ECONOMIC OUTLOOK

JANUARY 2011

In smooth waters

Nordic tiger economies

■ The economies in the Nordic region have now really shifted into a higher gear, led by Sweden.

Strong international recovery

■ The US is finally pulling out of the crisis and Asia seems unstoppable. Europe is still fighting with the debt crisis, but Germany is running at full steam.

Data overview

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Nordic economies

Major economies

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In smooth waters

Here at the onset of 2011 there is extra reason to pop the champagne corks, as the global economy came out of 2010 in even better shape than expected. The quite clear signs of a slowdown during the summer luckily soon evaporated and were replaced by renewed progress. This was achieved partly as a result of the pragmatic and growth-oriented economic policy in both the US and the Euro area, but also partly because the underlying strength in the Far East and other Emerging Markets economies proved sufficiently robust to withstand the initiated monetary policy tightening. Against this background, we have revised up our 2011 growth outlook, but this year nonetheless looks set to become very interesting. Not least because the upswing is challenged by the announced budget consolidation measures in most European countries and the surge in commodity prices. We therefore see 2011 as a transition year with global growth abating relative to 2010 before showing renewed strength in 2012.

US turnaround

Our growing optimism is largely based on the performance of the US economy. Recent economic indicators have unequivocally pointed to an accelerating upswing, which is now supported by additional fiscal policy easing: Congress has decided to extend the Bush administration's tax cuts, which would otherwise have expired at end-2010, and new stimulus measures in the form of new tax cuts of almost USD 200bn have been adopted.

In addition, Fed Chairman Ben Bernanke has now really proved to the world why his old nickname "helicopter Ben" was not randomly chosen. The printing press has been allowed to roll at an unprecedented speed and in step with banks easing credit standards for the small and medium-sized enterprises that are so vital for US job creation, the likelihood increases of a strong, self-sustaining economic upturn in the world's largest economy during the forecast period. In this connection the ongoing consolidation of households' financial position over the past two years could turn out to be crucial, as consumer spending accounts for nearly 70% of overall economic activity in the US.

Dual Europe

While the US continues to pump out money to finally pull out of the economic crisis, the approach is entirely different in Europe. Here the Growth and Stability Pact leaves no room for further fiscal policy easing. On the contrary, nearly all the EU countries will have to consolidate public finances, although the requirement varies greatly. The most severe belt-tightening in coming years is needed in the southern European countries, Ireland and the UK, while for example Germany needs much less drastic measures. The latter is a major benefit for the economic outlook for the old Continent, as Germany is by far the largest economy and a key trading partner for almost all the other countries.

The Euro area ended up in the eye of the hurricane last year as a result of the sovereign debt crisis, which will very likely continue to be a theme in financial markets for a long time yet. However, we do not think that the Euro area is on the brink of an imminent breakdown. One reason is that the Euro-area countries have become more unified during the crisis, which most recently was demonstrated at the December summit with the adoption of the permanent stability facility as a bailout for countries threatened by bankruptcy. Moreover, the ECB has gained more power and is now the main source for ensuring liquidity in countries whose banking sectors are still under severe pressure. And lastly it should not be underestimated that EMU is a decisive means to achieve the target set some 60 years ago of a political union in Europe. That project will not be abandoned based on one crisis.

Given the fiscal policy tightening we project quite weak growth in the Euro area during the forecast period, but with great variance among the countries. Central and northern European countries will experience quite decent growth, while the crisis sentiment will linger south of the Alps and in Ireland.

Asian bumper year

The rapidly growing Asian economies, headed by China, seem unstoppable at the moment. This has heightened the risk of overheating and led to significant monetary policy tightening in both India and China. In China not least because of skyrocketing house prices. Still, we do not fear an actual economic setback, as we expect that the Chinese authorities will be able to steer the country safely through the twelfth 5-year plan with growth rates steady at the 8-9% mark. At the same time, growth rates in the other BRIC countries, Brazil, Russia and India, will remain at high levels.

Record-high commodity prices threaten upswing

The high growth in 2010 has triggered a veritable explosion in commodity prices. We pointed to the risk of a price shock in the September issue of *Economic Outlook* and since then commodity prices have overall risen to a historically high level. This constitutes a clear risk for the outlook for growth and inflation in the slightly longer term. The rapidly increasing oil price is particularly worrying. Experience shows that when oil prices reach about USD 115-120 USD per barrel, economic growth is significantly curbed, as companies' costs rise sharply and households' purchasing power is eroded. Oil prices currently hover around USD 100, and it cannot at all be ruled out that the upward trend will continue.

The rising commodity prices threaten to lift consumer prices markedly in the developing countries where demand for basic goods makes up a relatively large share of overall consumer spending. This could lead to social unrest and restrictions on the countries' commodity exports, in turn leading to further price increases and an economic setback in the rest of the world. At this juncture trends in commodity markets therefore constitute one of the main risks to a stable and sustainable upswing in the global economy.

Monetary policy – a catch 22 situation

The mounting inflation via commodity prices entails huge challenges for the world's central banks, as the timing of the anticipated monetary policy tightening is further complicated. The diverse growth prospects for the individual countries in the Euro area means that the ECB is already walking a tightrope, and the Fed's double mandate to take both labour market conditions and inflation into account threatens to leave the otherwise notoriously forward-looking central bank further behind the curve than what in any way feels comfortable. For as long as the extremely lenient monetary policy is still pursued, the risk increases that ample liquidity will cause bubbles to emerge in financial markets, commodity markets and in some countries also housing markets. In this way, the world's leading central banks appear to be caught in a scary catch 22 situation. If interest rates are hiked too soon and too aggressively, asset market bubbles could be prevented, but the tentative upswing may be choked. If interest rates are hiked too late, the bubbles may emerge, with resultant fresh losses in the financial sector and the real economy when price corrections start.

We expect the ECB to hike its policy rate in Q3 this year but with full allotment of liquidity throughout 2011 due to the persistent difficulties in procuring liquidity for the banks in the most debt-ridden countries. On the other hand, we do not expect the Fed to end its QE strategy until mid-2011, subsequently hiking rates towards the end of the year. But the Fed will be more aggressive than the ECB. Towards the end of the forecast period we therefore expect the fed funds rate to stand at 3%, while the ECB's policy rate will only be 2.5%. This will also contribute to further USD appreciation versus the EUR during the forecast period where we will also see generally higher long yields.

Nordic tiger economies

The Nordic economies have now really shifted into a higher gear, led by the Swedish tiger economy, which has delivered impressive growth rates over the past year and which looks set to become the show case for the entire OECD area in terms of policy and economy. But all the Nordic countries are in a relatively favourable situation thanks to their generally healthy public finances.

After the deep recession in 2009 the **Swedish economy** recovered sharply in 2010. The export industry benefitted from the improvement in global trade, but export growth is expected to dampen from previous strong records. Households' financial position is in good shape, boosting private consumption. Investment started to pick up in 2010 and will increase further just like employment will. However, there are now increasing risks of bottlenecks in the labour market. Public finances have strengthened along with rising employment and are seen reaching the target of a 1% surplus of GDP as early as in 2011. Inflation will increase on the back of rising energy prices and higher wages. The Riksbank hiked the repo rate four times in 2010 to currently 1.25%. Further hikes are in the pipeline, leaving the repo rate at 2.5% in December 2011 and 3.5 % by the end of 2012.

A strong finish to last year means that growth in **Norway** in 2010 will be somewhat stronger than originally expected. Stronger momentum into 2011, somewhat better labour market conditions and prospects of very robust growth in oil investment have also led us to revise up our 2011 growth outlook. With stronger growth, unemployment may have peaked, but we may have to wait until 2012 for unemployment to decline. Labour shortages are thus not likely to be a major problem. Inflation looks set to remain relatively low although it will edge higher. Norges Bank will cautiously normalise interest rates in step with the pick-up in growth and capacity utilisation. With the global low interest rate regime, Norwegian rates will rise only moderately in 2011, but the pace could increase in 2012. The NOK will remain relatively strong, but in trade-weighted terms it will be somewhat weaker than the strong levels around the turn of the year.

After the massive setback in 2009, economic growth returned soundly to positive territory in **Denmark** in 2010. The contours of a broadly based upswing have emerged with five consecutive quarters of positive growth so far. On the threshold to the election year of 2011 consumers and businesses have stepped up a gear, and the course is set for a continued rebound in the Danish economy.

The economic outlook in **Finland** is positive. Rapid expansion of important trading partners' economies (Germany, Sweden and Russia) suggests that demand for Finnish exports remains strong, especially as demand is expected to shift more towards investment goods. Fairly decent growth in private consumption is supported by high household confidence, a fall in savings and improvement in employment. Following a rise in manufacturing capacity utilisation rates, a gradual recovery in machinery investment is expected. The projected favourable economic growth, 3% in 2011 and 3.4% in 2012, is not sufficient to turn the public sector financial deficit into a surplus by 2012

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Growth, %

	2008	2009	2010E	2011E	2012E
World[1)]	2.2	-1.0	4.3	4.0	4.2
BIG-3[2)]	-0.1	-3.5	2.4	2.4	2.6
USA	0.0	-2.6	2.9	3.3	3.3
Japan[3)]	-1.2	-5.2	2.8	1.5	2.0
Euro area	0.3	-4.0	1.7	1.6	2.0
Germany	0.7	-4.7	3.5	2.5	2.2
France	0.1	-2.5	1.6	1.5	2.0
Italy	-1.3	-5.1	1.1	1.1	1.6
Spain	0.9	-3.7	-0.2	0.5	1.8
Netherlands	1.9	-3.9	1.7	2.0	2.4
Belgium	1.0	-2.8	2.0	1.8	2.2
Austria	2.2	-3.4	2.0	1.8	2.5
Portugal	0.0	-2.6	1.3	-1.0	1.0
Greece	2.0	-2.3	-4.3	-3.0	1.0
Finland	0.9	-8.0	3.0	3.0	3.4
Ireland	-3.5	-7.6	-0.2	0.8	2.2
UK	-0.1	-4.9	1.7	1.8	2.0
Denmark	-1.1	-5.2	2.2	1.8	1.9
Sweden	-0.6	-5.3	5.5	4.5	2.8
Norway	1.8	-1.3	2.0	3.0	3.1
Russia	5.6	-7.9	4.1	5.4	5.7
Poland	5.0	1.7	3.9	3.8	4.1
Estonia	-5.1	-13.9	2.4	4.2	4.0
Latvia	-4.2	-18.0	-0.1	3.0	4.2
Lithuania	2.9	-14.7	1.2	3.0	3.8
Hungary	0.6	-6.5	0.9	3.2	3.4
Czech Republic	2.3	-4.0	2.5	3.1	3.8
Turkey	0.7	-4.7	7.5	5.1	5.5
China	9.6	9.1	10.1	8.7	8.9
India	5.1	7.7	9.2	8.7	9.3
Brazil	5.2	-0.7	7.6	4.5	4.7

Inflation, %

	2008	2009	2010E	2011E	2012E
World	4.7	0.7	2.6	2.7	2.5
BIG-3	3.3	-0.3	1.3	1.3	1.5
USA	3.8	-0.3	1.7	1.4	1.7
Japan[3)]	1.4	-1.4	-1.0	-0.3	0.2
Euro area	3.3	0.3	1.6	2.0	1.7
Germany	2.8	0.3	1.3	1.8	1.6
France	3.2	0.1	1.7	2.2	1.8
Italy	3.5	0.6	1.6	2.0	1.7
Spain	4.2	-0.3	1.8	1.8	1.0
Netherlands	2.2	1.0	1.0	2.2	1.6
Belgium	4.5	0.0	2.3	2.4	1.6
Austria	3.2	0.4	1.7	2.3	1.6
Portugal	2.7	-0.9	1.4	2.1	1.2
Greece	4.3	1.3	4.6	2.7	0.5
Finland	4.1	0.0	1.2	2.5	2.1
Ireland	3.1	-1.7	-1.6	0.3	1.0
UK	3.6	2.2	3.2	3.0	1.8
Denmark	3.4	1.3	2.3	2.0	2.0
Sweden	3.4	-0.5	1.2	2.7	3.0
Norway	3.8	2.1	2.4	1.8	2.0
Russia	14.1	11.7	6.9	7.7	7.5
Poland	4.3	3.7	2.5	3.4	2.2
Estonia	10.6	-0.1	3.0	3.6	2.5
Latvia	15.3	3.6	-1.1	2.9	2.6
Lithuania	11.1	4.2	1.3	2.6	2.4
Hungary	6.0	4.2	4.9	2.8	3.0
Czech Republic	6.3	1.0	1.5	2.7	2.3
Turkey	10.4	6.3	8.6	6.0	5.5
China	6.0	-0.7	3.3	4.5	4.0
India	9.1	2.1	9.2	6.0	5.0
Brazil	5.7	4.9	5.0	5.2	4.8

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

2) US, Japan and the Euro area

3) Source: IIMF WE October 2010

Public finances, % of GDP

	2008	2009	2010E	2011E	2012E
BIG-3	-2.9	-8.7	-8.0	-7.1	-5.6
USA	-3.2	-10.0	-8.9	-8.4	-6.1
Japan[3)]	-4.2	-10.3	-9.6	-8.9	-8.1
Euro area	-2.0	-6.3	-6.3	-4.6	-3.9
Germany	0.0	-3.3	-4.3	-3.3	-2.3
France	-3.3	-7.5	-7.5	-6.2	-4.8
Italy	-2.7	-5.3	-5.0	-4.4	-3.5
UK	-5.0	-11.4	-10.5	-8.0	-6.0
Finland	4.2	-2.7	-3.1	-2.0	-1.3
Denmark	3.3	-2.8	-3.6	-4.5	-3.3
Sweden	2.2	-1.0	0.1	1.1	1.7
Norway	19.3	11.0	11.3	12.0	14.5
Russia	4.1	-5.3	-4.2	-2.8	-2.0
Poland	-3.7	-7.2	-8.3	-6.0	-4.5
Estonia	-2.8	-1.7	-1.5	-2.0	-1.5
Latvia	-4.2	-10.2	-7.9	-5.4	-3.0
Lithuania	-3.3	-9.2	-7.8	-5.8	-3.0
Hungary	-3.7	-4.4	-3.8	-2.9	-3.0
Czech Republic	-2.7	-5.8	-5.1	-4.5	-3.5
Turkey	-1.8	-5.5	-5.2	-4.5	-4.0
China	-0.4	-2.1	-3.0	-2.4	-1.9
India	-6.0	-6.5	-7.0	-6.0	-5.0
Brazil	-1.6	-3.2	-2.7	-2.5	-2.0

Current account, % of GDP

	2008	2009	2010E	2011E	2012E
BIG-3	-	-	-	-	-
USA	-4.7	-2.7	-3.3	-3.2	-3.7
Japan[3)]	3.2	2.8	3.1	2.3	2.3
Euro area	-1.5	-0.6	-0.3	-0.3	-0.2
Germany	6.7	5.0	4.9	5.1	4.8
France	-2.7	-2.9	-2.5	-2.3	-1.9
Italy	-3.4	-3.2	-3.0	-2.9	-2.7
UK	-1.6	-1.7	-2.5	-2.0	-1.5
Finland	3.5	2.7	2.0	2.0	2.1
Denmark	2.7	3.6	5.3	4.2	3.8
Sweden	8.9	6.8	6.2	6.4	6.4
Norway	17.7	13.1	13.2	13.8	16.1
Russia	6.2	3.9	4.7	3.5	2.7
Poland	-4.8	-2.1	-2.3	-3.1	-4.7
Estonia	-8.8	4.5	3.8	0.8	0.1
Latvia	-13.1	8.6	4.0	-0.1	-0.8
Lithuania	-13.1	2.6	1.3	-0.2	-0.3
Hungary	-7.3	-0.5	2.2	-0.5	-2.0
Czech Republic	-0.6	-1.0	-2.5	-2.9	-3.5
Turkey	-5.8	-2.3	-5.6	-6.0	-6.0
China	9.6	6.1	5.2	4.4	3.7
India	-2.2	-2.1	-2.9	-3.0	-3.0
Brazil	-1.8	-1.5	-2.5	-3.0	-3.0

Monetary policy rates

	13.1.11	3M	6M	12M	24M
US	0.25	0.25	0.25	0.75	3.00
Japan	0.10	0.10	0.10	0.10	0.50
Euro area	1.00	1.00	1.00	1.50	2.25
Denmark	1.05	1.05	1.05	1.55	2.50
Sweden	1.25	1.75	2.00	2.50	3.50
Norway	2.00	2.00	2.25	2.75	4.00
UK	0.50	0.50	0.50	0.50	2.00
Switzerland	0.25	0.25	0.25	0.50	1.25
Poland	3.50	4.00	4.25	4.75	4.75
Czech Rep.	0.75	0.75	1.00	1.50	2.00
Hungary	5.75	5.75	5.75	6.00	6.50
Turkey	6.50	6.50	7.00	8.00	9.00
Russia	7.75	8.00	8.25	8.75	9.00
China	5.81	6.06	6.31	6.31	6.31
India	6.25	6.75	7.00	7.00	6.00
Brazil	10.75	12.25	12.25	12.25	9.00

Monetary policy rate spreads vs Euro area

	13.1.11	3M	6M	12M	24M
US	-0.75	-0.75	-0.75	-0.75	0.75
Japan[1]	-0.15	-0.15	-0.15	-0.65	-2.50
Euro area	-	-	-	-	-
Denmark	0.05	0.05	0.05	0.05	0.25
Sweden	0.25	0.75	1.00	1.00	1.25
Norway	1.00	1.00	1.25	1.25	1.75
UK	-0.50	-0.50	-0.50	-1.00	-0.25
Switzerland	-0.75	-0.75	-0.75	-1.00	-1.00
Poland	2.50	3.00	3.25	3.25	2.50
Czech Rep.	-0.25	-0.25	0.00	0.00	-0.25
Hungary	4.75	4.75	4.75	4.50	4.25
Turkey	5.50	5.50	6.00	6.50	6.75
Russia	6.75	7.00	7.25	7.25	6.50
China	4.81	5.06	5.31	4.81	4.06
India	5.25	5.75	6.00	5.50	3.75
Brazil	9.75	11.25	11.25	10.75	6.75

1) Spread vs US

3-month rates

	13.1.11	3M	6M	12M	24M
US	0.30	0.40	0.50	1.15	3.25
Euro area	1.00	1.10	1.25	1.85	2.50
Denmark	1.21	1.35	1.50	2.10	2.90
Sweden	2.00	2.50	2.75	3.25	3.60
Norway	2.60	2.54	2.74	3.18	4.39
UK	0.77	0.85	0.95	1.30	2.35
Poland	3.98	4.25	4.50	4.90	5.00
Czech Republic	1.20	1.25	1.50	1.95	2.40
Hungary	5.84	6.00	6.10	6.40	7.00
Russia	4.06	4.30	4.55	5.00	6.00
Latvia	0.84	1.00	1.20	1.50	2.00
Lithuania	1.30	1.50	1.80	2.00	2.30

3-month spreads vs Euro area

	13.1.11	3M	6M	12M	24M
US	-0.69	-0.70	-0.75	-0.70	0.75
Euro area	-	-	-	-	-
Denmark	0.22	0.25	0.25	0.25	0.40
Sweden	1.01	1.40	1.50	1.40	1.10
Norway	1.61	1.44	1.49	1.33	1.89
UK	-0.23	-0.25	-0.30	-0.55	-0.15
Poland	2.99	3.15	3.25	3.05	2.50
Czech Republic	0.21	0.15	0.25	0.10	-0.10
Hungary	4.85	4.90	4.85	4.55	4.50
Russia	3.07	3.20	3.30	3.15	3.50
Latvia	-0.16	-0.10	-0.05	-0.35	-0.50
Lithuania	0.31	0.40	0.55	0.15	-0.20

