International Monetary Fund

Sweden—2005 Article IV Consultation

Concluding Statement

May 25, 2005

1. **The Swedish economy recorded a year of strong economic expansion in 2004, outpacing the euro area by a wide margin.** This remarkable performance was underpinned by large gains in productivity, continued low inflation and a comfortable competitive position. A stable policy regime, supported by healthy public finances and a credible inflation targeting framework, continues to anchor macroeconomic stability. Beyond the favorable near term outlook, the longer term prospects will depend critically on how economic policy addresses the challenges facing the Swedish welfare state in the context of changing demography and accelerating globalization.

2. **The robust expansion of activity seems set to continue this year and next, supported by the strength of domestic demand.** In contrast to 2004, when external stimulus served to propel growth, the primary drivers of growth this year are likely to be private consumption and business investment. Household demand is projected to accelerate, with disposable incomes boosted by low inflation, income tax cuts, and the expected upturn in employment. The latter, albeit tentative at the moment, is likely to materialize as firms respond to the upswing in demand, and public employment is set to pick up as well. Surveys of business intentions confirm that fixed investment is likely to expand strongly, as Swedish industry adds to capacity after a period of extensive restructuring that has contributed to a sharp rise in productivity and profit margins. With the output gap expected to narrow, inflation is projected to rise from the current very low level towards the Riksbank's target of

2 percent by the end of 2006. The risks to the growth scenario are on the downside, stemming primarily from worsening prospects in the euro area or a further sustained rise in oil prices. However, a failure of employment to pick up could also dent confidence and dampen the expected strength of the upturn.

3. **Strong productivity growth and a subdued labor market have kept inflation lower than expected, allowing an aggressive easing of monetary policy in early 2004.** Declining non-energy import prices and, more recently, falling food prices reflecting greater competition in the retail trade sector, have also contributed to the exceptionally low inflation. Expectations have remained low and in line with the inflation target, despite the recent high oil prices. Since the decisive shift in an expansionary direction in early 2004, monetary policy has accordingly remained on hold, maintaining its stimulative stance. Indeed, nominal interest rates have been at their lowest level in over fifty years and real interest rates are also at historic lows.

4. **With broad consensus on the continued favorable prospects for growth and a gradual rise in resource use in 2005-6, the case for easing monetary policy further at present is rather weak.** If the labor market improves as expected, with the rapid pace of productivity growth tapering off and the benign impact of various transitory factors dissipating, inflation is likely to rise steadily toward the 2 percent target over a two-year horizon. With the sizeable fiscal stimulus planned for 2005, the macroeconomic policy stance is already supportive of demand. Some caution is also suggested by the rapid rise in house prices in recent years as the demand for housing has been fueled in part by increasingly favorable credit conditions. The continued strong growth foreseen by most analysts would

soon imply an abrupt reversal of any easing. Such a calibrated fine tuning of demand is more likely to prove destabilizing. The need for easing should be reassessed, however, if the downside risks noted above become more evident.

5. **A substantial fiscal stimulus is planned for this year, despite the projection of continued strong growth.** This stimulus reflects a significant widening of the central government deficit. The expected decline in the ratio of expenditure to GDP only partly offsets tax cuts and tax expenditures, so that the structural surplus of the general government is set to decline sharply to just above half a percent of GDP by 2006. The remaining margins under the expenditure ceilings provide little shelter if the economic outlook were to be less favorable than assumed.

6. **Public finances continue to be sound, but the gradual drift away from the spirit of the fiscal framework is a cause for concern.** Sweden's fiscal performance over the past decade remains impressive, especially in the international context. Gross debt has fallen by a third, to below 50 per cent of GDP, and the net asset position has turned positive. The fiscal framework has provided a firm anchor to the political commitment to fiscal discipline. Compliance with fiscal rules far exceeds the standards achieved elsewhere in Europe. However, when assessed against its ambitious targets, the fiscal framework shows signs of stress. An erosion of the framework, with admittedly minor consequences in the short term, could be costly at a later stage when fiscal pressures from population aging intensify.

7. **The strains on the fiscal framework are evident in a number of symptoms.** A series of downward revisions of the annual budget targets for the general government has pushed the attainment of the 2 percent surplus beyond the medium-term policy horizon.

Margins under the expenditure ceilings for central government have gradually narrowed. Moreover, compliance with the ceilings has increasingly relied on ad hoc measures such as tax expenditures and the postponement of outlays. Central government finances have progressively deteriorated, moving into deficit since 2002.

