Goldman Sachs

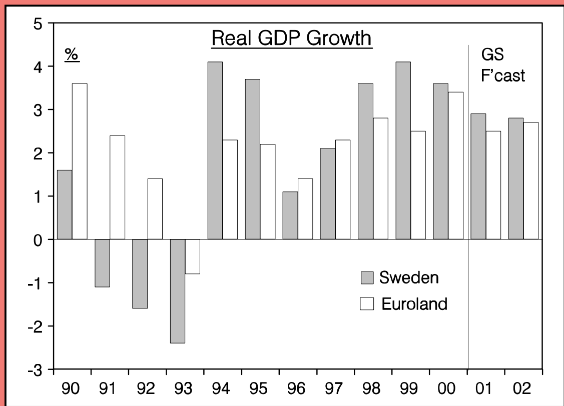
European Weekly Analyst

Lessons for the EU from Sweden's "New Economy"

- **These are: First, macro- and micro-economic policies need to go hand-in-hand to revive growth. Second, to ensure lasting success, reforms in the end must give market forces a greater role to play.**
- Timing and location of this weekend's EU summit could not have been chosen better: Against the background of a weakening world economy EU leaders meet to pursue a long-term growth strategy for Europe in a country that has experienced an impressive economic revival in recent years.
- Sweden was stung by a severe recession in the early 1990s, which proved to be the worst since the 1930s. The deep economic crisis motivated the Swedish government to implement major macroeconomic and structural reform policies in the mid- to late 1990s. As painful as these policies were, the years of austerity seem to be paying off.
- The revival of the Swedish economy was made possible by the combination of structural reforms with appropriate macroeconomic policies. Fiscal deficit reduction was accompanied by a restrictive incomes policy and an expansionary monetary policy. At the same time, de-regulation and privatisation led to increased competition and economic efficiency, which kept inflation in check.
- The example of Sweden shows that a society's preference for social security is no obstacle to economic reform. But it now seems important that the government builds on the past success and moves further towards more market-based economic structures.

Key Economic Data (2000)

	Sweden	Euroland
GDP Growth (%)	3.6	3.4
Harmonised CPI (%)	1.4	2.3
Budget Balance (% of GDP)	3.4	-0.8
Current Account (% of GDP)	2.3	-0.5
Unemp. Rate (%)	4.7	9.0



Things to Watch

The ECB Council's view on inflation and growth is shifting: Growth prospects have deteriorated and hence the medium-term outlook for price stability is improving.. With this shift in view, the likelihood of a near-term rate cut is rapidly increasing. M3 data for February—to be released next week—will provide additional information that could influence the timing of the rate decision. We expect year-on-year M3 growth to fall to 4.4%, marginally below the ECB's 4.5% reference value. This could clear the way for a rate cut on April 11, possibly even on March 29. As the ECB's change in view would be fairly recent, we would regard a 25 bp cut more likely than a 50 bp cut.

Goldman Sachs European Economic Research Group

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I. The Week in Review

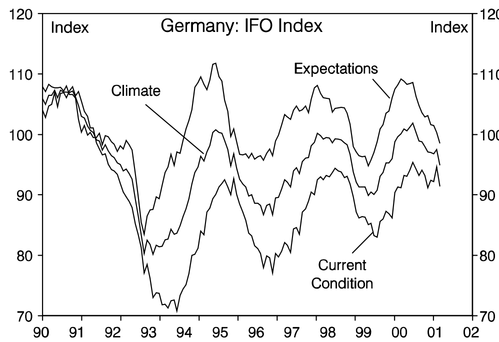
"A Complex Outlook for Growth"

This is how Mario Draghi, chairman of the ECOFIN's Economic and Financial Committee this week described the present state of affairs in Euroland. We could not have said it better. Data on real economic activity still look fairly robust and there are signs of the long-expected acceleration in consumer spending. On the other hand, German and Belgian business confidence—in the past useful leading indicators for Euroland industrial production—took severe hits this week. The latest inflation news were less ambiguous: Preliminary Italian and German data for March pointed to a renewed decline in headline inflation after its upward blip in February.

