

Economics

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Sweden

Europe's Top Performer to Outperform Again

- In 2010, GDP growth in Sweden turned out at about 5.5%, far above the start of year consensus (2.3%). This is the biggest outperformance (versus consensus) seen in any industrial country at any point in the last 10 years. In 2010, no other industrial country came close to matching Sweden's growth. This note explains why the Swedish economy is rebounding so quickly, why we think this will continue and the market implications.
- The strong growth outcome has, to a large extent, to do with global trade and Sweden's exports, the high level of household savings in combination with the country's very robust fiscal situation, and the fact that Sweden has not been hit by a housing market crisis. Hence, we suspect that the surprises relative to the consensus view will repeat this year.
- We expect GDP growth in 2011 at 5.0% Y/Y, not only beating the long-term trend, but also markedly overshooting the December-2010 consensus of 3.3%. Growth will likely remain strong in later years as well unless the currency and/or interest rates rise sharply, or global growth slows sharply.
- Inflation will remain low this year, in our view, largely reflecting record-low pay increases, but we expect it to pick up in 2012 as wages rise and resource use reaches more normal levels. The rapid recovery poses upside inflation risks further out, but the Riksbank has time to act before its inflation target is threatened.
- The combination of strong domestic growth and concerns over household lending and indebtedness plus rising house prices is likely to fuel additional near-term monetary tightening. Given slow monetary tightening globally, we also expect the Riksbank to proceed slowly; we expect the key policy rate to reach 2.50% by end-2011 and 3.50% by late-2012. This is a more aggressive view than the one currently held by the Riksbank, but well below the outcome of a simple Taylor rule (3.25% by end-2011 and 4.0% by end-2012). In 2013, however, we expect the actual key policy rate to catch up with the Taylor model of 4.25%. The gradual monetary tightening is key to our forecast of why we expect the economy will continue to boom in the near future.
- Being a small open economy, a major risk clearly relates to external demand prospects, especially from Western Europe, and the SEK.

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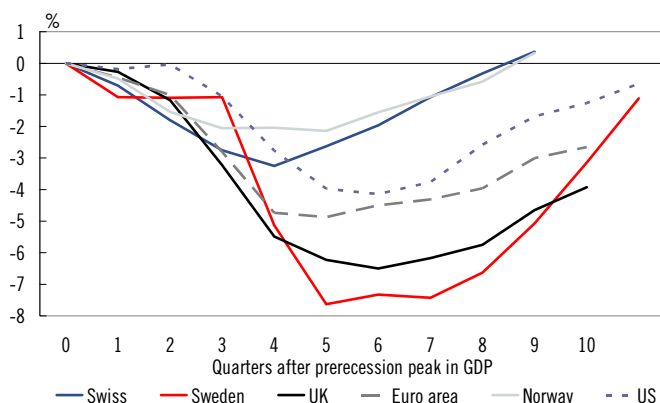
Sweden: The 2010/11 “Outperformer”

After having encountered one of the steepest declines from the pre-recession peak (7.7%), the Swedish economy has experienced a surprisingly strong rebound last year compared to other major industrialised countries, and the level of GDP growth is now only 1.1% below the pre-recession peak (see Chart 1+2). Real GDP growth markedly overshoot the early-2010 consensus forecast (by 2.7pp), and the situation is likely to reiterate itself this year. This piece tries to address the issue of why Sweden has outperformed the consensus and fared markedly better than most other industrialised countries last year and likely will continue to do so also this year. This has, to a large extent, to do with global trade and Sweden’s export, the high level of household savings in combination with the country’s very robust fiscal situation, and the fact that Sweden has not been hit by a housing market crisis.

Looking back, the economy in 2010 turned out better than expected in many respects. By growing an expected 5.5% Y/Y last year, real GDP growth overshoot the January-10 consensus forecast by about 3.2% – the largest overshoot registered in the past decade among industrialised countries – with particularly large overshoots in investment and consumer spending (see Chart 3). We also believe that the favourable Swedish export structure and geographical focus explain part of last year’s outperformance (exports account for approx. 50% of GDP).¹ The 2010 overshoot follows large GDP undershoots in 2008 and 2009. Recent data will probably be revised many times. But, it appears that domestic demand growth was much stronger than consensus expected at the beginning of the year. Investment growth was 8-9% higher (around the same as our forecast), the biggest overshoot since 1998. Despite weak incomes, consumer spending growth overshoot the Jan-10 consensus by 1.7%, the biggest overshoot in the last decade.