10-year government benchmark yields

	13.1.11	3M	6M	12M	24M
US	3.35	3.40	3.50	3.60	4.25
Euro area	3.02	3.05	3.25	3.55	3.80
Denmark	3.27	3.20	3.40	3.75	4.20
Sweden	3.24	3.30	3.40	3.70	4.00
Norway	3.80	3.80	3.91	4.15	4.59
UK	3.61	3.60	3.70	3.80	4.10
Poland	6.26	6.00	5.70	5.80	6.00
Czech Rep.	3.95	3.75	3.50	3.75	4.00
Hungary	7.90	8.20	8.00	7.75	8.00

10-year yield spreads vs Euro area

	13.1.11	3M	6M	12M	24M
US	0.33	0.35	0.25	0.05	0.45
Euro area	-	-	-	-	-
Denmark	0.24	0.15	0.15	0.20	0.40
Sweden	0.22	0.25	0.15	0.15	0.20
Norway	0.78	0.75	0.66	0.60	0.79
UK	0.59	0.55	0.45	0.25	0.30
Poland	3.24	2.95	2.45	2.25	2.20
Czech Rep.	0.93	0.70	0.25	0.20	0.20
Hungary	4.88	5.15	4.75	4.20	4.20

Exchange rates vs EUR

	13.1.11	3M	6M	12M	24M
EUR/USD	1.303	1.25	1.25	1.20	1.20
EUR/JPY	108.6	108	113	118	126
EUR/DKK	7.450	7.46	7.46	7.46	7.46
EUR/SEK	8.850	8.60	8.60	9.00	9.00
EUR/NOK	7.721	7.90	7.70	7.90	8.00
EUR/GBP	0.833	0.81	0.83	0.80	0.77
EUR/CHF	1.265	1.25	1.25	1.28	1.33
EUR/PLN	3.844	3.80	3.80	3.90	3.70
EUR/CZK	24.38	24.5	24.3	24.3	24.0
EUR/HUF	276.0	275	275	280	270
EUR/TRY	2.04	2.00	1.95	2.00	2.00
EUR/RUB	39.39	37.1	36.4	35.0	32.8
EUR/LVL	0.701	0.70	0.70	0.70	0.71
EUR/LTL	3.453	3.45	3.45	3.45	3.45
EUR/CNY	8.605	8.23	8.10	7.56	7.03
EUR/INR	58.71	55.6	55.0	54.0	52.8
EUR/BRL	2.187	2.13	2.19	2.04	1.98

Exchange rates vs USD

	13.1.11	3M	6M	12M	24M
-					
USD/JPY	83.37	86.0	90.0	98.0	105
USD/DKK	5.717	5.96	5.96	6.21	6.21
USD/SEK	6.792	6.88	6.88	7.50	7.50
USD/NOK	5.925	6.32	6.16	6.58	6.67
GBP/USD	1.565	1.54	1.50	1.50	1.55
USD/CHF	0.971	1.00	1.00	1.07	1.11
USD/PLN	2.950	3.0	3.0	3.3	3.1
USD/CZK	18.71	19.6	19.4	20.2	20.0
USD/HUF	211.8	220	220	233	225
USD/TRY	1.57	1.53	1.50	1.53	1.53
USD/RUB	30.23	29.7	29.1	29.2	28.5
USD/LVL	0.538	0.56	0.56	0.59	0.59
USD/LTL	2.650	2.76	2.76	2.88	2.88
USD/CNY	6.604	6.58	6.48	6.30	5.86
USD/INR	45.06	44.5	44.0	45.0	44.0
USD/BRL	1.678	1.70	1.75	1.70	1.65

Economy entering a new phase

- Decent growth despite less stimulus
- Strong labour market with risk of bottlenecks
- Repo rate to be hiked to 2.50% in 2011

Maturing business cycle

The Swedish economy recovered in 2010. Both GDP and employment returned to pre-crisis levels, public finances balanced again and the Riksbank phased out the extraordinary support measures for the financial system.

We look for continued decent growth, implying an additional increase in capacity utilisation. That will sharpen the focus on the economy's capacity to grow. In our view, the portion of idle resources in the economy should not be overestimated – not least because there are signs that structural unemployment has risen. Moreover, the strong trend will lead to a reduction in the previously massive stimulus measures, which will dampen growth from last year's record level. The Riksbank has already sanctioned a string of rate hikes and is expected to take its foot further off the accelerator going forward. The fiscal policy stance will shift from being highly expansionary to neutral during 2011. Moreover, SEK appreciation will contribute to a less accommodative environment.

The Riksbank will continue to raise interest rates in 2012. But strong public finances will make it possible to implement fiscal policy reform of a corresponding SEK 15bn, mainly as tax cuts for households. All in all, GDP growth is estimated to exceed the long-term trend also in 2012.

Broadly based upswing

Households have first and foremost benefited from recent years' expansionary policy line with low interest rates and tax cuts. The reduced stimulus in 2011 is offset by higher incomes via rising employment. Towards the end of the forecast period, hourly wages will also increase faster. At that time the anticipated tax breaks will also boost household finances, with an increase in real disposable income of about 3% annually in 2011 and 2012 despite sharply rising interest expenses. The household consumption climate is thus still favourable.

Households' improved finances are also reflected in the housing market. The decline in home prices during the crisis was negligible and residential construction has rebounded strongly, which is a key reason why investment activity rose as early as during 2010. Several service sectors expanded, and a reversal in manufacturing industry investment is by all accounts imminent. Continued increases in production, high corporate profits and strong confidence suggest that the broadly based upswing in investment activity will continue.

The strong rebound in foreign trade was a key factor behind the very high GDP growth in 2010. Indicators are still strong but the initial sharp upward move from the depressed levels after the crisis seems to be over. Exports will increase at a healthy clip in coming years, as export markets are expected to expand more rapidly than the past 15 years' average.

Tighter labour market

The robust economic growth has fuelled demand for labour. The steadily increasing number of vacant jobs and companies' still very optimistic hiring plans suggest that the upturn will continue. We look for an increase in employment of around 2% in 2011, which is a steep increase in a historical perspective.

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

	2007 (SEKbn)	2008	2009	2010E	2011E	2012E
Private consumption	1,460	0.0	-0.4	3.5	3.5	2.8
Government consumption	797	1.0	1.7	2.1	1.7	0.5
Fixed investment	612	1.4	-16.3	5.0	9.5	6.1
- industry	95	-0.2	-22.2	-5.5	13.9	8.9
- residential investment	121	-13.1	-23.3	17.5	14.0	8.0
Stockbuilding*	23	-0.5	-1.5	2.2	-0.1	-0.4
Exports	1,621	1.7	-13.4	11.0	7.0	6.4
Imports	1,388	3.5	-13.7	12.3	6.3	6.0
GDP		-0.6	-5.3	5.5	4.5	2.8
Nominal GDP (SEKbn)	3,126	3,204	3,089	3,302	3,510	3,684
Unemployment rate, %		6.2	8.3	8.4	7.3	6.8
Employment growth		1.1	-2.1	1.0	1.9	1.0
Consumer prices, % y/y		3.4	-0.5	1.2	2.7	3.0
Underlying inflation (CPIF), % y/y		2.7	1.7	2.0	1.8	1.8
Hourly earnings, % y/y		4.6	3.0	1.2	3.2	4.2
Current account (SEKbn)		286	210	204	224	234
- % of GDP		8.9	6.8	6.2	6.4	6.4
Trade balance, % of GDP		3.6	3.2	2.7	3.1	3.4
General govt budget balance (SEKbn)		71	-30	4	40	62
- % of GDP		2.2	-1.0	0.1	1.1	1.7
Gross public debt, % of GDP		37.7	42.1	41.6	39.4	37.6

* Contribution to GDP growth (% points)

Although employment had largely regained the ground lost as early as by the end of 2010, unemployment is still markedly higher than before the crisis. The reason is recent years' unusually strong inflow to the labour force. Changes in the unemployment insurance system, the in-work tax credit and the health insurance reform have probably resulted in more people entering the labour market. For demographical reasons the labour force will expand at a much lower pace in future. The increase in employment will therefore have a growing impact on unemployment data going forward.

The level of structural unemployment is subject to much uncertainty. The labour market reforms are expected to boost participation in the labour force and help reduce unemployment in the long term. However, there is reason to believe that structural unemployment has risen near term. According to our estimates, structural unemployment is currently some 7%, a level that actual unemployment will have reached by the end of 2011.

More rate hikes and continued SEK strength

It is worth noting that some pay deals will expire in the autumn this year. However, the rounds of pay talks will not peak until H1 2012. The coming pay talks will take place against a very different backdrop than the previous round. Labour market conditions will be tighter, corporate profits have been record high and compensation for previous crisis deals will likely be demanded. We expect total wage increases to exceed 4% in 2012.

Wage increases are currently low, but with rising capacity utilisation wage costs, and in turn inflation, will increase during the forecast period. Near term higher energy prices and more expensive food will contribute to CPIF inflation, the Riksbank's favourite measure, being in line with the target in 2011. Much therefore suggests that the Riksbank will not only scale back its monetary policy stimulus measures but also adopt a more restrictive policy line. We expect the repo rate to stand at 2.50% at the end of 2011 and 3.50% at the end of 2012.

The high growth, the Riksbank's rate hikes and the relatively strong public finances contributed to the significant SEK appreciation in 2010. The same factors suggest continued SEK strength, while improved international economic conditions and stronger expectations of rate hikes from other central banks pull in the opposite direction. We expect the SEK to trade at 9.00 against the EUR on a 12-month outlook.

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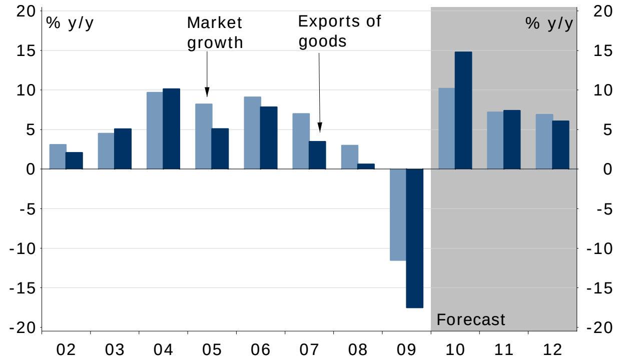
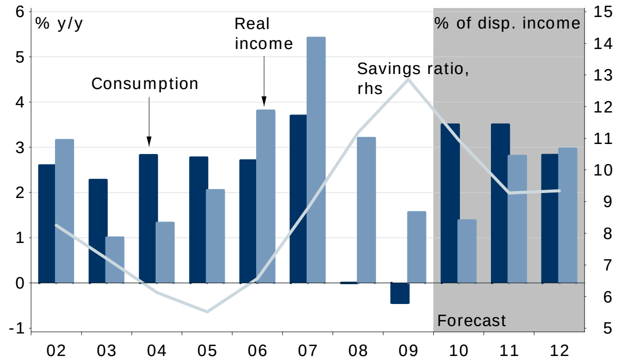
Strong growth in Sweden's export markets

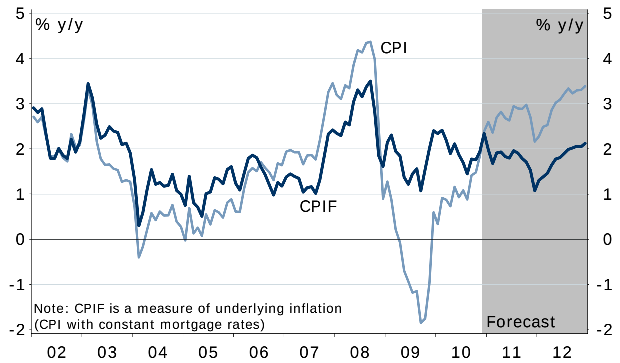


Large room for spending



Rapidly declining unemployment

Inflation in line with target in 2011



Consumers support economy after all

- Strong growth in demand and production
- No inflation pressures and relatively low inflation
- Norges Bank will progress cautiously

In 2010 we revised down our forecast for economic growth as consumer spending growth looked set to be weaker than originally assumed. But based on revisions to the historical data and a strong trend towards the end of 2010, the pace of both demand and production growth appears to have been stronger than expected. In light of the stronger momentum into 2011, the improved labour market situation and prospects of very strong growth in oil investment, we have also revised up our growth forecast for 2011, while our relatively optimistic view on 2012 remains intact. All in all, the scene is thus set for relatively strong growth in Norway in 2010-2012.

With stronger growth, unemployment should have peaked, we think. But a marked decline in joblessness is not very likely until 2012. Labour shortages and capacity constraints are not likely to be a major problem over the next 18-24 months. Inflation looks set to remain relatively low although it will edge higher. Norges Bank will cautiously normalise interest rates in step with the pick-up in growth and capacity utilisation. With the global low interest rate regime, Norwegian rates will rise only moderately in 2011, with the central bank acting slightly more aggressively in 2012.

Not so cautious consumers

Consumption growth in the autumn of 2010 was higher than we had expected. Consumer confidence has improved, and home prices rose sharply during the last months of 2010. With unemployment stabilising at a relatively low level and wage growth gradually rising, there are indications that consumption growth could be relatively high in the next few years. But consumption in early 2011 may show signs of weakness as high electricity bills erode consumers' purchasing power. When electricity prices move lower during the spring, consumer spending may regain momentum and periodically grow faster than the underlying trend.

A strong rebound in oil investment on the cards

The decline in oil investment in 2010 have been sharper than expected, but judging from Statistics Norway's oil investment survey the rebound in 2011 should be that much stronger. Based on investment plan surveys, commercial building starts data, the low interest rates and less restrictive credit standards as well as the overall brighter economic prospects, business investment in the mainland economy also looks set to rise, although several factors suggest that it will take place at a moderate pace. Investment activity except in the manufacturing industry is already at a relatively high level, and in many sectors there may still be idle capacity. Against the backdrop of low interest rates, a benign labour market outlook home prices should pick up further in 2011. Higher home prices will likely boost residential construction activity.

Good export growth; very strong import growth

We have revised up our growth forecasts for some of Norway's key trading partners. Still, growth in traditional exports is not likely to be as strong as in 2010 when world trade started to recover from the crisis. As a result of a sharp increase in import-intensive domestic demand components, growth in imports in 2011 will significantly outstrip that in exports.

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

	2007 (NOK bn)	2008	2009	2010E	2011E	2012E
Private consumption	940	1.6	0.2	3.4	3.3	3.0
Government consumption	447	4.1	4.7	3.1	2.0	2.0
Fixed investment	504	2.0	-7.4	-6.7	7.0	5.1
- gross investment, mainland	376	-1.4	-11.7	-4.4	4.5	4.3
- gross investment, oil	113	5.5	9.9	-12.0	15.0	8.0
Stockbuilding*	33	-0.3	-2.6	2.7	0.0	0.0
Exports	1,040	1.0	-4.0	-1.8	1.0	1.5
- crude oil and natural gas	480	-2.0	-1.2	-6.0	-0.6	-0.6
- other goods	302	4.2	-8.2	5.8	3.0	4.3
Imports	691	4.3	-11.4	9.4	4.8	3.7
GDP	2,272	0.8	-1.4	-0.1	2.2	2.3
GDP, mainland	1,724	1.8	-1.3	2.0	3.0	3.1
Unemployment rate, %		2.6	3.2	3.5	3.5	3.4
Consumer prices, % y/y		3.8	2.1	2.4	1.8	2.0
Core inflation, % y/y		2.6	2.6	1.4	1.6	2.2
Annual wages (incl. pension costs), % y/y		6.0	4.2	3.5	4.0	4.3
Current account (NOKbn)		449.1	311.8	327.4	367.7	470.3
- % of GDP		17.7	13.1	13.2	13.8	16.1
Trade balance, % of GDP		19.1	14.8	13.6	13.8	16.1
General govt budget balance (NOKbn)		486.7	262.0	280.0	320.0	425.0
- % of GDP		19.3	11.0	11.3	12.0	14.5

* Contribution to GDP growth (% points)

Slightly higher, but moderate wage/price growth

Despite strong growth in 2011 and 2012, unemployment is not likely to decline markedly until 2012 because the labour supply will increase and employment growth will be moderate. Many employers held on to their staff during the downturn and they can now increase production through more efficient resource utilisation and increased average working hours.

We expect wage growth to pick up slightly over the next few years as a result of a gradually tighter labour market situation. But with a more balanced labour market, wage growth will hardly be as high as before the financial crisis. And with benign productivity growth and moderate wage growth core inflation should remain relatively low, although it will rise somewhat. The effect of the NOK appreciation on prices of imported goods will gradually fade.

Cautious normalisation

In response to strong growth and prospects of rising capacity utilisation Norges Bank will resume its gradual normalisation of interest rates. But with low interest rates internationally and low inflation Norges Bank should progress cautiously in 2011. In 2012 the pace of rate hikes may be accelerated as interest rates globally will begin to move higher and inflation and capacity utilisation have increased.

NOK strength around end-2010 only temporary

Around the turn of the year 2010 the NOK strengthened relatively sharply, with the import-weighted NOK beating Norges Bank's projection. The rising oil prices, increased risk appetite, wider interest rate differential versus other countries and the absence of foreign currency purchases by Norges Bank probably induced investors to take on large speculative NOK positions. When the benign trend in NOK-positive factors fades, many market players will want to trim their positions and the NOK will weaken again. If, contrary to expectations, the NOK should strengthen in Q1, Norges Bank will likely revise down its interest rate forecast in its next Monetary Policy Report in March. Less confidence in further rate hikes by Norges Bank may contribute to weakening the NOK in Q2. Overall, we look for a weaker import-weighted NOK compared to at the turn of the year.

Home prices vs NOK rate – a potential dilemma

If interest rates globally remain low for a longer period than we expect, Norges Bank will most likely progress more cautiously to avoid excessive NOK strength and too low inflation, which could cause home prices to rise excessively and credit growth to pick up again. If Norges Bank when setting interest rates assigns more weight to the risk of financial instability than it did before, a unilateral rate hike and very strong NOK could be the result.

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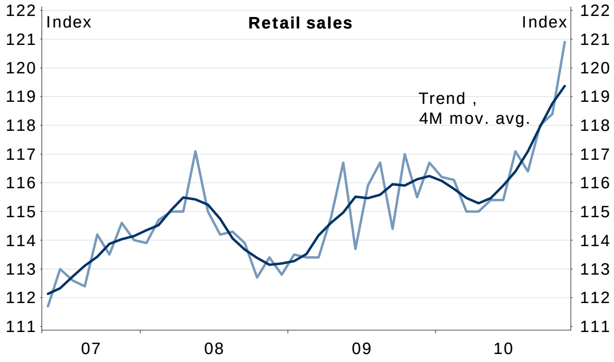
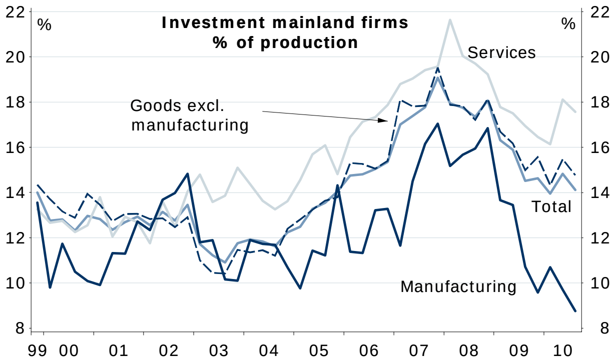
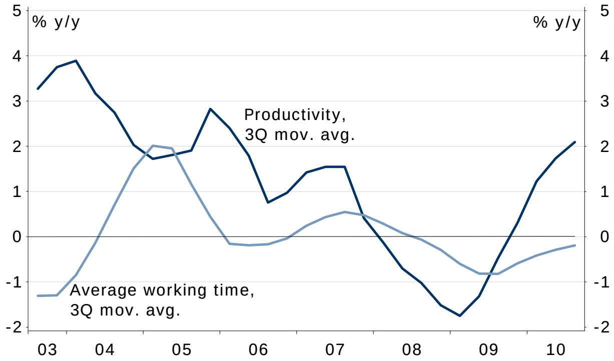
Consumers support the economy after all



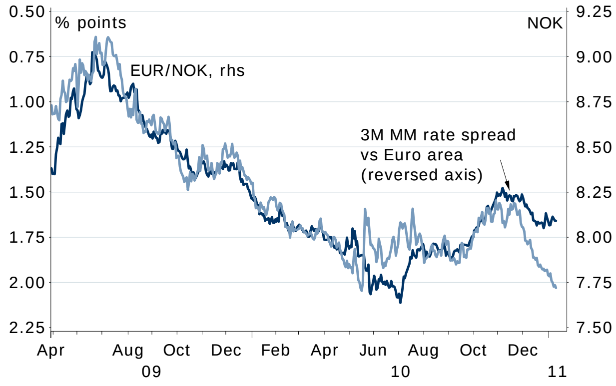
Investment generally at a high level



Productive employees limit employment growth



Strong NOK given the interest rate differential



The course is set

- Broadly based upswing taking shape
- Labour market finally to reverse this year
- Still hope for consumer spending
- Public spending boom over

After the massive setback in 2009, economic growth returned soundly to positive territory in 2010. The contours of a broadly based upswing have emerged with five consecutive quarters of positive growth so far. On the threshold to the election year of 2011 consumers and businesses have stepped up a gear, and the course is set for a continued rebound in the Danish economy.

