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Sweden

Economic and Financial Policy Briefing

BRIEFING NOTE

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1. EXECUTIVE SUMMARY

The current report aims to provide an assessment of the Swedish economy. The list of policies analyzed is by no means exhaustive, but attempts to reflect the priorities during the current crisis and the agenda of the European Parliament's ECON Committee.

- Growth performance: Having contracted for three consecutive quarters, the Swedish economy is now officially in recession. The Swedish government forecasts a -4.2% of GDP growth for 2009.
- Public finances together with relatively high household savings remain clear strengths of the Swedish economy. After a solid surplus of 2.5% of GDP in 2008 and earlier years, the public deficit is set to become -2.7% in 2009, and -3.8% in 2010 (Ministry of Finance).
- In response to the downturn, the Swedish government has been implementing a fiscal stimulus, similar to most other developed economies. The high share of the public sector in Swedish GDP guarantees a high level of automatic built-in stabilisers in relative terms. On the discretionary side, the government has announced tax cuts and numerous spending measures as well as credit guarantees.
- Unemployment is currently increasing from 6.2% in 2008 to a projected 8.9% in 2009, gradually reaching a peak of 11.7% in 2011, but set to decline thereafter.
- The Swedish central bank, the Riksbank, is the oldest central bank in the world with 350 years of history. It became fully independent only in 1999. It follows an inflation targeting strategy with a target of 2% annual CPI inflation and a tolerance band of +/- 1%.
- Most inflation forecasts for 2009 predict a negative headline inflation, with estimates ranging from -0.7% to 0.7% CPI inflation in 2009. The Riksbank may have to resort to unconventional measures in order to fulfil its inflation target of 2%.
- In order to provide liquidity, the Riksbank will offer for 365 days and at variable interest rates. In total the Riksbank has provided liquidity amounting to SEK 500 billion which corresponds to about 5% of the total assets of the major banks.
- The financial industry accounts for almost 4% of Sweden's GDP, with around 100.000 people working in it which is around 2% of the total workforce. The four largest banks are Nordea, Swedbank, Handelsbanken and SEB. Together these banks account for 75% of deposits. In November 2008, bank deposits stood at SEK 2,138 billion, out of these 43% was from Swedish households, from the corporate sector came 26% and foreign holders had 17%.
- Financial assets of Swedish households have increased 100% since 1995 and reached SEK 2,700 billion mid 2008. Most of the increase occurred in insurance and mutual funds and bank savings. Bank deposits now since the start of the current crisis, account for the largest share constituting 34% mid 2008
- Lending books stand around SEK 3,000 billion of which 41% is for the corporate sector and households have 24% of the share, the rest being for foreign borrowers. Lending has been on the increase since 2006. However, the liquidity risk has started to affect Swedish banks as it has become harder to fund at longer term maturities. Furthermore large portions of the banks loan portfolios are coming to maturity and will need refinancing.

- Lending abroad also continued to grow faster than domestic lending. Out of the big four banks, Swedbank and SEB have significant exposure in the Baltics whilst Nordea has less than 3% of its total lending in these countries.

2. POLITICAL BRIEF[1]

Despite a rapidly contracting economy and rising unemployment, public opinion has not turned against the government. In fact, the centre-right Alliance for Sweden government comprising the Moderate Party, the People's Party Liberals, the Centre Party and the Christian Democrats has so far benefited from its measured response to the global financial crisis and economic downturn. Although opinion polls still show support for the Alliance lying below that for the Social Democratic Party (SAP)-Green-Left Party opposition bloc, the gap has narrowed significantly since late 2008 and is now down to single figures.

Despite the Alliance's recently improved showing in the polls and the fact that the Moderate Party prime minister, Fredrik Reinfeldt, remains the most popular party leader, the road towards a full recovery will be difficult. The government will now be concerned about how its reform programme and voters will be influenced by a significantly weaker economic climate. Although the Economist Intelligence Unit expects the economy to have moved into recovery, albeit a slow recovery, by the next general election in September 2010, unemployment will still be rising. As with any multi-party government, there is a risk of tension within the coalition, but all parties are in agreement about the main elements of the Alliance's platform.

Since taking office in 2006, the centre-right coalition has emphasised measures aimed at strengthening the economic incentive to work, with a view to easing welfare dependency and social exclusion and boosting labour supply. These include income tax cuts, primarily for low- and medium-income earners; lower employers' social security contributions, aimed at encouraging the hiring of young, older and immigrant workers and the long-term unemployed; stricter qualification requirements and cuts in unemployment and sickness benefit; and an overhaul of the previously large number of state-funded training programmes. Employment protection legislation will remain quite strict, but Sweden has a high employment rate in comparison with most other countries in and outside Europe. The unions remain opposed to the welfare reforms. Although there is a risk of deterioration in industrial relations as unemployment increases, a marked worsening is unlikely.

