Macro Research

Sweden/Fiscal policy/Autumn parliamentary election

The election will be messy, but the market is relaxed

Public opinion indicates that the process of forming a government following the election on September 9 will be protracted and complicated. It appears that neither the current "Red-Green" government (of the Social Democrats and Green Party) nor the four-party centre-right Alliance will have sufficient support from voters to form a sustainable government. The issue of forming a government will make its mark on the election campaign, but there is no sign that any of the parties plan to clarify how they think the country should be run after the election, if neither traditional bloc can form a government. Most factors suggest that there will ultimately be a minority government with a weak and uncertain mandate. The election is not expected to have any major impact on the financial markets or on near-term macroeconomic trends. Sweden has a strong economy, sound public finances, and there is a consensus in Swedish politics concerning the overall direction of fiscal policy. In the longer term, however, the macroeconomic effects could be greater. A minority government will have trouble implementing the necessary structural reforms and pursuing an effective stabilisation policy in the event of an economic downturn.

Forming a government will be complicated after the election...

There is much to suggest that the process of forming a government following the election on September 9 will be complicated. The sharp rise of the Sweden Democrats (a social conservative, anti-immigration party) in the opinion polls, combined with the fact that the Social Democrats and the Moderate Party are losing voters, will make it hard to form a sustainable government, in our view. Meanwhile, the Christian Democrats and the Green Party are hovering around the four percent cut-off mark, and their fate in parliament may ultimately determine which parties form a government after the election (the threshold to enter the Swedish parliament is four percent of the vote).

If current polling proves accurate, neither the present government (Social Democrats and Green Party with the support of the Left party) nor the centre-right Alliance (Moderate Party, Centre Party, Liberal Party and Christian Democrats) would have enough voter support to pass their budgets alone. The Sweden Democrats could easily block a government budget proposal by voting for an opposition budget proposal, (see fact box: What is required to govern the country?). Not even a centrist government comprising the Social Democrats, Centre Party and Liberal Party would have sufficient voter support to both form a government and pass a budget.

Neither the centre-right Alliance nor the Red-Green block will be able to pass their budgets alone

The issue of government formation will make its mark on the election campaign, but there is no sign that any of the parties plan to clarity what collaborations could be possible if neither of the traditional blocs are able to form a government. In our view, the other seven parties will continue to maintain that they will not collaborate with the Sweden Democrats. A grand coalition the Social Democrats and Moderate Party is likely to be ruled out by the two parties, we believe. Consequently, once the votes have been counted on election night, there will probably be a great deal of uncertainty regarding who the new prime minister will be, and which parties will be included in the new government.

Record low support for the Social Democrats and record high support for the Sweden Democrats

	Opinion polls	Change since election
Social Democrats(S)	23,5	-7,5
Left party(V)	9,2	3,5
Green party(MP)	4,3	-2,6
Moderate party(M)	19,2	-4,1
Liberal party(L)	5,3	-0,1
Centre party (C)	9,0	2,9
Christian Democrats(KD)	3,1	-1,5
Sweden Democrats(SD)	22,7	9,8
M+C+L+KD	36,6	-2,8
S+MP+V	37,0	-6,6
S+C+L	37,8	-4,7
M+SD	*41,9*	*5,7*
S+C+L+MP	42,1	-7,3
S+M	42,7	-12
S+SD	46,2	2,3

Note: Opinion polls from June 2018

Source: val.digital

Handelsbanken Capital Markets

What is required to govern the country?

Forming a government: A government does not need the support of a parliamentary majority, but it cannot have a majority against it. A minority government can "be allowed in" by the other parties voting yes or abstaining.

Passing the budget: In the vote on the budget, the government's budget faces off against the largest opposition party's budget alternative (or the largest joint budget alternative, if several opposition parties have a joint budget alternative). If the government's budget is supported by more members of parliament than the opposition's largest budget alternative, the government's budget passes.

Passing bills (e.g. new laws): A majority of the members of parliament must vote in favour of the proposal.

