September 2001
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Sweden: 2001 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of Sweden

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with Sweden, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 20, 2001,** with the officials of Sweden on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 15, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **August 31, 2001,** updating information on recent developments;

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its August 31, 2001, discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Swedish authorities.

The documents listed below have been or will be separately released:

Mission Concluding Statement
Selected Issues paper

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SWEDEN

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with Sweden

Approved by Michael C. Deppler and G. Russell Kincaid

August 15, 2001

- The 2001 Article IV consultation discussions were conducted in Stockholm during June 11–20, 2001 by a staff team consisting of Mr. Thakur (Head), Ms. Cerra, Mr. Horváth (all EU1), and Mr. Keen (FAD). The mission met the Minister of Finance Mr. Ringholm, Governor of the Riksbank Mr. Bäckström, other senior officials of the Riksbank, the Ministry of Finance, the Ministry of Industry and Labor, as well as representatives of the Confederation of Trade Unions, the Confederation of Swedish Enterprises, the private financial sector, and the academic community.

- The authorities published the Concluding Statement of the mission and have communicated to the Fund their intention to publish this Staff Report. A Financial Sector Assessment Program (FSAP) is planned later this year.

- The minority Social Democratic government, ruling with the support of the Left and Green parties, faces parliamentary elections in September 2002.

- For the first time since joining the EU in 1995, Sweden held the six-month rotating European Union (EU) presidency during the first half of 2001. While sentiment against the European Monetary Union (EMU), reinforced by the Danish rejection of the single currency in late 2000, remains strong, Prime Minister Persson has indicated that a referendum on EMU will take place by late 2004.

- Sweden has accepted the obligations of Article VIII, Sections 2, 3, and 4, and subscribes to the Special Data Dissemination Standard. Sweden's provision of high-quality core data on a timely basis facilitates the conduct of effective surveillance by the Fund.

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Sweden: Executive Summary: Staff Report for the 2001 Article IV Consultation

Background: Sweden's strong growth and financial stability of recent years are rooted in the macroeconomic and structural reforms put in place in the wake of the crisis of the early 1990s. The short-term challenge to policy stems from emerging upside risks to medium-term inflation, reflecting in part the prolonged weakness of the krona, and the risk of a sharper slowdown in growth than was expected only recently. The latter risk flows from the gathering pessimism about European growth prospects and the slump in the global technology sector—a sector that has played a pivotal role in the recent Swedish revival. The Riksbank's intervention in support of the krona in mid-June was followed by an increase in policy rates by 25 basis points in early July. While the krona remains weak, the strong medium-term fiscal position combined with the authorities' proven record of countercyclical fiscal management, the relaxed monetary conditions prevailing over the recent past, and the authorities' considerable policy credibility leave them with ample room for maneuver.

Policy Discussions: The overarching theme of the discussions in Stockholm—and the topic of a Selected Issues paper to be issued with this Staff Report—was an assessment of the challenges facing the Swedish welfare state in a globalizing world. The mission's dialogue with a wide spectrum of Swedish opinion, including roundtable discussions at the Stockholm School of Economics and Uppsala University, did not reveal a consensus on whether to streamline the welfare state further.

Against this background, the discussions centered on:

- the appropriate macroeconomic policy stance in the light of the balance of evolving risks to activity and inflation;
- the scope for and timing of tax cuts within the authorities' medium-term fiscal framework;
- the broader reform agenda in the context of globalization, European integration, and demography.

The authorities and staff agree that:

- the Riksbank's July interest rate increase was appropriate given emerging pressures on medium-term inflation and the recent relaxed monetary conditions;
- strong fiscal performance and the medium-term fiscal rules left room for tax cuts in the coming years;
- the resulting policy mix of a more neutral monetary stance and a moderate fiscal expansion may have the fortuitous side effect of helping ease the path of the undervalued krona toward its equilibrium level.

In addition, the staff argue that:

- the prospective overperformance relative to the structural surplus target should be used for tax cuts;
- the authorities should aim at building a "New Swedish Model" for the coming century that would be guided by the vision of higher economic growth.

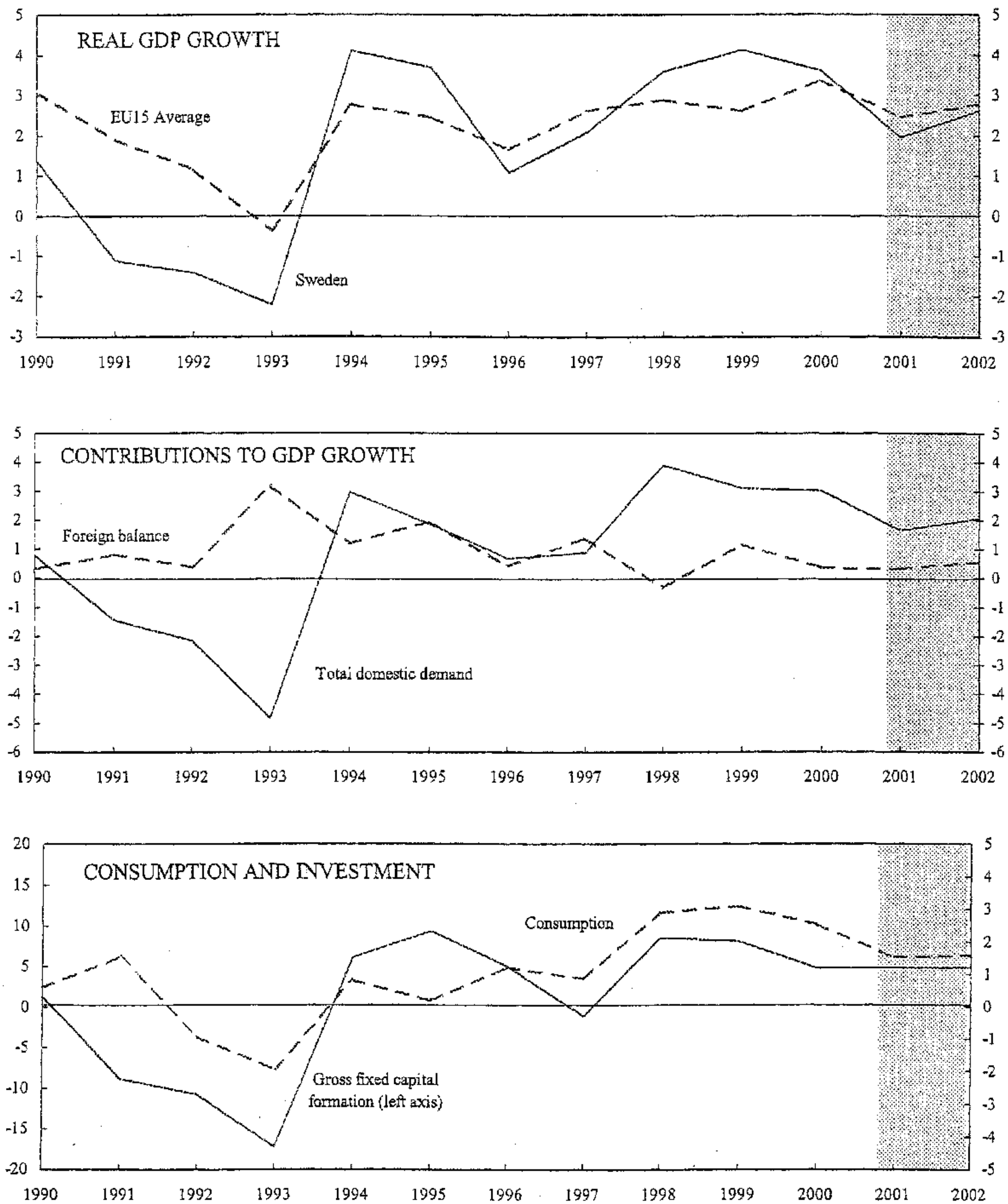
I. A Decade of Crisis, Reform and Recovery

1. **The crisis of the early 1990s set in motion major changes in the Swedish economic policy landscape.** The crisis—triggered by inconsistent policies in the wake of a boom following financial liberalization—was characterized by high wage and price inflation, the bursting of a bubble in real estate prices and an ensuing banking crisis, a forced exit from the currency peg against the ECU, and a huge fiscal imbalance. It culminated in the deepest recession since the 1930s. The adverse effects of high public sector employment, generous welfare benefits, high tax rates, and the strong sensitivity of government finances to the business cycle were laid bare by the recession and were viewed in part as embodying a larger crisis of the "Swedish model." The resulting resolve to streamline the large welfare state seemed to have reflected a consensus spanning the political spectrum. Since then, the authorities have done much to restore stability and credibility.

2. **The strong recovery and financial stability of the past five years reflect in large measure the fruits of economic reforms enacted over the past decade.** The dramatic policy transformation was anchored in the Riksbank's successful switch to inflation targeting; deregulation in key markets induced by EU membership; and a major fiscal adjustment entailing a substantial reduction in public spending, but also a further rise in the high tax burden. Enhanced policy credibility and a supportive international setting ensured robust growth and steady employment gains in the closing years of the decade.

