STEIN BROTHERS
LONDON-STOCKHOLM

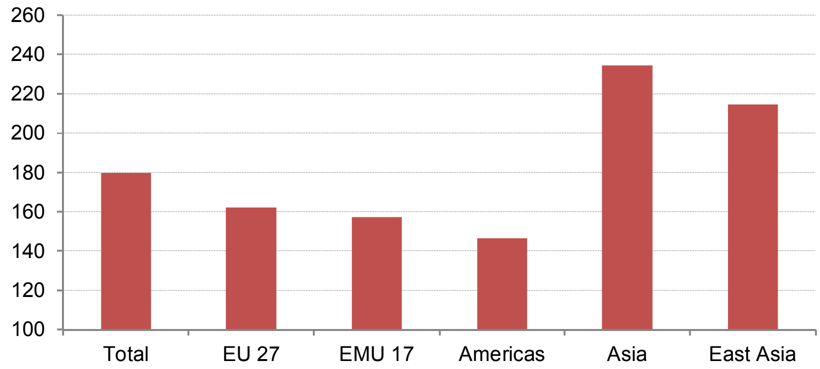
Sweden still less unattractive

Riksbank should – but won't – raise interest rates

The outlook for the Swedish economy has recently been revised down substantially. Last month Finance Minister Anders Borg halved his growth forecast for 2013 from a healthy (if below-trend) 2.7% to a rather less impressive 1.1%. Konjunkturinstitutet (the National Institute for Economic Research) is forecasting an even lower 0.8% growth this year, and assumes that GDP contracted in Q4 2012. The latest Riksbank minutes show the Bank concerned that the slowdown is stronger than it previously thought. Deputy Governors Lars E O Svensson and Karolina Ekholm – perennial doves – once again called for lower interest rates now and a lower interest rate path in the future.

There is no question but that Sweden is facing a slowdown. Anything else would be surprising. Sweden had relatively healthy growth in the first three quarters of 2012 (an average of close to 0.6% per quarter), but exports make up just under 50% of GDP, and with a continued weak global climate and slower-growing household spending at home, softer output data was just a question of time. Recent business survey data, as well as 'hard data' (eg, exports, manufacturing orders) confirm imminent weakness.

Swedish exports by market, 2011, index 1998=100



The Swedish economy currently has two major problems, its relative export-dependence and the continued rising indebtedness of the household sector.

But the export side is not entirely clear-cut. In 2011, 38% of Swedish exports went to the euro area, with another 18% to non-EA EU. However, this is down from 43% to the EA and another 19% to non-EA EU in 1998. Exports to Asia have risen from 10% of the total to 13% over the period. But that disguises the speed of growth of export to non-traditional markets. Exports to Asia (and to the sub-group East Asia) have grown more than twice as fast as exports to European and American markets. Nor does this show the full picture, since the data only refers to goods, while Swedish service exports (including very strong showing in music and computer games – play on!) have climbed from less than one-quarter to more than

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

one-third of total exports over the same 13-years. The export numbers further underestimate Sweden's shifting export-orientation once you take into account where large Swedish companies sell through subsidiaries and local plants. Sweden is still heavily geared towards exporting to other European countries; but this is changing, meaning Sweden will become less dependent on the slower-growing continental European economies. Significantly, Germany is no longer Sweden's largest export market; Norway is – which implies considerable transhipment, given Norway's 5 million population.

Sweden's other danger is the high level of household debt, which in the first three quarters of 2012 averaged 168.5% of personal disposable income, up from 167.6% a year earlier. As in other countries, this is primarily housing debt. Although housing loan growth has slowed from more than 6% in mid-2011 to around 4½% by late 2012, it remains almost three times as fast as broad money growth (see below). Moreover, the monthly pace of housing loan growth picked up in H2 2012 to an average of 0.40% compared with 0.35% in H1. Stefan Ingves, the Governor of the Riksbank, has repeatedly called for measures to halt this seemingly relentless rise in household indebtedness, including arguing for mandatory amortisation of housing loans. However, the Riksbank lacks the means to force banks to introduce mandatory amortisation; and Finance Minister Borg recently made it clear that the government does not intend to introduce any such measure. Finansinspektionen could in theory do it, but is also unlikely to.