...but the results of the election are not expected to have a major impact on markets

Although the political situation will probably remain uncertain in the weeks following the election, it is difficult to see this having a major impact on financial markets, in our view. Sweden has a strong economy, sound public finances, and compared with the government crises in many other European countries, the problems related to the formation of a Swedish government probably will not be particularly grave, we believe. There is also a consensus in Swedish politics concerning the overall direction of fiscal policy (see the fact box on the fiscal policy framework). Accordingly, regardless of which governing coalition assumes power following the election, the public finance and macroeconomic trends will probably remain largely the same in the coming mandate period. In conjunction with the government crisis in December 2014, when the Sweden Democrats prevented the government budget from passing, and Stefan Löfven said that he would call a snap election, market reactions were limited (interest rates remained unchanged, and the krona weakened marginally).

However, if the election results are unexpected, there could be some reaction in the market. The krona would weaken if the Sweden Democrats were to win most support, in our view. A clear indicator of this is the fact that the krona weakened following the Sweden Democrats' statement that they wanted to hold a referendum on Sweden's EU membership in the next mandate period. However, it is difficult to see how the Sweden Democrats could gain parliamentary support for a referendum on Sweden's EU membership, or that they would be part of the governing coalition, even if they were to win most votes. Accordingly, any effect on the krona would only be temporary, even if the Sweden Democrats gain more votes than current opinion polls indicate, we believe.

What happens after the election?

The clear block-based nature of Swedish politics has meant that the process of appointing a prime minister and forming a government has previously been quick and easy. In practice, it has already been clear on election night who the new prime minister would be, and the new government has formally assumed power a few days after parliament convenes following the election. This autumn, forming a government will probably take longer.

Forming a government will probably be protracted and complicated

It seems very likely that Stefan Löfven will remain prime minister after the election and initiate negotiations with the other parties to form a government that can pass the vote on a prime minister and pass its budget. For Stefan Löfven to step down right after the election, a clear government alternative that is supported by a majority of parliament would probably be required, and it does not appear that this will be the case, if current opinion polls prove accurate.

Even if the parties are prepared to compromise after the election, and negotiate with the parties that they would prefer not to collaborate with, forming a government will probably be a protracted and complicated process. However, the rules concerning the vote on a prime minister and the budget will probably facilitate the formation of a government, and help ensure that a new government will be in place by the autumn.

> *The rules concerning the vote on a prime minister and the budget may facilitate the formation of a government, and help ensure that a new government is in place by the autumn*

There must be a vote on a prime minister no later than two weeks after parliament has convened, i.e. by October 8. Accordingly, the candidate for prime minister will aim to have a governing alternative ready by no later than October 8.

The budget must be submitted to parliament by November 15. This means that the new government must assume power in early November to have time to draft a budget. This reference point will probably be more important for a government led by the Moderate Party. Income tax changes can only be enacted at year-end, so unless the Moderate Party could present a budget by the autumn, it would have to wait until January 1 2020 before it could implement its income tax proposals (including an in-work tax credit). Most other reforms could be presented in conjunction with the 2019 Spring Budget Bill and come into effect on July 1, 2019, unless the new government had managed to present a budget by the autumn. If a new government has not assumed power by November 15, the current government, which would remain in power in the form of a transition government until the new government assumes power, must present a budget. This budget must be as 'apolitical' as possible and should not include any reforms or significant changes to the government budget.

Meanwhile, a highly protracted government formation process, or even an extra election, cannot be ruled out. If a majority of the members of parliament were to vote against the candidate for prime minister in the first vote on a prime minister, the speaker would be tasked with selecting a new candidate for prime minister. There are no stipulations as to when the next vote on a prime minister must be held. Consequently, as in Germany and Belgium, the process of forming a government may be very protracted, and not finished until sometime in 2019. It is also possible that several votes on a prime minister would be required. However, if the proposed prime minister were to be rejected four times, an extra election would be called, which must be held within three months of the fourth vote.

