

International Monetary Fund
Sweden—2008 Article IV Consultation

Concluding Statement

June 2, 2008

1. **The Swedish economy is performing well...** Output and employment growth have been high, inflation has been moderate, the financial system is functioning well, public finances are solid, and the external position is favorable. Further, Sweden has addressed demographic challenges with pension reform, and now with labor supply measures.
2. **...and the future holds promise, subject to risk management.**
 - Now is the time to strengthen financial system resilience, before risks rise further.
 - Inflation is ticking up, and monetary policy needs to be firm.
 - Some risks in the public finances warrant monitoring.

Background and Outlook

3. **Economic developments could be seen as reflecting two cycles.** First, Sweden is completing a long-term structural recovery that followed the deep recession in the early 1990s. This recovery was exemplified by the steady, large increase in domestic saving in the public and private sectors, stepped up investment that boosted labor productivity, and moderate wage setting that raised employment and cut unemployment. Second, the economy has been influenced by the much shorter, regular business cycle of recent strong world demand that produced some capacity constraints. Riding out these two cycles, the economy is now easing to potential output growth. Looking forward, and pitching softer external growth against fully recovered internal balances, domestic demand is likely to take over supporting growth, with the external surplus declining.
4. **As a very open economy, Sweden is feeling the effects of the global slowdown.** The contribution from net exports can be expected to turn negative. At the same time, while Sweden has not had direct exposure to U.S. subprime paper or related derivatives in its banking system, funding costs have increased with markets repricing risk. In this context, households have pulled back a bit as short-run confidence has declined (more so than for business firms). Durables purchases have eased, and house prices are stabilizing after years of high growth.
5. **GDP growth is likely to slow to 2 percent in 2008, and slightly lower in 2009 but with a clear recovery by that year's-end.** The Swedish labor market continues to show good results (reacting with delay to the cycle) with employment growth around 2 percent and unemployment at 6 percent. This reflects both cyclical momentum and benefits from the labor supply reforms. The timing of the labor supply measures could not have been better,

benefiting from the strong cycle and capacity tightening. Indeed, wages have risen slightly less than expected. Going forward, unemployment is likely to rise, but not to the high rates seen in the past. Inflation, however, should be watched, because imported prices and inflation expectations are rising.

Financial sector policies

6. **Linkages between the financial system and the real economy are gaining importance, including in Sweden.** The recent financial turbulence has shown that markets can react to dents in confidence with high speed, thereby increasing credit costs and pinching off growth. This adds a premium to sound bank management, supervision, and regulation. Here too, Sweden has made great strides—with four large banks emerging from the crisis of the early 1990s to become dominant players in the Swedish market, while diversifying their services abroad in Scandinavian and Baltic neighbors and beyond. Swedish banks are exploring their growth possibilities through further foreign diversification. These strategies offer opportunities, but also require tight risk management to minimize contingent claims on Swedish and foreign tax payers.

7. **Banks have done well.** Profitability has been booming, and impaired loans and corresponding provisions have drifted down to very low levels, with some uptick recently. Banks now expect to free up some capital, implying higher unweighted leverage ratios, under the Basel II capital adequacy framework, given their high share of mortgage lending that tends to have low risk-weighting.

8. **However, market signals are indicating increasing risks.** Stock prices have dropped, while credit default swap spreads have increased, particularly for banks most active in the Baltic economies. Rating agencies, the Riksbank, and the FSA are confident that banks are able to cope with adverse events, as shown in stress testing and banks' own internal risk models. Nevertheless, as illustrated during the recent financial turmoil, increased interconnectedness in the financial system can greatly accentuate the impact of shocks. With the banks' strong current position, this is an excellent time to bolster resilience and cement the ability of supervisors to deal with bank stress, should it come.

9. **Sweden needs a dedicated remedial and resolution framework for banks.** The special provisions that were used to manage the banking crisis in the early 1990s are no longer in place. Sweden should not expect to manage any comparable stress the same way it did in the early 1990s. Markets are faster now, banks are larger, and regional cross-border dimensions add layers of complexity. The Ministry of Finance has been working for some time on a draft law that formalizes the resolution framework. This effort should be completed soon, and the mission recommends including the following principles:

- The FSA needs the authority and the tools to implement strict prudential measures in a coherent, comprehensive, step-by-step, graduated framework. It should range from provisions for special consultations for early assessment of stress, to firmer measures in a remedial context, and all the way to decisive measures for bank resolution.

- It needs to be based on written code that defers to specialized courts to ensure timeliness of judicial oversight, while preventing appeals from blocking the implementation of supervisory decisions.
 - It should include *all* banks, not just those deemed systemically important. Special treatment for systemic banks could accentuate moral hazard and add legal complexity.
 - Immediately after a bank license is revoked, relevant authorities should have the ability to take effective control, replace its management, and trigger the deposit guarantee. The authorities should have a wide range of tools to wind up a failing institution, from the partial sale of its assets to arranging its acquisition or merger with another bank.
 - The owners of a failing bank should take the first hit. To minimize the cost to society, authorities should have the legal option to redeem the shares of a failing institution at a price corresponding to its value in the absence of any state aid.
 - Legislation needs to prescribe a clear and credible priority of claims in bank liabilities, with potential losses for some creditors to mitigate bank excessive risk taking.
- The mission is mindful that such legislation requires close technical and legal scrutiny, but further delays would increase Sweden's vulnerability to risk.