Labour market finally to reverse this year

The crisis has taken a heavy toll on the Danish labour market. In two years unemployment has more than doubled, employment in the private sector has fallen by 170,000 and wage growth has roughly halved. But despite recent years' gloomy trends, there are growing signs of a near-term labour market reversal. In the private sector we expect continued solid demand in Denmark's key export markets and rising activity in the domestic market to lead to several businesses recruiting more employees. Conversely, we look for a slight reduction in the number of persons employed in the public sector over the coming years in order to ensure the necessary consolidation of public budgets. All in all, we expect unemployment to peak during the summer at less than 175,000 persons (full time), including those engaged in labour market schemes.

Subsequently, unemployment is likely to decline gradually, although jobless numbers (including those engaged in labour market schemes) will not approach the long-term structural level of around 120,000 persons (full time) until 2014 at the earliest.

In the years leading up to the crisis, wages in Denmark rose significantly faster than in other countries. Combined with weak productivity gains, this has eroded Danish companies' competitiveness – however, the fact that many Danish companies operate in markets not very sensitive to price increases has to some extent offset this loss. As a result of the rising unemployment, Danish wage growth is again on a par with wage growth abroad, but this also means that growth in real wages was largely flat in 2010. We expect this trend to continue in coming years, with wage growth probably only just matching inflation.

Optimistic consumers

As neither tax cuts nor appreciable real wage growth are in sight, the outlook for consumer spending over the next few years could seem a little worrying. But fortunately there are other signs of a fairly strong propensity and ability to spend. It is worth noting that Danish households are quite optimistic about the future – the 12-month expectations index is at a high level. Moreover, particularly this year interest expenses should still be low, and the fairly strong wealth gains seen during both 2009 and 2010 will also boost consumer spending. In addition, households increased their savings during the crisis and thus have the option of putting a bit less aside and spending more in stead.

The improving labour market conditions will also lift consumer spending decisively. An interesting wild card at play is the possible reform of the early retirement

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

	2007 (DKKbn)	2008	2009	2010E	2011E	2012E
Private consumption	820	-0.6	-4.5	1.9	1.8	1.7
Government consumption	440	1.6	3.1	1.7	-0.4	0.4
Fixed investment	371	-3.2	-14.3	-4.5	2.3	2.6
- government investment	32	0.8	4.6	14.2	8.4	-7.1
- residential investment	107	-10.9	-16.9	-12.8	-0.8	2.0
- business fixed investment	233	-0.7	-15.8	-4.3	2.2	5.0
Stockbuilding*	25	-0.6	-2.0	1.1	0.2	0.1
Exports	885	2.8	-9.7	2.8	5.4	5.5
Imports	847	2.7	-12.5	2.7	5.2	5.2
GDP		-1.1	-5.2	2.2	1.8	1.9
Nominal GDP (DKKbn)	1,695	1,741	1,657	1,709	1,778	1,832
Unemployment rate, %		1.8	3.4	4.0	4.2	3.8
Unemployment level, '000 persons		48.1	92.2	109.7	115.0	105.0
Gross unemployment level, '000 persons		74.2	129.0	164.5	170.0	160.0
Consumer prices, % y/y		3.4	1.3	2.3	2.0	2.0
Hourly earnings, % y/y		4.5	2.9	2.5	2.0	2.1
Nominal house prices, one-family, % y/y		-4.5	-12.0	3.0	0.0	2.0
Current account (DKKbn)		46.2	59.0	90.0	75.0	70.0
- % of GDP		2.7	3.6	5.3	4.2	3.8
General govt. budget balance (DKKbn)		56.9	-46.5	-62.0	-80.0	-60.0
- % of GDP		3.3	-2.8	-3.6	-4.5	-3.3
Gross public debt, % of GDP		34.1	41.5	44.2	44.5	47.9

* Contribution to GDP growth (% points)

scheme that could end up channelling several billions into additional spending during the forecast period.

Public spending boom over

During the crisis the government pursued a highly expansionary fiscal policy line with sharp increases in both public-sector employment (and in turn public spending) and public investment. However, after the crisis abated, it has turned out to be very difficult to reign in the rapidly swelling public expenditure and according to our calculations the government's target of zero cost growth in 2010 will be overshot by a hefty increase of 1.7%. The latest indicators suggest that the consolidation of public budgets has finally started, though, and against this background we expect public spending to contract by 0.4% in 2011, followed by growth of 0.4% in 2012.

This seems a very ambitious forecast in an election year, not least in a historical perspective with public consumption expenditure notoriously rising more than planned. In our view, though, this is a necessary consolidation aimed at trimming the public budget deficit and ensuring the required scope for expansion in the private sector in the years ahead. But note at the same time that if our forecasts are on the mark, the public-sector consumption pressure (public spending in per cent of GDP) will only ease to around 27% by the end of 2012. This is still a very high level both in an international context and a historical perspective.

Hope even for residential investment

After an extended period of sharp declines things are looking up for business investment, with a glimmer of hope even for residential investment. Although capacity utilisation in the manufacturing industry is still comparatively low, the cocktail of decent order intake and low interest rates has resulted in a tentative pick-up in investment in machinery. With continued gains in exports and domestic demand, business investment may contribute positively to growth going forward. Even the very lacklustre residential investment activity may be revived, as the free fall in housing starts came to a halt in 2010, and indications are for a tentative improvement during the forecast period.

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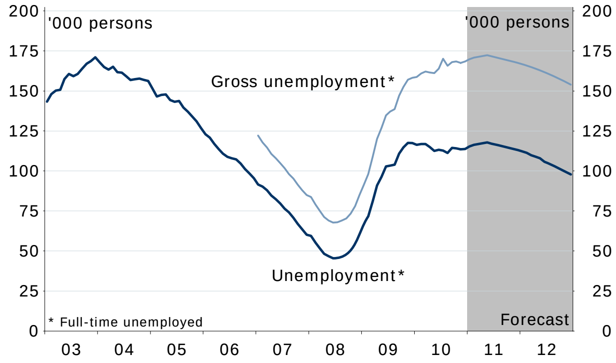
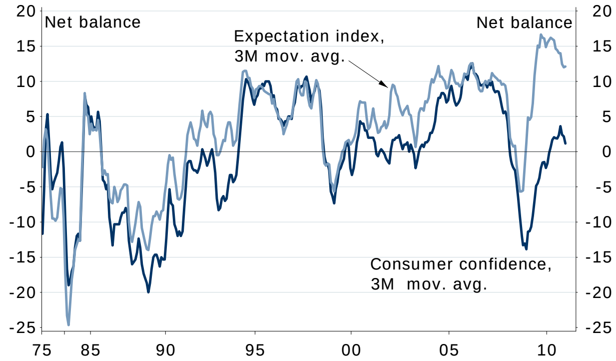
Labour market reversal underway



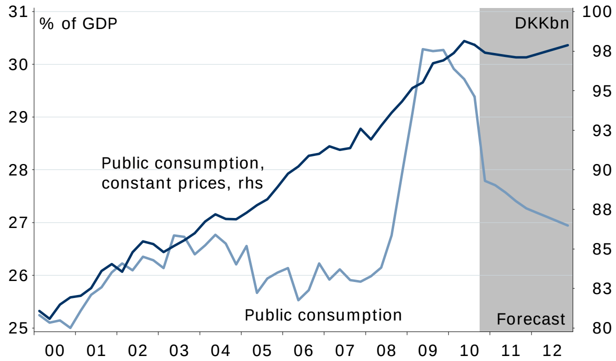
Source: Statistics Denmark and own calculations

Optimistic consumers



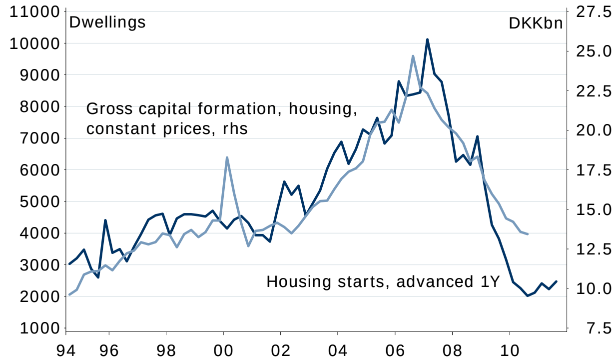
Source: Statistics Denmark and own calculations

Public spending boom is over



Source: Statistics Denmark and own calculations

Residential investment bottoming



Source: Statistics Denmark and own calculations

Increasing economic activity

- Growth will slow down in 2011
- Both exports and domestic demand support growth
- Fairly slow improvement in employment
- Household consumption grows faster than income

The Finnish economy had a robust recovery in 2010. Total demand, which measures economic activity, is estimated to have increased a little below 3.5% compared to the previous year, and all its main elements (exports, investment, and consumption) returned to the growth track. GDP grew about 3%. The outlook for the next few years is mainly favourable, despite the major problems in some European countries. The pick-up of the US economy and the strong activity in Asia indicate a further rise in international demand. Finland is therefore well-positioned for continued export-driven growth. Finland's most important export countries (Germany and Sweden) are doing well, Russia is recovering rapidly driven by the rise in crude oil prices and the weakening euro supports competitiveness in Finland. New manufacturing orders are increasing faster in Finland than in the rest of the EU.

During H1 2011, the Finnish economy will grow clearly slower than in H2 2010. On average, total production is, however, expected to increase 3% in 2011 and a little bit more than that in 2012. Growth is based on the increase in both exports and domestic demand.

Exports leaning more on investment goods

This year, exports will grow faster than last year. Growth of goods exports will slow down, but service exports will increase after a few years of decline. In 2010, growth of goods exports and industrial production was based on the increased demand of raw materials and intermediate goods manufactured by the paper, metal and chemical industries, as expected. This year, however, the export focus will change. The increase in investment goods orders in the euro area leads a rise in machinery and equipment exports from last year. Exports of the electro-technical industry are also expected to grow after a few weak years. Growth in paper exports will inevitably slow down after the industry's rapid recovery, especially as the comparison levels are substantially higher. A similar sluggish forecast applies to chemical industry exports.

Gradual increase in machinery and equipment investment

Investments grew only a little last year. Construction investment picked up clearly, but this was mostly offset by the decrease in machinery and equipment investment. Residential construction investment increased about 25%, returning to the pre-recession peak levels, whereas non-residential construction faced a steep decline for the second year in a row. During the forecast years, investment growth will pick up and the focus will also change. Construction growth will slow down. The level of residential construction investment will stabilise and growth will clearly wane. Non-residential construction will return to the growth track, albeit a fairly moderate one, as free business spaces are still amply available. Machinery and equipment investment will increase, but their quickest rise will most likely not be seen before 2012 when the industrial capacity utilisation rate is high enough. Lack of money dampens public sector investment.

Consumption growth faster than income growth

Private consumption growth has exceeded most forecasts, and the pre-recession consumption peak may already have been surpassed in Q4 2010. As the economy recovered, companies stopped temporary lay-offs and

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

	2007 (EURbn)	2008	2009	2010E	2011E	2012E
Private consumption	90	1.7	-1.9	3.0	2.4	2.5
Government consumption	39	2.4	1.2	0.4	1.0	1.0
Fixed investment	38	-0.4	-14.7	1.6	4.0	5.3
Stockbuilding*	3	-0.8	-1.4	0.3	0.0	0.0
Exports	82	6.3	-20.3	5.5	6.6	7.7
Imports	73	6.5	-18.1	4.6	6.0	7.2
GDP		0.9	-8.0	3.0	3.0	3.4
Nominal GDP (EURbn)	179.7	184.6	171.3	178.3	188.3	199.2
Unemployment rate, %		6.4	8.2	8.4	7.7	7.1
Industrial production, % y/y		-0.1	-19.9	4.7	5.5	6.0
Consumer prices, % y/y		4.1	0.0	1.2	2.5	2.1
Hourly wages, % y/y		5.5	4.0	2.4	2.7	3.0
Current account (EURbn)		6.4	4.7	3.5	3.7	4.2
- % of GDP		3.5	2.7	2.0	2.0	2.1
Trade balance (EURbn)		6.9	3.6	3.5	3.7	4.5
- % of GDP		3.7	2.1	2.0	2.0	2.3
General govt budget balance (EURbn)		7.7	-4.7	-5.5	-3.7	-2.6
- % of GDP		4.2	-2.7	-3.1	-2.0	-1.3
Gross public debt (EURbn)		63.0	75.0	85.0	94.0	102.0
- % of GDP		34.1	43.8	47.7	49.9	51.2

* Contribution to GDP growth (% points)

began to increase working hours. Coupled with low interest rates and inflation, this has lifted the household purchasing power quite nicely, fortified consumer confidence and cut saving, which was much favoured during the recession.

In 2011 and 2012, private consumption growth will slow down somewhat. The most rapid growth will continue to be seen within demand for durable goods. Especially this year, growth in real wages and purchasing power of individual households will be modest due to accelerating inflation. On the other hand, employment will improve, which will in turn increase the disposable income of the household sector. In addition, households will continue to save less, as consumption growth is faster than income growth. Saving will not, however, drop below zero, as in the exceptional period 2006–2008.

Fairly slow improvement in employment

During the recession, unemployment did not increase nearly as much as generally feared. Companies held on to skilled labour by rotating temporary lay-offs and avoiding dismissals, obviously aware of the fact that the retirement of the baby boomers in the near future will lead to labour shortage. Consequently, the number of working hours decreased much more than the number of employees. The same logic works in the forecast period the other way around. When production volumes grow, companies will first increase their productivity, then working hours, before hiring new employees. The unemployment rate is expected to decrease to around 7% on average in 2012. The drop will be hampered by an increase in the number of labour market entrants, a typical trend during an upswing.

The fairly low rise in wages on the horizon will in principle curb the upward pressure on consumer prices. However, there clearly is such pressure in the largest sections of the consumer price index (housing, food products and traffic), which cover almost half of the index. Prices will be pushed upwards by more expensive raw materials and energy as well as by the weakening euro. Furthermore, housing costs will rise already in the near term when market interest rates start to rise. Consequently, consumer prices are estimated to rise 2.5% in 2011 and about 2% in 2012.

Public sector finances a definite election theme

Compared to many other countries, the state of the Finnish public sector is good, but considering the future expenditure pressures it is all but that. The public sector deficit was around 3% of the GDP last year. The deficit will narrow in the forecast period, but without new measures to cut expenditure, the speed seems to be too slow. The pension system is clearly showing a surplus, but the central government will continue well in deficit.

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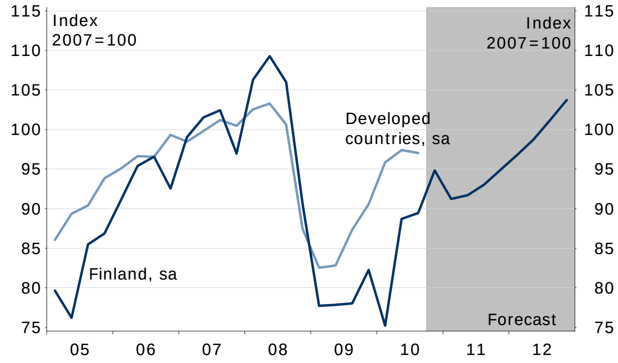
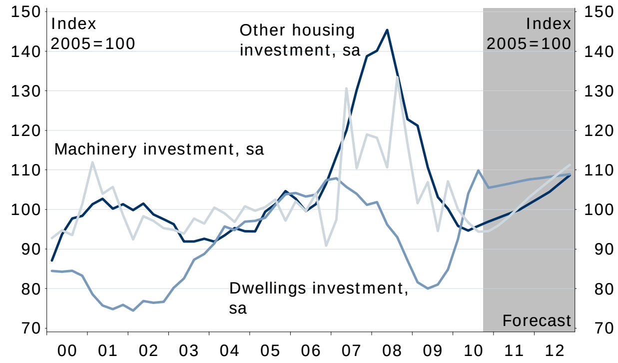
Rise in goods exports continues at a slower pace

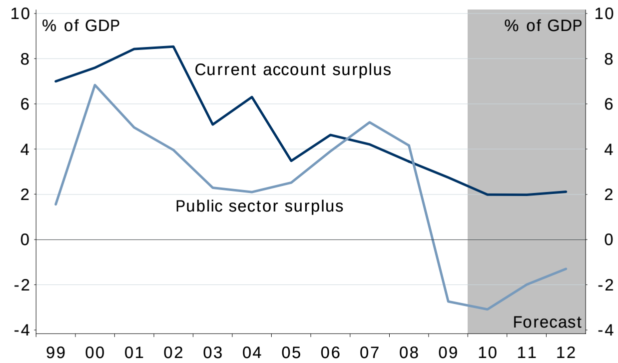


Machinery and equipment investment picking up



Unemployment rate gradually towards 7 per cent

New measures needed to tackle public deficit



Towards a brighter tomorrow

- The economy is gaining momentum …
- … after further fiscal policy stimulus
- Higher job creation, but joblessness remains elevated
- Monetary policy tightening at end-2011

Prospects for the US economy in 2011 are quite bright and now appear more promising than just a few months ago. After the slowdown in H1 2010 the economy is now gradually shifting into a higher gear, and it will gain further momentum this year from the new tax cuts adopted in December. Fortunately, the fears of a new recession, which periodically dominated the market last year, have thus been proved unjustified – just as we expected.

The strength of the recovery surprised on the upside in H2 2010. This, coupled with new unexpected fiscal policy easing in 2011, has made us revise up sharply our growth forecast for this year. Following estimated growth in GDP of 2.9% last year we look for growth of 3.3% in both 2011 and 2012. In the September issue of *Economic Outlook* we saw growth in 2011 and 2012 at 2% and 3%, respectively. With a more favourable demand composition the underlying improvement over the next couple of years is expected to be even more pronounced than suggested by the GDP growth rates. Unlike in 2010 when stockbuilding contributed markedly to growth, production should be driven by final demand going forward. Specifically, we expect final demand growth (GDP less inventory corrections) to increase from 1.3% last year to 3.4% this year and 3.3% in 2012.

The fiscal rescue package that Congress passed in December should in itself lift GDP growth by around 0.5% point this year. In addition to a 2-year extension of the Bush-era tax cuts from 2001 and 2003, which were otherwise due to expire at end-2010, the package contains a 2% point payroll tax reduction for all workers in 2011 and a 13-month extension of jobless benefits for long-term unemployed. Moreover, companies can write down this year's investments in equipment faster.