Government remains in place	Quick shift in power	Protracted government formation
24 Sept: ✓ Parliament convenes ✓ Vote on prime minister **Oct 9 at latest** ✓ Government submits budget to parliament	**10 Sept-23 Sept:** ✓ Prime minister submits letter of resignation **27 Sept** ✓ Vote on prime minister **28 Sept** ✓ New government assumes power **Oct 19 at latest** ✓ Government submits budget to parliament	**24 Sept** ✓ Parliament convenes **24 Sept-8 Oct** ✓ First vote on prime minister **28 Sept-?** ✓ New government assumes power **15 Nov** ✓ Budget must be submitted to parliament by this date

Quick formation of government; prime minister remains in place (low probability)

A possible scenario for a quick formation of a government would involve Stefan Löfven initiating negotiations with the Centre Party, Liberal Party and Green Party. If the Centre Party and Liberal Party were then to agree to vote for Mr. Löfven to continue as prime minister, and if they were to support the government budget, the prime minister could remain in place if current opinion polls were to prove accurate.[1] In this case, there could be a vote on a prime minister when parliament convenes on September 24, after which the new government is to present its budget on October 9.

Quick shift in power (low probability)

If it is apparent that the Social Democrats cannot succeed in forming a government, Stefan Löfven will probably step down as prime minister before parliament convenes on September 24. In this event, the speaker will probably assign Ulf Kristersson (chairman of the Moderate party) the task of forming a government. If this process is quick, as it has been during previous shifts in power, the vote on a prime minister would be held on September 27, and the government led by the Moderate Party would assume power the next day.

Probably a minority government with a weak and uncertain mandate

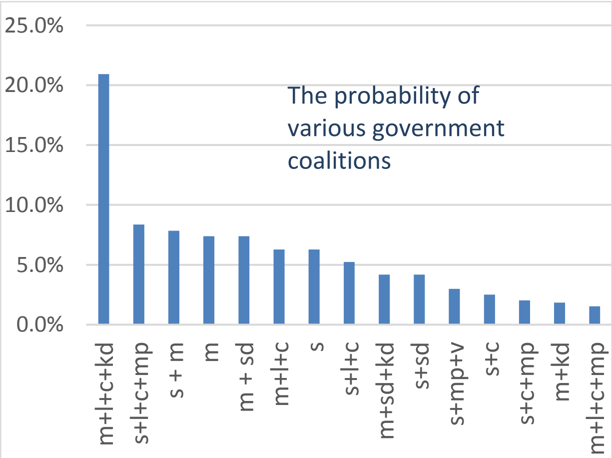
Most factors suggest that there will ultimately be a minority government, with Ulf Kristersson or Stefan Löfven as prime minister. In order to secure a majority government, the Social Democrats and Moderate Party would probably have to form a grand coalition, or include the Sweden Democrats in a government. For several reasons, it is hard to see the time being ripe for any of these alternatives. A government consisting of the Social Democrats and the Moderate Party would probably require a crisis to occur during the autumn that required a strong government to quickly assume power, or that the only alternative, following extensive negotiations, turned out to be an extra election, unless they formed a coalition.

However, there is a great deal of uncertainty surrounding who the new prime minister will be, and which parties will be included in the new government. This is also reflected in the odds on who the next prime minister will be, and the odds on various

[1] This type of government collaboration, where the current government remains in place with the support of the Centre Party and the Liberal Party, would have marginally more support than the Moderate Party and Sweden Democrats, according to current opinion polls. So even if the Moderate Party and Sweden Democrats vote against Stefan Löfven in the vote on a prime minister, and the Sweden Democrats vote for the Moderate Party' budget alternative, the government would get by in the vote on a prime minister and pass its budget.

government coalitions, according to the online gaming site Unibet. There are many possible combinations for government coalitions, and the most probable outcome (the Alliance) is only around 20 percent. According to the odds, it is relatively certain that the prime minister will be a member of the Moderate Party or the Social Democrats (a probability of about 83 percent). However, there is no clarity as to whether it will be Ulf Kristersson (about 44 percent) or Stefan Löfven (about 39 percent). The probabilities of the Centre Party or the Sweden Democrats winning the position of prime minister is about 9 percent and 8 per cent, respectively, according to Unibet.