The government plans to reduce the state's role in the economy further, with the proposed sale of government stakes in at least three more companies, including a telecommunications company, TeliaSonera, and Nordea Bank. However, the continuing turmoil in global financial markets has significantly weakened investor sentiment and will almost certainly delay more sales. Further liberalisation measures aim to open product markets (including public services) to wider private-sector competition and boost the low level of small scale entrepreneurship.

[1] Taken from the Country Report Sweden, Economist Intelligence Unit, March 2009

3. GENERAL ECONOMIC SITUATION

3.1. Economy hit by Downturn

Having contracted for three consecutive quarters, the Swedish economy is now officially in recession. In Q4 of 2008, real GDP in Sweden fell at an unprecedented -9.3% of GDP according to the Swedish National Institute for Economic Research (NIER). Being an open economy dependent on trade and exports that generate over 50% of GDP, the recession hits Sweden especially hard. The NIER expects exports to plunge by 15% in 2009.

In response to the downturn, the Swedish government has been pursuing an expansive fiscal policy, similar to most other developed economies. The government has introduced cuts in corporate taxes as well as in employers' social security contributions. For example, the corporate tax rate is to be reduced from 28% to 26.3% in 2009. Despite this measure, and other comparable ones, the Swedish tax burden remains among the highest in the world.

However, on the positive side, the high share of the public sector in Swedish GDP guarantees a high level of automatic built-in stabilisers during the crisis in relative terms (working mainly through constant public expenditure in an environment of declining economic activity). On the discretionary side, the government has announced numerous spending measures as well as credit guarantees (see below in more detail). The discretionary element of the stabilisers falls short of the OECD average, but due to the automatic element the aggregate fiscal stimulus reaches high levels.

As with all economies currently, the deepening crisis of the last months has turned all economic forecasts for Sweden, written in 2008 and before, largely redundant. The latest available official forecast by the European Commission, the Interim Forecast of January 2009, predicts inter alia a growth of -1.4% of GDP for 2009, a figure vastly outdated by now. Latest national figures from the Swedish government (1 April) forecast the following:

Table 1: Key growth indicators from the latest Swedish Government forecast (April 2009)

	2008	**2009**	**2010**	**2011**
GDP (% of GDP)	-0.2	**-4.2**	0.2	2.4
Unemployment (% of GDP)	6.2	**8.9**	11.1	11.7
Public Deficit (% of GDP)	2.5	**-2.7**	-3.8	-3.1
Hours worked (% of GDP)	1.6	**-4.4**	-2.3	-0.6
Productivity (% of GDP)	-2.7	**0.4**	3.6	3.8

Note that these latest government figures relating to growth (-4.2% in 2009) are even more pessimistic than that of most banks (e.g. SEB -2.5%, Danske-1.7%), private research institutes (EIU -3.5%) or even that of the NIER (-3.9%). This goes to show that with time, the crisis is only deepening and at the moment, the latest estimates are almost always the worst ones at the same time.

3.2. Public Finances remain a relative strength

Prior to the crisis, government finances had been on a very positive trend in recent years, owing to solid growth and lower expenditure. In relative terms, even in the midst of crisis, public finances together with relatively high household savings remain clear strengths of the Swedish economy.

Nevertheless, according to Swedish government projections, the deep recession will lead to a public deficit of -2.7% of GDP in net lending in 2009 and a peak of -3.8% in 2010, after a surplus of 2.5% in 2008. After 2010 the public finances would improve again and the deficit should be "both temporary and controllable", according to the government. Despite the deterioration in the situation, the government is committed to preserving the sustainability of public finances in the mid- and long term. However, other institutions such as SEB Bank warn that the public deficit could become as bad as -6% of GDP in coming years.

The public debt ratio in Sweden was at a relatively low 36.7% of GDP in 2008, but is expected to rise in 2009/2010. These fiscal projections are of course valid only provided that the operations of Swedish banks in Baltic States do not require any major additional rescue packages, an eventuality that cannot be excluded, but at the moment does not seem too probable.

The current account will remain in substantial surplus at 6.6% of GDP (evidencing also the high export dependency), although slightly decreasing in net effect from previous years due to exports decreasing faster than imports.

3.3. Swedish Government Stimulus Package

In January 2009, in a briefing to the ECON Committee, authors from Bruegel[2] had calculated the relative size of the Swedish stimulus package (among many other countries). Measures took the form of tax deductions, additional spending to boost employment creation & training as well as loan guarantees (see table below).

