Economic Outlook

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Markets

Data overview

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Nordic economies

Major economies

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Lean years ahead

Since the January issue of *Economic Outlook* the outlook for the global economy has deteriorated significantly. The credit crisis seems far from over, liquidity is still quite tight, the banks have raised their lending rates, house prices are under heavy pressure in many countries and the global equity markets have seen the most dramatic correction since the IT bubble burst in 2000.

At this point it is unclear when market conditions will normalise – and what credit spreads, asset prices etc that will prevail in future. One of the main reasons is that the current crisis is *not* only a traditional liquidity squeeze that can be solved through traditional monetary policy tools. The crisis is also rooted in lack of trust between players in the financial sector; there is no quick fix for this. However, as part of a long-term plan it seems obvious that similar situations will be sought circumvented through demands for more openness and stricter risk management in the financial sector.

On top of the gloomier growth outlook, prices of energy and food have skyrocketed. This development deeply frustrates the central bank governors, whose job is to curb inflation, and threatens to trigger social unrest in the world's poorest countries where food makes up a much larger share of private consumption than in the industrialised world. That is why we are left with a poisonous cocktail that will inevitably damage coming years' global economic growth.

USA in recession

The meltdown originated in the US where the economy has most likely already slid into a recession that will be followed by a long period of weak growth. The main culprit is the housing market, which is in its biggest slump since World War II. US housing prices have persistently fallen by over 10% on average from their peak in 2006 – and as the number of homes on the market is still very high, prices could well decline further. Note also that the Fed's aggressive interest rate cuts have not initially been channelled on to market rates. Mortgage rates have only fallen slightly, so something indicates that the monetary policy transmission mechanism to some extent is inoperative. But it is clear that the steeper yield curve will clearly improve the banks' chances of a speedy reconsolidation during this difficult period.

The ailing housing market has initially affected other parts of the US economy through a sharp decline in residential construction activity, but consumer spending is expected to be the main drag on growth going forward. Against this backdrop, we think that the Fed will cut interest rates further to 1.5% to boost the economy. Combined with the tax package that will take effect in June worth about 1% of GDP, this will gradually shift the economy into a higher gear in H2. But in our view growth will not approach the potential level of some 3% until the end of 2009. The Fed will not start to normalise its monetary policy until late in the forecast period.

We should point out that there is a risk of an even deeper and longer downslide if, for example, huge losses in the financial sector lead to an even more serious credit crunch. The IMF estimates[1] that losses could total USD 1,000bn or about four times the amount disclosed so far.

When the US sneezes…

When the US sneezes, the rest of the world catches a cold, or so the old saying goes. Although globalisation has changed the economic order of things, the slowdown in the US will very likely spill over to the rest of the world this time too. Directly because of lower imports and indirectly because the weak USD, which is a consequence of the weak US economy, will adversely affect countries outside the USD block whose competitiveness will suffer. Add to this the tighter credit standards and it is clear that the Euro area will be affected. But we have also lowered our 2008 growth estimates for Japan and China – in the latter case also because of its monetary policy tightening aimed at curbing the sharp spike in inflation. In Japan one of the implications of the gloomier growth outlook will be a longer period of unchanged interest rates than previously expected and we now anticipate a less aggressive monetary policy tightening than seen to date.

The challenge for exporters in the Euro area is increased by the fact that also the GBP has nosedived since the credit crisis erupted. The UK is a major export market for the Euro area and it seems unrealistic to expect the Euro area to steer clear of the international downdraft, although the export performance in new markets, including Central and Eastern Europe and East Asia, has so far been very impressive. However, the progress is largely attributable to German companies, while countries in southern Europe are facing massive problems. Spain is on the brink of a marked slowdown in the building and construction sectors, for example.

The ECB to cut interest rates in 2009

Based on the deteriorating growth prospects we now expect the ECB to lower interest rates during 2009 when employment is likely to wane and inflation should start to trend lower after reaching a 16-year high in the spring. In the Euro area developments give rise to a serious monetary policy dilemma. Should the ECB follow a monetary policy line consistent with conditions implying a swift rate cut, such as the financial crisis or currency issues, or should the bank fight the climbing inflation here and now. In this connection it is worth bearing in mind that according to the bank's mandate it is only in the medium term that inflation must be close to, but below, 2%. But

[1] IMF, Global Financial Stability Report, April 2008

the ECB has clearly chosen sides – it is currently combating inflation by leaving interest rates at 4%. The consequence is that growth will slow even more, increasing the need for more aggressive rate cuts at a later point. Against this background we expect interest rates to be cut to 3% during 2009, first time by 50 bp in March. The narrowing of the interest rate differential between the Euro area and the US will contribute to weakening the EUR versus the USD during the forecast horizon when we look for a gradual decline in EUR/USD. However, near term there is no doubt that the USD may weaken further, not least if several of the world's central banks push through the reallocation of their currency reserves from USD to EUR.

Decoupling on the agenda

Combined with declining risk appetite among investors the economic slowdown in the US economy has led to a dramatic drop in US yields, which except for a brief period in 2004 are at an all-time low since the 1960s. In light of the relatively high inflation, real interest rates are now in negative territory, which is unsustainable in the long run. Usually long yields back up when a monetary tightening cycle appears to be over. Against this backdrop, we expect long yields to move higher again in the course of H2 2008, but as long as the economy remains weak, the pick-up will be very moderate. In Europe, on the other hand, we look for a flat to slightly downward trend in long yields on a 12-month outlook when the ECB lowers the policy rate. We could thus see a periodic decoupling between US and European long yields. This correlation is not normal, but recent months have taught us that a normal scenario cannot be taken for granted any more.

Upswing over in the Nordic countries

The Nordic countries will also be hit by the economic downturn in the US. Finland and Sweden are generally somewhat more exposed to the US than Norway and Denmark because of their business sector structures, but the latter two countries will not escape weaker economic trends during the forecast period compared to previous years.

It seems to be increasingly clear that the **Danish** economy will face some years with much more moderate growth than in the past few years. The main reason is still the downturn in the housing market that has adversely affected private consumption growth and residential investment. The Danish economy is also affected by the fallout from the financial crisis in international markets, though. The high money market rates have made financial institutions announce rate hikes on certain loan products. The higher lending rates will in all probability strengthen the trend towards lower growth in investment and private consumption. More important factors, however, are the outlook for softer global growth and the weak USD, which point to weak export trends in the coming years. Over time the lower growth will cause unemployment to rise and thus help ease the current high inflation pressures in the Danish economy and ensure that exporters' competitiveness is not seriously harmed.

The **Swedish** economy started to slow down in 2007 and is expected to slow further in 2008. The slowdown is likely to stretch into 2009 with growth well below the potential level. Exports are well diversified, alleviating some of the negative effects of the US slowdown. Investment has increased sharply, but will dampen in 2008 and stagnate in 2009 as an effect of subdued demand. Private consumption is seen slowing despite a strong rise in disposable income, boosted by fiscal policy measures in 2009 worth SEK 20bn. Employment will fall and unemployment pick up next year as an effect of weaker growth. Inflation has remained high, but is expected to drop as the effect of higher prices of energy and food will fade drop out of the index during H2 2008. This paves the way for the Riksbank to start cutting the repo rate during the autumn, reaching 3.0% in 2009.

Finnish economic growth slowed markedly as early as in H2 2007. According to our earlier estimates the downturn in the world economy would temporarily slow down growth in Finland, which would mainly ease the bottlenecks caused by robust growth. However, the downswing in export markets will inevitably be reflected in the outlook for the Finnish economy. We expect economic growth to be around 2% on average in 2008 and 2009. So, the downturn still looks set to be relatively mild, as also indicated in our earlier estimate. Yet, risks have surely increased that the economic downturn in 2008-09 will be more than just a welcome breather.

In **Norway** the rate hike will help curb growth in domestic demand in the coming years. A weaker global growth outlook will also curtail growth going forward, although persistently high oil prices will limit the effect on the Norwegian economy. Given the weaker growth rates Norges Bank can keep the policy rate unchanged at 5.50% although inflation looks set to rise further this year. Based on the weaker growth prospects Norges Bank will estimate that inflation stabilises close to the target. Moreover, given the unrest in financial markets, Norges Bank's monetary policy will be tighter than its rate changes would suggest. With continued high oil prices and higher interest rates than those of Norway's trading partners, the NOK should remain relatively strong in the years ahead, although the NOK is currently somewhat weaker than expected due to reduced risk appetite.

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Growth, %

	2005	2006	2007	2008E	2009E
World[1)]	4.1	4.6	4.4	3.4	3.3
BIG-3[2)]	2.4	2.8	2.3	1.3	1.5
USA	3.1	2.9	2.2	1.0	1.5
Japan	1.9	2.4	2.0	1.3	1.8
Euro area	1.7	2.9	2.6	1.6	1.3
Germany	1.0	3.1	2.6	1.7	1.5
France	1.7	2.2	1.9	1.7	1.4
Italy	0.2	1.9	1.5	0.6	0.5
Spain	3.5	3.9	3.8	2.0	1.5
Netherlands	1.5	3.0	3.5	2.2	2.3
Belgium	1.1	3.1	2.7	1.6	1.3
Austria	2.0	3.1	3.3	2.2	1.5
Portugal	0.5	1.3	1.8	1.5	1.4
Greece	3.7	4.3	4.1	3.5	3.0
Finland	2.8	4.9	4.4	2.3	1.8
Ireland	5.5	6.0	4.9	2.5	2.5
Denmark	2.5	3.9	1.8	1.5	0.9
Sweden	3.3	4.1	2.6	2.1	1.5
Norway	4.6	4.8	6.0	3.4	1.8
Iceland	7.1	4.2	4.0	1.7	1.0
UK	1.8	2.9	3.0	1.7	1.9
Switzerland	2.5	3.2	3.1	1.8	1.6
Russia	6.4	6.7	7.5	7.0	6.2
Poland	3.6	6.2	6.5	5.3	5.4
Czech Republic	6.4	6.4	6.1	4.4	4.7
Hungary	4.3	4.0	1.8	2.5	3.4
Estonia	10.2	11.2	7.2	4.0	5.3
Latvia	10.6	11.9	10.9	5.6	5.1
Lithuania	7.9	7.7	9.1	7.4	6.7
Turkey	7.4	6.1	3.8	5.3	8.0
China	10.2	11.1	11.4	10.0	8.5
India	9.0	9.4	9.1	8.0	7.8
Asia-5[3)]	4.8	5.3	5.5	5.2	5.4
Latin America-3[4)]	3.8	4.7	4.8	4.1	3.7

Inflation, %

	2005	2006	2007	2008E	2009E
World	3.3	3.2	3.2	4.0	3.0
BIG-3	2.4	2.4	2.2	2.8	1.9
USA	3.4	3.2	2.9	3.2	2.3
Japan	-0.3	0.2	0.1	0.7	0.5
Euro area	2.2	2.2	2.1	3.1	1.9
Germany	1.9	1.8	2.3	2.9	1.7
France	1.9	1.9	1.6	2.8	1.9
Italy	2.2	2.2	2.0	3.0	2.1
Spain	3.4	3.6	2.8	4.0	2.7
Netherlands	1.5	1.7	1.6	2.2	2.3
Belgium	2.5	2.3	1.8	2.8	1.9
Austria	2.1	1.7	2.1	2.9	1.9
Portugal	2.1	3.0	2.5	2.7	2.1
Greece	3.5	3.3	3.0	3.5	3.2
Finland	0.9	1.6	2.5	3.4	2.2
Ireland	2.2	2.7	2.9	3.5	2.3
Denmark	1.8	1.9	1.7	3.0	2.6
Sweden	0.5	1.4	2.2	3.1	1.9
Norway	1.6	2.3	0.8	2.9	2.7
Iceland	4.0	6.7	4.9	3.9	3.0
UK	2.1	2.3	2.3	2.7	1.9
Switzerland	1.2	1.1	0.7	1.8	1.4
Russia	12.7	9.7	9.0	12.0	8.7
Poland	2.2	1.2	2.6	3.1	3.0
Czech Republic	1.8	2.5	2.8	4.9	3.3
Hungary	3.6	3.9	7.9	4.4	3.3
Estonia	4.1	4.4	6.6	7.9	4.8
Latvia	6.8	6.5	10.1	12.0	6.7
Lithuania	2.7	3.7	5.7	7.0	5.1
Turkey	8.1	9.6	8.8	5.7	5.1
China	1.8	1.5	4.6	7.0	5.0
India	4.4	5.3	4.6	5.0	4.7
Asia-5	5.7	6.2	3.5	4.1	3.8
Latin America-3	5.3	4.5	4.3	4.7	4.4

1) Weighted average of countries in this table. Accounts for 82.7% of world GDP. Weights calculated using PPP adjusted GDP levels for 2004 according to the IMF's World Economic Outlook
2) US, Japan and the Euro area
3) Indonesia, Malaysia, the Philippines, South Korea and Thailand
4) Argentina, Brazil and Mexico

Public finances, % of GDP

	2005	2006	2007	2008E	2009E
BIG-3	-3.1	-1.8	-1.3	-2.1	-2.1
USA	-2.6	-1.6	-1.4	-2.8	-2.7
Japan	-6.4	-2.9	-2.8	-3.2	-3.1
Euro area	-2.5	-1.5	-0.6	-0.6	-0.8
Germany	-3.4	-1.6	0.0	-0.2	-0.3
France	-2.9	-2.5	-2.7	-2.9	-3.0
Italy	-4.2	-3.4	-1.9	-2.4	-2.7
Finland	2.9	4.1	5.3	4.5	4.0
Denmark	5.0	4.9	4.5	3.7	2.7
Sweden	2.0	2.2	3.0	2.7	1.6
Norway	15.1	18.5	17.3	18.7	21.4
Iceland	5.2	5.2	1.7	-0.3	-1.0
UK	-3.6	-2.9	-3.1	-2.9	-2.5
Switzerland	0.4	-0.6	-0.1	0.0	0.0
Russia	7.4	7.5	4.5	2.5	1.0
Poland	-4.3	-3.9	-2.8	-3.1	-3.0
Czech Republic	-3.5	-2.9	-3.4	-3.3	-3.0
Hungary	-7.8	-9.2	-5.9	-4.5	-4.2
Estonia	1.9	2.6	3.0	1.0	1.0
Latvia	-0.4	-0.3	0.5	1.0	1.2
Lithuania	-1.0	0.0	-0.5	-1.0	-0.5
Turkey	-0.2	-0.4	-2.5	-2.0	-0.5
China	-1.2	-0.7	-1.1	-1.0	-1.0
India	-7.3	-6.4	-5.7	-6.0	-6.1
Asia-5	-0.2	-0.7	-0.8	-0.9	-0.8
Latin America-3	0.8	0.6	1.2	1.7	2.1

Current account, % of GDP

	2005	2006	2007	2008E	2009E
BIG-3	-	-	-	-	-
USA	-6.1	-6.2	-5.3	-4.0	-3.0
Japan	3.7	3.9	4.8	4.8	5.0
Euro area	0.1	-0.2	0.2	0.1	0.0
Germany	4.6	4.9	6.7	6.6	6.4
France	-0.9	-1.2	-1.2	-1.3	-1.5
Italy	-1.6	-2.6	-2.4	-2.5	-2.6
Finland	3.9	4.9	4.4	3.5	3.2
Denmark	4.4	2.9	1.2	0.7	0.5
Sweden	6.1	8.5	8.3	8.0	8.0
Norway	16.3	17.3	16.3	17.5	20.5
Iceland	-16.1	-26.7	-25.5	-15.0	-10.0
UK	-2.5	-3.7	-4.1	-4.1	-3.7
Switzerland	13.5	15.1	15.8	15.2	15.0
Russia	11.1	9.6	5.8	5.0	2.3
Poland	-1.4	-1.7	-4.0	-4.2	-4.3
Czech Republic	-1.7	-3.2	-3.9	-4.7	-6.0
Hungary	-6.8	-6.5	-4.5	-3.4	-3.5
Estonia	-10.0	-15.5	-15.8	-10.0	-8.5
Latvia	-12.6	-22.3	-27.0	-20.0	-16.4
Lithuania	-6.9	-10.8	-12.8	-15.9	-15.0
Turkey	-6.5	-8.6	-7.9	-8.4	-8.9
China	7.2	9.4	11.6	10.0	9.0
India	-1.1	-1.1	-1.2	-1.3	-1.1
Asia-5	1.5	3.2	3.5	2.6	2.6
Latin America-3	0.7	0.8	0.2	-0.3	-0.8

Monetary policy rates

	15.4.08	3M	6M	12M	24M
US	2.25	1.50	1.50	1.50	2.50
Japan	0.50	0.50	0.50	0.50	0.75
Euro area	4.00	4.00	4.00	3.50	3.00
Denmark	4.25	4.25	4.25	3.75	3.25
Sweden	4.25	4.25	4.00	3.25	3.00
Norway	5.25	5.50	5.50	5.50	5.00
UK	5.00	4.75	4.50	4.00	4.00
Switzerland	2.75	2.75	2.75	2.50	2.25
Poland	5.75	5.75	5.75	5.75	5.75
Czech Rep.	3.75	4.25	4.25	4.25	4.50
Hungary	8.00	8.00	8.00	7.50	6.50

