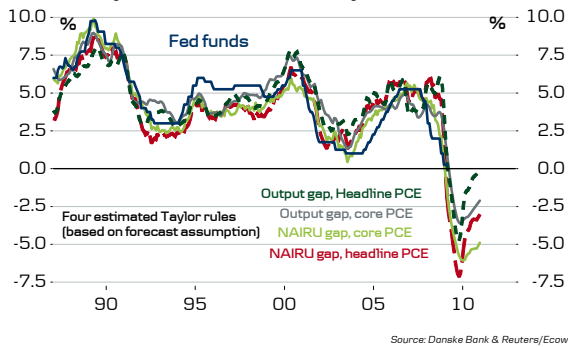


**Don't worry about Fed hikes anytime soon**



In the medium term there is no need to worry about rate hikes any time soon, we believe. Even with our relatively optimistic forecast on the US economy, we are not able to produce positive policy rates in any of our Taylor rules within the forecast horizon. Zero interest rates are here to stay for a longer while.

Danske Bank	USA			Euroland			Japan			China		
	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
GDP	1.1	-2.7	2.5	0.7	-2.7	0.8	-0.7	-5.0	2.8	9.1	7.2	9.2
Private consumption	0.2	-0.8	1.8	0.5	-0.5	0.4	0.7	-0.2	1.4	15.7	15.0	16.0
Investment	-3.9	-13.0	7.2	0.6	-6.0	0.6	-4.8	-6.4	2.1	12.8	10.3	14.3
Export	6.2	-14.1	0.5	1.7	-10.1	2.4	1.9	-27.2	18.2	14.4	-6.5	11.2
Import	-3.4	-9.5	5.4	1.7	-7.3	2.8	1.1	-12.6	1.1	20.4	-4.0	13.8
Industrial production	-1.8	-7.5	2.0	-2.1	-4.4	2.8	-3.4	-26.5	10.2	13.1	7.8	12.1
Inflation excl. food and energy	2.3	1.3	1.2	1.8	1.5	1.3	0.0	-0.3	-0.3	-	-	-
Inflation	3.8	-0.8	2.5	3.3	0.5	1.3	1.5	-0.9	-0.1	5.9	-0.4	1.4

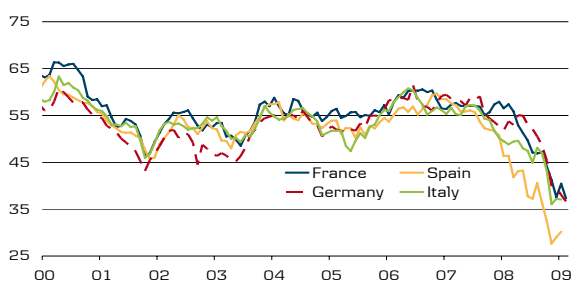
# Euroland: Facing its first stress-test

- Euroland is in a state of crisis. Exports are falling dramatically as a result of the slump in global demand; credit tightening and falling capacity utilisation are putting a brake on investments and a mix of collapsing housing bubbles and decreasing job security dampens private consumption. Most confidence indicators have only climbed minimally from record lows.
- The speed of contraction should soon begin to taper off, but Euroland GDP is still expected to shrink for most of 2009. Positive growth is not projected before Q4 2009 and we will then face a gradual recovery with growth reaching trend about a year later. We expect the Euroland economy to contract 2.7% this year and grow 0.8% in 2010.
- The economic downturn is bringing fiscal budgets deep(er) into the red in several member countries and concerns about fiscal sustainability have increased sharply. In addition some Euroland countries will face substantial costs in the event of an economic meltdown in Eastern Europe. This is developing into Euroland's first real stress-test.
- Policy response to the global downturn has not been as swift and decisive as in the US. Discretionary fiscal stimuli will contribute up to about 1% point to GDP growth in 2009. ECB cut its policy rate to 1.5% in early March. We believe that ECB will cut rates further, but from now on it will do so in steps of 25bp and will try to avoid going below 1.0%. Quantitative easing is likely to complement rate cuts.