Table 2: Size of the Swedish Stimulus package (end of January 2009)

	SEK bn[3]	**% of GDP**
Additional fiscal spending:	12.13	0.38%
Additional credit + similar measures	95.46	3.01%

[2] Authors: Jakob von Weizsäcker and David Saha, Bruegel. The paper can be found at http://www.europarl.europa.eu/activities/committees/studies/download.do?language=en&file=24251

[3] 1 euro currently equals about 10.9 Swedish kronor (SEK).

Category	Measure	Net amount (SEK bn)
Tax cuts	Tax deduction for house renovations, conversions, maintenance	3.60
Extra spending	Increased employment service (active labour market policy)	4.70
	More vocational education	0.50
	R&D in automotive sector	3.00
	Additional infrastructure investment	0.33
Extra credit + similar measures	Higher export credit guarantees[4]	75.00
	Deferment of tax payments by companies	0.46
	Credit guarantees for car sector	20.00

These figures add up to roughly 108 billion SEK (appr. EUR 10 billion). Note that these figures differ considerably from the ones that have been announced by the Swedish government. In total, the government announced to have presented measures worth around SEK 40 billion for 2009, written in its 2009 Budget Bill and amended in December 2008.[5] The answer to this difference could be that some credit guarantees, many of which have not been yet realized effectively, might not be counted in the government figures while Bruegel counts them. In any case, the above figures, both from Bruegel and the Swedish government, are meant to be indicative.

Automotive industry rescue measures

In terms of major industries, Sweden is known for its cars: Saab and Volvo. Saab, part of the troubled General Motors (GM) group, has been recording high losses lately. Following a withdrawal of support for Saab by GM, the company already enjoys some court protection against its buyers but the Swedish government has been reluctant to grant financial assistance or to take over the company as a credible long-term plan has been missing.

The EIB, having a lending facility standing-by, has also been unwilling to lend, owing to GM's weak credit rating, in the absence of loan guarantees by the Swedish government. However, these guarantees are pending on guarantees by GM and the ability to find a buyer for Saab. The Saab policy of the Swedish government therefore remains open at this point (early April 2009).

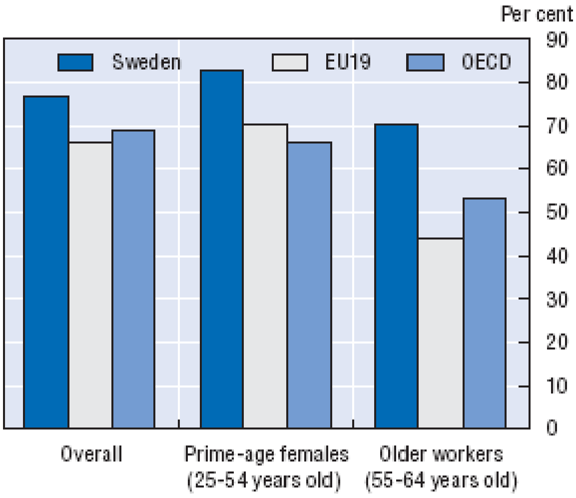
In the case of Volvo, the mother company Ford is also searching for a buyer. However, the government appears to be more willing to help with loan guarantees of EIB loans in this case as Ford has assured that it is taking full ownership responsibility and guarantees capital flows to Volvo until a buyer has been found.

[4] An increase in the ceiling for export guarantees by SEK 150 bn was approved. Bruegel assumes only 50% of that additional volume will be used in 2009.
[5] See http://www.sweden.gov.se/sb/d/11501.

3.4 Employment decreased modestly

Employment levels in Sweden have traditionally been higher than in other OECD countries. The country has especially managed to attain high levels of employment among female and older workers, as evidenced by the below comparison:

Figure 1 - Employment Rates in International Comparison, 2007(Source OECD)



While economic activity is currently contracting, the labour market conditions have also begun to worsen. The overall level of unemployment has currently increased from 6.2% in 2008 to a projected 8.9% in 2009, gradually reaching a peak of 11.7% in 2011, and set to decline thereafter. Most of the loss in employment until now is evidence of the dismissal of temporary workers and non-renewal of temporary contracts. However, layoffs of permanent staff may become reality during 2009 and 2010. The NIER also expects 250.000 jobs to disappear by the end of 2010 and unemployment to exceed 10%.

Until now, Sweden has had a "dual labour market" (OECD), where most employment is currently created (and lost) within the realm of temporary work-force. This owes to an exceptional rigidity in permanent contracts, an issue that the OECD has frequently criticized.

