2016 Article IV Consultation with Sweden
Concluding Statement of the IMF Mission

Swedish macroeconomic policies have deftly navigated a difficult period to achieve a revival of growth and inflation. Sustaining solid growth requires balanced policies. Monetary policy needs to remain stimulatory to further raise inflation and fiscal policy should continue to accommodate exceptional levels of migration-related spending. The recent slowing in housing prices does not lessen the importance of reforming the housing market. Timely actions are also needed to contain vulnerabilities related to household debt and to fix the legal framework for macroprudential policy. Integrating the refugee surge from 2015 requires ongoing improvement in refugee establishment and education complemented by temporary and targeted flexibility in high entry-level wages.

1. **Sweden is enjoying strong growth, aided by supportive monetary and fiscal policies**. Growth is heading for about 3½ percent in 2016 on the heels of an expansion of just over 4 percent in 2015. Employment has risen by 1½ percent so far in 2016, pushing unemployment down to about 7 percent. Domestic demand is the key driver of growth, boosted by the stimulatory monetary policy in recent years along with an increase in government spending related to migration in 2015-16.

2. **Solid growth is expected in coming years, yet there are both external and domestic risks.** Domestic demand will cool as monetary and fiscal impulses fade and resource constraints are becoming more binding so growth is expected to ease to about 2½ percent in 2017 and 2 percent thereafter. But growth could be lower if activity in major advanced and emerging economies weakens, or if investment was held back by political fragmentation in Europe, including uncertainty around post-Brexit arrangements. Swedish housing prices are historically high, implying downside risk to consumption even as housing shortages lower the risk of a major decline.

3. **Such shocks could hit the economy harder owing to rising household indebtedness even though the Swedish financial system has strong capital buffers.** Stress tests as part of the IMF's Financial Sector Assessment Program (FSAP) suggest that Swedish banks would cope in a severe adverse scenario, but they are highly reliant on wholesale funding. However, the growth impact of potential external and domestic shocks is rising as the share of households that are highly indebted increases.

4. **The key policy priorities to help sustain Sweden's solid growth are**:

- Returning inflation to target to promote macroeconomic stability and rebuild space for monetary policy to cushion the economy against future downturns;
- Containing the build-up of vulnerabilities from household debt, including by addressing housing market imbalances that crimp growth and threaten stability;
- Ensuring that Sweden's large financial sector remains resilient; and
- Accelerating the integration of refugees into the workforce.

Monetary policy

5. **Monetary easing has helped lift inflation and inflation expectations from low levels**. Slack in the economy widened to 2-3 percent by 2013-14 and inflation declined to only ½ percent on a core Harmonized Index of Consumer Prices (HICP) basis, wearing down two-year ahead inflation expectations to just 1 percent by end 2014. Monetary easing has kept Swedish yields roughly in line with those on German Bunds and the krona broadly stable in 2015-16. Core HICP inflation has risen significantly, to about 1.2 percent, and inflation expectations have moved up closer to the target.

6. **Inflation is expected to rise, although the pace could be gradual**. High growth has lifted resource utilization to just above normal levels, hence the outlook is for core HICP inflation to pick up from 2017 and to approach target by 2019. This rise is relatively gradual in part because the industrial sector—which traditionally leads wage rounds—faces smaller labor shortages and possible spillovers from sluggish euro area wages.

7. **Accordingly, monetary policy needs to remain stimulatory for some time.** Unwinding of monetary stimulus should await clear confirmation of a durable rise in inflation. If, however, inflation or expectations were to weaken, greater stimulus would be appropriate, yet foreign exchange intervention should be a last resort.

8. **The parliamentary review of the Riksbank law is an opportunity to strengthen monetary and financial stability arrangements**. Communication challenges arising from the immediate rise in headline CPI inflation after a policy rate hike suggest the inflation target should be based on the internationally comparable HICP. The Riksbank's financial stability mandate should be clarified, including by giving it a specific role in identifying, monitoring, analyzing, and reporting on systemic financial risks, together with the authority to provide liquidity for financial stability purposes.

Housing market and household debt

9. **Housing prices are historically high and household debts will likely keep rising.** Although annualized housing price gains have slowed to about 5 percent since the Fall of 2015, prices stand at some 40 percent above their 20-year average relative to incomes. More expensive housing has required a growing share of new borrowers to take on high debts relative to their income. Spending by highly-indebted households is more sensitive to interest rate moves and potential deleveraging of high debts can worsen recessions.

10. **Reforms of the poorly functioning housing market are key to a lasting solution**. Shortages of housing and rental apartments impede labor mobility and underpin the trend rise in prices and debt. Maintaining an adequate supply of land that is ready for development is needed to sustain the recent welcome rise in construction, requiring improved municipal land sale and planning processes. Phasing out rent controls would encourage more efficient use of housing, as would the proposed temporary removal of

the capital gains deferral threshold. Mortgage interest tax deductibility should also be phased out to reduce incentives to finance housing with large debts.

11. **Macroprudential policies should be reinforced by a measure targeted at highly-indebted households.** Implementation of minimum amortization requirements on mortgages is welcome. But a measure targeted at the growing share of highly-indebted households is also needed. Establishing a debt-to-income threshold which only a minority of borrowers may exceed can lean against a rise in vulnerabilities while allowing some flexibility for household circumstances. Alternatively, high risk weights on mortgages exceeding that threshold could be coupled with supervisory monitoring of the scale of such lending by each bank. Timely implementation of the latter approach could be followed up by regulation if needed. Either approach to a debt-to-income limit would moderate the lending response if housing prices rise faster than income, dampening any credit-price spiral.

