

# KINGDOM OF SWEDEN

Rating Analysis - 2/4/11

Debt: SEK1,117B, Cash: SEK60.5B

EJR Sen Rating(Curr/Prj) BBB/ BBB+

EJR CP Rating: A1

EJR's 1 yr. Default Probability: 1.8%

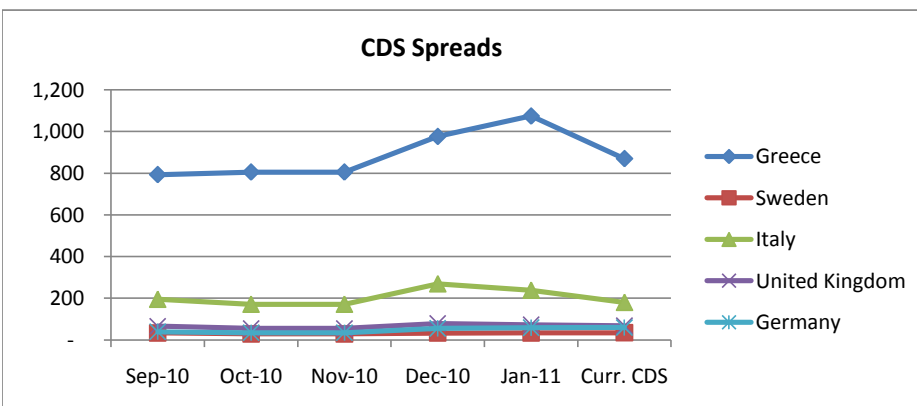
Sweden's economic recovery remains strong. GDP increased 6.9% YoY in Q3 2010 (2.1% QoQ). Meanwhile, GDP growth for Q2 2010 has been revised downward by 0.2% to 5.0%. Sweden's central bank forecasts growth of 5.5% in 2010 and 4.4% in 2011. Inventories and GFCF accounted for the largest contributions to GDP growth in the third quarter. Meanwhile, exports increased 11.9% while imports increased 14% in the quarter, resulting in a negative contribution to GDP. Trade in motor vehicles and telecommunication products were particularly high. Unemployment continues to fall modestly, recording a rate of 7.1% in November 2010. Retail sales were up 0.1% (5.3% YoY) following 0.6% growth (4.8% YoY) in October. Sales of consumer durables reportedly increased 1.5% YoY while sales of durables rose 8.5% YoY. Household lending grew an annual 8.4% while the average interest rate for new loan agreements to households was up 0.13% to 3.13%. In December, Sweden's central bank raised its benchmark interest rate by 25 bps for the fourth time since July 2010. The rate is currently 1.25%.

Sweden's CDS spreads have risen only slightly in recent weeks. Spreads remain among the lowest of EU states in the range of 35bps.

INDICATIVE CREDIT RATIOS	Annual Ratios					
	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Debt/ GDP (%)	31.4	42.4	42.0	41.6	40.9	40.2
Govt. Sur/Def to GDP (%)	2.2	-0.9	2.8	3.2	3.2	3.2
Adjusted Debt/GDP (%)	52.3	67.4	66.8	66.1	65.0	63.8
Interest Expense/ Taxes %	4.4	3.1	3.3	3.5	3.7	3.9
GDP Growth (%)	-1.7	6.9	1.0	1.0	1.8	1.8
Foreign Reserves/Debt (%)	1.8	2.4	2.4	2.3	2.3	2.3
Implied Sen. Rating	BBB+	BBB	BBB+	BBB+	BBB+	A-

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Govt. Sur/Def to GDP (%)	5.0	3.0	0.5	-2.0	-5.0	-9.0
Adjusted Debt/GDP (%)	45.0	55.0	65.0	85.0	125.0	155.0
Interest Expense/ Taxes %	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	5.0	4.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	25.0	20.0	15.0	12.0	9.0	7.0

PEER RATIOS	S&P Sen.	Debt	Govt. Surp.	Adjusted	Interest	GDP	Ratio-
		as a % GDP	Def to GDP (%)	Debt/ GDP	Expense/ Taxes %	Growth (%)	Implied Rating*
United Kingdom	AAA	79.2	-11.4	98.4	7.0	1.7	BB
Federal Republic Of Germany	AAA	71.8	-3.0	78.3	10.7	3.9	BBB-
Kingdom Of Spain	AA	52.1	-11.1	55.9	9.6	0.2	BBB
Italian Republic	A+	113.4	-5.3	118.7	15.9	1.1	BB-
Hellenic Republic (Greece)	BB+	122.7	-15.4	126.0	25.8	-4.6	B-



Country (EJR Rtg*)	Current CDS	Targeted CDS
Greece(B+)	869	600
Sweden(BB)	34	400
Italy(BBB+)	180	158
United Kingdom(AA)	68	30
Germany(AA)	59	30

\* Projected Rating

**Strong Economic Recovery**

In the years leading up to the global financial crisis, Sweden was in the midst of a sustained economic upswing due to strong exports and rising domestic demand. However, despite strong finances and underlying fundamentals, Sweden's economy entered into recession in the third quarter of 2008. Growth continued downward in 2009 as deteriorating global economic conditions reduced export demand and consumption in the country. GDP contracted 4.9% during the year, totaling US\$399.6 billion (US\$324 billion in terms of purchasing power parity), or 0.69% of the world's GDP.

