INTERNATIONAL MONETARY FUND
Sweden--1998 Article IV Consultation
Concluding Statement
June 10, 1998

The efforts of recent years to restore policy credibility by focusing monetary policy on price stability and by eliminating the fiscal deficit through a strong consolidation program have been highly successful. The authorities are strongly commended for these achievements. Inflation has for some years been exceptionally low and is envisaged to remain well within the established tolerance range. The general government financial balance is expected to record a surplus already in 1998 and to remain in surplus in subsequent years. The rewards have been palpable: a sharp narrowing of the interest differential relative to foreign rates, a strengthening of the krona and, more recently, a strong recovery of consumer and business confidence.

With the completion of the consolidation program ending the period of fiscal withdrawal and with low real interest rates, the economy is poised for a strong recovery. Growth is also becoming more balanced, with a greater contribution from domestic demand. Though there are risks to the outlook, such as from an intensification of the Asian crisis or from a sharp fall of equity markets, the short-term growth prospects are clearly positive.

The main risk, however, is that the cyclical recovery could soon run into bottlenecks and capacity constraints unless structural reforms strengthen sufficiently the productive potential of the economy. Though the earlier financial imbalances have been eliminated, other fundamental problems which contributed to the deep crisis of the early 1990s remain.

This is perhaps best illustrated by the fact that, based on early results, most forecasters expect wage increases--including drift--to be 3½-4 percent. Though such wage increases do not yet threaten the inflation target--thanks to offsetting favorable developments--they are excessive given the need for flexible real wages to support the creation of employment. The failure of real wages to decline during the recession is a main factor responsible for today's high unemployment. It is particularly troublesome that, even at today's high rate of unemployment, the present wage round is yielding wage increases higher than in European partner countries. Unless the functioning of the labor market, including the wage setting mechanism, is improved sufficiently, it is unlikely that much progress will be made in lowering unemployment durably and strengthening the productive capacity of the economy.

The limited progress on structural reforms also complicates the assessment of the stance of financial policies because of added uncertainty over the size of the remaining output gap, and the associated excess of overall unemployment over its structural level. This affects the assessment of both fiscal and monetary policies.

With the completion of the consolidation program in 1998, the stance of fiscal policy for 1999 envisaged in the Spring Budget Bill appears broadly neutral. This is appropriate at this stage of the cycle given the projected strength of domestic demand. We are concerned, however, with the intention (the ”technical assumption”) indicated in the Bill to return substantial resources to households (up to 1½ percent of GDP) in subsequent years through tax reductions or increased transfers. With the present range of estimates of the output gap and of the growth of potential output, the growth scenario underlying the Bill's projections means that the economy would then be above potential. Fiscal stimulus at that stage of the cycle would be pro-cyclical and would seriously threaten the inflation target forcing a tightening of the monetary policy stance. Such a policy would also be inconsistent with achieving the target of a fiscal surplus of 2 percent of GDP over the cycle.[1] If the fiscal surplus is to average 2 percent of GDP over the cycle, it must exceed this target at the peak of the cycle, and given the high cyclical sensitivity of Sweden's public finances, by a substantial amount.

Such a relaxation of policy would make sense only if there were clear indications that the growth of potential output is increasing significantly faster than generally believed at this time, so that the economy would not in fact be overheating. This requires a broadening and deepening of structural reforms. Not then, now--so that, with normal lags, productive potential will have increased sufficiently by then. While we understand that the thinking behind the ”technical assumption” is that the resources should be transferred to households only if there is evidence that potential growth has in fact accelerated and that there is unused capacity, it will be important to ensure that this necessary condition is fulfilled and that the assessment of potential is made in a conservative manner. This qualification, however, does not appear to have been widely communicated or explained.

Another troublesome aspect of fiscal policy is the introduction of several new spending initiatives in the last two years. A major accomplishment of the fiscal consolidation program of 1994-95 was the strengthening of the underlying structure of the fiscal accounts through lower spending. Though some increase in spending relative to earlier baseline projections is understandable given the methodology of projecting a number of expenditure items on an unchanged nominal basis, the new spending initiatives reverse some of the underlying structural improvements of the consolidation program. Instead, a program of sustained expenditure and tax cuts, with particular emphasis on lowering high tax wedges that distort incentives to work and save (see below), would support the hoped for improvement of productive potential.