8. **Resolving the ambiguity surrounding the surplus target for the general government will strengthen its transparency and promote accountability.** As currently defined, the target lends itself to different interpretations, ranging from an annual value in cyclically adjusted terms to an average value in nominal terms over a period of unspecified length. This makes it difficult to assess compliance and can compromise the effectiveness of the fiscal framework.

9. **Ambiguous targets may lead to the acceptance of lax policies in relatively favorable economic conditions.** An unchecked procyclical bias in good times reduces the margins for countercyclical policy in bad times. In the event, compliance with the target may require a procyclical correction during a downturn. The lack of economic rationale for such a prescription would harm the credibility of the fiscal framework and would likely lead to either pragmatic neglect or explicit repudiation.

10. **The lack of a precise anchor in terms of the budget balance undermines the discipline of expenditure ceilings.** Central government expenditure ceilings should, in principle, be set at a level consistent with the 2 percent surplus target. However, the elusive definition of the latter has not allowed the implementation of formal guidelines. The level of the ceilings has become somewhat arbitrary. It has been possible to ensure compliance through tax expenditures, despite their effects on the budget balance.

11. **Setting up an independent body to assist with the implementation of the fiscal framework could further enhance transparency and strengthen enforcement.** At present, while several institutions regularly comment and report on budgetary assumptions, plans and outcomes, none is formally responsible for assessing their consistency with the overall fiscal framework. The framework rightly aims at reconciling soundness and flexibility of fiscal policy. Therefore, its consistent implementation ultimately relies on variables such as the output gap and the cyclically adjusted balance. Given the complexity of the task, transparency is critically important. In this context, consideration could be given to appointing an independent body for translating the prescriptions of the framework into annual nominal budget goals. The same body could also conduct the ex post assessment of budgetary outcomes.

12. **While the short-term outlook for local government finances is favorable, longer-term challenges remain.** Higher transfers from the central government during 2005 will consolidate the slight surplus recorded last year. However, rising demand for public services will put pressures on local government budgets in the coming years. In order to meet these pressures, existing mandates could be reassessed and arrangements for determining the level of transfers could be revised accordingly. Encouraging local authorities to specify more clearly their medium-term spending plans could go some way toward improving fiscal coordination across levels of government. Greater coordination would facilitate attaining the general government surplus target as well as containing the overall tax burden.

13. **The task of raising labor utilization is becoming more pressing as demographic trends increasingly bear down on potential growth and public finances.** The high

taxation of labor continues to have adverse effects on labor supply. Moreover, the compressed wage structure prevents efficient utilization of labor, particularly at the lower end of the skill spectrum. A reduction of the tax burden for low-income workers would be supportive of the authorities' ambitious labor market objectives and could be more cost effective than the job creation measures currently in place.

14. **The shrinking labor supply, while driven in part by demographics, is also a reflection of the institutional setup that discourages work effort.** Features of Sweden's benefit regime, notably the generous provision of child and elderly care, have clearly contributed to raising participation rates, particularly that of women. However, other elements of the benefit system discourage work effort. Indeed, taking account of the large number of employees on sick leave, social assistance, labor market programs, and measures such as mid-life sabbaticals, effective employment is significantly lower. The marked rise in disability pensioners, especially among the younger population, is particularly worrisome. Some streamlining of the current benefit system and a tightening of its administration are necessary steps to stimulate labor supply and buttress the viability of the extensive social insurance system.

15. **The financial system has strengthened further**. Cost reductions and a sizeable decline in loan losses have improved bank profitability and corporations have consolidated their financial position considerably. Household borrowing, however, continues apace, reaching historic highs and contributing to the steady rise in house prices, especially in the largest cities. With interest rates expected to rise, debt service may become onerous for some households. An abrupt adjustment in property prices, though unlikely, would have a

considerable impact on household wealth. Close monitoring of these risks therefore remains essential.

16. **The pace of structural reforms needs to be accelerated.** Despite the progress in recent years, scope for raising competition remains in several sectors, including construction, pharmaceuticals, and retail trade. Deregulation in the housing market could also help to raise efficiency and promote labor mobility. As European and global integration gather pace, Sweden’s liberal approach to trade and immigration issues should place it in a favorable position to reap the potential benefits. However, a faster pace of deregulation of markets at home is necessary to realize the full benefits of enhanced integration.