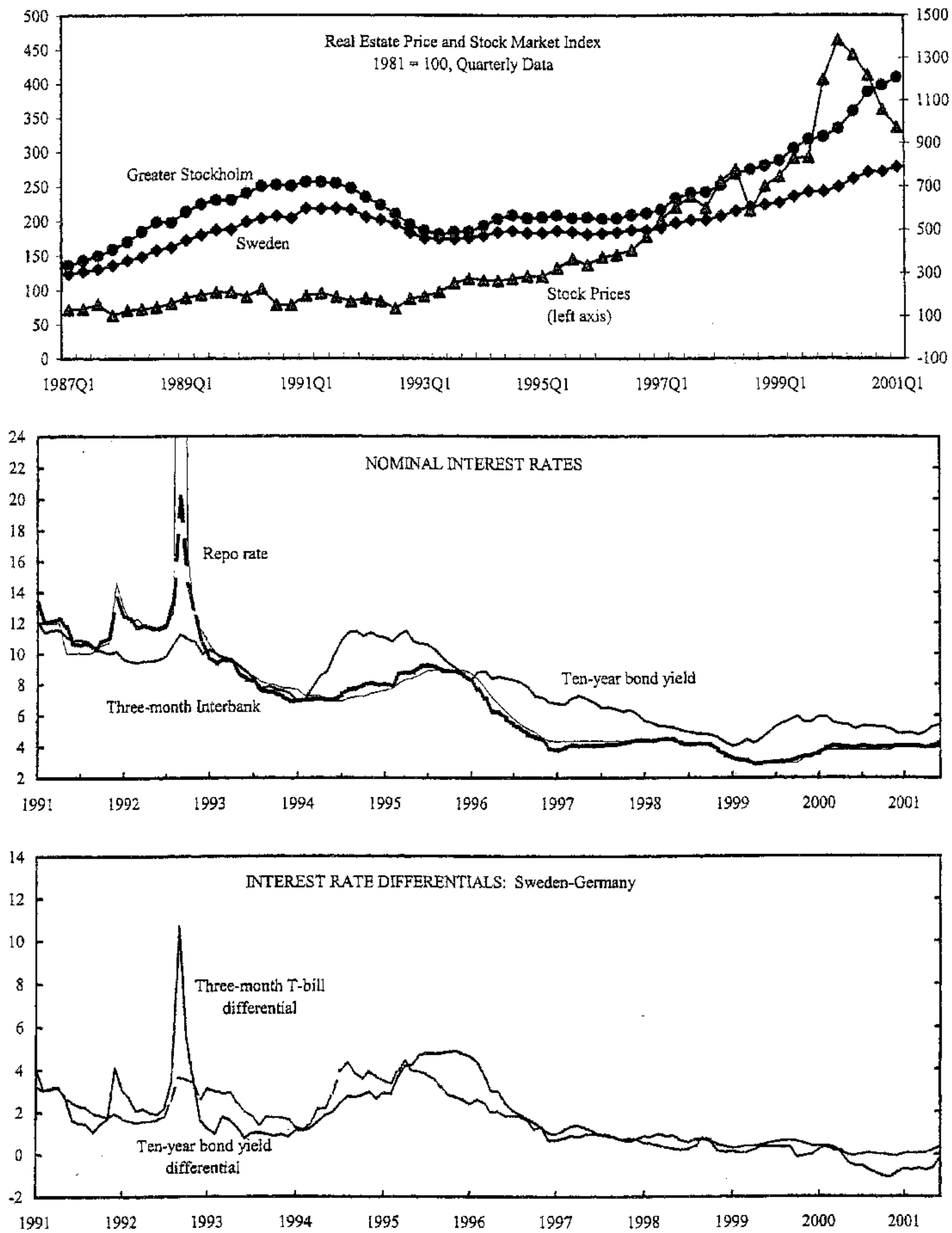
3. **The economic revival of the past three years has been marked by a booming high technology sector and low inflation.** Real growth averaged around 4 percent in 1998–2000, closing the output gap, with buoyant incomes and employment buttressed by the rapid build-up of household wealth (Figure 1). Consumer price inflation remained well under the Riksbank's 2 percent target, as the task of monetary policy was eased by non-monetary influences on inflation such as deregulation, greater competition and long-standing controls on housing rents. The consequent fall in inflation expectations played a major part in dampening wage demands. While equity prices mirrored the ascent in global technology stocks—before crashing in sync with them—real estate prices maintained their steady climb through mid-2001. The household saving rate fell to 2 percent in 2000, reflecting lower precautionary savings and a possible Ricardian response. Gross public debt fell by 13 percentage points of GDP over three years to 56 percent of GDP at end-2000. As resource pressures intensified, the Riksbank raised its repurchase rate late 1999 and early 2000, but with a benign inflation outlook, it kept rates generally steady thereafter. As policy credibility rose, ten-year bond yields converged to German levels by mid-2000 (Figure 2).

Figure 1. Sweden: Output Developments and Prospects
(Annual percentage change)



Source: Statistics Sweden and National Institute of Economic Research.

Figure 2. Sweden: Asset Price and Interest Rate Developments

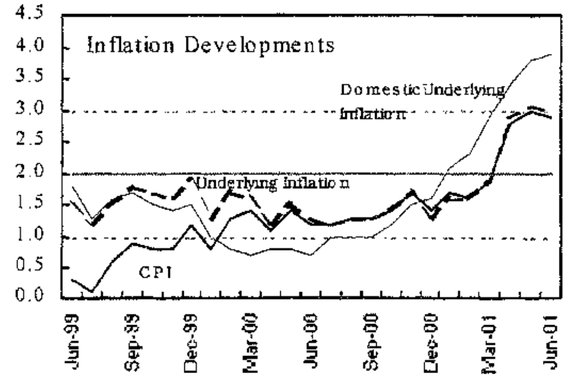


Source: Statistics Sweden; Riksbank; IMF, International Financial Statistics, and INS.

II. Slowing Growth and Rising Inflation

4. **Economic activity slackened in the first half of 2001, albeit from a rapid pace.** Export growth receded, reflecting primarily the sharp slowdown in the United States and the gathering weakness in Europe. The catalytic role of the technology sector in the recent economic dynamism in Sweden has made it particularly vulnerable to the U.S.-led global tech downturn. Indeed, the adverse wealth effects stemming from widespread holdings of equity concentrated in the plunging technology sector have dampened consumption, with both consumer and business confidence falling more markedly than in the euro area.

5. **Underlying, as well as headline, inflation surged unexpectedly in recent months.** The 12-month headline inflation rate rose sharply in May 2001, and stayed high in June, approaching the upper edge of the Riksbank's tolerance band of +/-1 percent around its target of 2 percent—the first time that it has reached this level in the past five years. The rise reflected contributions from many components—notably food, energy, telecom and house rents. The official measure of underlying inflation (which excludes indirect taxes and interest costs) increased to around 3 percent in June. Domestic underlying inflation (which in addition excludes import prices) climbed to nearly 4 percent.

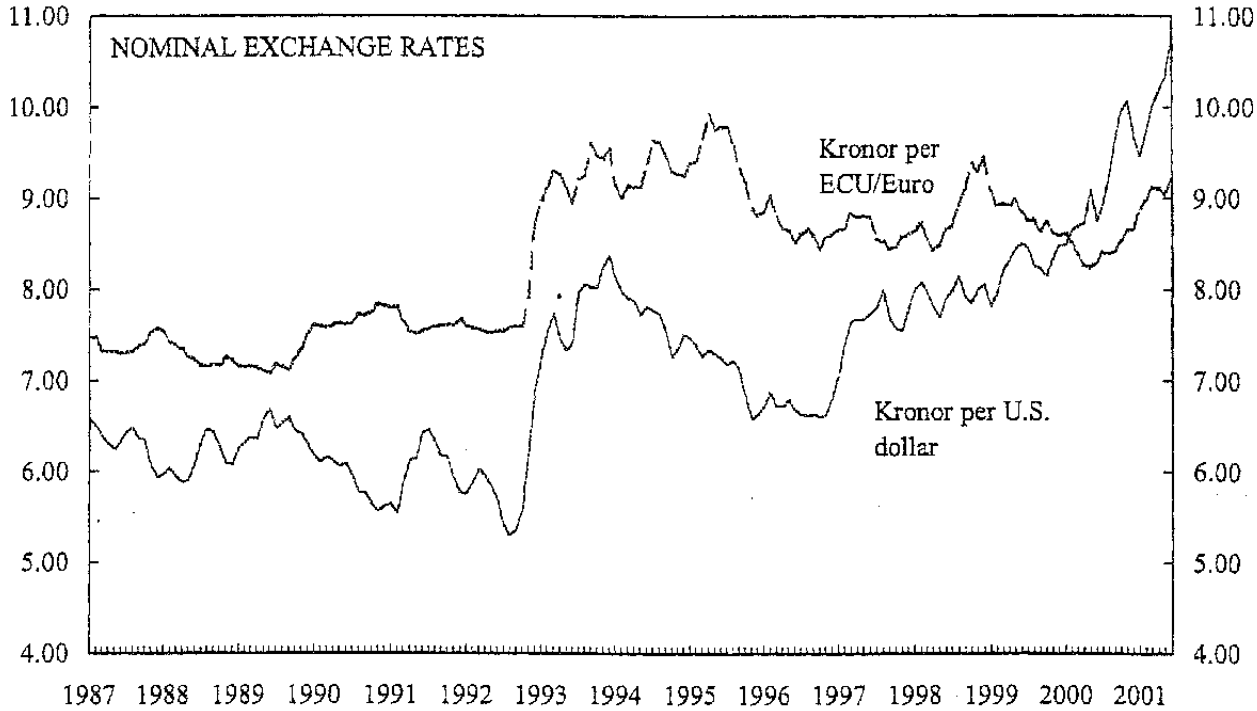


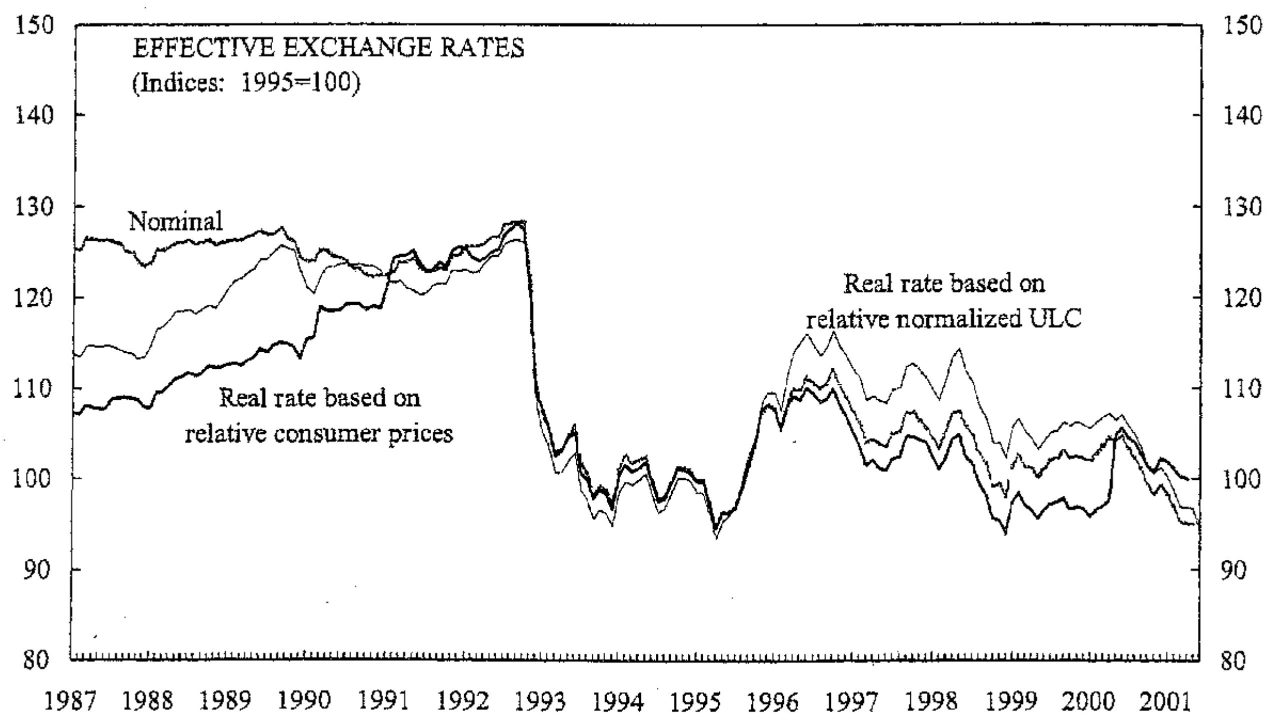
6. **The krona has weakened substantially since mid-2000, notwithstanding Sweden's strong fundamentals.** It fell by about 11 percent against the euro in the year to June 2001 and 15 percent in trade-weighted terms (Figure 3). Several possible factors seem to underlie the weakening of the krona (Box 1). In particular, it seems to reflect unusually large portfolio outflows in the wake of the global technology and telecom downturn as well as a structural shift brought about by a gradual relaxation of restrictions governing foreign currency exposure by pension funds from the beginning of 2001. The depreciation brought the real effective exchange rate close to six-year lows.

7. **The recent high growth of employment will likely taper off.** With the service sector providing the lion's share of the gains, employment climbed rapidly through the early months of 2001—raising the employment rate to 78 percent in mid-2001—and the unemployment rate continued to fall (Figure 4). The expansion was rooted in continued high demand for labor and a steady increase in the participation rate. Hours worked have risen at a slower pace, owing to growing absenteeism, primarily in the form of higher sick leave since 1997. However, as economic growth slows, a deceleration in employment gains is anticipated.