## in a deep recession

Euroland GDP contracted by 1.5% q/q in Q4 2008 dragged down by exports that fell with breakneck speed (-7.3% q/q) and investments that declined sharply (-2.7% q/q). Private consumption "only" contracted 0.9% q/q. Private consumption is keeping up in Germany, but is under significant pressure in countries with bursting housing bubbles - in particular in Spain and Ireland.

PMI's at record low after almost free fall



Source: Markit.

Confidence indicators seemed to show signs of stabilisation in December and January after a period of almost free fall. Euroland PMI did however reach new record lows in February for both the composite, services, new business and employment index. We are looking for an improvement in business confidence in the coming

months - in particular in the expectation components.

Euroland PMI is signalling that GDP will fall 1.1% q/q in Q1 2009. The dismal growth outlook for Q1 is confirmed by other indicators. We project a fall of 1.2% q/q in Q1 driven by a reduction in investments, falling net exports and substantial inventory adjustment.

Composite PMI signals contraction



Source: Markit, Ecowin and own calculations.

## Gloomy outlook for exports

Global trade contracted sharply in late 2009 as the financial crisis put a brake on demand across the globe. Euroland exports declined 7.3% q/q in Q4 not least because of the very negative developments in Central and Eastern Europe. The major export markets continue to show substantial

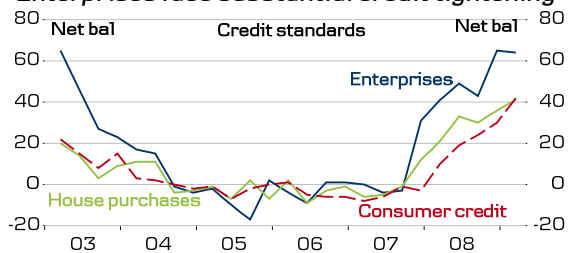
weakness and exports will continue to fall until autumn 2009. Export growth will pick up significantly during 2010 as a result of high export market growth (US and Asia), but the strong euro will continue to dampen competitiveness.

Reflecting the plunge in domestic demand imports have fallen sharply too (-5.5% q/q in Q4), although not quite as much as exports. The current account balance has deteriorated from a small surplus in 2007 to about -1 % of GDP in 2008 and is likely to worsen further in 2009. A somewhat stronger rebound in exports than imports is expected to result in an improvement in the current account in 2010.

**Investments continue to plunge**

A mix of credit tightening, very low share prices, sharply falling exports and a poor outlook for domestic demand has resulted in a sudden plunge in business investment. We expect investments to pick up in late 2009 or early 2010, but the rebound in business investment will be moderated by low capacity utilisation.

**Enterprises face substantial credit tightening**



Source: Ecowin

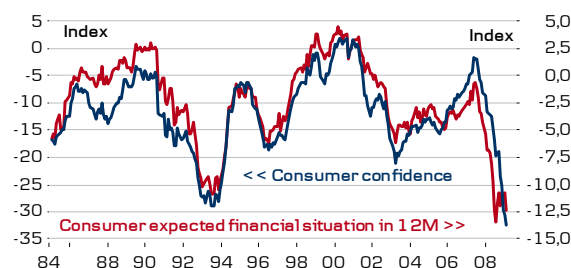
Deflating housing markets and tightened credit standards have put a brake on residential investment and although falling interest rates provide some relief we project that residential investment will continue to decrease for most of the forecast period. The contraction in residential investment will continue to put a significant drag on growth in those member states that have deflating housing bubbles.

**Households react to uncertainties**

Household consumption is held back by a combination of falling house prices, rising unemployment and record low confidence. Real wage growth will be high in 2009 due to a very low inflation level, and this will help private consumption from contracting significantly. In

addition German car sales hit their highest level in 10 years in February because of a EUR 2500 cash bonus for scrapping old cars. We do however expect to see a modest decline in consumption this year – with a more pronounced decline in member states with sharply falling house prices. Consumption will recover gradually next year.