Consumer spending, accounting for 70% of GDP, will likely make the biggest contribution to growth. In addition to the tax cuts consumer spending will be boosted by steady growth in employment and low interest rates. Add to this that the sharp increase in households' propensity to save in the wake of the crisis now largely appears to have come to a halt. A mere stabilisation of the savings ratio will in itself lift consumption growth.

Stronger job growth but still high joblessness

The stronger growth in final demand is expected to give a boost to job creation. By mid-2011 private sector employment growth is expected to be above 150,000 jobs per month on average compared to the more modest average increase of 128,000 in the last three months of 2010.

Especially small businesses, traditionally the key job-creating sector, are expected to add jobs after banks have eased credit standards for this sector. Conversely, public sector employment will remain subdued for some time to come due to the pressure on state budgets.

Unemployment is not likely to drop noticeably until 2012. The reason is that a large number of those who gave up finding a job and left the labour market during the crisis will likely now again show up in the labour force. We see unemployment declining to 9% by end-2011 and 8% by end-2012.

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

	2007 (USDbn)	2008	2009	2010E	2011E	2012E
Private consumption	9,806.3	-0.3	-1.2	1.7	4.1	3.4
Government consumption and investment	2,674.3	2.8	1.6	1.1	0.6	0.5
Private fixed investment	2,266.1	-6.4	-18.3	3.8	6.5	8.0
- residential investment	628.6	-24.0	-22.9	-3.3	0.5	9.5
- equipment and software	1,112.6	-2.4	-15.3	15.3	10.5	8.3
- non-residential structures	524.9	5.9	-20.4	-14.1	-0.3	5.1
Stockbuilding*	29.1	-0.5	-0.6	1.6	-0.1	0.0
Exports	1,661.7	6.0	-9.5	12.0	10.5	8.9
Imports	2,375.7	-2.6	-13.8	14.1	10.0	8.5
GDP		0.0	-2.6	2.9	3.3	3.3
Nominal GDP (USDbn)	14,062	14,369	14,119	14,682	15,451	16,306
Unemployment rate, %		5.8	9.3	9.6	9.3	8.5
Industrial production, % y/y		-3.3	-9.3	5.6	4.9	4.8
Consumer prices, % y/y		3.8	-0.3	1.7	1.4	1.7
Consumer prices ex. energy and food, % y/y		2.3	1.7	1.0	0.8	0.8
Hourly earnings, % y/y		3.8	3.0	2.2	2.0	2.0
Current account (USDbn)		-668.9	-378.4	-484.5	-494.4	-603.3
- % of GDP		-4.7	-2.7	-3.3	-3.2	-3.7
Federal budget balance (USDbn)		-458.6	-1,413.6	-1,300.0	-1,300.0	-1,000.0
- % of GDP		-3.2	-10.0	-8.9	-8.4	-6.1
Gross public debt, % of GDP		75.6	86.4	95.3	103.7	109.8

* Contribution to GDP growth (% points)

As joblessness thus looks set to remain above the structural level currently estimated at around 7%, inflation will likely remain weak. Rising energy and food prices will drive headline inflation higher short term, but in an economy where production is still some 5% below the full-employment output level, inflation pressures appear to be far out on the horizon. We consequently expect core inflation to remain below 1% in 2011 and 2012.

Monetary tightening at the end of the year

The improved prospects for the economy should ease the Federal Reserve's concern in 2011. We see the first rate hike coming in December this year. At that time the Fed is also expected to start absorbing some of the excess liquidity in the economy to counter the risk of new asset bubbles.

In light of the banks' huge excess reserves and the low starting point for interest rates the Fed will likely tighten monetary policy quite aggressively once it embarks on a normalisation of interest rates. On a 2-year horizon we see the Fed funds rate raised to 3%.

Risks on both sides

As usual, risks to our forecast are both on the upside and the downside. The key *upside* risk is that we underestimate the pent-up demand among households and corporates. Business investment in equipment rose sharply last year, probably as a result of a string of investment decisions being carried out that had been postponed during the crisis. This, coupled with the sustained low rate of capacity utilisation, makes us look for a minor slowdown in investment over the next two years. But in light of the seemingly rising demand, it cannot be ruled out that more well-capitalised companies increase capacity and payrolls more aggressively.

An unexpected sharp increase in bank lending may also result in a stronger recovery than we expect at present.

The key *downside* risk is that a further sharp decline in housing prices pulls the rug out from under the feet of consumers. Given the current high household savings level, the economy should be able to absorb an expected drop in housing prices of around 5% from current levels, we think. But due to the persistent imbalances in the housing market an even stronger price decline cannot be ruled out.

Also the rapid rise in commodity prices may lead to significantly lower growth than we factor into our baseline scenario, as may spill-over effects from the European sovereign debt crisis. Lastly, the unsustainable course of US federal and state budgets constitutes a risk factor on the downside.

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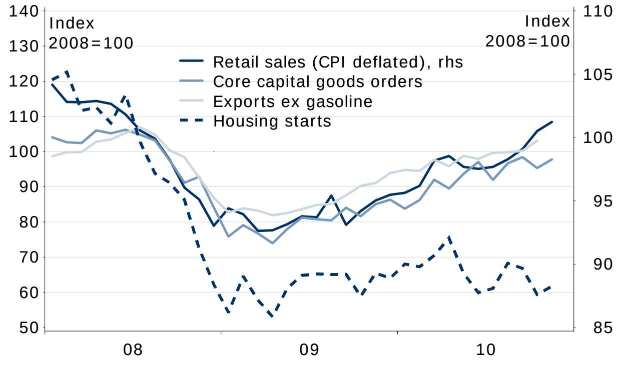
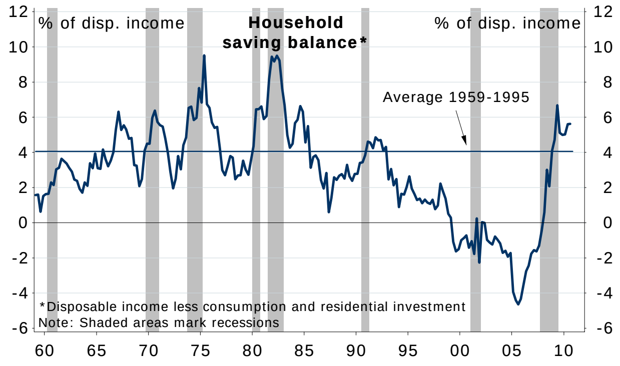
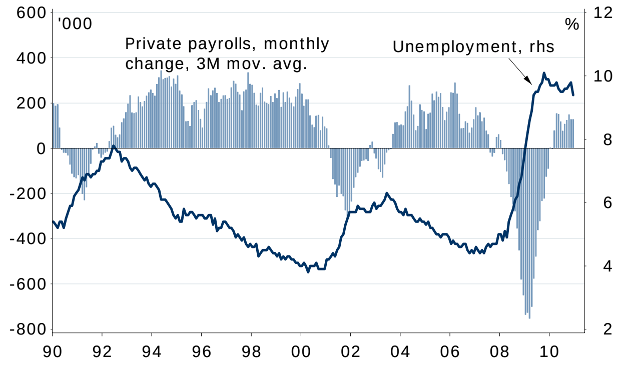
Most indicators suggest progress for the economy



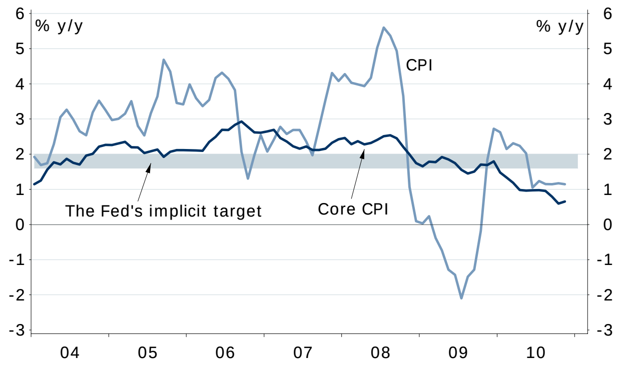
Household savings about to peak



Rising employment, but still high joblessness



Low inflation



Growth to continue in spite of sovereign debt crisis

- The sovereign debt crisis is likely to continue
- Crisis now more contained to peripheral countries
- Highly uneven growth performance inside Euro area
- The ECB to hike in Q3 2011, but with full allotment

Sovereign debt crisis likely to continue

The sovereign debt crisis is likely to continue in the Euro area over the next couple of years. During the latest round of turmoil, calls were made for political initiatives, such as common Euro-area bonds, as a way to end the debt crisis swiftly. Most of these steps would represent a big leap towards a common fiscal policy in the EU. Consequently, they have found only limited support in member states, with Germany as the most vocal opponent. Over the forecast horizon it will thus be the hard slog of fiscal austerity and structural reform that offers the best prospect of curbing the debt crisis. This is unlikely to bring immediate results, and market jitters are highly likely to recur. Such a situation could easily force another member state to seek financial support from the European Financial Stabilisation Fund (EFSF) and the IMF, even if the country would under normal circumstances not be facing a funding crisis.

Debt crisis mainly affects peripheral countries

In our main scenario, we do not expect the debt crisis to threaten financial stability in the Euro area as a whole. First of all, the EFSF ensures that a funding crisis for one of the more vulnerable member states will not lead to sovereign default, as long as the crisis can be contained to the smaller and medium-sized member states. Setting up a package for Portugal will be fairly easy under the current framework, and even a package for Spain should be manageable even though it could require as much as EUR 400bn. In addition, the latest round of turmoil has primarily affected the financial sectors in the most vulnerable member states, while the financial sector in the Euro area as a whole seems to be on the mend. This seems to pave the way for further relaxation of credit conditions, enabling renewed growth in lending to companies and households.

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

Obviously, the sovereign debt crisis represents one of the main risk scenarios. A drastic drop in the relative market values of Spanish or Italian government bonds would have much more widespread repercussions for the Euro area's financial sector, even if there was no actual default. This could easily lead to a renewed tightening of credit conditions, which could choke the recovery. Secondly, the tightening of fiscal policy could have a larger effect on growth than estimated. The tightening of fiscal policy coincides with very weak real income growth due to low wage gains and surging energy and food prices, and this could easily undermine consumer confidence.

Exports continue to drive growth

Compared to our previous forecast we have revised Euro-area growth for 2011 slightly up. This is primarily explained by the fact that the outlook for export demand is much better than previously expected. Looking ahead export demand is likely to continue growing, albeit at a

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

	2007 (EURbn)	2008	2009	2010E	2011E	2012E
Private consumption	5,182	0.4	-1.0	0.7	0.8	1.5
Government consumption	1,803	2.3	2.4	0.7	0.4	0.3
Fixed investment	1,970	-1.0	-11.3	-0.9	2.5	3.2
Stockbuilding*	39	-0.2	-0.8	1.2	0.0	0.0
Exports	3,735	0.7	-13.1	10.0	7.1	6.3
Imports	3,600	0.6	-11.8	10.2	6.2	5.6
Net exports*	135	0.1	-0.8	0.0	0.4	0.4
GDP		0.3	-4.0	1.7	1.6	2.0
Nominal GDP (EURbn)	9,022	9,240	8,952	9,198	9,489	9,829
Unemployment rate, %		7.6	9.6	10.1	10.0	9.7
Industrial production, % y/y		-2.4	-13.8	7.0	3.5	3.0
Consumer prices, % y/y (HICP)		3.3	0.3	1.6	1.8	1.7
- core inflation		2.4	1.3	0.9	1.2	1.1
Hourly labour cost, wages and salaries % y/y		3.2	1.5	1.5	1.5	1.6
Current account (EURbn)		-134	-51	-30	-27	-10
- % of GDP		-1.5	-0.6	-0.3	-0.3	-0.2
General govt budget balance, % of GDP		-2.0	-6.3	-6.3	-4.6	-3.9
Gross public debt, % of GDP		69.7	79.1	84.7	86.7	87.6

* Contribution to GDP growth (% points)

more moderate pace as the catch-up in world trade is fading out. Exports will still be supported by the EUR, which we expect to weaken further over the forecast horizon. In addition, there is increasing evidence that the continued growth in industrial production is leading to a rise in business investments, which will provide further dynamism to the recovery.

Obviously a truly self-sustained recovery in the Euro area will depend on more dynamic growth in private consumption. Our expectation of slightly stronger consumption growth is primarily based on a decline in household savings following a restoration of net financial wealth after the great recession.

With regards to inflation, the surge in energy and food prices has now pushed headline inflation above the ECB's target, but the ample spare capacity continues to exert downwards pressure on core inflation. In our main scenario, where we expect oil prices to hover around current levels, headline inflation should consequently decline somewhat during the forecast horizon.

ECB will begin to normalise policy in 2011

The sovereign debt crisis and the wide disparity in economic conditions among the individual member states are likely to pose a significant policy dilemma for the ECB in 2011. On the one hand, the general normalisation of money markets in the Euro area and the gradual reduction in spare capacity suggest that monetary policy could be returned to a stance more in line with a normal cyclical low, rather than the very accommodative stance adopted during the great recession. On the other hand, it is quite clear that banks in some of the peripheral member states still find it virtually impossible to obtain funding other than trough the Euro System. Thus, the ECB could provoke a serious deterioration for the banks in the peripheral member states if it returned to offering fixed amounts of liquidity at variable rate auctions. It was exactly for this reason that the ECB decided to continue with full allotments at the refinancing operations in Q1 2011.

Looking forward, we now expect the ECB to continue with full allotments at its liquidity operations at least throughout 2011. This will imply that money market rates will continue to trade below the ECB's refi rate throughout the year. Instead, we expect the ECB to tighten financial conditions by hiking the refi rate by 25 bp already in September 2011. Based on our macroeconomic forecast we expect this to be followed by quarterly rate hikes of 25 bp, leaving the refi rate at 2.25% towards the end of the forecast horizon, still a level consistent with fairly weak economic conditions.

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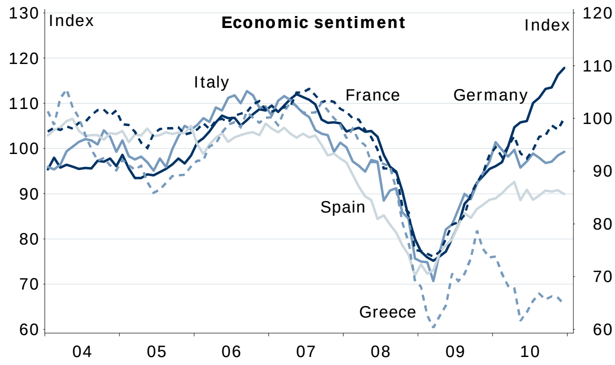
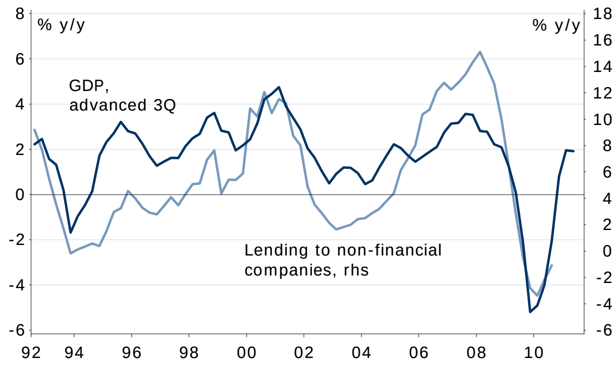
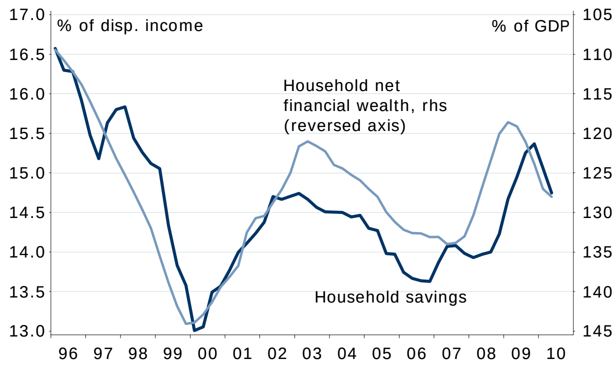
Wide divergence between member states



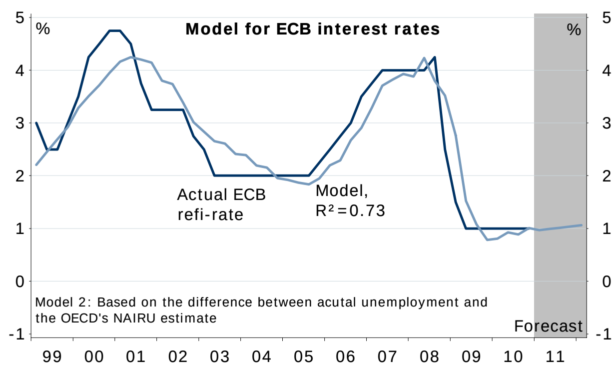
Business lending follows normal cyclical pattern



Household savings likely to decline



Only basis for small hike in ECB rates in 2011



Wirtschaftswunder 2.0

- Fiscal policy and exports led to swift recovery
- Unemployment has returned to pre-crisis levels
- Outlook for private consumption strongest in years
- Fiscal tightening will be relatively mild

A new economic miracle in Germany

The German economy has roared back after the great recession. Apart from an expansionary fiscal policy, the boom has been driven by exports, as strong external competitiveness has allowed German companies to fully exploit the rebound in world trade. Unemployment has already dropped to the same level as before the crisis, and this suggests that private consumption may finally begin to evolve more dynamically than seen over the past decade. Thus, the German government is only planning a relatively modest tightening of fiscal policy over the coming years, which will only partly reverse the significant easing of policy over the past two years. Combined with bright prospects for business investment, the German economy is well placed to enjoy a self-sustained recovery largely based on domestic demand.

Looking at the German economy in a longer-term perspective, it is important to remember that the current high level of growth is largely explained by catching up following the deep recession. Unlike other crisis-hit economies, Germany did not rely on a booming housing market prior to the recession. Instead, the recession in Germany was largely caused by a drop in world trade and inventory destocking, which primarily hit industrial production. Hence, there is no need for a painful adjustment process, where the real estate sector and associated employment is cut down to size which would dampen potential growth substantially. Indeed, Germany seems to be enjoying the benefits of the labour market reforms in the early 2000s, which contributed to lower unemployment from more than 5 million in 2005 to less than 3 million today. At some point the resource slack is likely to be absorbed, however, and this will probably lead to a significant slowdown in growth. Based on the demographic outlook for Germany, with a gradually shrinking labour force, most estimates put long-term growth rates at just over 1%. Consequently, Wirtschaftswunder 2.0 will most likely have a much shorter duration than the post-war boom initiated in the 1950s.

Export resilience despite challenges

In the next couple of years, we expect export growth to slow down substantially despite strong growth in the global economy and further weakening of the EUR.With import growth marginally higher, due to strong domestic demand, the growth contribution from net exports will thus be fairly limited. Much has been made of Germany's advantageous export composition, where a relatively high share of capital intensive goods, has allowed the manufacturing industry to take advantage of the boom in emerging markets. A large part of the export boom since the economy bottomed out in the summer of 2009 has been driven by a rebound in exports to other Euro-area member states, however. Consequently, the tightening of fiscal policy in other Euro-area member states and the UK is bound to weigh on export demand. Indeed, German export orders to the Euro area are now declining, while export orders to non-Euro-area countries are booming.

