International Monetary Fund

Sweden--2001 Article IV Consultation

Concluding Statement

June 20, 2001

1. **The Swedish economy continued in 2000 its impressive recent record of strong growth with monetary and financial stability.** A third year of buoyant activity ushered in by a boom in the high technology sector helped reduce unemployment sharply, and edged the economy closer to its productive potential. Nevertheless, inflation remained below the Riksbank's target and the competitive position of the economy remained robust. The fiscal surplus again exceeded the authorities' announced aim and public debt continued its downward trajectory. Deft macroeconomic management played a central role in these achievements, consolidating the gains of policy reforms of the last decade. All in all, Sweden enters the new century with the prospect of continuing to achieve the objectives of economic growth, monetary stability and social welfare, leaving well behind the painful experience of instability, crisis and adjustment of the early 1990s.

2. **Looking ahead, however, a few clouds are becoming visible on the economic horizon.** As the slowdown in the United States spreads to Europe and Asia, Sweden is bound to feel its downdraft. The adverse impact may be large, although starting from recent high growth rates, because of the catalytic role played in the Swedish economy by the hard-hit high technology sector. Indeed, a number of recent indicators point to a sharper slowdown in activity than was generally expected only a few months ago. At the same time, the unexpected surge in underlying as well as headline inflation in April and May and the prolonged fall in the krona underscore the risks to medium–term inflation. In Sweden, as elsewhere, the extent of the recent favorable shift in the trade-off between growth and inflation may have been overestimated. The coincidence of a slowing economy and heightened inflation risks poses a starker challenge than economic policy has had to face in recent years.

3. **Beyond the immediate issues facing economic policy, it is now time to embark on a structural reform agenda for the long term, now that a successful macroeconomic framework is in place**. Such an agenda would lift the potential rate of growth above its recent range of 2-2½ percent. The broad consensus that seemed to be shaping in the mid-1990s around the view that a streamlining of the welfare state was needed to help strengthen incentive structures appears to have eroded in the past few years, as memories of the crisis have faded. In this setting, the recent broadly-shared gains in income and employment and the strength of public finances offer a window of opportunity to rejuvenate the reform agenda—on taxation and public spending, the labor market, and deregulation. In any case, the forces of globalization, European integration, and demography are likely to make such reforms inevitable in the longer run. Therefore, a more ambitious approach to help ensure that the essential achievements of the welfare state are preserved is in order.

4. **The outlook for the remainder of 2001 is for slower economic growth in Sweden than was envisaged only a few months ago.** The weakening prospect is suggested by the global slowdown led by flagging demand in the United States, and a gloomier prognosis for the euro area, particularly for Germany. For Sweden, these adverse outside impulses could be amplified by softening sentiment and attempts by households to rebuild savings, keeping growth subdued into early 2002. Beyond that, with a projected rebound in global growth and the already high level of resource use in the Swedish economy, a return to potential output can be expected.

5. **A confluence of forces led to low inflation and interest rates through early 2001.** The Riksbank's consistent monetary framework, deservedly held up as an example of best practice in monetary policy design and its public articulation, has clearly helped bring down inflation and inflation expectations. In recent years, a number of non-monetary factors—such as the effects of prior deregulation and productivity gains stemming from the information and communications technologies—have helped keep price pressures at bay. These factors have aided the Riksbank in establishing and reinforcing its policy credibility without needing to raise interest rates significantly. Indeed, the policy interest rate has been held broadly steady since early 2000, allowing Sweden to enjoy one of the lowest rates among the advanced

economies. With easing cyclical pressures and solid growth prospects, these low and stable interest rates have been appropriate.

6. **The inflation surprises of the past two months have cast a shadow on this idyllic picture.** While the sharp spurt in headline inflation reflects some temporary factors, the Riksbank's indicators of underlying inflation, even that excluding import prices, are also trending up and many of the earlier favorable factors that kept inflation down are likely to fade. Moreover, the persistent weakness of the krona poses an increasingly menacing risk to medium-term inflation, undermining a key assumption of the Riksbank's May Inflation Report—that of a gradually strengthening krona. The moderate three-year wage agreements provide some anchor for inflation expectations. Nevertheless, the longer the krona weakness lasts, the greater is the probability of a substantial adverse effect on inflation and inflation expectations over time, particularly during a period in which resource use in the Swedish economy is already high.

7. **The spectrum of inflation risks facing the Riksbank has widened, and since the May Inflation Report the balance of risks has shifted to the upside.** Looking ahead, if weaker global demand were to ease medium-term inflation concerns, this would allow for a more relaxed monetary stance than would otherwise be appropriate. However, a solid recovery in Sweden as well as abroad is expected at least by the latter half of 2002, if not sooner. With resource use already high, such a recovery could lead to stronger inflation pressures within the 2-year forecast horizon. Continued vigilance by the Riksbank will be required, with a steadfast focus on medium–term inflation. There are good reasons to believe that the present level of the exchange rate is out of line with its medium-term equilibrium value. However, the portfolio outflows of recent months may take time to abate and the ongoing process of risk re-assessment in the global telecom sector may entail an adverse fallout for the krona. In light of the heightened risks to prospective inflation, the Riksbank has undertaken signaling interventions in the last few days to nudge a shift in market sentiment. Monetary policy is, and should remain, focused on keeping medium-term inflation within its tolerance band. Thus, if necessary, the Riksbank would need to follow through

with interest rate increases, as it has indicated it would do, to preserve the hard-won credibility gains of recent years.

8. **Most indicators of systemic stability suggest limited risks to the financial system.** In view of its strong financial position, the banking system should be able to cope with even a more marked downturn than now expected. Nevertheless, the recent financial consolidation and the risk of further declines in share prices call for expanded supervision and continued vigilance.

