INTERNATIONAL MONETARY FUND

SWEDEN

Concluding Statement of the Article IV Consultation Mission

May 30, 2011

Sweden has rebounded decisively from recession

1. In 2010, output rose 5¾ percent, with personal consumption, exports, and house prices all up. This momentum has been maintained into 2011. Unemployment is down from its mid-crisis peak, and core inflation has remained close to target throughout. Financial sector strains, largely imported in 2008-09, have been contained, bank capital and liquidity have strengthened, and most emergency stabilization measures have been withdrawn. With over-observance of the fiscal rules, the modest government budget deficit in 2010 is now heading decisively back to its customary surplus and public debt remains some 40 percent of GDP and on a downward trajectory. Alongside, a cautious monetary tightening cycle is under way, together with new loan-to-value regulations on mortgages to cool housing. And the krona remains competitive, albeit well up from its mid-crisis lows.

2. Accordingly, Sweden's exit from the global crisis has been uniquely successful compared to others in the European Union.

This reflects strong global and domestic policies

3. With the collapse in global demand for investment goods, inventories, and primary products after Fall 2008, Sweden was hit hard. Exports and fixed investment fell by one fifth peak-to-trough, output fell over 7½ percent and the output gap widened to 6 percent, domestic money markets seized up, and banking stability came into question.

4. Alongside the global turnaround, the response of firms, labor, the authorities, and banks quickly put matters right. Output, exports, productivity, and the krona began to recover as early as Q2 2009, and employment—both temporary and permanent—began to rise from Q4 2009, with credit growth to households buoyant and inflationary pressures moderate throughout. Capacity utilization is back to its long term average and the output gap in 2010 overall is estimated to have fallen to around 3 percent of GDP.

5. The laggards in recovery are long-term and youth unemployment, and fixed investment—which, although rising again, is still below 2006-08 levels relative to output. And there are concerns that although house prices have recently dipped, they may still be overvalued.

The challenge now is to sustain this success

6. While global growth is set to slow somewhat in 2011–12 after the 2010 rebound, confidence intervals around the central projections have narrowed. Given announced policy settings, this is projected to yield economic growth in Sweden somewhat below the rate achieved in 2010.

7. But were tail risks in the euro area periphery to spread to the core, euro area growth could be severely affected. And even if not, Swedish house prices appear overvalued with enduring price falls likely.

8. Policy therefore has to strike various balances: not to tighten too aggressively given remaining excess capacity; not to tighten too gradually given external and domestic buoyancy; to head off any latent macrofinancial risks, notably in the domestic housing market; and to anticipate external tail risks.

9. This will require continued close coordination of policies over the short- and medium-terms:

- Given that Sweden’s sovereign credentials are firm, fiscal policy has the latitude to continue to support output in the short term as the output gap closes. Large automatic stabilizers provide symmetric insurance against surprises in the size of the output gap. But external tail risks call for the maintenance of sizeable buffers relative to the fiscal rules.

- In that context, monetary policy rates should continue to rise steadily given that the krona is still competitive and housing richly valued. Their anticipated trajectory should be adjusted in response to surprises in the outlook for core inflation. Additional macroprudential measures should be considered alongside if house prices resume an upward trajectory.

- Over the medium term, further efforts by the government, employers, and employees are needed to drive unemployment down to 5 percent on a sustained basis.

- Though the assessment by IMF staff conducted under the Financial Sector Assessment Program (FSAP) finds the financial sector to be robust to large housing shocks, resilience to external tail risks requires decisive further steps to strengthen banking stability.

The underlying fiscal stance should remain unchanged in 2011-12

10. Sovereign strength—rooted in Sweden's strong fiscal reform record and commitment to medium-term rules—establishes that active fiscal policy is feasible. Given the remaining output gap and with the structural balance in 2010 considerably stronger than required to meet those medium-term targets, there is a case to maintain a neutral stance in 2011-12, notwithstanding buoyant growth.

11. But maintenance of strong buffers relative to the rules—reflected most clearly in the sustained and marked downward trajectory of public debt—is essential given elevated external tail risks.

12. The 2011 budget is welcome because it delivers both goals. It broadly maintains the structural balance from 2010—a neutral stance despite buoyant growth. And it increases buffers relative to the medium-term framework goals by increasing the "safety margins" between the spending ceilings and appropriated spending, and by postponing planned tax reductions to 2012.

13. This underlying budget stance should remain for 2012, and for the same reasons. This will be reflected in larger headline budget surpluses. Only in the unlikely event that significant sustained krona overvaluation occurs would there be need to shift the underlying stance for 2012 to a tightening.