8. **Three-year wage agreements for 2001–3 embody moderate negotiated wage increases.** Hourly wages are estimated to have risen by 3.6 percent in 2000—slightly more

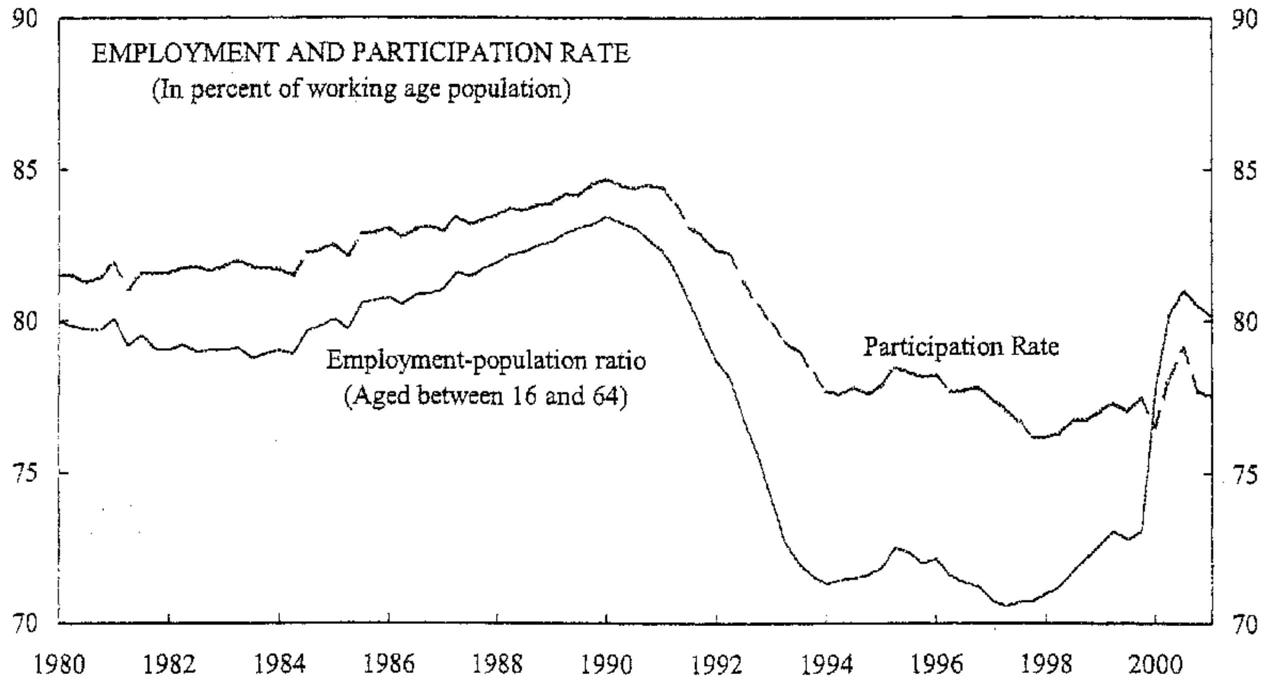
Figure 3. Sweden: Exchange Rate Developments

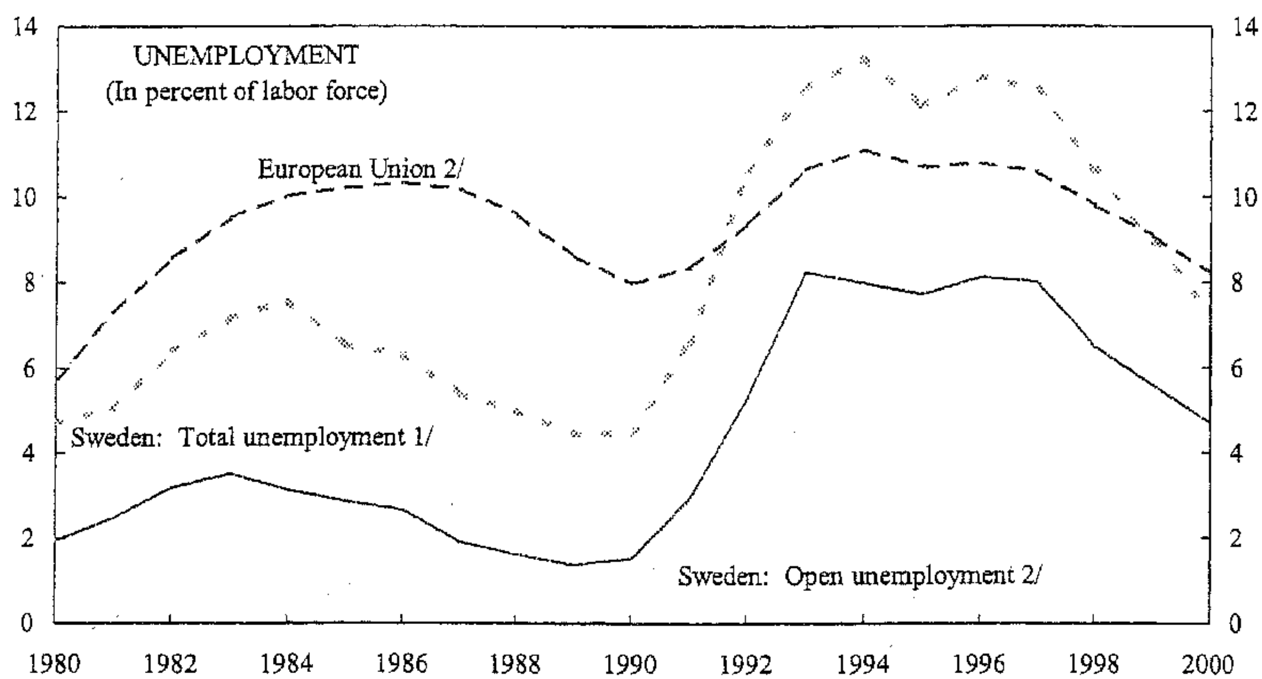




Source: IMF, International Financial Statistics

Figure 4. Sweden: Labor Market Developments





Sources: Statistics Sweden and OECD.

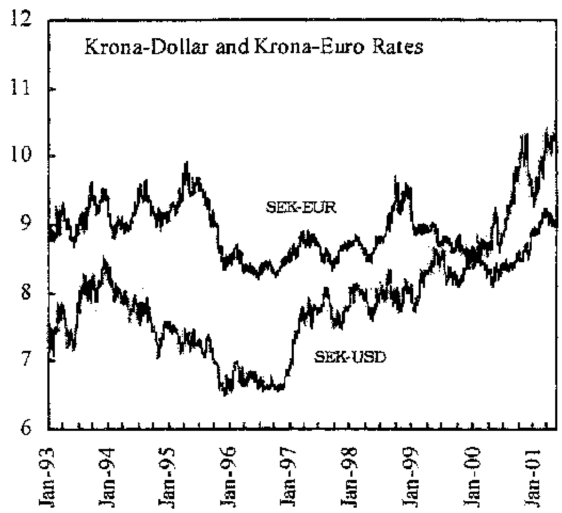
1/ Open unemployment plus labor market measures.

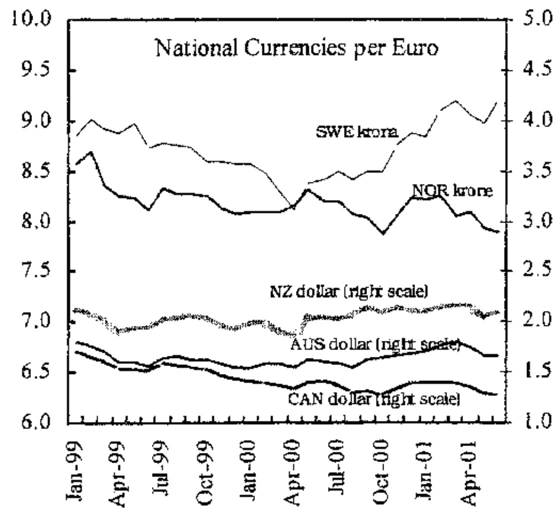
2/ Source is OECD.

Box 1. The Weak Krona

The prolonged weakness of the Swedish krona has heightened upside risks to the medium-term inflation target of the Riksbank. Although the pass-through into domestic prices has been limited so far, if the weakness persists, the impact on inflation could increase. The Riksbank's May 30, 2001 inflation report assumed that the krona would strengthen along its estimated equilibrium path. It nevertheless continued to decline in the weeks after the publication of the report, prompting a debate on the reasons for the weakness and spurring foreign exchange interventions by the Riksbank in mid-June.

The krona's weakness cannot be fully explained by global conditions. The krona has been more stable against the euro than against the U.S. dollar (see chart below), so the euro-U.S. dollar cross rate has been an important determinant of the trade-weighted index of the krona. An uncertain global environment often leads to a flight to safety and out of minor currencies such as the krona. Yet, the krona has been much weaker than other such currencies, e.g., the Australian, Canadian and New Zealand dollars and the Norwegian krone (see chart below).

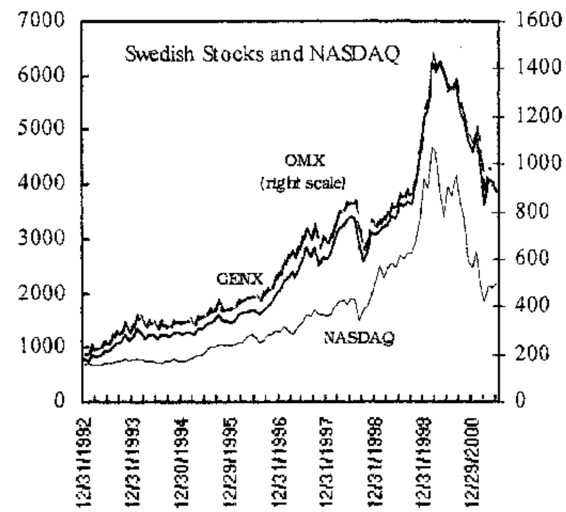




Traditional current account variables also do not fully explain the krona's slide. Adjusting Sweden's current account balance for the fact that earnings on direct investment abroad are generally reinvested leads to a halving of the surplus (Table 3). Some analysts believe that, because of the importance of multinationals and of the high tech sector, Sweden may be affected more than other countries by the global slowdown, leading to relative cyclical weakness, and subdued export performance in the near term. Sweden's terms of trade may have declined recently as well. Nonetheless, most models based on traditional factors estimate that the krona is significantly undervalued, perhaps by around 10 percent.

Several capital account considerations seem to primarily account for the krona's weakness.

- Ericsson—the telecom giant—represents a large share of the Swedish stock market, which tends to be highly correlated with the NASDAQ (see the chart below showing the general stock index, GENX, and a narrower index of 30 stocks with the highest trading volume, OMX). The recent bouts of negative news about Ericsson as well as telecom firms in other countries, such as Nokia and Nortel, have led to capital outflows from wary investors.



- New investment rules permit Swedish retirement funds to expose up to 15 percent of their portfolios to currency risk in 2001, up from 5 percent last year, leading to potential currency outflows of about 2½ percent of GDP over the course of 2001. This share will gradually rise to 40 percent in five years.

- Repayments on the government's foreign debt, although somewhat lower than in 2000, are still projected to be roughly equivalent to the adjusted current account surplus.

- For much of the year, Sweden had a negative short-term interest rate differential versus the euro area (see Figure 2).

