International Monetary Fund

Sweden—2003 Article IV Consultation

Concluding Statement

May 15, 2003

1. **The Swedish economy was able to ride out the global slowdown in 2002 with relative ease, managing to comfortably outpace growth in the euro area.** This resilience in the face of a continuing slump in the telecom sector was made possible by a strong stimulus from fiscal policy and substantial support from external trade, sustained in part by the weak krona. While the well-designed fiscal and monetary frameworks continued to ensure policy credibility, the exceptional strength of public finances built up over the boom years enabled the authorities to implement the third consecutive step of income tax reduction, helping to dampen the downturn. Looking ahead, as the room for policy maneuver shrinks rapidly in the face of slower growth, the challenge facing the authorities will be to preserve the credibility of the fiscal policy framework. Over the medium term, a renewed focus on streamlining the social insurance regime and enhancing effective labor supply is also necessary to ensure sustainable growth.

2. **On the backdrop of fragile prospects for a robust global recovery, Sweden faces subdued economic growth and rising unemployment in the near term.** The external sector is expected to contribute little, if anything, to growth in 2003 as weak external demand holds back exports, and imports recover from recent unusually depressed levels. Public consumption is projected to slow sharply after the high growth of last year, and an upturn in business investment will be hampered by the continued weakness of the telecom sector. With high house prices and low interest burden providing ample support to household financial

positions despite losses in stock market wealth, and the sharp rise in household saving rate over the past two years, private consumption is likely to hold up well, barring any unexpected shocks to confidence. All in all, economic growth is likely to remain significantly below potential, with continued unutilized resources.

3. **The inflation targeting framework has gained considerable credibility in recent years.** The Riksbank's clear and transparent communication of its inflation forecast and policy reaction has increasingly guided expectations, thereby providing a strong anchor to wage formation. Over the past year, monetary policy has responded with agility to changes in economic conditions and assessment of inflation prospects. After tightening in the first part of 2002, the Riksbank appropriately switched course as the global outlook worsened towards year end and as disappointing growth prospects in the euro area and increasing geopolitical uncertainties led to a reassessment of the inflation outlook in early 2003.

4. **With the medium-term inflation forecast below target, some room for additional monetary easing is emerging.** Most indicators of resource constraints point to slack in the economy: low consumer confidence; unutilized capacity; weak manufacturing growth; low or declining growth rates of money, credit, and asset prices; subdued economic projections; and low inflation rates excluding energy prices. The temporary rise in headline inflation above the target is due primarily to an increase in the price of electricity, which is expected to come down quickly. Wage demands in the autumn bargaining round are expected to be moderate, given a projected pickup in unemployment this year and the prospect that strong monetary policy credibility would prevent the temporary rise in inflation from feeding into expectations. Therefore, we see room for additional monetary easing over coming months,

especially if the global outlook continues to weaken. However, if the current labor unrest in the local government sector were to trigger high wage demands in the autumn wage round, monetary policy would be left with very little room to respond to a deterioration in the economic outlook.

5. **The financial system remains fundamentally sound**. Despite a decline in profitability and a marginal increase in loan losses, bank profitability and capital adequacy remain at sound levels. Although the recent decline of commercial property prices has reduced bank loan collateral values, and depressed equity prices have adversely affected the balance sheets of pension institutions and insurance companies, risks in the financial sector remain limited. Household indebtedness has risen, but its impact on credit risk has been mitigated by low interest expenses and higher home values. The high level of house prices appears to have been driven by growth in disposable income, low interest costs, and sluggish construction. While credit risks have been well contained, those associated with a significant decline in property values or a rise in unemployment bear continued monitoring. The authorities have taken welcome steps to improve the settlement system, to clarify the division of responsibilities between supervisory institutions, and to meet the Basle II requirements and new EU directives.

6. **In the event of a decision to join the EMU, Sweden's sound macroeconomic fundamentals position it well for a smooth transition.** Public finances are fully consistent with entry requirements, and indeed, are on a firmer footing than in many euro area countries. Strong automatic fiscal stabilizers should be sufficient to enable adjustment to most negative shocks, without additional fiscal stabilization instruments or a higher fiscal

surplus target. The government's decision not to adopt the proposal for a buffer fund is therefore appropriate. Moreover, Sweden's competitive position has strengthened following several years of high productivity growth and moderate wage increases, helping keep unemployment low and underpinning export growth despite the decline in the telecom sector. Indeed, sizeable current account surpluses would be expected in the medium term even if the real exchange rate were to appreciate moderately. Low inflation is also in line with criteria for EMU entry and would facilitate smooth monetary management during a potential transition period.

7. **The marked deterioration in the public finances in 2002 reflected the cyclical slowdown, but also in no small measure, a continued ratcheting up of public spending.** While the cut in income taxes was in line with the authorities' commitment under the four-step program of tax cuts, an important reason for the sharp fall in the structural surplus of the general government was a rise in discretionary spending. Indeed, expenditure growth has accelerated significantly in recent years. Primary expenditure (excluding interest payments) as a proportion of GDP is estimated to rise by at least as much as the size of the tax cuts in the three years to 2003, even while some cyclical spending declines. Much of this increase is taking the form of higher local government spending, and to a lesser extent, higher payments for sickness leave. Indeed, the path of primary spending has shifted up in each new budget bill since autumn 2000.

