7	2.8	3.5	3.5	3.9
India	9.1	8.8	7.7	8.0	8.2
Brazil	-0.7	7.6	3.9	4.1	4.2
Mexico	-6.3	5.4	4.1	3.9	4.0

Inflation, %

	2009	2010	2011E	2012E	2013E
World[1]	0.8	2.7	3.7	2.8	2.8
USA	-0.3	1.6	3.0	2.0	2.2
Euro area	0.3	1.6	2.6	1.8	1.8
China	-0.7	3.3	5.3	4.3	4.2
Japan	-1.3	-0.7	-0.2	0.3	0.8
Denmark	1.3	2.3	2.8	2.0	2.0
Norway	2.2	2.4	1.4	1.7	2.3
Sweden	-0.5	1.2	3.0	1.8	2.2
UK	2.2	3.3	4.5	2.5	2.0
Switzerland	-0.5	0.7	0.2	0.4	0.7
Germany	0.3	1.2	2.5	1.7	1.7
France	0.1	1.7	2.7	1.8	1.7
Italy	0.6	1.6	2.7	2.0	1.8
Spain	-0.2	2.0	3.0	1.8	1.6
Netherlands	1.0	0.9	2.5	2.0	1.7
Austria	0.4	1.7	3.5	2.1	2.0
Portugal	-0.9	1.4	3.4	1.6	1.6
Greece	1.3	4.7	2.8	0.8	1.0
Finland	0.0	1.2	3.3	2.0	2.0
Ireland	-1.7	-1.6	1.1	0.9	1.0
Estonia	-0.1	3.0	5.0	3.0	3.9
Poland	3.8	2.5	4.2	2.4	2.6
Russia	11.8	6.9	8.5	7.5	7.0
Lithuania	4.2	1.3	4.3	3.5	3.8
Latvia	3.5	-2.5	4.5	3.3	3.8
Czech Republic	1.0	1.5	2.1	1.7	2.2
Hungary	4.2	4.9	3.5	3.0	3.0
Kazakhstan	7.3	7.8	8.2	7.5	6.8
Romania	5.6	6.1	5.1	4.0	3.6
Turkey	6.3	8.6	6.0	6.2	5.9
South Africa	7.2	4.3	5.0	5.5	4.8
India	2.4	9.6	8.3	5.5	6.0
Brazil	4.9	5.0	6.4	5.2	4.7
Mexico	5.3	4.2	3.8	3.6	3.3

Public finances, % of GDP

	2009	2010	2011E	2012E	2013E
USA	-10.3	-8.8	-9.3	-7.1	-4.9
Euro area	-6.3	-6.0	-4.5	-3.6	-2.5
China	-2.1	-1.6	-2.2	-1.9	-2.0
Japan	-7.1	-7.7	-10.0	-8.0	-7.0
Denmark	-2.8	-2.8	-3.8	-4.7	-3.0
Norway	10.5	10.6	15.0	16.4	15.5
Sweden	-0.9	-0.2	0.1	0.4	0.9
UK	-2.7	-10.4	-8.5	-6.5	-4.5
Switzerland	0.8	0.2	0.2	0.6	0.7
Germany	-3.0	-3.3	-1.5	-1.8	-1.5
France	-7.5	-7.0	-5.8	-4.8	-3.0
Italy	-5.4	-4.6	-3.9	-2.0	-0.8
Finland	-2.6	-2.5	-2.0	-1.5	-0.6
Estonia	-1.7	0.1	-0.3	-1.5	0.0
Poland	-7.3	-7.9	-5.5	-4.5	-3.0
Russia	6.4	-4.0	-0.7	-0.5	0.0
Lithuania	-9.2	-7.8	-5.0	-2.8	-2.4
Latvia	-9.7	-7.7	-4.8	-2.6	-2.3
Czech Republic	-5.9	-4.7	-4.4	-3.5	-3.0
Hungary	-4.5	-4.2	1.8	-3.0	-3.0
Kazakhstan	-3.0	-4.1	-2.0	-1.2	-1.2
Romania	-8.5	-6.4	-4.4	-3.5	-3.0
Turkey	-5.5	-3.6	-2.3	-2.1	-1.5
South Africa	-5.8	-5.3	-5.3	-4.2	-3.8
India	-6.1	-5.0	-5.5	-5.0	-4.5
Brazil	-3.2	-2.7	-2.5	-2.8	-2.8
Mexico	-2.3	-2.9	-2.2	-1.8	0.5

Current account, % of GDP

	2009	2010	2011E	2012E	2013E
USA	-2.9	-3.2	-3.5	-3.7	-3.5
Euro area	-0.6	-0.5	-0.7	-0.8	-0.8
China	5.9	5.2	4.1	3.6	3.2
Japan	1.9	3.6	2.3	2.9	3.2
Denmark	3.6	5.4	5.1	4.7	4.1
Norway	13.8	12.9	14.7	14.8	14.9
Sweden	6.8	6.2	5.6	6.5	6.8
UK	-1.3	-2.5	-2.0	-1.5	-1.5
Switzerland	8.3	14.2	13.0	11.0	9.0
Germany	5.0	5.1	4.8	4.6	4.9
France	-2.9	-3.5	-3.9	-4.1	-3.8
Italy	-3.0	-4.1	-3.8	-3.6	-3.3
Finland	1.3	1.9	1.2	1.2	1.3
Estonia	4.5	2.8	0.1	-0.5	-1.2
Poland	-3.9	-4.5	-2.9	-3.3	-3.7
Russia	4.0	4.8	4.0	3.5	3.2
Lithuania	2.6	1.3	-1.2	-1.8	-2.0
Latvia	8.6	3.6	0.2	-0.2	-1.0
Czech Republic	-3.2	-3.8	-3.5	-3.5	-4.0
Hungary	0.4	2.4	1.5	1.0	-1.5
Kazakhstan	4.9	4.0	3.7	3.5	2.8
Romania	-4.3	-4.0	-4.5	-4.8	-5.0
Turkey	-2.3	-6.5	-9.5	-7.5	-6.5
South Africa	-4.0	-2.7	-4.2	-5.0	-5.3
India	-1.9	-3.0	-3.0	-2.5	-3.5
Brazil	-1.5	-2.5	-3.0	-2.8	-2.8
Mexico	-0.7	-0.5	-0.7	-0.9	-1.5

1) Weighted average of countries in this table. Accounts for 76.5% of world GDP. Weights calculated using PPP adjusted GDP levels for 2008 according to the IMF's World Economic Outlook

Monetary policy rates

	26.8.11	3M	6M	12M	24M
US	0.25	0.25	0.25	0.25	0.75
Japan	0.10	0.10	0.10	0.10	0.10
Euro area	1.50	1.50	1.50	1.50	2.00
Denmark	1.55	1.55	1.55	1.60	2.15
Sweden	2.00	2.00	2.00	1.50	2.00
Norway	2.25	2.25	2.25	2.50	3.25
UK	0.50	0.50	0.50	0.50	1.25
Switzerland	0.25	0.25	0.25	0.25	1.00
Poland	4.50	4.50	4.50	4.75	5.00
Czech Rep.	0.75	0.75	0.75	1.00	2.00
Hungary	6.00	6.00	5.50	5.50	5.50
Romania	6.25	6.25	6.25	5.75	5.75
Turkey	5.75	5.75	5.75	6.75	8.25
Russia	8.25	8.25	8.50	9.00	9.00
Kazakhstan	7.50	7.50	8.00	8.00	8.50
South Africa	5.50	5.50	5.50	6.00	7.00
China	6.56	6.56	6.56	6.56	6.56
India	8.00	8.00	8.00	8.00	8.00
Brazil	12.50	12.50	12.50	12.00	10.00
Mexico	4.50	4.50	4.50	4.50	5.50

Monetary policy rate spreads vs Euro area

	26.8.11	3M	6M	12M	24M
US	-1.25	-1.25	-1.25	-1.25	-1.25
Japan[1]	-0.15	-0.15	-0.15	-0.15	-0.65
Euro area	-	-	-	-	-
Denmark	0.05	0.05	0.05	0.10	0.15
Sweden	0.50	0.50	0.50	0.00	0.00
Norway	0.75	0.75	0.75	1.00	1.25
UK	-1.00	-1.00	-1.00	-1.00	-0.75
Switzerland	-1.25	-1.25	-1.25	-1.25	-1.00
Poland	3.00	3.00	3.00	3.25	3.00
Czech Rep.	-0.75	-0.75	-0.75	-0.50	0.00
Hungary	4.50	4.50	4.00	4.00	3.50
Romania	4.75	4.75	4.75	4.25	3.75
Turkey	4.25	4.25	4.25	5.25	6.25
Russia	6.75	6.75	7.00	7.50	6.85
Kazakhstan	6.00	6.00	6.50	6.50	6.50
South Africa	4.00	4.00	4.00	4.50	3.75
China	5.06	5.06	5.06	5.06	4.56
India	6.50	6.50	6.50	6.50	6.00
Brazil	11.00	11.00	11.00	10.50	8.00
Mexico	3.00	3.00	3.00	3.00	3.35

3-month rates

	26.8.11	3M	6M	12M	24M
US	0.31	0.30	0.30	0.30	1.10
Euro area	1.54	1.45	1.60	1.60	2.10
Denmark	1.56	1.60	1.75	1.80	2.30
Sweden	2.58	2.55	2.55	2.05	2.55
Norway	3.09	3.07	3.02	3.10	3.79
UK	0.88	0.90	0.90	0.90	1.75
Poland	4.72	4.70	4.75	5.00	5.25
Czech Republic	1.18	1.10	1.05	1.30	2.30
Hungary	6.09	6.10	5.95	5.75	5.75
Russia	4.79	4.80	5.00	5.40	6.00
Latvia	0.85	0.95	1.40	1.70	2.20
Lithuania	1.85	1.90	2.00	2.10	2.40

3-month spreads vs Euro area

	26.8.11	3M	6M	12M	24M
US	-1.22	-1.15	-1.30	-1.30	-1.00
Euro area	-	-	-	-	-
Denmark	0.02	0.15	0.15	0.20	0.20
Sweden	1.04	1.10	0.95	0.45	0.45
Norway	1.55	1.62	1.42	1.50	1.69
UK	-0.66	-0.55	-0.70	-0.70	-0.35
Poland	3.18	3.25	3.15	3.40	3.15
Czech Republic	-0.36	-0.35	-0.55	-0.30	0.20
Hungary	4.55	4.65	4.35	4.15	3.65
Russia	3.25	3.35	3.40	3.80	3.90
Latvia	-0.69	-0.50	-0.20	0.10	0.10
Lithuania	0.31	0.45	0.40	0.50	0.30

10-year government benchmark yields

	26.8.11	3M	6M	12M	24M
US	2.27	2.20	2.50	3.30	3.85
Euro area	2.21	2.20	2.80	3.25	3.55
Denmark	2.44	2.45	3.00	3.35	3.65
Sweden	2.11	2.20	3.00	3.35	3.70
Norway	2.63	3.02	3.51	3.83	4.18
UK	2.52	2.40	3.00	3.35	3.80
Poland	5.65	5.60	5.60	5.70	5.80
Czech Rep.	3.08	3.35	3.75	4.00	4.25
Hungary	7.20	7.00	7.00	7.25	7.50

10-year yield spreads vs Euro area

	26.8.11	3M	6M	12M	24M
US	0.06	0.00	-0.30	0.05	0.30
Euro area	-	-	-	-	-
Denmark	0.23	0.25	0.20	0.10	0.10
Sweden	-0.09	0.00	0.20	0.10	0.15
Norway	0.42	0.82	0.71	0.58	0.63
UK	0.31	0.20	0.20	0.10	0.25
Poland	3.44	3.40	2.80	2.45	2.25
Czech Rep.	0.87	1.15	0.95	0.75	0.70
Hungary	4.99	4.80	4.20	4.00	3.95

Exchange rates vs EUR

	26.8.11	3M	6M	12M	24M
EUR/USD	1.443	1.40	1.35	1.30	1.25
EUR/JPY	111.4	112	108	104	119
EUR/DKK	7.450	7.46	7.46	7.46	7.46
EUR/SEK	9.104	9.15	9.25	9.35	9.40
EUR/NOK	7.790	7.90	7.60	7.60	7.60
EUR/GBP	0.881	0.87	0.87	0.84	0.83
EUR/CHF	1.147	1.15	1.15	1.20	1.30
EUR/PLN	4.154	4.00	4.10	4.00	3.90
EUR/CZK	24.22	24.3	24.0	23.8	23.5
EUR/HUF	272.3	270.0	270.0	270.0	270.0
EUR/RON	4.25	4.25	4.20	4.10	4.00
EUR/TRY	2.54	2.60	2.40	2.30	2.20
EUR/KZT	211.2	202.3	193.1	182.0	168.8
EUR/RUB	41.61	39.2	36.5	33.7	32.9
EUR/LVL	0.709	0.71	0.71	0.71	0.71
EUR/LTL	3.453	3.45	3.45	3.45	3.45
EUR/ZAR	10.40	9.66	9.32	9.49	8.75
EUR/CNY	9.221	8.88	8.44	7.88	7.14
EUR/INR	66.41	63.0	60.8	57.9	55.0
EUR/BRL	2.327	2.17	2.09	1.89	1.75
EUR/MXN	17.94	16.52	15.80	14.95	13.13

Exchange rates vs USD

	26.8.11	3M	6M	12M	24M
-					
USD/JPY	77.19	80.0	80.0	80.0	95
USD/DKK	5.163	5.33	5.52	5.73	5.96
USD/SEK	6.309	6.54	6.85	7.19	7.52
USD/NOK	5.399	5.64	5.63	5.85	6.08
GBP/USD	1.637	1.61	1.55	1.55	1.51
USD/CHF	0.795	0.82	0.85	0.92	1.04
USD/PLN	2.879	2.9	3.0	3.1	3.1
USD/CZK	16.79	17.3	17.8	18.3	18.8
USD/HUF	188.7	193	200	208	216
USD/RON	2.95	3.04	3.11	3.15	3.20
USD/TRY	1.76	1.80	1.66	1.59	1.52
USD/KZT	146.4	144.5	143.0	140.0	135.0
USD/RUB	28.84	28.0	27.0	25.9	26.3
USD/LVL	0.492	0.51	0.52	0.54	0.56
USD/LTL	2.393	2.47	2.56	2.66	2.76
USD/ZAR	7.21	6.90	6.90	7.30	7.00
USD/CNY	6.390	6.34	6.25	6.06	5.71
USD/INR	46.02	45.0	45.0	44.5	44.0
USD/BRL	1.61	1.55	1.55	1.45	1.40
USD/MXN	12.43	11.8	11.7	11.5	10.5

Back to earth

- Growth set to slow
- Lower employment and higher joblessness
- The Riksbank will cut rates next year
- The SEK loses ground

The poorer outlook for the global economy will clearly also leave its mark on the Swedish economy. Demand for Swedish exports will decline and the stock market slide will hit both households and businesses. GDP growth will start to slow as early as in H2 this year, and the lower GDP growth will gradually show through in the labour market in the form of declining employment and rising unemployment. As a result, the outlook for public finances will also deteriorate.

A more expansionary monetary policy will, however, underpin the economy. Furthermore, the starting point is benign. The economy has recovered well and the financial situation is overall stable, which combined will mitigate any adverse effects. But the economic outlook is still a great deal weaker than previous forecasts have indicated. And the many uncertainties involved should be emphasised.

Slowing export growth

After almost two years of strong recovery, GDP growth now looks set to flatten. A key factor behind this trend is a slowdown in export growth, previously the key engine of the Swedish economy. Export growth started to slow already in Q2 this year. In addition, the order intake is weak and conditions in many key export markets are worrying. Exports will thus lose momentum as a growth engine – despite a more benign regional diversification in favour of emerging markets such as the BRIC countries. Next year we see exports rising again in tandem with a gradual recovery of global growth.

Stock market slide a drag on domestic demand

Household consumption has held up well so far this year. Despite sharply rising borrowing costs and more expensive energy, consumption has continued to grow, albeit at a slower pace than previously. But the plunging share prices on the Stockholm exchange add to the burden on households. From the beginning of the year till mid-August the market has dropped almost 20%. Preliminary calculations show that the market slide has eroded households' financial wealth by up to SEK 350bn, corresponding to 10% of households' financial assets or 20% of households' disposable income. Moreover, the outlook for household income will be affected by the expected weakening of the labour market and shelved tax cuts. Real disposable income will likely rise by a mere 1% per year on average in 2012 and 2013.

There is a risk that these negative factors will reinforce one another, thus prompting a decline in consumption. For example the erosion of households' financial wealth and the weakening labour market could adversely affect housing market activity, which often tends to influence households' propensity to spend.However, the potential decline in household demand will likely be limited. One reason is that household financial savings are relatively abundant and at significantly higher levels than prior to the bust years of 2001 and 2009 when consumption fell or growth slowed. Another factor is the changed outlook for interest rates, which supports both household consumption and the housing market.

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

	2008 (SEKbn)	2009	2010	2011E	2012E	2013E
Private consumption	1,505	-0.4	3.4	1.7	1.0	2.1
Government consumption	835	1.7	2.5	1.0	0.4	0.3
Fixed investment	642	-16.3	7.1	7.1	1.3	3.6
- industry	46	-22.2	-7.5	12.4	-0.9	6.9
- residential investment	112	-23.3	20.0	14.2	3.8	3.6
Stockbuilding*	6	-1.5	2.1	0.8	-1.2	0.0
Exports	1,715	-13.4	11.0	7.8	4.1	5.4
Imports	1,499	-13.7	12.8	6.4	2.0	4.6
GDP		-5.3	5.7	4.2	0.8	2.5
GDP, calendar adjusted		-5.2	5.4	4.3	1.2	2.5
Nominal GDP (SEKbn)	3,204	3,089	3,306	3,476	3,582	3,740
Unemployment rate, %		8.3	8.4	7.5	7.8	7.7
Employment growth		-2.1	1.0	2.1	-0.3	0.3
Consumer prices, % y/y		-0.5	1.2	3.0	1.8	2.2
Underlying inflation (CPIF), % y/y		1.7	2.0	1.5	1.8	2.1
Hourly earnings, % y/y		3.0	0.9	3.6	3.9	3.6
Current account (SEKbn)		209	205	195	234	254
- % of GDP		6.8	6.2	5.6	6.5	6.8
Trade balance, % of GDP		3.2	2.4	2.8	3.6	4.0
General govt budget balance (SEKbn)		-29	-7	4	16	33
- % of GDP		-0.9	-0.2	0.1	0.4	0.9
Gross public debt, % of GDP		37.7	42.1	36.9	35.4	33.4

* Contribution to GDP growth (% points)

The expected weaker trend in household consumption and exports will reduce the need for investments. Combined with a dramatic change in inventories this will likely dampen domestic demand in the year ahead. But towards the end of the forecast period we see domestic demand rising again driven by lower interest rates and improved conditions globally.

Unemployment on the rise

This year the number of people in work reached a record high, and employment should continue to rise during the remainder of the year, albeit at a slower pace. But as a result the expected slowdown in GDP growth, employment looks set to decline and unemployment to rise next year, thus breaking the past two years' uptrend in employment and reducing capacity utilisation.With the poorer growth outlook the economic environment for the upcoming pay talks has changed. Even so, we look for higher pay rises than those agreed at the previous round of pay talks which took place when the financial crisis was at its highest. But the risk of pay rises at unsustainable levels from a monetary policy perspective has decreased. Core inflation as measured by the CPIF, the Riksbank's favourite measure, has so far this year remained slightly below the 2% target. The decline in oil prices and other commodity prices should put a damper on inflation. Conversely, import prices, which have declined sharply in tandem with the past years' appreciation of the SEK, are expected to stabilise going forward. Combined with a normalisation of domestic inflation this will help bring back inflation in line with the inflation target next year.