Many government coalitions are possible



Source: Unibet

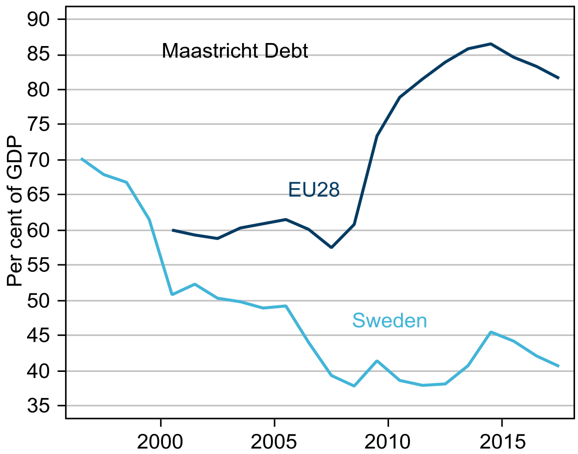
There are indications that the government will ultimately only consist of the Moderate Party or Social Democrats. Such a government would probably have an easier time collaborating with most of the parliamentary parties. It could, for example, collaborate on a budget with certain parties and reach other agreements with other parties. Under this scenario, not all of the parties with which the government collaborates on a budget have to back all the policies pursued by the government. Immigration, or the possibility of a direct/indirect collaboration with the Sweden Democrats, could facilitate collaboration, as these issues will probably be important during the next mandate period.

Experience from the current mandate period also suggests that this type of alternative could be attractive to many parties. The Left Party has been included in the budget negotiations, but has not had to back the government's other policies. It has managed to push through a number of its policies and has risen in opinion polls. Meanwhile, the Green Party has had a tough time and been forced to support many decisions that it actually opposed. However, a government solely comprising the Moderate Party or Social Democrats would have a weak and uncertain mandate.

The election will have minor effects on public finances and the economy in the short term...

There is a consensus in Swedish politics concerning the rules and guidelines in the fiscal policy framework, which include a surplus target for public sector financial savings (see the fact box on the fiscal policy framework). Even if the surplus targets are not met slavishly, they have served as a rudder for both the Alliance and the Red-Green governments. This has contributed to Sweden's current very low public debt, in both historical and international terms. Accordingly, regardless of which governing coalition assumes power following the election, public sector cutbacks and the national debt will probably remain largely the same. The national debt will continue to decline during the next mandate period, unless there is a recession or another 'crisis'.

Low public debt



Source: Macrobond

Fiscal policy probably more expansive than 'normal' in 2019

If the government forecasts presented in June are accurate, the margins for new, unfunded reforms in the 2019 budget will be relatively limited. The premise of the budget negotiations will probably be that the budget is to have around SEK 0-10 billion in new unfunded reforms, in addition to the reforms of about SEK 20 billion that have already been earmarked for

2019 in conjunction with this year's budget.[2][3] Complicated negotiations concerning the formation of a government and the budget will probably contribute to the 2019 budget ultimately being somewhat more expansive, i.e. more than SEK 10 billion in new unfunded reforms.

In the event of a shift in power, relatively speaking, fiscal policy tends to be tighter early in the electoral period, because some of the reforms can be financed by removing certain tax cuts or fee reforms that the previous government introduced. This would suggest that a government that was headed by the Moderate Party would pursue slightly less expansive fiscal policies in 2019, compared with a Social Democrat government. However, this effect will probably be less than 'normal', as several of the Moderate Party's expenditure cuts within the transfer system may be difficult to implement if its budget is to be passed by parliament.

Slightly more expansive fiscal policy will contribute to somewhat higher GDP growth in 2019

Slightly more expansive fiscal policy will contribute to somewhat higher GDP growth and somewhat lower unemployment in 2019. If, for example, the budget ultimately contained SEK 10 billion more in unfunded reforms than normal, according to the standard assumptions on how fiscal policy reforms affect growth and unemployment, this would lead to GDP growth being 0.1-0.2 percentage points higher, and employment being about 0.1 percentage points lower in 2019. This could have a marginal effect on inflation and make short-term interest rates somewhat higher.

The focus of the policies will overlap in many areas regardless of the government coalition. Investments will be made in welfare (healthcare, schools, elderly care), defence, law and order (police, etc.) and lower taxes for pensioners. A large share of the next mandate period's reform margin will be spent on the municipal sector to remove the need to reduce quality or raise taxes to manage the unknown needs resulting from more elderly and young people. The centre-right parties want to increase incentives to work by lowering taxes on labour and reducing some subsidies. The Social Democrats instead want to focus more on policies such as traditional redistribution. However, the differences are not substantial enough to have any major macroeconomic effects in the coming years.