Monetary policy rate spreads vs Euro area

	15.4.08	3M	6M	12M	24M
US	-1.75	-2.50	-2.50	-2.00	-0.50
Japan[1]	-1.75	-1.00	-1.00	-1.00	-1.75
Euro area	-	-	-	-	-
Denmark	0.25	0.25	0.25	0.25	0.25
Sweden	0.25	0.25	0.00	-0.25	0.00
Norway	1.25	1.50	1.50	2.00	2.00
UK	1.00	0.75	0.50	0.50	1.00
Switzerland	-1.25	-1.25	-1.25	-1.00	-0.75
Poland	1.75	1.75	1.75	2.25	2.75
Czech Rep.	-0.25	0.25	0.25	0.75	1.50
Hungary	4.00	4.00	4.00	4.00	3.50

1) Spread vs US

3-month rates

	15.4.08	3M	6M	12M	24M
US	2.71	2.00	1.75	1.75	2.75
Japan	0.93	0.80	0.85	0.90	1.30
Euro area	4.76	4.40	4.30	3.65	3.15
Denmark	4.97	4.60	4.50	3.85	3.35
Sweden	4.86	4.65	4.40	3.45	3.20
Norway	6.31	6.10	5.90	5.60	5.25
UK	5.93	5.50	5.00	4.30	4.25
Switzerland	2.81	2.75	2.75	2.50	2.25
Poland	6.30	6.05	6.00	6.00	6.00
Czech Rep.	4.10	4.30	4.40	4.50	4.70
Hungary	8.21	8.10	7.90	7.00	6.70
Estonia	6.32	6.00	5.90	5.30	4.80
Latvia	6.01	5.70	5.60	5.00	4.50
Lithuania	5.02	4.70	4.60	4.00	3.50

3-month spreads vs Euro area

	15.4.08	3M	6M	12M	24M
US	-2.06	-2.40	-2.55	-1.90	-0.40
Japan[1]	-1.78	-1.20	-0.90	-0.85	-1.45
Euro area	-	-	-	-	-
Denmark	0.21	0.20	0.20	0.20	0.20
Sweden	0.09	0.25	0.10	-0.20	0.05
Norway	1.55	1.70	1.60	1.95	2.10
UK	1.17	1.10	0.70	0.65	1.10
Switzerland	-1.96	-1.65	-1.55	-1.15	-0.90
Poland	1.54	1.65	1.70	2.35	2.85
Czech Rep.	-0.66	-0.10	0.10	0.85	1.55
Hungary	3.45	3.70	3.60	3.35	3.55
Estonia	1.56	1.60	1.60	1.65	1.65
Latvia	1.25	1.30	1.30	1.35	1.35
Lithuania	0.26	0.30	0.30	0.35	0.35

1) Spread vs US

10-year government benchmark yields

	15.4.08	3M	6M	12M	24M
US	3.56	3.50	3.75	4.00	4.75
Japan	1.34	1.50	1.60	1.85	2.20
Euro area	3.97	3.90	3.90	3.80	4.30
Denmark	4.22	4.10	4.05	3.85	4.35
Sweden	4.08	4.00	3.95	3.85	4.35
Norway	4.48	4.50	4.50	4.40	5.10
UK	4.44	4.40	4.50	4.70	4.90
Switzerland	3.01	2.80	2.80	2.70	3.00
Poland	5.98	6.00	6.10	6.20	6.30
Czech Rep.	4.66	4.85	4.90	5.00	5.10
Hungary	7.93	8.50	7.60	7.30	7.25

10-year yield spreads vs Euro area

	15.4.08	3M	6M	12M	24M
US	-0.41	-0.40	-0.15	0.20	0.45
Japan[1]	-2.22	-2.00	-2.15	-2.15	-2.55
Euro area	-	-	-	-	-
Denmark	0.26	0.20	0.15	0.05	0.05
Sweden	0.11	0.10	0.05	0.05	0.05
Norway	0.51	0.60	0.60	0.60	0.80
UK	0.47	0.50	0.60	0.90	0.60
Switzerland	-0.96	-1.10	-1.10	-1.10	-1.30
Poland	2.01	2.10	2.20	2.40	2.00
Czech Rep.	0.69	0.95	1.00	1.20	0.80
Hungary	3.96	4.60	3.70	3.50	2.95

1) Spread vs US

Exchange rates vs EUR

	15.4.08	3M	6M	12M	24M
EUR/USD	1.579	1.600	1.550	1.450	1.400
EUR/JPY	160.2	156.8	155.0	158.1	158.2
EUR/DKK	7.460	7.460	7.460	7.460	7.460
EUR/SEK	9.412	9.300	9.400	9.200	9.100
EUR/NOK	7.925	7.850	7.750	7.750	7.750
EUR/GBP	0.805	0.810	0.790	0.760	0.750
EUR/CHF	1.583	1.580	1.570	1.550	1.550
EUR/PLN	3.405	3.500	3.500	3.400	3.250
EUR/CZK	24.80	25.50	26.00	26.50	27.00
EUR/HUF	251.9	255.0	255.0	260.0	260.0
EUR/RUB	37.09	36.15	36.00	34.44	33.35
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.697	0.700	0.700	0.700	0.700
EUR/LTL	3.453	3.453	3.453	3.453	3.453
EUR/CNY	11.041	10.960	10.463	9.353	8.540

Exchange rates vs USD

	15.4.08	3M	6M	12M	24M
-					
USD/JPY	101.5	98.0	100.0	109.0	113.0
USD/DKK	4.723	4.663	4.813	5.145	5.329
USD/SEK	5.960	5.813	6.065	6.345	6.500
USD/NOK	5.018	4.906	5.000	5.345	5.536
GBP/USD	1.963	1.975	1.962	1.908	1.867
USD/CHF	1.002	0.988	1.013	1.069	1.107
USD/PLN	2.156	2.188	2.258	2.345	2.321
USD/CZK	15.70	15.94	16.77	18.28	19.29
USD/HUF	159.5	159.4	164.5	179.3	185.7
USD/RUB	23.49	22.59	23.23	23.75	23.82
USD/EEK	9.91	9.78	10.09	10.79	11.18
USD/LVL	0.442	0.438	0.452	0.483	0.500
USD/LTL	2.186	2.158	2.228	2.381	2.466
USD/CNY	7.246	7.200	7.000	6.700	6.400

Easy times over for the economy

- Growth set to drop sharply in the period ahead.
- Housing market main cause of slowdown...
- ...but estimates lowered due to the credit crisis.
- Threat of overheating is easing.

It seems to be increasingly clear that the Danish economy will face some years with much more moderate growth than the past few years. the main reason is still the downturn in the housing market that has adversely affected private consumption growth and residential investment. The Danish economy is also affected by the fallout from the financial crisis in international markets, although it has not initially led to substantial losses in the Danish financial sector. The high money market rates have made financial institutions announce rate hikes on certain loan products. The higher lending rates will in all probability strengthen the trend towards lower growth in investment and private consumption. More important factors, however, are the outlook for softer global growth and the weak USD, which point to weak export trends in the coming years. These factors are the main reason why we have downgraded our growth forecast.

Over time the lower growth will cause unemployment to rise from the current record-low level, and this will ease the upward pressure on wage growth. The low-growth period will thus help to reduce the current high inflation pressures in the Danish economy and ensure that exporters' competitiveness is not seriously harmed.

On the one hand, the need for an actual fiscal policy tightening is eliminated. On the other hand, it is of vital importance for the long-term stability of the Danish economy that growth is allowed to flatten by its own accord in the years ahead.

Housing market decisive for economic cycle

The recent years' downturn in the housing market plays a vital role for our forecast of lower growth in the years ahead. Historical experience suggests that the number of housing transactions is decisive for whether the economy moves above or below the capacity limit. By this reckoning, the decline in the number of home sales since early 2006 should thus eliminate capacity pressures in the Danish economy over the course of a few years. We therefore look for economic growth below the long-term average during the next couple of years with a resultant slight increase in unemployment.

The housing market does not seem poised for a recovery anytime soon. According to the latest data from the Association of Danish Mortgage Banks the number of homes on the market is still record high with a very weak trend in sales. In our view, the weak housing trend is closely linked with the strong price increases up to 2006 that pushed the housing burden to a very high level. This burden probably needs to ease by just over 5% points for the market situation to become more normal. However, this does not mean that we are facing a period with sharp price declines nationwide. The housing burden is more likely to ease over a lengthy period with zero growth in prices, while gradually increasing disposable incomes slowly reduce housing costs relative to income. The expected decline in interest rates will also help stabilise the market situation, although the interest rate decline is unlikely to be large enough to trigger new house price increases.

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

	2004 (DKKbn)	2005	2006	2007	2008E	2009E
Private consumption	707.2	5.2	3.8	2.5	2.6	1.5
Government consumption	389.0	0.9	2.0	1.7	1.8	1.1
Fixed investment	285.0	6.1	14.0	6.2	0.2	-0.3
- government investment	25.9	3.1	16.5	-3.9	4.5	6.0
- residential investment	76.9	18.7	12.2	4.5	-3.9	-3.3
- business fixed investment	182.2	1.4	14.5	8.8	1.6	0.0
Stockbuilding*	13.5	-0.7	0.6	-0.4	0.1	0.0
Exports	665.0	8.3	9.0	3.7	3.0	3.4
Imports	593.5	11.3	14.1	5.6	3.9	3.4
GDP		2.5	3.9	1.8	1.5	0.9
Nominal GDP (DKKbn)	1466.2	1,548.2	1,641.5	1,695.0	1,770.1	1,833.0
Unemployment rate, %		5.1	3.9	2.7	2.2	2.6
Unemployment level, '000 persons		141.0	109.0	77.1	60.0	72.5
Consumer prices, % y/y		1.8	1.9	1.7	3.0	2.6
Hourly earnings, % y/y		2.8	3.3	4.0	4.6	4.4
House prices, one-family, % y/y		16.4	24.3	2.0	0.0	0.0
Current account (DKKbn)		67.7	46.9	20.5	12.0	10.0
- % of GDP		4.4	2.9	1.2	0.7	0.5
General govt. budget balance (DKKbn)		77.4	79.9	75.6	65.0	50.0
- % of GDP		5.0	4.9	4.5	3.7	2.7
Gross public debt, % of GDP		36.4	30.4	26.0	22.0	18.0

* Bidrag til BNP vækst (% points)

So far the housing market downturn has masked large regional differences, which are most clearly reflected in house price data. Prices of owner-occupied flats in Copenhagen and Århus have fallen the most, with single-family houses in the Greater Copenhagen area coming in second. In the rest of the country house prices continued to rise throughout 2007, but the number of homes on the market is also on an uptrend. We also see tentative signs that the market for owner-occupied flats in Copenhagen is past the initial correction, as the number of homes for sale is starting to fall from a very high level; this suggests a more homogeneous house price trend in the various regions going forward.

Price increases weigh on private consumption

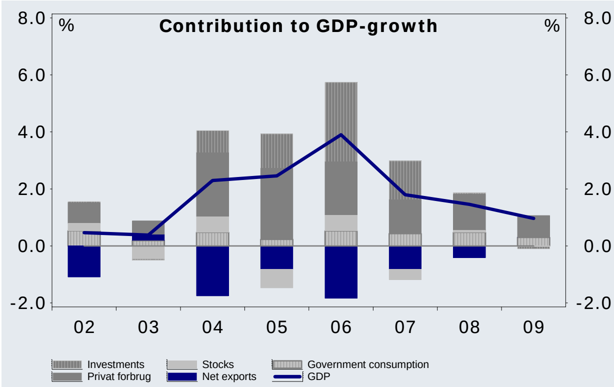
The record-low unemployment rates, prospect of healthy pay rises and tax cuts should actually provide the basis for quite healthy private consumption growth in the coming years. Still, consumers seem to have become more pessimistic about the economic outlook, which has sent consumer confidence to the lowest level since the spring of 2003 when the most recent downcycle in the Danish economy bottomed. Another reason for the low consumer confidence is probably that disposable income growth has to some extent been eroded by the steep increases in prices of energy and food, which have pushed inflation above 3%. This makes the impact of higher interest rates and the housing market slowdown somewhat stronger than we anticipated earlier. However, households' sensitivity to the banks' interest rate hikes should not be exaggerated. Firstly, the rate hikes do not apply to most home loans. Secondly, households' outstanding debt mostly consists of mortgage loans and adjustable mortgage rates have actually fallen slightly.

Although we expect private consumption growth to be comparatively weak this year, the annual growth rate will be quite high, but it mainly reflects the strong spending growth in H2 2007. Hence, the decline in private consumption growth will not affect our forecasts until 2009 when disposable income growth will slow down slightly as employment declines.

Crisis will mainly hit investment and exports

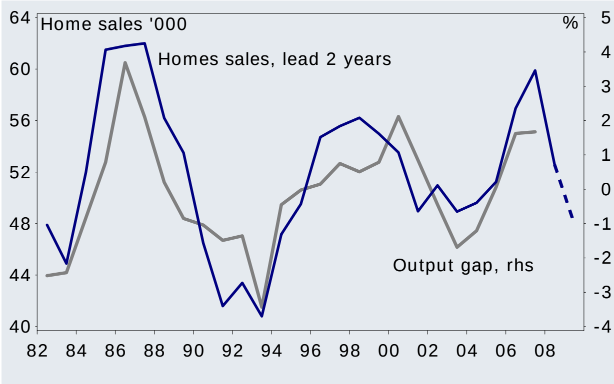
The softening of the housing market is the main reason why we expect quite a sizeable drop in residential investment this year and in 2009. Turning to business investment, we still expect a high *investment level*, but growth will probably be somewhat lower. One of the reasons is that growth in a string of Denmark's key export markets is likely to drop sharply, and domestic demand will also slow gradually. We have also lowered our business investment forecast for 2008 due to the protracted credit crisis. Investments by non-financial companies strongly surpassed last year's savings, making continued investment growth quite reliant on further borrowings. And non-financials have a larger portion of their debt with banks and are thus more vulnerable to higher lending rates in the wake of the credit crisis.

Consumption and investment boom coming to an end



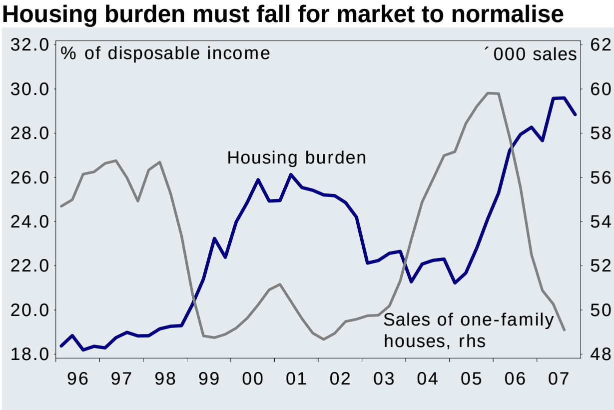
Source: Statistics Denmark, Danish central bank, Ecowin and own calculations.

Weak housing market curbs capacity pressure



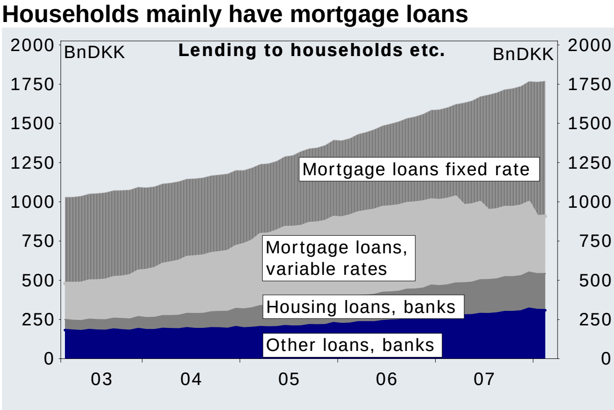
Source: OECD, Association of DK Mortgage Banks, Statistics Denmark and own calculations.

Housing burden must fall for market to normalise



Housing burden calculated based on fixed-rate loans including property tax and mortgage interest relief. Source: Statistics Denmark, Ecowin and own calculations.

Households mainly have mortgage loans



Source: Statistics Denmark, Danish central bank, Ecowin and own calculations.

Exports are also expected to be hit by the US slowdown and the weaker growth in the Euro area, Sweden and the UK. The setback in Denmark's main export markets coincides with an erosion of competitiveness due to the depreciation of the USD and the GBP. We see a risk that Danish exporters are facing a tough time in a situation of harsher price competition in response to weaker demand growth. Weak export trends are thus the reason why we expect the current account deficit to shrink further during the rest of the forecast horizon.