The Riksbank to cut rates next year

Going forward, the Riksbank's focus will shift from inflation risks to the risk of the economy losing too much momentum. The current financial market turbulence and the deteriorated growth outlook suggest that the Riksbank will not hike the repo rate further this year. We think that the bank's next move will be a rate cut in 2012. The expected increase in unemployment will affect the inflation outlook and prompt the Riksbank to cut rates even though inflation at that time will be close to the inflation target. Subsequently, as the economic outlook improves, the Riksbank will gradually resume its tightening cycle.

The SEK has weakened somewhat during this summer's financial market turmoil, albeit only moderately so the SEK has weathered the storm well. The stability of the Swedish economy and its moderate direct exposure to the most beleaguered countries in Europe indicate that the SEK will remain strong. But when the Riksbank changes its monetary policy line and cuts rates, the SEK will likely weaken slightly.

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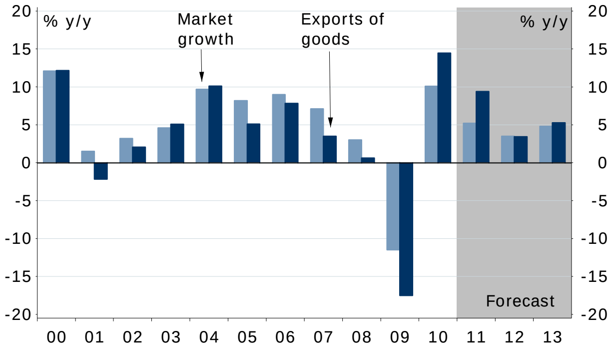
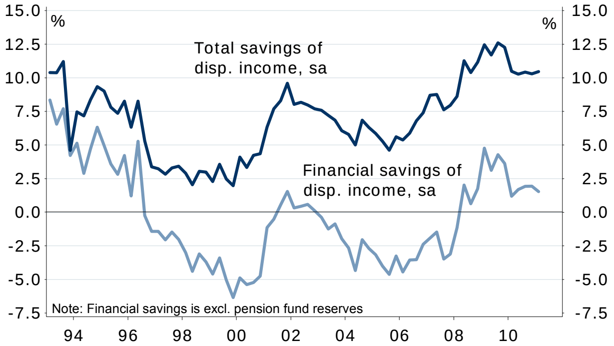
Sluggish growth on export markets



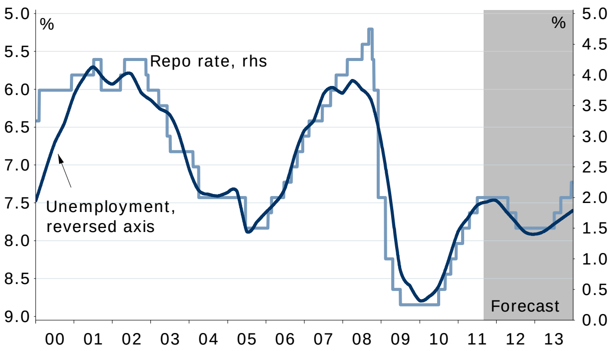
Source: Nordea Markets and Reuters Ecowin

Benign starting point for households



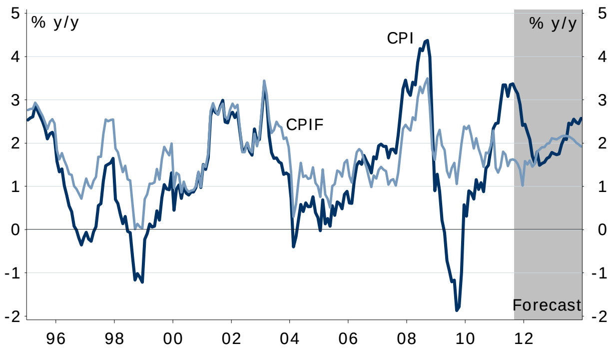
Source: Nordea Markets and Reuters Ecowin

Unemployment crucial for monetary policy



Source: Nordea Markets and Reuters Ecowin'

Core inflation in line with target



Source: Nordea Markets and Reuters Ecowin

Norway will be hit, but only modestly so

- Slightly lower growth, but no setback
- Low interest rates and high oil investment supportive
- Norges Bank to moderate its pace of rate hiking ...
- ... but will act ahead of other central banks

The much weaker global growth outlook and substantial financial turmoil have changed the outlook for the Norwegian economy. Especially exporters outside the oil sector should be hit. It is highly uncertain how the financial unrest will evolve and what the effect on the Norwegian corporate sector will be. But the funding costs of some investment projects look set to rise.

Still, we expect Norway to be hit far less than many other countries. The oil companies are sharply stepping up investment in both Norway and internationally, which will contribute to softening the effect on the manufacturing industry of lower growth in Norway's traditional export markets. We also think that the effect of increased economic uncertainty and the stock market slide on consumers' propensity to spend will be limited. In the May issue of *Economic Outlook* we projected that Norges Bank would hike rates sharply. But with weaker growth and prospects of low interest rates globally we now expect Norges Bank to proceed more cautiously. The borrowing costs of consumers/home buyers and robust businesses will thus be lower than we said in May.

As a result of the expected less aggressive rate hikes we have revised down our 2012 growth forecast only moderately. For 2013, now for the first time included in our forecast period, we foresee slightly rising growth mainly due to a better outlook for the global economy.

Private demand growing at a healthy clip

Consumption growth appears to have picked up before the summer after a weak start to the year. The increased uncertainty will likely put a damper on consumer spending growth in the autumn, but with benign real wage growth, good employment growth and sustained low interest rates we see relatively strong consumption growth in 2012 and 2013.

Based on an expected relatively sharp increase in interest rates in 2011 and 2012 we thought that home prices would flatten in 2012. But with prospects of much lower interest rates going forward there is now every reason to expect the uptrend in home prices to last longer as the lower interest rates will probably more than offset any effects of the increased economic uncertainty. So now we do not expect home prices to flatten until around the end of 2013. With a sustained rise in home prices, residential construction should grow more than previously assumed.

The outlook for business investment is far more uncertain. Experience from 2008 tells us that financial turmoil and tighter credit standards affect businesses' borrowing costs more than consumers'. It can prove more costly to get funding for high-risk projects at a time when lower economic growth makes such projects less profitable. We have therefore revised down our forecast for business investment in mainland Norway.

For oil investment the opposite is true. We are now far more comfortable with our forecast of very favourable times ahead for the supply industry. Capacity constraints and cost increases could turn out to be the biggest obstacles to oil investment going forward.

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

	2008 (NOKbn)	2009	2010	2011E	2012E	2013E
Private consumption	989	0.1	3.7	2.4	2.5	3.0
Government consumption	447	4.8	2.2	1.5	2.0	2.0
Fixed investment	504	-6.8	-7.4	10.8	6.8	4.8
- gross investment, mainland	376	-10.9	-3.1	10.0	6.0	4.6
- gross investment, oil	113	10.0	-18.3	15.0	10.0	6.0
Stockbuilding*	7	-3.2	3.2	0.0	0.0	0.0
Exports	1,218	-3.8	-1.7	-0.8	0.2	1.5
- crude oil and natural gas	616	-0.9	-7.4	-6.0	-0.6	0.0
- other goods	323	-8.0	4.9	3.0	1.0	3.0
Imports	743	-11.7	9.0	6.7	3.7	3.5
GDP	2,511	-1.7	0.3	1.1	1.9	2.4
GDP, mainland	1,812	-1.8	2.1	2.6	2.5	3.0
Unemployment rate, %		3.2	3.6	3.4	3.6	3.6
Consumer prices, % y/y		2.1	2.5	1.4	1.7	2.3
Core inflation, % y/y		2.6	1.4	1.2	1.9	2.3
Annual wages (incl. pension costs), % y/y		4.2	3.6	4.0	4.0	4.3
Current account (NOKbn)		274.9	310.0	401.8	429.8	461.7
- % of GDP		11.5	12.4	14.7	14.8	14.9
Trade balance, % of GDP		13.3	13.3	14.8	14.8	14.9
General govt budget balance (NOKbn)		249.6	265.7	410.0	475.0	480.0
- % of GDP		10.5	10.6	15.0	16.4	15.5

* Contribution to GDP growth (% points)

Sustained labour market balance

Domestic demand will hold up quite well, which is one of the reasons why we still expect fairly strong growth in Norway. But lower growth in traditional exports will dampen GDP growth relative to our May forecast

Thanks to the benign growth trend, unemployment will stay largely unchanged despite high labour migration. In some areas, eg engineering, the shortage of labour may, however, increase.

With weak export market growth and a strong NOK, demands at next year's pay talks will probably be fairly modest. But the still relatively tight labour market will likely ensure pay rises above 4% over the coming years.

Core inflation has risen less than we expected in May. With lower price pressure from abroad and lower wage growth, inflation should also be below our May forecast. The very low inflation is probably largely the result of temporary factors, eg margin pressure in the retail sector. We therefore see inflation rising, but core inflation will remain below the inflation target over the forecast period.

Difficult for Norges Bank

Before the financial turmoil accelerated in the summer, Norges Bank clearly wanted interest rates to go up. Although the economic environment has changed a lot lately with international interest rates now looking set to be on hold at least until end-2012, we think Norges Bank will want to hike rates in Norway for domestic reasons. So we expect slightly higher interest rates in 2012 and a further pick-up in 2013.

The risk of excessive NOK appreciation will, however, put a lid on rate hikes. The downward revision to our growth and inflation forecasts also suggests that the need for higher rates in the domestic economy will be lower. But sustained strong growth in home prices will pull in the opposite direction. The weight assigned by Norges Bank to the risk of imbalances (eg high indebtedness and home price growth) remains to be seen. Should the bank assign a stronger weight to such factors than we assume, rates may be hiked and the NOK appreciate more than we have factored into our forecasts.

Strong NOK

Interest rate differentials and the market turbulence have underpinned the NOK. We expect the NOK to stay strong in the years ahead, supported by Norges Bank hiking rates before the central banks of Norway's key trading partners. Should the NOK weaken, Norges Bank will likely act more aggressively, which reduces the risk of persistent NOK weakening. But in the event of a major financial crisis and sharply declining risk appetite, the NOK will be hit as in 2008. In this crisis scenario Norges Bank is not likely to hike rates.

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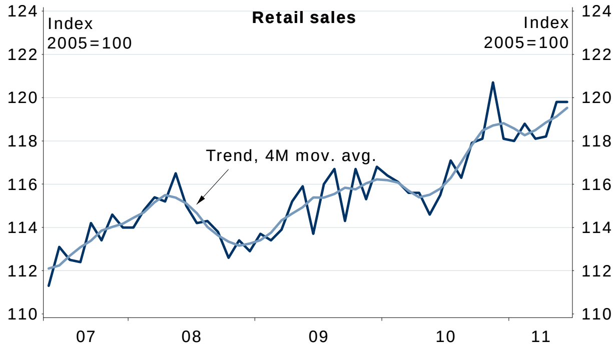
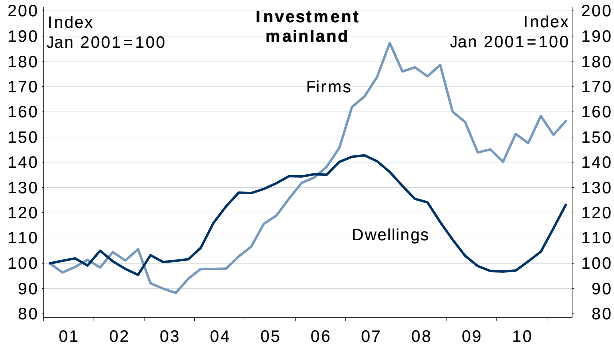
Retail sales moving north



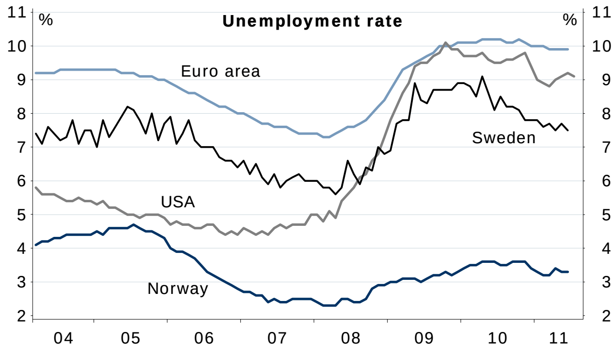
Source: Nordea Markets and Reuters Ecowin

Rebound in investment



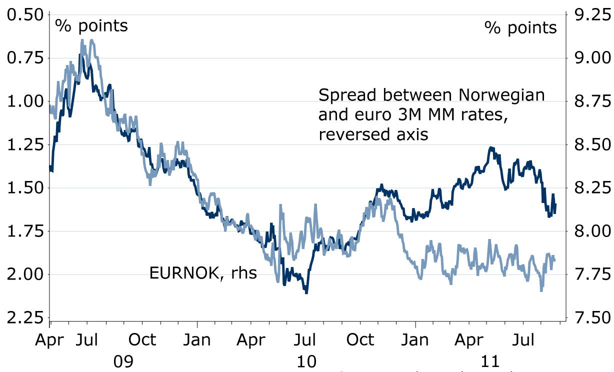
Source: Nordea Markets and Reuters Ecowin

Low unemployment



Source: Nordea Markets and Reuters Ecowin

Strong NOK driven by interest rate differentials



Source: Nordea Markets and Reuters Ecowin

The long tough haul

- Tailwind from export markets
- Cautious households
- Labour market loses momentum
- House prices pointing south

The Danish economy is still feeling the aftermath of the housing market downturn and the Great Recession. Since the global outlook turned for the better in 2009, the economy has made good headway, but not without bumps along the road. Unusually many factors of uncertainty are at play. We face a situation where domestic demand has not really shifted up in gear while trends in the global economy are very uncertain.

Tailwind from export markets

Export growth has been crucial for the recovery of the Danish economy. Sales in the manufacturing industry are largely driven by exports markets, whereas the domestic market is more sluggish.

Generally, domestic demand paints a mixed and sluggish picture. In volume terms retail sales have shown a slightly waning trend for an extended period, construction activity is very low, business investment has been under pressure and home sales are at a low level. But car sales are going well, underpinned by low interest rates and high leasing activity.

During 2011 confidence indicators for both the manufacturing and the service sectors have mainly been positive. But they could dip in H2 following the recent decline in global confidence indicators.

The improvement in industrial production has led to a rise in capacity utilisation and the investment climate is supported by low interest rates. But business investment is expected to make a negative contribution this year, as the export of an oil drilling rig in Q1 made a very significant negative contribution. With prospects of a moderate economic pick-up both globally and in the Danish economy in 2012 and 2013, business investment looks set to rise slightly in coming years.

Cautious households and public consolidation

The weak trend in retail sales, overall private consumption and home sales should be seen in light of falling real wages, a period of rising interest rates and the dragging out of any real labour market reversal. Consumers have chosen to increase their savings ratio during the crisis and have kept it at this higher level after growth returned.

The Danes are facing parliamentary elections this year. Policymakers have indicated a final adoption of the retirement reform after the elections: It will phase out the popular early retirement scheme. This is a sacred cow being slayed, which has triggered uncertainty about the possible slaying of other sacred cows such as the freeze on property value tax. Generally, there is much uncertainty associated with the future composition of the tax base, which contributes to put a damper on consumer spending.

In addition, the propensity to consume has been curbed by international unrest such as the European sovereign debt crisis and the economic downturn in the US as well as the ensuing stock market slide. Just now consumer confidence is in negative territory and only moderate increases in consumer spending seem to be in store this

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

	2008 (DKKbn)	2009	2010	2011E	2012E	2013E
Private consumption	840	-4.5	2.3	0.4	2.0	1.9
Government consumption	465	3.1	0.7	0.1	0.3	0.3
Fixed investment	365	-14.3	-3.2	-4.0	1.4	2.3
- government investment	33	4.6	6.9	8.0	-4.0	2.1
- residential investment	98	-16.9	-9.0	8.9	1.7	1.7
- business fixed investment	234	-15.8	-2.8	-11.9	2.6	2.7
Stockbuilding*	15	-2.0	0.9	0.3	0.0	0.0
Exports	959	-9.7	3.8	5.3	3.3	4.8
Imports	904	-12.5	3.9	4.0	3.7	5.1
GDP		-5.2	1.7	1.0	1.3	1.5
Nominal GDP (DKKbn)	1,741	1,656	1,743	1,775	1,806	1,826
Unemployment rate, %		3.5	4.2	4.0	4.0	3.7
Unemployment level, '000 persons		96.2	114.1	108.6	108.3	102.3
Gross unemployment level, '000 persons		129.0	164.9	162.6	162.1	153.4
Consumer prices, % y/y		1.3	2.3	2.8	2.0	2.0
Hourly earnings, % y/y		2.9	2.5	2.0	2.5	2.5
Nominal house prices, one-family, % y/y		-12.0	2.8	-3.0	-1.0	2.0
Current account (DKKbn)		59.0	94.0	90.0	84.0	75.0
- % of GDP		3.6	5.4	5.1	4.7	4.1
General govt. budget balance (DKKbn)		-46.5	-48.3	-68.2	-84.4	-54.8
- % of GDP		-2.8	-2.8	-3.8	-4.7	-3.0
Gross public debt, % of GDP		41.8	43.7	43.9	45.6	46.2

* Contribution to GDP growth (% points)

year. But prospects of political clarification and sustained low interest rates suggest higher consumer spending growth in both 2012 and 2013.

Also government spending has shown a downward trend lately. After budgets worsened significantly during the crisis, the purse strings have now been tightened. Going forward growth will likely only be moderate, as long-term fiscal policy sustainability must be ensured, but government spending is expected to make a positive contribution next year. Moreover, a string of public investment projects have been launched.

Labour market losing momentum

The labour market has turned in response to the waning momentum in the economy. Unemployment is on an uptrend again, while companies scale back their hiring plans and the number of vacancies remain at a very low level. We do not look for more sustainable employment growth until the pace in economic growth again outstrips productivity. This is not likely to happen until in 2012.

House prices pointing south

According to the latest housing market statistics available to us, house prices fell this year and turnover is low. A record number of homes are on the market and for long periods and buyers get sizable price reductions. The housing market has still not received support from the labour market. Mortgage rates have fallen lately, which will underpin the market. But as labour market conditions do not look set to turn around in the near future, prices are likely to continue falling. If policymakers' proposals to temporarily suspend stamp duty and housing taxes on newly bought homes are adopted, this will boost sales in the forecast period and prices should decline less steeply.

Denmark as a safe haven

During the latest turmoil in financial markets, Denmark has been one of an exclusive club of "safe-haven countries". This is for example reflected in Danish government yields trading relatively close to their German equivalents, and the DKK firming versus the EUR. The reason why Denmark despite low economic activity has managed to hold on to its safe-haven status is sound balances in the form of a record-large current account surplus, a small public budget deficit, a low gross general government debt and historically large currency reserves. But at the same time we believe that the political parties' will to implement the necessary long-term consolidation of public finances plays an important role for the international community's confidence in the Danish economy.