- The recent sharp increase in assessed home values may have pushed many investors in domestic financial securities above the low wealth tax threshold, thereby adding to capital outflows for tax reasons.

- Finally, some analysts may be questioning if the Swedish "miracle" was running out of steam, leading to some skepticism about Swedish economic prospects.

The depreciation of the krona reflects both cyclical and structural elements. The effects on the exchange rate of the flight to safety, and any temporary export or growth slowdown can be expected to reverse as soon as international and Swedish economic conditions begin to recover. Moreover, the Swedish interest rate differential has very recently turned positive against the euro and the euro is expected to strengthen against the dollar in most forecasts. These factors should help prompt a recovery of the krona. Also, technology stocks are highly volatile and may exhibit a strong sensitivity to the economic cycle. Therefore, as global growth turns up, Ericsson and the Swedish stock market may be expected to attract foreign inflows, although if previous peaks were partly based on irrational exuberance, the market levels may not fully recuperate in the medium-term. At least one of the structural factors, the pension fund currency outflows, will take a number of years to run its course. Repayment of public debt will also persist for some time, although the policy option exists to slow repayment of the foreign debt. The government also has the possibility of influencing a second structural factor: it can rejuvenate its reform efforts, thereby convincing the market of sound policies and a brighter economic future.

than in the year before. However, the recently concluded three-year wage agreements resulted in a negotiated rise in wages of around 3 percent for 2001—broadly consistent with the inflation target—and locked in similar moderate increases for the next two years. Wage drift has averaged around 1.1 percent for the past three years.

III. The Short-Term Outlook

9. **Sweden faces continued slower economic growth in the rest of 2001, followed by a return to potential output in 2002 with the projected global recovery.** The consensus forecast for growth in 2001 has fallen steadily in the past few months from 3 percent to 2¼ percent as the flow of orders for key export categories such as telecom, motor vehicles and chemical products has dropped below its level during the Asian crisis. As softening domestic demand adds to the effects of a deepening downturn in foreign demand, the staff expects output to grow barely 2 percent this year, slightly below potential growth and somewhat lower than the latest (May 30) published projection of the Riksbank. Moreover, the technology sector—which has contributed an average of ¾ percentage point to annual GDP growth over the past five years—has been hard hit by the global downturn. In particular, Ericsson—the world's biggest producer of wireless networks, the largest Swedish company, and pre-eminent in its stock market—has suffered large losses even as it restructures. Assuming a recovery of global growth in 2002 in line with WEO projections, some revival of the krona, and the fiscal stance suggested by the staff (see below), Swedish growth is projected to rise to 2½ percent, output to be near its potential level, and unemployment to remain around 4 percent (Table 1). However, continuing weakness of the technology sector, depressing confidence, may keep growth soft into 2002, risking a weaker rebound.

10. **Even as the economy enters a somewhat subdued phase, inflation is projected to be slightly above the Riksbank's target over a two-year horizon.** The moderate three-year wage agreements, and slowing global and domestic demand are the main factors limiting price pressures. However, stresses stem from a variety of other sources, including the recent energy and food supply shocks and the declining contribution from past deregulation to lowering inflation. In its May Inflation Report, the Riksbank projected inflation to be slightly above its medium-term target, assuming that the supply shocks would be temporary and the krona would strengthen. Since May, the krona has fallen further, raising the risk of an exchange rate weaker than assumed. The staff foresee a marginally higher rate of inflation than in the Inflation Report, partly on the basis of the weakening of the krona since May, although this difference has been to some extent offset by the increase in interest rates in July. Staff consider the balance of inflation risks to be on the upside. These risks arise from the likelihood of a rising pass-through to domestic prices if the weakness of the krona persists; the possible adverse effect of the recent broad-based inflation surprises on expectations and attempts to offset their impact on real wages, and the possibility that supply shocks could endure.

IV. THE PRESENT POLICY SETTING

11. **The macroeconomic policy setup rests on the firm foundations of a fiscal strategy grounded in clear medium-term guidelines and the Riksbank's inflation targeting framework.** The successful execution of this setup in recent years now affords the authorities room for maneuver to fashion an appropriate policy response to the short-term uncertainties. Over the medium term, they also face the challenge of sustaining the recent high growth through accelerating structural reforms.

12. **Fiscal policy is anchored in the authorities' medium-term fiscal rules.** The centerpiece of these is a target of 2 percent of GDP for the general government surplus over the business cycle, supplemented by annual nominal ceilings set on a rolling three-year basis on central government primary expenditures and a balanced budget rule for local governments. The old age dependency ratio is projected to rise in Sweden over the next few decades, although by less than the average for the advanced economies. A new pension system put in place in 1999 went a long way toward restoring financial viability in the face of this demographic shock. However, the surplus target is intended to leave sufficient room to cope with the impact of this shock on non-pension spending, as well as to ensure Sweden would meet the requirements of the EU Stability and Growth Pact. The surplus target was exceeded by a substantial margin during 2000, as revenues continued to outpace budget estimates. This surplus contributed to a faster reduction in public debt than was earlier envisaged.

13. **The 2001 budget continued the authorities' strategy of gradual reduction in the tax burden.** Income taxes were reduced by about 0.6 percent of GDP in 2000 and 2001 to offset half of an earlier rise in social security contributions. Expenditures were set in line with the ceiling, facilitating a decline in the projected general government spending ratio to 54 percent of GDP. The Spring Budget used up the contingency within the 2001 expenditure ceiling to raise expenditures, notably the generosity of unemployment benefits. It also made commitments—remaining within the expenditure ceilings—for further spending increases in future budgets.[1]

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[1] The budget process for central government involves two stages. The detailed budget law is formulated in the fall for the subsequent calendar year (which coincides with the fiscal year). The Spring Budget in April makes minor adjustments to the budget, sets out expenditure ceilings for the coming three years, and provides medium-term projections for general government.

14. **The authorities are set to use part of the room provided by the over-performance relative to the medium-term fiscal target, implying an expansionary fiscal stance in 2002.** Fiscal overperformance relative to the structural surplus rule is expected to continue, leaving room for tax cuts (expenditure increases being constrained by the ceilings). The spring 2001 budget projects the overperformance at roughly 1½ percent of GDP, assuming no additional tax measures and continued adherence to central government expenditure ceilings. The staff, on the other hand, projects the excess over the target to amount to around 2½ percent of GDP over the next three years, reflecting higher revenue forecasts and lower general government spending (see table).[2] The authorities have signaled the likelihood of continuing with the remaining two steps of their phased income tax reductions, each costing 0.6 percent of GDP, in 2002 and 2003. The staff recommends an additional tax cut of 0.8 percent of GDP in 2002 (see below and Table 2).

Sweden: General Government Finances in Percent of GDP

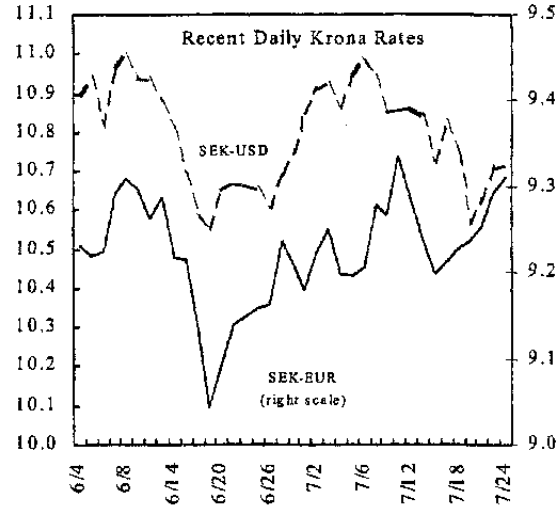
		Staff Projections			
	2000	2001	2002	2003	2004
Total revenues	59.5	57.7	57.6	57.3	57.2
Tax revenues	52.8	51.8	51.6	51.5	51.2
Total expenditures	55.4	54.1	53.5	53.2	52.6
Subject to expenditure ceiling	35.6	35.5	34.8	33.9	32.9
Overall balance	4.1	3.7	4.1	4.2	4.6
Structural balance 1/					
No tax changes	4.1	3.9	4.1	4.2	4.4
Authorities proposals 2/	4.1	3.9	3.5	3.0	3.2
Staff recommendations 3/	4.1	3.9	2.7	2.2	2.5

1/ In percent of potential GDP.
2/ Reflecting income tax reductions of 0.6 percent of GDP in each of 2002 and 2003 as signaled by the authorities.
3/ Reflecting--in addition to the authorities' proposals--the staff's recommendations to cut taxes by a further 0.8 percent of GDP in 2002.

15. **The Riksbank has built a strong reputation based on its inflation targeting framework.** Through consistent monetary policy formulation, the Riksbank has acquired credibility and lowered inflation expectations. Transparency and public articulation of policy have been centerpieces of this framework, facilitating greater public acceptance of a steadfast focus of monetary policy on inflation.

16. **Concerned about the potential impact of the prolonged weakness and further slide of the krona on inflation, the Riksbank intervened in mid-June.** The intervention was carried out over a period of several days in the second half of June, and was the first

[2] Staff see the higher-than-budgeted revenue outturns in recent years as representing in part a more persistent phenomenon. Moreover, the staff forecast for corporate taxes as a percent of GDP is in line with the trend of recent years, in contrast to the decline assumed by the authorities. Finally, the authorities' projections appear to assume higher local government spending compared with their earlier estimates; the staff sees this expansion of spending as unlikely, given that the balanced budget rule for local governments would imply an accompanying increase in local taxes.



such action since late 1998. The krona initially rose against both the euro and the U.S. dollar, but it then slid back to its pre-intervention levels by end-June (see chart). Although the slide of the krona, if it were to persist, could pose difficult policy dilemmas, the level of the repurchase rate—at 4¼ percent, among the lowest in Europe—leaves room for monetary policy flexibility, whether inflation risks rise or recede.

V. The Policy Discussions

A. The Overview and Policy Mix

17. **The staff's discussions in Sweden centered on the following key themes:**

- **What should be the macroeconomic policy stance in the light of the evolving risks to activity and inflation?** The debate on this issue acquired an added edge with the accelerated slide of the krona in the period before the mission, the Riksbank's decision to intervene during it, and the growing pessimism over the outlook for growth in Europe;

- **What is the scope for tax cuts within the authorities' medium-term fiscal framework, and in the broader context of the reform agenda?** How much and in what manner should such room be used in the budget for 2002, and how should this decision be calibrated in light of the required fiscal stance and the resulting policy mix?

- **Do new pressures reinforce the case for revamping the Swedish welfare state in an effort to raise long-term economic growth?** If so, what are the priorities for reform? The mission conducted a dialogue with a wide spectrum of Swedish opinion makers on this overarching issue, which is explored in the forthcoming Selected Issues paper.

18. **Discussions on the policy implications of these themes revolved first around how to implement the authorities' policy frameworks in the light of long-term goals.** Although tax and spending ratios have fallen in recent years, they remain the highest among the advanced countries, generating sizeable economic distortions (see section D below). Therefore, the staff argued for using more of the room allowed by the medium-term fiscal framework to reduce the most distortionary taxes, whereas the authorities appear to view the

structural surplus target as a lower bound that could be exceeded for a time. The staff were concerned that if fiscal overperformance relative to the medium-term target was allowed to persist, it could lead to irresistible demands for higher spending that would breach or weaken the expenditure ceilings.