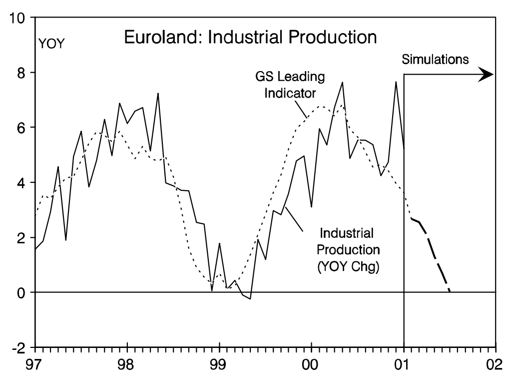
Signs of industrial slow-down and consumption strength: Euroland industrial production fell 1.9%mom in January after a 1.7% increase in December. Yearly growth dropped to +5.1% after the implausible +8.2% in December. Despite the correction, Euroland industrial activity showed plenty of momentum at the turn of the year: the average level of output in December and January was up 1.3% over the average in October / November. However, this looks too good to last: both the German Ifo and the Belgian business survey send clear signals of industrial weakness in the coming months. Our GS leading indicator now points to less than 3% yoy growth in industrial production next quarter, and about zero industrial production growth in 6 months.

There are signs that the likely industrial slow-down will be dampened by stronger consumption. In France, despite a dip in February, the average of January and February consumption was up 1.7% from its 00Q4 average. In Italy, consumer confidence unexpectedly rose markedly in March to its highest level since August 2000, resuming its upward trend and signalling that the effects of lower taxes and oil prices are finally being felt. Against this, however, Dutch consumer confidence plunged in March, perhaps on the back of stock market weakness (the Dutch own significant pension fund assets).

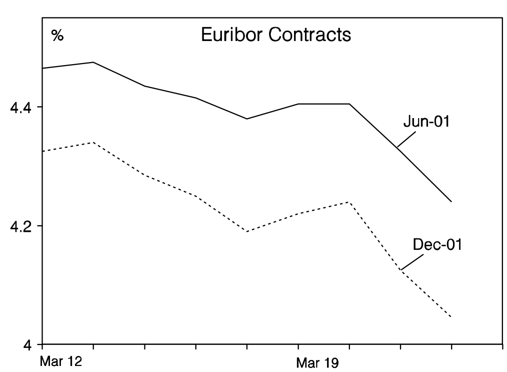
The West German Ifo business climate index fell sharply in February but remained above its recent lows.



The GS leading indicator now points to a significant slow-down in industrial production growth.



Financial markets now expect an early ECB rate cut. We agree.



The French and Italian data provide some assurance of endogenous resilience and support the expectation that domestic demand growth will be a counter-weight to lower exports to US and Japan.

But watch out for Germany: The West German Ifo index fell to 94.9 in February after 97.5 in January, with both of its components down. The index of current business conditions dropped to 91.4 from 94.6; and the index of business expectations – which has been an important leading indicator for Euroland industrial production in the past – declined to 98.5, after 100.3 in January.

With the level reached in February the overall index stands now at its lowest level since July 1999. But it is still above its post-unification average of 93.9 and may have further to fall. During the period of sluggish growth in 1999, following the Asian crises, the index troughed at 89.9. A low of 80.2 was reached in February 1993, during the last German recession.

Preliminary information suggests that there are no major differences in the development of business confidence across sectors – sentiment in manufacturing, retail and construction all seemed to have weakened. Within manufacturing, however, domestic concerns appear to have been more important than weakness abroad - export expectations seem to have held up roughly at the level reached in November last year. Hence, there is no evidence yet that weakness in global activity is directly affecting German demand.

Among other things, the fall in the index may have been influenced by the approval of the reform of Germany's controversial system of workers' co-determination in February, which was strongly opposed by the German business sector. These reforms will enhance union power at the company level and increase the regulatory burden on German industry.