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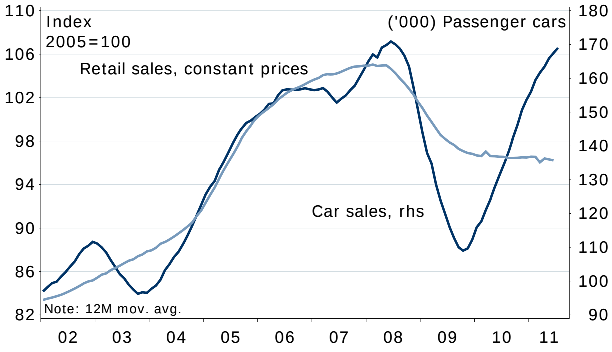
Sluggish domestic demand

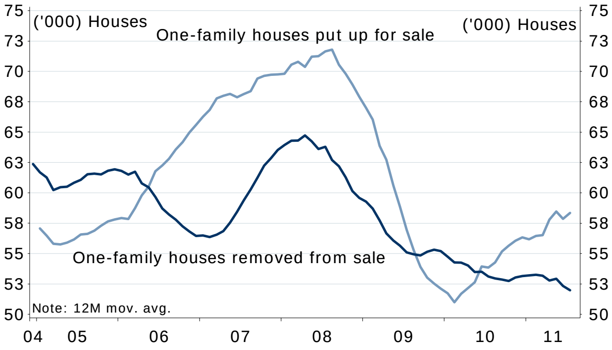
Sources: Statistics Denmark, Nordea Markets and Reuters Ecowin

Waning retail sales, while car sales flourish



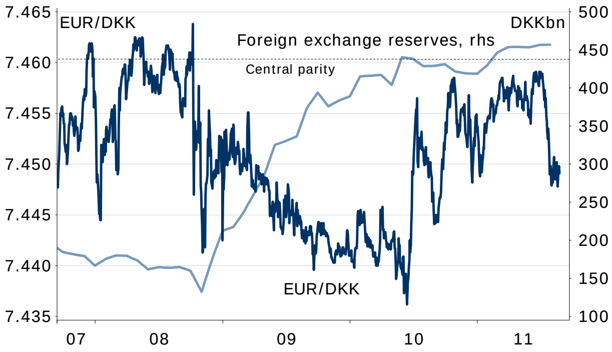
Sources: Statistics Denmark, Nordea Markets and Reuters Ecowin

Home sellers have returned, but buyers hesitate



Sources: Association of Danish Mortgage Banks, Nordea Markets and Reuters Ecowin

Record-large currency reserves and strong DKK



Sources: Danmarks Nationalbank, Nordea Markets and Reuters Ecowin

Problems in the global economy is slowing down the recovery

- Growth will decelerate markedly in 2012
- Good employment trend is in danger of stagnating
- Inflation will decrease towards the end of 2011
- Balancing public finances will become difficult

H1 was a smooth ride

The Finnish economy continued to recover in H1 2011 much faster than the euro area on average. Total production increased a good 5% in Q1 year-on-year and, according to Statistics Finland's monthly GDP indicator, continued to grow at a pace of little less than 3.5% in Q2. This trend was boosted by both foreign trade and domestic demand. Wage and salary growth was stronger than expected, which supported retail sales and private consumption. Moreover, employment improved and the increase in the number of working hours more than offset the rather moderate rise in earnings. Investment was on the rise with construction in particular remaining active. Machinery and equipment investment also increased.

Outlook turned upside down

In the spring we were able to count much on the demand of Finland's major trading partners, which were performing strongly. However, the sharp rise has now slowed down in Germany, Swedish growth forecasts are being cut heavily and it is difficult to find a growth driver from the US.

The uncertainty of the export outlook forces companies to be cautious and possibly to consider postponing planned investments until later. On the private consumption side, the drop in consumer confidence indicates extra caution in financially significant purchases. This will weaken residential construction, housing market and car trade as well as private consumption in general.

Due to the sharply weakened outlook, we have almost halved our GDP growth forecast for 2012 from 3% to 1.6%. We estimate that growth will be slowest in Q4 2011 and Q1 2012. Thereafter activity should pick up again.

Export and investment growth is slowing down

On the basis of the trend in global trade, it became clear already before the summer that growth of Finnish goods export will slow down towards the end of this year. Nevertheless, exports will increase somewhat, as the value of new orders has still grown at a two-digit rate. Demand is expected to remain weak for the most of 2012, restricting growth of goods exports to about 3%. On a more positive note, 2013 is expected to be markedly better.

The uncertainty over the economic direction curbs investment growth to around 2% in 2012 with distinct slowdown of growth in both construction and machinery and equipment investment compared to this year. Residential construction is hampered by the weakened consumer confidence and the current high construction volumes.

No momentum in private consumption

The ground for private consumption growth is crumbling. Because of slow growth, employment will in practice stop improving. The unemployment rate, excluding seasonal effects, is estimated to fall to 7.5% towards the end of the year and to remain at that throughout 2012. Purchasing power will mainly be supported by higher earnings growth and slower growth in consumer prices. The uncertain outlook encourages

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

	2008 (EURbn)	2009	2010	2011E	2012E	2013E
Private consumption	95	-3.1	2.7	2.8	2.0	2.5
Government consumption	42	0.9	0.6	0.7	0.7	0.4
Fixed investment	40	-13.5	2.8	5.2	2.1	3.9
Stockbuilding*	2	0.2	0.6	0.1	0.0	0.0
Exports	87	-21.5	8.6	6.4	2.9	5.7
Imports	80	-16.1	7.4	5.4	3.1	5.1
GDP		-8.2	3.6	3.5	1.6	2.7
Nominal GDP (EURbn)	186	173.3	180.3	189.7	197.0	206.2
Unemployment rate, %		8.2	8.4	7.7	7.5	7.1
Industrial production, % y/y		-22	10	6	3	5
Consumer prices, % y/y		0.0	1.2	3.3	2.0	2.0
Hourly wages, % y/y		4.0	2.6	2.4	2.8	3.0
Current account (EURbn)		3.7	3.4	2.3	2.3	2.7
- % of GDP		2.1	1.9	1.2	1.2	1.3
Trade balance (EURbn)		3.0	2.8	2.1	2.5	2.9
- % of GDP		1.7	1.6	1.1	1.3	1.4
General govt budget balance (EURbn)		-4.3	-4.6	-3.8	-3.0	-1.2
- % of GDP		-2.5	-2.6	-2.0	-1.5	-0.6
Gross public debt (EURbn)		75.0	87.2	95.0	102.1	107.6
- % of GDP		43	48	50	52	52

* Contribution to GDP growth (% points)

consumers to be prepared, so saving is not likely to decrease very much. Consequently, private consumption is estimated to increase only 2% in 2012.

Marked decrease in inflation in the coming months

Consumer price inflation accelerated to 4% in July, as expected, despite the fact that the prices have hardly increased after April. Thus the reason for high inflation is that the prices rose exceptionally fast in late 2010 when higher energy and raw material prices raised the costs of housing, food and transport. During that period, food prices rose more than 8%.

We expect inflation to decrease to clearly below 3% in late 2011 and to 2% on average in 2012. Crude oil prices are expected to fall when the slowing growth in the industrial countries decreases the demand. This will stabilise the costs of both housing and transport even though the euro is expected to weaken. Other factors curbing growth in housing costs are continued low interest rates and the probable stabilisation of housing prices. However, food prices are expected to keep on rising, as the increase in input prices has continued in the past few months. Furthermore, prices are pushed higher by the commodity tax increases planned for next year.

Slower decrease in public sector deficit

With weaker economic growth, tax revenue growth will slow down and the expenses of unemployment will decrease slower. This will also make it more difficult for the new government to decrease the puclic sector financial deficit and cut government borrowing. During the forecast period, the deficit will narrow slower than we estimated earlier and the amount of debt will correspondingly be higher.

The timing and scope of the expected expenditure cuts and tax hikes should be such that they do not knowingly slow down economic growth, which is already becoming weaker. This is no time to postpone measures supporting growth.

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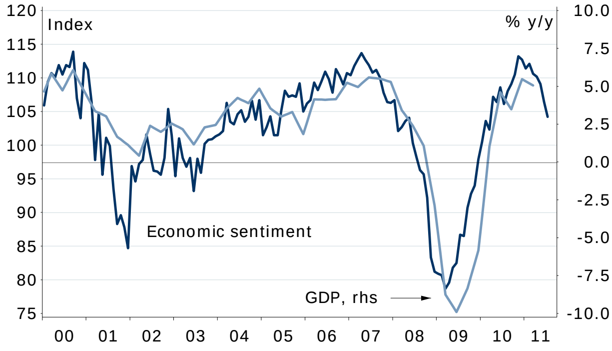
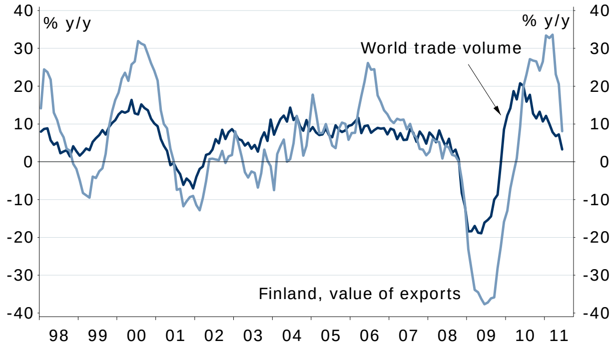
Fall in sentiment suggests weaker growth



Source: Nordea Markets and Reuters Ecowin

Export growth to slow down soon

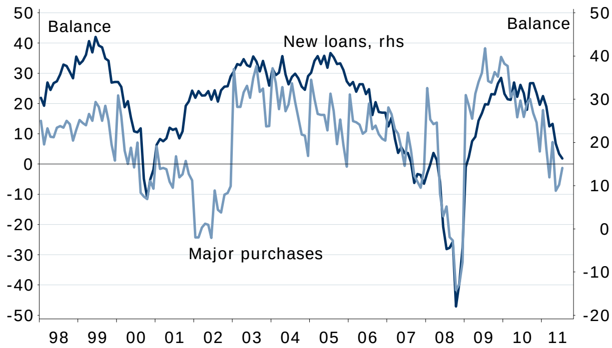


Source: Nordea Markets and Reuters Ecowin

Weaker confidence is a drag on retail sales

Source: Nordea Markets and Reuters Ecowini

Consumers hesitate with major purchases



Source: Nordea Markets and Reuters Ecowin

No summer – new winter on the way already?

- The soft patch of the economy has taken hold
- Odds of recession at close to 50%
- More easing from the Fed on the way
- Major fiscal policy uncertainty

The outlook for the US economy has worsened markedly since the May issue of *Economic Outlook*. The soft patch that the economy had already hit at that point now appears to have taken hold, and there is now significant risk of a new recession, only slightly more than two years after the end of the latest downturn. Currently, we put the odds of recession at close to 50%.

The bleaker outlook for the US is caused by a number of factors. Firstly, economic growth was much slower in 2010 and early 2011 than previously assumed. Sharply downward-revised historical GDP figures now show that not only was the recession in 2008-2009 the most severe since Word War II, the following upswing has also turned out to be the weakest.

Secondly, recent months have brought a string of disappointing key figures, showing that consumer spending ground to a halt in Q2 this year. The unexpectedly abrupt slowdown in demand is apparently not only a function of temporary factors such as high commodity prices and the Japanese earthquake in March. More fundamentally, the continued high debt, weak labour market and the beleaguered housing market still seem to weigh on both consumer and business confidence. This means that the economy must be expected to remain fragile for yet another few years, even if a recession is avoided now.

To this should be added that the weak growth indicators together with the escalation of the sovereign debt crisis in the Euro area, the political dogfight over the raising of the federal debt ceiling in August and Standard & Poor's subsequent downgrade of US Treasuries have triggered stock market losses that could now push the economy back into recession.

Based on hard economic facts no warning lights signalling recession are yet flashing. It is thus positive that businesses still appear to hire more manpower and banks step up lending. But uncertainties are rife, as there are not yet particularly many indicators of how recent weeks' financial turmoil has affected demand from households and businesses. However, consumer and business confidence has plunged and if consumers put action behind words, the recession will unfortunately become a reality. In other words, fears of recession could become self-fulfilling. (See also the special theme on page 36).

But unless stock prices continue to decline, the economy should in our view continue to expand in coming quarters, albeit at a very moderate pace. One of the factors behind this assumption is that the effects of the steep commodity price increases and the supply disruptions after the Japanese earthquake are estimated to diminish further. Also, financial players' risk appetite and domestic demand are expected to be stimulated by an even more lenient monetary policy, see below.

Our baseline scenario assumes GDP growth of only ¼% in H2, equal to a moderate growth rate of 1.3% for 2011 as a whole. Weak growth of 1.6% and 2.7% is expected in 2012 and 2013, respectively.

Given the outlook of weak and fragile economic growth, unemployment is forecast to remain close to 9% during

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

	2008 (USDbn)	2009	2010	2011E	2012E	2013E
Private consumption	10,035.5	-1.9	2.0	1.7	1.3	2.3
Government consumption and investment	2,878.1	1.7	0.7	-2.2	-1.1	-0.5
Private fixed investment	2,128.7	-18.8	2.6	4.7	4.7	7.4
- residential investment	472.4	-22.2	-4.3	-2.3	4.3	10.0
- equipment and software	1,070.0	-16.0	14.6	8.5	5.2	6.9
- non-residential structures	586.3	-21.2	-15.8	0.7	3.4	6.0
Stockbuilding*	-41.1	-0.8	1.6	-0.1	0.1	0.1
Exports	1,846.8	-9.4	11.3	7.2	6.3	7.4
Imports	2,556.5	-13.6	12.5	4.7	3.7	6.1
GDP		-3.5	3.0	1.3	1.6	2.7
Nominal GDP (USDbn)	14,292	13,939	14,527	15,002	15,531	16,246
Unemployment rate, %		9.3	9.6	9.1	9.1	8.6
Industrial production, % y/y		-11.2	5.3	3.4	2.1	3.6
Consumer prices, % y/y		-0.3	1.6	3.0	2.0	2.2
Consumer prices ex. energy and food, % y/y		1.7	1.0	1.5	1.3	1.5
Hourly earnings, % y/y		3.0	2.4	2.2	2.2	2.5
Current account (USDbn)		-376.6	-470.9	-450.0	-465.9	-568.6
- % of GDP		-2.7	-3.2	-3.0	-3.0	-3.5
Federal budget balance (USDbn)		-1,471.3	-1,275.1	-1,400.0	-1,100.0	-800.0
- % of GDP		-10.6	-8.8	-9.3	-7.1	-4.9
Gross public debt, % of GDP		86.4	94.5	103.8	110.9	115.8

* Contribution to GDP growth (% points)

most of the forecast period. The overall inflation rate is estimated to have peaked, and we now look for a drop towards 2% during the period. But core inflation, which currently is boosted by higher rents and other components, is not expected to start declining until 2012.

Even easier monetary policy in sight

The Fed has also sharply revised down its growth forecast for the years ahead. This recently prompted a pledge from the bank not to hike the fed funds rate from the currently extremely low level close to zero until mid-2013 at the earliest if the economy develops as expected. At the same time the Fed expressed its will to apply additional instruments if the economic outlook worsens further.

Against the backdrop of financial turmoil and the risk of a new recession, we thus expect the Fed to initiate a new round of quantitative easing in the form of financial asset purchases (QE3) later this year or early in 2012.

But pumping out even more cheap liquidity implies a clear risk of new bubbles. Therefore it is also our impression that the Fed – also in response to pressure from other central banks – will adopt quite an aggressive pace once the economy allows gradual monetary policy normalisation. We expect the first rate hike in mid-2013.

Major fiscal policy uncertainty

The need for a very lenient monetary policy is reinforced by the prospect for further fiscal policy tightening throughout the forecast period.

The public spending cuts that result from the agreement to raise the federal debt ceiling in early August will have no major curbing effect on growth in our forecast period. But the phase-out of previous easing measures will, and the pressure on budgets necessitates continued sharp fiscal policy tightening in the federal states.

Our baseline scenario assumes that the temporary income tax break for wage earners of 2% points and the extended unemployment benefit period, both due to expire at year-end, will continue for another year. If not, this could in itself curb growth by about 1% point next year.

A new large fiscal policy rescue package is not likely. On the contrary, Standard & Poor's downgrade of US Treasuries seems to have increased the likelihood of a restoration of public finances. This pressure will be reinforced if other rating agencies also downgrade the US.

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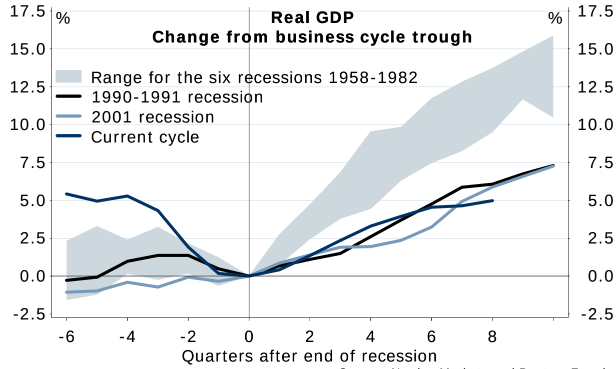
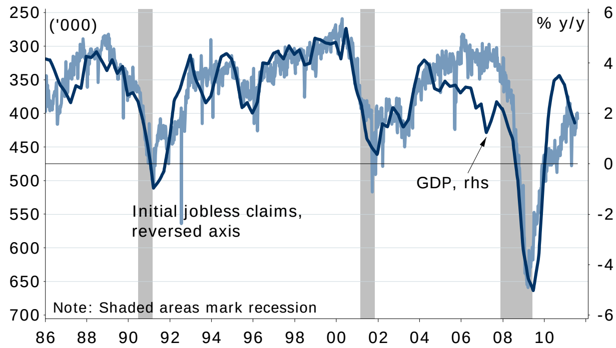
Weakest economic recovery since World War II



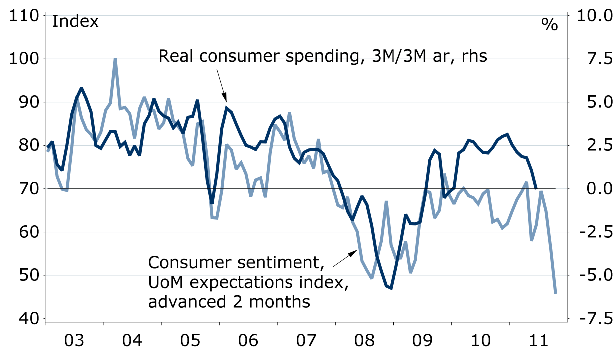
Source: Nordea Markets and Reuters Ecowin

Little hard evidence of a new recession...