9. **Fiscal policy remains firmly—and admirably—anchored in medium-term fiscal rules.** The target of a general government surplus of 2 percent of GDP over the cycle is intended to leave room to cope with the coming demographic shock, and is underpinned by ceilings on nominal central government spending for the subsequent three years. These expenditure ceilings will prove tight for at least two reasons. First, the room for discretionary spending increases within the buffer has been largely used up by measures already announced in 2001-02, and second, the recent unanticipated rise in inflation will reduce the real value of the nominal ceilings. It will be essential to the credibility of fiscal policy to ensure that the announced expenditure ceilings are scrupulously adhered to. This may mean offsetting mandatory inflation-induced increases in some components of spending by discretionary cuts in others.

10. **The full amount of the prospective overperformance relative to the structural surplus target should be used for tax cuts.** Given the structural surplus rule, the estimated structural surpluses over 2002-2004 imply room for tax cuts of at least 2 percent of GDP. The envisaged two remaining income tax cuts in 2002 and 2003 to offset the earlier increase in employees' social security contributions—most likely already built into consumers' expectations—would use up about 1¼ percentage points of GDP. The remaining room of three-quarters of a percent should be used in the budget for 2002 to reduce the most distortionary taxes as part of a medium-term program. Such early tax cuts would be fortuitously timed to help counter any unexpectedly large slowdown in growth later this year and extending into 2002. The implied policy mix—a tighter monetary stance if required, and a moderate fiscal expansion—could help strengthen the krona. The enhanced monetary

policy credibility as the framework is seen to be adhered to and a fiscal policy conducive to long-term growth would tend to reinforce this effect.

11. **The authorities should build on their recent achievements to further reduce tax and expenditure levels.** Such a strategy should aim at enhancing the efficiency of the tax-benefit system and its effectiveness in delivering social support. The recent strong economic performance has been underpinned by the landmark reforms of the tax and benefit systems that began in the early 1990s. Public spending has been substantially reduced and its composition improved. While these structural reforms have to some degree continued—changes to the pension and unemployment benefit systems being especially notable—there are signs that the process may be running out of steam. For instance, the most recently announced expenditure ceiling (for 2004) is the first to imply no reduction in the ratio of central government spending to GDP. In the medium to long term, there remains scope and need for continued rationalization of the tax-benefit regime without compromising its key social objectives. Moreover, while the extent of the pressures to be expected from increased international mobility of the tax base remains uncertain, their direction is clear. Pressures are also likely to arise from the looming demographic shock, as emphasized in the Spring Budget. These considerations argue for a reinvigoration of the reform process.

12. **The more ambitious reform agenda should encompass a balanced reduction in taxation and public spending.** It is critical to target reforms so as to achieve the maximum gains in efficiency and economic growth, while respecting distributional concerns. Thus, reducing the high marginal effective tax rates on labor implied by the taxation of earnings and the withdrawal of benefits, especially toward the two ends of the income scale, should be a high priority. Unifying the two central income tax rates at a level below the current lower rate is feasible, and holds the prospect of improving incentives for a key part of the labor force. It would, at the same time, mitigate the incentive to transform labor into capital income that is a central difficulty of the dual income tax regime. Structural reforms to the wealth tax—removing exemptions favoring the wealthiest and raising the threshold to exclude moderate housing wealth—are also needed. On the spending side, the rapid increase in

sickness benefit payments during the upswing stands out and calls for reassessing their extent and design, as well as the allocation of their financing between employer and state.

13. **In the long run, additional measures will be needed to offset the projected fiscal impact of the demographic shock.** Safeguards have been built into the reformed pension system to ensure its solvency. However, a full response to the demographic transition—which will impact on non-pension age-related expenditures—will also require measures such as raising the effective retirement age.

14. **Local governments have a key role to play in the strategy of fiscal reform.** The balanced budget rule effective last year is an important and welcome change, but there is a real risk that pressures on central government spending will be deflected to the local level. In the longer term, the fiscal equalization system, which damages the incentives for local authorities to increase their tax bases or to moderate their tax rate increases, will need to be reassessed.

15. **The recent performance of the labor market has been strong, but structural problems remain.** Employment and participation rates have risen markedly since the trough of the recession. Significant structural improvements are also being achieved, with the better adaptation of active labor market programs to market needs and the tightening of duration rules for unemployment benefits. Looking ahead, the outcome of the recent three-year wage agreement is encouraging and consistent with the inflation objective. But with inflation expectations now likely to be fragile, it is essential that this moderation not be undermined by excessive wage drift. Moreover, the functioning of the labor market would be improved by easing employment protection regulations, by enhancing regional mobility through an easing of the distortions in the housing market created by rent control, and by continuing the trend of reduced wage compression.

16. **The authorities should continue the rapid strides of recent years in deregulating the economy.** Enhancing competition throughout the economy would promote efficiency and growth in the long run. Sectors which hold promise of substantial efficiency gains through rapid deregulation or the elimination of monopolies include rental housing, construction,

pharmaceuticals, retail trade, and transportation. The privatization of public enterprises operating in competitive markets would also be desirable.

17. **Sweden's economic policy record has been generally successful, but new challenges lie ahead.** The crisis and turbulence of the early 1990s raised valid questions about the long-term viability of the Swedish model, unless some of its features were modified. The vastly strengthened macroeconomic policy framework since then, complemented by structural reforms, has placed the economy on a much stronger footing. The emerging challenges at home and abroad call for broadening and deepening the reform agenda so as to ensure Sweden's continued success in a rapidly globalizing world economy.