INTERNATIONAL MONETARY FUND

Sweden—1997 Article IV Consultation

Concluding Statement

May 28, 1997

In dealing with the legacies of the economic crisis of the early 1990s, Sweden has had a number of successes and one notable failure. The successes include bringing the general government deficit, which ballooned to above 12 percent of GDP in 1993, down to 2½ percent in 1996 and reducing inflation to record lows notwithstanding the forced de-linking of the krona from the ECU in late 1992. Policy credibility has gained substantially, as reflected in the narrowing of the long-yield differential relative to Germany and the strengthening of the krona. However, no progress has been made in reducing unemployment, which almost overnight rose from among the lowest in the industrial world to average EU levels, despite adequate growth in recent years. Strengthening the gains in economic policy credibility so laboriously built up by the government over the past two years will require implementation of policies focused on the promotion of sustainable growth, with fundamental labor market reforms to reduce unemployment given a central role.

The improvement in the fiscal position by 10 percentage points of GDP in a span of only three years is a remarkable achievement. One area of concern, however, is that the success in reducing the deficit and the understandable disappointment over the high level of unemployment might lead to a premature easing of policy. Many of those features of Sweden's general government finances that contributed to the fiscal crisis in the early 1990s, notably the high cyclical sensitivity of both expenditure and revenue, remain and the level of general government debt is sharply higher. The mission accordingly welcomes the reaffirmation in the Spring Budget Bill of the government's intention to balance the budget in 1998 and, over the medium term, to achieve an average surplus of 2 percent of GDP over the cycle.

However, the announcement in the Spring Budget Bill of new expenditure programs raises some concerns. Evidence from other countries' adjustment efforts is that the likelihood of sustained success of a fiscal correction program is higher with a larger expenditure reduction component, which directly addresses the factors responsible for the underlying widening of the deficit. Also, notwithstanding the planned lowering of expenditure relative to GDP over the medium term, Sweden's very high public expenditure, and tax burden, relative to GDP cannot but discourage the growth and creation of employment opportunities in the private sector. Thus, the prospects for growth and employment would have been enhanced by using the additional resources identified in the Spring Budget Bill to lower taxes—notably, given concerns over unemployment, employers' social security contributions and income taxes so as to reduce the tax wedge, see below—rather than introducing new expenditure programs. In addition, use of part of the budgeting margin under the expenditure ceiling to help finance the new programs undermines the procedures established only recently to strengthen budgetary discipline.

With growing acceptance by financial markets of the program of fiscal consolidation and signs of a slowing economy, the Riksbank wisely used the scope available to lower its operational repo rate in 1996. By December 1996, when the sequence of bi-weekly reductions of the repo rate was stopped, the repo rate had been lowered by almost 5 percentage points to 4.1 percent, the lowest level for the Bank's instrumental rate in 30 years. Acceptance by the markets of the appropriateness of monetary easing was reflected in the continued narrowing of the long-yield differential with German rates and the strengthening of the krona through most of 1996, though these developments were further helped in the latter part of 1996 by market-wide EMU-related convergence movements. The subsequent shift in market sentiment against currencies thought less likely to be initial participants in EMU led to some reversal of these gains and to an easing of monetary conditions from the depreciation of the krona. The mission concurs that these developments, together with the acceleration of narrow monetary aggregates and signs of growth picking up, meant that the time had come for a pause in the lowering of the repo rate.

The mission also agrees that the monetary stance appears at present to be well balanced. With projected growth rates envisaged to close the output gap at an appropriately gradual pace, underlying inflation foreseen to remain within the lower half of the target range for inflation and headline CPI projected to be around target in 1998, there may be some scope for further easing. The case for additional easing would be strengthened by a firming of the krona and a narrowing of the long-term differential with Germany; or if the expected economic recovery failed to materialize. The recent acceleration of narrow money raises some questions, however, of whether inflation may not rise somewhat faster than is now envisaged. Also, with uncertainty over estimates of the output gap and whether wages will slow down sufficiently, there could be an earlier build up of inflationary pressures than now seems apparent, requiring a tightening of policy.

The mission very much welcomes in this context the recent multi-party agreement to strengthen the independence of the Riksbank, notably the decision to give legal status to price stability as the primary objective of monetary policy, the strengthening of the management structure of the Riksbank and a division of responsibilities over exchange rate policy which avoids possible conflicts in the conduct of policy. The cautionary stance of the Riksbank in waiting for a firming of trends before initiating the lowering of the repo rate in January 1996, the gradual and measured lowering of the rate during the course of 1996, and the stabilizing of the repo rate in recent months have gradually increased the credibility of policy. This could have been compromised by the adoption of diluted institutional arrangements.

