With a Steady Hand

Essays on Long-Term Investing

Number 6

This is not a Swedish fairy tale: Once upon a time when crises policies were successful…

By Karl-Heinz Thielmann

Part One: Like Phoenix from the ashes…

When the Euro crisis violently shook up the markets some months ago, one of the preferred escape currencies for scared investors was the Swedish Crown. However, Sweden has not always been popular as a safe haven for risk-shy investors. Twenty years ago the country's reputation was the exact opposite.

At that time the most populated Scandinavian country was in the middle of a deep economic crisis. The combination of expensive social-democratic policies of wealth redistribution and a bursting speculation bubble on the property market had ruined the country. Inflation had spiralled out of control. Rapidly increasing national debt, rising unemployment, a bank system on the brink of a breakdown as well as the currency in free fall constituted the nightmare-like components of an economic disaster which the country struck hard. The rest of the world had given up Sweden as a hopeless case.

However, the country succeeded in completely turning around its economy within a few years. A courageous reversal of politics achieved more than just overcoming the crisis. Sweden was transformed from a notorious case into an economic model. Far-sighted decisions that broke radically with traditions removed not only dysfunctions, but also created the conditions that enabled Sweden to develop again into an especially sound state. Therefore, in view of the still unsolved structural problems in the Eurozone, it could be

Speed Read:

- Currently Sweden is regarded as a "safe haven" for investors. However, 20 years ago, it was suffering as deeply from economic troubles as the Eurozone is today.
- Not only effective emergency measures were essential for the success of the recovery. Also many structural reforms were introduced to improve Sweden's competitiveness. This led to export-driven growth, which was essential to pull the country out of the economic mess.
- Austerity was successful, but its timing was essential. Sweden delayed imposing strict saving measures until the economy started to recover. It therefore avoided the vicious circle of a saving-driven depression, which can be observed in many Eurozone countries today due to their hastily rushed austerity.
- The outperformance of the stock market reflects the success of the economy. Innovative global niche leaders have become typical and are responsible for outstanding value creation.
- The situation in Sweden 20 years ago had many similarities to the current problems of some Eurozone countries. Especially some parallels to the current Spanish economy are striking. However, there are also remarkable differences. Therefore, their crisis policy cannot serve as an exact blueprint to solve the crisis, but gives valuable hints on how to deal with the Eurozone problems.
- The Swedish experience shows that structural reforms to improve competitiveness are critical for the long-term success of crisis management. These reforms must involve modernising the role of the state in the economy. They also need a lot of time to become effective.
- Above all, the precondition for Swedish success was to deal ruthlessly and honestly with one's own mistakes and not play the "blame game", as is the case with the Eurozone leaders at the moment.

worthwhile to take a look at the experiences of the biggest Scandinavian nation over the last 20 years.

In 1993 Sweden hit rock bottom. Like in some countries of the Eurozone today, a debt crisis due to excessive real estate speculation and an overly inefficient state not only threatened to destroy the financial system, but also exposed enormous structural flaws in the economy. To prevent a complete collapse, reforms combining short-term and long-term measures were implemented in a way that was afterwards described by many economists as exemplary.

At first, short-term emergency measures were taken to stabilise the financial sector; these later served as a blueprint for bank rescue operations during the financial crisis of 2008:

1. The Swedish government delivered an early unlimited guarantee to all local and foreign depositors in Swedish banks that their deposits were safe. This was decisive to prevent private customers from running away from the financial institutions. It was also crucial to allow Swedish banks to quickly return to the international capital market for funding. For shareholders, however, no support was given. As the providers of risk capital they had to fulfil their duty. The banks in need were recapitalised with public funds and nationalised, if necessary. These measures were completely at the expense of the owners, but not at the expense of the depositors. The decision to prevent troubled banks from going bankrupt, but to save them fast, actually turned out to be crucial for rebuilding trust in the Swedish financial system.

2. A politically independent institution was created to co-ordinate the rescue measures for the financial sector. This institution guaranteed that the bank rescue was conducted without significant influence from special political interests.