In the first quarter of 2010 Sweden's GDP increased 3.0% YoY and 1.4% over the prior quarter. Both imports and exports increased during the period while household consumption expenditures increased by 3.1%. Growth continued to pick up in the second quarter of the year as GDP increased by 4.6% YoY and 1.9% quarterly. By the third quarter, the economy recorded growth of 6.9% YoY. Compared with the previous quarter, GDP rose 2.1%. Household consumption expenditures increased 3.5% while general government consumption expenditures increased 1.8%. The EU has forecast Swedish GDP to grow 4.8% in 2010, the highest rate in the EU.

<b>Heritage Foundation 2010 Index of Economic Freedom - Sweden*</b>				
World Rank: 21 of 183; Regional Rank: 10 of 43**				
	<b>2010 Rank</b>	<b>2009 Rank</b>	<b>Change in Rank</b>	<b>World Average</b>
<b>Business Freedom</b>	95.5	95.9	-0.4	64.6
<b>Trade Freedom</b>	87.5	85.8	+1.7	74.2
<b>Fiscal Freedom</b>	36.7	35.0	+1.7	75.4
<b>Government Spending</b>	17.3	7.3	+10.0	65.0
<b>Monetary Freedom</b>	79.5	82.1	-2.6	70.6
<b>Investment Freedom</b>	85.0	80.0	+5.0	49.0
<b>Financial Freedom</b>	80.0	80.0	No Change	48.5
<b>Property Rights</b>	95.0	90.0	+5.0	43.8
<b>Freedom from Corruption</b>	83.0	83.0	No Change	40.5
<b>Labor Freedom</b>	54.9	55.5	-0.6	62.1

\*The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).  
 \*\*World: Based on a scale of 1-183 with 1 being the highest ranking; Regional: Europe includes 43 countries total.  
 Source: The Heritage Foundation & Wall Street Journal

**Unemployment Decreases in Late 2010**

In November, Sweden's unemployment rate was 7.1% with a total of 349,000 persons out of work. The data marked the first time since the end of 2007 that the number of unemployed persons decreased compared to the same month one year earlier. Meanwhile, the overall *employment* rate increased by 0.8% to 64.8%. Data show continued positive trends in employment for both sexes but it is stronger for men. The number of hours worked during the month increased 3.9% on average over November 2009.

**Underlying Inflationary Pressures Remain Low**

While higher electricity prices and commodity prices temporarily push up inflation, underlying inflationary pressures in the economy remain low due to low labour costs. CPI inflation stood at 1.8% in November 2010, up 0.3% from the 1.5% the month prior. The rise in CPI inflation is due primarily to the fact that housing costs increase as the repo rate is raised. The country's central bank aims to maintain inflation at a rate of 2% when measured by the CPI. Inflationary pressures are expected to increase as economic activity strengthens.

**Heavy Reliance on Foreign Trade**

The Swedish economy remains heavily oriented toward foreign trade. The country has become especially reliant on EU states which account for more than 75% of Sweden's exports. In the most recent year, Sweden's main trading partners included Germany, Norway, the U.K. and Denmark.

In November 2010, Swedish exports of goods amounted to SEK 105.9 billion (23% increase YoY) while imports of goods totaled SEK 95.9 billion (15% increase YoY). The resulting net trade balance was SEK 10 billion. Comparably, the net trade balance in November 2009 was SEK 2.1 billion. For the year 2010, exports are estimated to total SEK 728.2 billion (US\$102.9 billion) while imports SEK 687.6 billion (US\$97.2 billion).

Balance of Payments, Net SEK Billions					
	Q3 2010	Q2 2010	Q3 2009	Yr. 2009	Yr. 2008
<b>Current Account</b>	<b>50.3</b>	<b>55.4</b>	<b>51.0</b>	<b>221.0</b>	<b>278.1</b>
Trade in Goods	18.0	21.3	22.3	104.1	101.4
Trade in Services	31.2	31.2	25.5	103.1	109.8
Compensation of employee	-0.5	-0.5	-0.5	-2.4	-2.1
Investment income	15.0	10.5	15.0	55.5	111.4
Current Transfers	-13.3	-7.1	-11.2	-39.3	-42.2
<b>Capital Account</b>	<b>-0.6</b>	<b>-1.3</b>	<b>-1.3</b>	<b>-3.9</b>	<b>-5.2</b>
<b>Financial Account</b>	<b>-60.8</b>	<b>-65.8</b>	<b>-36.3</b>	<b>-50.1</b>	<b>138.7</b>
Direct investment	-1.5	-11.3	-84.9	-124.7	32.4
Portfolio investment	-9.6	-110.5	154.3	513.5	-200.7
Financial derivatives	4.8	4.7	14.3	-20.5	16.2
Other investment	-87.3	110.8	-83.6	-302.5	287.2
Reserve assets	32.8	-59.5	-36.3	-116.0	3.7