This leaves the Riksbank with a dilemma. Ideally, it should raise policy interest rates. 50 basis points extra is unlikely to do much to strengthen the krona and harm exports. But, in a country where the majority of indebted households still have variable interest rate loans, it could provide a jolt to them and stem the continued borrowing growth, possibly even triggering some voluntary repayment. (This is not certain, of course. In 2011, when the repo rate was 2%, ie twice the current rate, housing loan growth, both monthly and annually, was considerably stronger than now.) But this is unlikely to happen. Inflation is currently -0.1%. The last time it was within the Riksbank's 2%±1% target range was in May 2012. Given this, plus the presence of two very outspoken doves on the Riksbank board, it is clear that even if Mr Ingves wanted to raise interest rates, he would find it all but impossible to do so. Moreover, raising interest rates would also risk triggering an implosion in the equally inflated commercial property market.

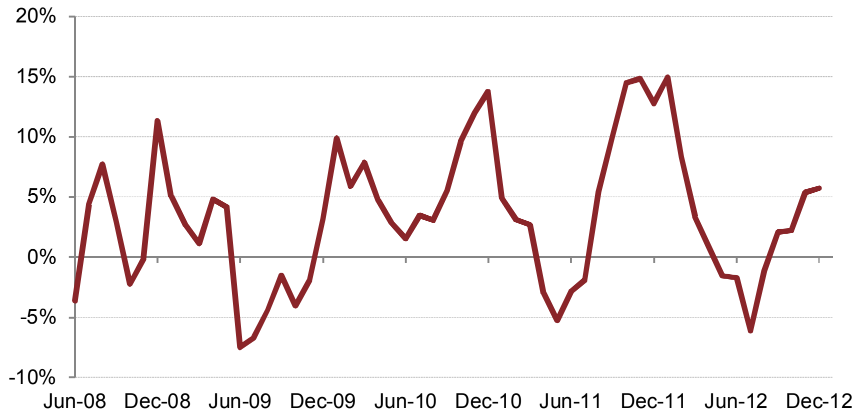
Sweden has a major advantage compared with most other advanced economies, namely its healthy public finances. The experience of the euro area, as well as attempts to introduce a balanced-budget amendment in the United States, have shown the futility of attempting to force unwilling politicians to adhere to fiscal probity. However, following years of budget deficits and the banking crisis of the early 1990s, Swedish politicians reached a cross-party consensus that the aim of fiscal policy would be a surplus of 2% of GDP (recently changed to 1%) over the business cycle – and with none of Gordon Brown's tinkering with the timing of the cycle. A second factor in helping to achieve stable public finances is that (again since the early 1990s), the Swedish budget is presented on a take-it-or-leave-it basis, with

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

no room for amendments.[1] This limits the capacity for the kind of additional unplanned pork barrel spending that bedevils US public finances.

Moreover, one of the flipsides of continued strong housing loan growth is that broad money growth is picking up again. M3 growth slowed sharply over the course of 2012, but six-month annualised growth has been positive for the past four months, reaching 5.8% in December (2% from a year earlier), somewhat higher than the post-crisis average (although the series is volatile). This is not just due to household borrowing; bank deposits of non-financial companies are rising by around 5%on an annual basis, implying healthy liquidity.

Swedish M3, six-month annualised change, %



Were Sweden alone, or even just alone in Europe, the country's near-term outlook would be enough to give rise to concern. The household debt issue would add to this, not least because it seems that he authorities, while aware of the issue, are unable to come up with a policy to deal with it. But Sweden is not alone. The outlook for the euro area - even if further crisis eruptions are avoided – and for the UK are both worse than for Sweden. Yes, growth will be weak and below-trend; but the economy should still *grow* in 2013, which his more than can be said for many other European economies. So in an unattractive field, Sweden remains somewhat less unattractive than others. And, of course, if the world economy turns out to do better than expected in 2013, Sweden will benefit from that as well.

Gabriel Stein
gabriel.stein@steinbrothers.co.uk

Gabriel Stein is Managing Director of Stein Brothers (UK) Ltd and Chief Economic Advisor to OMFIF. The views expressed are his own.

[1] The importance of this issue was pointed out to me by Anders Lindell of Informed Portfolio Management AB in Stockholm.