3. General conditions for bank restructuring were approved. This aimed to prevent the support for the banking industry from being misused and also ensured that it was really accepted if necessary. Stress tests were used to establish whether and to what extent banks required support. In addition, neutral and strict valuation directives were introduced for the banks to create transparency concerning the risk situation.

4. The rescue operations remained limited to the banking sector. The Swedish government made no arrangements to rescue industrial enterprises. Also the banks were given no instructions on how to use their support funds. This therefore resulted in a wave of bankruptcies and restructuring outside of the banking sector. In the end, however, this turned out to be a shakeout after the previous speculative bubble.

5. "Bad banks" were used extensively to restructure the problematic investments of banks. This had two advantages: on the one hand, healthy banks could return to business as usual relatively fast. On the other hand, the concentration of risky assets in special units made it possible to wind them down cautiously without disturbing the markets too much.

Nevertheless, parallel to these measures to fight acute problems, long-term structural reforms were also introduced. In the course of the crisis, the Swedes had become conscious that their economic problems were not only due to the bursting of the speculative bubble, but also due to more deeply rooted problems:

1) A new tax system was introduced with a widened tax base and lower marginal rates to reward economic success and provide incentives for investment.

2) Sweden joined the EU to restore trust in the economy.

3) The election periods were extended from 3 to 4 years to prevent long-term election campaigns with politicians outbidding themselves with populist promises.

4) The legal conditions of the monetary policy were modernised. The central bank attained independence de facto and de jure to give credibility to the target of fighting inflation.

5) The planning process for state budgets was radically changed. A surplus target for the net loan admission of the public budgets was approved. At municipal level, the local communities were obliged to submit well-balanced budgets. In addition, an independent authority was installed to control fiscal policies.

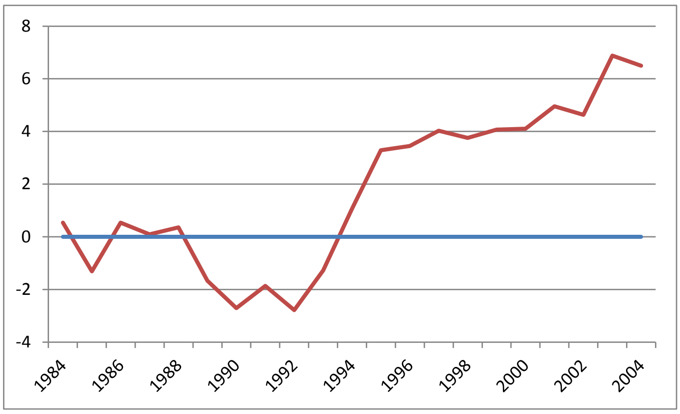
6) A new pension system was introduced to take into account the structural changes caused by an ageing population. Among other things, incentives were introduced to encourage people to retire later.

7) A lot of single measures were implemented to improve the efficiency and competitiveness of the economy. Many markets were deregulated and state interventions reduced to impede free competition as little as possible.

8) The Swedish welfare state was not abandoned, but radically reformed. Thus the privatisation of many public services was initiated. In addition, many measures were introduced to increase transparency in the public area to prevent inefficiencies.

An essential contribution to long-term success was the Swedish government's commitment to implementing a policy of austerity and fighting the inefficiencies of the public sector. However, tough cost-cutting was postponed until the climax of the crisis had passed and the economy had stabilised again. Therefore, in 1993, a budget deficit of 12% was still tolerated. It was only from 1995 onwards that the deficit was continuously reduced. Since 1999, surpluses have been regularly achieved. This has allowed the government to tolerate small deficits during difficult years, such as after the global financial crisis, without jeopardising their general policy of austerity.

However, the core of the Swedish "economic miracle" after the crisis was its rebirth as an export nation. The structural reforms decisively improved their industry's international competitiveness. Therefore it was possible to achieve above-average economic growth in spite of the gradual retreat of the state. Thus the share of the public sector in the economy has been falling for many years and was 49.2 % in 2012 in spite of still relatively high social benefits.