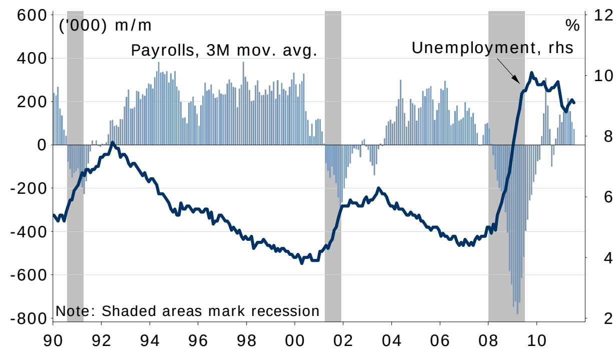
Source: Nordea Markets and Reuters Ecowin

... but fears of a double dip could cause one



Source: Nordea Markets and Reuters Ecowin

Unemployment to go sideways



Source: Nordea Markets and Reuters Ecowin

Flirting with recession

- High oil prices have led to abrupt growth slowdown
- Resurgent debt crisis increases the risk of recession
- Low rates should eventually lift growth somewhat
- The ECB will keep rates on hold until Q1 2013

After a very strong start to 2011 economic activity in the Euro area came to an abrupt halt over the summer. This has coincided with a resurgence of the sovereign debt crisis and once again this has contributed to widespread turbulence in financial markets. The latest round of turbulence has implicated both Italy and Spain, the third- and fourth-largest largest economies in the Euro area, and once again the debt crisis threatens to lead to a new round of credit tightening from Euro-area banks. Consequently, the economic outlook for the Euro area is fraught with risk. Looking at the coming quarters we expect economic activity to be stagnant or perhaps even decline slightly, and several member states burdened by the sovereign debt crisis are likely to experience an outright recession over the coming quarters. The risk to the outlook for the whole of the Euro area mainly pertains to the duration of the slowdown, as fiscal policy will be tightened in several member states. There are also a number of factors which point to a mild slowdown, however. First of all, monetary policy is still very supportive of growth and is likely to remain so over the forecast horizon. Secondly, several of the more cyclically sensitive demand components, such as car registrations and construction are already at very low levels, and this diminishes the risk of a sharp contraction in activity.

High oil prices and fiscal policy behind slowdown

The sharp slowdown in economic activity has been particularly noticeable in the manufacturing sector, where indicators have pointed to a sharp drop in new orders. In addition, hard data point to a drop in private consumption during spring. This suggests that the rapid increase in the price of oil and other commodities, which peaked in Q2 has played a significant role in slowing demand. As oil prices have now stabilised, growth in private consumption may again turn positive. Private consumption may also be supported by continued growth in employment, which for the Euro area as a whole may continue growing slightly following the period of strong growth last winter. However, the sharp drop in equity prices and the prospect of further fiscal tightening suggest that private consumption growth will only grow modestly over the forecast horizon.

Debt crisis points to new round of fiscal tightening

The resurgence of the debt crisis has led to fresh pledges to tighten fiscal policy in several member states. Most notably, the Italian government has unveiled new savings measures worth 3% of Italian GDP to be phased in before the end of 2013. To counter speculations about a possible downgrade by the rating agencies and to contain a widening of yield spreads relative to Germany, the French government has announced that it will present further savings measures to ensure that deficit targets will be met in spite of slower growth. Italy and Spain have pledged similar steps, as the ECB demanded that both countries undertook a further squeeze of budgets in return for reactivating the purchases of government bonds under its Securities Markets Program. While it is still too early to judge the effect on aggregate GDP, it seems quite obvious that fiscal policy will exert a drag on growth considerably larger than the 0.5% annually we have previously estimated. Thus, fiscal savings in Italy alone could subtract as much as 0.2% points from Euro-area growth in both 2012 and 2013.

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

	2008 (EURbn)	2009	2010	2011E	2012E	2013E
Private consumption	5,190	-1.2	0.8	0.7	0.8	1.5
Government consumption	1,897	2.4	0.6	0.5	0.0	0.0
Fixed investment	1,987	-11.7	-0.9	3.2	1.7	3.9
Stockbuilding*	31	-0.7	0.6	0.0	-0.3	-0.1
Exports	3,874	-13.1	10.9	6.7	4.2	5.4
Imports	3,777	-11.8	9.3	5.5	4.4	5.4
Net exports*	97	-0.8	0.8	0.6	0.0	0.1
GDP		-4.1	1.7	1.6	0.6	1.8
Nominal GDP (EURbn)	9,242	8,951	9,183	9,469	9,675	10,002
Unemployment rate, %		9.7	10.1	9.9	10.1	10.0
Industrial production, % y/y		-3.5	4.7	2.0	1.0	2.5
Consumer prices, % y/y (HICP)		-0.9	1.6	2.6	1.8	1.8
- core inflation		1.3	0.9	1.4	1.3	1.2
Hourly labour cost, wages and salaries % y/y		1.5	1.5	1.6	1.8	1.8
Current account (EURbn)		-28	-43	-70	-80	-80
- % of GDP		-0.3	-0.5	-0.7	-0.8	-0.8
General govt budget balance, % of GDP		-6.3	-6.0	-4.5	-3.6	-2.5
Gross public debt, % of GDP		79.1	84.7	86.6	88.4	88.0

* Contribution to GDP growth (% points)

Slowdown in exports will also affect investment

The sharp slowdown in global growth is likely to dampen the Euro area's export growth over the next couple of quarters. The bleaker prospects for exports are particularly disconcerting for member states hit by the sovereign debt crisis, where export growth was supposed to compensate for depressed domestic demand. This has undoubtedly played an important role in the latest round of investor concern, which has also hit Italy and Spain, while strong growth in Emerging Markets will benefit member states with a relatively high share of capital goods in exports, such as Germany, which will partly outweigh the effect of slower demand growth in neighbouring countries. Further out on the forecast horizon, Euro-area exports should be supported by a gradual depreciation of the EUR vs the USD.

The momentum behind business investment has been relatively strong, but the sharp decline in equity prices and the risk of a new round of credit tightening in Euro-area banks is likely to slow down business investment over the coming quarters. Residential construction will be burdened by a large housing overhang in some member states, particularly Spain, although the low level of interest rates expected throughout the forecast horizon should lend support to housing demand in other markets.

Inflationary pressures likely to decline

Headline inflation is likely to decline over the coming months as the base effects associated with the rise in energy and food prices last autumn drop out. In addition, Euro area labour markets are likely to weaken once more. Both the tightening of fiscal policy in several member states, which are likely to involve significant redundancies in the public sector, and the sharp slowdown in activity suggest that unemployment could soon start to rise again. Here, it should not be forgotten that labour markets held up relatively well in Germany and other core member states during the Great Recession in 2008, and this is likely to repeat itself even though growth will slow to a crawl. Nevertheless, there is likely to be very limited pressure for higher wages, which could otherwise push up underlying inflation.

The ECB likely to stay put until 2013

Even though the ECB has so far indicated that it was concerned about upside risks to inflation, the sharp slowing of growth should cause the ECB to put further rate hikes on hold. In addition, the resurgence of stress in Euro-area money markets, could lead the ECB to introduce additional liquidity measures, which will ensure that EONIA rates continue to trade well below the refi-rate. Only at the beginning of 2013, do we expect economic activity to have revived enough for the ECB to hike interest rates again, and even then we only expect a modest hike in rates to 2.00%

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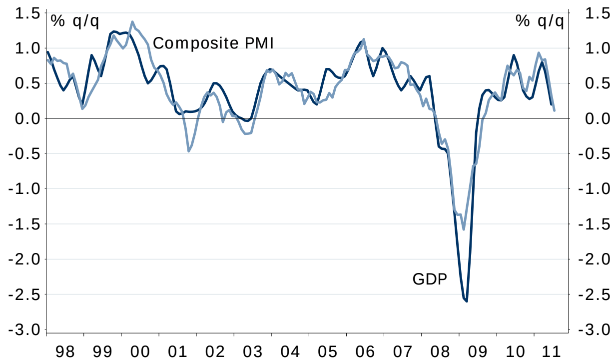
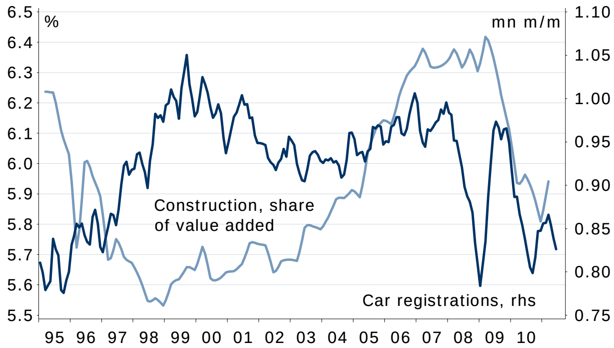
Surveys point to sharp slowdown in growth

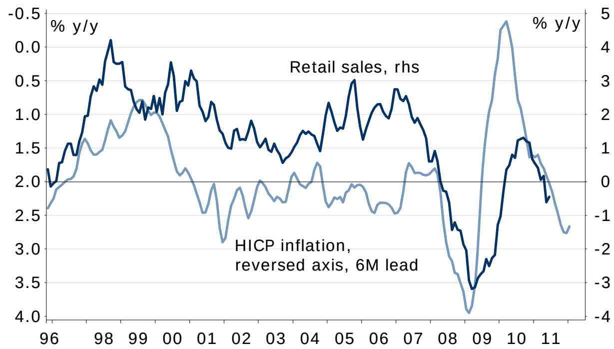


Cyclically sensitive demand is already low



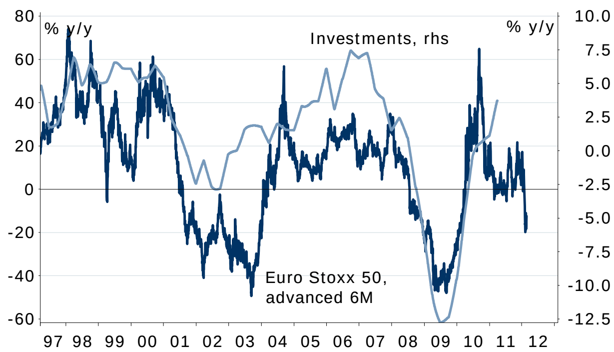
Source: Nordea Markets and Reuters Ecowin

Lower inflation should stimulate consumption



Source: Nordea Markets and Reuters Ecowin

Declining equities likely to weigh on investments



Source: Nordea Markets and Reuters Ecowin

Restoration keeps growth on short leash

The UK economy is in the midst of a major transition. In the wake of the crisis the government has launched an ambitious restoration plan to ensure public budget balance by 2015. The restoration is intended to be 3:1 in favour of public spending cuts, with the increase in income mainly coming from the VAT hike on 1 January 2011. The massive tightening has paid off as the UK so far has withstood the upward pressure on government yields faced by many other countries.

The price of the deep public budget cuts has been a very weak upswing. Consumer spending is under particular pressure due to negative real wages, a beleaguered housing market and the ongoing public budget slashes. However, we believe that towards the end of our forecast period the UK will begin to reap the benefits in step with consumer spending accelerating and the pressure from the public budget cuts starting to ease.

Despite major internal strife the Bank of England (BoE) has maintained a very lenient monetary policy – although consumer prices have surged and are currently rising at twice the pace of the official 2% target. In coming months inflation will likely stay at a very high level, but into 2012 we expect it to drop again. Meanwhile, the low capacity utilisation will put heavy downward pressure on prices and wages, solidly anchoring the inflation outlook medium term.

Against this background, we expect the BoE to leave the policy rate unchanged until end-2012. It is still uncertain whether the existing asset purchasing programme will need to be extended. In our baseline scenario the BoE will not extend the current programme, but if the financial market turmoil persists, it may be necessary during the autumn – but so far the gun powder is kept dry.

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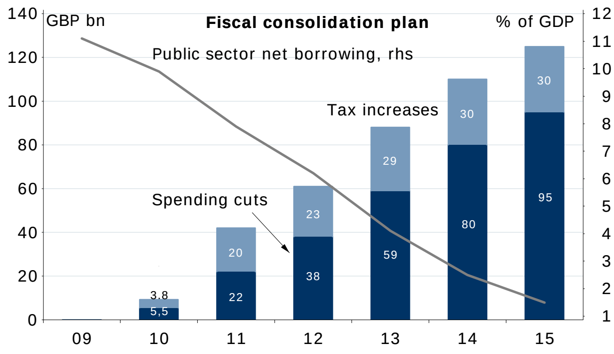
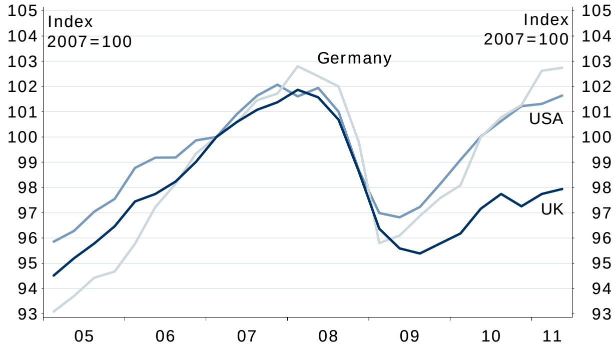
Deep public budget cuts



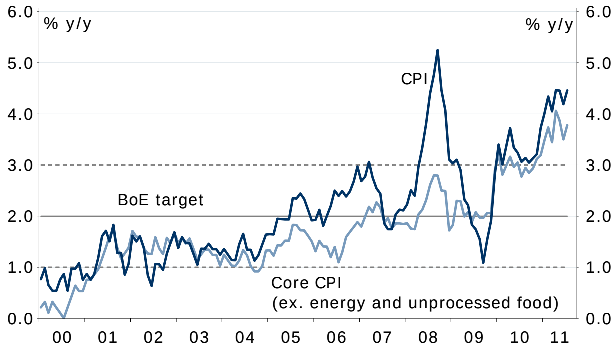
Source: Nordea Markets and Reuters Ecowin

Growth under pressure



Source: Nordea Markets and Reuters Ecowin

High inflation, but no rate hikes



Source: Nordea Markets and Reuters Ecowin

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

	2008 (GBPbn)	2009	2010	2011E	2012E	2013E
Private consumption	928,0	-3,2	0,7	-0,5	1,5	2,5
Government consumption	314,0	1,0	1,0	0,1	-1,0	-0,6
Fixed investment	240,4	-15,4	3,7	0,2	4,3	4,1
Stockbuilding*	0,3	-1,2	1,5	-0,1	0,0	0,0
Exports	422,9	-10,1	5,2	7,5	6,2	6,2
Imports	460,7	-11,9	8,8	1,5	3,3	4,3
GDP		-4,9	1,4	1,2	2,1	2,6
Nominal GDP (GBPbn)	1445,6	1395,0	1455,4	1530,7	1606,1	1676,2
Unemployment rate, %	5,7	7,6	7,9	8,1	8,0	7,7
Consumer prices, % y/y	3,6	2,2	3,3	4,5	2,5	2,0
Current account, % of GDP	-1,6	-1,7	-2,5	-2,0	-1,5	-1,5
General govt budget balance, % of GDP	-5,0	-11,4	-10,4	-8,5	-6,5	-4,5
Gross public debt, % of GDP	54,4	69,6	80,0	85,0	88,0	90,0

* Contribution to GDP growth (% points)

Recovering from earthquake, new challenges ahead

The economy is recovering rapidly from the earthquake and this rebound will continue the rest of the year. With most production facilities up and running again and fewer electricity supply problems, the negative effect from Japan on the rest of the world via supply-chain problems should very soon fade. And Japanese industrial production will again be driven by demand and not supply.

Unfortunately, the outlook for Japanese exports has become bleaker in line with the worsened global outlook. Furthermore, the prospects of unchanged interest rates for several years in the US have postponed the expectations for JPY weakening, and the record strong JPY erodes exporters' competitiveness. Exports to Japan's biggest export market, China, could, however, gain from CNY appreciation as well as from new Chinese stimuli.

Private consumption too is rebounding strongly from the depressed days in the aftermath of the disaster. However, private consumption growth will be subdued again in 2012 and 2013 as households most likely will be hit by various tax increases earmarked to finance earthquake reconstruction costs. The extent of these tax increases is, however, yet unknown as politicians have failed to reach an agreement on this matter.

Political deadlock is also to blame for the delay of the passage of the third supplementary reconstruction budget. Therefore, the boost to economic growth from reconstruction-related public spending and investment has been postponed too. It should, however, kick in during 2012, thereby alleviating somewhat the negative developments in exports and private consumption.

We expect the authorities to continue their fight against the strong JPY both via direct interventions and quantitative easing. This should prevent excessive JPY strengthening. Meaningful weakening of the JPY versus the USD is not to be expected until in 2013, as mentioned above.

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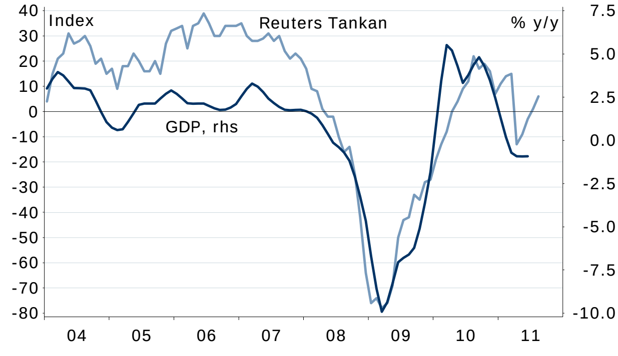
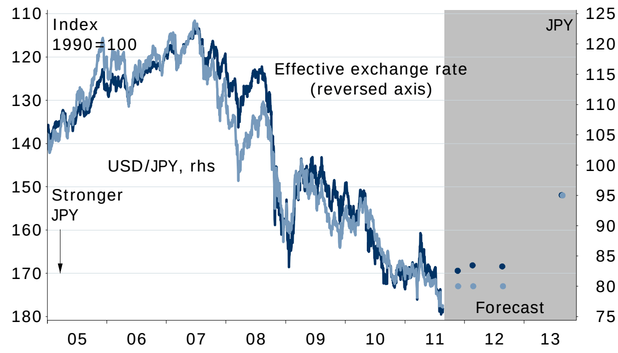
GDP growth back in positive territory next year



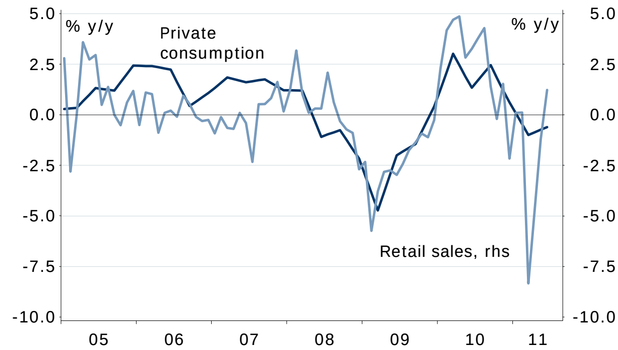
Source: Nordea Markets and Reuters Ecowin

Strong JPY poses a serious risk for exporters



Source: Nordea Markets and Reuters Ecowin

Private consumption has rebounded



Source: Nordea Markets and Reuters Ecowin

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

	2008 (JPYbn)	2009	2010	2011E	2012E	2013E
Private consumption	291,595.7	-1.9	1.8	-0.7	1.0	0.8
Government consumption	93,242.7	3.0	2.2	2.1	1.0	0.5
Gross fixed capital formation	116,475.2	-11.7	-0.2	2.0	5.0	2.0
Stockbuilding*	2328.6	-1.4	0.6	0.0	0.1	0.0
Exports	88,493.7	-23.9	23.9	1.0	7.5	5.0
Imports	87,758.1	-15.3	9.8	5.5	4.0	4.0
GDP		-6.3	4.0	-0.2	2.5	1.2
Nominal GDP (JPYbn)	504,377.6	470,936.6	479,172.5	474,860.3	485,743.4	492,921.5
Unemployment rate, %		5.1	5.1	4.8	4.4	5.0
Consumer prices, % y/y		-1.3	-0.7	-0.2	0.3	0.8
Current account, % of GDP		2.8	3.6	2.3	2.9	3.2
General government budget balance, % of GDP		-7.1	-7.7	-10.0	-8.0	-7.0

* Contribution to GDP growth (% points)

Strong currency threatens growth

Since mid-2009 the Swiss economy has experienced a strong economic boom driven by domestic demand and significant expansion in export markets. The growing demand has also increased the pressure on production factors. Since 2010 unemployment has been on a downtrend and capacity utilisation in the manufacturing sector is back above the historical average.