The drop in German business confidence was echoed by Belgian business confidence in manufacturing, which fell to –5.9% in February from –0.6% in January. The drop in Belgian manufacturing confidence reflected especially weak foreign orders--which may have been related to the weakness in Germany (Belgium trades mainly with Germany, France and the Netherlands).

Inflation coming off its peak: Data from the Italian cities pointed to a decline in Italian inflation to 2.9% in March from 3.0% in February while data from the German states suggested an easing in German inflation to 2.5% in March from 2.6% in February. Based on these data, we expect the Euroland inflation rate to ease to 2.4% after 2.6% in February.

Probability of Early ECB Move Has Increased

With signs of weakening of the real economy getting stronger and money growth well-behaved, the ECB Governors may well feel that the upside risks to price stability emanating from high headline inflation are fading faster than thought previously. Both ECB Chief Economist Issing and Bank of France Governor Trichet this week signalled that such a shift in view is under way. If the Council is confident that inflation will fall over the medium term as the effects of past oil prices increases fade, a current rate of headline inflation above 2% may no longer appear to them as an obstacle to a rate cut.

Hence, we see a rising probability for a rate cut in the near future. So far, we expected the ECB to cut the minimum-bid rate by 50 basis points to 4.25% by mid-year. We now see a rising probability that a move will come earlier. A cut on April 11 now seems a distinct possibility, and even March 29 seems possible. As we believe that the Council's view on the economy and inflation is shifting rather than turning, we would regard a 25 basis points cut in the near-term more likely than a 50 basis points move.

Following this, the next 25 basis point step could come in June or July. We would then expect the ECB to leave rates unchanged for the remainder of the year, but cut again by 25 basis points in the first half of 2002 after the successful introduction of euro notes and coin.

II. Lessons for the EU from Sweden's "New Economy"

The Swedish Economy on a Roller-Coaster

In the doldrums: Sweden was stung by a severe recession in the early 1990s, which proved to be the worst since the 1930s. Like the previous recessions of the mid 1970s and early 1980s, it was associated with periods of accelerating wage costs which resulted in a loss of competitiveness, lower output growth and rising unemployment. Unlike previous recessions, however, the cost crisis of the early 1990's was exacerbated by the commitment of Sweden's central bank, the Riksbank, to maintain a fixed exchange rate policy.

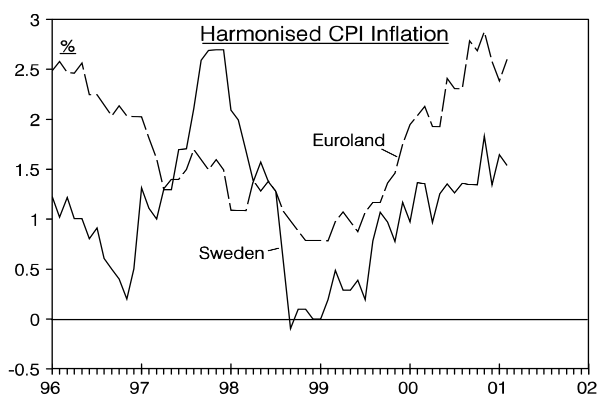
Together with the deterioration of private consumption on the back of a collapse in asset prices and the slowdown in export growth as foreign demand weakened, the recession became deeper and longer than most commentators expected. Industrial production fell by around 20% between 1990 and 1993, contributing to a drop in GDP growth from 1.6% in 1990 to -2.4% in 1993. As a result, open unemployment increased sharply from 1.5% in 1990 to around 8% three years later. If the people who were on various job training schemes are included total unemployment was close to 14% by the end of 1993.

An almost miraculous recovery: The deep economic crisis motivated the Swedish government to implement major macroeconomic and structural reform policies in the mid- to late 1990s. As painful as these policies were, the years of austerity seem to be paying off. The Swedish economic recovery, which was ignited in mid-1993 by a strong pick up in exports following the krona devaluation in November 1992, is now in its seventh consecutive year of favourable growth and Sweden arguably has one of the healthiest economies in Europe.