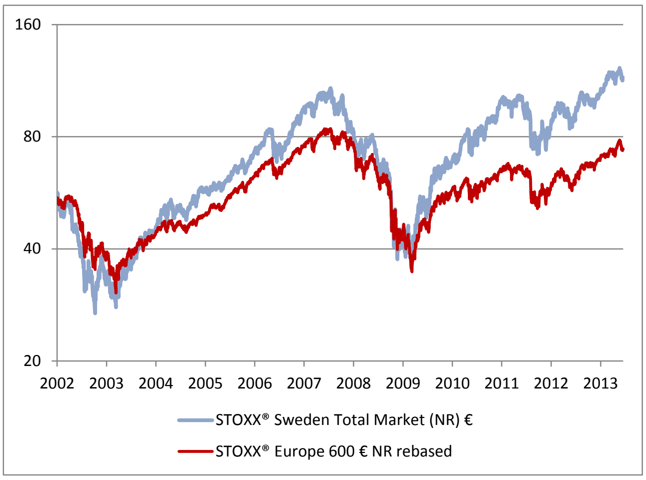
Current account balance; percent of GDP
Source: International Monetary Fund, World Economic Outlook Database

The Swedish economy has remained strong, especially in comparison to the economic performance of the European Union since the financial crisis in 2007. Despite a short blip in 2009 due to high dependence on global trade, in general the economic performance has been much better than in the EU. However, as a side effect of export-driven growth, its economic development has become more volatile, but all in all clearly better than the EU.

One distinctive feature of Swedish success is the performance of the corporate sector, which is reflected in its outstanding stock market performance over the last years. The strong weighting of global niche leaders has led to an increase in the €-value of Swedish shares in the last decade of approximately 300%, measured by the STOXX ® Total Market Net Return Index (incl. dividends).

This development was far better than that of the remainder of Europe, as shown by the relative comparison with the STOXX ® Europe 600 Net Return Index. However, like the whole economy, Swedish shares have also appeared more vulnerable to global growth shocks, like after the financial crisis of 2008 when a short-term set-back was recorded.

For big Swedish companies, the home market is typically relatively unimportant. With the exception of the financials, the commercial focuses of the big enterprises on the Swedish stock exchange are global. For the banks Scandinavia has become the home region. Almost all enterprises have a clear strategic focus, either on the product category or on a certain region. Adoption of new technologies happens faster than in most other countries, even in the area of financials. Furthermore, the relative share of research expenses in non-financial enterprises is generally higher then for their international competitors.



Source: http://www.stoxx.com/index.html

Research published by the McKinsey Global Institute has pointed to another specific success factor of Swedish enterprises: the quality of management and employees and the way they deal with each other. It has been shown that Swedish managers act much more professionally than colleagues from other countries. Swedish employees are also exceptionally well qualified. Furthermore, they put much more emphasis on constructive relations between employees and their employers than in other countries.

One controversial feature of the Swedish stock market with regard to corporate governance is the different classes of shares, mostly so-called A shares and B shares, with different voting rights. The constrained type is, as a rule, the more liquid one and more popular with international investors. The stock category with preferential voting rights is in general controlled by core stockholders, who are connected with the enterprise in the long term.

While preference for single shareholder groups was criticised internationally during former years, the picture has now changed. The close connection of an enterprise with its controlling shareholders has prevented company executives from enriching themselves with inflated bonus programmes at the expense of their companies. Unlike a lot of their international competitors, business decisions have been driven more by the long-term interests of the enterprise and less by short-term financial optimisation. In this respect the advantages of this system are relatively clear in the light of the difficult economic situation of the past years.

In summary, the economic development of Sweden during the past years must be viewed as a relative success. However, there are some drawbacks, which may indicate that the austerity policies have gone a little bit too far in some respects.

A flaw in the Swedish list of successes is the stickiness of unemployment. Since the beginning of the 90s, the unemployment figures have fluctuated between 6% and 10%. The latest figure (April, 2013) is 8.7%. Recent youth riots in the poor suburbs of Stockholm point to the fact that there are too many losers in the current system and that they need be taken care of in a better way.