The strong economic headway, a large current account surplus and solid public finances have once again made Switzerland one of the most sought-after safe-haven countries during the sovereign debt crisis. Moreover, considerable winding-up of CHF funding has led to a massive strengthening of the CHF, which adjusted for inflation has appreciated by more than 15% over the past year vs major trading partners.

However, despite the sharp tightening of monetary conditions the export sector has performed surprisingly well. The key reasons are that Swiss exports are concentrated in sectors with low price sensitivity (such as pharmaceuticals and high-tech equipment) and that the companies have trimmed their profit margins. However, we think that they have now reached the pain threshold and look for a marked slowdown in exports in coming quarters. With exports accounting for more than 50%, this will put heavy downward pressure on Swiss economic growth over the forecast period.

The Swiss central bank has repeatedly warned against the effects of the strong CHF. At the same time, the verbal intervention has been followed by a massive liquidity injection in the Swiss money market to slow the currency strengthening. Despite the central bank's efforts, results have been limited so far and we believe that a sustained stabilisation cannot be achieved until the central bank acts on the demand side, intervening directly against the currency. It could supplement such action with a specific temporary currency target versus the EUR.

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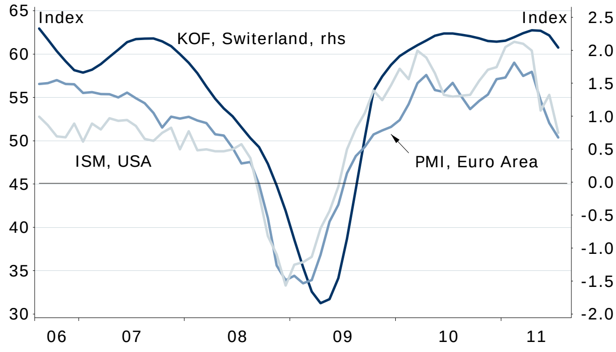
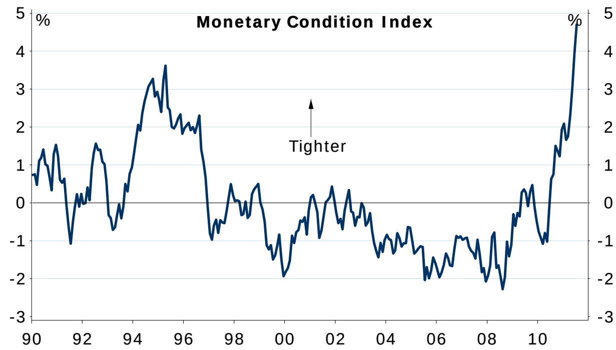
Business confidence loses momentum



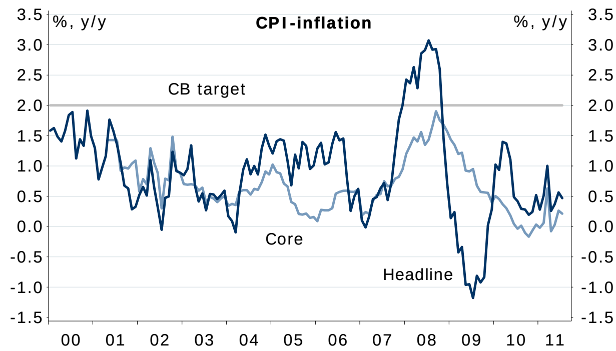
Source: Nordea Markets and Reuters Ecowin

Monetary conditions have tightened sharply



Source: Nordea Markets and Reuters Ecowin

Still very low inflation



Source: Nordea Markets and Reuters Ecowin

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

	2008 (CHFbn)	2009	2010	2011E	2012E	2013E
Private consumption	308.7	1.4	1.7	1.4	1.8	1.9
Government consumption	59.3	3.3	-1.6	1.1	0.8	0.5
Fixed investment	115.1	-4.9	4.6	4.4	2.7	3.2
Stockbuilding*	-0.8	-0.9	-1.3	0.7	0.0	0.0
Exports	307.3	-8.6	9.2	3.5	2.3	4.0
Imports	245.6	-5.5	6.6	1.7	1.2	2.8
GDP		-1.9	2.6	2.1	1.8	2.3
Nominal GDP (CHFbn)	545.0	535.6	546.6	559.2	571.5	588.6
Unemployment rate, %	2.5	3.7	3.8	3.5	3.5	3.3
Consumer prices, % y/y	3.6	0.3	0.5	0.2	0.4	0.7
Current account, % of GDP	2.3	11.5	14.2	13.0	11.0	9.0
General govt budget balance, % of GDP	2.0	0.8	0.2	0.2	0.6	0.7
Gross public debt, % of GDP	54.9	54.9	55.0	53.0	52.0	50.0

* Contribution to GDP growth (% points)

Elections coming up

- Bleaker and more uncertain outlook
- General elections 9 October
- Government debt less of a risk, or?
- Monetary policy on stand-by

Bleaker and more uncertain outlook

We have revised down our Polish growth forecast somewhat even though nothing much has changed in this economy, at least not yet. The global economic outlook is uncertain, at best. The world's largest economies slowed significantly in the second quarter of the year and the more high-frequent data such as the PMI manufacturing activity indicators point to even further slowdown in the third quarter. It remains to be seen if the recent market turmoil will have additional adverse effects on the global economy in the quarters to come, but the risks to growth are on the downside.

We now expect Polish growth around 3.5% this year and in 2012, while growth in 2013 is expected to be around 4%. For the reasons mentioned above, we expect a slowdown in exports in the coming quarters. The domestic economy is also likely to show slightly weaker momentum, as companies may postpone investment decisions due to the uncertain outlook for demand and tighter financing conditions, and consumers may decide to postpone spending because of general uncertainty and the rapid strengthening of the CHF, which is important given the widespread use of this currency for mortgage loans.

Poland was never in recession during the global recession at the end of 2008 and the beginning of 2009. The factors that kept the Polish economy running back then are to some extent still in place and make us believe that an outright recession is somewhat unlikely even if the global economy slows more than we currently expect. The main differences now compared with the latest global recession are that the Polish domestic economy is weaker and that the room for fiscal policy responses is limited.

General elections 9 October

One of the big themes for this autumn is general elections scheduled for 9 October. Polls currently point to a re-election of the incumbent government, ie a government led by the centre-right Civic Platform (PO) and supported by the Peasant's Party (PSL). The risk of a surprise result should not be underestimated given Poland's recent election history. Financial markets prefer a PO-led government with the PO as strong as possible. We would not expect major changes in the economic policy should the main opposition party, Law and Justice (PiS), be able to form the next government. However, the potentially harder line in foreign policy, especially towards Russia and Germany, of a PiS-led government could have negative effects on the investor climate.

Euro-area membership is obviously not a major issue at the moment given the state of most Euro-area economies. However, it is worth mentioning that should the general elections fail to provide a qualified majority in favour of changing the constitution to allow for Euro-area membership, it will mean that the entry date is postponed at least a year or two compared to the currently perceived (though not official) target of 2015.

Government debt less of a risk, or?

Another big theme is government debt. Not because government debt at 50-55% of GDP is detrimental in any way, but because of three self-imposed prudential debt limits that – when breached – restrict fiscal policy more and more. Earlier this year, we argued that the second limit of 55% of GDP could be breached this year, which would require a balanced budget in 2013 and onwards. However, so far, the budget deficit has been somewhat lower than expected and revenues coming from privatisations and from dividends from state-owned companies and the central bank have been higher than expected. Therefore, this risk is seemingly lower now, at least for this year.

Or is it? 27% of public debt was in foreign currency at

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

	2008 (PLNbn)	2009	2010	2011E	2012E	2013E
Private consumption	774	2.1	3.2	2.9	1.8	2.7
Government consumption	236	2.0	4.0	2.0	2.0	1.0
Gross fixed capital formation	284	-1.0	-1.0	4.1	4.2	6.9
Exports	509	-8.5	10.1	4.3	2.1	5.3
Imports	560	-12.5	11.6	5.3	3.0	5.8
GDP		1.6	3.8	3.3	3.4	4.0
Nominal GDP (PLNbn)	1,275	1,343	1,415	1,515	1,605	1,712
Unemployment rate, %		11.0	12.1	12.0	11.2	11.0
Consumer prices, % y/y		3.8	2.5	4.2	2.4	2.6
Current account, % of GDP		-3.9	-4.5	-2.9	-3.3	-3.7
General government budget balance, % of GDP		-7.3	-7.9	-5.5	-4.0	-3.0

the end of the first quarter 2010, mostly in EUR. That means that the recent weakening of the PLN will increase the PLN value of FX denominated government debt. The Ministry of Finance (MoF) started to exchange EUR receipts from EU funds in the markets to support the PLN and hence to keep debt below the second prudential debt limit already last year, but the amount of EUR sold will be much bigger this year. We expect these EUR conversions to continue and to be stepped up towards year-end, but renewed market turmoil and a consequent renewed weakening of the PLN is a clear risk.

CHF concerns

Households' CHF loans are likely to be a drag on growth this year, as the CHF has strengthened almost 15% measured in PLN so far. Polish banks' still report very limited amounts of non-performing CHF loans, but more may come if the CHF remains at current levels or even strengthens further. Moreover, consumers' debt servicing costs have risen and hence consumers have less money to spend on other things. At the end of June, 60% of mortgage loans were in foreign currency and probably mostly in CHF. This corresponds to around 12% of GDP.

Monetary policy on stand-by

The National Bank of Poland (NBP) hiked by 100 bp in the first half of the year before signalling a pause just before the summer. The recent market turmoil changes the situation for the NBP, though. Headline inflation will fall during the second half of this year due to base effects from last year's significant increase in food and energy prices and risks to core inflation, ie inflation excluding food and energy prices, are now skewed to the downside in the medium term given the bleaker and more uncertain economic outlook. The NBP should now be more confident that inflation will move gradually down to the inflation target of 2.5% +/-1% point.

Thus, we have changed our forecast and now expect the next interest rate hike in the autumn of 2012. The next move is still most likely to be a hike, in our view. However, we would not be surprised to see a rate cut in case the global outlook deteriorates further in the near term. Indeed, the NBP has kept a rather dovish tone during the year even when it has seen it necessary to hike interest rates because of high inflation.

PLN sideways

We now see the PLN closer to 4.00 at year-end. At that rate the MoF would probably be confident that debt-to-GDP will remain below 55%. Further PLN weakening is likely in the near term, if risk aversion spikes again. However, closer to the year-end market participants will acknowledge that the MoF and possibly even the central bank will be ready to go far to support the PLN

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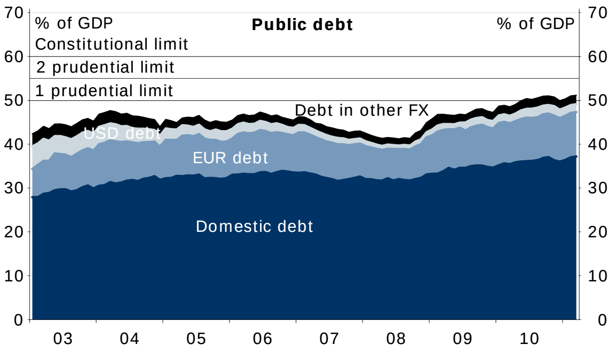
Moderate recovery so far

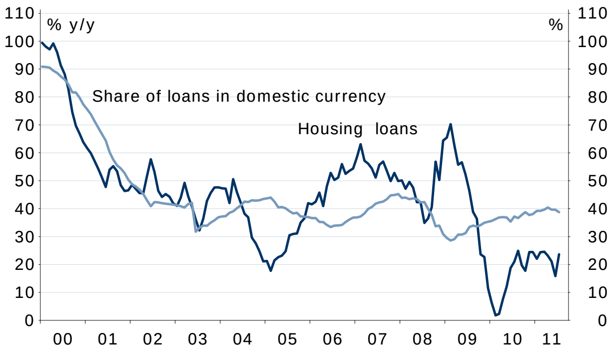
Source: Nordea Markets and Reuters Ecowin

Government debt near 2nd prudential debt limit



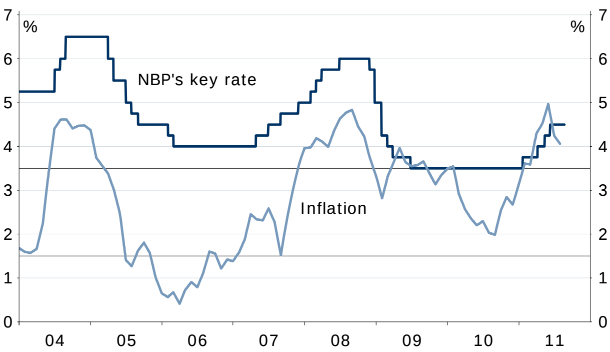
Source: Nordea Markets and Reuters Ecowin

Housing loans



Source: Nordea Markets and Reuters Ecowin

NBP on hold



Source: Nordea Markets and Reuters Ecowin

Comfortable consumers

- Consumers in the driver's seat, investment lagging
- Credit growth accelerates
- Core inflation to concern the central bank

As expected, consumers continued to drive the economy in the recent quarter, as judged from the strong retail sales growth. This is hardly surprising, given the latest developments. Unemployment fell to just above 6%, down from over 9% at the peak of the crisis. Growth in savings, as seen from deposit accumulation, has slowed down, meaning that consumers now opt for more spending. Meanwhile, wage growth and household credit growth have accelerated, which should underpin consumption in the months ahead.

Consumers may be relieved now that headline inflation has peaked – we expect it to moderate towards 7.5% by the end of 2011. Food prices, which have been the key culprit of high inflation since last year, will keep decelerating in y/y terms. Food constitutes nearly 40% of the consumer basket in Russia, thus the recent developments will help consumers to regain some of the purchasing power lost after the food price shock last year. As a result, food retail sales, which lagged the rest of retail sales recently, will also gain momentum in H2, which will be seen from yet stronger consumption numbers.

Fixed capital investment – tentative recovery

Fixed capital investment, which started the year dismally, undershooting our expectations, recovered somewhat in Q2, yet still remained below our estimates.

Looking at higher frequency indicators, it seems that investment has room to recover. Imports of machinery goods and production of investment goods have performed, hinting that investment demand is there. Industrial production is back in the 5-6% y/y growth range, showing solid recovery. We believe fixed capital investment will return to growth above 8% y/y in H2, as the relevant factors develop favourably. First of all, funds are still cheap, as the recent monetary policy tightening has not translated into higher interest rates in the economy yet, as average lending rates have dropped to below 9% in the past quarter.

Some tax reforms should also support business. For example, social contribution taxes were raised from 26% to 34% this year, but the government has acknowledged that this was a wrong move, promising to lower taxes again. Another factor which may spur investment activity is the certainty over the tax reform in the oil sector. The government plans to introduce the "66/60" tax scheme, which will help promote oil production and incentivize production of higher quality products, and the final details of the plan are to be released before long.

Lastly, one should not underestimate the importance of the uncertainty over the upcoming parliamentary and presidential elections. Once it is resolved and the framework for rules in the coming few years is thus more clear, both domestic and foreign businesses will likely have more courage to invest in Russia.

Credit growth accelerates

Credit growth has clearly accelerated since the start of the year. The monthly rates of household credit growth now correspond to nearly 40% annualised, as corporate credit growth also remains robust at around 20% annualised.

As a reflection of the credit growth, money supply (M2) growth has picked up again in y/y terms. More importantly, the money multiplier (M2 divided by M0) has accelerated from the start of the year, up from 0% y/y in January to over 15% in the past few months. We believe it is part of the credit growth story, as the banks start transferring their excess reserves (M0) to finance credit growth – and this is expected to continue as domestic demand gradually recovers.

The banking sector is strengthening markedly, among other things by the gradually decreasing non-performing loan share. It will further help the credit flow improve, supporting the real sector.

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

	2008 (RUBbn)	2009	2010	2011E	2012E	2013E
Private consumption	20,184	-4.8	3.0	5.7	6.3	6.5
Government consumption	7,360	0.2	1.4	1.6	1.8	1.8
Fixed investment	9,201	-14.4	6.1	7.0	7.5	9.0
Exports	13,074	-4.7	7.1	5.5	5.8	6.0
Imports	9,111	-30.4	25.6	17.0	14.0	15.5
GDP		-7.8	4.0	4.9	5.3	5.6
Nominal GDP (RUBbn)	41,277	39,064	45,300	51,559	58,363.4	65,945.9
Unemployment rate, %		8.4	7.5	6.5	5.8	5.5
Consumer prices, % y/y		11.7	6.9	8.5	7.5	7.0
Current account, % of GDP		4.0	4.8	4.0	3.5	3.2
Central govt budget balance, % of GDP		-5.9	-4.0	-0.7	-0.5	0.0

Monetary policy tightening to resume

The deceleration of food inflation has taken the heat off and relieved the CBR. The CBR lifted deposit rates for the fourth time before summer and signalled that the rates are appropriate for the "coming months".

The CBR maintains that the goal for 2011 is to keep inflation within 6-7% and the government expects to reduce inflation to 4-5% by 2014. These are in our view ambitious targets, requiring more action from the CBR. Yet from the recent comments from policymakers it appears that they are fully committed to this target.

Money supply growth has reaccelerated and money multiplier growth has picked up, which should concern the CBR going forward. Given the rising core inflation pressures, resulting from tightening in the labour market, a decreasing savings rate and lower credit growth, we believe the tightening of monetary policy is not finished yet. We expect the CBR will resume rate hikes in H2. Raising the deposit rates will also help to narrow the operating interest rate corridor to make the monetary policy transmission mechanism more effective.

RUB risks primarily global

The RUB reacted negatively to a large sharp fall in oil prices, yet this was mainly due to external factors – the global spike in risk aversion. The CBR interventions have decreased to up to RUB 300m/day, we estimate, which is not enough to call significant. The CBR widened the RUB floating band from 4 RUB to 5 RUB in March 2011, and if the RUB strengthening continues we expect a further widening.

Excess domestic liquidity, which facilitated capital outflows, is gradually decreasing. Capital outflows have receded in recent months and inflows may turn out positive in H2, which will support the rouble. The reason behind the reduction of domestic liquidity, and hence outflows, is the increase in RUB demand domestically, as the banks choose to provide credit to the domestic economy over directing excess liquidity to the foreign assets.

The CBR has publicly claimed many times that it prioritises the inflation goal over keeping the rouble from strengthening. Thus, we believe that the CBR will not stand in the way of rouble strengthening, giving it more flexibility. We expect a much stronger rouble, based on our oil forecast of USD 110/bbl toward the end of the year. The key risk factors are external – such as a further slowdown in global growth or a shock to the financial system.