Private consumption at last looking brighter

Considering that private consumption was largely stagnant over the previous decade it is quite natural to harbour a great deal of scepticism towards the idea of consumption-driven growth in Germany. Nevertheless, the prospects for private consumption growth are now brighter than anytime since the German reunification. Consumer confidence has already returned to the highs seen before the crisis and optimism in the retail sector is at a record high. Looking forward, continued employment growth and the prospect of slightly higher wage gains over the coming years indicate that real disposable incomes will grow relatively robustly, even though high energy and food prices will eat up some of the gain. In addition, households' concern over unemployment has already been reduced to pre-crisis levels and the net financial assets of households have been largely restored following the financial crisis. Consequently, there are good prospects for a decline in household savings, which

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

	2007 (EURbn)	2008	2009	2010E	2011E	2012E
Private consumption	1,379	0.6	-0.1	0.5	1.6	1.9
Government consumption	435	2.3	2.9	2.2	1.0	1.1
Fixed investment	456	1.8	-10.0	5.7	5.1	4.2
Exports	1,145	2.0	-14.3	14.2	7.6	5.1
Imports	971	2.9	-9.4	13.3	7.0	5.5
GDP		0.7	-4.7	3.5	2.5	2.2
Nominal GDP (EURbn)	2,436	2,478	2,395	2,501	2,600	2,699
Unemployment rate, %		7.8	8.2	7.7	7.4	7.2
Consumer prices, % y/y		2.6	0.3	1.3	1.5	1.5
Current account, % of GDP		6.6	5.0	5.8	6.0	5.4
General government budget balance, % of GDP		0.1	-3.0	-3.5	-2.7	-1.8
General government gross debt, % of GDP		66.3	73.4	73.8	73.7	72.8

* Contribution to GDP growth (% points)

will lend further support to private consumption.

Fiscal tightening relatively mild

Despite the fact that the German government's budget deficit is likely to fall below 3% of GDP already in 2011, the German government has stuck to its plans to tighten fiscal policy in 2011-14. Still, the cuts in the annual budget deficit will actually be fairly modest, implying a total tightening of fiscal policy of around 1.3% of GDP over the next four years, and the stance of fiscal policy will still be easier in 2014 than before the onset of the crisis in 2008. The plan is generally focused on a reduction of expenditures and subsidies, while taxes on households are maintained at current levels, and the government clearly hopes that the targeted savings will have a relatively small impact on private consumption and investment. We estimate that fiscal policy will pull GDP growth down by 0.2-0.5% point over the coming years.

The real miracle happened in the labour market

The strong rebound in economic activity since the through in the summer of 2009 has earned much accolade, but even more astonishing is the relatively mild impact on the labour market of the deep economic contraction. This has often been explained by the strong surge in the number of employees on short-term working schemes, Kurzarbeit, where more than 1.4 million employees were enrolled in such schemes in the summer of 2009. Still, Kurzarbeit only accounted for approximately 375,000 full-time employees at its peak, and the total number of employees on Kurzarbeit has now fallen to pre-crisis levels. Hence, there is little reason to fear that the German labour market has just "pushed forward" the adjustment following the great recession.

On the other hand, the fact that unemployment has already returned to pre-crisis levels could lead to concerns over accelerating wage growth. This may already be visible in the smaller wage negotiations taking place in 2011, with wage demands typically calling for increases between 4% and 6%. The benchmark negotiations in the metals sector will take place in March 2012, at which point the labour market is likely to be even stronger. Combined with a positive upward drift in wages, this would result in wage increases above 3% annually. This should not be too detrimental to the economic outlook, since the wage share of national income is near the historical low reached before the crisis. In fact slightly stronger wages gains over the coming years could be just the right medicine for Germany and the Euro area as a whole, as it will support private consumption growth and help other Euro-area member states to regain competitiveness.

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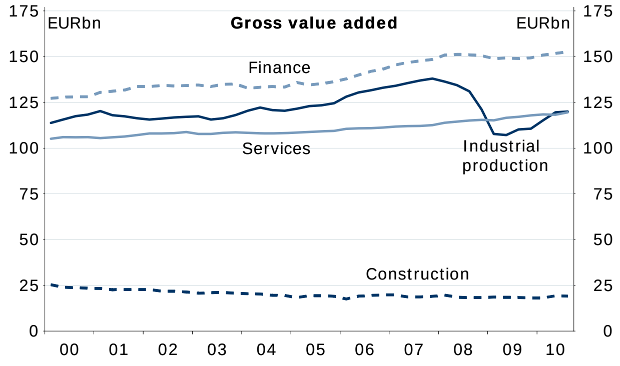
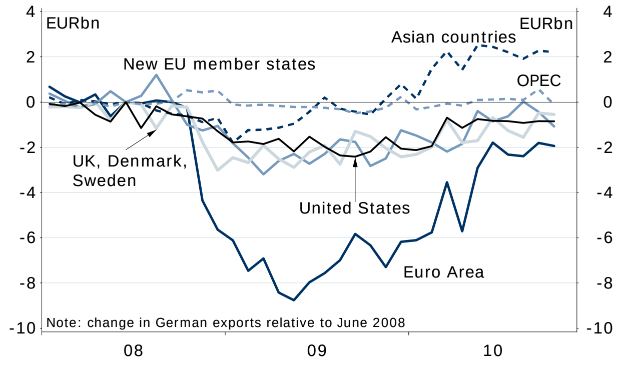
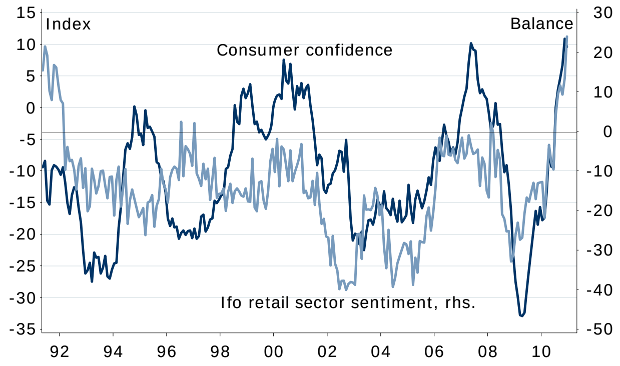
Industry took the biggest hit during the recession



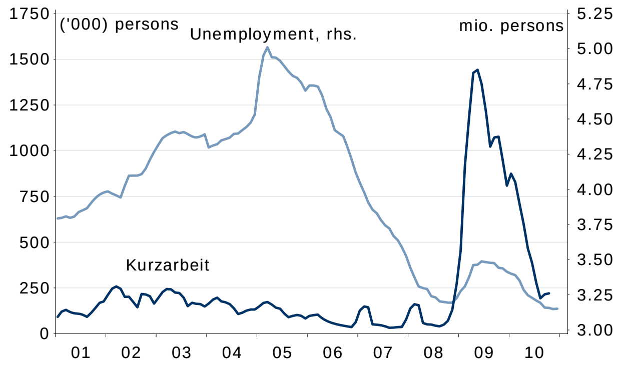
Rebound in exports largely driven by Euro area



Best outlook for consumption in years



Short-term work sharing has declined



Fiscal tightening really starts to bite

The UK economy has continued on a seemingly robust growth path in recent quarters, driven by the domestic sector. But much of the surprisingly strong growth over the past year has been due to inventory building, and also construction growth has been unsustainably strong. Both factors should unwind and point to weaker growth in the near term. That said, we do expect some of the strength to persist and because of higher carry-over from 2010 we have revised up our projection for GDP growth for 2011 from 1.5% to 1.8%, while the forecast for 2012 is unchanged at 2.0%. This relatively sluggish outlook reflects the gradual normalisation of credit conditions, efforts to reduce private sector indebtedness and the impact of the government's fiscal consolidation.

In 2011 net foreign trade is expected to be the largest contributor to growth, as the domestic economy is likely to slow sharply with the fiscal consolidation beginning in earnest, knocking around ½% point from GDP growth through a combination of spending cuts and direct tax and VAT increases. The 2.5% points hike in the standard rate of VAT to 20% at the start of 2011 and a weakening labour market will contribute to falling real household incomes. Against this background and due to the wealth effect from declining real house prices we expect to see consumer spending soften this year.

As companies were reluctant to cut staff during the recession, it is possible that the UK recovery will see little job creation. As growth slows in the near term, unemployment is likely to rise again, peaking above 8% in 2011. A sustained decline in unemployment is not expected until late in the forecast period. However, because the increase in VAT is likely to boost the rate of inflation by just over 1% point in 2011, inflation is not expected to fall below the 2% target before 2012. Unless the economy falters dramatically, the Bank of England will probably not engage in a new round of quantitative easing. However, the first rate hike is not likely until early 2012.

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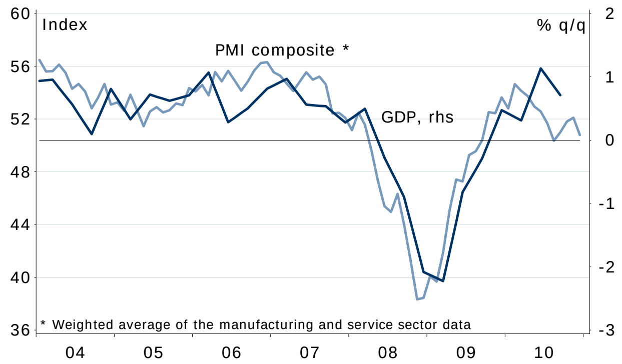
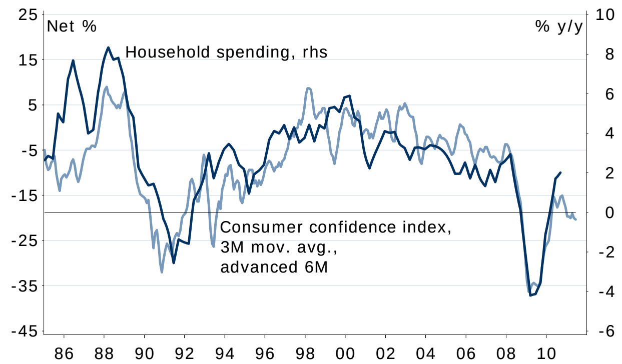
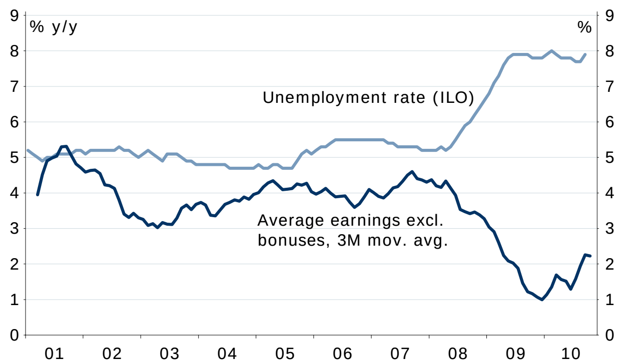
Business surveys point to weaker growth



Consumer confidence remains weak



Sustained unemployment on the cards



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

	2007 (GBPbn)	2008	2009	2010E	2011E	2012E
Private consumption	896.0	0.4	-3.2	1.3	1.0	1.5
Government consumption	296.1	1.6	1.0	1.2	-1.4	-2.2
Fixed investment	249.5	-5.0	-15.4	3.5	4.3	4.1
Stockbuilding*	5.8	-0.4	-1.2	1.1	0.1	-0.1
Exports	374.0	1.0	-10.1	5.2	6.2	8.2
Imports	417.0	-1.2	-11.9	7.9	3.4	4.6
GDP		-0.1	-4.9	1.7	1.8	2.0
Nominal GDP (GBPbn)	1,404.8	1,445.6	1,395.0	1,456.3	1,509.4	1,570.9
Unemployment rate, %		5.7	7.6	7.8	8.2	8.0
Consumer prices, % y/y		3.6	2.2	3.2	3.0	1.8
Current account, % of GDP		-1.6	-1.7	-2.5	-2.0	-1.5
General govt budget balance, % of GDP		-5.0	-11.4	-10.5	-8.0	-6.0
Gross public debt, % of GDP		52.1	68.2	78.7	86.7	92.7

* Contribution to GDP growth (% points)

Political risks have increased

- Below-consensus growth in 2011
- Heightened risks ahead of October general elections
- Monetary tightening cycle started
- Stronger PLN in the near term

Below-consensus growth in 2011

We change our projection of weaker momentum in the economy at the beginning of the year to one involving somewhat higher growth for the year, although still below consensus, followed by stronger growth again in 2012. Moreover, we now flag heightened political risks ahead of the October elections. The government is reluctant to tighten fiscal policy significantly and its debt is approaching critical levels. Monetary policy tightening is expected to come earlier than previously thought, but the cumulative tightening is likely to be less than in previous tightening cycles.

Growth may disappoint

World trade and global manufacturing activity has been somewhat stronger than we had anticipated and the German economy in particular is powering ahead. Consequently, the weakness that we see coming from fiscal tightening at home and in many Euro-area economies and from monetary policy tightening by the National Bank of Poland (NBP) is likely to kick in a little later and at that point the economy will be somewhat stronger than previously thought. The PMI manufacturing readings have been really strong and imply strong growth momentum in Q4 last year and going into 2011. Industrial production numbers and actual export numbers have been slightly less bullish, though still strong.

Private consumption probably grew strongly at the end of last year, but is expected to gradually lose momentum this year. The small VAT hike with effect from 1 January will have some adverse effects, as will the general increase in inflation. Moreover, wage growth has continued to slow and the unemployment rate has started to increase again. On the other hand, credits to households accelerated towards the end of last year. The labour market is key for consumer spending in the medium term and is expected to support stronger growth again in 2012.

We expect investment to recover in earnest in 2011. Capacity utilisation in the manufacturing sector has some way to go before returning to pre-crisis levels, but is at levels that normally prompts increasing investment. The recovery may be supported, if uncertainties related to the Euro-area sovereign debt crisis recede.

Political risks have increased

General elections are due not later than October, which is probably the reason why the incumbent government is reluctant to tighten fiscal policy significantly at present. The outcome of the elections is crucial as the Civic Platform will need sufficient support not only to stay in power, but also to make constitutional changes to allow EMU membership when, or if, it is found beneficial for the country. There is no need to rush for EMU membership at the moment, but it is still a key objective and a crucial anchor for economic policy.

Government debt may come very close to the 55% of GDP mark during the year, which prompts fiscal policy tightening by rule. The debt level could be breached if growth surprises on the downside, privatisation revenues come in lower than planned or if the PLN weakens significantly and hence increases the PLN value of foreign currency denominated government debt. According to Reuters, the Ministry of Finance sold EUR on the Polish markets in the final days of December to support the PLN, which could be an indication that government debt is closing in on the limit and the Ministry was adding a safety margin. Moreover, privatisation revenues, intended to finance the budget deficit without adding to the debt stock, came in lower than planned last year. Risks to this year's privatisation plans are on the downside as well.

In the final days of last year, the government also announced plans to change the pension system, also to finance the budget deficit without increasing the level of government debt. Of the 7.3% of gross wages that wage earners so far have been obliged to pay into private pension funds, the government wants 5% points redirected into the state pension administration to finance the government deficit starting from April. Such a measure

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

	2007 (PLNbn)	2008	2009	2010E	2011E	2012E
Private consumption	702	5.3	2.4	3.2	2.6	2.8
Government consumption	211	7.1	2.4	3.5	1.5	0.7
Gross fixed capital formation	254	9.6	-0.9	-2.2	12.5	7.6
Exports	480	5.8	-5.9	10.1	4.5	7.5
Imports	513	6.1	-13.2	10.7	4.1	9.1
GDP		5.0	1.7	3.9	3.8	4.1
Nominal GDP (PLNbn)	1,177	1,275	1,344	1,415	1,516	1,611
Unemployment rate, %		9.8	11.0	12.1	11.7	9.2
Consumer prices, % y/y		4.3	3.7	2.5	3.4	2.2
Current account, % of GDP		-4.8	-2.1	-2.3	-3.1	-4.7
General government budget balance, % of GDP		-3.7	-7.2	-8.3	-6.0	-4.5

* Contribution to GDP growth (% points)

merely serves to buy time and adds to uncertainty about what the government might do to avoid implementing proper tightening measures and key structural reforms before the elections.

The general government budget deficit is unlikely to meet the Maastricht criteria earlier than to allow EMU membership in 2015. However, there is no desire currently to join before that anyway. We keep 2015 as the expected entry date even if risks appear to be skewed significantly towards a later rather than an earlier entry date at the moment.

Monetary tightening cycle started

The NBP has hiked banks' reserve requirements and is likely to hike interest rates for the first time very soon. Inflation is expected to increase towards the upper limit of the inflation target of 2.5% +/-1% point in the coming months. Moreover, core inflation, which excludes food and energy prices, will soon start to trend upwards. We expect total inflation to decrease slightly later in the year, but risks are skewed to the upside due to the current strong growth momentum and the lenient fiscal policy.

The PLN has become a key element of monetary policy. With government debt hovering around the ceiling and inflation risks on the upside, the NBP is likely to allow some strengthening of the PLN in the near term. We therefore move the expected interest rate hikes forward to reflect that the NBP is likely to actually support a somewhat stronger level of the PLN. NBP chief Belka has said several times that the bank does not have a target range for the PLN, but merely seeks to act against excessive moves in either direction. Still, a key argument against hiking interest rates during the autumn was concern about excessive PLN strength. Therefore, we still believe that the cumulative interest rate hikes will be somewhat lower than in previous hiking cycles.

Stronger PLN in the near term

While we see a moderate strengthening of the PLN in the near term for the above-mentioned reasons, we see some risks in the medium term. Political risks are getting more important and the public debt and deficit could become a focal point. Moreover, the ECB and the Fed will have to tighten monetary policy at some point, which could trigger capital outflows from Poland. The PLN is still seen as a strong-fundamentals currency, though.

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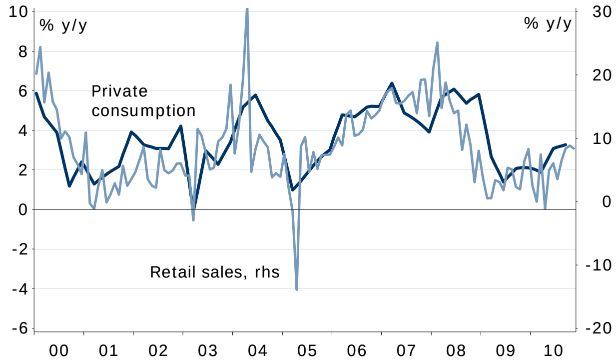
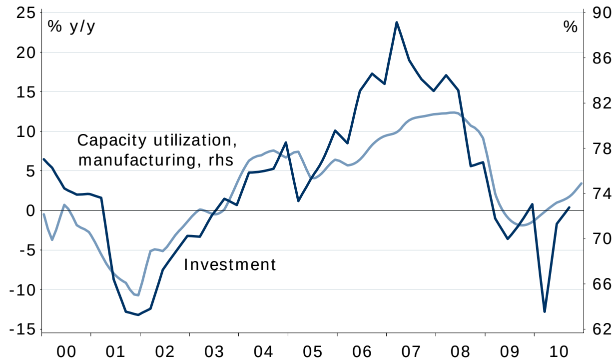
Strong momentum

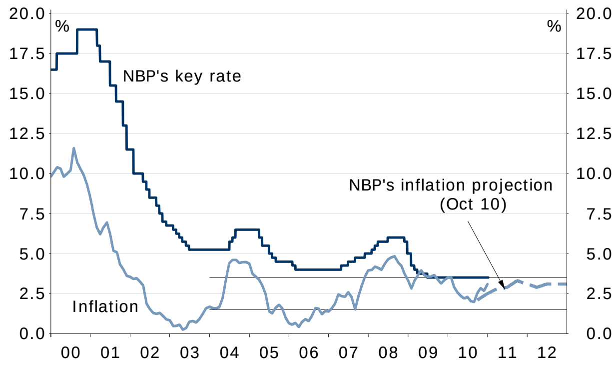
Private consumption grew strongly at end-2010



Investment to recover in earnest in 2011



Inflation has surprised on the upside



Rebuilding growth momentum

- Private domestic demand drove economy in H2 2010
- Consumers to get more appetite in 2011
- Interest rate cycle has turned

Domestic demand picking up speed

The economy did not grow as fast as expected in H2 2010 mostly due to the shock to the agriculture sector, which because of the summer drought and heat wave contracted more than 20% in Q3 alone. This reverberated negatively with consumers, as confidence was hit and retail sales growth was a bit slower in the autumn on rising food inflation. Still, household consumption was the main growth engine in H2.