Inflation pressure at multi-year high

In the early months of the year inflation surprised strongly on the upside on the back of persistently higher prices of oil and food. Concurrently with the rising commodity prices, the strong capacity pressure in the Danish economy has accelerated producer price growth; the price growth of goods made in Denmark has not been higher since the spring of 1982. Households have also noticed the higher consumer prices, as their inflation expectations have risen sharply over the past eight months. Combined with the record-low unemployment, this suggests quite high wage growth this year, which will further add to domestic inflation pressures. The rising commodity prices could also contribute further to inflation; overall, we thus expect average inflation in 2008 to move as high as 3% although the contribution from energy prices will decline during the year. Next year inflation should be somewhat lower thanks to the stabilisation of oil prices measured in DKK and the halt in the strong price increases of food. Moreover, towards the end of 2009 we also expect the slight rise in unemployment to gradually ease some of the upward pressure on wage growth.

Central bank keeps interest rate gap vs ECB

Despite the turbulence in the financial markets since last summer the DKK has not been under fundamental pressure and the Danish central bank has maintained its interest rate differential of 25 bp versus the ECB. We expect this to remain the case also going forward. At the long end of the yield curve the turmoil in financial markets has widened the yield spread between Danish government bonds and German equivalents due to the higher liquidity in the German government bond market. This spread will likely narrow again once the markets calm down a bit. Later in the forecast period a referendum may be held about Denmark's membership of the Euro area. The outcome of the 2000 referendum showed that a No vote will not affect the support for the fixed exchange rate policy, and we therefore do not expect any appreciable yield spread swings versus the Euro area ahead of a possible referendum.

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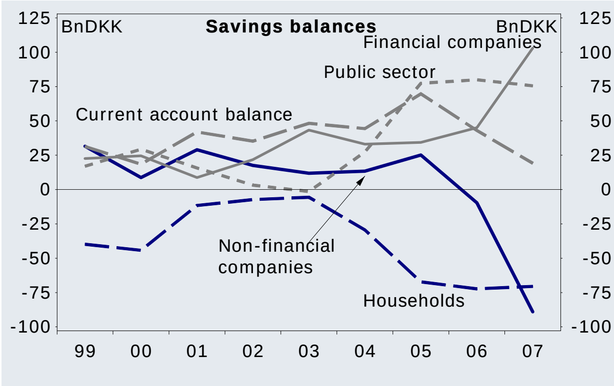
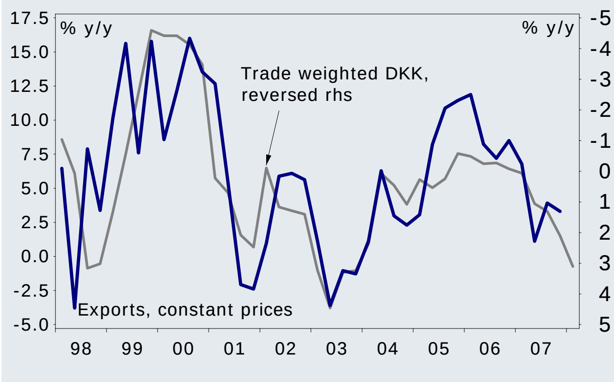
Business investment relies on borrowings



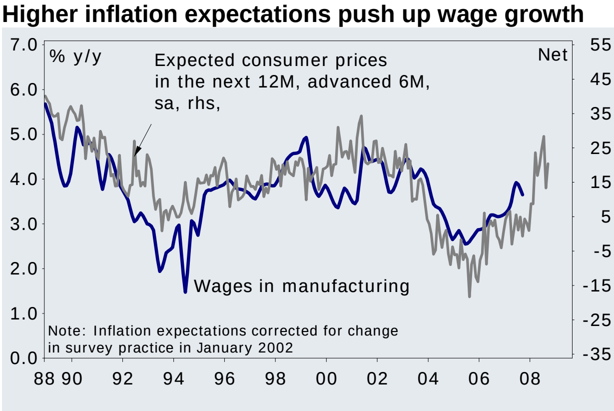
Source: Statistics Denmark.

Strong DKK implies weak export trends



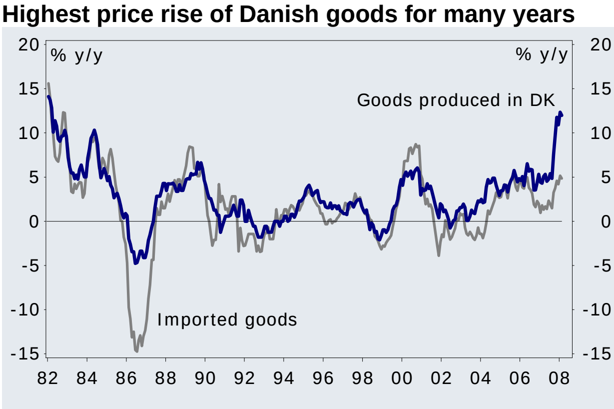
Source: Statistics Denmark and Danish central bank.

Higher inflation expectations push up wage growth



Source: Statistics Denmark and own calculations.

Highest price rise of Danish goods for many years



Downturn set to last a few years

- Slowdown more prolonged than earlier foreseen.
- Risks may lurk also in Finland.
- Inflation is a worry now, but it will ease next year.
- Tax cuts awaited in 2009.

Growth slows for longer than expected

Finnish economic growth slowed markedly as early as in the latter half of 2007. The growth rate was some 3.5%, while in H1 it was just over 5%. Our earlier estimates assumed that the downturn in the world economy would temporarily slow down economic growth in Finland, which would mainly ease the bottlenecks caused by robust growth. However, the downswing in the export markets appears to be longer than estimated earlier. This will inevitably be reflected in the outlook for the Finnish economy.

We expect economic growth to be around 2% on average in 2008 and 2009. So, the downturn still looks set to be relatively mild, as also indicated in our earlier estimate. But the development is so weak that employment growth looks in danger of stagnating, while unemployment may not continue to fall.

The overall picture of the Finnish economy is very balanced in many respects, but the risk associated with a prolonged slowdown of the world economy cannot be shrugged off. The risks are partly domestic. Households' savings ratio is record low. A drop in confidence caused by weakening labour market conditions may thus have a surprisingly strong negative effect on consumption.

Export growth close to stagnating

Finland's exports to Emerging Markets exceed the average of the Euro-area countries. Russia accounts for 10%, for instance. Unfortunately, this does not guarantee Finland a better-than-average export outlook. In 2007 Finnish exports already grew more slowly than in the Euro area, and Finland's exports typically fluctuate quite heavily because of its sector structure. A longer-than- expected slowdown in export markets combined with the strong EUR is indeed bad news for the Finnish economy. According to our estimates, export growth will nearly halt during 2008 and improvement is not likely until 2009.

Another worry for the export industry is Russia's timber duties. Russia has raised the duty on timber exports to EUR 15 per cubic metre and plans another hike to EUR 50 by early 2009. This exceeds the price of pulpwood used as raw material for pulp; in practice the duty threatens to end imports of timber from Russia. The percentage of imports has been quite high, so not only will the duty increase demand for timber in Finland, but also lead to further arrangements that will reduce the capacity of the wood processing industry.

Consumption growth on shaky ground?

Exports account for nearly half of Finland's GDP, so cyclic fluctuations related to exports always play a key role. Nonetheless, Finland's economy has recently grown more robustly than the export markets or Sweden, for instance, where trends are usually very similar to Finland. One explanation could be the brisk consumption growth, which has run close to 4% over the past few years.

Employment, wages and capital income have all improved, supporting consumption demand. In this respect the outlook for 2008 is also good, although rising

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

	2004 (EURbn)	2005	2006	2007	2008E	2009E
Private consumption	78.1	3.3	4.1	3.7	3.1	2.1
Government consumption	33.3	1.9	0.6	1.7	1.5	1.5
Fixed investment	27.8	3.5	4.7	7.6	3.5	2.1
Stockbuilding*	0.8	0.9	-0.5	0.2	0.3	0.1
Exports	60.9	7.0	11.8	4.8	1.6	1.7
Imports	48.6	15.1	8.3	3.5	2.8	2.1
GDP		2.8	4.9	4.4	2.3	1.8
Nominal GDP (EURbn)	152.3	157.2	167.0	178.8	184.1	192.6
Unemployment rate, %		8.4	7.7	6.9	6.2	6.2
Industrial production, % y/y		3.9	10.6	6.1	3.0	2.5
Consumer prices, % y/y		0.9	1.6	2.5	3.4	2.2
Hourly wages, % y/y		3.9	3.0	3.2	5.3	4.8
Current account (EURbn)		6.1	8.3	7.8	6.5	6.1
- % of GDP		3.9	4.9	4.4	3.5	3.2
Trade balance (EURbn)		7.7	9.2	8.9	7.5	7.3
- % of GDP		4.9	5.5	5.0	4.1	3.8
General govt budget balance (EURbn)		4.3	6.4	8.0	8.6	8.8
- % of GDP		2.9	4.1	5.3	4.5	4.0
Gross public debt (EURbn)		64.9	65.5	63.3	60.6	58.7
- % of GDP		41.3	39.2	35.4	32.9	30.5

* Contribution to GDP growth (% points)

prices will erode purchasing power. In 2009 employment growth will slacken, but the rise in real wages will remain good, so the income development appears moderate. However, this does not mean that there are no worries in sight.

The rise in disposable income does not correspond to the amount of cash that households have spent – hence households' savings ratio has dropped to a record-low level. This is a typical trend when consumers are confident about their own finances. Conversely, in a downturn there is a risk of a rising savings ratio. The risk is especially significant if labour market conditions start to falter. Hence, it would be wrong to say that the only risks lie abroad. It is possible that households' saving balance is in need of correction, which may intensify the downward trend of the economy.

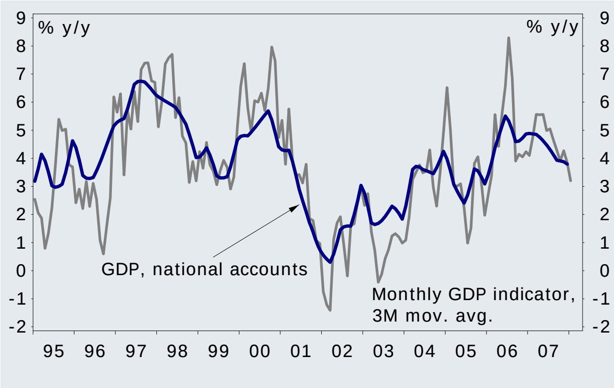
Inflation still bigger worry than unemployment

Employment has improved sharply in recent years, surpassing even the most optimistic expectations. Vacant positions have been at historical highs and the biggest concerns have been employment mismatches and bottlenecks. Against this backdrop, unemployment growth has seemed a distant threat. However, in our view economic growth will slow to such an extent that unemployment will start to increase. Ultimately, this is greatly dependent on how the labour supply reacts to slowing growth. At the beginning of this decade, labour supply fell more than before, which combined with a growing number of people retiring may keep unemployment under control this time too. Structural changes in the economy could still accelerate, which may notably increase regional differences.

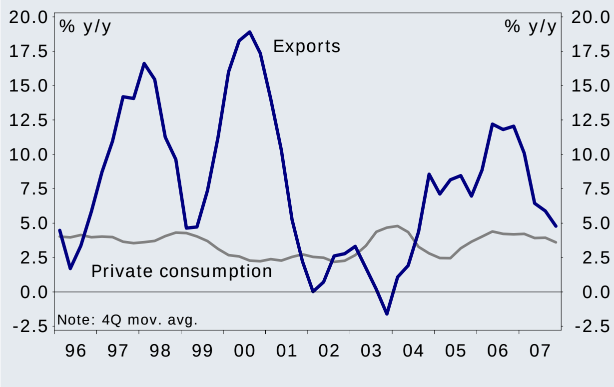
Consumers are currently more concerned about the rising prices of food and fuels than the threat of unemployment. In Finland, major changes in food prices usually occur about three times a year. Therefore food prices did not jump until the turn of the year, but the increase was steep. The year-end increases will not be the only ones; more increases are in store during the course of the year. Oil prices are also higher than we estimated earlier. In addition, the uncertainty in the financial markets has prevented declines in credit interest rates, which are included in the domestic consumer price index.

Overall, inflation risks have been largely realised this year. Still, it holds true that the highest inflation spike is likely to occur in the first half of the year and inflation will slow after that. The estimate is based on the view that prices of oil and other commodities will no longer rise from the peak levels seen during the spring of 2008, but ease somewhat at least temporarily.

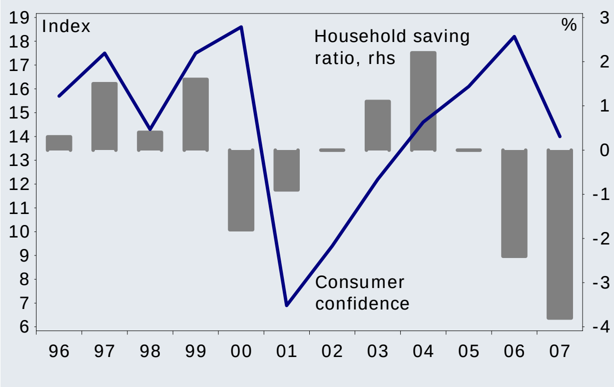
GDP growth to slow further



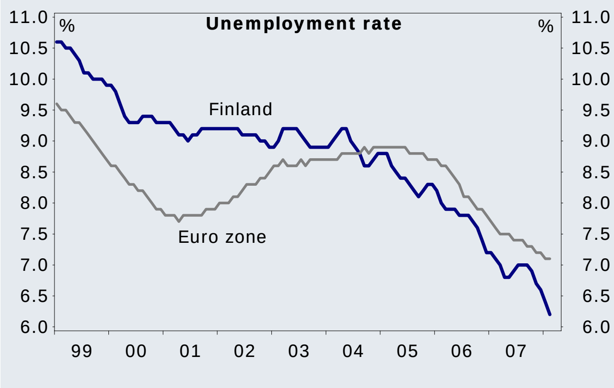
Export growth to decelerate sharply



Household savings rate record low



Unemployment still falling



It should ease households' worries that inflation will slow markedly in 2009. This is due to special factors, such as falling interest rates and the VAT cut on food, which, coupled with a moderate oil price trend and slowing growth, will push inflation lower. There are risks, though. Wage increases are quite big, the increase in productivity will decelerate and the inflation spike may cause multiple effects.

Housing market taking a breather

The unrest in global financial markets has been reflected in Finland in sharply increased deposits with banks and stronger demand for corporate bank credits. Dramatic news headlines about the US housing market crisis have also occasionally weakened households' willingness to borrow. However, the number of new housing loans granted at the beginning of the year was still higher than in the previous year and despite a slight slowdown, credit growth still runs at double-digit figures.

The outlook for this year is moderately positive, as households have probably adjusted to the current interest rate level, which is reasonable from a Finnish perspective. The outlook for households' finances for 2008 is also robust, but the situation will start to worsen in 2009 at the latest. Falling interest rates will certainly support demand for credits, but if the downturn is so hard that unemployment starts to increase, lower rates will not necessarily have as positive an impact as at the beginning of the decade.

The pace of activity in the housing market has also normalised and households have become more cautious. The number of unsold new homes has increased and construction companies have cut down their production. Residential investment will decrease markedly this year. In Finland the rise in prices has been more moderate than, say, in the other Nordic countries, but a calmer period of a few years seems natural after an uptrend lasting several years.

Room for tax cuts

Public finances were even healthier last year than expected. A surplus of over 5% provides some room for manoeuvre in case households start to increase their savings. We expect VAT on food to be cut next year in line with general expectations. In addition, income tax is likely to be eased. It is, indeed, possible to make even bigger tax cuts, which might be implemented at a suitable time next year cycle-wise. Still, the cyclic situation is not the most important factor in favour of tax cuts. Structural reasons are more important. However, Finland cannot afford to ease the tax burden at the expense of the surplus targets for public finances.