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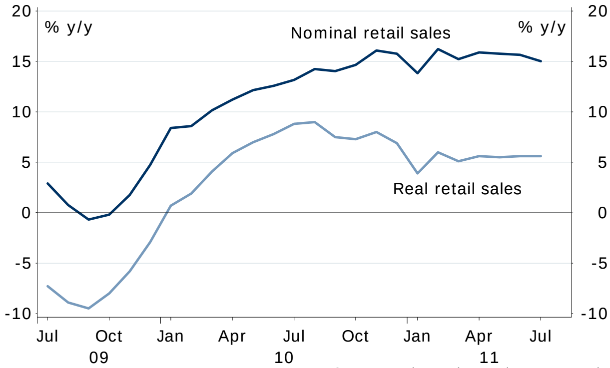
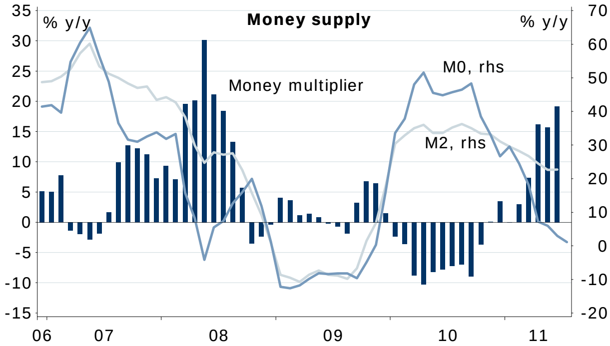
Retail sales growth reaccelerates



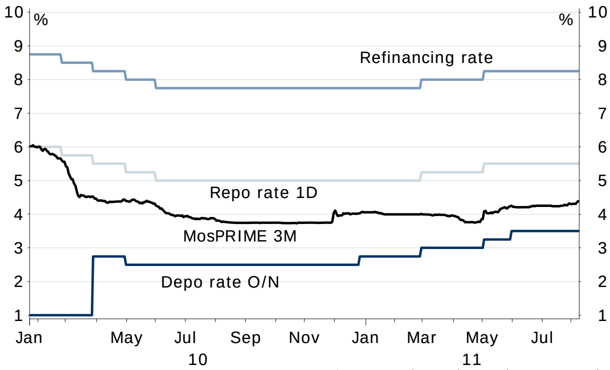
Source: Nordea Markets and Reuters Ecowin

Money multiplier growth accelerates



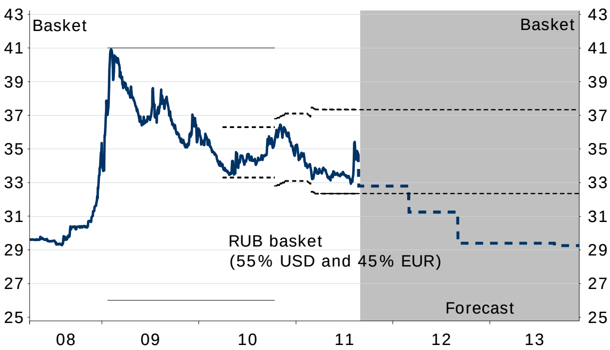
Source: Nordea Markets and Reuters Ecowin

Monetary policy tightening paused, but not finished



Source: Nordea Markets and Reuters Ecowin

Stronger RUB on the horizon



Source: Nordea Markets and Reuters Ecowin

Recovery exceeds expectations

The pace of the recovery during the first half of the year has exceeded expectations, reaching over 8% y/y on average. Compared to the previous quarter, growth has been strong as well, confirming a robust upward trend. The main factor behind the Estonian tiger has been vigorous export growth supporting especially the manufacturing sector. Despite signs of a slowdown in global manufacturing and the US, the growth outlook for Estonia's main trade partners – the Nordics, Russia and the Baltics – has remained decent. However, the economy is not immune to a continued and more wide-spread global slowdown, and this as well as an elevated inflation rate pose the main two risks going forward.

Encouragingly, domestic demand is gaining increasing traction. Private consumption is expected to stage a robust recovery this year despite the elevated inflation and unemployment rate. Inflation, led by food and energy prices, is expected to ease from its recent highs as global price pressure abates, thus improving the outlook for consumption. In addition, consumer confidence has recovered, and consumers view for instance the future general economic situation fairly positively. On the other hand, consumers' cautiousness is reflected in the willingness to make major purchases. Growing consumption will boost imports going forward, curbing growth and pushing the current account towards a deficit.

Confidence has strengthened on the vigorous recovery and the euro adoption. This has been reflected in further narrowing in the CDS spread to Germany and an improved credit rating, with Standard & Poor's latest move raising Estonia to AA-. However, challenges remain, as especially structural unemployment remains high and GDP per capita levels are still clearly lagging other Euro-area countries. Higher growth can also be seen as an opportunity to invest into further improvement in the labour market and reach a budget balance faster.

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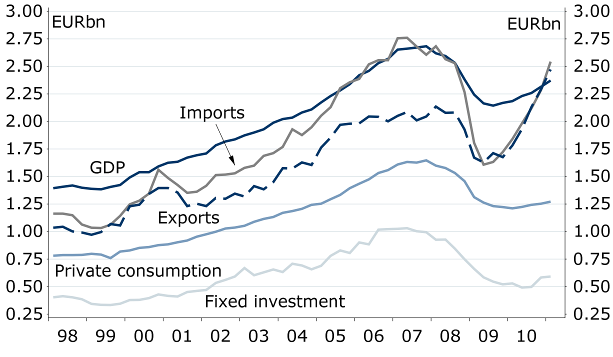
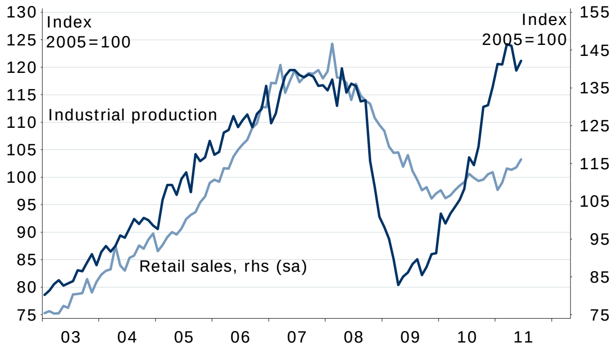
Recovery spreading slowly to domestic economy



Source: Nordea Markets and Reuters Ecowini

Industrial production booming, retail sales lagging



Source: Nordea Markets and Reuters Ecowin

Consumer sentiment already at decent levels

Source: Nordea Markets and Reuters Ecowin

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

	2008 (EURbn)	2009	2010	2011E	2012E	2013E
Private consumption	8.9	-18.4	-1.9	5.1	4.2	5.0
Government consumption	3.1	0.0	-2.1	2.0	1.5	1.8
Fixed investment	4.6	-32.9	-9.2	16.0	9.0	11.0
Exports	11.5	-18.7	21.7	25.0	6.1	6.6
Imports	12.2	-32.6	21.0	25.7	6.5	7.2
GDP		-13.9	3.1	7.5	3.6	4.8
Nominal GDP (EURbn)	16.1	13.9	14.5	16.3	17.4	18.9
Unemployment rate, %		13.8	16.9	12.8	10.5	8.9
Consumer prices, % y/y		-0.1	3.0	5.0	3.0	3.9
Current account, % of GDP		4.5	2.8	0.1	-0.5	-1.2
General govt budget balance, % of GDP		-1.7	0.1	-0.3	-1.5	0.0

Upward trend still intact

The economy has continued to climb, as reflected in the strong GDP growth for Q2. The gradual upward trend is expected to largely continue during the next couple of years, although stalling global growth would adversely affect Latvian export demand. Exports have continued to develop favourably, clearly exceeding the 2008 highs already. The main risk to the economy is nevertheless its export-dependence – a sharp slowdown in world trade and especially growth in its main trade partners could trigger tougher times for the economy. However, we expect Latvia's most important trade partners to continue performing fairly well.

Private consumption, on the other hand, is still expanding only modestly. The continued improvement in consumer confidence does, however, imply improving spending. This is also reflected in the consumer confidence index for major purchases, which points towards higher spending a year ahead. Strengthening domestic demand is also expected to boost imports, thus pushing the trade balance even deeper into negative territory. Spending growth is currently weighed down by the only gradually improving labour markets and the elevated inflation. The abating global food and energy prices should, however, help decelerate inflation in the second half of the year, thus improving the purchasing power of consumers.

The main event this autumn is the parliamentary election in mid-September, triggered by the dissolving of the parliament as a result of the referendum in July. The election increases the risks for the 2012 budget and the continued fiscal consolidation, but overall the tight fiscal stance and the work towards a lower budget deficit should continue. The international loan programme will end after this year, but this is not expected to be of any major significance, since Latvia managed a successful return to the international markets in June with a dollar-nominated Eurobond with a lower-than-expected yield.

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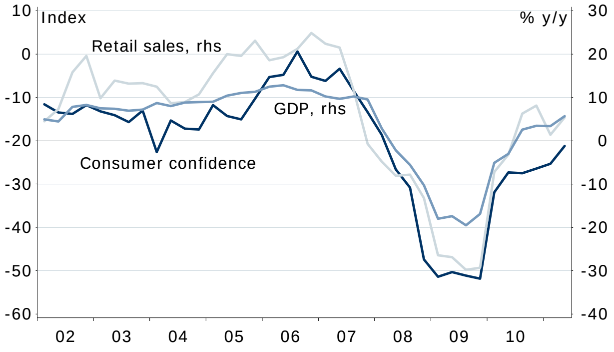
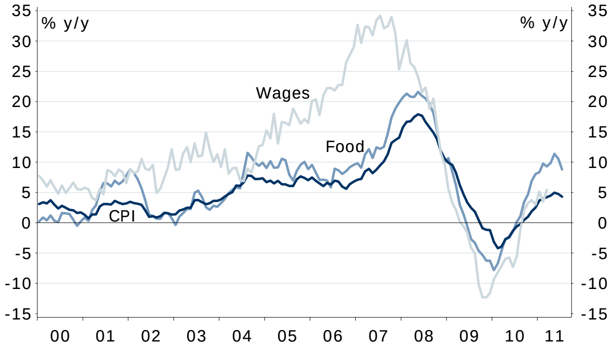
Uneven and fragile recovery in consumption



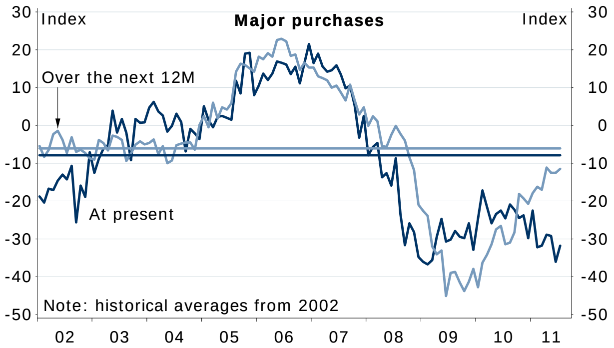
Source: Nordea Markets and Reuters Ecowin

Easing food prices bringing relief to inflation



Source: Nordea Markets and Reuters Ecowin

Consumers increasingly optimistic on spending



Source: Nordea Markets and Reuters Ecowin

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

	2008 (LVLmn)	2009	2010	2011E	2012E	2013E
Private consumption	10,181	-24.1	-0.1	4.0	3.9	5.0
Government consumption	3,170	-9.2	-11.0	-0.1	-0.2	1.0
Fixed investment	4,748	-37.3	-19.5	19.5	8.0	9.3
Exports	6,931	-14.1	10.1	11.0	5.5	6.2
Imports	9,141	-33.5	8.4	12.8	5.9	7.0
GDP		-18.0	-0.3	4.6	3.6	4.9
Nominal GDP (LVLmn)	16,188	13,083	12,736	13,895	14,880	16,175
Unemployment rate, %		17.1	18.7	16.0	14.3	12.8
Consumer prices, % y/y		3.6	-1.0	4.5	3.3	3.8
Current account, % of GDP		8.6	3.6	0.2	-0.2	-1.0
General govt budget balance, % of GDP		-9.7	-7.7	-4.8	-2.6	-2.3

Growth continues despite global uncertainties

Growth has continued as all key economic indicators have developed positively. The rising trend is seen continuing over the coming quarters despite recent fears of a global slowdown, which at the moment is only expected to have a limited effect on Lithuanian growth through increased uncertainty in export demand. Continued quarterly growth is, however, supported by the positive economic outlook for Lithuania's main trading partners.

Especially the industrial sector has continued to benefit from strong export demand, but also the domestic economy has begun to gain traction and is expected to post a solid recovery this year. Consequently, overall profitability of companies has increased substantially with manufacturing and transport sector companies already showing pre-crisis profitability levels. Owing to strong foreign demand, capacity utilisation levels of manufacturing companies are rapidly approaching pre-crisis levels.

Weighing on consumption is, however, the still fairly modest improvement in the labour market as structural unemployment remains high, wage growth is weak and inflation elevated. However, inflation seems to have reached its peak during the summer, and hopes are especially for further declines in global food and energy prices. The slowdown in inflation improves the purchasing power of consumers and could thus give a further boost to consumer confidence and consumption.

The main risk to the recovery remains a global slowdown spreading to Lithuania's main export partners, as the recovery remains export-dependent. In addition, structural unemployment in e.g. the construction sector will remain a challenge, as the economy is undergoing structural changes by shifting employment from low-cost manufacturing to a growing service sector. A further risk is the high inflation, which not only weighs on spending but is also a risk factor for the plan to adopt the euro in 2014.

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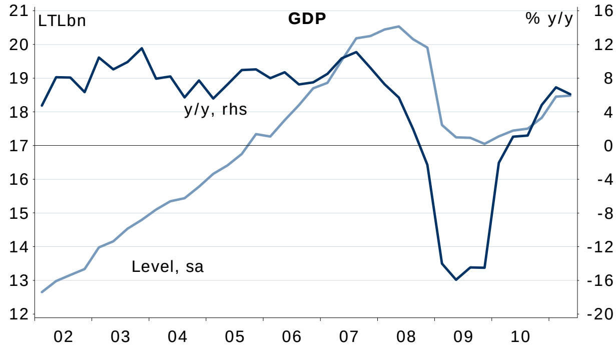
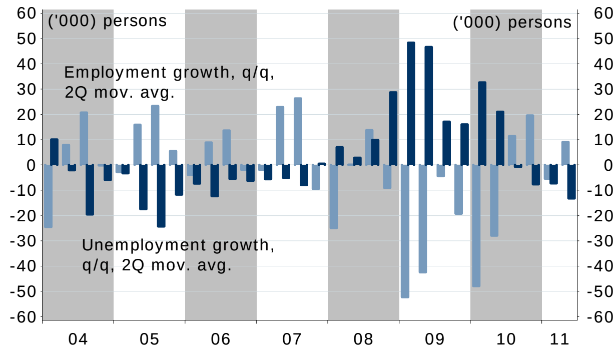
Economy recovering but 2008 levels still far away



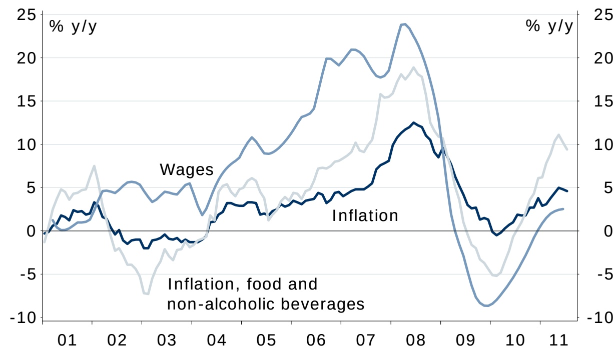
Source: Nordea Markets and Reuters Ecowin

Employment turning gradually to growth



Source: Nordea Markets and Reuters Ecowin

Inflation peaked in the summer?



Source: Nordea Markets and Reuters Ecowin

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

	2008 (LTLmn)	2009	2010	2011E	2012E	2013E
Private consumption	73,027	-17.7	-4.5	6.0	4.3	5.0
Government consumption	21,505	-1.9	-3.4	-0.1	1.0	2.0
Fixed investment	28,370	-40.0	0.0	22.0	7.5	9.0
Exports	66,752	-12.7	17.4	12.8	5.7	6.4
Imports	79,922	-28.4	17.9	15.9	6.3	7.0
GDP		-14.7	1.3	6.0	3.7	4.8
Nominal GDP (LTLmn)	111,482	91,525	94,461	104,190	111,800	121,415
Unemployment rate, %		13.7	17.8	16.0	13.8	12.2
Consumer prices, % y/y		4.2	1.3	4.3	3.5	3.8
Current account, % of GDP		2.6	1.3	-1.2	-1.8	-2.0
General govt budget balance, % of GDP		-9.2	-7.8	-5.0	-2.8	2.4

Ready to send in the cavalry

- Growth is slowing but will likely stabilise soon
- Stimuli packages and monetary easing on the way
- Official public debt only the top of the iceberg
- Change of leadership to take centre stage in 2012

Economic growth will continue to slow this year as the many monetary policy tightening measures implemented are kicking in. Also the worsened outlook for advanced economies weighs on China's export going forward. However, monetary tightening has most likely come to an end and economic growth should soon stabilise and stay in the 8-9% range throughout the forecast period. Fiscal stimuli will likely be put on the table, especially if the economy falters more dramatically. Inflation remains elevated but will fall gradually going forward, leaving room also for monetary easing if needed.

China in a favourable position

China is entering the current slowdown in a better position than most advanced economies in the sense that China contrary to the advanced economies does in fact still have the possibility to boost its economy via fiscal policy. Furthermore, China is less vulnerable to a slowdown in advanced economies now than in 2008-09. Firstly, exports as a percentage of GDP is lower now than when Lehmann collapsed. Secondly, the plunge in China's exports during the financial crisis in 2008 was exaggerated by dysfunctional trade finance, which should be avoided this time. Lastly, the external shock in 2008-09 coincided with China's self-imposed domestic credit squeeze aimed at cooling down the housing market. This time, the construction sector is still thriving as the dampening measures taken in this cycle have had only limited effect.

Fiscal stimuli ahead – but less than in 2008

When renewed fiscal stimuli nevertheless prove necessary, the authorities have several tools at their disposal. The massive social housing project is already ongoing and could fairly easily be scaled up, perhaps already late this year. And the well-known tool of kicking off infrastructure projects could also come into play again even though the highly profiled high-speed rail programme has experienced a serious set-back from the deadly train collision in July. A new stimuli package will, however, be significantly smaller than the CNY 4,000bn stimuli from November 2008.

If the authorities put action behind their words in the new 5-year plan of more balanced growth with more emphasis on private consumption, stimuli targeting the household sector instead of investment should be preferred. However, improvements of for instance social security, education and health care take much longer to take effect than a boost to public investment.

Monetary easing if needed – rate cuts the last option

Monetary policy could also be eased if needed, and we expect that to happen early next year. The many reserve requirement hikes could straightforwardly be reversed, thereby increasing liquidity in the financial system. Also measures targeted at easing credit conditions for specific segments such as small and medium-sized enterprises could fairly soon be implemented.

Interest rate cuts will only feature on the agenda if the economy suffers severely because the monetary stance is already fairly loose. Despite the five hikes since October last year, the 1- year lending rate is still lower than before the global financial crisis struck in 2008. And given the current high inflation, real rates are close to zero. Thus, boosting the amount of credit at the prevailing interest rates via higher lending targets and quotas will probably be preferred to cutting rates.

Dampening the elevated inflation remains a priority for the authorities. But inflation seems to have peaked both due to base effects and somewhat slower food price increases. Thus, inflation should not stand in the way for policy easing.