19. **Monetary and fiscal policies enjoy considerable room for maneuver to deal with short-term risks.** Sweden is in a strong medium-term fiscal position to combat the threat of a downturn. This contrasts with the situation of some other EU countries, which—in order to ensure they meet the rules of the Stability and Growth Pact—can at best only afford to let automatic stabilizers play out. Moreover, Sweden has a history of using discretion to stabilize output (see Box 2). The authorities and the staff are cognizant of the benefits of conforming to the macroeconomic policy framework. While being consistent with this framework, the staff's fiscal policy advice would provide greater stimulus in 2002—a stimulus that would be welcome if downside risks to growth were to materialize. If the growth outlook were to be more benign, monetary policy would need to be somewhat tighter than otherwise. The resulting policy mix could have the salutary side-effect of nudging the undervalued krona toward its equilibrium level, thereby helping bring inflation down to its medium-term target.

B. Monetary Policy

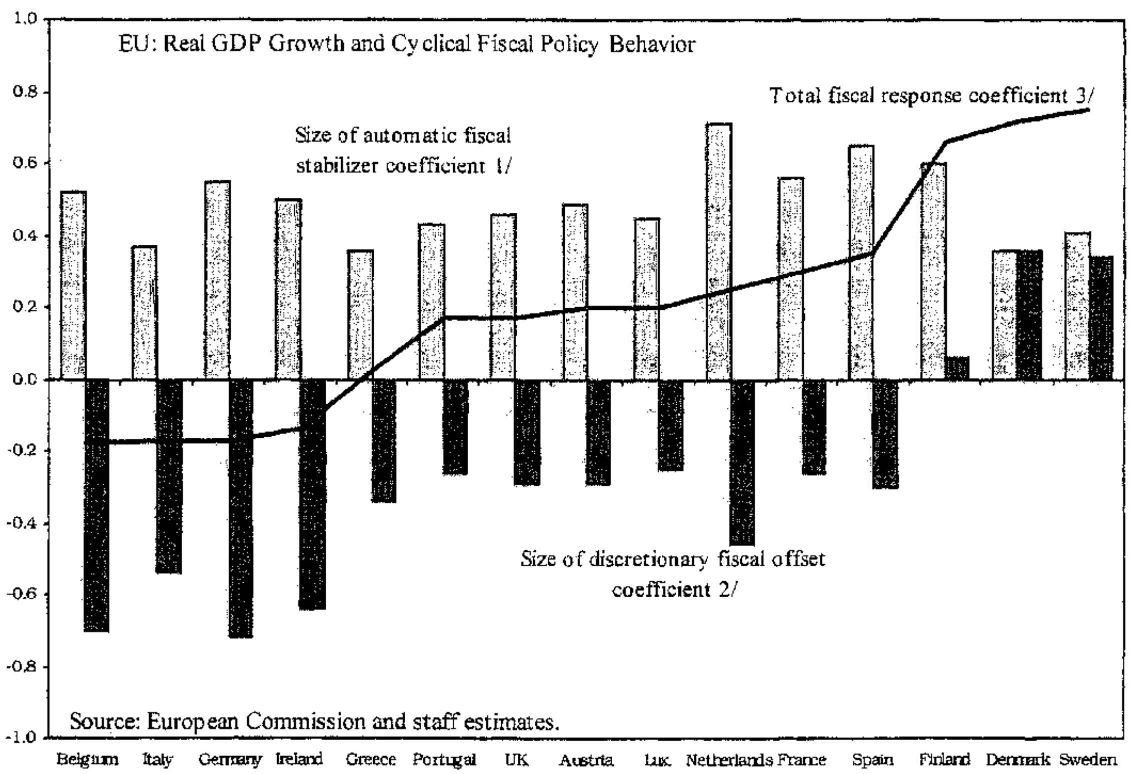
20. **The Riksbank's consistent application of its monetary framework helped bring down inflation and inflation expectations.** Favorable effects of earlier deregulation and productivity gains stemming from the new technologies also helped keep price pressures at bay, obviating any need to raise interest rates significantly. Indeed, policy interest rates were held broadly steady since early 2000, allowing Sweden to enjoy one of the lowest rates among the advanced economies. In the staff's view, these low and stable policy interest rates were appropriate, given the below-target inflation outcomes and the lack of any visible signs of inflation pressure at the time. However, with the benefit of hindsight, monetary conditions appear to have been too relaxed over the past year, as a result of the unforeseen decline of the krona, and given inflation surprises of recent months.

21. **The Riksbank saw the spectrum of risks to its central forecast for inflation two years ahead widening since late last year**. The rising upside risks included the possibility of higher wages, higher oil prices, and a continued weakness of the krona. Since then, global growth prospects had unmistakably worsened, a view reflected in the Riksbank's May 31 Inflation Report. Nevertheless, the persistent weakness of the krona, higher world inflation, and likely resource pressures as output moves above potential in the two-year horizon added to the upside risks. Riksbank officials had also become more sympathetic to the view—as had the staff—that the limits to noninflationary growth may not have improved as much as had been imagined earlier based on an optimistic assessment of the benefits of the new economy.

22. **The further sharp slide in the krona since May underscored the upside risks to inflation and led the Riksbank to intervene, followed by a rise in its policy rate.** Officials

Box 2. Sweden: A Record of Countercyclical Fiscal Management

Sweden has had a long record of countercyclical fiscal policy, with the highest total (automatic plus discretionary) fiscal stabilizer in the European Union (EU). The chart below shows the average annual change in the budget balance of the general government in response to a 1 percent change in GDP over 1978–2000 for the EU members. Strong automatic stabilizers reflect Sweden's high revenue and expenditure shares and large transfer programs. Moreover, in the case of Sweden, discretionary fiscal impulses were countercyclical and sizeable as well, in contrast to all of the non-Nordic EU countries. Indeed, only Denmark displayed on average a similar strong discretionary fiscal policy behavior.



1/ Automatic change in general government balance-GDP ratio in response to a 1 percentage point increase in real GDP.

2/ Change in structural general government balance-GDP ratio in response to a 1 percentage point increase in real GDP.

3/ The total fiscal response coefficient line shows the net sum of the automatic and discretionary stabilizer coefficient bars.

noted that the weakness of the krona had so far had only a small impact on inflation, probably because it was regarded by price-setters as temporary. However, the longer the weakness lasted, the less likely it was to remain benign. The intervention decision was motivated by concerns that the weakness of the krona may start posing a threat to the medium-term inflation target, particularly with the expected continued high level of resource use. Riksbank officials were keen to underline that their monetary policy actions remained consistent with inflation targeting and that, contrary to some market perceptions, the significance of the exchange rate within that framework had not changed. The Riksbank, following through on its announced intention to raise interest rates if necessary to meet its medium-term inflation target, raised its repurchase rate by 25 basis points on July 5. Staff agree that this move toward a more neutral stance was appropriate.

23. **Looking ahead, the Riksbank faces the challenge of assessing the effects of the weak krona, the supply shocks, and the slowing activity on medium-term inflation.** Officials, while not complacent, viewed the recent upsurge in headline and underlying inflation as largely transitory, reflecting—as in the euro area—the effects of various supply shocks. The relative stability of inflation expectations—having hovered around 2 percent in recent months, and risen to 2.4 percent in June—suggested that consumers shared this perception. Based on the assumption of a krona appreciation by 5 percent over two years, inflation was forecast by the Riksbank to be only marginally higher than its 2 percent target by June 2003. Looking ahead, while the degree of uncertainty was judged to be considerable, the Riksbank viewed the risk spectrum as balanced. Financial markets are nevertheless pricing in a rise of 50 basis points in the refinancing rate over the next year.

24. **Indicators of systemic stability suggest limited risks to the financial system** (Table 4). The authorities noted that in view of its strong financial position, the banking system should be able to cope with even a more marked downturn than now expected. Bank exposures to the stock market and information technology sector were quite limited, although the large role that Ericsson played in the economy added to general risk. Capital adequacy ratios fell slightly, reflecting in part a desire to enhance efficiency. Household wealth was at a high level and interest costs were low in relation to disposable income. The corporate sector's borrowing ratio was also low. Nevertheless, the recent financial consolidation and the risk of further declines in share prices call for expanded supervision and continued vigilance. The Fund will conduct a FSAP in the autumn with the aim of assessing the strengths and weaknesses of the financial system and its vulnerability to macroeconomic shocks, the observance of standards on regulation, supervision, and transparency, and identifying required policy responses.

C. Fiscal Policy

25. **Fiscal overperformance provides room for significant tax cuts over the next three years**. The authorities saw scope to reduce the general government structural surplus by around 1½ percent over 2002–2004 without compromising the structural surplus target. However, they believed that the size of the tax cuts should not be too large due to uncertainties about the output gap and the true structural surplus. Moreover, they were eager

to avoid an unexpected surge in public debt from an adverse shock and were content to allow a faster pay-down of debt. The staff's projections indicate somewhat greater scope for tax cuts (footnote 2 and paragraph 14), in part because the authorities' revenue estimates in recent years have erred consistently on the cautious side. By contrast, the staff consider that there is a risk of missing the current opportunity to reduce taxes before future expenditure pressures use up the available room provided by structural surpluses over the target. This line of reasoning points to using at least 2 percent of GDP over 2002-2004—which would still provide some buffer for uncertainty—to reduce the most distortionary taxes.

26. **The authorities and the staff view front-loaded policy measures as appropriate given the cyclical position.** As last year's fears of overheating have transformed into this year's concerns about an economic slowdown, the authorities shared the staff's view that implementing a significant proportion of the tax cuts in 2002 would be preferable from a demand management perspective. This could not only help forestall a larger-than-expected negative growth shock in the near-term, but could also avoid the need to impose a significant positive fiscal impulse in later years as output rebounds and capacity constraints tighten. The staff foresees its policy recommendation as implying only a limited impact on demand in view of Sweden's small open economy, and the likelihood that much of the authorities' tax proposals have already been reflected in higher household consumption levels.

27. **Tax cuts are on the agenda for the forthcoming budget.** The authorities will decide how to use their fiscal policy headroom in the context of the annual budgets, with that for 2002 to be announced on September 20. Nonetheless, they have already reduced income taxes in 2000 and 2001 to offset half of an earlier rise in social security contributions, and have signaled the likelihood of continuing with the remaining two steps in 2002 and 2003. Other tax policy initiatives will likely await the results of a study underway to investigate the relative benefits of various policy measures in the context of globalization. Taxes on capital income, wealth, property and inheritances are likely to be among those under consideration. Calls to cut real estate tax rates appear to be gaining momentum, following a recent sharp increase in property assessments.[3] The authorities were committed to maintaining the level of nominal expenditure ceilings over 2002–4 in the face of pressures to breach them. They have avoided revising previously announced ceilings since their introduction in 1997 and saw this practice as indispensable for their fiscal credibility.

28. **Staff underscored that the room provided by the fiscal overperformance should be used to reduce the most distortionary taxes.** After allowing for the two phased income tax cuts in 2002-03, the mission estimated that about ¾ percent of GDP in fiscal room would remain, after allowing for a safety margin. In its view, this room should be used in the upcoming 2002 budget to reduce the most distortionary taxes. Specific measures for consideration include:

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[3] Property taxes in Sweden are somewhat below the average for the EU.

- Unifying the two central income tax rates applying to higher incomes at a level below the current lower rate would be feasible, and holds the prospect of improving incentives for an especially productive 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.

- Reducing the starting rate of income tax, and increasing the allowance (with a rationalization of the allowance structure).