In the unlikely event that no new government has assumed power by November 15, the current government, which will remain in power in the form of a transition government until the new government takes over, must present a budget. This budget must be as 'apolitical' as possible and should not include any reforms or significant changes in the government budget. This would mean that fiscal policy would be austere in the first half of 2019. It is reasonable to assume that the public sector, above all, would suffer because of this, including less funding for the municipal sector. However, in conjunction with its 2019 Spring Budget Bill, the new government would be able to present reforms that would come into effect on July 1, and so fiscal policy would only be marked by austerity in the first half of 2019.

...but in the longer term, the macroeconomic effects could be greater

A minority government will have trouble implementing necessary structural reforms in areas such as the labour market, housing and tax policy. In the long term, this will hamper growth potential in the Swedish economy. The experience of the past eight years of minority government shows that it is possible to achieve cross-party agreements concerning, for example, pensions, defence and energy policy, but that housing and tax policy, where there are clear ideological differences among the traditional parties, are more difficult.

There is a significant risk that Sweden will enter a recession in the coming mandate period. Recessions have major socio-economic costs. Unemployment rises, production slows, and it tends to be difficult to return to the trend growth or unemployment levels that prevailed before the recession. Consequently, recessions tend to have lasting effects on the economy.

[2] In its June forecast, the government estimated that structural net lending (savings adjusted for economic effects) will be 0.5 percent of GDP 2019. This indicates that the fiscal space will be about SEK 0-10 billion, so that structural net lending will be in line with the 2019 surplus target.

[3] In conjunction with its 2018 budget bill, the government advised that government subsidies to the municipal sector would increase by SEK 5 billion in 2019, and that taxes on pensioners would be cut further.

Fiscal policy must take greater responsibility for stabilisation policies in the current low-interest rate environment

From the 1990s until the financial crisis of 2008-09, there was more or less a consensus on the fact that an independent central bank should bear primary responsibility for stabilising the economy in countries with their own currencies, such as Sweden. Fiscal policy is to contribute to stabilising the economy only via automatic stabilisers, except in very severe recessions when active fiscal policy measures can be taken, provided that there is scope in terms of public finances.[4] This approach was based on a belief that fiscal policy stimulus was inefficient and that there was a distrust of the political system's ability to rein in stimulus when it was no longer needed.

However, in recent years, many have begun to question this view:

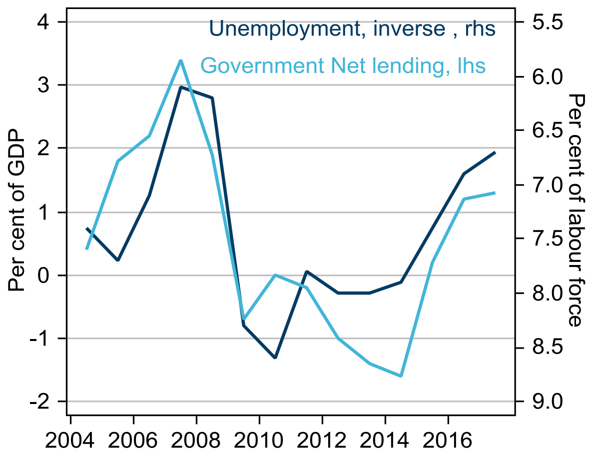
1. At present, the Riksbank's ability to pursue more expansive monetary policy is limited. Most analysts also agree that the natural interest rate has fallen globally, and many believe that it will remain low due to demographic trends and other structural factors, such as weak productivity. This means that the central bank's ability to stabilise the economy in a recession via monetary policy has weakened.

2. New research has shown that fiscal policy stimulus measures, such as more money to households and the municipal sector, have greater positive effects on growth and employment than the consensus understanding implied before the financial crisis. It has also been found that fiscal policy stimulus measures have a much greater positive effect on the economy in a low interest rate environment where key rates are close to their lower limit. It has also contributed to that the fiscal space to pursue an active fiscal policy has increased. Nowadays, there are even those who claim that a fiscal policy stabilisation package can be self-financing in some cases, as a result of the positive growth and inflation effects, meaning that government debt will not increase in the event of a more expansive fiscal policy.