**Record low consumer confidence**



Source: Ecowin

**Inventory adjustment still ahead**

Production has not fallen as fast as new orders and as a result inventories have risen. In Germany inventories contributed positively with 0.5 %-point to growth in Q4. In the current juncture of the business-cycle inventories should begin to adjust downward, which is expected to put a drag on growth at least until mid-2009.

**Sharp decline in orders**



Source: Ecowin

**Labour market**

Employment expectations have fallen sharply since mid-2008 and the PMI composite employment index currently signals that jobs are slashed at record speed. The unemployment rate has already increased from a low of 7.3% in early 2008 to 8.2% in January 2009. We project a relatively sharp increase in unemployment in H1 2009 and expect unemployment to continue to rise throughout the forecast period. At the end of 2010 the unemployment rate is anticipated to have reached 10 %.

## Stress-testing Euroland

The financial markets are increasingly concerned about the fiscal sustainability of several member states and the risk of default, which could eventually lead to a break-up of the monetary union. The primary reason for concern is that fiscal deficits will rise sharply due to the negative budgetary impact caused by automatic stabilisers in the midst of a severe economic downturn. This is putting pressure on countries with high debt and fiscal deficits that never were reduced sufficiently despite years of high growth.

### Budget balances deteriorate markedly

	Public budget <sup>1</sup>			Gross Debt <sup>2</sup>
	2008	2009	2010	2008
Belgium	-0.9	-3.0	-4.3	88
Euroland	-1.7	-4.0	-4.4	69
Finland	4.5	2.0	0.5	33
France	-3.2	-5.4	-5.0	67
Germany	-0.1	-2.9	-4.2	66
Ireland	-6.3	-11.0	-13.0	41
Italy	-2.8	-3.8	-3.7	106
Netherlands	1.1	-1.4	-2.7	63
Spain	-3.4	-6.2	-5.7	40

Note: 1) % of GDP

Source: European Commission

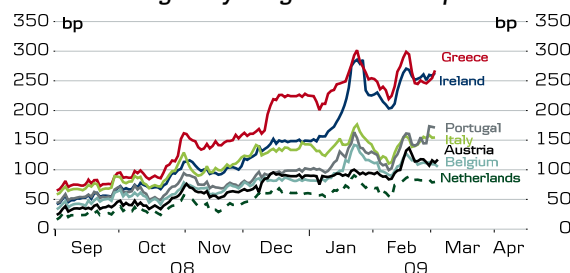
In addition some countries are likely to face considerable losses from the financial sector, not least because of substantial exposure to the crisis in Central and Eastern Europe, cf. the box below. It is likely that governments will have to pay part of that bill. At the same time, and because of increasing concerns about the abovementioned developments, financing cost have diverged and Greece and Ireland are now paying more than 2.5% higher interest rate on 10-year government bond issues than Germany. It is however important to keep in mind that although financing costs have diverged, the current interest rate in Greece is below 6%, or less than in 2000.

The fiscal costs of the crisis will be huge and some countries were ill prepared. However, a breakdown of the monetary union is politically unacceptable and the economic consequences would be enormous. It is therefore to be expected that the utmost will be done to find reasonable solutions to the problems as they emerge.

The next year is likely to show whether Euroland was just a short-lived experiment or whether it has

the strength to be a long-lasting monetary union. We fear the first, but believe in the latter.

### Widening 10-year government spreads



Source: Ecowin

### Exposure to the Central and Eastern European crisis

Central and Eastern Europe (CEE) has become an increasingly important region for Euroland. Exports to the region have grown significantly over the past decade and accounted for almost 20% of Euroland exports and almost 1/3 of goods export growth before the crisis set in. The current crisis in the CEE region will thus have a significant negative macroeconomic impact on Euroland.