Indeed, the average annual GDP growth rate since the economy emerged from recession in 1993 is almost 3%, which is above the EU average of around 2.5%. It has been accompanied by large current account surpluses, making it possible to repay foreign debt, and by a large reduction in open unemployment (from 8.2% in 1993 to 4.7% last year). Government finances now show a surplus and since 1996 Sweden has displayed one of the lowest inflation rates in the OECD. Inflation averaged a little over 1% last year, at the lower range of the 1-3% target set by the Riksbank.

The Swedish Economic Policy Mix

The revival of the Swedish economy was made possible by the combination of structural reforms with appropriate macroeconomic policies. Fiscal deficit reduction was accompanied by a restrictive incomes policy (which fostered social consensus for wage restraint) and an expansionary monetary policy (which at the same time stabilised inflation expectations by introducing an inflation targeting regime). This allowed exchange rate depreciation without inflationary consequences.



There was also progress in structural reform. Most importantly, the government pared down the state sector through spending control (the share of expenditure in GDP fell from 64% in 1995 to 55% in 2000), which facilitated deficit reduction. De-regulation and privatisation led to increased competition and hence kept inflation in check—which helped the Swedish National Bank to pursue its expansionary monetary policy without risking higher inflation.

A smaller share of government spending in GDP, de-regulation and privatisation are likely to have helped to increase economic efficiency and may have contributed to faster technical progress. According to a recent EC estimate, Swedish potential growth rose from 2.3% in 1995 to 3.0% in 2000. Of the 0.7% increase, 0.5% was accounted by faster technical progress and 0.2% by higher investment. Higher potential growth helped to contain inflation at a time of high actual growth. In the following, we take a closer look at a few of these policy initiatives.

Fiscal Consolidation

Sweden's public finances were truly in dire straits when the current SDP administration took office in the autumn of 1994. The 1990's recession resulted in a significant deterioration in public finances, with the budget balance falling from surplus in 1990 to a deficit of just over 12% of GDP in 1993. This resulted in the government adopting one of the most restrictive fiscal consolidation programmes of any OECD country.

The so-called "Consolidation Program" aimed to achieve a budget balance by 1998 and an improvement in the structural budget balance of about 8% of GDP. In addition, to improve budgetary discipline the government established twice yearly reviews involving corrective measures within a set period if budget limits are exceeded. The Consolidation Program was an unqualified success; the large budget deficit in 1993 was transformed into a surplus of around 2% of GDP in 1998 and the government now expects a surplus of over 3 per cent for 2000.

Monetary Expansion

As the government consolidated the public finances, the Riksbank gradually eased monetary conditions - lowering interest rates from around 9% in the summer of 1995 to a low of 2.9% in early 1999 (the repo rate currently stands at 4%). This easing in monetary conditions reflected the Riksbank's success in countering inflation tendencies and reducing inflation expectations following the devaluation of the Swedish krona in November 1992.

Low inflation in Sweden in recent years is not exclusively a consequence of surplus capacity that existed in the economy following the recession. It also has to do with the credibility the Riksbank has built-up in its monetary policy strategy in recent years by targeting inflation and keeping inflation expectations in-check. Lower inflation expectations played a major part in the concerted effort on the part of labour market organisations in lowering wage growth from the 1995-97 wage round to the 1998-2000 bargaining period by 1 percentage point per annum to around 3 1/2%.