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[1] As we indicated at the conclusion of last year's consultation, we believe that such a target-- though more ambitious than similar targets adopted by other countries-- is appropriate for Sweden given the high cyclical sensitivity of the fiscal accounts. This would lower the risks both that the limits for the deficit under the Growth and Stability Pact would be exceeded and that the debt/GDP ratio would not be reduced from present levels. The latter risk increases rapidly with less ambitious fiscal targets (see ”Sweden, The Outlook for Public Debt”, IMF, 1998).

Uncertainty over the size of the output gap also complicates assessments of monetary policy. Several factors underlay the decision of the Riksbank this past week to reverse the December increase of the repo rate: the tightening of monetary conditions from the strengthening of the krona since February and the evidence from several indicators of lower inflation risks, including lower growth of monetary aggregates, lower import price increases and lower inflation expectations. There remain nevertheless risks that the strong growth envisaged could lead to bottlenecks and inflationary pressures, such as if reported shortages of skilled labor pushed up wage drift from solidarity increases in other sectors as well. Vigilance remains the order of the day and the Riksbank will have to be ready to take prompt action, as it did in December and again last week, when the balance of risks on inflation shifts.

Inflation has been subject to large temporary and one-off factors in recent years--notably declining mortgage costs and changes in indirect taxes--which have pushed headline inflation below the lower limit of the Riksbank's inflation target range. The Riksbank has accordingly increasingly relied on concepts of underlying inflation to explain its assessment of price developments. The preparation of a formal measure of underlying inflation would enhance the validity of such assessments. The mission supports the Riksbank's proposal that Statistics Sweden prepare and publish, along with the CPI, such a measure of underlying inflation. It should be recognized, however, that this will not end all controversies as, given the long lags of monetary policy, the Riksbank will still have to base its monetary policy decisions on a forward looking assessment of inflation.

On the structural side, we welcome the recent agreement on the reform of the pension system. The closer link between contributions and benefits, and the introduction of mechanisms that make the pension system more robust *vis-a-vis* adverse macroeconomic and demographic developments will strengthen the financial foundation of the pension system. It will be important that the final key decisions still to be taken ensure the financial sustainability of the reform.

Developments in the labor market, however, remain a source of serious concern. These concerns were already elaborated on extensively at the conclusion of last year's consultation and will not be repeated here. We note, however, that the government's response to the European Council's 1998 Employment Guidelines, while encouraging in some respects, is disappointing in others. This is the case, in particular, for the negative response to the recommendation to set targets for gradually reducing both the overall tax burden and the taxation of wages, especially on relatively unskilled and low paid labor.[2] This is also a measure that we, and many others, had put forward earlier.[3] Some continental European countries, notably the Netherlands and more recently Denmark, have initiated broad reforms of their labor markets and are beginning to reap the benefits in rising employment.

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[2]Sweden, National Employment Plan, April 1998.

[3]A background study we prepared for the present consultation suggests that narrowing such wedges could have a significant effect on employment, with a 10 percentage point narrowing of the wedge raising employment by 3-5 percent over a 5-10 year horizon.

Beyond improvements in the working of the labor market, another important catalyst in the creation of employment opportunities would be an improvement in the environment for the expansion of small and medium-size enterprises, especially in the service sector where future employment growth will be concentrated. Several proposals are included in the Spring Budget Bill to promote employment in small enterprises. It is not clear to us, however, that these address what studies report to be the main factors impeding the growth of small and medium size enterprises, in particular the high marginal tax rates and the restrictive labor market rules, notably regarding job protection.

The emphasis of the government's program to lower unemployment is to improve education and training. These are important means by which workers in advanced economies can upgrade their skills to match the changing demands of the economy. However, education alone will not be sufficient to resolve the problem of unemployment unless improvements in the labor market and in the business environment lead to the creation of jobs. With 4½ percent of the labor force projected to be in adult education or in the expanded tertiary education initiatives, the targeted reduction of the open unemployment rate is only achieved temporarily through a shrinkage of the labor force. By 2001, official projections imply that 12 percent of the labor force will be either in those education initiatives or openly unemployed or in labor market programs, only slightly below the 13 percent total unemployment rate in 1994. Unless jobs have been created in the meantime at a rate much faster than presently envisaged, the open unemployment rate will clearly increase again once the temporary component of the education initiatives expires.

In closing, we would like to thank officials of the Riksbank, the Ministry of Finance, other government ministries and associated institutes, and the many researchers and economists we have met during our visit for their hospitality and frank discussions. We have found a strong feel-good factor, and rightly so, as the crisis has been effectively addressed, confidence is up, and the economy is poised for recovery. It is important, however, not to let this optimism obscure the fact that much remains to be done if the recovery is not to peter out prematurely.