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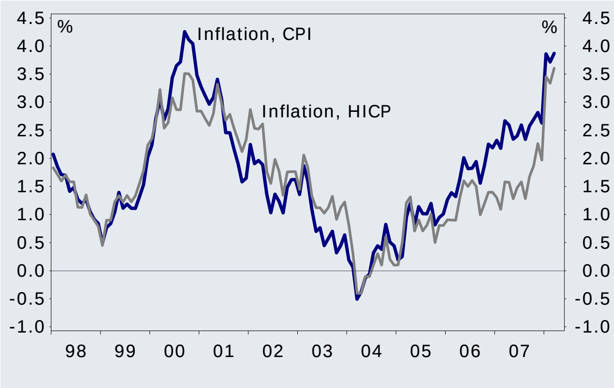
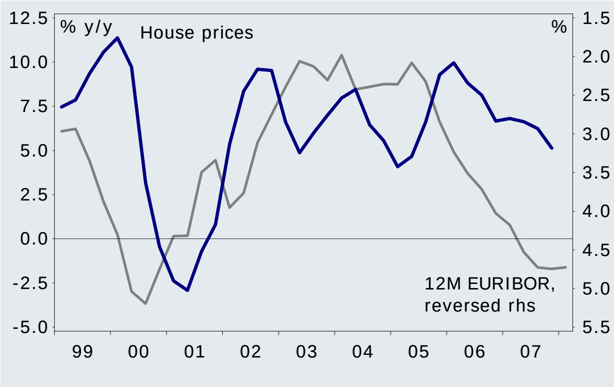
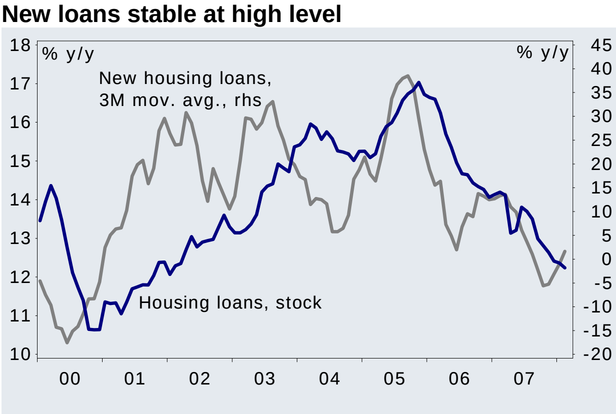
Inflation to peak soon, but upside risks remain



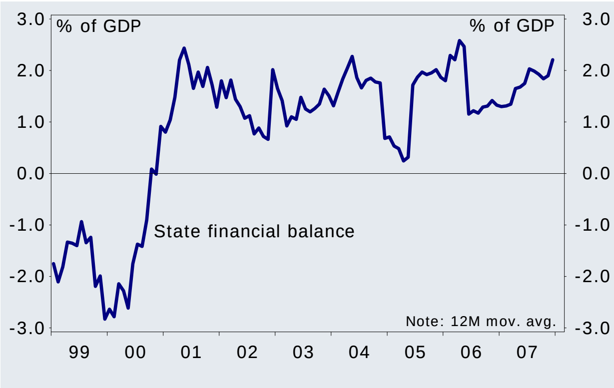
Rise in housing prices to slow further



New loans stable at high level



Room for manoeuvre in state finances



Norway feels international downturn, but to a lesser extent

- Wages and prices will rise sharply.
- Capacity utilisation set to decline.
- Financial markets more difficult for central bank.
- Official interest rates near peak.

International turmoil creates uncertainty

The Norwegian economy has developed largely as forecast in our January issue of *Economic Outlook*. On the one hand there are signs of slowing growth in household demand. On the other hand it is becoming increasingly clear that high capacity utilisation has fed through to higher prices and costs.

Turning to the international economy, notably the US, the picture has deteriorated severely. Also, the turmoil in credit markets with widening margins has worsened rather than improved. The impact on Norway from the weaker international performance largely depends on the direction of oil prices and prices of other key exports. With continued buoyant growth in Asia, we expect that demand for oil and many other Norwegian exports will hold up well. In this scenario Norway could be one of the western countries least affected by the downturn in the US economy.

Another key determinant is the direction of financial markets. With the unrest in credit markets, borrowing costs are increasing at a faster pace than the central bank's tightening moves. Borrowing costs are driven higher by the financial turmoil, but we are not sure that it will affect the domestic economy that much. If market rates and credit margins remain at exceptionally high levels, we expect the Norwegian central bank to keep its policy rate lower than would otherwise be the case.

Yield spreads to other countries and the Norwegian exchange rate may prove just as important. In a scenario with a severe global economic downturn, the central banks of Norway's key trading countries may sanction substantial easing moves. That would lead to marked NOK appreciation and make the Norwegian central bank set rates lower than assumed in our forecasts.

Our baseline scenario does not involve sharply lower rates in Norway's key trading countries. In this case Norges Bank may keep rates up pending clear signals that prices and wage growth are heading lower.

Mixed demand picture

Oil companies' investment plans for 2008 are well above the forecast for 2007 at the same time last year. Part of this rise likely reflects pure cost increases. But in real terms oil investment is also set to grow in 2008. Persistent high oil prices would suggest a high level of investment in 2009 as well. Prospects for the oil-related industries in mainland Norway therefore remain favourable. For exporters the picture is rather more mixed. Export prices have accelerated sharply since 2003 and will likely remain elevated, at least this year. Combined with substantial capacity expansions, this also points to healthy output growth for these industries in 2008. Next year a weak international setting will put a damper on growth in Norway's traditional exports.

Business investment in the mainland economy has increased sharply over the past few years. Both Statistics Norway's survey of manufacturers' investment plans and new construction starts in the manufacturing industry point to strong growth in manufacturing investment this year. For the other sectors of the mainland economy we project investment growth to flatten out during 2008.

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

	2004 (NOKbn)	2005	2006	2007	2008E	2009E
Private consumption	786.0	4.0	4.7	6.4	3.3	2.0
Government consumption	373.3	0.7	2.9	3.2	2.8	3.5
Fixed investment	314.2	13.3	7.3	9.6	5.8	2.1
- gross investment, mainland	230.0	12.7	7.6	9.2	3.5	0.3
- gross investment, oil	74.1	19.1	3.8	5.6	12.0	8.0
Stockbuilding*	33.7	0.4	0.7	-0.6	0.0	0.0
Exports	732.7	1.1	0.4	3.2	2.9	2.0
- crude oil and natural gas	337.2	-5.0	-6.6	-2.4	1.5	2.0
- other goods	209.8	5.0	6.2	9.0	4.0	2.0
Imports	497.8	8.7	8.1	8.6	4.7	3.5
GDP	1,743.0	2.7	2.5	3.5	3.0	1.8
GDP, mainland	1,355.3	4.6	4.8	6.0	3.4	1.8
Unemployment rate, %		4.6	3.4	2.5	2.3	2.6
Consumer prices, % y/y		1.6	2.3	0.8	2.9	2.7
Core inflation, % y/y		1.0	0.8	1.4	2.3	2.5
Annual wages (incl. pension costs), % y/y		3.3	4.3	5.6	5.8	5.2
Current account (NOKbn)		316.6	373.4	372.2	432.4	554.7
- % of GDP		16.3	17.3	16.3	17.5	20.5
Trade balance, % of GDP		16.5	18.2	16.5	17.4	20.3
General govt budget balance (NOKbn)		293.5	398.9	396.0	460.0	580.0
- % of GDP		15.1	18.5	17.3	18.7	21.4

* Contribution to GDP growth (% points)

Housing starts have declined over the past few months. Given the drop in prices of existing homes, high construction costs and a much slower pace of new home sales, housing starts are likely to fall further before stabilising. Recently construction starts for holiday homes, garages etc have also slipped. Here the downturn may become substantially more dramatic than for housing starts.

In conclusion, the growth rate should remain favourable although we expect investment growth in the mainland economy to decelerate this year. Moving into 2009, investment growth will weaken. Combined with slower growth in exports, this will contribute to a gradual deceleration in demand. But whether economic growth will moderate sufficiently to alleviate labour shortages and, in turn, wage pressures, depends on the extent of the decline in consumer spending. Following the high spending growth in 2007, the latest retail sales data reflect lower growth in consumer spending. Negative household savings ratios, lower growth in households' disposable real income and gradually lower employment growth suggest markedly lower spending growth going forward. A sharp setback in spending is not on the cards, though.

Our forecasts involve gradually slowing demand growth in the private sector. In the public sector the pattern could be the opposite. In 2008 wage growth will erode much of the increase in local authority revenues, but we expect them to be compensated in 2009, and fiscal policy should again become more expansionary. Once signs of slower consumer demand emerge, this should be particularly relevant.

Labour shortages gradually disappear

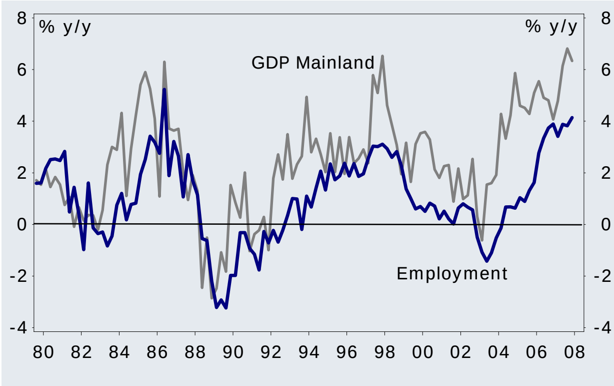
Overall, we foresee a gradual slowdown in output growth. That also implies lower employment growth. Similarly, the supply of labour is likely to expand at a slower pace. Unemployment is thus set to remain low but rise somewhat in 2009.

So far the first pay deals indicate that wage growth this year should end up at nearly 6%. A less tight labour market in 2009 and lower corporate earnings, partly due to high wage growth in 2007 and 2008, point to more moderate wage growth next year. Core inflation is set to accelerate in 2008 and into 2009. It will take time before high costs spill over to consumer prices.

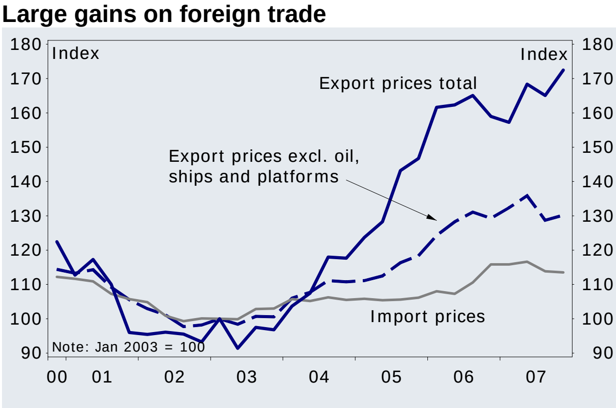
Rates peak, but tighter monetary policy

We expect core inflation to reach the inflation target in the course of the year. With wage growth at the same time above the level compatible over time with the inflation target of 2.5%, there are good arguments for further monetary policy tightening.

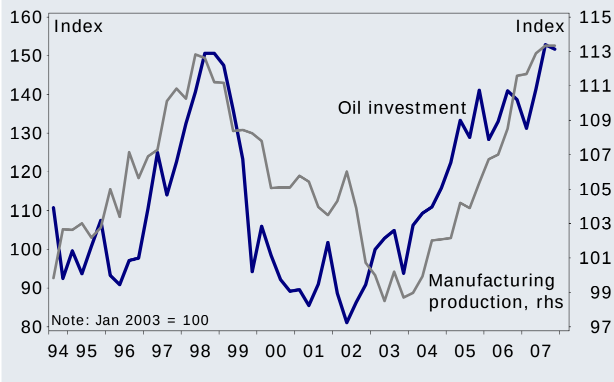
Accelerating growth in 2007



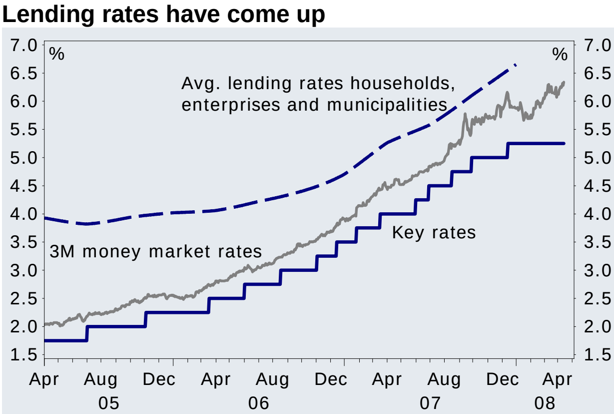
Large gains on foreign trade



Oil investment pushing up manufacturing growth



Lending rates have come up



Although inflation seems to end up broadly in line with our view in the January issue of *Economic Outlook*, we have revised down our policy rate forecast. We now see the policy rate peaking at 5.5% versus our previous call of 5.75%. Our downward revision is based on two factors: growth internationally has lost some momentum and lending rates payable by bank customers have been raised more than the policy rate due to the problems in international financial markets. It will take time, we think, before the turmoil is over. Also, lending margins will likely remain above the levels of the 2003-2006 period.

Further NOK appreciation will also contribute to tightening monetary policy overall. A strong currency eases the impact of inflationary impulses from abroad and dampens exports as Norwegian companies become less competitive.

Accordingly, monetary policy is set to be tightened (chiefly in 2008) more than warranted by the central bank's interest rate setting alone. A policy rate at 5.50% will then likely be sufficient to dampen growth in domestic demand, reducing labour market pressures. With a shrinking output gap, lower wage growth and rate cuts in euroland we could see a moderate reduction in Norwegian key rates in 2009 or 2010.

NOK held back by financial market turmoil

The market is discounting significantly wider interest rate differentials towards Norway's key trading partners compared to last autumn. At the same time oil prices have reached record highs. Presumably the financial crisis is the reason that the NOK is not stronger. Reduced risk appetite among international investors also likely means that fewer investors take a bet by investing in peripheral currencies such as the NOK. We do not believe that the market turmoil will be over anytime soon, and the NOK is likely to fluctuate sharply going forward. Longer term, higher yields compared to Norway's key trading partners and high oil prices will help drive further NOK appreciation. In a scenario with the NOK gradually softening more than we expect, the central bank may signal further tightening moves, limiting the potential for a weaker currency.

Long yields wider again

Norwegian 10-year government bond yields have lost ground versus comparable EUR yields, possibly on stronger demand for Norwegian government securities due to the financial crisis. Over time, with relatively high short-term rates in Norway, we think Norwegian long yields will rise further than EUR yields. But risk sentiment will have to improve for spreads to widen.

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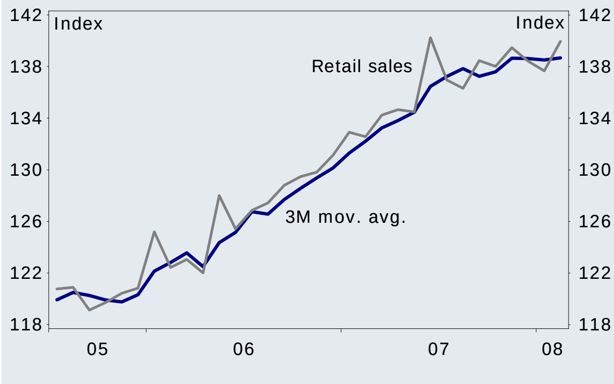
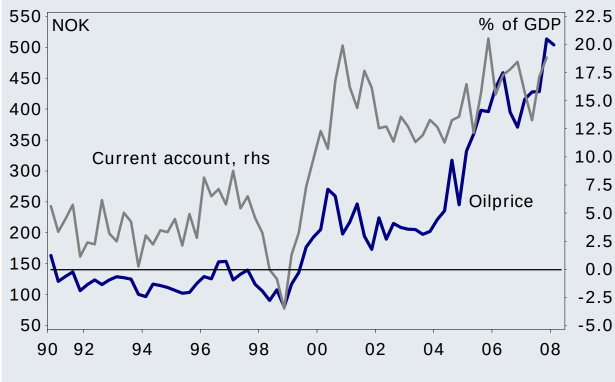
Spending growth showing signs of flattening out

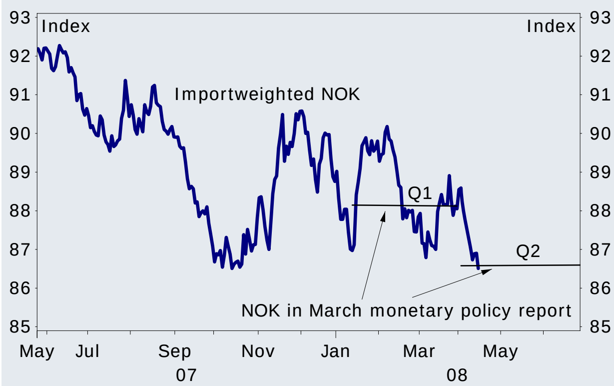


Solid foreign trade, oil prices at record high



Higher interest rates expected in Norway

NOK still on the weak side



The Swedish economy is loosing momentum

- Swedish growth below the potential level.
- Inflation to drop below target next year.
- Riksbank to cut the repo rate to 3.0%.

US slowdown affects Sweden

Black clouds are looming large on the horizon. US economic activity has stagnated and the financial crisis hampers growth and creates uncertainty also outside the US. The unfavourable trends on the other side of the Atlantic have already started to spill over to the Swedish economy. Exports to the US have declined sharply, interest expenses for some borrowers in Sweden have risen, equity prices on the Stockholm stock exchange have dropped and the weak USD has adversely affected many export sectors, notably the car industry.

However, there are factors in the Swedish economy that limit the risk of a major slowdown. First of all the financial balances are in good shape, leaving room for fiscal stimulus packages, and the need to consolidate finances among businesses and households is limited. We expect that fiscal policy measures to the tune of SEK 20bn will be introduced. Swedish exports are moreover well diversified both regionally and in terms of products, which helps to alleviate the effects of the US slowdown.

But Swedish economic growth clearly looks set to slow. As the slowdown will likely stretch well into 2009, the Riksbank will have arguments to cut rates.