Prudential supervision

12. **It is urgent to fix deficiencies in the legal framework for macroprudential policy to allow timely action.** The recent introduction of mortgage amortization requirements came after long delays, revealing deficiencies in the macroprudential mandate and powers that Finansinspektionen (FI) was given in 2014. FI cannot fulfill its mandate without the timely capacity to adopt new tools to address risks as they emerge. The Financial Stability Council (FSC) has provided a valuable forum for sharing information. Joint work on risk analysis and on the design and impact assessment of potential measures should be expanded. The coming FSC review should seek to structure its operations to most effectively support FI's fulfilment of its macroprudential mandate.

13. **FI needs to step up supervisory intensity.** FI is responsible for supervising some of the largest and systemically important banks in the region, but its resources should be expanded to achieve an appropriate frequency of supervisory inspection, especially if the conversion of Nordea's regional banking subsidiaries into branches proceeds. Delays in the introduction of regulations while relevant legislation and ordinances are being amended should be minimized to support FI's capacity to safeguard stability.

14. **A leverage ratio can provide a useful backstop to risk-based capital requirements.** Reflecting the strong capital buffers of Swedish banks, stress tests suggest that their solvency is resilient under a severe scenario where a slump in global growth is associated with a sharp rise in unemployment and a large fall in housing prices. Yet, the exercise also illustrated the challenges of modeling tail risks in Sweden. It is therefore welcome that FI has proposed a new supervisory approach to risk weights on corporate exposures. Timely adoption of a leverage ratio as a backstop would further safeguard against model and measurement errors.

15. **A strengthening of bank liquidity requirements in foreign currency should be evaluated.** Although Swedish banks meet international liquidity requirements, sizable

liquidity support needs in foreign currency could arise depending on the duration of a funding shock and on market liquidity in the securities held by banks. Strengthening regulation in this area should be considered when reviewing foreign reserves.

16. **The highly interconnected Nordic-Baltic financial system requires close coordination in supervision, liquidity support, and resolution**. The interconnectedness of Nordic-Baltic financial systems means developments in one country could have significant spillovers across the region. Regional cooperation on financial stability should therefore be enhanced, building on the Nordic-Baltic Macroprudential Forum established in 2011. Memoranda of Understanding being negotiated among the regional supervisors should entail full access to supervisory information including participation in on-site inspections. Similarly, cooperative agreements among the relevant authorities are needed regarding liquidity support and also to ensure financial stability in all countries is protected in event of resolution.

Fiscal policy

17. **Accommodating the sharp rise in migration-related costs in 2016 is appropriate**. Last year's historic surge in asylum seekers has almost doubled spending on refugee reception and introduction to about 1.5 percent of GDP. But the budget deficit is still expected to be small owing to robust revenues and also due to lower than expected spending in other areas, so the fiscal stance is broadly neutral.

18. **Support for migrant integration and other initiatives in the Budget for 2017 is welcome**. While preserving a small fiscal deficit in 2017, the budget provides for initiatives totaling 0.6 percent of GDP in education, child and elder care, and active labor market policies, among others. Spending on refugee reception and introduction is expected to remain historically high.

19. **Sweden's fiscal health will continue to be protected following the proposed revisions to the fiscal framework**. Lasting fiscal discipline puts Sweden in a strong position to cope with short-term fluctuations and long-term challenges. The new surplus target of 0.33 percent of GDP (lowered from 1 percent) will continue to protect these buffers and the new debt anchor (at 35 percent of GDP) is valuable. In practice, these targets should be achieved over periods sufficient to avoid a pro-cyclical fiscal stance.

Migration-related and labor market policies

20. **Vulnerable groups face rising unemployment despite the strong labor market.** Job creation has been concentrated in skilled occupations leaving unemployment high and rising among less educated workers born outside Sweden. This problem will escalate as the new arrivals, many of whom have less education, enter the workforce.

21. **Further improvements in refugee reception and establishment are critical for their integration into the labor market.** Sweden has a well-developed refugee

integration framework and current labor market conditions are favorable. Nonetheless, the exceptional number and heterogeneity of new arrivals has put this framework under great pressure. The authorities have put in place welcome measures to reduce burdens on reception, speed up introduction, and open more pathways into the labor market. Yet, further efforts are needed to provide affordable housing to avoid settlement delays, ensure sufficient capacity at the municipalities for language training and basic education, and improve coordination among the many agencies involved in the integration process. The medium-term fiscal projections show some room to support such investments in coming years while still observing the new fiscal targets.

22. **The social partners also have a key role to play in supporting integration.** Budget initiatives in adult education and vocational training will help migrants prepare to join the labor force. Yet, it is also important to enable skills to be built on-the-job. Temporary and targeted exceptions to high entry-level wages have been used by neighboring countries to boost demand for lower skill workers. To protect living standards and improve work incentives these measures can be combined with expanded tax credits and strengthened benefit conditionality. Employment subsidy programs should be streamlined to increase their take-up and employer-employee matching should be improved to boost subsequent employment outcomes.

The mission team thanks the Swedish authorities and other counterparts for the excellent discussions and greatly appreciates their warm hospitality.