Overall, a new view of fiscal policy has begun emerging, where institutions such as the IMF and OECD advocate fiscal policy taking more responsibility for stabilisation policies in today's low-interest rate environment.

However, a minority government will have trouble pursuing an effective stabilisation policy in the event of an economic downturn, in our view. If a recession occurs, the government must be able to act quickly and implement stabilisation policy measures that have substantial effects on employment and GDP for every krona invested. A minority government requires negotiations both within the government and with other parliamentary parties, which makes it difficult to act quickly. There will also be many compromises along the way, so it will be difficult to pass the stabilisation policy measures that are most effective. In conclusion, this means that the next economic downturn risks being deeper, and that the lasting effects (the persistence effects) of the recession will be greater.

Fiscal policy dampens cyclical fluctuations



Source: Macrobond

[4] Automatic stabilisers are fiscal policy's automatic reaction to the economic climate. In an economic downturn, tax revenues automatically decline and public expenditure on unemployment compensation rises without new decisions being made. In other words, a budget deficit arises without politicians making decisions on the matter, and this budget deficit automatically helps to counteract the economic downturn.

The fiscal policy framework

Today's fiscal policy framework emerged as a result of the severe government finance situation in the early 1990s. The framework is a tool meant to ensure that fiscal policy is sustainable and long-term. Some of these principles are regulated by law, and others by standard practices. Unless fiscal policy is sustainable in the long term, financial markets, households and companies will lose confidence in the public sector's ability to fulfil its commitments.

The **budget policy targets** for fiscal policy are a key part of the fiscal policy framework. These comprise a surplus target for the entire public sector, an expenditure cap for the government, requirements for the municipal sector to balance its budgets and to have a debt anchor.

In 2007, the parliament adopted a **surplus target** equivalent to financial cutbacks of an average of 1 percent of GDP over the course of an economic cycle. As of 2019, the surplus target will be lowered to 0.3 percent, following a cross-party agreement.

Under the new framework, which will apply as of 2019, a **debt anchor** has also been introduced. The debt anchor is a benchmark for how large the consolidated gross debt is to be on a medium-term horizon. The debt anchor is set at a gross debt for the public sector (the Maastricht debt) of 35 percent of GDP.

A **government spending cap** is the overarching restriction on the budget process. It sets the upper limit for government expenditure for the next three years. The spending cap stipulates, for example, the conditions for achieving the surplus target. The level of the spending cap is also to promote a preferred long-term trend for government expenditure. The spending cap, along with the surplus target, helps prevent a trend whereby taxes must gradually be raised due to inadequate spending controls.

Since 2000, the municipal sector has been subject to a **balance requirement**. Under the balance requirement, every municipality and county council must have a balanced budget, barring mitigating circumstances.

In addition to the national budget policy targets, Sweden, in its capacity as an EU member state, is subject to the rules of the Stability and Growth Pact. These rules comprise a corrective arm and a preventive arm.

The corrective arm stipulates limits that bar the public finance deficit from exceeding 3 percent of GDP and gross public debt from exceeding 60 percent of GDP.

The preventive arm of the pact is to ensure that member states pursue sound fiscal policy in the medium term, and to prevent excessive deficits in the public finances of member states. Each member state has a medium-term budgetary objective (MTO) for its structural cutbacks, i.e. for the public sector's economy adjusted financial cutbacks. Sweden's MTO is -1 percent of GDP.