Good start to 2008 for exports after all

After a very weak start to the year growth in exports of goods in 2007 came to a meagre 2.6%. Growth in exports of services was, however, strong, bringing total export growth to 5.6%. The weak trend in goods export growth in 2007 was partly attributable to the drop in exports to the US and partly to a weak trend in key export sectors. Demand in Europe was strong, though, and goods export growth picked up during the year. Monthly foreign trade statistics indicate that the good trend continued into 2008. But growth in Swedish exports markets will decline going forward so export growth will slow from the current benign level. On the other hand, last year's weak development in key sectors is not likely to continue this year. We expect growth in exports of goods to run at 4-5% both this year and next year. Owing to a stronger trend in exports of services total export growth may approach 6% in 2008 and 5% in 2009.

Households have lost huge sums on stocks

Export growth of 5-6% is positive, but lower than the previous 5-year annual average of almost 7%. As noted above, Swedish foreign trade is not the only factor hit by the US slowdown. A rough estimate of the effect on household financial wealth of the drop in equity prices suggests that Swedish households have lost close to SEK 300bn from the peak in July 2007 to early April 2008. This figure represents as much as 20% of annual household consumption!

Another key factor for households is the housing market. Over the past years house prices have risen at a healthy clip, boosting household wealth and, in turn, consumption. But in H2 2007 the upturn in house prices came to an abrupt halt, partly as a result of the capital gains tax reform at the turn of the year. The Riksbank's rate hikes over the past years are probably also to blame for the stagnation in house prices, and this effect is of a more long-lasting nature. We expect house prices to remain relatively stable going forward. This, coupled with the decline in equity prices, means that households' finances will change markedly compared with the previous years when they benefited from the surging asset prices. The plummeting equity prices have also significantly weak-

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

	2004 (SEKbn)	2005	2006	2007	2008E	2009E
Private consumption	1,278.1	2.7	2.5	3.1	2.0	1.6
Government consumption	703	0.4	1.5	0.8	1.6	1.2
Fixed investment	432	8.9	7.7	8.0	3.5	0.5
- industry	74	12.8	4.2	9.8	3.9	-0.4
- residential investment	64	15.7	13.8	8.7	-0.4	-2.5
Stockbuilding*	-1	0.0	0.2	0.7	-0.4	-0.2
Exports	1,216	6.6	8.9	5.6	5.9	4.8
Imports	1,002	7.0	8.2	9.5	5.6	4.2
GDP		3.3	4.1	2.6	2.1	1.5
Nominal GDP (SEKbn)	2,625	2,735	2,900	3,074	3,229	3,344
Unemployment rate, %		7.7	7.0	6.1	5.9	6.4
Employment growth		0.5	2.1	2.6	1.0	-0.1
Consumer prices, % y/y		0.5	1.4	2.2	3.1	1.9
Underlying inflation, % y/y		0.8	1.2	1.2	2.4	1.9
Hourly earnings, % y/y		3.5	3.4	3.1	4.7	4.5
Real disposable income, % y/y		1.2	2.6	4.1	2.6	2.4
Current account (SEKbn)		168.0	247.3	256.4	257.5	267.0
- % of GDP		6.1	8.5	8.3	8.0	8.0
Trade balance, % of GDP		5.8	5.8	4.6	4.6	4.3
General govt budget balance (SEKbn)		54	63	93	87	54
- % of GDP		2.0	2.2	3.0	2.7	1.6
Gross public debt, % of GDP		50.9	45.9	40.6	34.2	29.9

* Contribution to GDP growth (% points)

ened households' confidence in their own financial situation. However, on the positive side, household income growth is benign. Households' disposable incomes will rise by 2.6% this year and by an estimated 2.4% in 2009. The forecast for 2009 assumes that the government introduces reforms to boost household finances by some SEK 10bn, thus lifting household income growth by 0.7% point. Despite solid income growth the outlook for consumer spending has deteriorated sharply. Wealth effects and increased uncertainty about future economic trends indicate that households will save more and that spending growth will lose momentum going forward. The slowdown in spending growth will mainly show through in 2009, with consumer spending growth estimated to run at 2.0% this year and 1.6% next year.

Investment has peaked - lower GDP growth

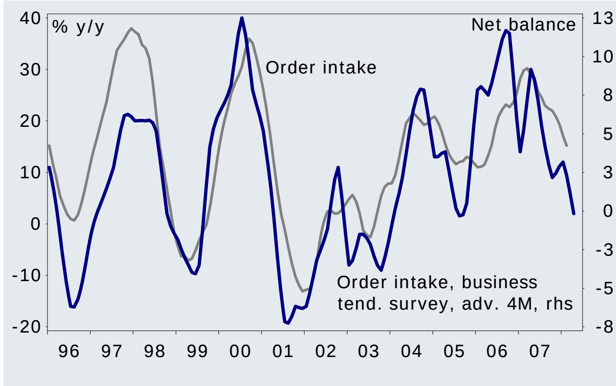
After a very strong trend in 2007 investment growth now seems to have peaked. We expect investment growth to more than halve this year from last year's strong rate of 8%. In 2009 it looks set to slow down further to a level largely unchanged relative to 2008. Particularly residential construction growth has levelled out and is even forecast to decline somewhat both this year and next year. Also, after several years of strong growth investment activity in other sectors of the economy will gradually slow in step with a weaker trend in demand. But investment in the energy sector and in infrastructure will remain brisk, the latter as a result of the government's expansionary fiscal policy.Despite a good start to the year the slowdown in investment activity, the more cautious household behaviour and the elimination of unwanted inventories will cause GDP growth to slow to 2.1% this year from 2.6% in 2007. The downturn will continue well into next year, with GDP growth in 2009 forecast to be 1.5%.

Labour market still strong, but…

GDP growth at some 2% or lower is clearly below the potential level estimated at about 2.5%. The labour market is already showing clear signs of slowing momentum. The number of new jobs reported to job centres is declining, businesses' hiring plans have been cut back and the downtrend in unemployment has been broken.

But the effect of lower production growth generally tends to show through in employment with a considerable time lag. Hence, the labour market should remain tight in most of 2008 and unemployment should not start to pick up until around year-end. The demographic development with a declining population of working age will dampen unemployment growth and the drop in employment should be moderate over the forecast period despite expectations of rising productivity. We therefore see unemployment rising from 5.9% this year to 6.4% next year. A less tight labour market reduces the risk of increased wage drift. However, with the wage deals already in place total hourly wages should rise by around 4.5% annually in 2008 and 2009.

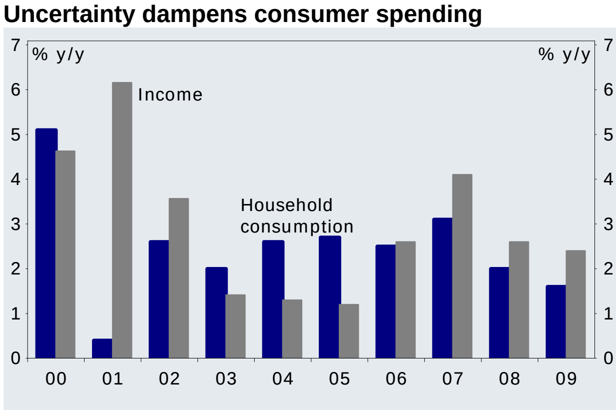
Slowdown in the manufacturing industry …



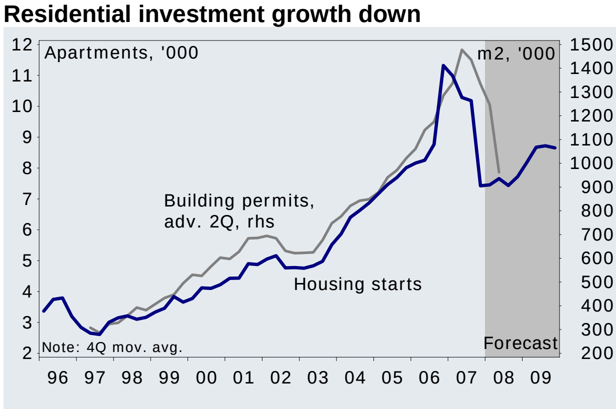
Source: Statistics Sweden and own calculations

…when growth slows in Swedish export markets

Uncertainty dampens consumer spending



Residential investment growth down



Riksbank to cut rates in the autumn

At the end of 2007 CPI inflation was at a 15-year high. The high rate of inflation was driven by a few factors: rising mortgage rates and higher food and fuel prices. Excluding these items inflation was just around 1%, which is very low considering the strong economic trend of the past years. Much indicates that food prices will rise further near term, and at the same time wage increases will also to some extent show through in inflation numbers. The Riksbank's favourite target, the CPIX, should therefore pick up in the period ahead and peak at just below 3.0% during the summer. After that, the effect of the sharp increase in fuel and food prices in 2007 and this year will start to drop out of the 12-month index and inflation will move lower. Lower economic activity will also to an increasing extent curtail price pressures. We therefore expect CPIX inflation to move below the 2% target in 2009. With a weaker economic trend, rising unemployment and inflation below target, rate cuts will gradually start to feature on the Riksbank's agenda. Much indicates that it will take some time before the Riksbank acts, though. GDP growth early this year is expected to be fairly high. Also, inflation is running high and the labour market should remain tight during most of the year. This is important as the Riksbank seems to attach great importance to present conditions. In addition, an inflation rate above target may keep inflation expectations – a key factor for the Riksbank – high. Towards year-end the signs of a slowdown will become clearer, and we expect the Riksbank to start cutting rates during the autumn. We see the repo rate at 3.0% next summer.

SEK to trade sideways this year

This year EUR/SEK has traded in a range between the January high of 9.55 – when expectations for Riksbank action were low and the financial market unrest widespread – and a low of slightly under 9.30 after the Riksbank's surprise rate hike in February. We expect the SEK to trade at the lower end of this range in most of 2008. The Riksbank is expected to cut rates this year while the ECB will not take similar steps until next year, and this will prevent the SEK from strengthening this year. However, in one year's time the SEK should appreciate towards 9.20 in step with the narrowing interest rate differential and fading financial market uncertainty.

Risks tilted towards a weaker trend in 2009

There is definitely a risk of a weaker trend than outlined above. The risk is related to a more profound effect of the US slowdown on the global economy than expected, which would further dampen Swedish export growth and to a greater extent adversely affect investment, household consumption and the labour market. In such a scenario the Riksbank would ease monetary policy more than envisaged in this report and the SEK would probably also display a weaker trend.

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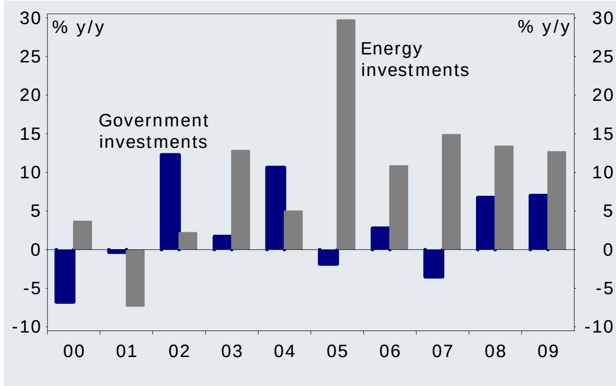
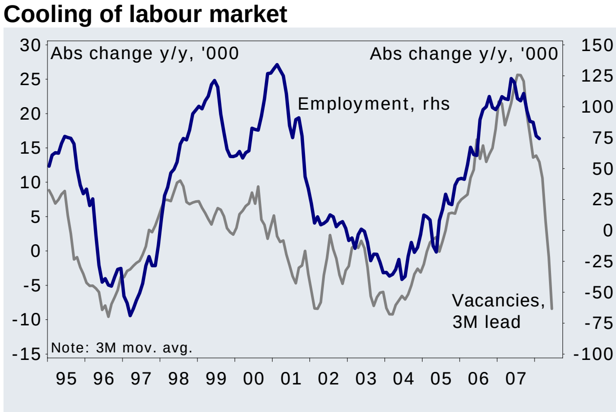
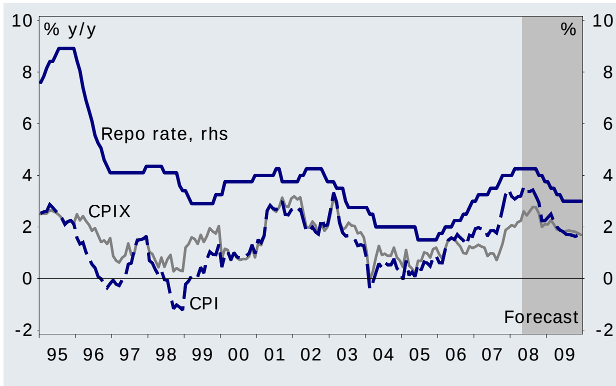
Investment in energy sector and infrastructure



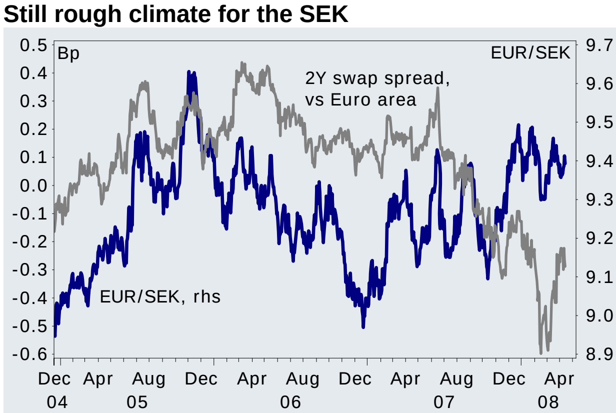
Cooling of labour market



Lower inflation leaves room for rate cuts



Still rough climate for the SEK



Recession – how deep and how long?

- The recession is probably a reality.
- The recession will most likely be mild.
- But a long period of weak growth is ahead.
- Risk of deeper and more protracted crisis.

The US economy has deteriorated markedly over the past few months and it has now become more obvious that the financial crisis rooted in the housing market will have consequences for the real economy. At the time of our January issue of *Economic Outlook* it was still an open question whether the economy was heading for a recession, but now the question is rather how long and deep the recession will be.

The most telling signs that the recession is now a reality are seen in the labour market. Employment in the private sector has fallen for four consecutive months by a total of 300,000, and unemployment has risen to just over 5% – up 0.7% point from last year's low. A similar trend has only been seen during previous recessions. Economic indicators point to further weakening of the labour market in the months ahead.

But so far key data point to a relatively mild recession. On the other hand, much indicates that the slowdown will be protracted. More specifically, we look for slightly negative GDP growth in H1 2008 followed by slightly positive growth rates in H2 2008 and into 2009. We do not expect to see durable economic growth at the potential level of an estimated 2½-3% until end-2009 at the earliest. In 2008 as a whole we forecast GDP growth of a modest 1%, while the forecast for 2009 is 1.5%.

We base our expectation of a long period of lacklustre growth on the very low household savings ratio coupled with growing job uncertainty, tighter credit standards and persistent house price declines. This cocktail will probably mean a very slow road to recovery of private consumption and the overall economy once the current recession is over.

The gravity of the situation has made the Fed react very aggressively. The Fed has to date slashed the fed funds rate by 300 bp to 2.25%, pumped liquidity into the money marked in concert with other central banks and eased the access to USD-denominated loans. In addition, the US government has pushed through fiscal policy easing of USD 150bn or just over 1% of GDP.

Combined with the generally sound finances of non-financial companies and companies not related to the housing sector as well as continued solid exports, this significant economic policy easing is one of the reasons why the recession is expected to be relatively mild.
But we see risks of a somewhat deeper crisis. The housing market is in the biggest slump since World War II, with house price declines so far of more than 10% from their peak. Much indicates that house prices will drop significantly lower, possibly weakening household demand further and thus the overall economy more than we have assumed in our baseline scenario.

The Fed's aggressive action is positive for banks' earnings and for homeowners with adjustable-rate mortgages. Still, further declines in house prices and employment could result in additional losses in the financial sector. Such losses may restrict lending to households and businesses considerably, which in turn could weaken the economy even more.

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

	2004 (USDbn)	2005	2006	2007	2008E	2009E
Private consumption	8,195.9	3.2	3.1	2.9	1.2	1.2
Government consumption and investment	2,216.9	0.7	1.8	2.0	2.0	1.8
Private fixed investment	1,830.0	6.9	2.4	-2.9	-6.0	1.0
- residential investment	675.5	6.6	-4.6	-17.0	-22.5	-1.5
- equipment and software	856.3	9.6	5.9	1.3	-1.1	2.0
- non-residential structures	298.2	0.5	8.4	12.9	4.3	0.4
Stockbuilding*	58.6	-0.2	0.1	-0.3	-0.2	0.1
Exports	1,182.4	6.9	8.4	8.1	7.0	5.1
Imports	1,797.8	5.9	5.9	1.9	-0.2	4.0
GDP		3.1	2.9	2.2	1.0	1.5
Nominal GDP (USDbn)	11,685.9	12,433.9	13,194.7	13,841.4	14,240.8	14,729.0
Unemployment rate, %		5.1	4.6	4.6	5.4	6.2
Industrial production, % y/y		3.3	2.2	1.7	0.0	1.5
Consumer prices, % y/y		3.4	3.2	2.9	3.2	2.3
Consumer prices ex. energy and food, % y/y		2.2	2.5	2.3	2.3	1.7
Hourly earnings, % y/y		2.7	3.9	4.0	3.5	3.0
Current account (USDbn)		-754.8	-811.5	-738.6	-569.6	-441.9
- % of GDP		-6.1	-6.2	-5.3	-4.0	-3.0
Federal budget balance (USDbn)		-321.8	-209.2	-187.9	-398.7	-397.7
- % of GDP		-2.6	-1.6	-1.4	-2.8	-2.7
Gross public debt, % of GDP		62.2	61.5	62.4	65.0	67.0

* Contribution to GDP growth (% points)

Given the losses on mortgage loans and tighter liquidity the Fed's aggressive rate cuts have so far only affected yields on mortgage and corporate bonds moderately. Yields on relatively safe (investment grade) corporate bonds are actually slightly higher at present than just before the Fed started cutting rates in September. Yields on lower-rated corporate bonds have risen even more.

