International Monetary Fund

Sweden—2004 Article IV Consultation

Concluding Statement

May 19, 2004

1. **The Swedish economy weathered the global downturn relatively well.** A strong stimulus from expansionary fiscal policy in 2002, supported by a highly competitive exchange rate, helped sustain demand while lower interest rates provided an added boost to private consumption in 2003. A notable feature of growth has been a strong rise in productivity, helping to bring inflation well under its target level. The mirror image of the rise in productivity has, however, been a continuing fall in employment. Indeed, the tide of growth has failed to lift all boats, as evident in the weak labor market and sharply rising unemployment, both open and latent. Looking beyond the cyclical recovery expected in the near term, prospects for sustainable growth and employment depend on the authorities' resolve to revive the stalling agenda for structural reform.

2. **As the world economy gathers pace, economic activity in Sweden is expected to pick up steadily.** Adjusted for the unusually high number of working days in 2004 — reflecting the leap year and public holidays falling on weekends — output is expected to rise by around 2 percent, rather than the unadjusted forecast of 2½ percent, implying a lower utilization of the economy's productive resources. Indeed, the recovery over the coming year is unlikely to be accompanied by substantial gains in employment. The supportive monetary policy stance and rising household confidence should stimulate private consumption, and improved demand prospects and profit position of manufacturing should assist a revival in business investment. Barring a sustained spike in oil prices, strong productivity gains and

moderate wage increases would be expected to keep inflation below the target of 2 percent. The risks to this scenario are evenly balanced. The external demand stimulus could be larger than expected, especially if the krona continues to remain undervalued. However, protracted weakness in the labor market could hold back consumer spending and persistent excess capacity in manufacturing could again postpone the projected pick up in business investment.

3. **The waning momentum for structural reforms is a growing cause for concern.** The relatively benign economic outlook and the parliamentary election calendar would suggest that this is an opportune moment for addressing the unfinished task of further streamlining the Swedish welfare state. Indeed, in the aftermath of the referendum on the euro late last year, it seemed that a national consensus was beginning to gather around the proposition that the Swedish model was in need of a new elixir of growth and dynamism. The Government as well as the other social partners seemed keen to build on this momentum. Unfortunately, this national conversation on growth has not led to a concrete program of action. As the European Union expands and global economic integration gathers pace, it is critical for Sweden not to miss this window of opportunity to enhance its long-term prospects for growth and welfare.

4. **The benign outlook for inflation validates the Riksbank's recent aggressive policy easing.** Inflation is projected to be below target over the next two years. Given the possibility of higher than expected wage outcomes at the local level set against the likelihood of continuing strong productivity gains, domestic risks to inflation are broadly balanced. In this light, barring unforeseen shocks, a policy of keeping rates on hold for the near term would be appropriate. As the restraining impact of domestic influences recedes over time and

upside risks from the projected upturn at home and abroad begin to predominate, inflation is expected to rise gradually. The policy rate would accordingly need to be raised. To the extent that the fiscal stance is insufficiently restrictive as the recovery gathers speed, monetary policy would need to be tightened earlier rather than later.

5. **Riksbank's conduct of monetary policy and its success in achieving the inflation target have earned it high credibility, although there may still be room for clearer communication.** The outcome of the recent round of wage negotiations testifies to Riksbank's ability to guide expectations. With expectations firmly anchored to the Consumer Price Index (CPI) as the target variable, Riksbank has focused its forecast on the CPI over a one- to two-year horizon, but highlighted various measures of underlying inflation to rightly underscore that policy would not try to counter the effects of transitory shocks that cause projected inflation to deviate from its target level. However, it appears that Riksbank has not always succeeded in communicating clearly its message to the markets, resulting on occasion in some confusion about the target variable and horizon. There may be room for refining the communication strategy by being more explicit about the role of judgment in assessments and extending the forecast horizon beyond two years.

6. **Safeguarding the fiscal surplus target of two percent of GDP over the business cycle is central to maintaining confidence in Sweden's medium-term fiscal framework.** Although the framework has a good track record and Sweden's position remains favorable in a comparative EU context, efforts to attain the target for the general government have visibly slackened in the recent past. New spending initiatives in the Spring Budget preclude the possibility of meeting the target at least until 2007. Official estimates suggest that, on present

policies, cumulative deviations from the surplus target would rise to 4 percent of GDP by 2006. Over time, this gradual slippage could raise concerns about fiscal discipline and begin to undermine the fiscal framework that has served to anchor macroeconomic stability. A renewed demonstration of the authorities' commitment to achieve the target is necessary to dispel any doubts about their determination to adhere to the medium-term fiscal framework. A more ambitious fiscal adjustment in 2005-6 through forceful measures to rein in public spending would go a long way in this direction. A regular public monitoring of deviations from the target would be in the interest of transparency.