Source: Statistics Sweden

Sweden's current account surplus continued to worsen in the third quarter of 2010, amounting to SEK 50.3 billion. Trade in services decreased significantly from the prior quarter while trade in services remained unchanged. Exports were lowered during the quarter as a result of the strong Swedish krona despite the fact that both imports and exports have begun to recover from the slowdown in 2009.

**Monetary Policy: Riksbank Raises Benchmark Rate**

At its most recent monetary policy meeting in mid-December 2010, the Executive Board of Sweden's central bank raised the repo rate by 25 bps to 1.25%. Though underlying inflationary pressures in the economy are currently low, they are expected to rise as the labour market improves and wages increase. As a result, the recent rise in the repo rate was intended to stabilize inflation close to the 2% target.

Forecast for the Repo Rate, percent quarterly averages						
	Q3 2010	Q4 2010	Q1 2011	Q4 2011	Q4 2012	Q4 2013
<b>Repo Rate</b>	0.5	1.0	1.4	2.0	2.9	3.4

Source: The Riksbank

**Fiscal Policy**

Sweden has a very burdensome income tax rate which was increased substantially during the mid-1990's. The top rate is currently 57%. Meanwhile, the country's corporate tax rate has been reduced to a more moderate 26.3%. The country also carries a capital gains tax, property tax and value-added tax (VAT). Although the wealth tax has been abolished, the overall tax burden remains large.

**Assumptions for Projections**

	Peer	Issuer	Base Case	
	Median	Average	Yr 1&2	Yr 3,4,5
<b>Income Statement</b>				
Taxes Growth%	(4.8)	(2.1)	<b>(2.0)</b>	<b>0.5</b>
Social Contributions Growth %	(1.8)	(6.8)	<b>0.5</b>	<b>0.5</b>
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.1	(4.9)	<b>(2.0)</b>	<b>1.0</b>
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(6.4)	(3.3)	<b>1</b>	<b>1.8</b>
Compensation of Employees Growth%	5.4	0.2	<b>0.2</b>	<b>0.2</b>
Use of Goods & Services Growth%	5.4	4.2	<b>4.2</b>	<b>4.2</b>
Social Benefits Growth%	8.7	7.3	<b>7.3</b>	<b>7.3</b>
Subsidies Growth%	2.3	(0.2)		
Other Expenses Growth%	0.4	0.4	<b>0.4</b>	<b>0.4</b>
Special Items (billion SEK)	0.0	0.0		
<b>Balance Sheet</b>				
Currency and Deposits Growth%	0.4	(37.8)	<b>1.0</b>	<b>1.0</b>
Securities other than Shares LT Growth%	7.8	2.5	<b>2.0</b>	<b>2.0</b>
Loans Growth%	2.4	20.5	<b>20.5</b>	<b>18.4</b>
Shares and Other Equity Growth%	14.8	16.9	<b>16.9</b>	<b>15.2</b>
Insurance Technical Reserves Growth%	2.7	0.0		
Financial Derivatives Growth%	0.0	31.4	<b>1.0</b>	<b>1.0</b>
Other Accounts Receivable LT Growth%	8.0	6.6	<b>2.0</b>	<b>2.0</b>
Monetary Gold and SDR's Growth %	0.0	0.0	<b>5.0</b>	<b>5.0</b>
Other Accounts Payable Growth%	9.2	(0.7)	<b>(0.7)</b>	<b>(0.7)</b>
Currency & Deposits Growth%	4.5	(21.2)	<b>0.5</b>	<b>0.5</b>
Securities Other than Shares Growth%	16.3	1.4	<b>1.0</b>	<b>1.0</b>
Growth%	0.0	0.0		
Loans Growth%	0.8	28.6	<b>28.6</b>	<b>25.7</b>
Insurance Technical Reserves Growth%	0.0	0.0		
Financial Derivatives Growth%	0.0	0.0		
Addl debt. (1st Year) billion SEK	0.0	0.0		

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**Base Case****ANNUAL REVENUE AND EXPENSE STATEMENT (BILLIONS SEK)**