This trend is in itself a major worry, because it curbs an economic recovery. If financial institutions at the same time sharply curtail their lending activities, the negative spiral in which the economy is currently stuck will become stronger, leading to a somewhat deeper downturn than we project at the moment.

Housing market still caught in a negative spiral

As noted earlier the housing market is in the worst slump in more than 50 years. Since the market peaked about two years ago, home sales have plunged 34%, the number of housing starts has contracted by 54% and house prices have dropped more than 10% on average although the decline varies greatly from region to region. The latter is unprecedented since the depression in the 1930s. And there is every sign that the housing market downslide will continue.

The enormous excess supply of homes on the market – the fundamental problem in the housing market – is still intact. According to our calculations there is still an excess supply of about 900,000 vacant homes, corresponding to about 10 months' housing construction at the current pace. The estimated time on market for existing homes is still close to 10 months.

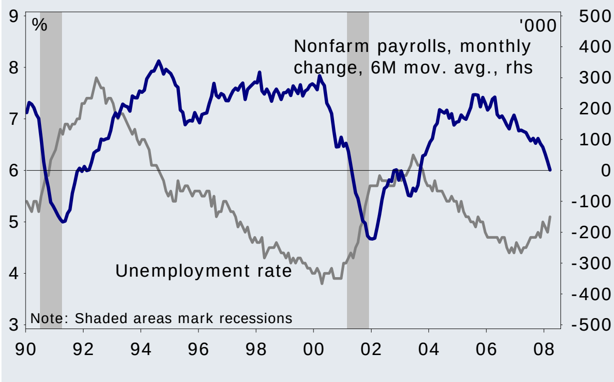
At the end of 2007 the number of mortgage loans in foreclosure totalled around 1m, and much indicates that this number is on the rise. The increasing number of foreclosures will boost the excess supply of vacant homes on the market, thus adding to the downward pressure on prices and construction activity.

Although lower mortgage rates will at some point start to revive demand for housing, it will take a long time before the excess supply is eliminated and residential investment and house prices start to rise again. A further house price decline of 10-15% does not seem unrealistic. But as residential construction has already dropped sharply, we expect residential investment to gradually make a smaller direct, negative contribution to GDP growth over the coming quarters.

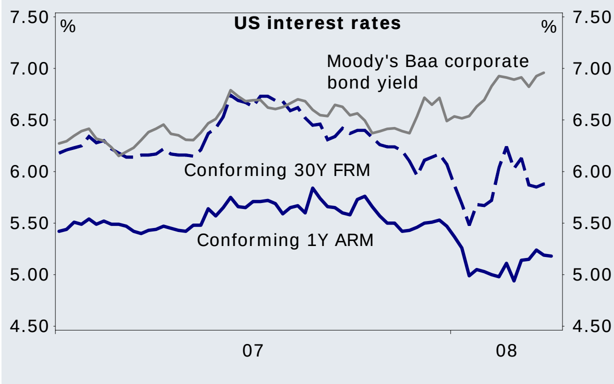
Drop in consumer spending prior to tax refunds

In recent months consumer spending has slowed markedly mainly due to weaker growth in households' purchasing power as a consequence of lower employment and higher prices of energy and food. The savings ratio has been largely stable.

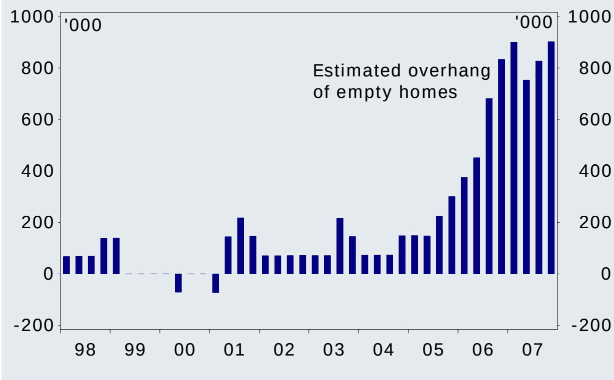
Job market showing clear signs of recession



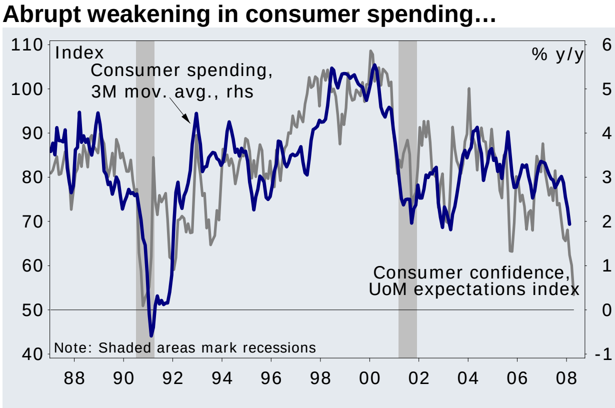
Limited effect on mortgage and corporate loan rates



Still huge overhang of empty homes



Abrupt weakening in consumer spending…



However, in step with further increases in unemployment and continued tight credit standards we expect the house price decline to hit consumer spending harder than previously. In other words, we expect negative wealth effects to lead to a clear rise in the savings ratio throughout 2008. More specifically, we look for an outright decline in consumer spending this quarter – the first quarterly decline since 1991.

In Q3 consumer spending should be significantly boosted by the individual tax rebates of USD 107bn, which are the main element of the government's fiscal easing package. Based on a cautious assumption of a marginal propensity to consume of one-third, the tax rebates could lift the annualised GDP growth rate by about 1% point in Q3[2]. The stimulus will be short-lived, but the policymakers will probably implement new measures to bolster the economy if it does not show signs of recovery.

Investment and earnings under pressure

Tighter credit standards and lower profits in US-based non-financial companies could cause business investment to decline moderately this year.

Against the backdrop of sustained solid export growth aided by the weak USD and the generally sound finances of non-financial companies and companies not related to residential construction, an actual collapse in investment does not seem the most likely scenario. Moreover, the risk of heavy inventory liquidation seems limited. This also supports our expectations of a relatively mild recession.

Easy monetary policy for a long time yet

Given the expected protracted economic slowdown that could turn into a deeper crisis, we expect the Fed to cut interest rates further. The Fed has signalled that it will cut rates at a slower pace than previously, though. All in all, we look for a further overall interest rate reduction of 75 bp to 1.50% by the end of this quarter.

The Fed is not likely to embark on a gradual normalisation of interest rates until the economy is showing clear signs of recovery. At this juncture, we believe this will happen at the end of 2009 at the earliest.

Given how we expect the Fed and ECB to act, we think the USD will remain under pressure near term. But longer out when the US economy starts to show signs of having bottomed, the USD should start to strengthen again.

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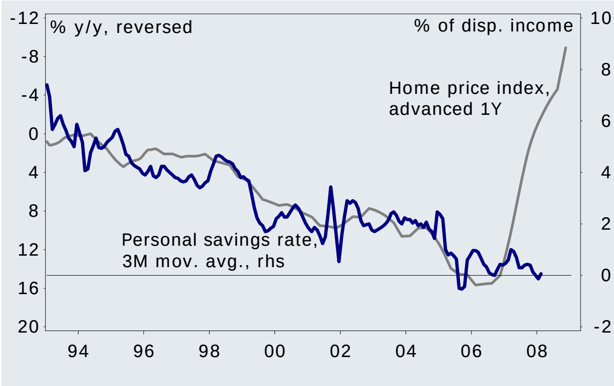
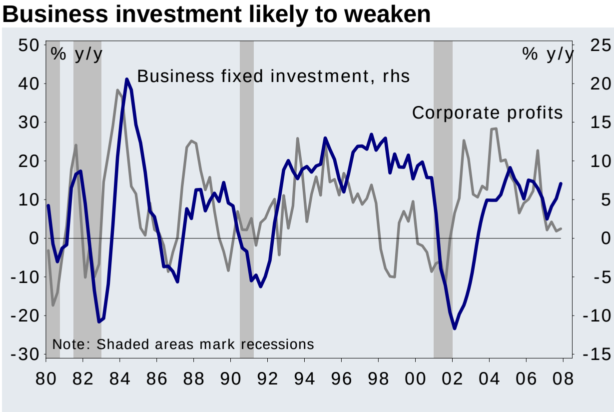
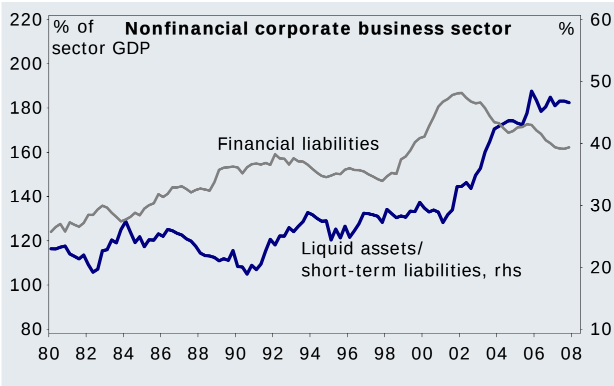
… and it has not bottomed yet



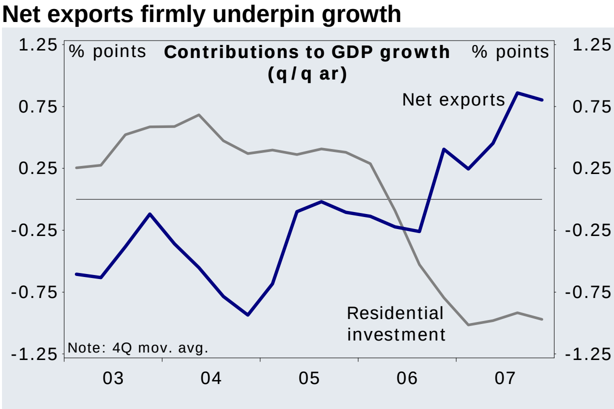
Business investment likely to weaken



Sound finances in non-financial business sector



Net exports firmly underpin growth



[2] We base our assumption on studies of the propensity to consume in connection with the 2001 tax rebates.

Economy on the brink of a downswing

- Phase of subdued growth will drag on.
- Inflation threat will slowly disappear.
- Policy rate will not be cut for a long time.
- Risk of mild stagflation exists.

Growth slows for longer than expected

Growth in the Euro area decelerated towards the end of last year but still remained reasonable in the winter despite the financial market turbulence. The prospects are getting bleaker, though. We believe that the US slowdown will last longer than previously estimated. That will inevitably dampen the development of Euro-area export markets also in other parts of the world. For the time being the strong momentum has continued globally even though exports to the US have decreased. However, the export markets will gradually start to falter also elsewhere. Furthermore, exporters' headache will be aggravated by the more expensive EUR, which in our view should remain strong for most of the current year. Overall, export growth will clearly stumble towards the end of 2008, and an actual recovery is not on the cards until in the latter half of 2009.

In addition, the Euro area has problems of its own. A spurt in inflation hit consumers' purchasing power hard in most countries during the winter. Overall, Euro-area consumption demand did not get properly off the ground during the entire cycle. The outlook is still rather dim, but the trend in purchasing power due to eg higher wage increases than before supports the view that consumption growth will remain rather subdued but quite stable.

On the whole, the Euro-area economy is slowing down, but an actual recession will likely be avoided. The pace will remain reasonable in the first half of 2008 but later in the year the momentum will wane to clearly below average. Circumstances enabling a recovery are not likely to be in place again until the end of 2009.

Outlook for Germany above average

The differences between Euro-area countries are perhaps now clearer than ever. The setting has changed markedly in the past few years, though. Germany used to be the poorest performing economy and even Italy was able to report better growth figures. Now Germany has managed to restore its price competitiveness and balance its public finances.

Nevertheless, also Germany's "Export-Wunder" will be losing momentum in 2008. But the pace will slow gradually as exports look set to remain buoyant in H1 2008 driven by continued fairly solid demand from foreign markets. Manufacturers' order books are still full and keep the wheels spinning, but only for a while as activity will decelerate as a result of the global slowdown that will inevitably hurt German exports. In the year ahead sales of goods will hinge on economic growth in Eastern Europe including Russia as well as in Asia and the rest of Europe. However, the German economy is very important to the emerging Eastern European markets, too, so the spillover effects will also be felt elsewhere and circle back to Germany.

German consumption demand has remained weak, but this year higher wages and record-low unemployment will help to boost consumer spending. Inflation hurts purchasing power, but the pay talks so far would appear to lead to a rise in real wages anyway this year. Yet, German consumption prospects depend a lot on employment growth as there is little indication that the Germans

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

	2004 (EURbn)	2005	2006	2007	2008E	2009E
Private consumption	4,450	1.6	1.8	1.4	1.4	1.6
Government consumption	1,587	1.5	2.0	2.1	1.8	1.7
Fixed investment	1,573	3.0	5.3	4.8	3.2	2.3
Stockbuilding*	5	0.1	-0.2	-0.2	0.0	-0.2
Exports	2,844	4.9	8.1	6.0	3.2	3.4
Imports	2,685	5.5	7.6	5.2	3.8	4.1
Net exports*	159	-0.2	0.3	0.5	-0.2	-0.1
GDP		1.7	2.9	2.6	1.6	1.3
Nominal GDP (EURbn)	7,776	8,057	8,445	8,853	9,064	9,318
Unemployment rate, %		8.8	8.2	7.4	7.0	7.1
Industrial production, % y/y		1.4	4.0	3.5	2.0	1.8
Consumer prices, % y/y (HICP)		2.2	2.2	2.1	3.1	1.9
- core inflation**		1.5	1.5	2.0	2.6	2.0
Hourly earnings, % y/y		1.8	2.2	2.2	3.0	2.7
Current account (EURbn)		10	-12	15	8	-3
- % of GDP		0.1	-0.2	0.2	0.1	0.0
Trade balance (EURbn)		9	-14	20	10	0
- % of GDP		0.1	-0.2	0.2	0.1	0.0
General govt budget balance, % of GDP		-2.5	-1.5	-0.6	-0.6	-0.8
Gross public debt, % of GDP		70.3	68.6	66.6	65.0	63.5

* Contribution to GDP growth (% points)

will cut their savings at a time when consumer confidence is weak. This makes private consumption highly dependent on the export sector's performance and thus the slowdown in the global economy. All in all it seems that consumer spending will rebound from last year's slump, but still expand only modestly this year and next year.

Among the large Euro-area countries France and Italy lagged markedly behind Germany last year. Certainly the two countries are very different. Growth in France has been driven more by the domestic market and consumption demand and its fluctuations have also been milder. Italy, on the other hand, suffers from fundamental problems which cause its growth potential to lag continuously behind other countries and the economy has serious balance problems.

Spanish economy – from engine to brake

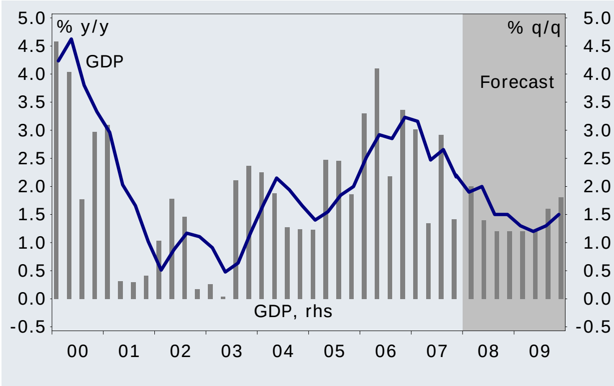
The Spanish economy, accounting for 12% of Euro-area GDP, should affect the Euro-area development more than its weight in the next few years. Last year Spain celebrated the fact that its GDP per capita exceeded that of Italy. The party threatens to be short-lived, though, as the momentum in the Spanish economy in the next few years will probably be the weakest in more than a decade. The debt-driven housing market boom in Spain has been even stronger than in the US. The level of home prices has become markedly higher in relative terms than in the US, and so has the percentage contribution of construction to GDP. The debt-driven nature of the development is reflected by the fact that the current account deficit has increased to 10% of GDP.