4. THE RIKSBANK, MONETARY POLICY AND THE EURO[6]

The Swedish central bank, the Riksbank, is the oldest central bank in the world with 350 years of history. Yet it became fully independent only in 1999. The Riksbank follows an inflation targeting strategy with a target of 2% annual CPI inflation and a tolerance band of +/- 1%.

Overview Box Riksbanken

Objective: Price stability (single objective)

Strategy: Inflation targeting, target of 2% annual CPI inflation, tolerance +/-1%
Numerical target defined by the bank, time horizon 2 years

Monetary policy making body: Executive Board

Membership (6 members)

- Governor as the Chairperson of the Board
- 5 further members

Appointment: After each election to the Riksdag, the Swedish Parliament, appoints 11 members to serve on the General Council of the Riksbank. Therefore, the General Council reflects the composition of the Riksdag. All six members of the Executive Board are appointed by the General Council for a term of 6 years. A rolling schedule is in place so that one member gets appointed per year.

The Chairman and Vice-Chairman of the General Council can attend meetings of the Executive Board and give an opinion there, however, they cannot make proposals nor participate in decision-making.

Transparency arrangements: Monetary Policy Report (3 per year with 3 updates in between publication)

Minutes of Executive Board meetings published with time lag of 2 weeks

Votes of individual members of Executive Board published at the same time as monetary policy decision is communicated (new measure released on 2 April 2009)

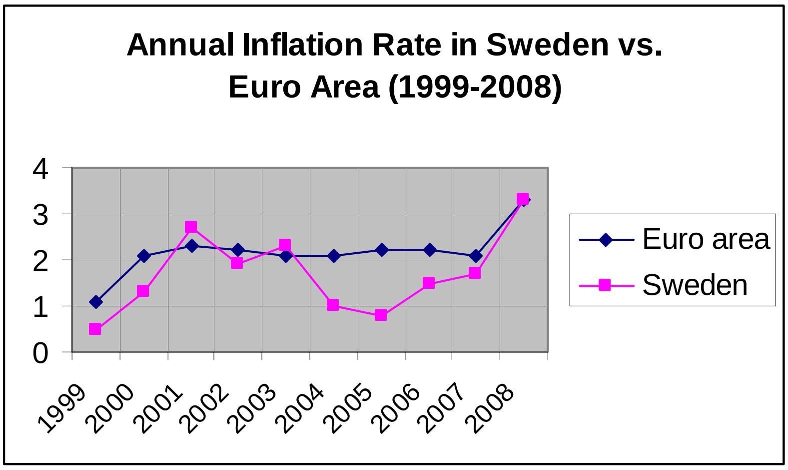
Before switching to inflation targeting, Swedish monetary policy was directed towards reducing inflation and keeping a stable exchange rate. The problems with the fixed exchange rate system began to emerge, after several previous episodes, around 1988 when the Swedish financial crisis began to take shape. With rapidly rising unemployment and a worsening public sector deficit the requirements for monetary policy were becoming contradictory. An easing was required for turning the economy round but concerns over sustainability putting pressure on the exchange rate argued for a tightening in order to remain within the ERM bounds. Finally, the need for interest rate rises proved far greater than anticipated culminating in the 500% interest rate defence of the krona on 16 September 1992.

[6] An upcoming ECON commissioned study on the comparison of monetary policy strategies of major central banks will analyse the development of the Riksbank in more detail. This section is largely based on the forthcoming report the lead author of which is Pedro Schwartz, also member of ECON's panel of monetary experts.

This unusual show of resolve was successful in the sense that the exchange rate peg held and the interest rate could be lowered to 50% and subsequently eased to more normal levels. However, this did not last and in mid-November 1992 Sweden experienced a further run on the currency. This time the extraordinary interest rate defence was not repeated and the krona was floated on 19 November. Sweden's move to inflation targeting followed from the abandoning of the exchange rate peg.

There was no evidence from the early years of the euro area that macroeconomic outcomes would have been served better by joining the euro. As evidenced by the below Figure 2, the Swedish record on inflation has been rather better than that of the ECB, if anything straying too much below the target band, and not more inflationary. Policy has not needed to be much more active and the Swedish economy has not been more volatile than those of its partners, as evidenced by the following figure.