Exchange rate analysis

10. **The krona is freely floating with its value determined daily by market demand and supply.** The current position of the krona provides Sweden with excellent external competitiveness. The mission expects the krona to appreciate gradually over the medium term, and the current account surplus to ease down as the domestic saving-investment balance gravitates to a longer-term equilibrium. A slightly firmer krona would assist, in the margin, to lean against the wind of foreign price increases.

Monetary policy

11. **The inflation targeting framework is working well.** Nevertheless, with the jump in energy and food prices, inflation has risen above the upper limit of the band, and indicators of core inflation and inflation expectations are picking up. The policy rate has recently been taken up to its approximate long-run neutral level of 4.25 percent. Moderating growth should limit future price increases, but short-term pressures should not be allowed to seep into second-round effects.

12. **Monetary policy needs to be on hold with an upward bias.** The repo rate should only ease if inflation expectations clearly break and broad indicators of capacity use and economic activity trend down. The future monetary stance will need to be firmer, on average, than over the past six years, including because the important foreign supply shock (the "China sale") now appears over.

Fiscal policies

13. **2007 yielded an impressive fiscal performance.** While the year started with concerns that the income tax cuts could be procyclical, the authorities combined them with expenditure containment that, ultimately, proved very successful and produced a substantial countercyclical net result. For 2008, the authorities are on track to produce another sound overall fiscal surplus, with an approximately neutral fiscal impulse. The outlook for 2009 through 2011 continues to be favorable, especially in the official projections that assume some constant nominal appropriations (e.g. transfers to local communities and subindexing of government consumption). These assumptions may yield too flattering a result and could be adapted to more neutral guidance. Nevertheless, fiscal policy is in good shape.

14. **Underlying public finances are also strong.** The *structural* fiscal balance is projected to remain well above the rule of 1 percent surplus over the cycle. With the economy likely dipping below potential next year, the mission therefore supports reforms in the 2009 budget to cut taxes further (e.g. with a shift up in the income tax threshold or a small cut in the 20 percentage points jump in the top marginal income tax rate), in combination with investments in infrastructure, R&D, and pre-schooling, as is now widely expected. These steps should be designed to strengthen long-run supply conditions further.

15. **The government should aim to include an intertemporal public sector balance sheet in the Budget Bills, updated on an annual basis.** Sweden's demographic profile and aging costs appear modest in comparison with other high-income countries, and it may even be satisfying its long-run intertemporal budget constraint of positive net worth—few countries in the world have such an enviable position. Such a balance sheet would provide additional transparency into the fiscal position and government forward-looking strategy, thereby enriching the public debate about options for the future. The balance sheet should include some alternative scenarios on long-run productivity and potential growth and alternative aging cost estimates. An independent body could prepare alternative estimates of aging costs, as these are key parameters driving the long-run outlook.

16. **The authorities continue to pursue an ambitious structural reform program to increase employment.** The mission supports the thrust of these measures:

- *The earned income deduction.* This measure has removed key distortions in the marginal tax schedule. Some of this benefit may be offset by income effects that vary along the income distribution. The mission appreciates that this involves careful compromises in view of the unusual hump-shaped income dependent standard deduction—a feature unique to Sweden. Going forward, it would be important to limit distortions as much as possible to benefit transparency in the tax system and reduce compliance costs.
- *Narrowly targeted incentive programs.* The mission cautions against further multiplication of narrowly targeted incentive programs. The first round effects on the public finances of the targeted incentive programs (sickness benefits, unemployment insurance, new-start jobs, step-in jobs, employment related cuts in social security contributions for special age groups, etc.) have provided ample net savings for the central government. Over time, there may be some netting out as agents adapt their behavior or as some displacement occurs to other programs and levels of government. If the economy stays strong, this effect

could be limited. Moreover, the combined use of targeted and broad-based measures can lead to complicated tax and benefit system interactions that subtract from transparency. The mission welcomes the evaluations of labor supply and demand measures by the authorities and stakeholders. Careful monitoring remains warranted to track their impact on employment, hours worked, and different levels of government budgets.

17. **The authorities should remain vigilant to some risks in the sound fiscal outlook:**

- The costs of an earned income deduction is difficult to estimate.
- The subsidy for household services could turn out more costly than expected.
- Pressures could build for unproductive spending.
- Some erosion of the fiscal balance could take place if the strong impact effect of the targeted measures sees some attrition, and
- An economic downturn, coupled with a slowdown in banking profits, perhaps combined with an increased need for provisioning (dependent on what happens in financial markets and the Baltics), could lead to unexpected losses in fiscal revenue.

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