There are clear signs that the overheated construction boom has come to an end. The Spanish economy is now facing a period of stabilisation. The most recent financial data support the view that economic growth has started to slow rapidly. One consolation is certainly the balanced national economy and the fact that in a historical context real interest rates are especially low. Still, the debt-driven growth phase is coming to an end and relatively slow growth is inevitably ahead. A halving of growth in Spain will clearly show through in overall Euro-area growth. Hence, even though Germany's position has improved, the pace at least in Spain is slowing correspondingly.

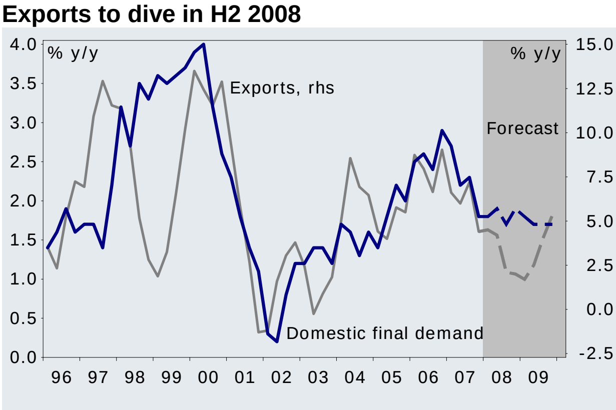
Inflation threats not yet over

The slowing of the Euro-area economy cannot be blamed solely on the US. With inflation at a euro-era high purchasing power started to be markedly eroded already at the end of 2007. Most of the inflation can be attributed to the sharply rising fuel and food prices. The expensive oil has swelled inflation for years now, so its impact cannot be considered temporary. It would probably also be naive to assume that the higher food prices are of a temporary nature. Yet, food and energy prices are not likely to continue to rise at the pace seen lately.

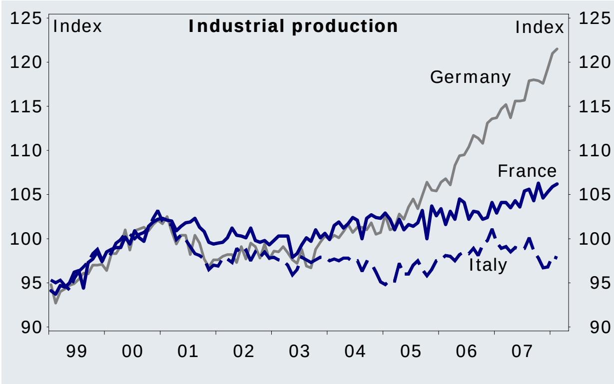
GDP growth to slow gradually



Exports to dive in H2 2008



Slowdown in exports will finally hit Germany too…



…but German household finances are solid

Our inflation forecast is based on the view that the rise in oil and food prices will halt temporarily and that prices even will fall occasionally. As a result the record-high inflation spike will even out. Unfortunately, this will still take some time partly because inflation is accelerating also for other reasons, eg rising wages. However, we expect economic growth to slow to such an extent that the spillover effects from the inflation spike will be weaker than feared. Certainly risks continue to be on the upside this year, and it seems that inflation will be higher than generally expected. Still, there is certainly a better chance that inflation will slow to the ECB's target level next year and we do think it is the most likely scenario.

Still time before the ECB cuts rates

The European central bank has had to take measures on various fronts. The continuing uncertainty in the financial markets has required ever bigger liquidity operations, but the ECB has kept the management of the financial market liquidity strictly separate from monetary policy. As regards monetary policy, its biggest problem is the continuing inflation.

Normally, the ECB would have hiked the policy rate in corresponding circumstances, but now the nervousness of the financial markets, the stronger EUR and the weakening global growth have worked on the ECB's behalf. We expect that the ECB will still have to keep a close eye on inflation. It will not get an opportunity to cut rates for a good while, and it is likely that we will have to wait for monetary easing well into next year. When rate cuts are finally sanctioned, the policy rate will be lowered quite markedly. We estimate that the ECB will cut its policy rate by 1% point in 2009.

In our forecast rate cuts are thus relatively far ahead, which naturally means that the risks related to the estimate are also big. In our opinion inflation will remain a threat to be reckoned with as long as growth in emerging markets continues to be exceptionally strong as supply cannot keep up with demand for raw materials. If the US economy falters, but emerging markets remain resilient, this even increases the risk of mild stagflation. In that case there would not necessarily be any rate cuts despite the weak growth. Moreover, the current decade has taught us that rates should be hiked rather quickly because rates that remain very low for a long time easily cause balance problems. When the economy ultimately recovers after the incipient downswing, rates are bound to go up more easily.

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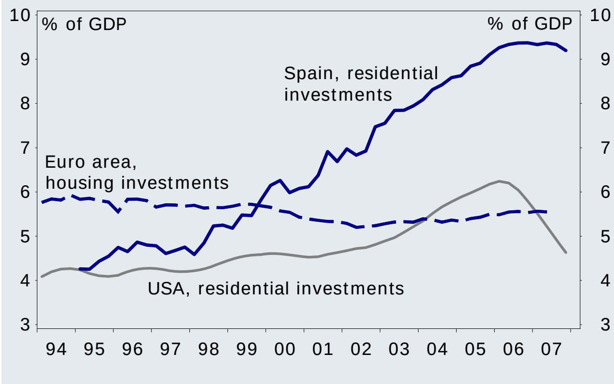
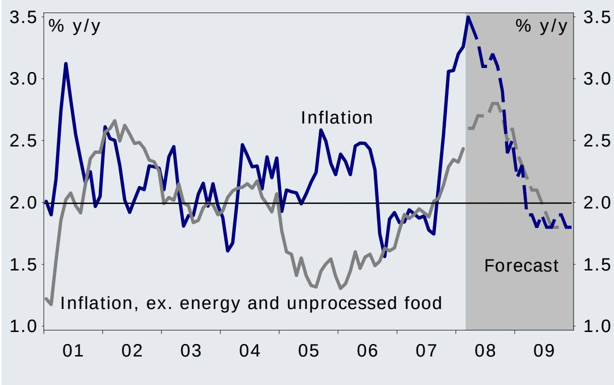
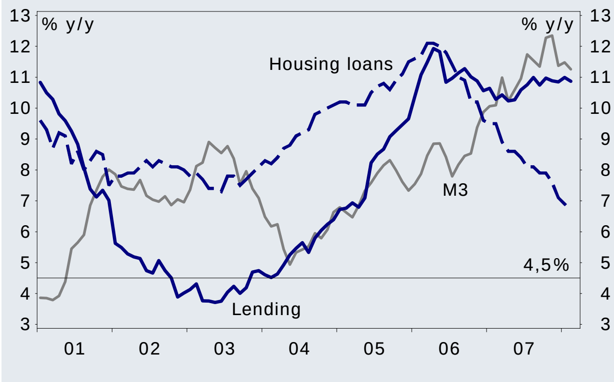
Residential construction to fall in Spain



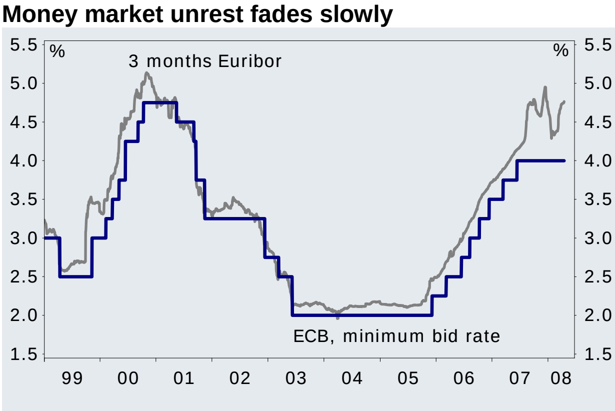
Inflation to stay a risk this year



Housing loan growth easing, money growth vigorous



Money market unrest fades slowly



Export reliance makes Japan vulnerable

- Exports to weaken in step with global downturn.
- Housing investment to pick up.
- Tentative signs that wages are finally increasing.

Growth revised down

Compared to the January issue of *Economic Outlook* we have lowered our growth forecasts for both 2008 and 2009. For 2008 we now look for a growth rate of 1.3%, while growth in 2009 is projected to run at 1.8%, ie close to Japan's potential level. Domestic demand and exports have developed largely as expected, and the downward revision should mainly be viewed in light of our expectation of a sharper downturn in the global economy.

In recent years, notably in 2007, exports have been the key driver of economic progress. The continued sharp upturn in exports to Europe and the rest of Asia (excluding China) has so far more than compensated for the drop in exports to the US and China. With the currently gloomier outlook for the global economy, this export reliance makes Japan vulnerable, and the downturn in the US economy will have a spill-over effect on Europe and Asia going forward. Moreover, the appreciation of the JPY, notably versus the USD, since the summer of 2007 also makes life a bit more difficult for exporters. On the other hand, exports will still be supported by sales to oil-producing countries owing to the high oil prices.

Industrial production has thus been underpinned by exports, and although higher commodity prices have squeezed profit margins, corporate optimism was not affected until recently. But the latest Tankan survey of business confidence among major manufacturers showed a significant drop. Business confidence among companies trading in basic materials has been on a downslide for about 12 months, but in Q1 confidence also fell among companies dealing in processed goods. Against this background, we will likely see a drop in business investment.

Consumption – stable, but not impressive

Private consumption was tipped to overtake exports as the key growth driver in step with the gradual rise in wages and households' disposable income. We have waited a long time for this to happen and now wages finally seem to be rising. Average contractual monthly wages are now growing by more than 1% y/y, which is a positive signal. Unemployment has been relatively stable at just under 4% since unemployment stopped falling in 2007, and employment has hardly increased. Despite the increasing wages, total payrolls have therefore not risen by much. Coupled with higher energy and food prices, this has sent consumer confidence plunging. However, it is worth noting that private consumption has previously to some extent appeared to be resilient to weakening consumer confidence – and this is also the case now. This suggests that private consumption growth will continue to be relatively stable.

Ketchup effect from new construction rules

Construction investment plummeted last year as a consequence of new construction rules. One of the reasons why building activity stalled was that neither the authorities nor the construction firms were properly prepared for the new rules. However, private residential investment seems to have bounced back to the pre-summer level faster than expected, which will make a large positive contribution to GDP growth in the coming quarters. The new and stricter rules made notably multi-storey construction more expensive and non-residential construction is therefore unlikely to recover quite as strongly.

Murky domestic political situation

The domestic political situation has been rather murky since the opposition won the majority in the upper house of the Diet at last summer's election. The ruling coalition still holds the majority in the influential lower house, but for example the appointment of the governor of the Bank of Japan (BoJ) must be approved by both chambers. The political tensions led to a cumbersome process in connection with the appointment of a new BoJ governor and for some time the bank only had an acting governor. This issue is typical of the political situation in Japan at the moment and prospects are not good for the implementation of more long-term economic reforms such as the

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

	2004 (JPYtrn)	2005	2006	2007	2008E	2009E
Private consumption	297.1	1.3	2.0	1.5	0.9	1.7
Government consumption	93.4	1.6	-0.4	0.8	1.4	0.7
Gross fixed capital formation	120.7	3.4	1.5	-0.3	0.9	2.1
Stockbuilding*	0.3	-0.1	0.2	0.0	-0.4	0.0
Exports	68.8	6.9	9.7	8.8	7.5	6.0
Imports	54.7	5.8	4.2	1.7	4.2	7.0
GDP	-	1.9	2.4	2.0	1.3	1.8
Nominal GDP (JPYtrn)	498.5	501.9	509.0	517.3	525.1	535.5
Unemployment rate, %		4.4	4.1	3.9	3.7	3.5
Consumer prices, % y/y		-0.3	0.2	0.1	0.7	0.5
Current account, % of GDP		3.7	3.9	4.8	4.8	5.0
General government budget balance, % of GDP		-6.4	-2.9	-2.8	-3.2	-3.1

* Contribution to GDP growth (% points)

planned VAT hike in 2009.

The BoJ to leave interest rates unchanged

After having been negative or only slightly positive for the main part of the past decade, inflation has now risen to more than 1%. Core inflation, which in Japan is defined as inflation excluding fresh food, has also risen to about 1%. Note, though, that there is no general price pressure. Inflation is mainly pushed up by higher prices of energy and food; prices of several other products are still declining. Excluding energy and food inflation is thus still in negative territory.

The current high headline inflation would have supported former BoJ governor Fukui in raising interest rates. The newly elected governor Shirakawa shares Fukui's inclination to normalise interest rates. But given Japan's currently more uncertain economic situation, rate hikes are no longer on the agenda. On the contrary, it is widely argued that the BoJ should follow in the footsteps of several other leading central banks and lower interest rates. However, we do not consider this a likely scenario, unless the economy starts to show clearer signs of an actual recession. With the policy rate already as low as 0.5%, the central bank has little left in its armoury. Moreover, a rate cut would only have a limited effect on the economy and thus not at present offset the disadvantages of an interest rate even closer to zero. We expect interest rates to be left unchanged throughout 2008 and then hiked at the end of 2009. The JPY is expected to firm against the EUR, but weaken against the USD as the US economy gradually recovers.

One risk factor to our forecast is that exports may be harder hit by the global downturn. That would also make it even more difficult for the domestic economy to move into the upswing that we expect to slowly materialise.

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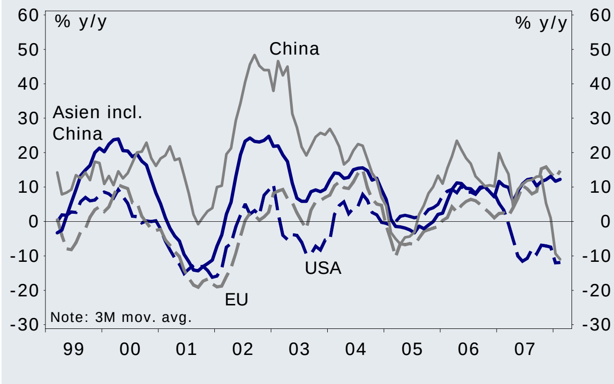
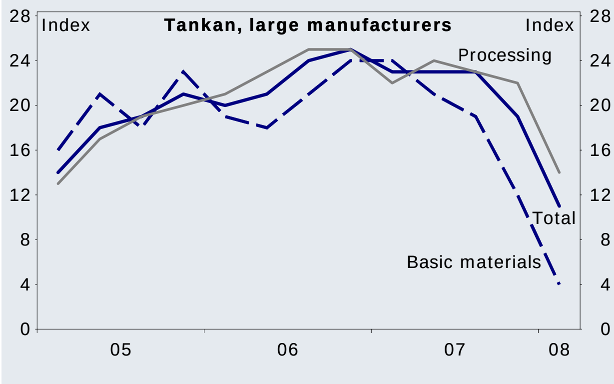
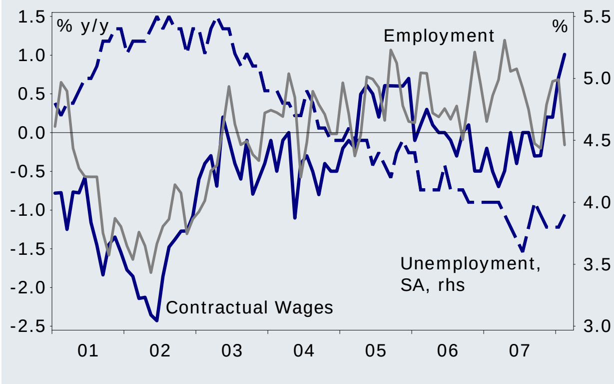
Still strong growth in exports to the EU and Asia



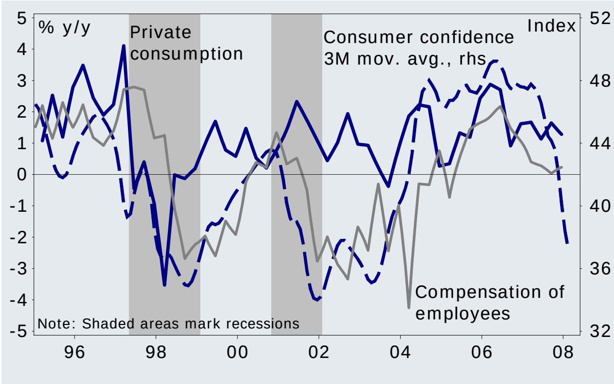
Basic material-heavy companies suffer the most



Wages finally increasing, but not employment



Private consumption relatively resilient



Olympic gold in growth – but slowdown just around the corner

- Inflation sets 12-year record.
- Growth slowdown in the cards.
- No hangover after the Olympic Games.

Private consumption as growth driver

While China is currently facing harsh criticism from the international community because of its reactions to the troubles in Tibet, the country's impressive growth march internationally continues. In 2007 economic growth reached a record 11.4% not least thanks to persistently steep increases in investment activity and exports. Private consumption also grew rapidly by close to 10%, and while growth in investment as well as exports now seems to be waning, recent years' increases in private consumption are likely to continue – even though high inflation and falling consumer confidence initially throw doubt on private consumption trends. Although the downturn in exports to some extent can be ascribed to weaker market growth owing to the international slowdown, this development fits very well with the government's long-term growth strategy, which is based on private consumption gradually taking over the role as the all-important driver of economic growth.