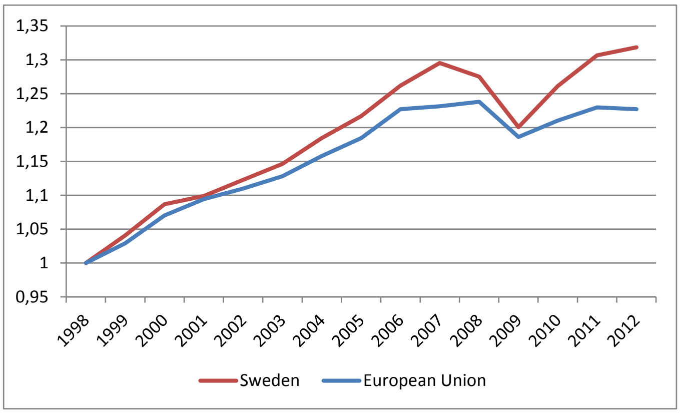
Another problem which has gradually become apparent in Sweden is the successive deterioration of its education system. Twenty years ago it occupied a leading position in international comparisons. While Swedish universities still enjoy an excellent reputation, schools have slid to more mediocre rankings. This deterioration is also notable relative to the country's Scandinavian neighbours. For a country whose success is based on the export of creative and technically high-quality products, this may lead to a dangerous development in the long term.

Part Two: Is the Swedish way of crisis management a model for the Eurozone?

Twenty years ago Sweden was in a heavy economic crisis, just like Spain and Italy. However, while the big economic nations of Southern Europe have returned to the starting point with the Euro crisis, Sweden stands more strongly than ever. In this respect, a comparison to what has been done differently and better in the north of Europe in the past 20 years seems justified.

It is not indisputable as to whether the Swedish example of crisis management really is comparable to the situation in Southern Europe. In Italy and Spain the role of the state is traditionally seen much more suspiciously; the black economy generally plays a much bigger role. However, an ineffective state has a critical role in all the current and past crisis countries, even if the reasons for inefficiency are very different.

Sweden carried out a massive devaluation during its crisis. This possibility is not available for the countries currently bound to the Euro. Twenty years ago, however, this possibility existed and it was also used by all of the crisis countries. As it appears now, this has not benefited Southern Europe in the long term. The lasting success of Sweden must be based on other factors.



Gross domestic product per capita, constant prices (1998=100%)
Source: International Monetary Fund, World Economic Outlook Database

The advantages of the devaluation also have to be seen in the context of high interest rates. Twenty years ago the Swedish, Spanish and Italian central banks initially had to remain very restrictive after devaluation in order to restore confidence, while the ECB's light monetary policy is currently beneficial for the Southern European countries in the Eurozone.

Furthermore, the exchange rate has become less important for success in the foreign trade of technically advanced high-quality goods. German and Swedish products are popular internationally because they are better than others and not because they are cheaper. Some Spanish and Italian enterprises have remained competitive, but not the national economies as a whole. The international cost competition largely takes place between the cheap labour countries of Asia and East Europe. To compete with these countries would be as hopeless for Italy and Spain as it would be for Sweden.

An analysis of the causes of the crisis, especially the developments in Spain before 2012 and in Sweden before 1992, shows many similarities:

- There was a drop in international competitiveness before the crisis which was reflected in the constant deterioration of the foreign trade balance. The leading industrial enterprises mainly invested abroad, while speculative capital flows came into the country.

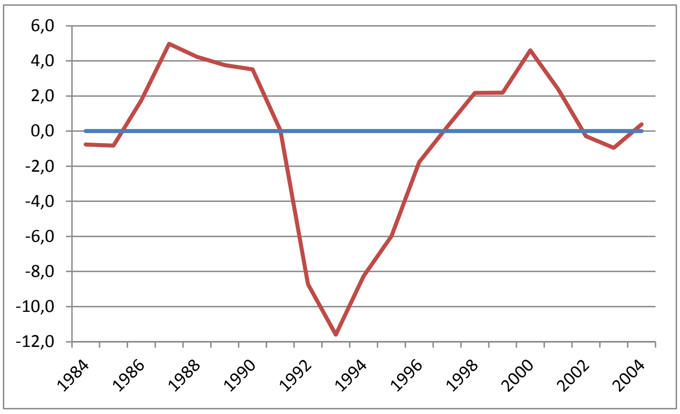
- Ineffective public services were the principal reason for the lack in efficiency of the domestic economy in both countries.