	<u>Dec-07</u>	<u>Dec-08</u>	<u>Dec-09</u>	<u>PDec-10</u>	<u>PDec-11</u>	<u>PDec-12</u>
Taxes	1,180	1,209	1,184	1,160	1,137	1,142
Social Contributions	308	288	268	270	271	272
Grant Revenue	0	0	0	0	0	0
Other Revenue	216	229	218	213	209	211
Other Operating Income	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Revenue	1,704	1,726	1,669	1,643	1,617	1,626
Compensation of Employees	466	473	474	474	475	476
Use of Goods & Services	270	287	299	312	325	338
Social Benefits	559	574	615	660	708	760
Subsidies	44	47	46	46	46	46
Other Expenses	108	127	128	128	128	128
Grant Expense	0	0	0	0	0	0
Depreciation	<u>66</u>	<u>71</u>	<u>73</u>	<u>73</u>	<u>73</u>	<u>73</u>
Total Expenses	1,515	1,578	1,635	1,693	1,756	1,822
Operating Surplus/Shortfall	189	148	34	-51	-139	-196
Interest Expense	<u>55</u>	<u>53</u>	<u>36</u>	<u>38</u>	<u>40</u>	<u>42</u>
Net Operating Balance	134	95	-2	-89	-179	-238

**ANNUAL BALANCE SHEETS (BILLIONS SEK)****ASSETS**

	<u>Dec-07</u>	<u>Dec-08</u>	<u>Dec-09</u>	<u>PDec-10</u>	<u>PDec-11</u>	<u>PDec-12</u>
Currency and Deposits	67	97	61	61	62	62
Securities other than Shares LT	323	310	318	324	330	337
Loans	391	420	506	609	734	869
Shares and Other Equity	1,116	923	1,079	1,262	1,476	1,701
Insurance Technical Reserves				0	0	0
Financial Derivatives	28	30	40	40	41	41
Other Accounts Receivable LT	325	309	330	336	343	350
Monetary Gold and SDR's						
Additional Assets	<u>(0)</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Financial Assets	<u>2,250</u>	<u>2,090</u>	<u>2,333</u>	<u>2,633</u>	<u>2,986</u>	<u>3,361</u>

**LIABILITIES**

Other Accounts Payable	144	154	153	152	151	150
Currency & Deposits	34	51	40	40	41	41
Securities Other than Shares	1,080	1,035	1,050	1,060	1,071	1,082
Loans	202	201	258	801	1,324	1,927
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities	<u>57</u>	<u>100</u>	<u>163</u>	<u>(0)</u>	<u>(0)</u>	<u>(0)</u>
Liabilities	<u>1,518</u>	<u>1,541</u>	<u>1,665</u>	<u>2,054</u>	<u>2,586</u>	<u>3,199</u>
Net Financial Worth	<u>732</u>	<u>548</u>	<u>668</u>	<u>580</u>	<u>400</u>	<u>162</u>
Total Liabilities & Equity	<u>2,250</u>	<u>2,090</u>	<u>2,333</u>	<u>2,633</u>	<u>2,986</u>	<u>3,361</u>

## **Sovereign Rating Methodology**

Egan-Jones takes the perspective of the investor as its primary point of view when developing the ratings it issues for sovereigns. Therefore, in the case of sovereign ratings, we attempt to take a more holistic view of credit quality to include not only analytic comparisons of various sovereign issuers but also the impact on our quantitative and qualitative analyses by current global, sovereign, governmental and market events, including the effects of government investments in speculative, volatile or other high risk investment products. For example, many sovereign issuers have taken on significant exposures of major financial institutions over the past several years. Hence, we calculate the under-funding of financial institutions and include this amount in the total indebtedness of sovereigns. (We use a base assumption that no country can afford to allow its major banks to fail and therefore we believe that there will almost always be an intervention by either a host or allied nation should financial institutions or markets require support at some measurable level.)

Generally we devise modeling calculators and do an analysis that examines the debt load of a country with respect to its GDP and other economic indicators. The analysis is then adjusted to reflect the outlook on a myriad of factors that reflect the firm's overall view of the sovereign debt and the quality of the country's ability to meet and thrive under such load. Some of the qualitative factors that impact our ultimate assessment of credit quality such as the flexibility, stability and overall strength of the economy, ease of tax collection, acceptance of contract law, ease of doing business, and prospects for future growth and health. The non quant issues are generally subjective and a moving target, so each rating of a sovereign may differ because of the non-quantitative nuances being addressed.

## **Nota Bene**

History has proven that defaults on domestic public debt do occur. In fact, seventy out of three hundred twenty defaults since 1800 have been on domestic public debt (1). Egan-Jones does not view a country's ability to print its own currency as a guarantee against default. Additionally, Egan-Jones generally views cases of excessive currency devaluation as a de facto default.

1. "This Time Is Different: Eight Centuries of Financial Folly", Reinhart & Rogoff, p.111, 126