The Swedish government is yet to decide whether to seek EMU membership from the outset. Some benefits, such as lower interest rates from a successful start of EMU and efficiency gains, are clear. Others may be less so. In particular, Sweden's checkered stabilization history under the earlier discretionary policy environment could make the adoption of a stricter—rules-based—environment, such as provided by EMU, useful in preserving and strengthening the stabilization gains of recent years. There are also, however, some risks. The still relatively short record of stabilization and the lukewarm, at least so far, popular and political support for joining EMU—in contrast to other likely early participants—could make Sweden susceptible to speculative attack in case of disturbances in financial markets in the lead up to EMU. In any event, not joining from the start would certainly not ease the need for tight financial policies and rapid implementation of labor market reforms.

On the structural side, developments in the labor market remain a source of serious concern. Despite the recovery of output, the total unemployment rate (including participation in labor market programs) has remained above 12 percent; moreover, wage increases have not been moderated by the high levels of unemployment. In fact, real wage increases in Sweden since 1991 (the period of high unemployment) have exceeded those of its main foreign competitors, with increases in 1996 the highest in 20 years. Consequently, after establishing a long-standing enviable record of low unemployment, Sweden appears to be moving rapidly towards the kind of persistent high unemployment that has characterized European labor markets in the last two decades.

The Spring Budget Bill rightly emphasized some key principles needed to combat unemployment, notably: (i) unemployment should be reduced primarily by putting more people to work; and (ii) employment growth in the coming years should primarily take place in the private sector. The five point program appears, however, to violate some of these principles in that it relies most heavily on an increase in adult education, sustaining local government employment, and early retirement schemes to lower open unemployment. No genuine labor market reform proposals have been put forward, though a commission has been established to recommend new negotiation/conflict resolution procedures.

In the present environment, two main factors would likely severely limit the scope for lowering unemployment without effective labor market reforms. First, with downward rigidity in nominal wages, an environment of low inflation makes it all the more difficult to achieve reductions in the real marginal cost of labor to firms in the absence of reforms to increase the flexibility of labor markets. The channel through which flexibility of real wages was achieved earlier, with cycles of high inflation and devaluations of the krona, would result in greater financial instability in today's world of integrated capital markets.

Second, because of differential productivity gains in industry and services, it has already been apparent for several years that employment creation in industrialized countries will take place primarily in the service sector, with a likely much larger role for small and medium-size enterprises. The growth of productivity in the economy as a whole, and consequently the improvement in living standards, will be determined to an increasing extent by productivity developments in the service sector. It will thus be important to provide the appropriate incentive structure for increasing productivity in services: remunerations that not only compensate for wide differences in skills and productivity but also offer incentives for human capital accumulation.[1]

In this respect, education and training are essential, since these are important means by which workers in advanced economies can upgrade their skills to match the demands of the changing economy. However, education alone will not be sufficient to resolve the problem of unemployment. Without sufficient labor market reforms, making possible the creation of jobs for all skill levels, the targeted reduction of the open unemployment rate through early retirement and expanded education, which reduce the labor force rather than create employment, will not be sustained and will undermine the financial foundation and goals of the welfare state.

Some other countries in continental Europe, notably the Netherlands and more recently Denmark, have initiated such reforms and are beginning to reap the benefits. The measures introduced are similar to those which have been recommended already by several observers for Sweden. These would include, in particular, measures to improve the supply of labor and job search: wage differentiation to promote skill acquisition, lowering replacement ratios and tightening eligibility requirements for unemployment benefits, shortening their duration period (cum labor market programs), and cutting the income tax burden. And measures to stimulate labor demand, notably (in addition to greater wage differentiation) reducing non-wage labor costs by reducing employers' social security contributions, making labor unions and their members bear the cost of the unemployment insurance system, and liberalizing employment protection legislation.[2]

In addition, while all industrialized countries will have to reform their industrial relations to varying degrees to cope with the changes in the structure of production and employment, the extent of adaptation may have to be more far reaching in countries, such as Sweden, that have had a tradition of centralized bargaining. A wage bargaining system based on the competitiveness requirements of the traded goods sector is unlikely to be an optimal labor market arrangement in an increasingly service-based economy.

The above suggestions for labor market reforms do not mean that countries like Sweden with a strong tradition of promoting a relatively equal distribution of incomes will have to

[1]See, for example, **World Economic Outlook**, IMF, May 1997, Chapter 3.

[2]See also **OECD Economic Surveys. Sweden 1997**, OECD, December 1996, Chapter III.

abandon egalitarian objectives altogether. However, appropriate mechanisms will have to be worked out for fostering those objectives while allowing the labor market to respond in ways which promote productivity gains and standards of living.

In closing, we would like to thank officials of the Riksbank, the Ministry of Finance, and other Government ministries and associated institutes, and the many researchers and economists we have met during our visit for their hospitality and frank discussions. The fact that we have devoted more attention in our concluding remarks to structural issues is testimony to the substantial progress achieved in financial stabilization. It also reflects, however, our view that structural reforms, especially in the labor market, are essential to the sustainability of the financial stabilization itself.