### An important export market



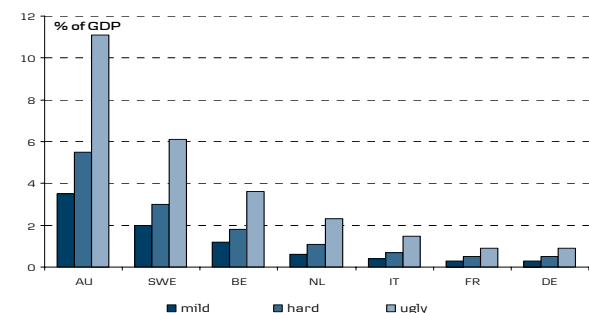
Sources: Ecowin and own calculations (2008 estimate).

Of even more concern are the potential implications of the financial exposure to the region. Western European banks have shown substantial willingness to set up subsidiary banks in the region and provide high lending growth. The top lenders to the region are Austria, Sweden and Belgium. We have looked at three risk scenarios, cf. Euro area: **Exposure to the crisis in Central and Eastern Europe.** Depending on which scenario materialises Austrian banks could face losses of 3-11% of GDP. The question is then who will pick up the bill. A loss of up to 11% of GDP would be very unpleasant, but absorbable by the Austrian government. Belgium and Italy, which are high-debt countries with a fiscal budget that is already stretched, are in for

smaller losses, but they also have less room to manoeuvre.

Total losses for Western Banks add up to USD 275bn in our “ugly” scenario. This is a lot of money, but to put it into perspective the IMF now estimates the total losses on US-originated credit assets at USD 2.200bn. Thus even if the ugly scenario occurs it would still be wrong to equal this to the US subprime crisis.

**Losses in three risk scenarios**



Sources: BIS Banking Statistics, European Commission AMECO database, Ecowin and own calculations.

**No miracle cure**

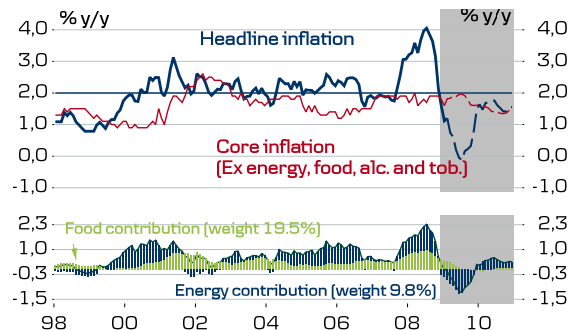
Fiscal and monetary stimuli are providing substantial support to the Euroland economy and will help to gradually stabilise the economy, but for the moment there is no miracle cure. Policy response to the global downturn has not been as swift and decisive as in the US. The discretionary fiscal stimuli announced since the European Commission presented a European Economic Recovery plan will contribute up to about 1% point to GDP growth, but additional measures are likely to be announced as long as the economic crisis continues to deepen. However, in a number of member states the room to manoeuvre is limited due to already high government debts and deficits.

ECB decided to cut its policy rate to 1.5% at the meeting in early March. We believe that ECB will cut rates further, but will avoid going below 1.0%. ECB projects inflation at 1.0% in 2010, which gives them plenty of room for further cuts. We think they will deliver a final 50bp rate cut in April. It will then have to look for other instruments. ECB has signalled that all options are open and we find it likely that quantitative easing will be applied. One possibility is that ECB buys commercial papers from companies, but nothing has been decided yet. The ECB is already providing almost unlimited liquidity.

**Inflation at zero this summer**

Inflation (HICP) has fallen from 4.0% in July 2008 to 1.2% in February. The sharp decline in energy and global food prices is projected to bring inflation down to zero this summer. However, we are not concerned about Euroland getting into a deflationary scenario (at least not yet...). Core inflation has come down slightly, but wage growth is still relatively high and will keep inflation well into positive territory in the medium term. We expect inflation to be a modest 0.5% this year and to increase to 1.3% next year.

**Inflation will be gone, but only for a few months**



Source: Ecowin

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	2008	2009	2010	2008	2009	2010	2008	2009	2010	2008	2009	2010
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Inflation	3.8	-0.8	2.5	3.3	0.5	1.3	1.5	-0.9	-0.1	5.9	-0.4	1.4