INTERNATIONAL MONETARY FUND

Sweden

Concluding Statement of the 2012 Article IV Consultation Mission

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After many years of success, the outlook for growth is clouded

1. Sweden has long secured strong growth, low inflation and government bond yields, declining trend unemployment and government debt, rising incomes, and strong current account and net foreign asset positions. These are the result of robust policy frameworks and sustained reform initiatives.

2. But the outlook now is closely tied to that of Europe given that the economy is very open and that two thirds of exports go to Europe, as does much of the financial sector's external lending.

3. Recent developments underscore these European spillovers. Sweden's V-shaped passage through the Great Recession reflected international trends alongside the decisive domestic policy response—with Swedish output at end 2011 up some 10 percent from its trough. But as elsewhere in Europe, stresses in the banking system have risen since Fall 2011 and growth momentum has weakened, led down by exports. And though the kronor is competitive now, it remains on an appreciating trend which, if continued, would compound the drag on growth.

4. Policies have responded well to this cycle. Monetary and fiscal policies tightened appropriately as output recovered in 2010-11, with both easing as momentum softened in late 2011. And on the structural side, various actions, including further reductions in the income tax wedge, were launched in support of employment.

5. Nonetheless, weak demand for exports is likely to continue. So we project GDP growth of 0-1 percent in 2012 with activity regaining steam from mid-year. But near- and medium-term downside risks to these projections are significant, reflecting European fragilities.

Policies are now set to address near-term weakness and downside tail risks

6. In particular, the government budget remains firmly guided by its medium-term rules, thereby allowing an appropriate and modest rise in the deficit for 2012 to reflect the effect of the economic cycle on revenue. And with medium-term inflation expectations anchored at

the target, the monetary policy stance remains accommodative with the policy rate negative in real terms. Both fiscal and monetary policy instruments have room to make decisive adjustments should tail risks materialize, and, in the financial sector, various steps have been taken to bolster financial market resilience, with more underway.

But the challenges are extensive

On the financial stability side

7. Though direct exposures to strained Euro Area economies are negligible and risk-weighted capital is high, the financial system is large (some 5½ times GDP), and the banking system is directly exposed to many other European economies, is highly concentrated, with low raw capital ratios, and is heavily reliant on wholesale funding, including in U.S. dollars. Furthermore, various financial fragilities are apparent, including household debt at 170 percent of disposable income, a soft housing market, a high share of interest-only mortgages, and high debt-to-income ratios in some recent credits. Alongside, young and vulnerable debtors' income security—and so debt payment capacity—has been eroded in recent years by curbs to welfare insurance and the shift towards less secure employment contracts.

8. While standard financial sector stress tests reassure, shocks could go well beyond the range of historical experience that is reflected in those tests—and beyond the ranges likely to be typical of European economies.

9. In this light, the EU-wide banking regulations under the Fourth Capital Requirements Directive, which are now being finalized, will have a major impact on Sweden. In the single market context, a common floor is essential to prevent regulatory competition and to ease compliance burdens. But the variety of risks across European financial systems and the absence of a common European banking backstop argue for broad flexibility for national regulators to implement country-specific macroprudential policies above agreed floors—including in the case of Sweden.

10. So the Swedish authorities rightly see need for further substantive steps, in some cases beyond proposed European floors, to bolster financial sector resilience to tail risks. Common equity Tier 1 capital requirements for the four major banks will rise to 10 percent from 2013, and to 12 percent from 2015, augmented by needed increases in risk weights for mortgages. These steps are rightly proposed as "Pillar 1" rather than as less transparent and robust "Pillar 2" rules. Liquidity reporting has been introduced, with plans underway to strengthen liquidity requirements in 2013, including by currency. And supervisory resources, focus, and arrangements for coordination amongst the authorities have been substantially upgraded—with more to come on all these fronts. The practice of extensive prior

consultation and coordination with European partners should continue, especially when plans to exceed European regulatory floors are under consideration.

11. But alongside there is considerably more to be done. Additional steps include ensuring that supervisors are able to make effective use of "Pillar 2", and securing an appropriate application of the additional regulatory resources that have been provided. Other necessary steps include strengthening early intervention and resolution powers of the supervisors, assessments (as for capital) of the adequacy of international liquidity standards for Sweden, extension of resolution planning to all major banks, and deepening regional supervisory coordination and crisis management under the Nordic-Baltic arrangements. Establishment of a macroprudential authority is under consideration by the Franzén Committee. It will be key to have a clear stability mandate, decision-making structure, tools, accountability—all respecting the independence of the Riksbank and bank supervisors.

On the fiscal side

12. The modest anticipated additional slack in the economy, strong access to market financing, and the credibility of the medium-term fiscal rules framework call for and allow for the automatic stabilizers to operate unimpeded. And given tail risk of large jumps in public debt (as recently occurred elsewhere), this budget stance also retains appropriately large fiscal buffers. It thereby retains scope to adjust the underlying fiscal trajectory to support the economy if European tail risks materialize.

13. In this context, both the modest relaxation of the fiscal deficit in 2012 which leaves public debt on a downward trajectory, and the framework of rules targeting 1 percent of GDP surplus over the cycle and nominal expenditure ceilings are appropriate. We project the budget to deliver a small headline deficit in 2012, implying a modest structural stimulus, followed by a consolidation thereafter as revenues recover and as expenditures remain guided by the nominal spending ceilings.

14. In this context, the tax structure could be more "growth friendly". In particular, reduced tax expenditures, and better-targeting of tax and expenditure measures, including to support employment of vulnerable groups, are recommended. This could include reducing the number of VAT rates and strengthening the "in work" tax credit and raising threshold for state income tax as part of efforts to reduce the overall tax wedge.

15. Given tail risks in Europe actions to bolster further the Fiscal Policy Council—notably by further increasing its resources and its focus on sustainability—would reinforce the credibility of the fiscal framework.

On the monetary side

16. The Riksbank has set the repo rate appropriately at 1½ percent given the benign inflation outlook, modest cost pressures, and a temporary slowdown in demand. Monetary policy should continue to be set according to the baseline scenario—offsetting any drag on activity emanating from prudential actions while slack in the economy remains. This focus on the central case is appropriate because the stance of policy can be adjusted rapidly if tail risks are realized, particularly given the likely depreciation of the kronor in those circumstances. Macro prudential instruments should be deployed further if the housing market reflates once again.

17. The monetary and free floating exchange rate frameworks remain credible, as indicated by inflation expectations and recent reviews. However, given persistent deviations of market forward rates from the projected official rate, the Riksbank could also start publishing macroeconomic forecasts conditioned on market implied domestic and foreign forward rates, and keep the commitment to publish its expected policy rate path under review. Alongside, and in the context of initiatives to establish a macroprudential council, consensus on the mandate of the Riksbank with regard to asset prices and financial stability should be sought. And the Riksbank should raise its research efforts further in the area of equilibrium unemployment, including analysis of its composition, and of macrofinancial linkages as key inputs into policy rates setting.

And on structural reforms

18. With the international outlook clouded, further progress in structural reforms is recommended. In particular, with labor market entrants particularly exposed to European tail risks, steps being actively considered by the social partners to increase the accommodation of new entrants in employment contract structures are strongly supported. And in the housing sector, deregulation of rental market could reduce shortages and improve employment prospects, notably in the main cities.