- Structural reforms to the wealth tax—removing exemptions favoring the wealthiest and raising the threshold to exclude moderate housing wealth.

- Further steps to mitigate distortions stemming from the double taxation of dividends may also be advisable.

D. The Swedish Model and Structural Issues

29. **The Swedish welfare state reflects a strong social consensus in favor of substantial direct intervention in the pursuit of social justice**. An accent on economic security and an egalitarian way of life have been the hallmarks of the Swedish approach, which explain a societal structure in which large centralized institutions dominate, and sets the "Swedish model" apart. Besides the large public spending on transfers and public services and the associated high tax burden, this model is also marked by extensive non-fiscal intervention—widespread regulation of product and labor markets, a pivotal role for government in wage bargaining, high public employment, and significant continued public ownership and control—although it is characterized by a high degree of transparency. The crisis of the early 1990s led to significant skepticism about the efficacy of this institutional set-up, and a marked scaling back of government.[4] With the advent of better times, however, a consensus no longer exists for cutting back the size of government further. Nevertheless, Sweden is bound to face pressures on its welfare state similar to those felt in other European countries. Increased mobility of goods, capital, and labor as European integration proceeds is likely to bring substantial downward pressure on the sustainable extent of taxation, and hence, of public intervention and redistribution. At the same time, the strong current fiscal

[4] This skepticism and the analysis leading up to it are succinctly presented in Assar Lindbeck et al: 1994, *Turning Sweden Around*, (Cambridge: MIT Press). See also Assar Lindbeck, 1997, "The Swedish Experiment," *Journal of Economic Literature*, Vol. XXXV, pp. 1273-1319. For a discussion of the Swedish model from a variety of perspectives, see also Special Issues, *Swedish Economic Policy Review*, Spring 1998 and Spring 2000, and Richard Freeman, Robert Topel and Birgitta Swedenborg, 1997, *The Welfare State in Transition:Reforming the Swedish Model* (University of Chicago Press, National Bureau of Economic Research).

position may well raise pressures to increase social expenditures rather than further whittle down the size of government.

30. **Sweden's updated EU Convergence Program outlines a cautious strategy for reducing the tax burden and the size of government**. The Program, broadly endorsed by the EU, builds on the government's medium-term fiscal objectives and reiterates the need for sustained surpluses ensuring a continued downward trend in the public debt-to-GDP ratio to meet the challenges posed by the aging population. It also aims to build up a safety margin for public finances to leave room for counter-cyclical fiscal policy action. However, while hinting at the limits to maintaining a high tax burden, the program stops short of proposing further substantial tax cuts, or of setting any specific goal for the medium-term size of government.

31. **Indeed, the view that economic costs of maintaining the large welfare state have been overstated is encapsulated in a comment that "the bumblebee still flies."** In the mission's discussions with leading members of the policy community, no consensus on the need to trim back the welfare state further could be detected.[5] Some expressed skepticism about the proposition that Sweden's growth performance had suffered significantly from disincentives stemming from the large welfare state and even more as to the lessons from the empirical literature on the link between taxation, spending, and growth. Indeed some economists argued that besides exogenous shocks and avoidable policy errors, the fiscal reforms of the early 1990s were partly responsible for the ensuing recession, as expectations of diminished social support led to sharply increased household savings.

32. **However, there was recognition of sizeable efficiency losses from high marginal effective tax rates**—not only taxes and social security contribution rates but also the withdrawal of income–related benefits, especially towards the top and bottom of the income scale. While there was no immediate evidence of large-scale tax-induced capital flight, the 30 percent flat tax on personal capital income was sensed to be somewhat high. Lowering it, however, could intensify incentives under the dual income tax for labor income to masquerade as capital income. Strong demographic pressures on non-pension spending on the elderly will imply future claims on tax revenues, and may call for a preemptive reduction in other spending and taxes.

33. **The mission argued for a new Swedish model which would aim to reduce the economic costs of large government, without losing sight of the goal of social justice**. The achievements of, and strong political support for, the essence of the welfare state were recognized. Indeed, Sweden's quality of life, public health and educational attainment indicators are among the best in the world. The policy changes of the 1990s, especially the

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[5] The mission's discussions on the future of the Swedish welfare state covered a wide spectrum of opinion, including seminars at the Stockholm School of Economics and Uppsala University. See Box 3 and the forthcoming Selected Issues paper.

Box 3. Sweden: Selected Issues Paper on the Role of Government

The paper assesses the effectiveness and impact of the extensive and highly developed welfare state in Sweden. This is characterized by a large, well-organized government sector, and high taxation needed to sustain sizeable public consumption and extensive income transfers. Non-fiscal measures—including interventions in product and labor markets, the prominence of public employment in the provision of family services, and public ownership of enterprises—also play a key role. The paper, which builds on the mission's discussions with leading contributors to the Swedish debate reviews key aspects of this Swedish model, considers the likely pressures upon it in the coming years and develops recommendations for further streamlining of the role of government.

The Swedish welfare state has achieved notable successes, as even its critics concede. Sweden's public health, educational attainment, employment and participation indicators are among the best in the world; inequality and poverty are low with high coverage against a range of risks not insurable in private markets; the system also allows a greater use of available human talent through free higher education and enhances individuals' capacity to take risks. Moreover, awareness of the potential inefficiencies has led to important and worthwhile rationalization of government interventions over the past decade.

Coming challenges argue for using the present strong fiscal position to further streamline government, rather than to return to the past. The implications of increased globalization for Sweden should not be overstated. Sweden has long recognized the consequences of high capital mobility, and continues to set low effective marginal tax rates on investment. Nevertheless, tax bases—commodities and labor, as well as capital—are likely to become more elastic in response to fiscal incentives, pointing to a need to lower effective tax rates. At the same time, the coming demographic transition will create pressures to increase non-pension age-related spending. Much of the burden of financing government will continue to fall on labor; and although marginal effective tax rates on labor income have fallen significantly in recent years, they remain high enough to suggest substantial welfare losses. The resulting tax wedge on labor, reinforced by generous transfers, gives rise to a sizeable gray economy and strong disincentive effects on effective labor supply. Non-fiscal interventions may also imply increasing efficiency losses. Rigidities in the housing market, in particular, imply costly distortions in a sector with far reaching significance in terms of both the functioning of the labor market and the allocation of capital.

The paper concludes that further streamlining of the welfare state is both necessary and consistent with preserving its essential achievements. It identifies desirable reforms of the tax-transfer system consistent with continued adherence to the medium-term surplus target of 2 percent of GDP and argues that reforms of non-fiscal aspects of the welfare state should complement these fiscal measures.

bold and innovative tax reform of 1991, have led to efficiency gains.[6] However, Sweden, like others, will face increasing pressure from globalization and demography. Heightened mobility of tax bases will increase the distortionary cost of high taxes and make redistributive measures harder to sustain, while increased age-related non-pension spending will strain public finances. In order to raise long-term growth, policy should mitigate distortions induced by the tax-transfer system, and increase incentives to work, save and invest by reducing labor and capital taxation and the extent of wage compression. Such an approach would also help sustain and develop Sweden's leading role in the high technology sector by educating and attracting high-skilled workers.

34. **The role of the local government and its relationship with the center are key to enhancing the efficiency of the public sector**. Subnational governments play a large role in the financing and delivery of social support, contributing 70 percent of total public investment and consumption, including for health, education, and social assistance spending. The authorities emphasized that local governments would face long-run spending pressures as demographic trends increased the need for health and care services for the elderly. Complex local government equalization arrangements reduce incentives to these levels of government to undertake beneficial expenditures to expand the local tax base and introduce disincentives to lower local tax rates. The mission suggested that these arrangements should also be on the reform agenda.

35. **Further structural reforms are needed to address the rigidities in Sweden's product markets, where the government continues to play a large role.** The authorities noted that with prices for electricity, postal services, and telecommunications largely deregulated, enhanced competition had contributed to a noticeable convergence of the traditionally high Swedish price level toward the EU average. Nevertheless, since many markets (e.g., construction, building materials and retail banking) continued to be characterized by high concentration, domestic monopoly positions, and barriers to effective foreign competition, the Swedish price level remained about a fifth higher than the EU average six years after joining the EU. The housing market was still over-regulated, with de facto rent control leading to a thriving black market in major city centers. Partly as a result, Swedish housing investment is by far the lowest of any advanced economy, resulting in a shortage of housing in high growth areas. The staff saw these factors as limiting labor market flexibility.

36. **The divestment of public enterprises is not on the present political agenda.** The central and local governments have a stake in public enterprises to the tune of a quarter of the GDP, making them the largest owners of companies in Sweden. Nonetheless, the authorities viewed their management practices as mitigating the adverse effects of public ownership and had no current significant privatization plans. They pointed out that central government

[6] A thorough and generally positive assessment is provided by Jonas Agell, Peter Englund and Jan Södersten, 1998, *Incentives and Redistribution in the Welfare State: The Swedish Tax Reform*, (London: Macmillan Press).

holdings were supervised in a transparent manner, with quarterly published reports on their performance. The government also enforces market orientation on public enterprises, and oversees agencies that are responsible for the effective regulation of monopolies.

37. **Despite notable progress, the labor market retains restrictive features**. The authorities were satisfied that the wage bargaining system had delivered wage moderation in recent years, while allowing for improved incentives through a shift toward decentralized setting of individual wages at the local level. As a result, while wage differentials across sectors continued to decline—increasing measured wage compression—wage dispersion within sectors actually rose somewhat. The authorities also noted several recent measures to increase labor market flexibility. From February 2001, they set an effective upper limit on the length of the unemployment benefit period, and established an activity guarantee program (which enables all willing unemployed to obtain a subsidized job or participate in active labor market programs) to help lower long-term unemployment. However, benefits for part-time unemployed remained a concern because of increasing signs of abuse. In addition, while restrictive employment protection rules were marginally relaxed from the beginning of 2001, legal limits on overtime hours and on the number of temporary workers continued to hamper labor market flexibility. The staff and the authorities agreed that the sharp rise in sickness leave during the past few years was a cause for concern, and the staff suggested a tightening of the scheme by making employers bear more of the costs.

38. **Sweden's trade, aid and environment policies are exemplary**. Sweden has led the EU decision to grant duty- and quota-free treatment to exports of the least developed countries and has consistently provided official development assistance representing one of the highest shares in GDP; the Spring 2001 Budget includes a commitment to gradually raise this share further, to 0.87 percent of GDP in 2004. The long-standing emphasis on sustainable development has ensured that Sweden is placed ahead of most advanced economies on OECD environmental indicators. Sweden has also been at the forefront of international action to address cross-border environmental issues, including global warming.

39. **Sweden's statistical data are of high quality, and its approach in various areas can serve as "best practice" for other Fund members.** The recently completed data module of the ROSC concluded that the national accounts, consumer prices, producer prices, and balance of payments statistics follow internationally accepted guidelines. Nevertheless, monetary, and especially government finance statistics, could be aligned more closely with internationally accepted guidelines. The Swedish authorities indicated that the conclusions of the ROSC were helpful in highlighting the need for statistical improvements in certain areas and have outlined a work plan to implement prioritized recommendations.

VI. Staff Appraisal

40. **The Swedish economy continued its impressive recent record of rapid growth with monetary and financial stability in 2000**. 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. Inflation remained below the Riksbank's target, 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.