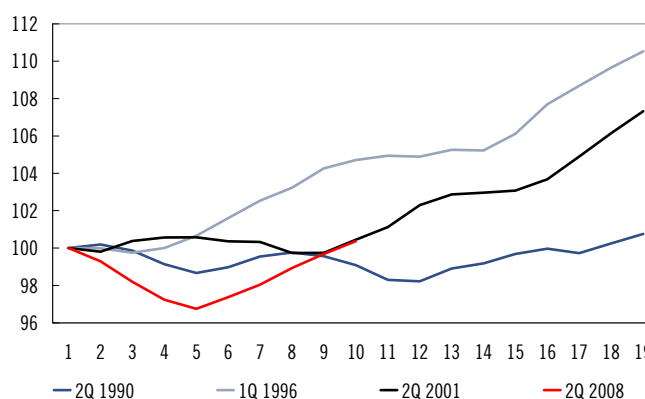
- **Global trade and Swedish exports.** The global downturn of 2008/09 had a particularly dramatic impact on such key Swedish exports as intermediate and capital goods. Since then, the recovery has been strongest in these areas (see Chart 4), and Swedish exports have now almost regained their pre-crisis level.

Figure 1. Selected Countries: Cumulative Change in GDP from Pre-Recession Peaks, 2008-2010



Sources: DataStream and Citi Investment Research and Analysis

Figure 2. Sweden: Comparison of Recovery Following Various Recessions, GDP Sweden



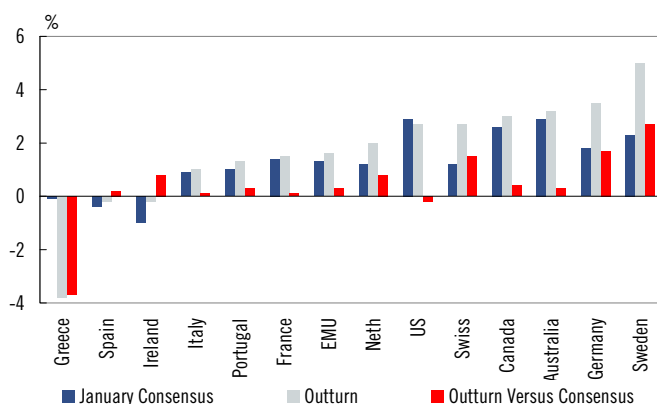
Note: Index in the quarter preceding the beginning of the recession = 100. Legends denote the quarter in which the index = 100. Sources: Consensus Economic and Citi Investment Research and Analysis

¹ Among the indicators in the national account, Consensus Economics only compiles forecasts for private consumption and investment activity.

It is not only the export structure that has benefited the Scandinavian country. Its geographical focus is also very favourable. Key export markets include Germany (10.2% of total exports) and the Nordics (Norway: 10.1%, Denmark: 6.6% and Finland: 6.2%), which all have performed comparatively well last year, while the share of exports to the struggling peripheral countries remains rather limited (6.4%). Sweden has also benefitted from its very high export exposure to high-growth Emerging Market countries, especially Asia. This has also been the case for the other two growth outperforming industrialised countries, Switzerland and Australia, last year (see Chart 5+6). To some extent, the recovery of Swedish exports has also benefited from the marked weakening of the SEK in connection with the crisis.²

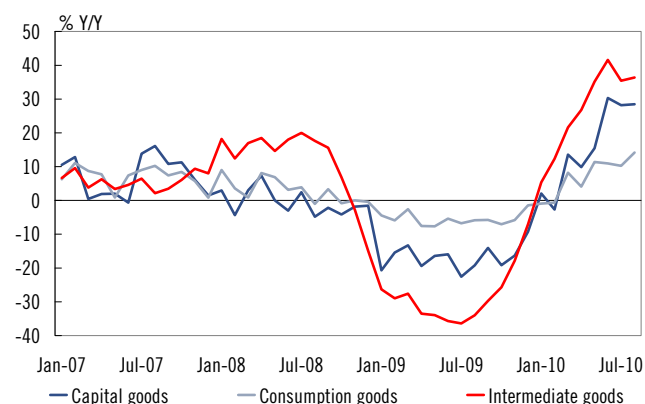
- **High level of household savings and no boom-bust on the Swedish housing market.** The composition and direction of trade, though, are not the most important explanations behind last year's outperformance. Even in level terms, output and employment have expanded more profoundly in Sweden than elsewhere. As an example, employment has now regained about half of its drop during the crisis, whereas no recovery, so far, in the euro area is traceable (see Chart 7). The comparatively short-lived slump in domestic demand (both capital and private spending) has to a large degree to do with an initially high savings rate in Sweden (since household savings were never extraordinarily low, there has not been a sharp rise in savings and hence no consumer collapse) and good income growth combined with the fact that the country did not experience a housing market crisis (see Chart 8-10).