We see the negative effects from the summer anomaly as temporary, and expect consumer confidence and spending to recover on rising real wages and a low unemployment level. Inflation, having outstripped the credit and deposit rates, will help push consumers to opt for more spending. Alongside domestic consumption, fixed capital investment is now recovering fast, and will be the key growth driver, as bank lending is set to expand above 15% in 2011. That said, the reviving domestic demand will lead to increasing imports, which are set to rebound after the large drop during the crisis, helped by a stronger rouble. Meanwhile, exports, while bolstered in value terms by high oil prices, will still be constrained by oil and gas sector capacity, and remain dependent on foreign demand.

Budget to rely heavily on domestic issuance

Helped by higher revenues, the budget deficit in 2010 was lower than the official target of 5.3% of GDP stipulated in the federal budget law. The budget draft for 2011-13 points towards a planned reduction in the fiscal deficit from 3.6% in 2011 to 2.9% in 2013. The bulk of financing (70-80% of the deficit in 2011) is expected to come from domestic borrowing, which is in strong contrast to last year's pattern where the government relied on the oil Reserve Fund as a key source (about 60%) of financing. In addition, the budget plan pencils in about USD 10bn coming from the new privatisation plan.

Excessive domestic borrowing in 2011 poses some risks of crowding-out effects in the domestic market. Yet government officials have said they will try to avoid these negative effects by borrowing more in foreign markets, as the planned USD 7bn of foreign issuance can be stretched to USD 15bn. In our view, the excess liquidity globally and high demand for extra yield abroad, making a perfect environment for cheaper funds, will lure the government into more foreign issuance than currently planned. Overall, with the debt-to-GDP ratio of just 11% this year, and around 16% in 2013, Russia looks very attractive compared to other sovereigns, which will greatly contribute to supporting foreign appetite for government bonds.

That said, it is very likely that the overall borrowing requirement will not be that excessive at all, provided oil prices remain above the government's baseline of USD 75/bbl, which might help reduce the deficit more than budgeted in 2011. But a large reduction is unlikely, still, since the government promised further increases in public sector wages and social benefits. With the elections on the agenda at the end of 2011 and in early 2012, the risks are towards government spending more than the other way around.

Credit flow improves

Developments in the banking sector have been very encouraging recently, as total credit to households and companies, including small businesses, surprised on the positive side, expanding more than 10% in 2010. This was encouraged by the positive dynamics in the banking sector, where overall profits in 2010 increased more than five times compared to 2009, and the share of non-performing loans decreased in Q4 2010.

The supply-side conditions for further robust credit expansion are good, as interest rates to consumers and companies have reached historical lows, which will support domestic consumption and corporate investment activity in the coming quarters. As the economy accelerates, the demand for credit will also increase further on companies' needs to finance investments projects. A continuation of the government support programme for

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

	2007 (RUBbn)	2008	2009	2010E	2011E	2012E
Private consumption	16,193	11.2	-7.6	4.3	5.8	6.5
Government consumption	5,745	2.5	2.0	1.2	2.0	2.3
Fixed investment	6,984	10.0	-16.5	4.4	7.8	7.0
Exports	10,029	0.5	-4.6	8.8	5.1	5.8
Imports	7,138	15.0	-30.2	20.0	13.2	8.8
GDP		5.6	-7.9	4.1	5.4	5.7
Nominal GDP (RUBbn)	33,258	41,445	39,064	45,300	51,430	58,440
Unemployment rate, %		5.6	7.5	7.5	6.5	5.8
Consumer prices, % y/y		14.1	11.7	6.9	7.7	7.5
Current account, % of GDP		6.2	3.9	4.7	3.5	2.7
Central govt budget balance, % of GDP		4.1	-5.3	-4.2	-2.8	-2.0

* Contribution to GDP growth (% points)

mortgage loans, with their provision in roubles at a single relatively low 11% interest rate level and an initial contribution maximum at 20% of housing value, will support this household credit segment. We therefore expect total bank credit portfolio expansion to continue, with further 15-18% growth seen for 2011.

Monetary tightening has begun

After the supply-side shock to food prices following the summer drought, inflation has not shown any respite, and the government changed the forecasts for 2010 from 6.5% in the summer to over 8.5% towards the end of the year. The government's official forecasts for next year are also too optimistic, in our view, with inflation expected at just 6-7% in 2011. We see risks of higher inflation, as price increases will become more broad-based, especially if oil prices remain high and capital flows to Russia resume. At the beginning of 2011 inflation will be bolstered by tariff hikes in the service sector, as well as government spending at the end of 2010. Later in the year additional inflationary pressures will also start to build on the demand side, as the output gap is set to close by the end of 2011.

The Central Bank of Russia (CBR) has already indicated its concern over inflation and started to tighten monetary policy by raising the outright deposit rates. We expect further tightening to come, and the CBR will gradually narrow the interest rate corridor by raising the deposit rates more and faster than the refinancing rates, which at current ample rouble liquidity levels are still too high to serve as the "key" rates of the CBR. Since the monetary tightening cycle has begun, money market rates – Mosprime, RUONIA – will continue edging higher.

More gains for rouble seen ahead

The rouble has moved a step further towards becoming a more flexible currency, as the CBR widened the floating intervention band from RUB 3 to 4 in the autumn. Further widening and a reduced presence in the foreign exchange market in the coming years are stipulated in the CBR's guidelines for monetary policy for 2011-13. Its goal is to move towards a floating exchange rate system, which it needs in order to be able to pursue an independent monetary policy (changing interest rates). As a result, the currency will be more influenced by market trends, hence higher volatility should not come as a surprise.

We expect the rouble to continue strengthening, which is both a structural story common to growth markets, and also a medium-term trend supported by favourable global market conditions and oil prices, which we, as our baseline scenario, expect to remain above USD80/bbl and move toward USD 110/bbl in the coming two years.

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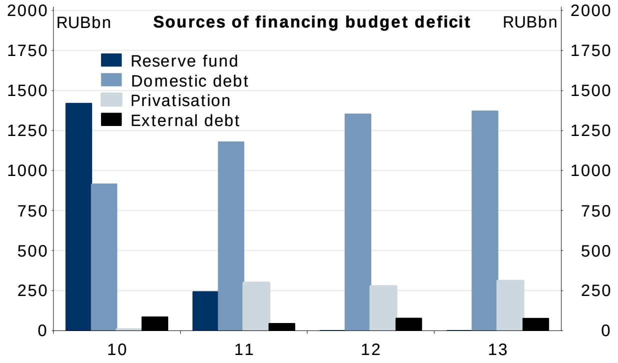
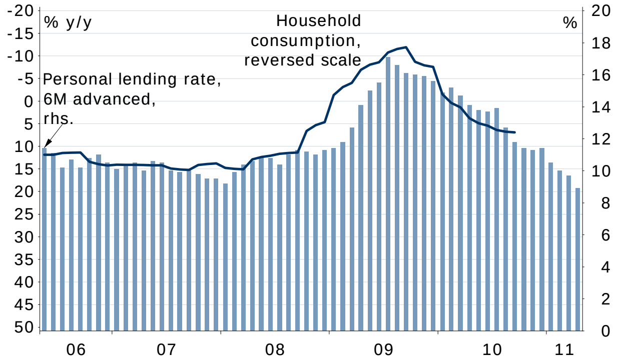
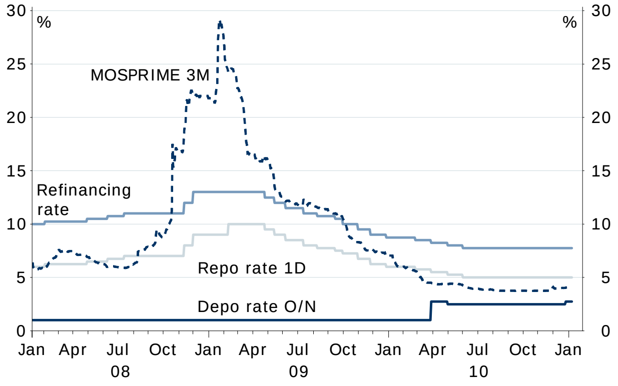
Changing pattern of budget deficit financing



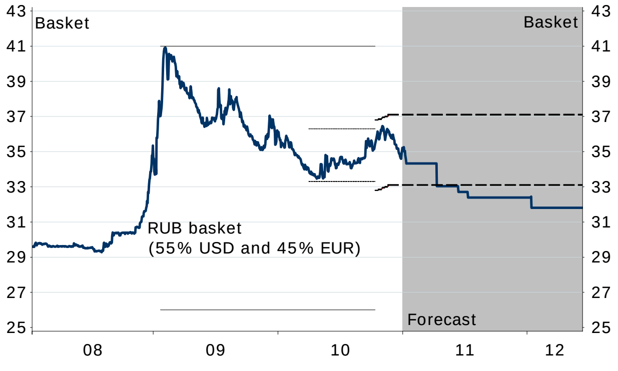
Easy credit to support consumption next year



Interest rate normalisation cycle has begun



Rouble basket set to strengthen further



Improving economic outlook

The recovery has proceeded faster than initially anticipated, with growth reaching 5% y/y in Q3, indicating Estonia has been able to benefit markedly from the global upturn. Growth expectations are boosted by the adoption of the euro, which supports confidence in the economy especially by attracting foreign investment.

The recovery is still highly dependent on foreign demand. In Q3 exports rose close to the 2008 highs, erasing the last of the almost 24% drop during the downturn. Imports have recovered roughly a third of their collapse, supported by reviving foreign demand and the importance of intermediate products. Inventories have also recently started to contribute strongly to growth. As inventories get filled, this trend could moderate. Overall, a global recovery is vital for the upswing to continue, as the revival in domestic demand remains fragile.

Household demand remains constrained by the weak labour markets. However, positive signs are seen in the relatively high consumer confidence, the modest wage growth and the reduction in unemployment. Although the initially rapid decline in unemployment is slowing down, unemployment is likely to decline steadily over the next couple of years. Reducing structural unemployment on e.g. the industrial sector is a challenge, especially considering the continued rise in long-term unemployment.

Inflation is a concern, especially as the euro adoption is feared to induce further price pressure. The high inflation can largely be attributed to the rise in food and energy prices as well as tax hikes, which are expected to be of a temporary nature. Domestic price pressure could emerge through the reviving economy, but the slowly declining unemployment is likely to restrain wage increases. Thus, we only see a modest acceleration in inflation.

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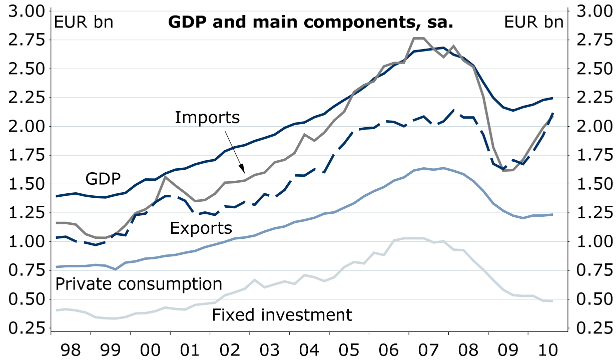
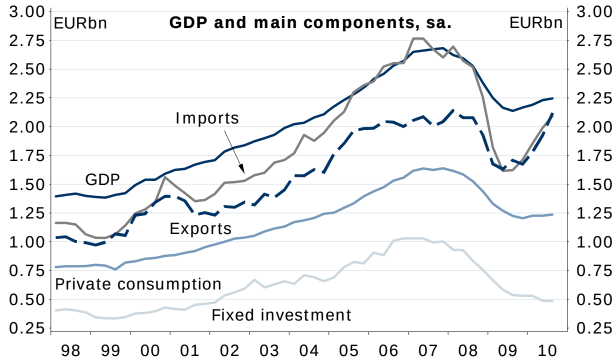
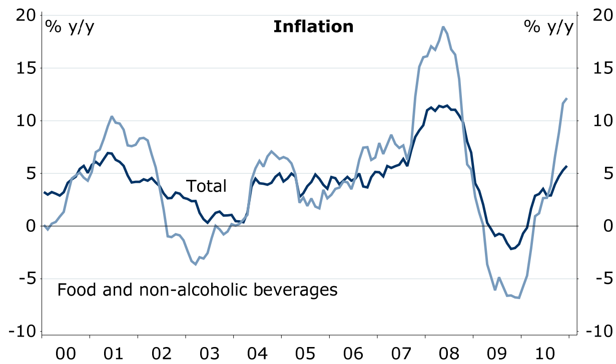
Private consumption still lagging exports



Labour markets gaining strength gradually



Inflation supported especially by food prices



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

	2007 (EURbn)	2008	2009	2010E	2011E	2012E
Private consumption	8.7	-5.4	-18.4	-1.3	3.8	4.3
Government consumption	2.6	3.8	0.0	-1.7	1.0	1.5
Fixed investment	5.5	-15.0	-32.9	-10.0	11.0	6.5
Exports	10.7	0.4	-18.7	16.5	6.3	5.5
Imports	12.4	-7.0	-32.6	18.0	6.1	5.8
GDP		-5.1	-13.9	2.4	4.2	4.0
Nominal GDP (EURbn)	15.8	16.1	13.9	14.4	15.5	16.5
Unemployment rate, %		5.5	13.8	17.2	14.5	13.2
Consumer prices, % y/y		10.6	-0.1	3.0	3.6	2.5
Current account, % of GDP		-8.8	4.5	3.8	0.8	0.1
General govt budget balance, % of GDP		-2.8	-1.7	-1.5	-2.0	-1.5

* Contribution to GDP growth (% points)

Post-recession mood

A cautious rise in the level of GDP confirms that the recession has finally passed, with GDP having risen quarter-on-quarter for three consecutive quarters. The strong Q3 y/y growth also surprised on the upside. So far the main driver has been exports, which have corrected almost the entire decline seen during the downturn. A stabilisation is also seen in consumption and investment. In addition, growing inventories have recently supported growth. We see the gradual recovery continuing, with domestic demand contributing increasingly to growth.

The domestic economy remains weak, with the still fragile gains in the labour market and confidence restraining spending. Employment will improve fairly slowly, as unemployment is largely structural due to the different composition of growth than before the downturn, but combined with the outflow of the labour force the unemployment rate is seen declining moderately. The weakness in domestic demand is expected to constrain inflation as well, with prices rising only modestly.Fiscal consolidation has amounted to an impressive 15% of GDP during the past few years. A budget for 2011 was approved, which is projected to cut the deficit to 5.4%. However, increases in public revenues account for about two thirds of the consolidation and some cuts on the expenditure side appear to be postponed to 2012. In addition, the IMF and the EU are looking for further structural reforms. All in all, euro adoption in 2014 is still possible, but only if substantial fiscal consolidation is achieved in 2012 and the recovery continues as expected.

The financial markets took a break in 2010 after the 2009 roller-coaster ride, with CDS rates at low levels and the FX market stable. The main risks to stability are related to the expiry of the IMF/EU programme at the end of 2011. Despite this, Standard & Poor's recently upgraded Latvia's credit rating to BB+, reflecting the improved economic growth and lower-than-expected public debt.

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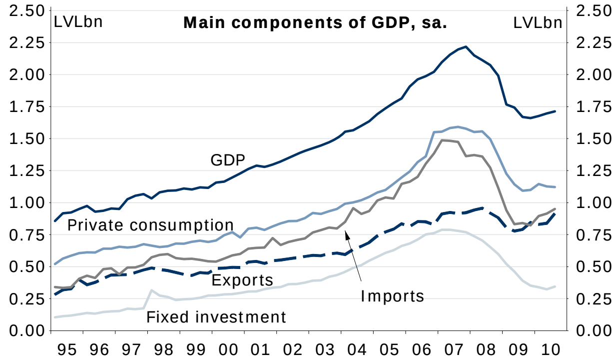
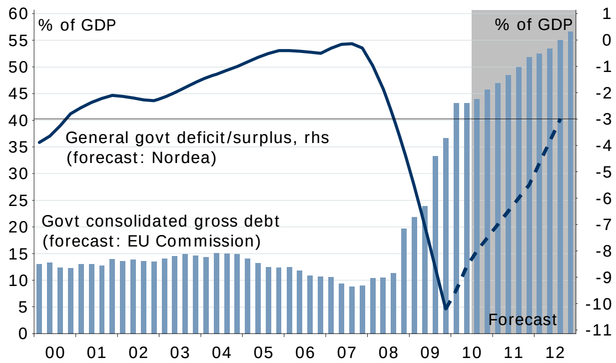
Exports close to pre-crisis levels



Strict fiscal consolidation still ahead



Financial markets eased in 2010

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

	2007 (LVLmn)	2008	2009	2010E	2011E	2012E
Private consumption	9,196	-5.2	-24.1	-0.4	3.0	4.0
Government consumption	2,575	1.5	-9.2	-8.5	-1.0	1.0
Fixed investment	4,975	-13.6	-37.3	-19.5	12.0	8.0
Exports	6,259	2.0	-14.1	8.6	6.4	6.0
Imports	9,220	-11.2	-33.5	8.3	7.0	6.8
GDP		-4.2	-18.0	-0.1	3.0	4.2
Nominal GDP (LVLmn)	14,780	16,188	13,083	12,939	13,702	14,634
Unemployment rate, %		7.5	17.1	19.0	16.8	15.5
Consumer prices, % y/y		15.3	3.6	-1.1	2.9	2.6
Current account, % of GDP		-13.1	8.6	4.0	-0.1	-0.8
General govt budget balance, % of GDP		-4.2	-10.2	-7.9	-5.4	-3.0

* Contribution to GDP growth (% points)

Economic recovery broadening

The economic recovery is slowly broadening in Lithuania. So far the main growth driver has been exports, but in Q3 a significant improvement in investment was also seen. In addition, inventories have swung into growth over the past few quarters, contributing clearly to the economic upswing as well. All in all, GDP has remained at bottom levels so far, but we expect a gradual increase over the forecast horizon.

We see GDP growth accelerating to around 3% y/y over the next couple of years, as the domestic economy gradually gains strength. Due to the high dependence on foreign demand in the recovery, the main risks to our forecast are a slowdown in growth in Lithuania's main trade partners - the EU and Russia. Although exports to Russia and Germany are very important, comprising over 20% of total exports in 2010, also the other Baltics, Poland and the Nordics remain significant trade partners.

While exports are already at pre-crisis levels, household consumption and investment still have a long way to go. Positive developments have been seen in consumer confidence, which fuel expectations of rising private consumption and industrial production, which mainly reflect the upturn in exports. The declining unemployment rate and abating decline in wages support consumption. We believe the unemployment rate to have peaked already, with the decline continuing into 2011. Households' unemployment expectations have also declined markedly from their highs, indicating improvement in the labour market.

In Lithuania the parliament extended fiscal consolidation measures for 2011 and the budget was approved with a deficit of 5.8% of GDP, a significant improvement from an expected 8.1% in 2010. Cutting the deficit below 3% of GDP in 2012, and thus adopting the euro in 2014, still requires significant fiscal consolidation and a strong economic recovery.