Structural Reforms

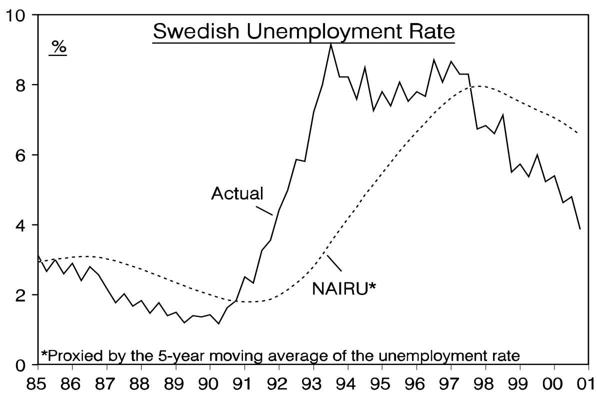
Deregulation: The Swedish government has made great strides in building a competitive market economy. In recent years, important utilities markets such as telecommunications, electricity and postal services have been deregulated. As a result, prices for telecommunications and electricity have exerted downward pressure on consumer prices.

Privatisation: Two years ago, the Swedish government adopted a policy of active ownership which focuses on increasing the quality of state ownership to increase returns, which have been dismally low in recent years. The government wants to incorporate its companies to increase their efficiency and to enhance transparency. To do this government-owned companies have found it increasingly necessary to focus on core business fields, while non-essential activities could be sold.

This refocusing has already been applied to the national railway operator SJ, whose hotel chain and ferry boats were divested last year; SJ is now one of the most profitable rail operators in Europe. While the government wants to hold on to the national mail carrier Posten, which underwent major restructuring last year, it sold the company's bill handling arm Postgirot. Also last year, the government completed the divestment of its 25% holding in defence group Celsius AB.

Parliament has already given the go-ahead to sell the state's 18% share in Nordea, the Swedish holding company for Swedish-Finnish banking group MeritaNordbanken. There are also likely to be further divestments from Telia, the telecommunications company, and the Persson administration is considering disposing of Vattenfall, the state-owned electricity provider and Europe's sixth-largest utility. This project, which is still some considerable time off, could bring in around SEK60bn, according to independent estimates.

Labour market reform: In the 1996 Employment Bill, the Swedish government introduced a number of reforms in the areas of employment protection, unemployment insurance, active labour market policies and education to achieve its objective to lower open unemployment to 4% by 2000; this target was reached in the autumn of last year.



In the Budget for 2001, the government signalled a further objective of achieving full employment with the employment-to-population ratio expected to reach 80% for the 20 to 64 year olds by 2004, compared to about 77% last year. The reforms proposed include: (i) legislation against enforced retirement before the age of 67; (ii) an activity guarantee for the long-term unemployed (requiring them to participate in employment or training programmes); (iii) tightening the eligibility for unemployment insurance; and (iv) further easing in employment protection legislation.

Pension reform: The new pension system has been up and running since the beginning of this year. Pension contributions are frozen at a level of 18.5% of salaries and pension benefits will be more closely linked to the contributions paid with a view to increasing incentives to work.

Taxation: More recently, Sweden has begun to tackle the high tax burden through tax reform. In the autumn budget of 1999, the government presented a four year strategy for income tax reform. The reform consists of two parts and is aimed primarily to reduce the income tax burden of low and middle income earners. The first part consists of a tax discount to compensate for the increase in employee contributions imposed in the early 1990s. The second part consists of increasing the lower threshold in the tax payable so that only 15% of taxpayers pay state tax. Thus far, with the budgets for 2000 and 2001, half of the tax cut programme has been implemented with the threshold for the state tax having been raised sufficiently so that the percentage of income taxed at state income tax level has fallen to 16%.

On the corporate side, in the budget for 2000 the government introduced more immediate measures to boost the profitability of Swedish companies. In particular, from 2001 the percentage of companies' total profits that can be set aside for future investments in tax-free accrual funds is to be increased to 25% from 20% for limited companies and other legal entities and to 30% from 25% for sole traders and partnerships.

Plenty of room to improve: To make sure that recent achievements indeed last, the government will need to give market forces still a larger role to play in the economy. Among other things, (1) a more comprehensive tax reform lowering the still high tax burden further is needed. (2) There is the need to liberalise the labour market (to permit increased wage differentiation), further lower payroll taxes on labour (to reduce disincentives to work) and to increase incentives for the unemployed to search for new jobs. (3) Competition in the retail sector needs to be raised by loosening red tape for new entrants. However, given recent economic improvements it is not clear whether the momentum for reform is still intact.