Figure 3. Selected Countries: 2010 GDP Growth Outturn Vs. Consensus Expectations (Pct.)



Sources: Consensus Economic and Citi Investment Research and Analysis

Figure 4. Euro Area: Merchandise Imports (Pct. Yr.-Yr.), 2007-Aug 2010



Note: The euro area receives more than one third of Swedish merchandise exports.
Sources: Ecowin and Citi Investment Research and Analysis

² At the time of writing, the real effective exchange rate stands at 84.39, which compares with the 30-year average of 92.4.

The housing boom-busts in many countries (not Sweden) led to too-low household savings (which had to correct), plus excess construction activity (which had to correct) and also vulnerable banking systems (which had to correct). Sweden managed to avoid such a severe cycle. First, Sweden's investment in housing relative to GDP has been at a very low level compared to those in countries such as Denmark, Spain and the US. Second, in the run-up to the crisis, there was a shortage of housing in approximately half of the municipalities of Sweden.³ Third, Swedish households primarily buy their houses to live in, not to rent out. While in i.e. the UK (where house prices fell substantially), there is a large market for buy-to-let, this element is largely non-existing in Sweden.⁴

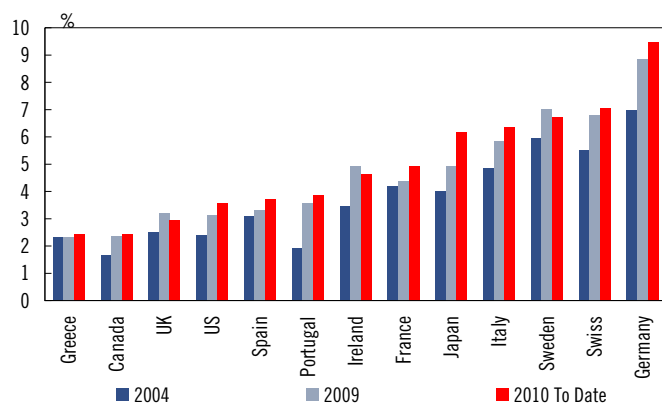
It is also worth keeping in mind that Riksbank studies on Swedish households' debt servicing ability, given changes in interest rates and unemployment, show that the ability of Swedish households to service their mortgages is not particularly affected by higher unemployment. This is due to a combination of an extensive social safety net and the fact that the largest part of the household sector's debt is held by households with two wage-earners. This conclusion is also supported by Sweden's experience during the 1990s when only a very limited proportion of the banks' loan losses could be related to the household sector despite the substantial fall in house prices and the rapid increase in unemployment.

- **Strong Swedish Public Finances.** Strong public finances at the beginning of the crisis enabled Sweden to pursue an expansionary fiscal policy without jeopardising its credibility. At the outset of the economic financial crisis, the general government financial balance in Sweden was well into surplus, clearly different from the situation in most other industrialised countries. In 2007, Sweden had a surplus of 3.5% of GDP, well above that of the euro area (-0.7% of GDP), the US (-2.9% of GDP), and the OECD average (-1.3% of GDP). This has also been the case historically; in the ten years preceding the crisis, the general government fiscal balance in the euro area and the US averaged approximately -2.0% of GDP, compared to a 1.2% surplus in Sweden (i.e. in line with the 1% fiscal rule). Although other countries loosened fiscal policy similar to Sweden in the crisis, the key difference is that Sweden has no overhang of fiscal tightening to cap recovery (see Chart 11 and 12).

³ See speech: "The property market and the financial crisis" by Deputy Governor Barbro Wickman-Parak, June 2009, the Riksbank.