Figure 2 - Annual Inflation in Sweden and Euro Area



4.1. Current Inflation Prospects

Just as elsewhere in Europe, currently a positive effect of falling demand is the easing of upward pressure on inflation. The European Commission expects, for 2009, only 0.7% inflation in Sweden (after 3.3% in 2008). However, as with the other figures from the Commission, this should be outdated. Other observers, such as the Economist Intelligence Unit, predict even 0.3% for 2009, including a modest period of deflation, before recovery of the inflation rate sets in 2010. The NIER predicts a -0.3%5 CPI inflation for 2009, and 0.4% for 2010. In the forecasts of SEB, the threat of deflation is even more pronounced, with -0.7% CPI growth for 2009.

4.2. Current Monetary Policy[7]

With economic conditions continuing to deteriorate in the light of the current crisis, the Riksbank cut its main policy interest rate, the repo rate, to just 1% in February 2009. It was already the 4th cut in the crisis, contributing to a total reduction of 375 basis points since October 2008. The central bank noted that rates may have to fall slightly further later in the year if the inflation target is to be met over the two-year forecast horizon. The Riksbank forecasts that headline inflation will turn negative in 2009 (-0.5% on average) and that economic activity will be revived in 2010. This will cause a reversal of the temporary downward influences on inflation to result in an inflation rate of 1.6%.

[7] Source: Economist Intelligence Unit, March 2009.

This scenario assumes another quarter-point cut in the repo rate during the second quarter of 2009 and a stable path for the policy rate until activity begins to revive in 2010. This would be enough, in the Riksbank's assessment, to push inflation back to its 2% target by the end of its forecast horizon.

However, with the policy interest rate expected to fall close to or even to 0% in 2009, the Riksbank has little remaining room for manoeuvre if conditions worsen even more, as interest rates cannot be reduced below zero. This has revived the debate over how monetary policy should be operated in a zero-interest-rate environment, and in particular the risk that even zero interest rates will not be enough to prevent outright deflation. In fact, it is now likely that the Riksbank will begin using unconventional methods in order to improve the functioning of financial markets.

The krona appreciated strongly against the US dollar in 2007 and the first half of 2008, but it has weakened fairly rapidly in recent months. The US dollar should continue to appreciate against the krona, during the first half of 2009 while a continued weakening of the krona against the euro is projected until late 2009.

4.3. Sweden and the euro

Sweden has chosen firmly to run an independent monetary policy and keep a floating exchange rate rather than join the euro area as it is obliged to do by the EU Treaty. In a report commissioned by the government in 1996 the general conclusion was that there was little to lose by staying out until unemployment was reduced and the conditions for being able to respond to idiosyncratic shocks in a relatively costless manner were in place.

Sweden held a referendum on the Euro on Sept. 14, 2003. In that nationwide ballot, 56 per cent of voters chose to keep the krona as the national currency.
However, as in many other EU Member States that have not (yet) adopted the euro, the discussions on the euro benefits have surfaced again during the present crisis. In February 2009, Swedish Prime Minister Fredrik Reinfeldt called for a thorough review of the effects of Sweden's use of the krona, saying, "I am not clear yet with the exact forms for this, but there might be reasons to deepen our knowledge [about the euro zone]."

However, on the other hand, the 'very low to inexistent' spread on Swedish government bonds at the moment compared to the German bond is evidence that markets seem to believe that Sweden is doing fairly well outside the euro area. In line with this, in the latest poll conducted during February 2009 and published on March 1 2009, the "No"-block of those opposing Swedish adoption of the euro has not gotten any smaller, but the "Unsure"-block seems to have shifted towards the "Yes"-block. This may be evidence for the fact that the matter of euro adoption moves up on the public agenda, and that the number of voters that are apathetic towards the issue decreases. However, as regards the eventual decision for or against adoption, clearly the jury is still out as evidenced by the high and unchanged share of the "No" vote.

Table 3- Swedish Polls on Euro Adoption

Date (when published)	**YES**	**NO**	**Unsure**	**Number of participants**	**Held by**
May 2004	38 %	51 %	11 %	6687	SCB
24 March 2007	37 %	60 %	3 %	N/A	Skop
May 2007	33,3 %	53,8 %	12,9 %	N/A	SCB
December 2008	44 %	48 %	7 %	1006	SCB
1 March 2009	**45 %**	**51 %**	**4 %**	**1800**	**Skop**

5. FINANCIAL SERVICES

5.1. The Swedish financial market

The financial industry accounts for almost 4% of Sweden's GDP, with around 100.000 people working in it which is around 2% of the total workforce. Overall balance sheet of the industry at end 2007[8] was SEK 13.8 billion; the largest players are banks, mortgage institutions and insurance companies. Banks share of the assets stood at 44% at the end of 2007. The Swedish market has experienced considerable change with many new entrants to the market and a major cross sector move between banks and insurance companies. Branches have become less important as customers have moved to an increasing use of internet banking, and using cash withdrawals in supermarkets and chain stores. Bank savings have increased over the past years representing a major part of household savings, with over 75% of the population having some part of their savings in equities of funds, which according to international comparison seems high.[9]