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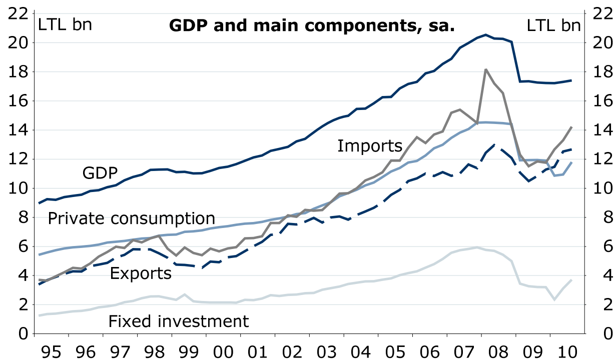
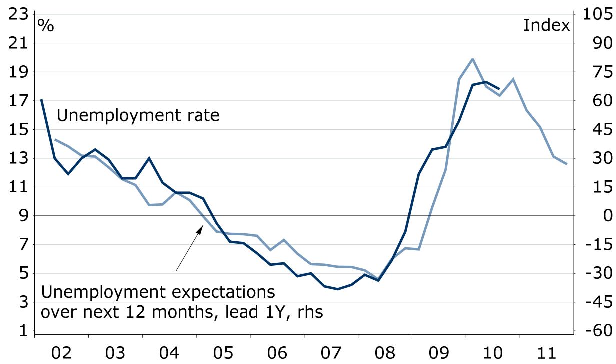
Exports driving the recovery



Unemployment rate seems to have peaked



Demand strong especially from Russia

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

	2007 (LTLmn)	2008	2009	2010E	2011E	2012E
Private consumption	63,736	3.7	-17.7	-4.0	3.2	4.5
Government consumption	17,638	7.3	-1.9	-1.7	0.0	1.2
Fixed investment	27,919	-5.2	-40.0	-3.5	11.0	7.0
Exports	53,371	11.6	-12.7	12.0	6.5	5.4
Imports	66,537	10.3	-28.4	14.0	6.8	5.5
GDP		2.9	-14.7	1.2	3.0	3.8
Nominal GDP (LTLmn)	98,669	111,190	92,016	94,316	99,030	104,970
Unemployment rate, %		5.8	13.7	17.8	15.8	14.1
Consumer prices, % y/y		11.1	4.2	1.3	2.6	2.4
Current account, % of GDP		-13.1	2.6	1.3	-0.2	-0.3
General govt budget balance, % of GDP		-3.3	-9.2	-7.8	-5.8	-3.0

* Contribution to GDP growth (% points)

Domestic recovery finally gaining traction

The new government is pushing ahead with measures to stimulate the economy and kickstart the recovery, disregarding widespread concerns about fiscal sustainability and financial stability. As a consequence, the risk premium on Hungarian assets has increased and the rating agencies now have the country only one notch from junk status and with a negative outlook. Another consequence, however, is that the domestic recovery is finally gaining traction.

Scaling back the pension reform and taxing specific industries heavily form part of the measures to finance the government budget for 2011. These measures may have severe adverse long-term effects and increase the risks related to obtaining foreign financing to repay the emergency loans from the IMF and other international creditors starting from 2012. We expect compensating structural reforms to improve market confidence once the domestic recovery is sustainable, though.

Private consumption increased in Q3 last year after more than two years of consecutive falls and the consumer confidence indicator points to further gains in Q4. Personal income tax cuts in 2011 will bring additional spending growth. However, consumer spending remains dependent on the development of CHF/HUF due to the large share of CHF-denominated mortgage loans. Hence, risks remain. We expect GDP growth to be just below 3% in 2011 and slightly higher in 2012.

The central bank hiked interest rates twice towards the end of last year, as inflation moved above the upper limit of the inflation target of 3% +/- 1% point and because of the expected fiscal policy easing. Moreover, the hikes may have been provoked by the government's threat to replace part of the Monetary Policy Committee and increase the inflation target. Tensions between the government and the central bank are obvious and could intensify ahead of the replacement of four members of the Monetary Policy Committee whose terms expire in March.

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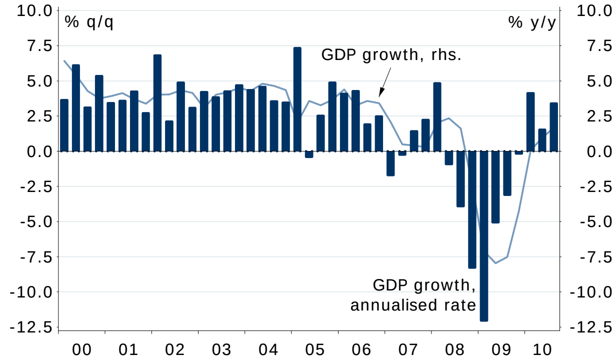
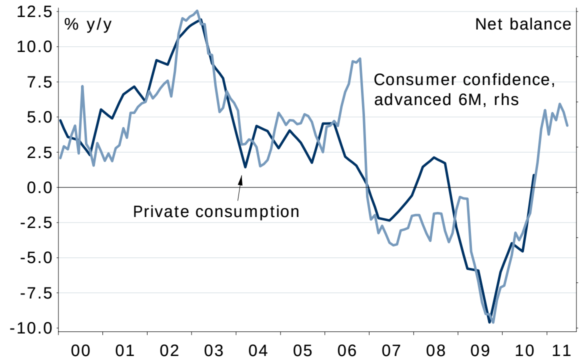
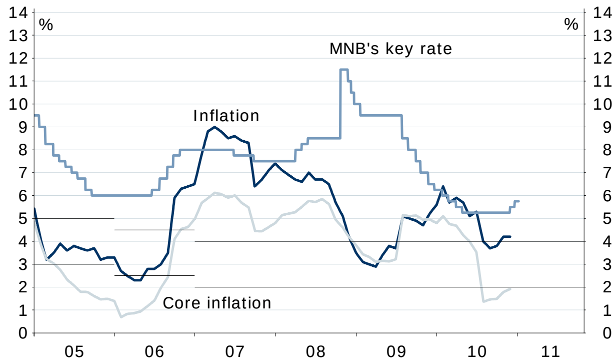
Growth picking up



Private consumption recovering



Two rate hikes late last year



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

	2007 (HUFbn)	2008	2009	2010E	2011E	2012E
Private consumption	16,559	-0.6	-6.8	-1.3	3.4	2.9
Government consumption	2,476	0.1	2.2	2.4	2.0	0.5
Fixed investment	5,381	2.9	-8.0	-3.5	4.5	7.0
Exports	20,444	5.6	-9.6	14.7	4.6	7.5
Imports	20,044	5.8	-14.6	11.2	5.0	7.7
GDP		0.6	-6.5	0.9	3.2	3.4
Nominal GDP (HUFbn)	25,408	26,543	26,094	27,608	29,374	31,254
Unemployment rate, %		7.8	10.0	11.1	10.6	10.0
Consumer prices, % y/y		6.0	4.2	4.9	2.8	3.0
Current account, % of GDP		-7.3	-0.5	2.2	-0.5	-2.0
General government budget balance, % of GDP		-3.7	-4.4	-3.8	-2.9	-3.0

* Contribution to GDP growth (% points)

Recovery gaining strength

The economic outlook remains bright and we have added a bit to the growth forecast for this year. Uncertainties have risen, though. The central bank seems convinced that the economy will perform much worse than what is generally expected and new political risks have surfaced during the autumn.

We expect growth to be just above 3% this year. The main reason for the upward revision is the improved outlook for the main export markets and a faster-than-expected recovery of private consumption. We still believe that foreign demand growth will slow in the beginning of this year, but not by as much as we originally thought. Private consumption is likely to continue recovering at a moderate pace. The labour market is still rather weak, but consumer confidence and retail sales have shown significant improvements. Investment is also about to start recovering in earnest, as capacity utilisation and credit conditions are recovering.

Fiscal policy will have a dampening effect on growth in 2011 as the new government's budget deficit target is set to 4.5% of GDP. Pension reform is high on the agenda for 2011. However, the government lost its majority in the upper house of parliament in October, where especially the smallest coalition partner, the VV, lost support. Therefore, we see heightened political risks relating to the government's chances of meeting next year's deficit target and implementing reforms.

Inflation is hovering around the central bank's 2% target. Core inflation is likely to remain subdued due to the weak labour market and the appreciation of the CZK. Therefore, the central bank appears content with keeping interest rates very low and its own rate path does not factor in the first hike until the second half of the year. Food and energy prices could push inflation higher in the near term, though. We believe the central bank is too pessimistic on growth and think that the first interest rate hike could come in Q2. We only expect moderate rate hikes this year.

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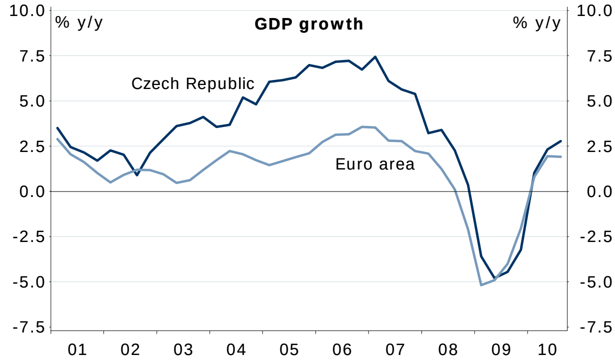
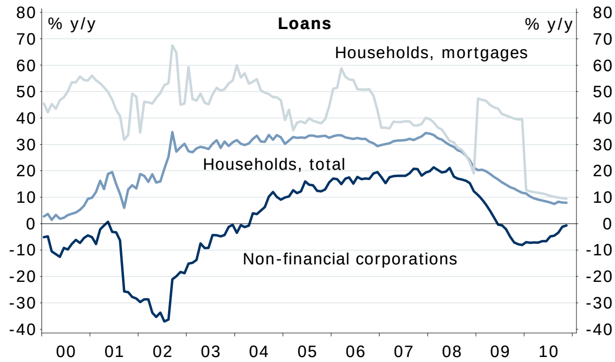
Growth picking up



Labour markets still weak

Credit conditions recovering



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

	2007 (CZKbn)	2008	2009	2010E	2011E	2012E
Private consumption	1675	3.5	-0.1	1.3	2.4	3.0
Government consumption	718	1.0	2.6	0.9	0.5	0.5
Fixed investment	890	-1.5	-7.9	-1.3	5.0	8.0
Exports	2803	5.6	-11.4	13.6	5.0	6.5
Imports	2655	4.3	-10.6	14.2	4.8	6.0
GDP		2.3	-4.0	2.5	3.1	3.8
Nominal GDP (CZKbn)	3535	3689	3626	3772	3978	4212
Unemployment rate, %		5.4	8.1	9.0	8.2	7.5
Consumer prices, % y/y		6.3	1.0	1.5	2.7	2.3
Current account, % of GDP		-0.6	-1.0	-2.5	-2.9	-3.5
General government budget balance, % of GDP		-2.7	-5.8	-5.1	-4.5	-3.5

* Contribution to GDP growth (% points)

Rebalancing process will gradually gain momentum

- Solid growth despite monetary policy tightening
- GDP set to grow by 8%-9% in 2011 and 2012
- New 5-year plan will ignite rebalancing process
- CNY revaluation expected to continue

China's economy strengthened late last year following the intended slowdown in the first half of 2010. Thus, China's economy enters 2011 with more momentum, which is likely to be accompanied by more monetary policy tightening. The end result will in our view neither be an overheated economy nor an economy hurt by too much tightening. Instead we expect growth to slow somewhat from recent years' double-digit growth but remain relatively solid in the 8%-9% range in both 2011 and 2012. Meanwhile, the process towards a more balanced economy will likely gradually gain momentum, as we expect the authorities to live up to the stated goals in the new 5-year plan for 2011 to 2015.

New 5-year plan to ignite rebalancing process

The new 5-year plan will be submitted to Congress for final approval in March 2011 but the overall elements have already been announced, pointing to increased focus on changing the growth pattern. For instance, the key objectives of the plan include "*...driving economic growth higher via domestic demand and achieving a more equal income distribution.*" This rebalancing process towards more sustainable and consumption-led growth is to be achieved trough various structural changes and reforms: 1) Higher wages also for low-income consumers (higher minimum wages and agricultural sector reforms). 2) Improved social security and health care system. 3) Continued urbanisation. 4) Increased service sector competition. 5) Increased regional focus: moving growth also to the western parts of China.

It should be noted that many of the plan's elements were also goals in the now expiring 5-year plan. But reforms were delayed first by the inflation spike in 2007-08 and then by the global recession. In the absence of any severe shocks, the economic rebalancing process should be on track from here on. Likely triggers of further delays (not our main scenario) could be elevated inflation, asset bubbles or a trade war.

Investments to remain important

Investments will remain the most important driver of the economy in the forecast period, underpinned by renewed strong infrastructure projects as the projects in the new 5-year plan probably will be initiated soon after the plan takes effect. The public sector is furthermore inclined to support growth because the government is to be replaced in two years' time (new National People's Congress, Central Committee and Politburo in late 2012, new President in March 2013) and likely wants to ensure a positive posthumous reputation.

Housing construction activity will be lower in the coming years. The effect from the many measures taken to dampen house price increases and speculative activity has been limited and less than anticipated. Thus, more targeted measures as well as general monetary tightening are likely to be pursued until house and property prices stabilise and even fall in the big cities where they increased the most. However, the dampening effect on construction activity will to some extent be counterweighed by the authorities' highly profiled programme to construct affordable or social housing. The programme seems to have gained momentum recently with 2.2 million of economic housing and subsidised rental units reportedly under construction. The total number of units pledged by the authorities under the programme has recently been increased to 15.4 million by the end of 2012.

Household sector the future growth driver

Private consumption will gain importance in the coming years, with the biggest change happening beyond the forecast period. But already in the forecast period we see private consumption growth outstripping overall GDP growth slightly, meaning that private consumption's currently relatively low share of GDP slowly will begin to increase. In the very short term, however, indicators of household consumption such as retail sales and consumer confidence point to subdued private consumption growth. The expected deflation of the housing bubble should not

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

	2007 (CNYbn)	2008	2009	2010E	2011E	2012E
Private consumption	9,360	8.6	10.4	9.4	9.5	10.0
Government consumption	3,519	8.5	7.2	9.0	9.5	9.0
Fixed investment	10,544	10.4	21.2	11.0	10.0	9.5
Stockbuilding*	548	0.5	-0.2	0.0	0.0	0.0
Exports	10,210	13.9	-9.1	12.0	10.0	10.0
Imports	7,872	15.2	-2.7	12.0	13.0	12.0
GDP		9.6	9.1	10.1	8.7	8.9
Nominal GDP (CNYbn)	26,309	30,686	33,535	38,029	43,048	48,602
Unemployment rate, %		4.2	4.3	4.4	4.3	4.1
Consumer prices, % y/y		6.0	-0.7	3.3	4.5	4.0
Current account, % of GDP		9.6	6.1	5.2	4.4	3.7
General government budget balance, % of GDP		-0.4	-2.1	-3.0	-2.4	-1.9

* Contribution to GDP growth (% points)

hurt household consumption much, as households' leverage is very low. The ratio of issuance of home mortgages to the value of homes sold is only around 35% because many homeowners initially paid very little for their homes and obtained subsidies during the transition from socialist allocation to a more market-based housing market

The export sector will continue to expand as the developed world's economies continue their recovery. And the gradual revaluation of the CNY will only have a limited dampening effect on exports. A huge share of imports is inputs to production of export goods, and imports thus follow exports. Imports to domestic demand still primarily consist of commodities and to some extent also machinery and equipment, but once private consumption becomes the main growth driver, the consumer goods market will take off too.

Inflation has taken off

With high economic growth, inflation has taken off and broken the 5% mark. It is primarily food price increases that are pushing up inflation, and the higher prices are mainly due to seasonal supply disruptions. But supply shocks are not the only explanation: the higher prices are also due to increased demand, indicating general inflationary pressure. And also non-food inflation has increased somewhat recently. The high inflation has been addressed by the authorities both via direct price controls and monetary policy tightening. The former will only work temporarily but should ensure that the inflation acceleration ends before summer this year. The latter should dampen inflation back below 4% in late 2010. But in general, China is bound for somewhat higher inflation in future than in the past. In line with this, the government's inflation target is raised in the new 5-year plan to 4% from 3%. The main reason for the higher inflation is stronger wage growth, despite the fact that wage increases seem to go hand in hand with strong productivity gains and thus should not be that inflationary.

More monetary tightening and CNY revaluation

The monetary tightening will likely continue with hikes in lending rates, reserve requirement rate hikes and lower lending targets and quotas. Also the gradual revaluation of the CNY versus the USD is expected to continue. Historically, the revaluation pace has been closely correlated with inflation, and alone for this reason, revaluation should continue because inflation will likely stay elevated. Other reasons are that the international pressure on China likely will persist and that a stronger CNY will support changing the growth engine from exports to domestic demand and from being investment-driven to being driven by private consumption.

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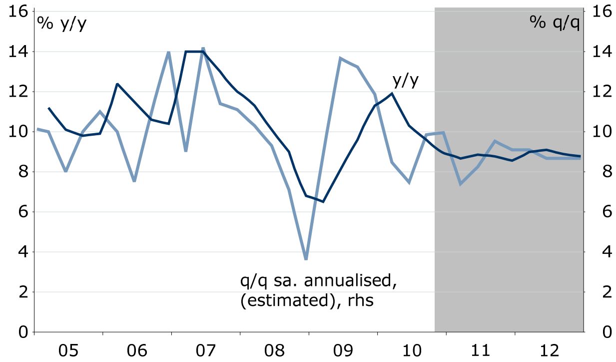
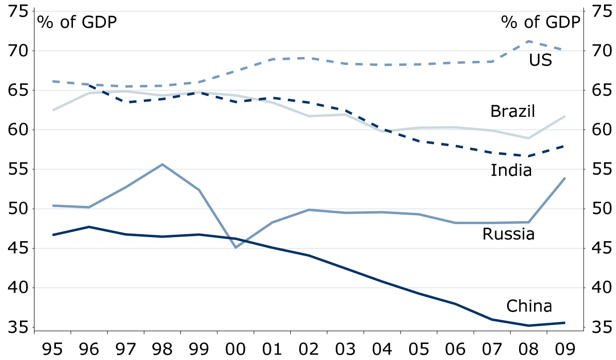
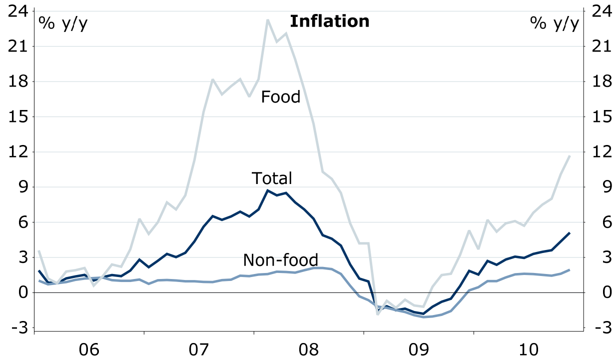
GDP growth to remain relatively solid



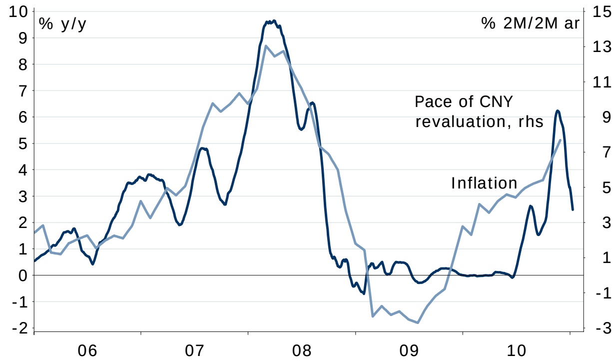
Private consumption will gradually gain importance



Also non-food inflation has increased somewhat



Inflation points to continued CNY revaluation



A growth story of its own

The story of strong and healthy economic growth is still intact. Growth will slow down this year compared with 2010, but pick up again in 2012 to close to 9%. Investment growth will likely cool off further, but remain in double-digit territory. Private consumption is set to accelerate as the big rural population gains from the much better harvest this year than last year. And urban households will prosper as wage increases stay strong. India is in a good position to sustain high economic progress in the coming years, among other factors due to its favourable demographics, its big pool of labour and foreign investors' eagerness to bring in know-how and capital. India is thus set to generate higher GDP growth than China in 2012.