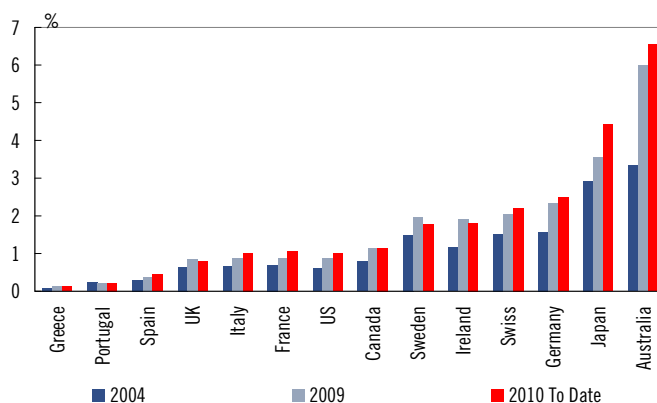
⁴ See speech: "The property market and the financial crisis" by Deputy Governor Barbro Wickman-Parak, June 2009, the Riksbank.

Figure 5. Selected Countries: Exports to All Emerging Markets, (Pct. Of GDP), Selected Years



Sources: IMF and Citi Investment Research and Analysis

Figure 6. Selected Countries: Exports to Asia, (Pct. Of GDP), Selected Years



Sources: IMF and Citi Investment Research and Analysis

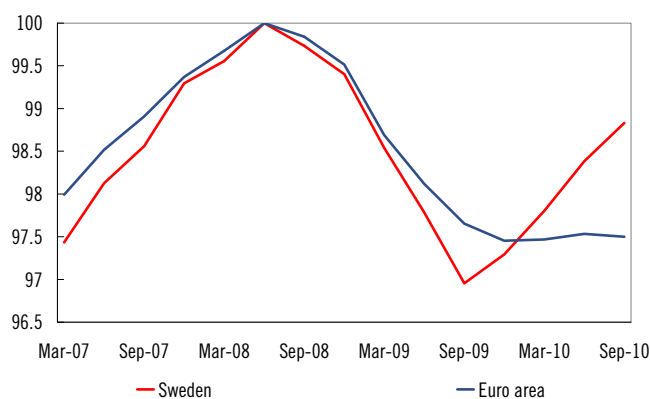
We suspect that last year's growth surprises relative to the consensus view are not random, and likely reflect underlying themes which probably have important lessons for this year. Hence, we have lifted our GDP forecast for this and next year, now expecting an expansion of 5.5% Y/Y in 2010 and 5.0% Y/Y in 2011 (versus 3.4% Y/Y previously). In 2012, GDP growth should slow somewhat (3.4%), but still remain above the long-term trend. With a December-2010 consensus forecast for GDP growth of 3.3% Y/Y for 2011, we expect consensus growth forecasts again will rise sharply during the next 12 months.

- Although exports nearly are at pre-crisis levels, we see no reasons to expect a market slowdown ahead. The supportive factors during the recovery stage, i.e. the geographical focus and sectoral structure of Swedish exports, remain in play, suggesting decent export growth also this year. The fiscal tightening measures that are being enacted in many European countries (and the US) will probably primarily lead to weaker demand for consumer goods, i.e. hurting sectors of less importance to Swedish exports. In addition, we expect key export markets like Germany and the rest of the Nordic countries to continue to perform relatively well, and EM Asia should again outperform as China and India continue to undergo transformational booms, not just in 2011 but for many years after. In addition, thanks to a quick cost adjustment during the crisis, Swedish export companies remain relatively profitable (even given the strengthening of the SEK of late).⁵

⁵ The quarterly business tendency surveys from NIER support this.

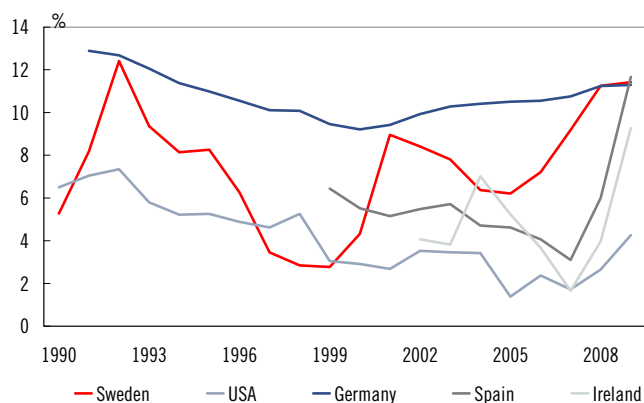
- We expect the drivers behind last year's healthy rebound in private consumption to remain in place as well in the years ahead. No fiscal austerity measures are on the agenda in Sweden, the labour market is likely to sustain its improving trend and inflation will probably fall further, supporting household income despite weak wage growth. With a household savings ratio around historical highs, combined with consumer confidence on par with historical peaks and having climbed more rapidly than in i.e. Europe and the US, plus healthy public finances, preconditions for reduced savings today appear better in Sweden than elsewhere. In addition, the upturn on equity markets and rising house prices are likely to boost the wealth situation among Swedes. The housing market upturn looks set to continue near-term. Rising interest rates and the cap on the loan-to-value ratio, though, should slow the pace, while rising employment and income pull in the opposite direction. The longer-term trend will, to a large degree, depend on how economic policy will be shaped (i.e. to address the longer-term risks of a re-acceleration in home prices and high household indebtedness).