5.2. Supervision

Finansinspektionen (the Swedish Financial supervisory authority) and The Riksbank (Swedish Central Bank) have the main responsibility in monitoring compliance.
Finasinspektionen is a public authority under the responsibility of the Ministry of Finance. It is responsible for supervising the financial markets and its institutions. Its objective is to contribute to the stability and efficiency of the financial system and to promote consumer protection. Financial market laws are passed by Parliament in some cases as framework laws within which Finansinspektionen issues detailed regulations; it also issues guidelines which are optional and issues banking licenses. Supervision of the institutions is done on-site or by requests for information.

The Riksbank (see Chapter 4) has independent status under the jurisdiction of the parliament. Its main task is to maintain price stability; a second task for the Riksbank is to promote stability in the financial system and promoting a safe and efficient pay system and handle a financial crisis.

5.3. Banking

In November 2008, Sweden had 123 banks. The number of foreign banks and branches increased from 43 in 2000, to 64 in November 2008[10]. The four largest banks; Nordea Swedbank, Handelsbanken and SEB. Together these banks account for 75% of deposits. After the big four, there are a number of smaller Swedish owned banks mostly focussed on retail and savings. The first foreign bank was established in 1986 when foreign banks where for the first time allowed to open subsidiaries. During the Swedish financial crisis of the nineties, the number of foreign banks declined. In November 2008, the number of foreign banks stood at 33, these focus mostly on the wholesale market[11].

[8] Unfortunately there are no 2008 figures out yet.
[9] Swedish Bankers Association briefing published November 2008.
[10] Swedish Bankers Association
[11] Out of the 33, 4 are subsidiaries and 29 are branches

In November 2008, bank deposits stood at SEK 2,138 billion, out of these 43% was from Swedish households, from the corporate sector came 26% and foreign holders had 17%. Since July 2004, credit institutions are also allowed to receive deposits as well as with some restrictions, deposit companies. However the deposit guarantee schemes apply only to deposits in banks and credit institutions. Financial assets of Swedish households have increased 100% since 1995 and reached SEK2, 700billion mid 2008, most of the increase occurred in insurance and mutual funds and bank savings. Bank deposits now since the start of the current crisis, account for the largest share constituting 34% mid 2008. Insurance and pension savings have also been on the increase since the early 1990's, especially life insurance products and unit life insurance policies. All Swedish big commercial banks have their own life insurance companies, the largest bank owned Life Insurance Company is SEB TRYGG which together with Skandia (owned by Old Mutual from the UK) has the largest market share in life insurance.

Regarding the mortgage market, only banks are able to provide a second mortgage over the first, which mortgage institutions are not able to. Total outstanding with mortgage credit institutions is SEK 1,600 billion end 2007. The lending portfolio usually consists of a pledge on the property for about 70 to 80%, additional credit can be provided by a bank as mentioned. Funding for the mortgage portfolio is mainly financed by the issue of bonds and commercial paper (short term). From the 1st quarter 2008, all Swedish mortgage bonds are now covered bonds. Lending books stand around SEK 3,000 billion of which 41% is for the corporate sector and households have 24% of the share, the rest being for foreign borrowers. Lending has been on the increase since 2006.

5.4. Swedish Banks and their resilience in the crisis

Currently, Swedish banks are assessed as having relatively good resilience to deal with the crisis, losses stemming directly from the crisis have been limited and credit losses so far stand at historical low levels. However, the liquidity risk has started to affect Swedish banks as it has become harder to fund at longer term maturities[12]. Furthermore large portions of the banks loan portfolio are coming to maturity and will need refinancing. The Riksbank has sought to counter this by announcing on the 25th of March 2009 that it would extend the temporary credit facility set up in October 2008 which was supplying banks with liquidity against commercial paper as collateral. In October the maturity was for 3 months, now the Riksbank will offer for 365 days and at variable interest rates. In total the Riksbank has provided liquidity amounting to SEK 500 billion which corresponds to about 5% of the total assets of the major banks.

Risks facing Swedish banks are:

1. Contagion effect from the global financial markets undergoing increasing strains and reducing liquidity even further;
2. stronger slowdown in the Swedish economy, slowing down household and corporate borrowing due to a credit strangle by banks which creates a negative spiral
3. Developments in the Baltic countries, which could further affect the loan books of Swedish banks (see further on for section on the Baltics).