7. **The authorities should remain firmly committed to the expenditure ceilings and ensure that margins are restricted to cyclical spending.** The ceilings have no margins left for error this year and there are signs that spending on sickness and disability benefits will not slow down as much as expected. As growth gains momentum, fiscal fine tuning would be unnecessary and costly. A coherent medium-term plan is needed to contain public spending without resorting to ad hoc steps such as shifting expenditure between years and additional tax expenditures. The system of expenditure ceilings with safety margins is well designed in principle and serves a useful role. However, the authorities should avoid using the margins for discretionary spending.

8. **The scope for tax cuts has narrowed further even as they are needed to provide impetus to work effort and saving.** The tax burden of the general government, already one of the highest in the world, is likely to rise further as local governments try to balance their budgets. As also recognized by the Tax Base Commission, reducing the high marginal tax burden on labor income is crucial to raising labor supply and ultimately potential growth.

Implementation of the final step of the income tax cut, financed through expenditure restraint, would be a welcome step in this direction. As international competition over tax bases intensifies, a review of the complex capital tax system, encompassing taxation of wealth, inheritance, and gifts, is warranted. High marginal effective tax rates on domestic savings could be eased and the fairness of the tax system improved by increasing the threshold of the wealth tax and tightening exemptions. Raising corporate taxation to make up for revenue losses from lowering or abolishing the wealth tax would, however, adversely affect investment and be contrary to international trends.

9. **The rising tax burden is, in part, a reflection of insufficient policy coordination between central and local governments.** Facing increasing demands for public services and underfunded mandates, local authorities have resorted to raising income tax rates, partly offsetting the tax cuts implemented by the central government. The perverse incentives inherent in the revenue equalization scheme among local governments may add to the upward tax creep, as the benefits of broadening the tax base are dissipated to other regions, while revenues from raising tax rates are retained. The intention to encourage local authorities to specify more clearly their medium-term spending plans could go some way towards improving fiscal coordination. The use of balancing grants from the central government would help smooth fluctuations in local revenue and prevent procyclical increases in tax rates.

10. **The financial system remains sound.** After the increase in loan losses that followed the 2001 slowdown, banks have improved their profitability and further strengthened their balance sheets in the context of increased competition. Capital adequacy and loss provision

remain at satisfactory levels. With economic activity and corporate profitability improving, the business sector does not represent a significant source of risk. Although household debt has kept rising in recent years and, at around 120 percent of disposable income, is relatively high, low interest expenses and higher home values serve to considerably mitigate its burden. All in all, credit risks are well contained, although those associated with a significant decline in property values or a rise in interest rates bear careful monitoring.

11. **A decisive reform of the tax-benefit regime is necessary to improve incentives, raise potential growth, and ease fiscal pressures.** Cutbacks in entitlements, coupled with a reduction in the high tax burden on labor, would help encourage greater effective labor supply in the face of population ageing and the sharp fall in hours worked. Sizeable steps in this direction are required to realize the authorities' ambitious labor market and social policy objectives such as the target of 80-percent employment rate and the goals of halving the number of people on social assistance and sickness leave. The recent erosion of labor supply, while partly driven by demographics and the business cycle, is also a reflection of the institutional setup that discourages work effort. High wage compression and generous social benefits continue to impede an efficient use of labor resources. Overall, underlying trends in labor supply signal a need for more fundamental policy reforms rather than short-term palliatives.

12. **Efficient use of human resources is imperative for long-term sustainability of the Swedish model.** As the main source of labor supply over the coming years is expected to be the foreign-born population, better integration of immigrants into the labor force is crucial. At the same time, the incentive structure in the education system could be re-assessed to help

reverse the declining trend of youth participation. Despite a leveling off in short-term sickness, long-term sickness has continued to rise. The role of incentives in sickness absence warrants a better recognition. In this context, the decision to reverse the small reduction in the replacement rate of sickness benefits introduced last year is clearly unhelpful. More flexible work arrangements could also contribute to raising work effort. Overall, the complex effects of the interaction within social welfare programs and with labor market institutions merit a systemic evaluation.

13. **Strengthening competition in product markets is a necessary component of the agenda for growth.** Despite notable progress achieved in many areas in recent years, barriers to competition are still significant in key sectors and the Swedish price level remains significantly above the European Union average. Reducing rigidities that continue to impair the functioning of product markets would raise consumer welfare and could have positive spillover effects on the labor market. Competition between private and public sectors in the provision of services could be further encouraged. With controls on rent-setting inhibiting the development of an efficient rental market, there is room to move towards a more market-oriented approach that would preserve social policy objectives. Internationally, Sweden's advocacy of liberal trade policies serves to complement well its commendable record of generous development assistance.