Figure 7. Sweden and Euro Area: Employment (Index, 100=2008:2Q), 2007-3Q 2010



Sources: Ecwin and Citi Investment Research and Analysis

Figure 8. Selected Countries: Households' Saving Ratio (Pct. Of Disp. Income), 1990-2009

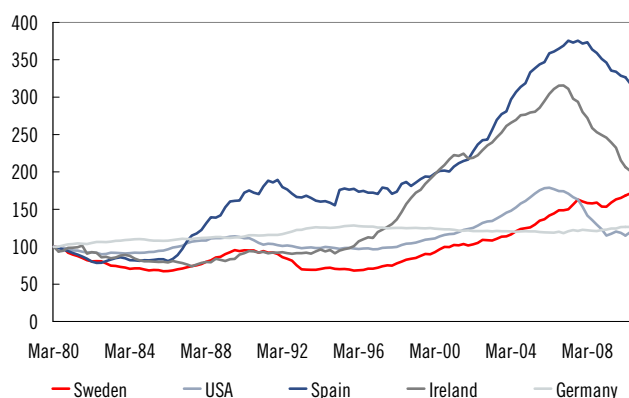


Sources: OECD and Citi Investment Research and Analysis

- The stock rebuilding together with the upturn in global demand for Swedish export goods have rapidly pushed capacity use upwards, implying a rebound in capital spending from its record-low last year (-16% Y/Y). However, abundant spare capacity suggests that business investment activity will enter a calmer phase next year.
- Reflecting the economic crisis, pay hikes in the collective pay agreements for 2010-11 are at record lows (around 2-2.5% Y/Y). As the next wage round will occur under much stronger labour market conditions, pay increases in 2012 will likely rebound (3.0-3.5% Y/Y). Low cost pressures are likely to imply below-target core inflation (CPIF, i.e. CPI with a fixed mortgage rate) in the years ahead and the strengthening of the SEK will exert further downward pressure in the first half of this year. Food prices, on the other hand, constitute an upside risks. With the gradual rise in the key policy rate, and hence higher mortgage interest costs, we expect headline inflation to exceed the 2% target next year.

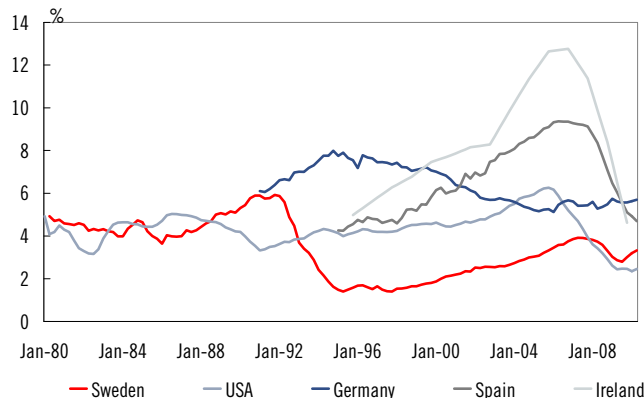
- Following the major budget deterioration between 2007-2009, amid the measures taken to limit the negative effects of the economic crisis, we expect the budget balance to be close to zero over the coming years. Against a background of strong economic growth and planned sell-offs of government-owned shares in Swedish companies, the central government's debt ratio is likely to improve to just above 30% of GDP in 2012 from 38% in 2009. Although fiscal measures in the Autumn Budget Bill are likely to stimulate the economy by around 0.7% of GDP, we anticipate overall fiscal policy will be broadly neutral this year as temporary crisis aid in the form of local government and infrastructure grants disappears.