Lessons for Euroland

The example of Sweden shows that a society's preference for social security is no obstacle to economic reform. However, to ensure lasting success, economic reform in the end must give market forces a greater role to play in the economy. Without this, there is the risk that economic structures, after a temporary improvement, again become inflexible and the necessary continuing structural adjustment is impeded.

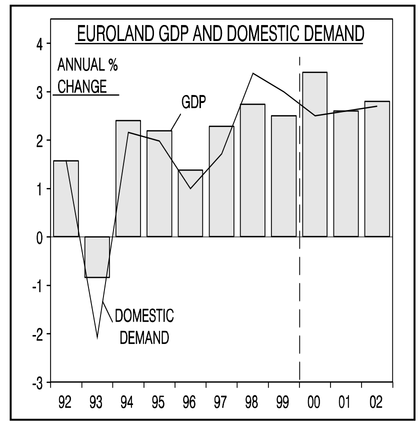
Binit Patel and Thomas Mayer

III. Key Data in Euroland

Key Economic Forecasts

	2000 Q4	2001 Q1E	2000	2001E	2002E
GDP [1]	0.7	0.7	3.4	2.6	2.8
Domestic demand [1]	0.6	0.7	2.8	2.5	2.7
-- Final domestic demand [1]	0.5	0.8	2.9	2.8	2.9
Net exports [2]	0.1	0.0	0.6	0.1	0.1
CPI [3]	2.7	2.7	2.3	1.4	1.3
Government deficit[4]			-0.1	0.7	0.6
Broad money (M3) [5]	5.2	5.2	5.2	4.6	4.8

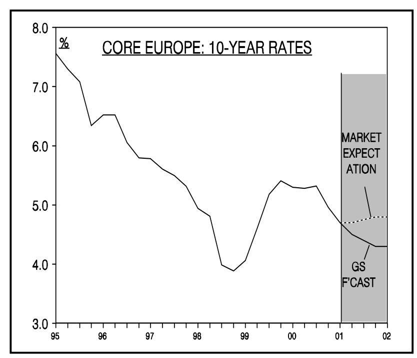
[1] % change over previous period, [2] contribution to GDP growth,
[3] year-on-year, [4] % of GDP, [5] year-on-year, end of period



Key Interest Rate Forecasts *(We have slightly lowered our 3-6 month forecast for 3-month rates)*

	Current [1]	*3 Months*	*6 Months*	*12 Months*
3-month rate	**4.6**	**4.5**	**4.3**	**4.2**
Forward		4.2	4.0	4.0
10-year core yield	**4.7**[2)]	**4.5**	**4.4**	**4.3**
Forward		4.7	4.7	4.8
$/EUR	**0.89**	**0.98**	**1.05**	**1.22**
Forward		0.89	0.89	0.89

[1] Close Mar 22nd, [2)] Average of Germany and France.



PAST WEEK'S ECONOMIC INDICATORS					
Country	**Date**	**Indicator**	**Period**	**Actual**	**Forecast**
France	20-Mar, 08:45	Industrial Production	Jan	-0.3%mom, +2.5%yoy	+0.4%mom, +2.7%yoy
France	20-Mar, 08:45	Manufacturing Production	Jan	-0.3%mom, +3.2%yoy	+0.6%mom, +3.4%yoy
Italy	20-Mar, 09:00	GDP - Revised	Q4	+0.8%qoq, +2.9%	+0.8%qoq, +2.9%
Italy	20-Mar, 12:30	CPI - Provisional - Cities	Mar	+0.2%mom, +2.9%	+0.3%mom, +3.0%
Euroland	20-Mar, 12:00	Industrial Production	Jan	-1.9%mom, +5.1%yoy	-0.1%mom, +8.0%yoy
Germany	21-Mar, 10:00	IFO Business Survey	Feb	94.9	96.8
Euroland	22-Mar, 16:00	Belgian Business Confid.	Feb	-5.9	-1.5
France	22-Mar, 08:50	Household Consumption	Feb	-0.9%mom, +1.7%yoy	-0.8%mom, +2.8%yoy
Italy	22-Mar, 09:30	ISAE Consumer Confid.	Mar	121.2	120
Euroland	23-Mar, 12:00	Trade Balance	Jan	-EUR7.9bn	-EUR3.8bn
Germany	23-Mar, 14:00	CPI - Provisional	Mar	+0.1%mom, +2.5%yoy	+0.6%mom, +2.6%yoy