Focus on inflation

Coupled with a very lenient monetary policy, which is partly a result of China's reluctance to let its currency float freely, the strong growth has for some time sparked fears of overheating and inflationary pressure. And since end-2007 consumer prices have indeed started to rise sharply on the back of surging prices of food, particularly meat, which periodically have risen by more than 40% y/y. In February when China was paralysed by the worst winter on record, inflation rose to 8.7%, which was the highest level in almost 12 years and well above the central bank's target of 4.8% in 2008. The government is now battling the mounting inflation with interest rate hikes and a string of administrative measures aimed at keeping prices down, including a temporary freeze of the already heavily subsidised energy prices in January this year. However, given sharply growing cost pressures China's monetary authorities will no doubt keep focusing on inflationary trends for a long time to come. The policy rate will therefore most likely be raised further from the current 7.47% in the coming year, and the government will probably seek to curtail the strong credit growth for example by tightening the banks' reserve requirements again; a method used frequently since early 2007. Given the tighter monetary policy and the downturn in the global economy we expect overall growth to decline to 10% this year and further in 2009.

Currency revaluation

The dramatic weakening of the USD in recent years has also had consequences for China, as the CNY is still linked to the USD, albeit somewhat more loosely than before the exchange rate regime was changed in July 2005. While the CNY following massive pressure from the US has gradually been revalued versus the USD, the CNY has on the other hand weakened sharply versus the EUR – by 4% this year alone. The weakening makes China much more competitive in the European markets, but this trend increasingly leads to trade policy problems with the EU. As a result of mounting pressure from both parties for a more flexible Chinese exchange rate policy, it would come as no surprise if the Chinese authorities increase the revaluation rate significantly throughout 2008. We believe that the CNY may drop as far as to 6.75 against the USD by the end of the year, but if inflation accelerates further, it cannot be ruled out that the government may allow a one-off revaluation of the CNY as an indirect way of tightening monetary policy.

Huge current account surplus

In 2007 China clocked up a current account surplus of some USD 375bn or 11% of GDP. This year China will also record a large surplus of about USD 400bn. The surplus mainly stems from trade with the US and Europe, while trade with other Asian countries is showing a deficit. Combined with substantial capital inflows the huge current account surplus has caused China's currency reserves to swell. In 2007 alone its currency reserves thus rose by more than USD 450bn and China's total currency reserves stood at more than USD 1,500bn at the end of 2007. China now has the world's largest currency re-

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

	2004 (CNYbn)	2005	2006	2007	2008E	2009E
Private consumption	6,383	9.1	9.5	9.5	9.5	10.0
Government consumption	2,320	10.1	9.0	8.0	8.0	8.0
Fixed investment	6,512	17.1	16.0	17.0	15.0	11.0
Stockbuilding*	405	-0.9	-1.0	-0.7	-0.5	-0.5
Exports	4,060	19.1	18.3	18.3	15.0	15.0
Imports	3,650	11.2	10.7	12.3	12.0	12.0
GDP		10.2	11.1	11.4	10.0	8.5
	16,028	18,670	21,087	24,662	28,485	32,451
Nominal GDP (CNYbn)						
Unemployment rate, %		4.2	4.1	4.0	3.8	3.9
Consumer prices, % y/y		1.8	1.5	4.6	7.0	5.0
Current account, % of GDP		7.2	9.4	11.6	10.0	9.0
General government budget balance, % of GDP		-1.2	-0.7	-1.1	-1.0	-1.0

* Contribution to GDP growth (% points)

serves by far. A major chunk has so far been invested in USD-denominated bonds, but since the establishment of the new sovereign wealth fund, the China Investment Corporation (CIC), the investment strategy has become somewhat more offensive. The CIC, which began operations in September 2007 and has assets worth USD 200bn under management, must thus invest in foreign equities. The CIC has for example bought large stakes in US financial institutions Morgan Stanley and Blackstone.

In light of the international financial market unrest, the Chinese equity market has nosedived. The leading Shenzhen 100 and Shanghai 180 indices thus shed 25% and 30%, respectively, in Q1 2008. However, this dive follows a sharp rise since 2006, so a correction is quite natural – but it nonetheless implies a risk for coming years' growth outlook as equity ownership is popular among Chinese households as a means of saving up.

No Olympic hangover

Speculation has been rife about whether China could slide into an economic downturn after the Olympic Games that are being held in the host cities Beijing, Qingdao and Hong Kong. While it seems clear that the macroeconomic consequences of the Olympic Games will be limited due to China's vast size, it is more uncertain how much the country's capital will be affected now that the substantial Olympic-related investments lapse. However, in this context it should be noted that local authorities have already prepared several investment projects that will be carried out once the Olympic Games are over, including the development of new suburban areas, new underground railroad connections and a new airport. In addition, a number of fixed assets investments are being planned to protect the environment and water supply. Against this background we expect no major fluctuations in fixed investment, which is estimated at CNY 430bn this year or almost 40% of Beijing's total gross regional product (which incidentally has grown by 12% y/y over the past five years). The annual growth rate for the greater Beijing area is estimated at 9% for the coming five years!

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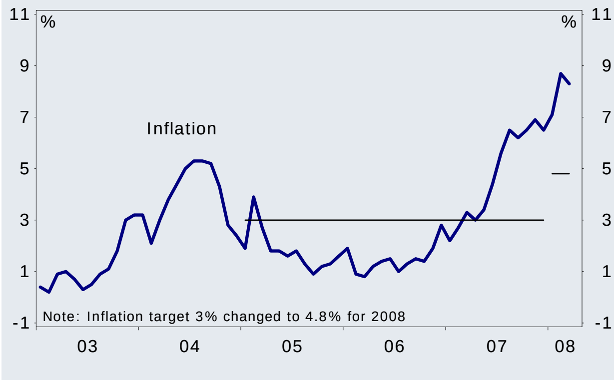
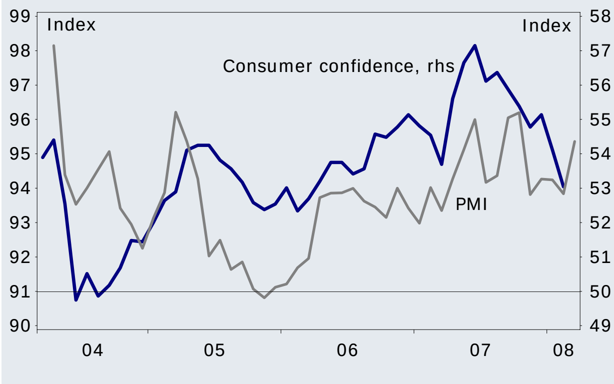
Inflation overshoots the target

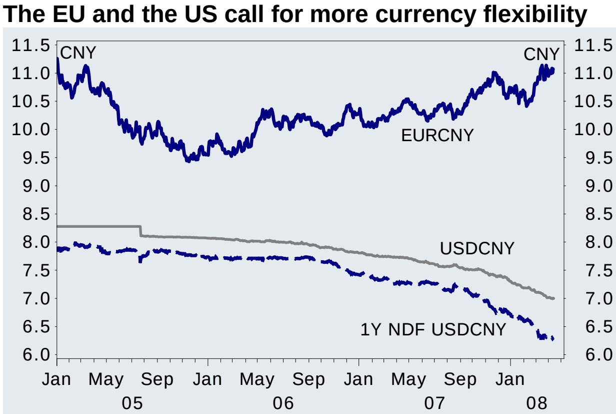


Decoupling between consumers and businesses



Equity market collapse

The EU and the US call for more currency flexibility



Still trending upwards, but the US is the wild card

The oil price is still trending upwards, but the price pressure may be somewhat weaker in the short term due to the US recession. Non-OPEC production growth is uncertain and OPEC's capacity growth has disappointed in spite of persistently higher oil prices in recent years. Higher production costs are also contributing to higher prices.

Oil prices have continued climbing to new all-time highs. In early April Brent peaked at USD 109.98/barrel and WTI at USD 112.21/barrel. Persistent USD weakness and oil price run-ups have triggered an influx of financial players into the oil market, amplifying the price movements. Geopolitical and unfavourable weather conditions have also contributed to the oil price run-ups.

Marginal production costs have continued up. Sharply rising equipment and labour costs require higher oil prices to get new oil on stream. Especially the exploration and development drilling parts of the oil industry value chain have seen a dramatic increase in prices. OPEC pumps at close to full capacity. Since 2004 spare capacity has been at historical lows. Non-OPEC production growth is uncertain, which puts pressure on OPEC to increase capacity. The marginal oil is expected to come from low-yield wells or wells that produce high sulphur oil that is costly to refine. Declining average field sizes and technological challenges with exploiting "difficult" fields (small fields in deep waters) increase the risk of more subdued supply growth. Although we do expect new production to come on stream at the end of 2008, the risk of further production delays and steeper decline ratios at existing fields is considerable.

Weak economic growth in the US will curb demand for oil and oil products in 2008. The Fed's easing and the Bush administration's stimulus packages are expected to slowly start influencing economic activity. This, in turn, will lead to a gradual pick-up in demand for oil and oil products during 2009. Solid economic growth in emerging economies is expected to compensate for weaker US demand. Increasing living standards especially in countries with large populations such as China and India will bolster demand for transportation and boost car sales. This requires investment in infrastructure and increases the need for oil/energy. Transport fuel is expected to increase its share of total oil consumption going forward. Strict price control regimes (subsidies) for domestic oil products in many emerging economies have made demand less sensitive to higher oil prices in the world market. We expect the medium-term underlying price to continue trending upwards although we may see short spells of weaker prices this spring and summer.

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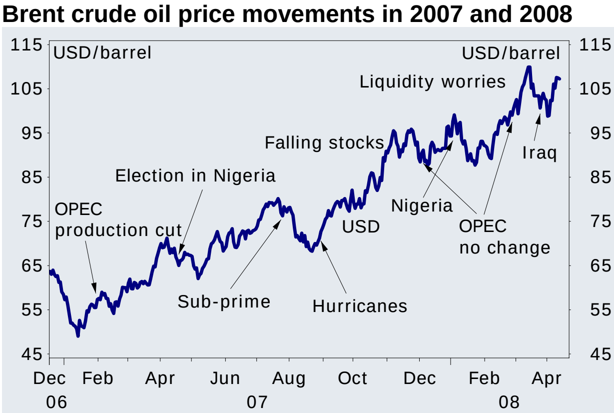
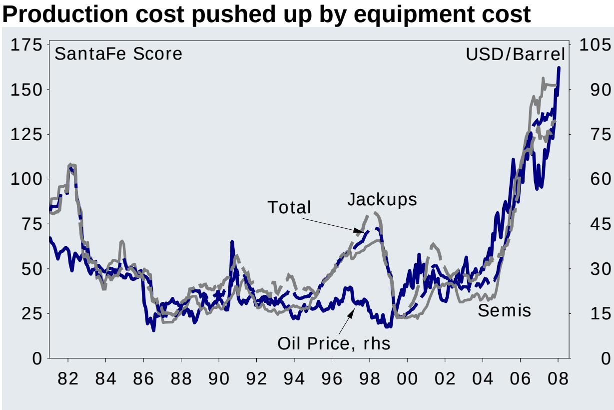
Oil price forecast (Brent spot, USD/barrel)

	Q1	Q2	Q3	Q4	Year
2003	31.5	26.1	28.4	29.5	28.9
2004	32.1	35.4	41.4	44.3	38.3
2005	47.7	51.1	61.6	56.6	54.3
2006	61.4	69.3	69.3	59.5	64.9
2007	57.8	69.0	75.8	88.7	72.8
2008E	97.2	90.0	95.0	97.0	94.8
2009E	98.0	97.0	108.0	110.0	103.3

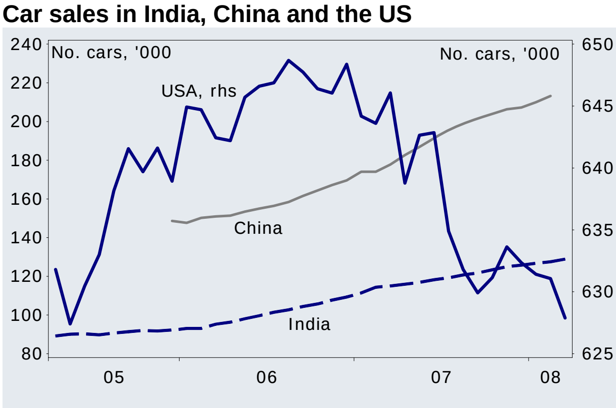
Brent crude oil price movements in 2007 and 2008



Production cost pushed up by equipment cost



Car sales in India, China and the US



Clouds gathering on the horizon

Prices of industrial metals continued seesawing at a peak level during early 2008. Concerns about economic growth in the US have occasionally pushed prices downwards, as inventories were also increasing, but the weakness has only been temporary. The drive of Emerging Markets has proved strong and inventories have even started to decrease again. Prices have risen once again despite the weak momentum in the US economy. The rise is undoubtedly partly related to investment. Investors have for a change looked for safety in the commodities markets, while equity markets have faltered and inflation has remained a threat as well. Still, the sentiment would hardly be favourable even to investors if the markets were not still tight.

In our view, the US economy has slipped into a mild recession and the recovery will last well into next year or longer. The effect will undoubtedly be reflected in other parts of the world. Economic growth will gradually decelerate also in Europe and China. The whole world economy will slow more than estimated earlier during the next 18 months.

For the time being, industrial metal markets are still strong and it could easily take six months before any signs of slower growth in Emerging Markets start to appear. Hence, prices may rise further short term. The weakness of the USD also favours this. The slowing pace of the world economy will gradually start to dampen the demand for metals. The balance in the markets will improve in relation to previous expectations and at some stage investors' confidence will also be tested more clearly than before.

Of course, metal prices have not been driven only by fluctuations in demand but also by the fact that supply has not corresponded to demand. In aluminium production there have been problems arising from energy production, for instance. The marginal costs of aluminium production have at worst nearly doubled in a few years largely due to the higher price of energy. Copper production has also been hampered by electricity production problems in China. Once again copper supply has not increased according to demand and inventories have shrunk close to historical lows. The importance of China in particular to the development of demand cannot be overemphasised. Last year China accounted for almost 90% of the increase in demand. Hence, our forecast that the momentum in the Chinese economy will also slacken is a very central factor that should curb further rises in prices of industrial metals.

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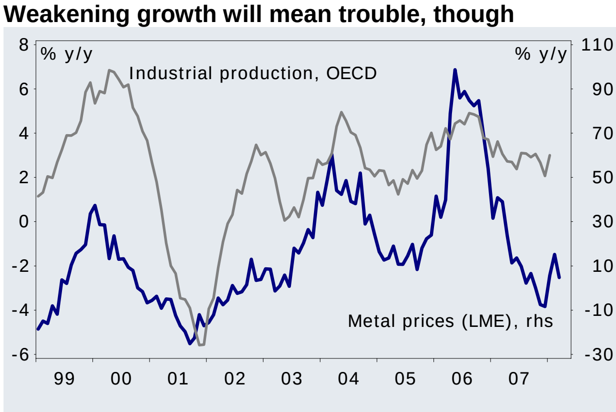
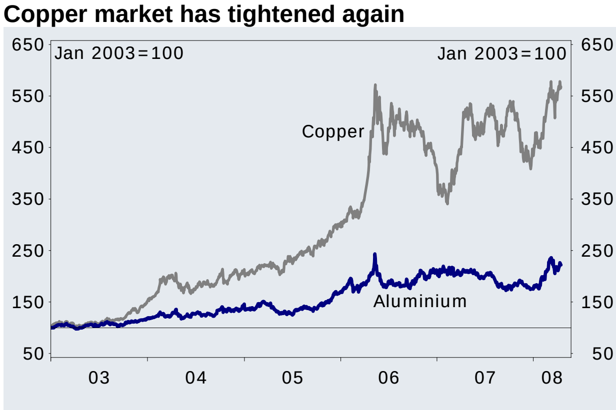
Still going strong

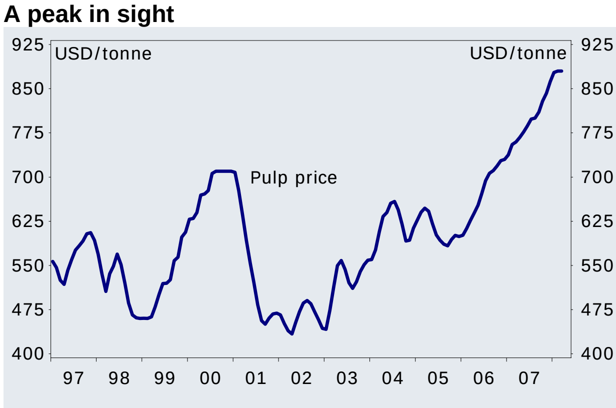
Weakening growth will mean trouble, though



Copper market has tightened again



A peak in sight



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