41. **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 has begun to feel its downdraft, with the impact amplified by the catalytic role played in the Swedish economy by the hard-hit high technology sector. Softening sentiment and attempts by households to rebuild savings could add to adverse external impulses, keeping growth subdued into early 2002. With a projected rebound in global growth, the staff projects a return to potential output during the course of 2002. At the same time, recent inflation surprises and the prolonged fall in the krona underscore the risks to medium–term inflation. While the sharp spurt in headline inflation reflects some temporary factors, in Sweden, as elsewhere, the extent of the recent favorable shift in the limits to noninflationary growth may have been overestimated. The coincidence of a slowing economy and heightened inflation risks poses a challenge to economic policy.

42. **The staff shares the Riksbank's assessment that the spectrum of inflation risks had shifted to the upside, and the degree of uncertainty in the forecast remains large.** Inflation rates below target in 2000 permitted the Riksbank to appropriately maintain interest rates at low levels. However, the subsequent unexpected decline of the krona led to a period of relaxed monetary conditions. The persistent weakness of the krona, particularly during a period in which resource use in the Swedish economy was already high, has begun to pose an increasingly potent risk to medium-term inflation. Given the Riksbank's decision to intervene in support of the krona and its continued weakness thereafter, which could endanger its medium-term inflation objective, it was particularly important for it to demonstrate a clear commitment to its inflation targeting framework. The decision to raise interest rates by 25 basis points in early July was therefore fully justified. In the period ahead, monetary policy decisions would depend on how the constellation of risks evolves. The Riksbank should remain vigilant with a steadfast focus on medium-term inflation.

43. **The prospective fiscal overperformance relative to the structural surplus target should be used for tax cuts.** Given this target, the estimated structural surpluses over 2002-2004 imply room for tax cuts of at least 2 percent of GDP. This room should be used for a front-loaded reduction in the tax burden. Such early tax cuts would be fortuitously timed to help counter any unexpectedly large slowdown in growth. The implied policy mix—a tighter monetary stance than earlier, and a moderate fiscal expansion—could bring about a welcome strengthening of 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.

44. **Fiscal policy should continue to adhere firmly to the medium-term rules.** The general government structural surplus rule and the ceilings on nominal central government spending for the subsequent three years have played a very positive role and should be retained. However, these expenditure ceilings will prove tight since the room for discretionary spending increases within the buffer has been largely used up, and 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 observed. This may mean offsetting mandatory inflation-induced increases in some components of spending by discretionary cuts in others.

45. **Beyond the immediate issues facing economic policy, now is an opportune time to embark on a structural reform agenda for the long term, building on past reforms.** Such an agenda should lift the potential rate of growth above its recent range of 2–2½ percent. The recent strong economic performance has been underpinned by the landmark reforms of the tax and benefit systems that began in the early 1990s. However, this process may be running out of steam. A more ambitious approach would be desirable in order to help ensure that the essential achievements of the welfare state are preserved and enhanced. The current strength of the public finances and the recent broadly-shared gains in income and employment offer a window of opportunity to press ahead with 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.

46. **A program of balanced reduction in taxes and spending beyond the current horizon of the fiscal rules should aim to maximize gains in efficiency and economic growth, while respecting distributional concerns.** Thus, top priority should be accorded to 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. This reduction, coupled with structural reforms of the wealth tax—to remove exemptions favoring the wealthiest and raise the threshold to exclude moderate housing wealth—would greatly improve the incentive structure. 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.

47. **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 and on the dependency ratio—will also require further measures such as raising the effective retirement age.

48. **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 hampers the incentives for local authorities to increase their tax bases or to moderate their tax rate increases, will need to be reassessed.

49. **The recent performance of the labor market has been strong, but structural problems remain.** Significant improvements are being achieved, with the better adaptation of active labor market programs to market needs and the tightening of effective 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 relaxing 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 toward reduced wage compression.

50. **The authorities should continue the 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 the 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.

51. **The authorities should aspire to build a "New Swedish model" for the coming century that would be guided by the vision of higher economic growth.** 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. However, a broadening and deepening of the reform agenda is needed to address the new challenges of globalization, European integration, and demography.

52. It is expected that Sweden will remain on the standard 12-month consultation cycle.

Table 1. Sweden: Selected Economic and Financial Indicators

	1996	1997	1998	1999	2000	Staff projections 2001	2002
	(Percent change, unless otherwise noted)						
Output and Prices							
Real domestic demand	0.7	0.9	4.2	3.4	3.3	1.8	2.3
of which							
Private consumption	1.4	2.0	2.7	3.8	3.1	1.7	1.9
Gross fixed investment	5.0	-1.1	8.5	8.1	4.7	4.8	4.8
Real GDP	1.1	2.1	3.6	4.1	3.6	1.9	2.6
Output gap (In percent)	-4.0	-4.2	-3.1	-1.3	0.0	-0.3	-0.1
Consumer price index	0.5	0.5	-0.1	0.5	1.0	2.5	2.3
Labor Market							
Employment	-0.6	-1.1	1.5	2.2	2.2	1.4	0.6
Open unemployment rate (In percent)	8.1	8.0	6.5	5.6	4.7	4.1	4.0
Participation in labor market programs (as percent of labor force)	4.7	4.5	4.1	3.3	2.6	2.5	2.4
Hourly wages in manufacturing	6.6	4.4	3.6	2.0	3.6	3.6	3.6
Productivity in manufacturing	1.4	6.3	2.6	1.5	3.1	2.3	2.3
Unit labor costs in manufacturing	5.2	-1.9	1.0	0.4	0.5	1.3	1.3
Household sector							
Household disposable income	1.1	2.0	2.4	4.8	5.3	4.3	5.0
Saving ratio	4.4	1.1	3.7	0.3	0.5	0.6	1.3
	(In Percent of GDP)						
Fiscal Indicators							
General government financial balance	-3.4	-2.0	1.8	1.9	4.1	3.7	4.1
Revenue	59.3	58.7	60.1	59.5	59.5	57.7	57.6
Expenditure	62.6	60.7	58.3	57.7	55.4	54.1	53.5
Central government balance	-3.8	-1.8	0.6	3.7	3.9	3.4	3.4
Consolidated gross public debt	80.3	78.5	76.0	65.2	55.6	52.9	49.9
Monetary Indicators							
Money supply (percent change, end period)							
M0	5.3	3.0	5.1	12.0	1.9	5.9 1/	...
M3	11.4	1.3	2.1	9.9	2.1	-1.4 1/	...
Credit to non-bank public (percent change)	3.5	6.4	6.8	5.6	9.1	11.5	...
Interest rates (period average)							
3-month interbank rate	5.8	4.1	4.2	3.1	4.0	4.3 2/	...
10-year bond yield	8.1	6.7	5.0	5.0	5.4	5.4 2/	...
External current account balance	2.7	3.4	2.9	3.5	2.6	2.4	2.4

Source: Ministry of Finance; Statistics Sweden; the Riksbank; and staff estimates.

Table 2. Sweden: General Government Fiscal Operations 1/

	1999	2000	2001	2002		2003 2/		2004 2/	
			Staff proj.	Staff proj.	Official proj.	Staff proj.	Official proj.	Staff proj.	Official proj.
				(In percent of GDP)					
Total revenue	59.6	59.5	57.7	57.6	56.7	...	...	...	...
Primary revenue	57.2	57.4	56.2	56.1	55.2	...	...	...	...
Tax revenue	52.3	52.8	51.8	51.6	50.9	...	...	...	...
Nontax revenue	4.9	4.6	4.4	4.5	4.3	...	...	...	...
Interest receipts	2.4	2.1	1.5	1.5	1.5	...	...	...	...
Total expenditure	57.7	55.4	54.1	53.5	53.5	...	...	...	...
Primary expenditure	52.4	51.1	50.8	50.4	50.4	...	...	...	...
Current	50.0	48.7	48.3	47.9	47.9	...	...	...	...
Capital	2.4	2.4	2.5	2.5	2.5	...	...	...	...
Interest payments	5.3	4.3	3.2	3.1	3.1	...	...	...	...
Primary balance	4.8	6.3	5.4	5.7	4.8	...	...	...	...
Overall balance	1.9	4.1	3.7	4.1	3.1	...	...	...	...
Cyclically adjusted fiscal operations									
				(In percent of potential GDP)					
Total revenue	59.5	59.5	57.7	57.6	56.8	57.3	56.6	57.2	56.6
Primary revenue	57.1	57.4	56.2	56.1	55.3	55.8	55.1	55.7	55.1
Tax revenue	52.3	52.8	51.8	51.6	51.0	51.5	50.7	51.2	50.7
Nontax revenue	4.8	4.6	4.4	4.5	4.3	4.3	4.3	4.5	4.4
Interest receipts	2.3	2.1	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Total expenditure	56.6	55.4	53.8	53.5	53.5	53.1	53.5	52.6	53.0
Primary expenditure	51.4	51.1	50.6	50.3	50.3	50.3	50.6	49.8	50.2
Current	49.0	48.7	48.1	47.8	47.8	47.7	48.1	47.3	47.6
Capital	2.4	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Interest payments	5.2	4.3	3.2	3.1	3.1	2.9	2.9	2.8	2.8
Primary balance	5.7	6.3	5.6	5.8	5.0	5.6	4.5	5.8	4.9
Overall balance	2.9	4.1	3.9	4.1	3.3	4.2	3.1	4.5	3.6
Memorandum items:									
Real growth (percent)	4.1	3.6	1.9	2.6	2.6	...	...	...	...
Gap (percent of potential GDP)	-1.3	0.0	-0.3	-0.1	-0.3	...	...	...	...

Sources: Ministry of Finance; and Staff estimates.

1/ Projections for 2002-2004 are before tax cuts.

2/ Figures for 2003 and 2004 are based on the assumption of zero output gap. Therefore, the actual and cyclically-adjusted figures are identical.

Table 3. Sweden: Balance of Payments
(In billions of US Dollars)

	1994	1995	1996	1997	1998	1999	2000
Current account balance	2.4	8.1	8.5	9.0	8.2	8.9	6.7
(in percent of GDP)	1.2	3.0	2.7	3.4	2.9	3.5	2.6
Trade in goods (f.o.b.)	9.4	16.9	18.7	19.0	17.5	16.8	15.2
Services	0.2	-0.6	-1.2	-1.8	-2.6	-2.3	-3.1
Transportation	0.6	0.1	0.1	0.4	0.6	1.2	0.7
Travel	-2.0	-2.2	-2.8	-3.2	-3.5	-3.9	-4.0
Other services	1.7	1.5	1.4	1.0	0.4	0.3	0.1
Compensation of employees	-0.1	-0.2	-0.3	-0.2	-0.3	-0.3	-0.2
Investment income	-5.8	-5.3	-6.0	-4.7	-3.0	-1.8	-1.8
Direct investment	2.2	2.9	3.2	3.3	5.1	5.0	4.0
Portfolio investment	-0.7	-0.8	-2.5	-3.4	-6.4	-5.2	-4.0
Income on equity	-0.1	-0.4	-1.0	-0.8	-0.7	0.1	-0.1
Income on debt (interest)	-0.6	-0.5	-1.5	-2.6	-5.6	-5.3	-3.9
Other investment	-7.3	-7.4	-6.6	-4.6	-1.7	-1.6	-1.8
Current transfers	-1.2	-2.7	-2.8	-3.3	-3.5	-3.6	-3.3
CAPITAL ACCOUNT	-1.0	-0.5	-0.7	0.0	0.8	-2.2	0.4
FINANCIAL ACCOUNT	3.4	-4.4	-5.2	0.8	-1.6	-5.3	-2.9
Direct investment	-0.3	3.2	0.4	-1.7	-4.8	38.9	-17.8
Abroad	-6.7	-11.2	-4.7	-12.6	-24.4	-21.9	-39.5
In Sweden	6.4	14.5	5.1	11.0	19.6	60.8	21.6
Portfolio investment excl. fin. Derivatives	-13.5	-2.3	-12.4	-11.7	-14.9	-35.7	-3.05
Assets	-2.6	-10.6	-13.2	-9.2	-17.7	-37.4	-12.2
Equity securities	-2.5	-9.1	-7.5	-5.6	-7.4	-30.4	0.9
Debt securities	-0.1	-1.5	-5.7	-3.6	-10.3	-7.0	-13.1
Liabilities	-10.9	8.2	0.7	-2.5	2.9	1.7	9.2
Equity securities	6.8	2.0	4.1	-1.7	-0.4	-4.0	17.3
Debt securities	-17.7	6.2	-3.3	-0.8	3.2	5.6	-8.1
Financial derivatives	0.0	-1.9	0.2	1.1	-2.5	-0.1	-0.4
Other investment	19.6	-4.8	0.3	6.5	23.8	-6.4	18.6
Reserve assets	-2.3	1.4	6.2	6.5	-3.3	-2.0	-0.3
Net errors and omissions	-4.8	-3.2	-2.5	-9.7	-7.4	-1.4	-4.1
Memorandum Items:							
Official reserves							
In months of imports	6.4	5.4	3.9	2.1	2.7	2.8	2.5

Source: Riksbank; IFS; staff estimates.