Notes: :nsa = not seasonally adjusted; sa = seasonally adjusted; mom = month on month; yoy = year on year. All times refer to local time

FORTHCOMING ECONOMIC INDICATORS					
Country	**Date**	**Indicator**	**Period**	**Forecast**	**Previous**
Germany	26-Mar, 08:00	Producer Prices (nsa)*	Feb	+0.2%mom, +4.6%yoy	+0.8%mom, +4.6%yoy
Germany	26-Mar, 08:00	Import Prices (nsa)*	Feb	-0.2%mom, +4.5%yoy	-0.8%mom, +6.5%yoy
Euroland	29-Mar, 13:45	ECB Meeting**	-	-	-
France	29-Mar, 08:50	INSEE Business Survey**	Mar	110	113
Euroland	30-Mar, 12:00	Labour Cost (Qtrly)*	Q4	-	+3.9%yoy
France	30-Mar, 08:45	Unemployment Rate*	Feb	8.9%	9.0%
France	30-Mar, 08:50	Producer Prices	Feb	Flat mom, +3.2%yoy	-0.5%mom, +3.6%yoy
Spain	30-Mar, 10:00	Producer Prices	Feb	+0.4%mom, 3.5%yoy	-0.3%mom, +3.9%yoy
During next week					
Euroland	10:00	Money Supply - M3**	Feb	+4.4%yoy	+4.7%yoy
Euroland	11:00	Current Account Balance**	Jan	-EUR5.0bn	-EUR4.8bn

Notes : = important data, = noteworthy data; for methodological details see our publication 'Understanding Euroland Economic Statistics'
nsa = not seasonally adjusted; sa = seasonally adjusted; mom = month on month; yoy = year on year. All times refer to local times.

RECENT ECONOMIC INDICATORS (i)							
	Sep	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**
Activity Indicators							
Industrial production (% mom)	+0.6	-0.2	+1.2	+2.0	-1.9	*+0.1*	
Industrial production (% yoy)	+5.2	+3.7	+4.3	+8.0	+5.1	*+3.5*	
Business confidence (% balance of opinions)	+6	+6	+5	+5	+3	+1	*-2*
Total orders (% balance of opinions)	+5	+5	+4	+4	+0	0	
Export orders (% balance of opinions)	+2	+5	+3	+1	-1	0	
Assessment of stocks (% balance of opinions)	+4	+5	+6	+7	+6	+8	
Consumer confidence (% balance of opinions)	-3	-3	-3	-1	-1	-2	*-3*
Unemployment rate (sa)	9.0	8.9	8.7	8.7	8.8	*8.8*	
Balance of payments							
Trade balance nsa (Euro bn)	-0.4	+2.3	+1.7	-0.2	*-7.9*	*-0.3*	
Current balance nsa (Euro bn)	-1.5	-0.1	-2.9	-4.8	*-1.5*		
Prices and Money							
Consumer prices, (% yoy)	+2.8	+2.7	+2.9	+2.6	+2.4	+2.6	*+2.4*
Producer prices in industry, (% yoy)	+6.1	+6.5	+6.3	+5.4	+4.8	*+4.5*	
Money supply M3 (% yoy)	+5.4	+5.2	+5.0	+5.2	+4.7	*+4.4*	

(i) Eurostat's harmonised figures for Euroland unless otherwise indicated. Italics indicate estimates, underlined figures in italics indicate forecasts, yoy = year on year, nsa = non seasonally adjusted figures.