Overall public debt manageable but not negligible

Much attention has been drawn to the size of Chinese public debt and more specifically to the huge hidden debt

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

	2008 (CNYbn)	2009	2010	2011E	2012E	2013E
Private consumption	11,059	9.2	8.5	9.5	9.8	10.0
Government consumption	4,175	6.1	7.5	9.0	9.5	9.0
Fixed investment	12,808	22.0	11.3	10.0	9.5	9.0
Stockbuilding*	1,024	-0.7	-0.5	0.1	0.0	0.0
Exports	10,990	-9.1	15.8	10.0	9.0	8.0
Imports	8,567	-2.7	12.0	11.0	12.0	11.0
GDP		9.2	10.3	9.1	8.5	8.1
Nominal GDP (CNYbn)	31,490	34,502	39,798	45,529	51,357	57,673
Unemployment rate, %		4.3	4.1	4.1	4.0	4.1
Consumer prices, % y/y		-0.7	3.3	5.3	4.3	4.2
Current account, % of GDP		5.9	5.2	4.1	3.6	3.2
General government budget balance, % of GDP		-2.3	-1.6	-2.2	-1.9	-2.0

* Contribution to GDP growth (% points)

of local authorities. A significant chunk of the investments in the 2008 fiscal package was carried out by local authorities who set up investment corporations which accumulated huge off-balance debt. Recently, the publication of several reports (some leaked and some published by authorities) has shed some light on the size of this debt, and independent research institutions (for instance Dragonomics, China Economic Quarterly, June 2011) estimate the true public debt to amount to around 80% of GDP compared to the official figure for government treasury debt of less than 20% of GDP. A major part of the off-balance debt is likely bad debt, which poses a risk for the banking system. Still, most banks are state-owned and China has before successfully transferred bad debt from banks to formal government debt. And with all public debt held by residents, a conventional public debt crisis seems unlikely.

Change of leadership to take centre stage in 2012

The fifth generation of leaders since the revolution will take over power next year with Hu Jintao stepping down as Party Secretary in late 2012 and as President in March 2013. Also the National People's Congress, the Central Committee and the Politburo's Standing Committee will be replaced in late 2012. The new President and the new Secretary of the Communist Party will almost with certainty be the current Vice President Xi Jinping.

Very little is known about the policy orientation of Xi and the other new leaders. The best indication of future economic policies is probably the new 5-year plan from early 2011 which likely was drafted by the incoming leadership. As described in more detail in *Economic Outlook* from January 2011, the key objectives of the plan include "*...driving economic growth higher via domestic demand and achieving a more equal income distribution.*" What is known, however, is that the new leadership in general will be better educated, more internationally-oriented (and English-speaking) and have more bureaucratic experience than their predecessors.

Currency appreciation to continue

Inflation seems to have peaked but will remain elevated and likely breach the target also next year. With monetary policy more likely to be eased than tightened due to the external slowdown, renminbi appreciation remains an important tool to dampen inflation. And also the continued efforts to internationalise the renminbi acts in favour of continued renminbi revaluations. Should the current financial turmoil on the other hand escalate into a full-blown crisis with further deterioration of the outlook for China's export market, the authorities will likely bring CNY appreciation to a halt just like they did in 2008 in order to support the export sector.

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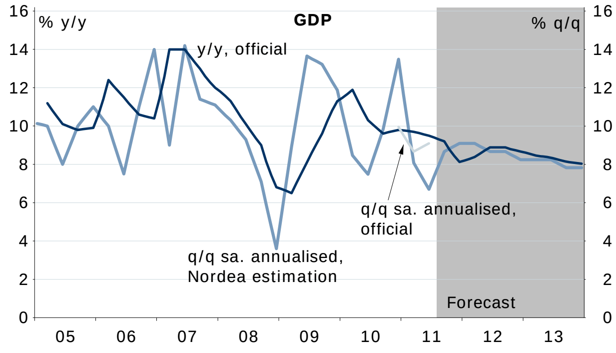
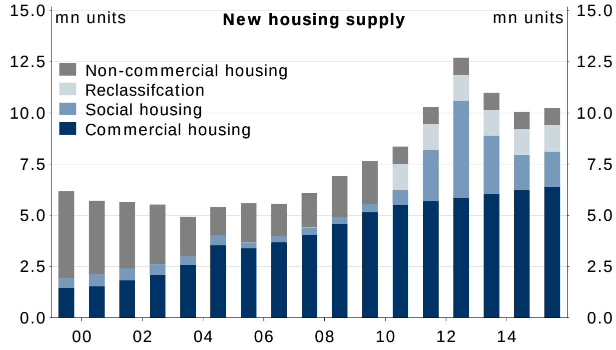
Economic growth to stabilise in the 8-9% range



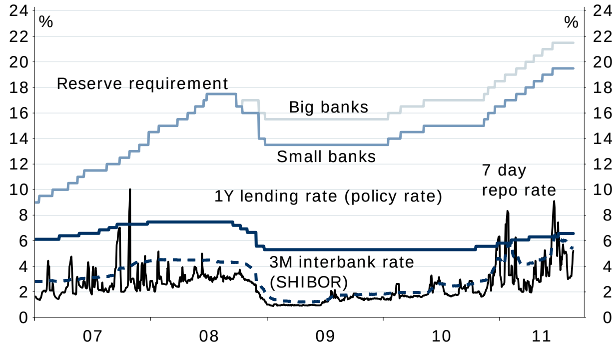
Source: Nordea Markets and Reuters Ecowin

Scale-up of social housing the new boosting tool



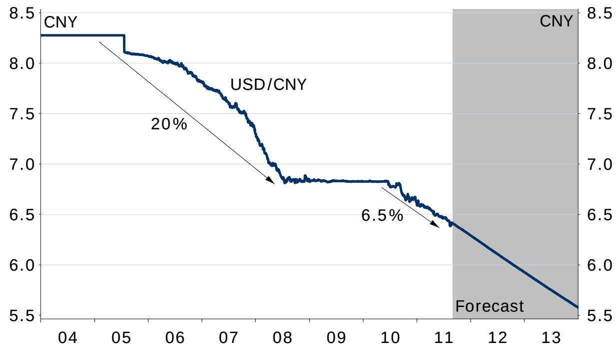
Source: Dragonomics

Monetary policy easing should start early next year



Source: Nordea Markets and Reuters Ecowini

Gradual appreciation versus USD to continue



Source: Nordea Markets and Reuters Ecowin

Authorities in straitjacket

India will be hit by the slowdown in the developed economies, though less so than many other countries thanks to the economy's relative closedness. But unlike last time the global crisis hit back in 2008, the domestic economy is this time unfortunately already slowing. Private sector investment is severely hurt by the high interest rates following the many rate hikes from the Reserve Bank of India. And we have not even yet seen the full effect of the aggressive hikes in the first half of 2011. More bad news comes from private consumption, which despite high wage increases for urban workers and a good harvest in rural areas will be dampened as persistently high inflation erodes households' purchasing power.

Public investment projects, which could mitigate the overall slowdown, have become more difficult to get through due to renewed focus on the bad shape of public finances. Even though the lower global energy prices reduce the bill for subsidising end-user energy and fertiliser prices, the public deficit (state + central government: 8% of GDP) and public debt (70% of GDP) are close to the levels seen in troubled southern Europe. The good thing is that most debt is domestically held and that the still high GDP growth allows India to run a bigger deficit without increasing the debt to GDP ratio.

With the politicians in a straitjacket, one could hope for the Reserve Bank of India to ease the slowdown. However, the chronically high inflation will have to fall before monetary policy can be eased. And even though global commodity prices are falling, domestic food price inflation should remain high due to demand pressures resulting from the improved living standards of part of the population that have structurally changed the consumption pattern.

Although the authorities have fewer tools at their disposal to ease the current slowdown, the underlying long-term trend remains encouraging, among other factors due to favourable demographics and the big pool of labour. Economic growth should therefore stay close to 8% in the forecast period.

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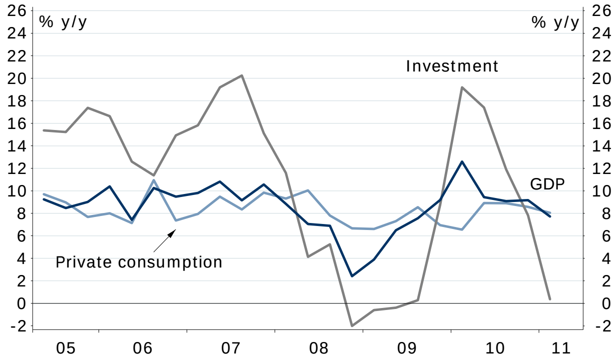
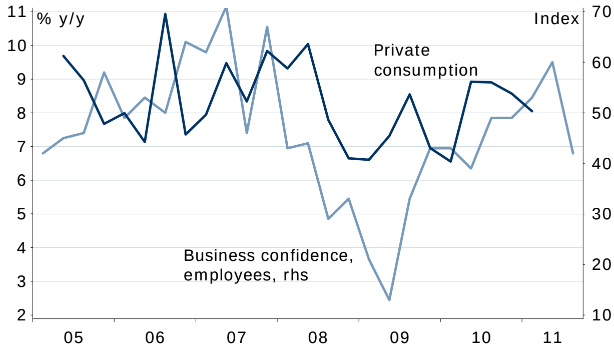
Investment dampened by higher interest rates

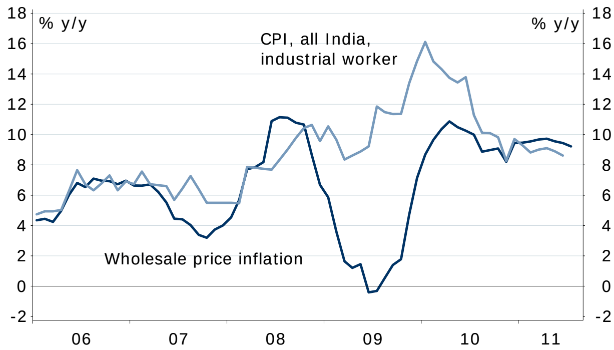


Private consumption growth will also slow



Source: Nordea Markets and Reuters Ecowin

High inflation prevents rate cuts



Source: Nordea Markets and Reuters Ecowin

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

	2008 (INRbn)	2009	2010	2011E	2012E	2013E
Private consumption	32,578	7.3	8.3	7.0	7.5	8.0
Government consumption	6,164	16.4	4.8	6.0	6.5	6.5
Fixed investment	17,888	7.3	8.6	10.0	12.0	11.0
Exports	13,110	-9.0	14.0	14.0	12.0	13.0
Imports	16,140	-7.9	11.6	11.0	12.0	12.0
GDP		9.1	8.8	7.7	8.0	8.2
Nominal GDP (INRbn)	55,826	65,503	78,756	91,347	103,657	118,340
Wholesale prices, % y/y		2.4	9.6	8.3	5.5	6.0
Current account, % of GDP		-1.9	-3.0	-3.0	-2.5	-3.5
General government budget balance, % of GDP		-6.1	-5.0	-5.5	-5.0	-4.5

Better foreign financing mix

Domestic private consumption growth remains high, supported by still robust credit growth of around 20% y/y. Recently introduced measures (for instance a doubling of the tax on consumer credits) should slow down credit growth going forward, however. As expected, inflation has breached the upper tolerance limit of 6.5% y/y and will remain sticky in the coming months, we think. The labour market remains tight, as unemployment continues to fall. This intensifies the inflationary pressures as wage growth remains robust in real terms. A strong BRL supports consumers relative to local producers, as industrial production has stalled over the past quarters, not least due to import competition.

The central bank has acknowledged that inflation will not come down to the target level of 4.5% soon (within a year's time). However, the most recent indicators suggest that economic activity is finally slowing. Coupled with the unfavourable global development, the central bank should be done hiking rates despite its earlier announcement that the tightening cycle has been prolonged. This will leave the policy rate at 12.5%.

The policymakers have continued to introduce a number of measures against speculation in a stronger BRL lately, yet these did not prevent the BRL from strengthening. The Brazilian currency is to become less volatile and less susceptible to capital outflows now due to the improving balance of payments situation. The current account deficit has stabilised at just above 2% to GDP, as the trade balance has improved. Meanwhile, the financing of the current account has become of better quality as the bulk of net capital inflows to the country is now in the form of foreign direct investment (FDI) – this is in sharp contrast to the situation in 2010 when the portfolio invesment inflows constituted around two-thirds of the total capital inflows.

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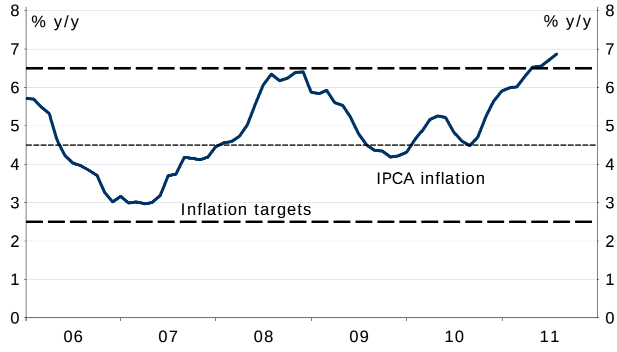
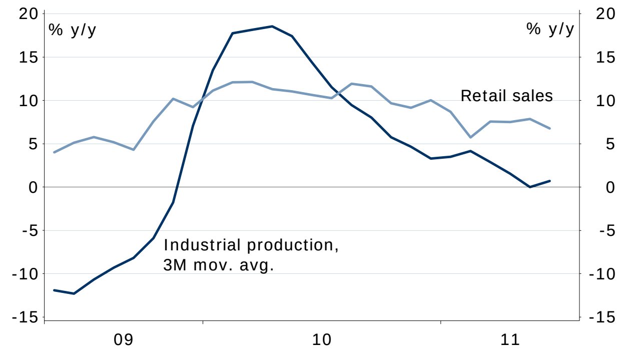
Inflation topped the comfort limits



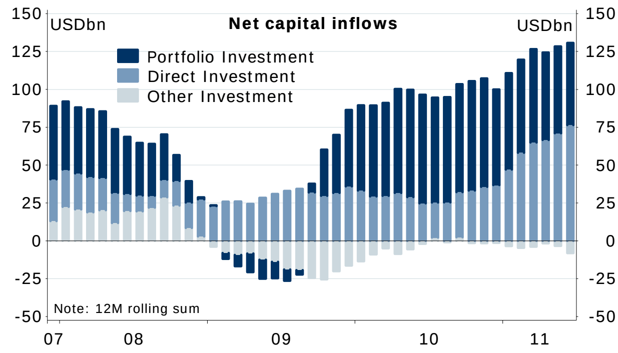
Source: Nordea Markets and Reuters Ecowini

Consumption strong – at the expense of production?



Source: Nordea Markets and Reuters Ecowini

FDI overtakes portfolio inflows



Source: Nordea Markets and Reuters Ecowini

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

	2008 (BRLbn)	2009	2010	2011E	2012E	2013E
Private consumption	1,786.8	4.2	7.0	4.5	4.4	4.8
Government consumption	612.1	3.9	4.0	3.2	3.2	3.0
Gross fixed capital formation	579.5	-10.4	22.0	6.9	6.3	6.8
Stockbuilding*	47.6	-2.0	0.2	0.0	0.2	0.2
Exports	414.3	-10.3	11.5	8.5	6.6	7.0
Imports	408.5	-11.5	36.3	12.8	6.9	7.2
GDP		-0.7	7.6	3.9	4.1	4.2
Nominal GDP (BRLbn)	3,031.9	3,257.1	3,721.5	4,114.1	4,505.5	4,915.4
Unemployment rate, %		8.1	6.7	6.5	6.4	6.2
Consumer prices, % y/y		4.9	5.0	6.4	5.2	4.7
Current account, % of GDP		-1.5	-2.3	-2.5	-2.8	-2.8
General government budget balance, % of GDP		-3.2	-2.7	-3.0	-2.5	-2.2

* Contribution to GDP growth (% points)

Long term prices still trending up – blurry short-term outlook

Sovereign debt worries, a growing mistrust in politicians and a weaker underlying economic environment on both sides of the Atlantic Sea will continue to weigh on demand for oil. Waves of risk aversion may trigger temporary sell-offs and the oil price may dip below the underlying long-term upward sloping trend. We expect the oil supply/demand balance to continue to tighten over the forecast period, but at a slower pace on the back of the gloomier outlook for the world economy. OPEC spare capacity will remain at low levels in the forecast period as global oil demand is expected to continue to pick up at a faster rate than non-OPEC supply growth.

We think non-OPEC oil production can surprise on the upside. Higher oil prices trigger investment in deepwater production and unconventional oils such as Canadian oil sand and US shale oil. Marginal production costs are expected to continue up from around USD 85/barrel in 2011. Investment has picked up markedly since the sharp fall in 2009 and we expect this trend to persist. Higher exploration and production activity is expected to increase demand for equipment, steel and labour. Cost inflation indicates that oil prices will find higher support levels going forward. OPEC capacity expansion plans are struggling with project delays and underinvestment. Even Saudi Arabian capacity expansion plans may develop too slowly to be able to keep a sufficient buffer capacity and meet the rapidly rising domestic oil consumption in the future. OPEC oil production has taken a hit from the shut-down of around 80% of Libyan oil production. Strong geopolitical tensions in the Middle East and North Africa region (MENA) will continue to put oil production, refineries and the infrastructure at risk. In addition, the political climate in vital oil producing countries outside MENA such as Nigeria, Venezuela and Sudan/South-Sudan heightens the risk of supply-side disturbances and oil shortages.

Oil demand is closely correlated to growth in economic activity, increasing living standards and population growth. The lion's share of future oil demand growth is expected to come from emerging economies, especially China, India and the Middle East. Power sector problems in China and the long-term effect of the earthquake in Japan on the nuclear power industry may boost demand for oil. The transportation sector is expected to be the primary driver of future oil demand growth, accounting for more than 50% of total consumption. Although higher oil prices also will trigger investment in competing fuel sources such as natural gas and electric cars, we do not expect this to make an impact on transportation fuel demand over the forecast period.