Figure 9. Selected Countries: Real House Prices (Index, 1980=100), 1980-2Q 2010



Sources: Riksbank and Citi Investment Research and Analysis

Figure 10. Selected Countries: Housing Investment (Pct. Of GDP), 1980-2Q 2010



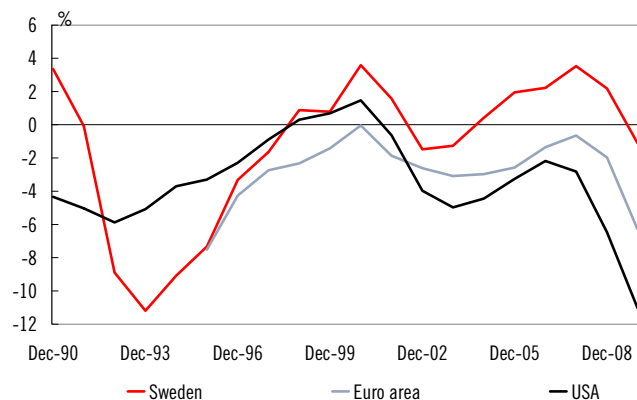
Sources: Riksbank and Citi Investment Research and Analysis

Summing up, economic growth in Sweden was surprisingly strong last year, and surpassed expectations. Although a large contribution comes from companies replenishing inventories (has added 2.8pp to overall growth in 1-3Q 2010), the overall performance remains impressive. It is worth keeping in mind, though, that since the downturn in 2008-09 was deeper than in most other countries, the potential for recovery is larger. In addition, the factors featured above should not be viewed as an extensive list of explanations behind last year's outperformance, but more a highlight of the most central factors. Another important aspect clearly is the stability of the Swedish banking sector, which has supported the recovery.

Inflation is unlikely to prove an immediate threat medium term. Instead, we expect a strong domestic economic growth outlook combined with an attempt from the Central Bank's side to try to lean against strong household credit and continued strong developments on the housing market to continue to trigger gradual rate hikes ahead. Although we expect the Riksbank to rein in on growth before inflation gets out of control, the Bank will likely hike cautiously this year in order to limit the extent to which the shift in interest rate differentials boosts the SEK and hurts exports. Unless the SEK soars markedly, we see the key policy rate at 2.50% by end-2011 and 3.50% by late-2012 (versus 2.00% and 2.75%, respectively, previously). Although this is a more aggressive view than the one currently held by the Riksbank, our rate path is well below the outcome suggested by a simple Taylor rule (3.25% by end-2011 and 4.0% by end-2012). In 2013, however, we expect the level of the actual key policy rate to catch up with the Taylor model of 4.25%. The gradual rise in the policy rate in Sweden is also an important explanation of why we expect the economy to continue to boom in the near future.

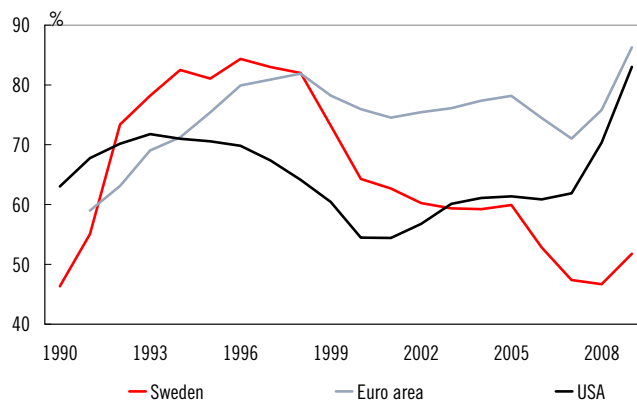
Being a small open economy, a major risk clearly relates to external demand prospects, especially from Western Europe, and the SEK.

Figure 11. Selected Countries: General Government Financial Balance (Pct. Of GDP), 1990-2009



Sources: OECD and Citi Investment Research and Analysis

Figure 12. Selected Countries: Central Government Debt (Pct. Of GDP), 1990-2009



Note: Public gross debt. Sources: OECD and Citi Investment Research and Analysis

Figure 1. Sweden: Economic Forecasts, 2009-2012F

		2009	2010	2011	2012
Real GDP	YoY	-5.2	5.5	5.0	3.4
Final Domestic Demand	YoY	-3.1	3.4	4.2	3.1
Public Consumption	YoY	1.8	1.7	0.9	0.8
Private Consumption	YoY	-0.4	3.3	3.1	2.6
Investment (Ex Stocks)	YoY	-16.2	6.2	12.3	7.3
Exports	YoY	-13.1	11.1	9.4	5.7
Imports	YoY	-13.3	12.5	8.9	5.0
CPI (Average)	YoY	-0.3	1.2	1.9	2.2

Note: F- Citi forecasts. YoY Year-on-year growth rate. Sources: Ecowin and Citi Investment Research and Analysis

Appendix A-1

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