14. With the underlying fiscal stance unchanged, a mix of expenditure and tax initiatives will be feasible in 2012. Of the latter under consideration, we recommend emphasis on the steps to strengthen labor market performance—expansion of the earned income tax credit—rather than the adjustments to the VAT structure. Additional infrastructure investment—in particular to improve the transport infrastructure—could also be given consideration.

15. Alongside, the Fiscal Policy Council remains a key element of the fiscal framework. To build on its successes and in formal recognition of its watchdog role, we suggest that it could be made directly accountable to Parliament, that its resourcing should be enhanced, and that, building on the recent review by the authorities, its mandate could be even more narrowly focused on medium-term fiscal sustainability.

The monetary stance should continue to tighten in 2011 as indicated

16. Inflation has been remarkably well managed during the global crisis. It steered well clear of deflation during the downturn, and thus far it remains contained in the upswing, despite surging global commodity prices.

17. But with the output gap closing quickly and real policy rates still negative, the case to continue with gradual tightening is persuasive, on balance. The Riksbank anticipates further

quarterly 25bp rate increases into 2013. Markets have priced in this expectation over coming quarters.

18. If assessments of the output gap, wage developments, and commodity and house prices signal renewed inflationary pressures, the policy rate should be raised more rapidly than indicated.

19. But if the krona continues to appreciate strongly, then the path for the policy rate rises may need to be delayed to offset its disinflationary effects.

20. The free floating exchange rate regime Sweden maintains, has clearly served well during the global crisis, and appropriately will be retained. International reserves are sufficient to address risks. But given Euro Area strains, this judgment should remain under active review.

Sustained falls in unemployment remain a priority

21. The ambition to lower equilibrium unemployment to 5 percent is appropriate. Measures already taken, including tax and benefit reforms, set Sweden on this path.

22. In this context, moderate settlements in the 2011-12 wage round—in the neighborhood of 3 percent—will be key. As part of this, we urge employers and employees in the 2011-12 wage round to make significant permanent concessionary arrangements for labor market entrants in the negotiated wage agreements.

23. But even further actions will likely be necessary over the medium term—notably payroll and further income tax reductions, and education reforms. Additional liberalization of housing rent controls, as recommended by the OECD, could make a further important contribution by easing labor market rigidities.

External fragilities underscore need for further progress on financial stability

24. The financial system is over 5 times GDP, concentrated, and significantly short term funded. Given risks in the Euro area and housing, further progress to secure financial stability, including strengthened diagnostic data and inter-agency coordination is essential. This will also underpin the long run solvency of the Swedish sovereign.

25. In that regard, the FSAP assessment provided initial reassurance on credit risks. But it would be important to confirm that the debt service patterns by more recent generations of house buyers continue to adhere to the standards maintained by their forebears. Thus the mission urges the authorities to collect historical data on mortgage service by vintage of house purchase, and to use it to inform adjustments to capital risk weights and the

specification of technical parameters used in stress tests. This dataset should be maintained on an ongoing basis.

26. But, in the event of a housing resurgence, further actions will be needed to ensure that these credit risks do not deteriorate. Lower mortgage interest deductions, loan-to-value ratios, introduction of debt-to-income caps, and adjustments to capital risk weights will be amongst the options to be considered in this context.

27. Furthermore, given the unique characteristics and risks of the Swedish financial system, the mission strongly endorses the authorities' intention to go further and faster than Basel III regulations, and notes their efforts to reflect this in EU legislation. With bank capital already strong relative to ultimate Basel III goals, there is no need for the phase-in period. Alongside, following the recent strengthening of monitoring of liquidity, the mission encourages the early introduction of strong liquidity regulations, taking particular account of risks in foreign currencies. We also support systemic capital and liquidity surcharges to internalize risks posed to the system. Effects on credit growth from all these actions should be factored in to decisions on the policy rate.

28. The FSAP also recommended a number of institutional reforms: reviewing options to merge the stability and deposit insurance funds; introducing a special bank resolution framework; and establishing a Systemic Financial Stability Council of all key macroprudential institutions to strengthen coordination. The mission welcomes establishment of the Committee on the Review of the Regulatory Framework set up to consider such institutional arrangements.

29. But given external vulnerabilities, action should not await completion of the report. In particular, we urge the principals of the Riksbank, National Debt Office, Finansinspektionen, and Ministry of Finance to commence immediately routine quarterly meetings to review macroprudential risks and coordinate policy settings. Initial tasks could be to reexamine prudential risks and policies pertaining to housing, and the risks arising from broader Euro Area strains.

30. And the FSAP confirmed long-standing calls from the IMF to increase further the resources allocated to banking supervision. Given the unique characteristics of the financial system, effective discretionary supervision will be an essential complement to the new regulatory frameworks coming into effect under Basel III and European auspices, especially if these international frameworks constrain country-level discretion above floors.