Different stress tests were performed by the Riksbank showing a variety of scenarios. The first scenario was a great impairment of credit worthiness among Baltic borrowers that would affect especially the big four banks having large exposures in the Baltics.

[12] Riksbank; Stability Report November 2008.

According to the results of the test, both SEB and Swedbank would have a severe impairment. However, Swedbank would have more resilience due to a recent share issue in 2008, which increased their capital ratios. The second test looked at how banks would cope with a severe economic downturn in Sweden, the results here show better resilience than for the previous test. Finally, the third test explored a combination of the two preceding, and even in this scenario, the big four banks showed a capacity to cope with this double crunch[13].

However Swedish banks have been showing an increased unwillingness to take risks as seen in a Riksbank questionnaire send out every semester. Profitability of major banks declined to 14% a decrease of 4% compared to the preceding year (November 2008 figures). This was mainly due to rising credit losses. Seen historically this figure still remains in line with the average level of profitability over the last 10 years. Deteriorating asset values are having a negative impact on banks balance sheets as the net result of financial transactions fell by 1/3 over the last quarter. This figure is composed of a mixture of write downs related to the financial crisis and the increase in credit spreads, leading to a fall in interest-bearing assets. However on a more positive note for the banks, it seems that they have been able to pass on higher funding costs to end customers with as a result that their margins and earnings on their lending portfolio have not diminished in 2008.

Lending increased by 19% in the 3rd quarter of 2008 (which is the latest available); this is high compared to historical results, within this figure, 22% was to corporates. Lending abroad also continued to grow faster than domestic lending. Out of the big four banks, Swedbank and SEB have significant exposure in the Baltics whilst Nordea has less than 3% of its total lending in these countries.

Table 4: Lending in the major Swedish banks, geographical breakdown as at September 2008 (in %)[14]

	Swedbank	**SEB**	**Nordea**	**SHB**
Sweden	73	40	25	68
Norway	2	9	17	13
Denmark	2	6	25	7
Finland	1	1	19	3
Estonia	6	3	1	below 1
Latvia	4	2	1	below 1
Lithuania	4	5	1	below 1
Germany	below 1	24	below 1	below 1
UK	below 1	below 1	below 1	4
rest of World	9	below 1	11	5

[13] Riksbank communiqués and Stability report November 2008.
[14] Riksbank

Banks have started to focus more in the Baltics on the ability of customers to repay and demanding larger buffers. Mortgages have been reduced to a maximum of the true value of the property and the average maturity has been reduce to 20 years which is much shorter than in Sweden; Banks have also been showing much more restriction when lending to construction companies; however the major Swedish banks remain market leaders in the Baltics.

Banks tier one capital ratios were at an average of 7.7% end September 2008 where the average level was higher than the preceding year; however it seems these comparisons should be viewed cautiously as Swedish banks have been reporting according to CRD since Q1 2007, and up to 2010 transitional regulations still apply. However the four major banks have either already issued new share or are about to do so, in order to further bolster their capital. Should the market not be able to absorb these, the government has announced that it will set aside SEK 50 billion to fund a programme that will guarantee to purchase up to a maximum of 70% of new share issues by banks.

Table 5: Tier 1 capital ratios in accordance with CRD, transitional regulations, as at 30 September 2008 (in %)[15]

	CRD/Basel II	**Transitional regulations**	**Basel I**
SEB	9.9	8.1	7.3
Nordea	7.9	7.0	-
Swedbank	10.5	8.2	-
SHB	10.0	6.7	6.0

5.5. Exposure to the Baltics

According to the Bank for International Settlements (BIS) in December 2008, outstanding lending by Swedish banks to Central and Eastern European countries amounted to USD 111 billion of which USD 87 billion was to the Baltic States. This equivalent to 22% of Sweden's GDP. If the Baltic countries were forced to abandon their currency pegs their ability to service external debt most of it in Euros and other Western European currencies would deteriorate even further. Much of the potential losses would in theory be covered by state loan guarantees but it might be doubtful whether governments could honour these commitments, which would leave the Swedish government to cover some of the losses adding to government debt. The Riksbank has announced it is keen to help the Baltic States and to that effect already entered into, a precautionary agreement with Estonia in February entitling them to borrow up to SEK 10 billion. It had already done another agreement with Latvia end 2008. In the worst case scenario, Swedish banks could suffer a complete loss of capital in Eastern Europe, which would lead to their Baltic subsidiaries becoming insolvent.[16]

In June 2005, the Riksbank signed a Memorandum of Understanding with the central banks of Estonia, Latvia, Lithuania providing for cooperation between central banks through a structure for crisis management and open communication channels; it furthermore signed another Memorandum with respect to cross border subsidiaries.