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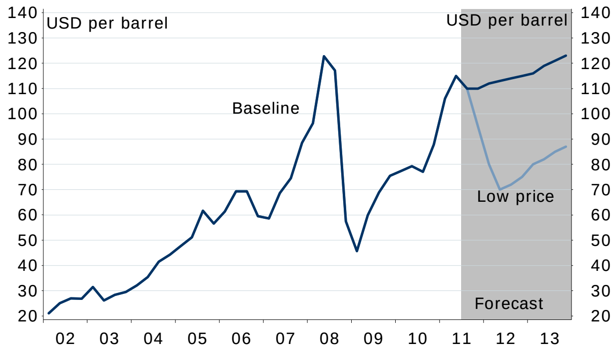
Oil price forecasts Brent – baseline (USD/barrel)

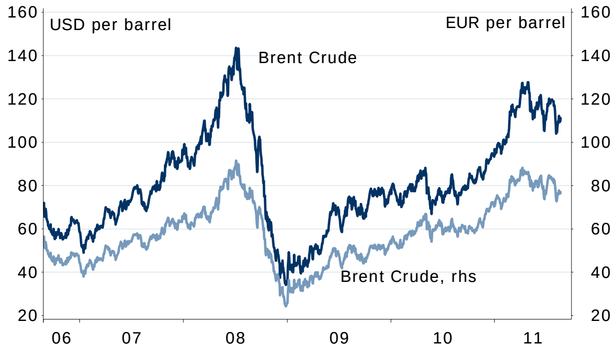
	Q1	Q2	Q3	Q4	Year
2007	59	69	75	89	**73**
2008	96	123	117	57	**98**
2009	46	60	69	76	**63**
2010	77	79	77	88	**80**
2011E	106	115	110	110	**110**
2012E	112	113	114	115	**114**
2013E	116	119	121	123	**120**

Oil price forecasts – baseline and low price



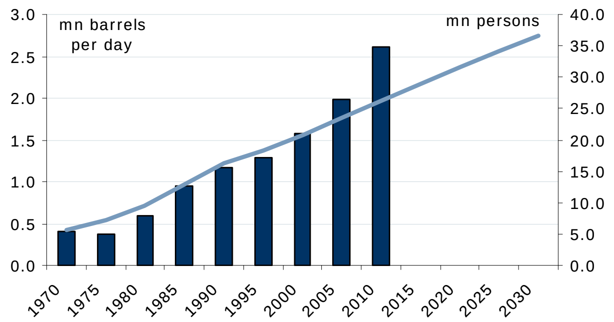
Source: Nordea Markets and Reuters Ecowin

Oil prices in USD and euro



Source: Nordea Markets and Reuters Ecowin

Saudi Arabian oil consumption and population growth



Source: United Nations and International Energy Agency

Metal prices to reflect subdued economic growth

Base metal prices in general normally reflect the current strength in global industrial production, while the forward market provides signals about the industrial production growth outlook. Since the previous issue of *Economic Outlook* (May) prices initially rose in June-July, before falling sharply in August to new lows for the year. The outlook for a more subdued economic recovery than previously expected has weighed on metal prices recently. The forward market term structure has also moved to price in slower growth in the near term. We lower our metal price forecasts to reflect this less optimistic view on metals demand.

Global aluminium demand has set new record-highs this year and has in every month since January grown stronger than output. Demand should remain strong in the coming years. Growing urbanisation, income and market share in automotive, aerospace, electrical, electronics and solar energy support robust demand growth in the coming years, albeit at a slower pace than previously estimated. Supply will struggle to keep up in our base scenario, with few expansions to come on stream outside China the next two years. We lower our price forecasts slightly but expect higher average prices over the forecast period.

Copper output has struggled with declining ore grades and supply disruptions for years. 2012 will, however, see a strong rebound in supply growth. Demand will continue to show steady growth as urbanisation and industrialisation in China and other Emerging Markets continue. We forecast a more balanced market over the next two to three years due to our dampened GDP growth outlook, but copper prices will likely stay high and volatile.

Nickel has been the underperformer among base metals recently on expectations of steady supply additions this year and in 2012. China's ramp-up of production of nickel pig iron has further reduced import requirements of refined nickel and will continue to do so for a while. A slower economic growth trajectory will also reduce demand, thereby relaxing the market balance further. We lower our price forecasts, but longer-term fundamentals such as the marginal cost of production should support nickel prices at around USD 20,000/tonne.

Zinc still has the weakest fundamentals of the base metals complex. There is expected to be ample supply next year, but we see scope for a structural strengthening of the zinc market towards the end of the forecast period as several large mines could reach the end of their life and be shut.

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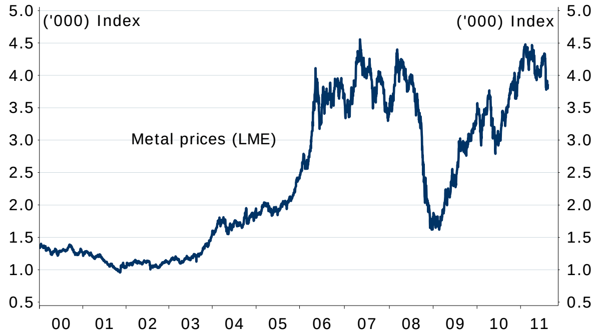
Base metal price forecasts (USD per tonne)

	2011E	2012E	2013E
Aluminium	2,460	2,500	2,600
Copper	9,200	8,500	8,500
Nickel	23,600	21,000	21,000
Zinc	2,200	2,000	2,000

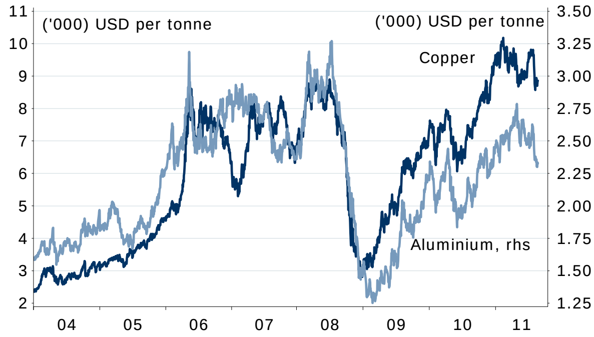
Source: Nordea Markets

Prices signal slower growth for a while



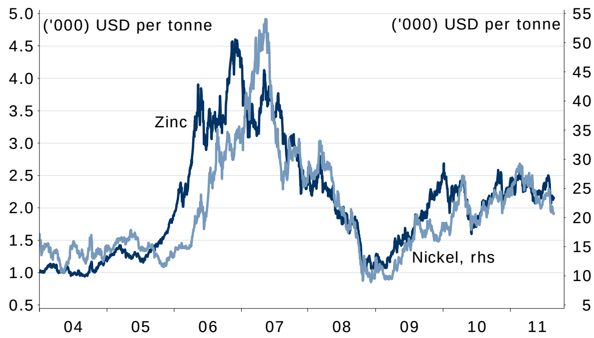
Source: Nordea Markets and Reuters Ecowin

Copper and aluminium – strong fundamentals



Source: Nordea Markets and Reuters Ecowin

Nickel and zinc – weaker fundamentals



Source: Nordea Markets and Reuters Ecowin

Gauging the risk of recession in the US and the Euro area

- Financial turmoil reflects fear of recession
- The risk of a recession is approaching 50%
- A US recession would most likely be shallow
- The Euro-area debt crisis could be a recession trigger

In our baseline scenario we predict that both the US and the Euro area will avoid sliding into a recession. However, the turmoil in financial markets on both sides of the Atlantic has significantly raised the risk of a vicious circle, where market participants' fears of a recession cause consumers and businesses to pull back, creating a self-fulfilling prophecy. In the following we look at the key recession triggers in the two economies. In reality, a recession in the US could easily trigger a recession in the Euro area and vice versa.

Nordea's risk scenarios for GDP growth

Real GDP growth, %	Probability, %	USA 2011	USA 2012	Euro area 2011	Euro area 2012
Baseline	45	1.3	1.6	1.6	0.6
Positive surprise	10	1.5-2.0	2.0-3.0	1.7-2.0	1.0-2.0
Mild recession	40	0.7-1.2	0.5-1.5	1.2-1.5	-0.5-0.5
Deep recession	5	0.5-1.0	-2.0--1.0	0.5-1.0	-2.0--1.0

Potential triggers of a new US recession

As the US economy has lost upward momentum, a double-dip recession could be triggered more easily. The risk of recession is amplified because the already fragile economy seems to have moved into a vicious circle with negative sentiment now feeding on itself. Hence, it would not take much of a shock to push the economy back into recession. The mere fear of a double-dip could cause one. Currently, we put the odds of recession at close to 50%.

In our baseline scenario, where the US economy just barely escapes recession, further easing of monetary policy later this year or in early 2012 is assumed to support financial players' risk appetite and domestic demand. Recent surveys also suggest that more asset purchases by the Fed may already be priced in. However, additional monetary stimulus is far from certain, especially if the Fed does not see evidence of a renewed decline in core inflation. Moreover, the central bank may also be wary of a potential boost to commodity prices from QE3, which would weaken real incomes.

But even in case of more monetary easing the support to the real economy might not be enough to prevent a recession given the already low level of bond yields and the already ample liquidity in banks and businesses.

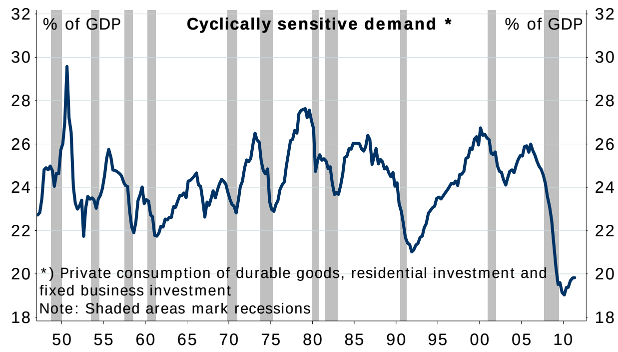
More fiscal tightening could also risk triggering a new recession. Standard & Poor's downgrade of the US sovereign rating has increased the likelihood of fiscal restraint at a time when the economy is already weak. The pressure for fiscal consolidation would increase in the event of more downgrades, potentially triggered by the weaker growth prospects and/or a new round of political paralysis as recently seen during the debt ceiling discussions. Specifically, if policymakers fail to extend the 2011 payroll tax cut and the emergency unemployment benefits programme, the fiscal drag will be intense in early 2012 as these programmes expire.

Finally, a potential trigger of a new recession could be further tightening of US financial and credit conditions, reflecting heightened concerns about debt sustainability and bank solvency in several European countries.

A Great Recession 2.0 does not seem likely

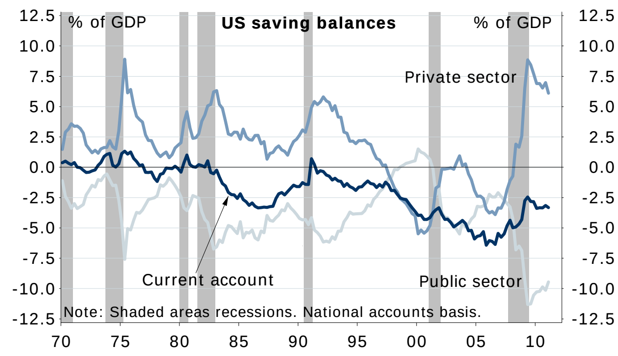
A new recession could be very difficult to pull out of because policymakers might not have the resources or the will to respond appropriately. Still, a new US recession of the same severe depth as the so-called Great Recession in 2008-2009 seems unlikely.

Cyclically sensitive demand still at very low levels



Source: Nordea Markets and Reuters Ecowin

Higher private sector savings act as a buffer



Source: Nordea Markets and Reuters Ecowin

First of all, US banks' balance sheets are now much healthier relative to the situation prior to the Great Recession. It is indeed encouraging that US banks continued to ease lending standards across all major categories of loans through July and that bank lending has continued to expand despite recent weeks' market volatility. Banks as well as businesses are awash in liquidity, but should liquidity begin to dry up in earnest, the Fed and other central banks have the tools that worked in 2008.

Moreover, the still-low level of cyclically sensitive demand reduces the risk of a new sharp drop in GDP. The most extreme example of this is residential construction where a further decline of the magnitude normally seen during a recession is physically impossible. With employment still at the same level as in 2004 and GDP back at 2008 levels, there also seems to be no apparent need for businesses to shed jobs very aggressively, unless demand collapses. Finally, historically very high private sector savings act as a buffer for the economy. Thus, in the event of a new shock, households and businesses could more easily than previously absorb it by cutting their savings instead of their spending.

Sovereign debt crisis key recession risk in Euro area

The risk of a recession in the Euro area is closely linked to the risk of a recession in the US, but a further deterioration of the sovereign debt crisis could also trigger a drop in economic activity. Here the slowdown in global growth and the general deterioration in risk appetite have also hit Euro-area growth prospects, and in turn this has led to increasing investor concern about the ability of Euro-area member states to successfully consolidate public finances.

The latest round of turbulence has implicated both Italy and Spain, the 3rd and 4th largest economies in the Euro area, and once again the debt crisis threatens to lead to a new round of credit tightening from Euro-area banks. For the moment, the ECB has successfully managed to contain Italian and Spanish yields by reactivating its Securities Markets Program, but this has been done on the express condition that the European Financial Stabilisation Fund (EFSF) will take over the responsibility shortly. This awaits the approval of the EFSF's new powers by national parliaments, a process that is unlikely to be completed before the beginning of October – at the earliest.

Even if the EFSF begins to purchase bonds later this fall, it remains questionable if this approach will quell the debt crisis on its own. If the ECB/EFSF should end up with the same holdings of Italian and Spanish bonds as the 10-15% of Greek, Irish and Portuguese bonds estimated to be held by the ECB, the ECB/EFSF would have to purchase for EUR 230bn Italian bonds and for EUR 85bn Spanish bonds, an amount which would quickly drain remaining reserves at the EFSF. In addition, it is worth remembering that the ECB's bond purchases in the three smaller peripherals could not prevent a general upward drift in yield spreads.

The resurgence of the debt crisis has already led to a new round of austerity measures, and this creates a risk of recession in the member states concerned, particularly Italy and Spain. For the Euro area as a whole the risk of a recession primarily pertains to a further tightening of credit conditions. Indicators already suggest that funding conditions for Euro-area banks have deteriorated to levels last seen during the Great Recession, and this could easily spill over to lending conditions for households and firms.

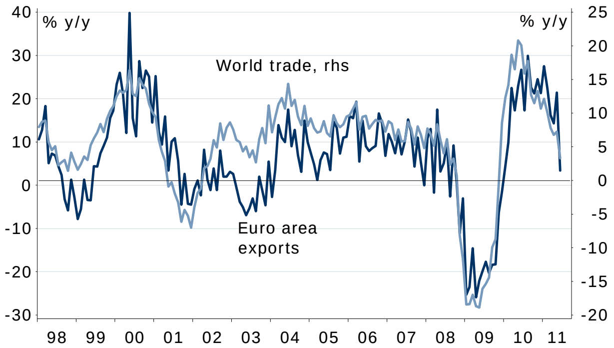
In a risk scenario, a new round of credit tightening among Euro-area banks leads to a liquidation of business inventories and a curtailment of business investments. As in the aftermath of the Lehmann collapse in September 2008, such a situation might lead to a further drop in risk appetite, causing overall liquidation of inventories across the globe. Such a drop in global demand would also feed back to the Euro area through lower exports and could also affect the export-oriented German economy.

Under such a scenario we would expect GDP to decline by 0.1% in 2012 compared to our baseline forecast of 0.6% growth next year. For 2013 we would expect growth to turn positive again, although the rebound in activity would most likely be dampened by the need for additional fiscal tightening. Consequently we would expect to see growth just above 1% compared to our baseline forecast of 1.8% growth in 2013.

CDS premia for European banks at Lehman levels

Source: Nordea Markets and Reuters Ecowin

A drop in world trade would hurt Euro area exports



Source: Nordea Markets and Reuters Ecowin

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Slowdown can push oil prices below USD 85/barrel threshold

A severe slowdown in global economic activity will cut oil demand markedly and thereby trigger a sharp fall in oil prices. During the financial crisis the Brent oil price fell by 75% to USD 36.6/barrel in December 2008 from USD 146/barrel in July. If we assume that the recent increase in uncertainty and the weaker economic performance of the US and the Euro zone will push the world economy into a prolonged period of low economic growth, do we expect a new collapse in the oil price?

Assuming that global GDP growth will be 0.5% lower in 2011 and 2% lower in 2012 than in our baseline scenario, oil demand is expected to be reduced by 400k in 2011 and 1.4mb/d in 2012. A new economic downturn will clearly trigger a sharp fall in oil demand, but in our opinion a few recent developments in the oil market may have a counterbalancing effect on the fundamental situation, thereby preventing oil prices from falling to the lows seen in 2008.

First, OPEC has not changed its official output quota since January 2009 when the cartel agreed to cut 4.2 mb/d. The cartel does not need to coordinate new production quotas before it can start reducing its output if demand conditions deteriorate to a level where the market becomes oversupplied. Second, we expect OPEC to cut oil production at an earlier stage of a new recession cycle. Huge spending packages to try to prevent further uprising in the MENA region have in our opinion pushed up OPEC's breakeven price of oil – the price at which its budget is balanced while accommodating greater public spending. In 2009 OPEC's unofficial oil price target was USD 70-90/barrel, but we now expect this unofficial price range to have moved to around USD 85-105/barrel. Saudi Arabia, the cartel's ultimate leader, needs an oil price of around USD 85/barrel to balance its budgets. Third, the refilling of the emergency inventories after the IEA stock release will contribute to tighten the market. In addition, as prices drop we would not be surprised if China uses this opportunity to fill up its strategic petroleum reserves (SPRs).

How far can oil prices fall before we see cuts in oil investments? The global average marginal cost of a new project is around USD 85/barrel, but it varies markedly around the world. For example in the North Sea the marginal cost averages around USD 50-70/barrel compared to USD 20-40/barrel in the low-cost Middle East. If the oil price falls below the marginal cost, new projects may be put on hold or cancelled. This in turn will reduce activity in the oil sector and cut demand for upstream and downstream services. Falling costs may counterbalance the drop in investments, but with a lag.

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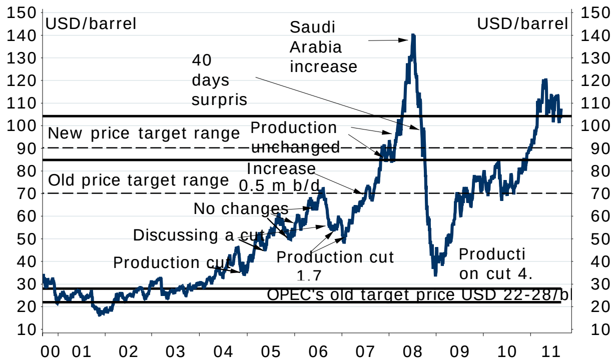
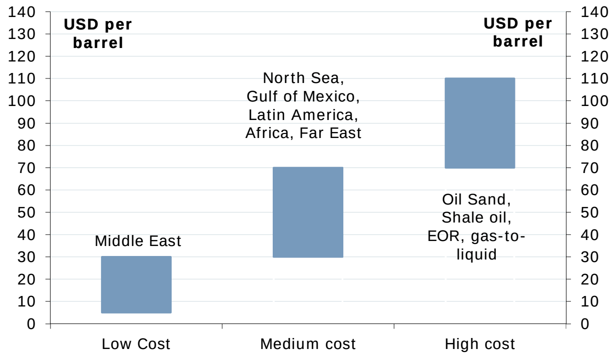
Oil price Brent – low-growth scenario (USD/barrel)

	Q1	Q2	Q3	Q4	Year
2010	77	79	77	88	80
2011E	106	115	110	95	107
2012E	80	70	72	75	74
2013E	80	82	85	87	84

OPEC's new unofficial price range

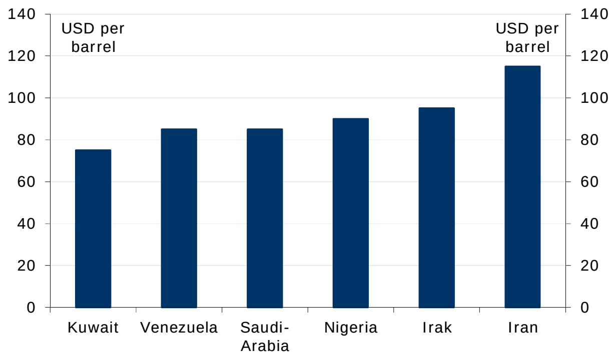


Marginal cost of a new barrel of oil



Source: PIRA and Nordea Markets

Indicative oil price to balance budgets – OPEC



Source: PIRA and Nordea Markets

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