Focus: The Swedish Referendum

SEB

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Sweden after the No poll

In Sunday's referendum, the Swedish people voted a resounding **No to the euro**: 56.1 per cent No vs 41.8 Yes (and around 2 per cent undecided). Despite the national trauma of recent days, the result is in line with what most opinion polls stated before the assassination of Foreign Minister Anna Lindh last week. Nonetheless, the No victory was **stronger than expected**, and the turnout was high. This means that the result is clear-cut, easy to interpret and that it will be respected by Parliament.

No drama in the short term

Even though it seems petty to talk about financial markets after the past few traumatic days, the outcome of the referendum will not give any dramatic effects in the near term. Within the next couple of days, the **krona will weaken somewhat**, approaching 9.25-9.30 vs the euro, while **bond yields will climb** by some 15-20 basis points against Germany. But the movements will be fairly small, and uncertainty will soon subside, as the Riksbank and the government declare that economic policy will not change. Strong Swedish fundamentals mean that within a couple of months the krona may actually become stronger than it was before the referendum. In the longer term, however, the strong No will raise doubts regarding policy stringency.

Our economic forecast for next year still holds. Our latest Nordic Outlook (September) was based on a No scenario. The Swedish economy continues to recover, with private consumption as the primary driver. GDP growth is expected to reach 1.5 per cent this year and 2.1 per cent next year – stronger than the euro zone growth rate.

We assume that the **government and the Prime Minister will remain in power**, and that economic policy co-operation between the Social Democrats (SDP), the Greens and the Left Party will hold. The autumn budget – to be presented on September 22 – will pass. The budget proposals are in line with expectations, and the three parties seem bent on continuing their cooperation. Furthermore, they want to avoid further political turbulence after the tragic assassination of the Foreign Minister. The autumn budget will consequently reaffirm that its goal is still to meet existing budget targets – despite some lingering uncertainty about cost-cutting and expenditure ceilings (as usual).

As early as Sunday evening, the governor of the Riksbank declared that the framework of Swedish monetary policy framework – central bank independence and an inflation target of 2 per cent – remains unchanged. The bank will continue to work as usual, and we do not see any reason why its credibility would take a dent.

The Riksbank will keep its repo rate constant. Our low inflation forecast (underlying inflation of 1.7 per cent in 2005) indicates that there is room for one more rate cut. Nonetheless, the Riksbank will choose to keep its key rate on hold, because of the cyclical upswing, both in Sweden and internationally, but also because of the initial market uncertainty that will be seen for some time after the referendum. The spread to the ECB key rate will thus remain at 75 basis points for the most part of next year.

All in all, these political declarations mean that some of the political uncertainty will melt away. The commercial currency flows that had waited for the political instability surrounding the referendum to dissipate will thus resume.

At the same time, fundamental **macro factors point towards a strengthening of the krona**. According to all available analyses, the krona is undervalued, which is accentuated by Sweden's large current account surplus. Our comparatively optimistic picture of Sweden's economic performance compared to that of the euro zone, plus a continued growth in risk appetite during the autumn, also point towards a certain strengthening of the krona. We conclude that **at year-end the EUR/SEK rate will stand at 9.00**.

Bond yields will climb gradually. The 10-year bond yield spread to Germany will widen from around 40 to around 60 basis points at year-end. This is a normalisation: back to a situation where expected repo rate differentials influence Swedish bond yields.

Political developments

The government and the Prime Minister will lose strength. Still we don't expect any dramatic domestic policy turbulence in the short term. There have been rumours that the SDP might want to end its parliamentary alliance with the Greens and the Left and instead seek a new non-socialist partner. For our part, we see such a shift as unlikely. The PM has stated that he does not see any alternative to the present cooperation. Furthermore, experience shows that any non-socialist part that cooperates with the SDP is likely to be severely punished by its voters.

Consequently, the present cooperation between the red and green parties will survive. Internal relations will nonetheless be subject to strains. The large No victory will strengthen those Leftists and Greens who want Sweden to leave the EU, as well as strengthen the fiscally less responsible elements within the Left and Greens and in the SDP. Proposals to breach the expenditure ceiling are likely to be seen, as the negotiations about the spring 2004 budget will start.

Göran Persson has called an SDP party conference for next spring, to launch a new policy for growth. He is likely to meet stiff **resistance from a born-again leftist faction** within his party. The assassination of Anna Lindh will, however, dampen the contradictions, as the quarrelling factions will search for compromises. The consequence will be that any structural reform strategy for growth will be substantially less ambitious than it would have been after a Yes vote.

So, even if the near future looks reasonably undramatic, a **political risk premium may eventually return**. Both in Norway and Denmark, the parties supporting No votes have gained political strength after referendum victories. If growth-promoting tax and deregulation proposals are halted by strong No forces in Parliament, the investment climate may cool. The autumn budget proposals of shorter working hours are illustrative examples that growth policies are not ranked high on the list of priorities. Structural reforms of the tax system are likely to be postponed into a distant future; only minor adjustments (such as inheritance taxes between married couples) will take place next year.

There will be no new euro referendum for several years. The great No victory – won against the parliamentary majority which called the referendum, hoping for a Yes – will mean that Yes supporters will be extremely cautious about calling another referendum.

Difficult forecasting the krona's long-term movements

Our forecast is a somewhat stronger krona during the winter. The long-term trend of the krona is considerably harder to forecast.

- On the one hand, Sweden's large **current account surplus** will persist. The krona is undervalued: Calculations in earlier issues of Nordic Outlook indicate that its long-term equilibrium value against the euro is around 8.70. After several years of large current account surpluses, this undervaluation should gradually give way to an appreciation – maybe even to a certain overvaluation – so that external balance is achieved. From the perspective of a “fundamental” analysis, there is thus reason to assume that towards 2005 the krona will greatly strengthen.

- On the other hand, the market is influenced by **short-term capital flows and external disruptions**, which may cause exchange rates to deviate for long periods from its theoretical equilibrium. The long-term political risk premium may increase again, according to the above analysis. Foreign direct investments may be negatively affected.

It is an open question whether a No vote will **cause the krona to begin breaking away from its relatively close relationship to the euro** – something that has probably been connected in part to the market’s expectation of future euro zone accession. In our forecast, the dollar will weaken perceptibly against the euro during 2004, and after a No vote the US currency’s depreciation may also affect the krona’s exchange rate against the euro.

An appreciation of the krona that is justified by the economic fundamentals will thus stand in contrast to a number of factors that are difficult to quantify and that will pull in the opposite direction. In light of this, we assume that during the second half of 2004 the EUR/SEK rate will climb somewhat again.

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