- The budgetary situation in both countries seemed very solid before the outbreak of the crisis. However, this changed fast when the unemployment figure exploded and the central state had to deal with fiscal gaps in banks, regional governments, social security organisations, etc. all at once.

- In both countries a real estate boom caused by carelessly granted credit was the main reason for a too optimistic appraisal of the economy before the outbreak. It was also the cause of the deep and persistent downturn during the crisis.

However, there were also other developments as reasons for the crisis. Currently it is more interesting to identify the extent to which the Swedish experiences can be used to avoid possible mistakes in crisis management and to develop suitable therapy measures. The following issues are the most important:

1) The stabilisation of the financial sector was the key to stabilising the economy. A chain reaction caused by one or several bank bankruptcies was prevented only by the decisive intervention of the state. The Euro crisis countries Spain and Ireland faced similar problems. While Ireland acted fast, valuable time was lost in Spain in 2011 and 2012 by delaying rescue measures for ailing banks.



General government primary net lending/borrowing; percent of GDP
Source: International Monetary Fund, World Economic Outlook Database

2) Austerity was important only after the worst of the crisis was over. Although Sweden started saving during the crisis, high budget deficits were initially still allowed. The tough cuts started after the economy had stabilised and the export industry was able to grow again. In the Euro crisis, the reverse approach was pursued with fatal results. During the Euro crisis, politically responsible persons in the IMF, ECB and the EU failed to recognise that the success of austerity was also a question of timing. Concentration on deficit targets in the Eurozone forced countries to make heavy cutbacks before their economies had stabilised again. This is increasingly being recognised as a significant mistake.

3) In 1992 Spain and Italy reacted to the crisis by devaluating their currencies and introducing measures to stabilise the budget. Superficially, this policy was successful at first: both countries recovered relatively quickly. Nevertheless, structural reforms were not implemented. In Italy, serious measures to fight corruption were diluted; Spain never properly took steps to tackle the structural weaknesses in the job market. Sweden,

however, had prescribed a harder approach: the crisis served as a starting signal for a package of measures to improve international competitiveness.

4) Inefficiencies of the public sector are a central problem which can be strongly defused with privatisations, transparency and effective controls in the public area. Austerity is possible without neglecting social standards. However, social politics must then be combined with measures to increase the economic efficiency of social services. This is perceived as a sacrilege, not only by left-wing politicians in the Eurozone. At the moment the redistribution bureaucracy mainly benefits from the welfare state in the Eurozone - and not the socially weak. This is also especially the case in Germany. Public finances in continental Europe are still heavily abused by bureaucrats and populist politicians who want to create monuments to themselves with ludicrous prestige projects. In this respect not only the current crisis countries can learn from Sweden, but in particular also Germany and France.

5) The competitiveness of the private sector must be strengthened to create the conditions for an economic recovery. In particular the Southern European countries still have a dramatic need to catch up. However, this issue is complicated by the fact that the role of the state and the self-image of politicians are characterised by completely outdated society models. What is often forgotten is that Southern Europe is still haunted by the ghosts of former authoritarian military dictatorships. The inflexible job market in Spain and its unadaptable regulations were inherited from the Franco dictatorship. In Italy, a political and economic ruling class was established after the Second World War which has dominated until this day. It is mainly concerned with self-enrichment and not the public interests. All this has brought a combination of mistrust, corruption and inefficiency – a state from which Southern Europe has not yet succeeded in escaping. In this context the Euro crisis is a big opportunity, because now basic problems can finally be dealt with.

6) There is an evident connection between problems in foreign trade and budget deficits. In Sweden, like in the crisis countries, current account balance deficits preceded the budget deficits. This is a nasty parallel with the present situation in France, where the foreign trade position is steadily eroding. All political parties are strictly refusing to properly analyse the reasons for this. In Spain and Italy, however, the foreign trade position during the last months has improved again somewhat, which gives reasons for hope.

7) To overcome a crisis takes a long time, even if crisis measures are taken fast and courageously. Sweden suffered an acute crisis from 1990 to 1993 and implemented a hard austerity policy between 1995 and 1997. The country needed a total of 8 years to get back on track. However, after 1998 this policy paid off. Sweden had an above-average economic growth in comparison to other industrial countries, was able to cut back debts and also survived the turbulences of the financial crisis better than comparable countries. In the crisis countries of the Eurozone, the adaptation process will probably take even longer, because the possibility of a devaluation for the short-term improvement of competitiveness is not available to them.