[15] Riksbank
[16] Riksbank, Stability report 2008 and the Economist Intelligence unit Country report on Sweden March 2009

5.6. Lessons from the Swedish crisis of the 90's

1. The Swedish banking system was in crisis in 1992 after a property boom and years of a booming financial market with an easygoing supervisory culture.
2. Sweden's largest banks with a total of 90% market share were de facto insolvent.
3. Sweden bailed out all debts of the troubled banks through a blanket guarantee, unlimited in order to rebuild confidence in the system.
4. The government did not just take over the debt. Banks had to write down losses and issue warrants to the government thereby ensuring some upside for the taxpayers.
5. A special authority was set up to administer the bank guarantee and manage those banks facing insolvency, uniform criteria for valuation was applied.
6. The bad loans were assessed on realistic levels and put in a special company Securum whose mission was to regain as much of the public money used as possible once the real estate market would stabilize.
7. The central bank provided liquidity but did not solve the banks insolvency.
8. Sweden required its banks to write down losses promptly before coming to the state for recapitalization.

5.7. Financial Infrastructure

Changes have been happening to the financial infrastructure, one important one being that the Riksbank's new technical system for large value payments will be commissioned beginning 2009. As regards clearing and settlement, Euroclear recently acquired the Swedish central securities depository, VPC AB. In derivatives it is NASDAQ OMX derivatives market which acts as the central counterparty in derivative clearing. BGC is the clearing house in retail payments between banks. During the current financial crisis the infrastructure in Sweden functioned well. NASDAQ OMX handled a large number of transactions without any problems during the second semester of 2008. Authorities continued to work on the introduction of a CCP for OTC derivatives.

5.8. NASDAQ OMX and the Nordic Integration of Equity trading

Over the last few years trading has become increasingly integrated. The NOREX collaboration as it is known, which was established in 1998, shares a regulatory system which applies to stock market trading in Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. OMX owns the exchanges and acts as central securities' depository in Estonia, Latvia and Lithuania; Euroclear acquired VPC AB end 2008. The Nordic exchange as operated by OMX controls 80% of market trading in the above-mentioned countries. The Nordic Exchange comprises a Nordic list[17] and a Baltic list. At year end 2007, 729 companies were listed on the Nordic list for a total market capitalisation of SEK 8,537 billion. In 2007 NASDAQ purchased OMX completing the transaction in early 2008. Mifid has been applied since November 2007.

NASDAQ OMX group is the world's largest exchange company operating in more than 50 countries.

[17] For Stockholm, Copenhagen, Helsinki and Iceland as of 2007.Trading expanded to Norway on March 2 2009.

In January 2009, the company announced that a majority owned subsidiary International Derivatives Clearing Group would launch a clearing house for derivatives.
The largest market maker on the OMX part is Swedbank with 41.8% followed by SHB with 22.69% with Nordea in 4th position with 9%.

5.9. Nordea (owned for 36 % by the Swedish government, Sampo Oy and Nordea fonden)

1. Income up 4% through growth in net interest income and customer driven capital markets operations.
2. Lending up 17% in local currency.
3. Higher loan losses leading to a loan loss ratio of 19 bps.
4. Strengthening of core tier 1 capital ratio by rights issue (subscribed for by 36% of the major shareholders, Sampo oy underwriting a further 13% and banks JPMorgan and Merrill Lynch underwriting the remainder percentage[18]) and dividend reduction, in order to proactively position the bank for further turbulence. The final outcome of the rights issue results will be announced on 17 April 2009!
5. Income contribution from the new European Markets (the Baltic States, Russia and Poland) up 97%.
6. In line with its Nordic peer group, Nordea has a ROE (return on equity) of 15.3% in 2008 down from 2007 which was 19.7%. It is the in top 5 European banks.[19]
7. Outlook for 2009 is a focus on risk management, capital and costs. Lending will be slower in 2009 than 2008. Based on current economic outlook, Nordea expects its net loan losses to be broadly in line with 2008, as well as the figures for its risk-adjusted profit.
8. Total lending in the new European markets is split as follows: Lithuania 16%; Poland 26%; Estonia 14%; Latvia 20% and Russia 24% out of total lending portfolio for this market of EUR 15.3 billion.

[18] Nordea presentation by the CFO to investor s 10 February 2009;
[19] In order of total shareholder return profitability SHB, Nordea, Santander and Intesa Sanpaolo, BNP Paribas, in the top 5 figures from Thomson Reuter's ecowin for 2008.