Anders Bergvall, +46(0)87018378, anbe83@handelsbanken.se

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Macro Research and Trading Strategy

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Head of Macro Research and Trading Strategy & Chief Economist

Ann Öberg		+46 8 701 28 37
Lena Fahlen	Deputy Head	+46 8 701 83 29
Christina Nyman	Head of Forecasting	+46 8 701 51 58

Web Editor

Terese Loon	Editor	+46 8 701 28 72

Sweden

Helena Bornevall	Scenario Analysis and Senior Economist	+46 8 701 18 59
Johan Löf	Senior Economist, Sweden	+46 8 701 5093
Anders Bergvall	Senior Economist, Thematic Analysis and US	+46 8 701 8378

Finland

Tiina Helenius	Head, Macro Research	+358 10 444 2404
Janne Ronkanen	Senior Economist, Finland	+358 10 444 2403

Denmark

Jes Asmussen	Head, Macro Research, Denmark and Netherlands	+45 46 79 12 03
Rasmus Gudum-Sessingø	Senior Economist, Denmark and Eurozone	+45 46 79 16 19
Bjarke Roed-Frederiksen	Senior Economist, China and Latin America	+45 46 79 12 29

Norway

Kari Due-Andresen	Head, Macro Research, Norway, UK	+47 22 39 70 07
Nils Kristian Knudsen	Senior Strategist FX/FI	+47 22 82 30 10
Marius Gonsholt Hov	Senior Economist, Norway	+47 22 39 73 40
Halfdan Grangård	Senior Economist, Norway	+47 22 39 71 81

Trading Strategy

Claes Måhlén	Chief Strategist	+46 8 463 45 35
Martin Jansson	Senior Commodity Strategist	+46 8 461 23 43
Nils Kristian Knudsen	Senior Strategist FX/FI	+47 22 82 30 10
Lars Henriksson	Strategist FX	+46 8 463 45 18
Kiran Sakira	Junior Strategist	+46 8 701 46 14

Debt Capital Markets

Tony Lindlöf	Head of Debt Capital Markets	+46 8 701 25 10
Per Eldestrand	Head of Debt Capital Markets Sweden	+46 8 701 22 03
Måns Niklasson	Head of Corporate Loans and Acquisition Finance	+46 8 701 52 84
Thomas Grandin	Head of Corporate Bonds	+46 8 463 45 83

Sales

Fixed Income Sales

Henrik Franzén +46 8 701 11 41

Corporate Sales

Bo Fredriksson +46 8 701 345 31

FX Sales

Håkan Larsson +46 8 701 345 19

Syndication

Thomas Grandin +46 8 701 345 83

Regional sales

Copenhagen

Kristian Nielsen +45 46 79 12 69

Gothenburg

Björn Torsteinsrud +46 31 774 83 39

Gävle

Petter Holm +46 26 172 103

Helsinki

Mika Rämänen +358 10 444 62 20

Linköping

Fredrik Lundgren +46 13 28 91 10

London

Tolga Kulahcigil +44 207 578 86 12

Luleå/Umeå

Ove Larsson +46 90 154 719

Luxembourg

Snorre Tysland +352 274 868 251

Malmö

Fredrik Lundgren +46 40 243 900

Oslo

Petter Fjellheim +47 22 82 30 29

Stockholm

Malin Nilén +46 8 701 27 70

Toll-free numbers	From Sweden to N.Y. & Singapore	From Norway to N.Y. & Singapore	From Denmark to N.Y. & Singapore	From Finland to N.Y. & Singapore	Within the US
	020-58 64 46	800 40 333	8001 72 02	0800 91 11 00	1-800 396-2758

Svenska Handelsbanken AB (publ)

Stockholm
Blasieholmstorg 11
SE-106 70 Stockholm
Tel. +46 8 701 10 00
Fax. +46 8 611 11 80

Copenhagen
Havneholmen 29
DK-1561 Copenhagen V
Tel. +45 46 79 12 00
Fax. +45 46 79 15 52

Helsinki
Itämerenkatu 11-13
FI-00180 Helsinki
Tel. +358 10 444 11
Fax. +358 10 444 2578

Oslo
Tjuvholmen allé 11
Postboks 1249 Vika
NO-0110 Oslo
Tel. +47 22 39 70 00
Fax. +47 22 39 71 60

London
3 Thomas More Square
London GB-E1W 1WY
Tel. +44 207 578 8668
Fax. +44 207 578 8090

New York
Handelsbanken Markets Securities, Inc.
875 Third Avenue, 4th Floor
New York, NY 10022-7218
Tel. +1 212 326 5153
Fax. +1 212 326 2730
FINRA, SIPC