8) Germany is currently showing some disconcerting parallels to Sweden in the 80s. The country’s relative economic strength has led to complacency. The budget deficit seems superficially under control because money has been saved due to cutbacks in infrastructure investments. This has not stopped the politician of all parties from carelessly spending taxpayers’ money and from renouncing efficiency controls in the public area. Large-scale public projects are notorious for overshooting their initial cost estimates several times. Therefore, conditions have been created for budgetary holes in upcoming years. Besides, negative real interest has promoted excessive real estate speculation. In top locations in Hamburg or Munich, real-estate prices are starting

to appear overheated. Especially some banks, which have not yet recovered from the financial crisis, have started again to chase credit growth.

Even if the Swedish model of crisis management cannot be applied in detail to Southern Europe, one should still keep in mind some of the basic lessons for comparing the different developments:

- Short-term stabilisation measures are not sufficient in the long term. Structural problems have to be approached extensively; otherwise the crisis will return after some years.
- The timing of crisis policies is as vital as the measures themselves. In particular austerity cannot be the first step, even if it is vital for long-term success.
- The role of the state in the economy must be radically modernised, regardless of the reasons for state inefficiency. This can be achieved by introducing market-like control mechanisms, privatisation or more transparency.
- Real crisis management needs a long time: hectic attempts to achieve quick solutions only have a cosmetic effect. In this respect, all demands to finish the Euro crisis "fast" have been counterproductive.

Up to now, the crisis policies in the Eurozone have been marked by a constant shift between reality and refusal, badly timed measures and attempts to enforce specific national interests. It has been apparent for quite a while that this does not work. Indeed, it is no longer accepted by the population, as the latest election results confirm. The twenty-five percent of votes for the 5-Stelle movement in the last Italian parliamentary elections are a sign of this. One quarter of the voters voted for the party whose sole policy consists of strictly denouncing corruption, pointing to the central cause for the structural weakness of Italy, even if it is stated by a former clown with very populist slogans. Whether this election result can really be transformed into constructive politics, however, remains to be seen. Italy put a fox in charge of the geese once before. Twenty years ago, the bearer of hopes was a successful entrepreneur called Silvio Berlusconi, who at that time seemingly did not belong to the political establishment and promised to change everything. Then, however, he proceeded to mainly act in his own interests and further cemented the old structures.

At the moment it is still unclear whether Southern Europe will be willing to seriously approach structural problems. However, ultimately, this is exactly what is necessary. A refusal to implement real reforms will only aggravate the existing problems. On the other hand, integration in the Eurozone has greatly increased the pressure to introduce real reforms, because crisis countries can no longer simply fall back on short-term stimuli such as devaluation. Sooner or later the moment of truth comes.

Sweden is less a model in view of single measures to fight the crisis, although many of these currently would also be very suitable. Above all the Eurozone can learn that a precondition for a real solution is to deal at first ruthlessly and honestly with one’s own mistakes. And there has to be courage to replace outdated structures quickly and rigorously, even if it hurts very much. Furthermore concepts have to be developed to enable the current problem nations to recover in the long term. However, these should be formulated by the countries themselves, taking into account their specific requirements, and not in Brussels or Berlin. The search for a universal solution for the Eurozone so far has only resulted in coordination problems and delays. It is only if the crisis states recover from their plight in a self-responsible manner that there are good chances for the Eurozone to regain strength.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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LONG-TERM INVESTING Research AG - Institut für die langfristige Kapitalanlage

Managing Directors: Karl-Heinz Thielmann, Oliver Clasen

Supervisory board: Dr. Gregor Seikel (Chairman)

Weinbrennerstr. 17, D-76135 Karlsruhe, Germany

Tel.: +49 (0) 721 6293 9773, Fax.: +49 (0) 322 2376 4968

E-mail: info@long-term-investing-research.com

Website: www.long-term-investing-research.com

Responsibility for the contents: Karl-Heinz Thielmann

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