Strong domestically driven growth is often accompanied by demand-driven inflationary pressure. The central bank's preferred inflation measure, wholesale price inflation, is finally falling, but it will likely bottom as early as this summer and increase throughout 2012. Despite the projected better harvest this year, which gives some relief to food prices, the high food price inflation seems to have become structural. One explanation is that the improved living standards of part of the population have changed the consumption pattern structurally to include a more protein-rich diet, the production of which is far more soft commodity-intensive. This has not gone hand in hand with adequate efficiency gains in the agricultural sector.

To dampen inflation, the central bank will likely sanction rate hikes of a total of 75 bp this year and also raise the reserve requirement rate further. The high inflation should make the central bank more tolerant of INR appreciation, and in fact, intervention has become very infrequent since mid-2009. We expect few, if any, measures to prevent further INR strengthening and therefore expect the strong growth story to be reflected in continued INR appreciation. Note, however, that India (and the INR) is one of the Emerging Market economies that could suffer – not gain – from too high global commodity prices, especially oil prices.

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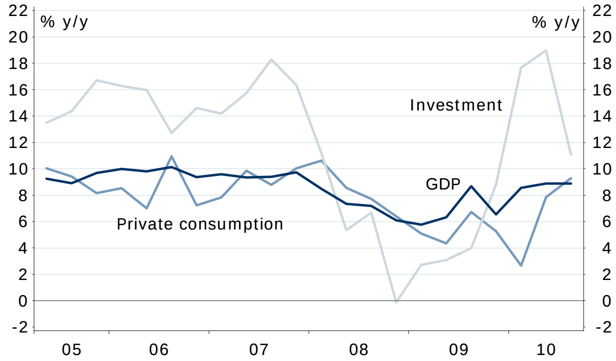
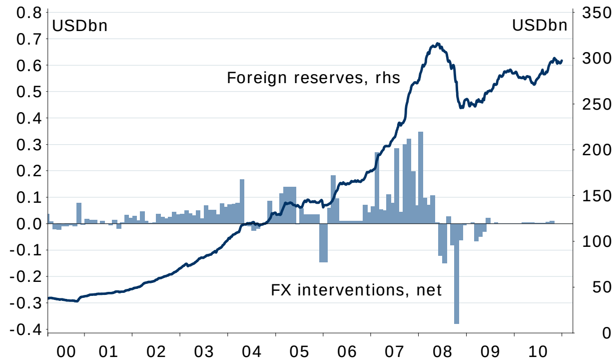
Households set to accelerate consumption



Inflation expected to take off again before long

Disclosed FX interventions have been very muted



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

	2007 (INRbn)	2008	2009	2010E	2011E	2012E
Private consumption	28,157	8.2	5.4	7.0	6.5	7.1
Government consumption	5,153	16.7	10.5	8.0	7.0	7.0
Fixed investment	16,305	4.0	7.2	12.0	13.0	15.0
Exports	9,843	21.1	-9.1	13.0	15.0	14.0
Imports	12,198	31.9	-8.4	10.0	12.0	13.0
GDP		5.1	7.7	9.2	8.7	9.3
Nominal GDP (INRbn)	49,479	55,744	61,183	72,446	83,102	94,947
Wholesale prices, % y/y		9.1	2.1	9.2	6.0	5.0
Current account, % of GDP		-2.2	-2.1	-2.9	-3.0	-3.0
General government budget balance, % of GDP		-6.0	-6.5	-7.0	-6.0	-5.0

* Contribution to GDP growth (% points)

Time to scale back the loose fiscal policies

Economic growth stays remarkably high as strong credit growth and a sustained loose fiscal policy support domestic demand. The flip side is that demand by far exceeds supply, with many overheating indicators in the red. The unemployment rate is seemingly hitting new record lows every month, and inflation is moving swiftly towards the 6.5% upper end of the inflation range. The lack of capacity will eventually dampen domestic demand growth, but in the short term, the main effects will be even higher inflation and a deterioration of the trade balance and current account. We do, however, expect a soft landing with economic growth slowing only to around the potential growth rate at a little below 5% this year before increasing a tad again in 2012.

The optimal way to combat the overheating tendencies would be to scale back the loose fiscal policy, for instance by cutting transfers and subsidies or reversing tax cuts. But the new government with newly elected President Rousseff has so far not shown much desire for fiscal tightening and economic reforms, and the budget deficit is expected to remain between 2% and 3% of GDP. Meanwhile, monetary policy will have to carry the burden of cooling down the economy and we expect interest rate hikes during the winter and spring. Also alternative measures for instance with a view to limiting credit growth will probably be introduced as rate hikes lead to unwanted currency strengthening. As inflation recedes again, it should be possible to lower interest rates during 2012. We expect long-term strengthening of the BRL supported by still relatively strong growth, high interest rates and increasing global commodity prices. The main BRL risk is the ever-looming risk of a sudden turnaround in global risk sentiment that would hurt especially the BRL hard. One domestic risk is the possibility of more capital restrictions in order to dampen inflows and BRL appreciation, but with an increasing current account deficit and huge direct investment needs, it is after all necessary for Brazil to continue to attract foreign capital.

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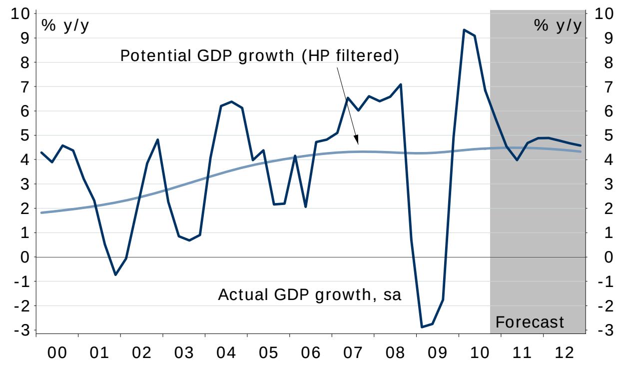
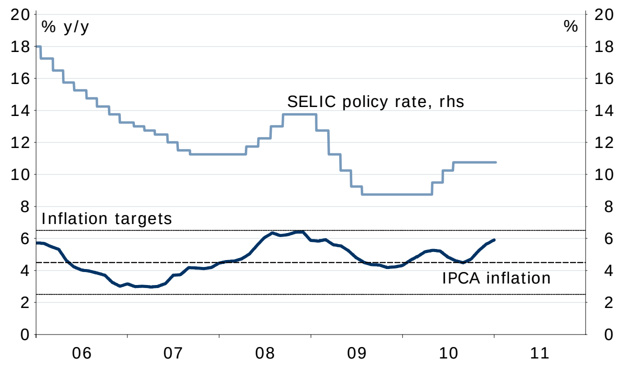
Overheating indicators in the red

Growth to slow to around potential



Hikes now, cuts in 2012



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

	2007 (BRLbn)	2008	2009	2010E	2011E	2012E
Private consumption	1,594.1	5.7	4.2	7.0	4.8	4.6
Government consumption	539.1	3.1	3.9	4.0	3.5	3.5
Gross fixed capital formation	464.1	13.6	-10.4	26.0	7.0	6.5
Stockbuilding*	23.6	0.9	-2.0	0.2	0.0	0.0
Exports	355.7	0.4	-10.3	10.0	9.0	7.0
Imports	315.2	15.3	-11.5	30.0	13.0	7.0
GDP		5.2	-0.7	7.6	4.5	4.7
Nominal GDP (BRLbn)	2,661.3	3,031.9	3,257.1	3,721.5	4,129.4	4,587.8
Unemployment rate, %		7.9	8.1	6.7	6.5	6.4
Consumer prices, % y/y		5.7	4.9	5.0	5.2	4.8
Current account, % of GDP		-1.8	-1.5	-2.5	-3.0	-3.0
General government budget balance, % of GDP		-1.6	-3.2	-2.7	-2.5	-2.0

* Contribution to GDP growth (% points)

Risk of overheating

Economic activity expanded sharply in 2010 and the economic policy mix with tighter fiscal policy and lower interest rates to deter capital inflows has worked reasonably well. Fundamentals are still looking strong going into 2011, but the economy is increasingly showing signs of overheating and hence tighter economic policies will be required during the year. With general elections scheduled for June, fiscal policy is unlikely to be tightened significantly, which leaves monetary policy as the key policy tightening tool.

We see growth around 5% this year with the domestic economy as the key driver. Domestic demand grew really fast during 2010, fuelled by easy credit conditions, especially in the latter part of the year. Credit conditions are likely to support domestic demand also this year despite the central bank's tightening of banks' reserve requirements and probable interest rate hikes in H1 2011.

The June general elections will most likely allow the current AKP government to continue in office. Such an outcome will be taken positively by the markets unless the AKP gets enough seats in parliament to make constitutional changes on its own. In that case, we believe that the "old" fear of an underlying religious agenda could spook the markets.

The central bank met last year's inflation target of 6.5% by end-year and inflation may drop further in the first half of 2011. The target for the end of this year is 5.5%. Still, we believe that inflation is the key risk factor, not least due to the central bank's recent willingness to tolerate large temporary deviations from the inflation target. The rapid widening of the current account deficit due to the strong domestic economy and amble foreign liquidity begs a weaker currency and makes it all the more difficult for the central bank to tighten monetary policy enough to anchor inflation.

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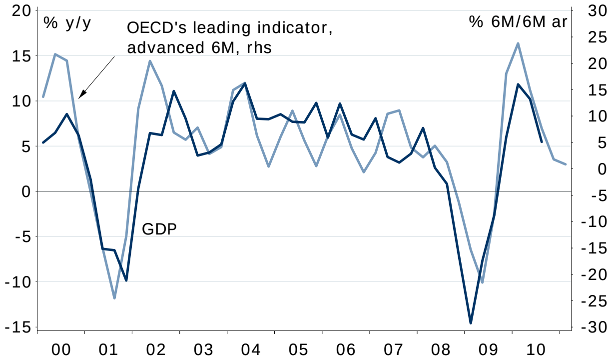
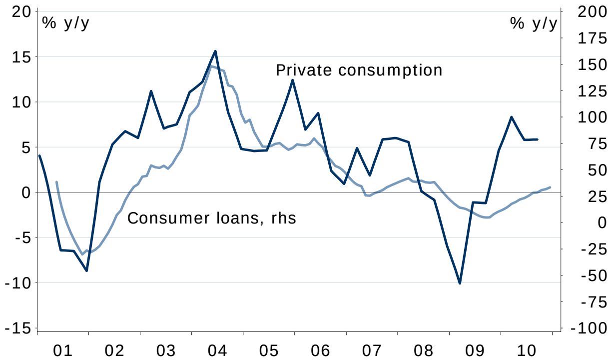
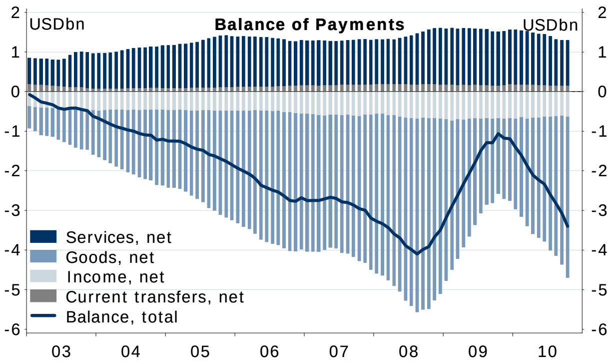
Strong growth



Credit growth supports domestic demand



Current account deficit widening rapidly



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

	2007 (TRYbn)	2008	2009	2010E	2011E	2012E
Private consumption	601	-0.3	-2.2	6.8	4.5	5.3
Government consumption	108	1.7	7.8	2.5	2.0	1.0
Fixed investment	181	-6.2	-19.1	15.9	5.9	7.5
Exports	188	2.7	-5.3	9.8	6.9	8.0
Imports	232	-4.1	-14.3	10.7	5.9	6.5
GDP		0.7	-4.7	7.5	5.1	5.5
Nominal GDP (TRYbn)	843	951	953	1,106	1,229	1,365
Unemployment rate, %		11.0	14.0	14.2	12.5	10.5
Consumer prices, % y/y		10.4	6.3	8.6	6.0	5.5
Current account, % of GDP		-5.8	-2.3	-5.6	-6.0	-6.0
Public sector balance, % of GNP		-1.8	-5.5	-5.2	-4.5	-4.0

* Contribution to GDP growth (% points)

Oil price rally may put world economic growth at risk

The underlying oil price trend is expected to move higher and accelerate in late 2011 as world economic growth gains momentum and global oil demand is anticipated to outpace non-OPEC supply growth. In turn, this will heighten the pressure on OPEC to increase production and OPEC's spare capacity is expected to decline. In the short term there is a risk that the oil price may fall below the underlying trend as renewed concerns about vulnerable Euro-area economies or weaker growth signals from major oil consuming countries such as China may weigh on risk appetite.

Oil production has outstripped new discoveries since the 1980s. The average size of new fields is shrinking and the marginal costs on new fields outside OPEC are mounting. Adequate and timely investments are vital to secure sufficient capacity expansion to compensate for the natural decline in existing fields and to meet the future demand for energy. We expect to see an upswing in upstream oil investments in 2011 as lower exploration and development costs and higher oil prices have improved the investment climate. Cost inflation is expected to pick up as prices on input factors such as materials, drilling rigs and labour are expected to rise. The marginal cost of production is expected to increase as a growing share of oil production is moving offshore and to greater depths and declining non-OPEC conventional production is replaced by high-cost unconventional oil such as Canadian tar sand. Limited potential to expand non-OPEC production capacity increases the pressure on OPEC countries to invest as the cartel holds around 75% of the world's proven oil reserves.

World economic activity, urbanisation and population growth are vital oil demand drivers. The centre of economic gravity and oil demand is expected to continue to shift eastward with China, India and the Middle East as frontrunners. Transport fuel is expected to increase its share of total oil consumption in these regions going forward. Strict domestic price control regimes especially in Asia and the Middle East, have sheltered consumers from rising oil prices and supported strong demand growth for transportation fuels. Many countries have now gradually started to increase the pass-through of oil price changes to end-users or abolish subsidies completely. US shale gas production and strong growth in global LNG capacity revolutionised the global gas markets and led to a decoupling of oil and gas prices. If the gas glut remains for a period, ample gas reserves, increasing flexibility in the gas market and stricter environmental requirements could increase the significance of natural gas in the global energy market and dampen oil demand growth.

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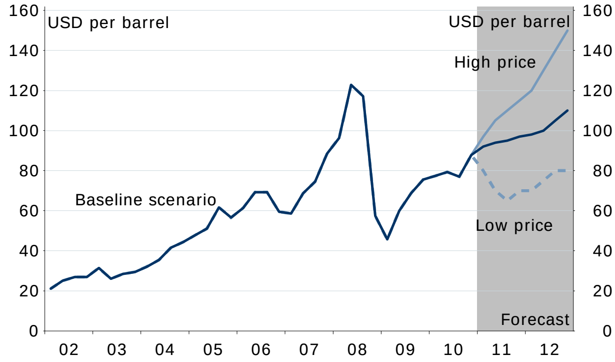
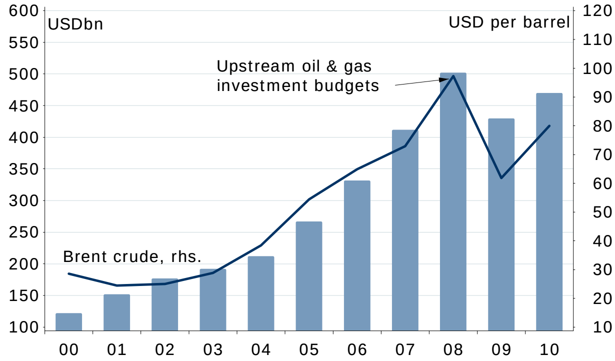
Oil price forecast – baseline (Brent – USD/barrel)

	Q1	Q2	Q3	Q4	Year
2008	96.3	122.8	117.2	57.5	98.4
2009	45.7	59.9	68.9	75.5	62.5
2010E	77.4	79.3	77.0	87.8	80.4
2011E	92.0	94.0	95.0	97.0	94.5
2012E	98.0	100.0	105.0	110.0	103.3

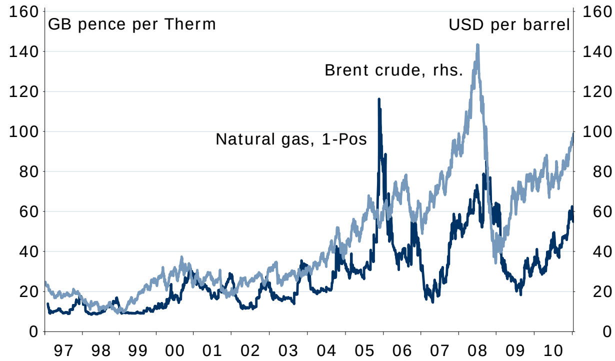
Oil price scenarios – baseline, high and low prices



Oil price and upstream oil & gas investment budgets



Brent crude & National Balancing Point natural gas



Metal prices still trending up

As we expected, base metal markets have fluctuated widely since the previous edition of *Economic Outlook*. Prices accelerated in October, fell back in November and then re-accelerated in December, reaching year-high levels for the LME index. Key factors behind the price increases were improving physical market fundamentals for several metals, increased risk appetite and encouraging economic indicators.

The physical market fundamentals for copper have tightened rather rapidly, primarily driven by non-Chinese demand growth. Price action has surprised on the upside, recently reaching new nominal all-time highs. According to the International Copper Study Group, supply barely kept up with demand in 2010 and commercial inventories have come down significantly. This year we expect a tighter supply-demand balance, resulting in further inventory draws as the potential for increasing production is limited. Prices should stay high and volatile, stimulating demand substitution into other metals.

Aluminium prices have also been volatile in 2010, but ended the year slightly higher. Inventories have trended downwards, but are still well above normal industry levels. After a strong production recovery, supply growth will probably slow this year. Meanwhile, we expect continued strong demand growth. We thus expect the aluminium market to tighten gradually. Prices could therefore rise, leaving aluminium among the best performing base metals over the coming years.

Nickel has been one of the best performing base metals in 2010. Key factors have been an improving supply-demand balance driven by a strong increase in stainless steel production. A number of new supply projects are planned to come on steam, but delays are probable. With expected robust growth in demand, the nickel market may stay relatively tight for a while. This will likely result in volatile and high price levels until production catches up with demand.

Fundamentals for zinc remain among the weakest in the base metal complex. Prices have been volatile in 2010, ending the year slightly lower. According to the International Lead and Zinc Study Group, supply has outstripped demand in 2010 leading to steadily rising inventories. Going forward, we expect zinc demand to rebound in step with rising economic momentum. Supply will probably still outweigh demand this year, but a supply deficit can occur already in 2012. Current prices reflect a move towards a balanced market, but we still expect zinc to underperform relative to other base metals.

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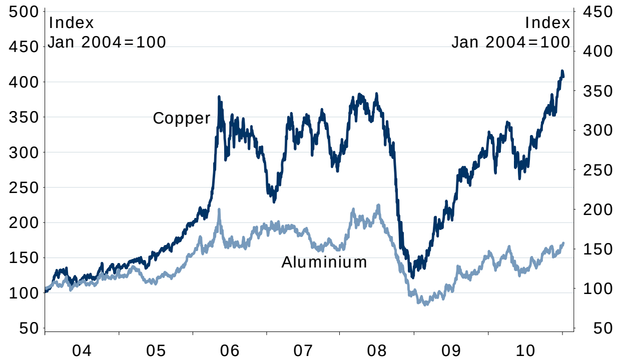
Metal prices approaching all-time highs

Copper fundamentals expected to remain strong



Zinc fundamentals improving, but still weak

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