8. **The trend of higher public spending has stalled the long-overdue process of lowering Sweden's high tax burden.** The fourth and final stage of the income tax reform has been delayed on concerns over the impact of the economic slowdown on the fiscal

position. However, the 2003 budget contained measures that would raise the expenditure ratio by about the cost of the final stage of the income tax reduction. Moreover, the local authorities have resorted to raising tax rates to finance their rising expenditures, lifting the tax burden by almost ½ percent of GDP this year. With unabated pressures on local spending—evident in the ongoing strike by municipal employees seeking higher wages—it is likely that local governments will resort to more tax increases. Such a response undercuts the central government's steps to lower income taxation. As demographic forces increase pressures on age-related spending over the coming years, the prospect of a reduction in the tax burden is becoming increasingly illusive. Indeed, there is a risk of a steadily rising tax burden, with all its attendant efficiency costs.

9. **A reform of the local government financing arrangements may be needed to ensure a coherent fiscal framework**. Given the large size of the local government sector and the balanced budget rule, the cyclicality of local government revenue sources risks undermining the objectives of the overall fiscal framework. The local governments were able to use the revenue boom of recent years to raise expenditure without being constrained by their balanced budget rule. Such increases in spending are difficult to reverse as revenue growth slows, prompting a general upward trend in tax burden. Moreover, such public policy responses risk leading to a procyclical fiscal policy behavior, similar to that observed in parts of the euro area. Therefore, it is essential to restructure the local government tax base to reduce its current sensitivity to the economic cycle, as noted by the Committee on Stabilization Policy in the EMU. The revenue sharing arrangements among local governments also put upward pressure on the size of government in the economy through their perverse incentive effects. The benefits of broadening the tax base are mostly dissipated

to other regions, while higher revenues obtained by raising tax rates are kept locally. Reform of the revenue equalization scheme is becoming imperative to provide incentives to maintain the quality of services, which will be all the more important through the upcoming demographic transition.

10. **The credibility of the expenditure ceilings should be preserved.** The ceilings have restrained spending growth and contributed to healthier public finances. However, some expenditure has been shifted between years and the government is making increasing use of tax expenditures to provide subsidies to local governments. Even with the expenditure cuts in 2003 and 2004 announced in the recent Spring budget, the risk is high that expenditure will exceed the ceiling. Maintaining the ceilings depends on the authorities' ambitious goal of significant savings in sick leave expenses. The proposals in the Spring budget, such as marginally reducing the generosity of the sickness benefit and restricting the unemployed from receiving higher benefits when they become sick, are necessary and welcome. However, these measures are unlikely to be sufficient to curtail the steep rise in sickness payments. Stronger measures to affect incentives may be called for, such as significantly reducing the replacement ratio and shifting a portion of the cost of long-term sick leave to the employer.

11. **The design of the expenditure ceilings within the fiscal framework could be improved.** Some complacency has crept in, as cyclical margins under the ceilings have repeatedly been used up by discretionary spending increases. Moreover, the ceilings have yet to be tested in a serious downturn. The decision to postpone setting a ceiling for 2005 until the autumn budget is also unhelpful. Going forward, margins under the ceiling should only

be used for cyclical spending. In addition, expenditure ceilings should be linked explicitly to the surplus target and a consistent fiscal strategy incorporating spending and tax plans should be devised to ensure that the surplus target remains credible.

12. **The recent strains on public finances have brought into sharp relief the urgency of renewed efforts to streamline the generous welfare state.** Over the medium and longer term, demographic pressures will intensify age-related spending and make it impossible to meet the rising demands for public services without straining the framework of fiscal rules to a breaking point. Already, pressures to increase wages in some areas of the public sector are starting to test the fiscal framework. Ultimately, a choice needs to be made between generous social insurance benefits and provision of adequate public services, if the tax burden is not to be raised to unsustainable levels. Indeed, growing international mobility of tax bases and the imperatives of efficiency and growth may well require a reduction in the tax burden. An early commitment to trim back the generous welfare provisions to strengthen incentives would help avoid future strains on the fiscal framework.

13. **The current policy setup discourages work effort in the short run and risks lowering further the effective supply of labor in the long run.** In particular, the high level of taxation on labor income and the high replacement ratios for social benefits discourage labor force participation and work effort. Similar disincentive effects flow from the generosity of the sickness and early retirement schemes, while the compressed wage structure serves to discourage acquisition of skills. In addition, the revenue sharing arrangements among the local authorities inhibit local efforts to foster growth of incomes,

and the heavily regulated housing market hinders labor mobility. A concerted effort to address these issues is necessary to raise sustainable long-term growth.

14. **Strengthening competition and opening up markets would help enhance economic growth.** Despite the progress made since participation in the EU internal market, significant barriers to competition remain in areas like pharmaceuticals, retail trade, and construction. Recent steps to strengthen the Competition Authority and improve efficiency in public procurement are welcome. However, measures to encourage competition and liberalize the housing market should be accelerated. On the international front, Sweden's efforts to champion more open trade policies aptly complement its generous development assistance.