Table 4. Sweden: Indicators of External and Financial Vulnerability
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000
External Indicators					
Exports of goods and services (annual percentage change, in U.S. dollars)	5.3	-0.4	2.8	0.9	2.5
Imports of goods and services (annual percentage change, in U.S. dollars)	5.0	-0.1	6.0	1.5	5.8
Terms of Trade (annual percentage change)	0.6	11.8	-9.5	0.8	-9.4
Current account balance	2.7	3.4	2.9	3.5	2.6
Capital and financial account balance	-1.8	0.5	0.1	-3.4	-2.6
Direct investment, net	0.2	-0.7	-2.0	16.1	-8.5
Portfolio investment, net	-4.2	-4.0	-6.8	-14.7	-2.6
Central Bank net foreign assets (end of period, in billions of U.S. dollars)	20.6	12.0	16.9	18.0	17.4
Exchange rate against US dollar (SEK,period average)	6.7	7.6	7.9	8.3	9.2
Exchange rate against Euro (SEK, period average)	8.5	8.7	8.9	8.8	8.4
Real effective exchange rate (based on CPI, annual percentage change)	8.4	-5.0	-2.8	-3.2	-2.0
TCW-Index (annual percentage change)	-8.9	3.9	2.2	1.3	-0.2
Financial Markets Indicators					
Consolidated public sector gross debt (end of period)	80.3	78.5	76.0	65.2	55.6
3-month T-bill yield (nominal, in percent per annum)	5.8	4.1	4.2	3.3	4.1
3-month T-bill yield (ex post real, in percent per annum)	1.1	1.0	1.0	1.0	1.1
spread of 3-month T-bill vs. Germany (percentage points, end of period)	2.5	0.8	0.7	0.2	-0.4
spread of 10-year T-bill vs. Germany (percentage points, end of period)	1.8	1.0	0.4	0.5	0.1
General stock index (annual percentage change)	24.8	47.0	16.2	29.2	38.0
Real estate price index (annual percentage change)	0.8	7.0	9.6	9.2	11.0
Credit to households (growth rate in percent)	3.5	6.4	6.8	5.6	9.1
Financial Sector Risk Indicators					
Risk-weighted capital adequacy ratio (CAR) in four major banks	12.5	10.9	10.4	11.4	9.9
Tier 1 capital ratio in four major banks	7.8	7.0	6.9	7.7	6.8
Share of foreign exchange loans in percent	12.0	14.3	15.3	14.8	17.3
Share of foreign exchange deposits in percent	14.0	20.0	19.4	16.4	24.2
Banks' return on capital after tax in percent	22.6	18.9	14.2	16.0	15.7
Ratio of households' financial liabilities to financial assets in percent	70.2	65.0	63.0	51.0	48.9
Share of floating rate mortgages in new loans from mortgage institutions, in percent	20.9	23.5	41.2	71.6	73.6

Sources: Riksbank; Statistics Sweden; National Debt Office; and staff calculations.

SWEDEN: STATISTICAL ISSUES

National accounts

1. The overall structure of the **national accounts** follows the *System of National Accounts 1993 (1993 SNA)* and the *ESA 95*. The scope of the accounts is consistent with international standards and agreed practices. The data comprise both quarterly and annual accounts; for the latter, a full set of institutional sector accounts, including financial accounts, is compiled. Constant price series are based on Laspeyres chain indices. The delimitation of the economy, the production and asset boundary, and the classifications used are in accordance with internationally recommended systems. Recording is done on an accrual basis taking into account the new EU rules for recording of taxes and social contributions.

Prices

2. The **Consumer Price Index (CPI)** and the **Producer Price Index (PPI)** follow internationally agreed practices and standards in terms of concepts, definitions and use classifications. The scope of the indices follows international standards concerning both weights and the coverage of prices collected. Thus the CPI covers all resident household consumption of goods and services classified according to the Classification of Individual Consumption by Purpose (COICOP), and the PPI includes all resident market-enterprise production of goods classified according to the Combined Nomenclature (CN). The CPI weights and prices refer to market prices; the PPI weights refer to basic prices and the prices collected exclude taxes. The prices collected for the CPI are mid-month prices; the PPI prices are based on average monthly prices.

Government finance statistics

3. The SCB compiles the **general government** statistics in the context of the national accounts based on the *ESA 95*, which is broadly consistent with the *1993 SNA*. The available data appear to provide a minimum set of variables for fiscal policy. The general government statistics cover the budgetary and extra-budgetary (self-financed) central government, social security funds, and local governments.

4. In documents that accompany the budget, the Ministry of Finance presents an analytical framework showing the previous year's general (and central) government aggregates for revenue, expenditure, and net lending/borrowing along with annual forecasts. However, they are not accompanied by full documentation on concepts, sources, and methods; there are no time series; and there is no separate dissemination.

5. There is no assignment of responsibility to any particular agency to produce government finance statistics. An analytical framework and details supporting the aggregates could be developed further following the recommendations in the *Government Finance Statistics Manual 2001*.

Monetary statistics

6. With regard to the **monetary statistics**, monthly balance sheet data for the Riksbank and the credit institutions are disseminated separately on the Riksbank Internet website. The institutional coverage of these data comprises the central bank and the other depository corporations (ODCs) or deposit money banks that are engaged in financial intermediation and issue liabilities included in the definition of broad money used by the Riksbank. The monetary and credit aggregates that are disseminated for these institutions are based on international principles of classification and sectorization.

7. However, monetary statistics are not presented in the form of an analytical framework in which the consolidated monetary liabilities of the Riksbank and the ODCs as a group are linked to the claims of these corporations on the nonresident and resident sectors of the economy. While the building blocks exist to construct a monetary survey in which the intrasectoral claims and liabilities of the depository corporation would be consolidated, the absence of this framework complicates the interpretation of the monetary statistics.

Balance of payments statistics

8. Sweden's **balance of payments** statistics are compiled in broad conformity with the conceptual framework of the fifth edition of the IMF's *Balance of Payments Manual (BPM5).* Supplementary guidelines issued by Eurostat and the European Central Bank (ECB) also inform the present structure of BOP statistics. Resident institutional units are classified in accord with the *BPM5*'s concepts of economic territory, residence, and center of economic interest. Classification and sectorization of the BOP are largely consistent with *BPM5*; recent initiatives on the reclassification of financial derivatives in line with revised international standards represent an important contribution in advancing the methodological soundness of Sweden's BOP statistics.

Sweden: Core Statistical Indicators
as of July 31, 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	General Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	July 31, 2001	July 20, 2001	July 20, 2001	June 2001	June 2001	July 31, 2001	June 2001	June 2001	May 2001	End - 2000	1st Quarter 2001	End-2000
Date Received	July 31, 2001	July 27, 2001	July 30, 2001	July 20, 2001	July 27, 2001	July 31, 2001	July 13, 2001	July 27, 2001	July 10, 2001	April 13, 2001	June 14, 2001	April 10, 2001
Frequency of Data	Daily	Weekly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually
Frequency of Reporting	Daily	Weekly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually
Source of Update	Commercial	Riksbank	Riksbank	Riksbank	Riksbank	Commercial	Statistics Sweden	Statistics Sweden	Riksbank	Ministry of Finance	Statistics Sweden	Riksbank
Mode of Reporting	On Line	Publication	Publication	On-Line	On-Line	On-Line	On-Line	On-Line	On-Line	Publication	On-Line	On-Line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Weekly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually

Sweden: Fund Relations

(As of June 30, 2001)

I. **Membership Status**: Joined 08/31/51; Article VIII

II.	**General Resources Account:**	**SDR Million**	**Percent of Quota**
	Quota	2,395.5	100
	Fund holdings of currency	1,676.2	70
	Reserve position in Fund	719.4	30

III.	**SDR Department:**	**SDR Million**	**Percent of Allocation**
	Net cumulative allocation	246.5	100.0
	Holdings	277.5	112.6

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Exchange Arrangements:** The Krona has been floating since November 19, 1992. Under Decision 144-(52/51), Sweden has amended restrictions vis-à-vis the Federal Republic of Yugoslavia (Serbia and Montenegro) and maintains restrictions vis-à-vis Angola (EBD/96/91, 7/12/96) and Iraq (EBD/90/286, 9/10/90).

VIII. **Article IV Consultation:** Discussions for the 2000 Article IV consultation were held in Stockholm, June 13-21, 2000 and the staff report (SM/00/184) was issued on August 1, 2000. The consultation was completed by the Executive Board on a lapse of time basis.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

APPENDIX III

Sweden: Basic Data

Demographic and other data:

Area	449,964 square kilometers
Population (mid-2000)	8.87 million
GDP per capita	$27,256
Exchange rate (2 August, 2001)	SKr 10.4 per US $1

Composition of GDP in 2000, at current prices	In billions of Kronor		Distribution in Percent
Private consumption	1050.0		50.4
Public consumption	552.9		26.5
Total investment (including stockbuilding)	372.7		17.9
Total domestic demand	1975.6		94.8
Exports of goods and services	993.0		47.6
Imports of goods and services	884.6		42.4
GDP at market prices (average estimate)	2084.0		100

Selected economic data	1998	1999	2000
Output and unemployment:		(Annual percentage change)	
Real GDP (at market prices, average estimate)	3.6	4.1	3.6
Open unemployment rate (In percent)	1.5	2.2	2.2
Earnings and prices:			
Hourly wages in manufacturing	3.6	2.0	3.6
Consumer price index	-0.1	0.5	1.0
Money and interest rates:			
M0 (end of period)	5.1	12.0	1.9
M3 (end of period)	2.1	9.9	2.1
3-month Interbank rate	4.2	3.1	4.0
10-year government bond yield	5.0	5.0	5.4
TCW-Index	2.2	1.3	-0.2
Real effective exchange rate (based on CPI)	-2.8	-3.2	-2.0
		(In percent of GDP)	
Public finance:			
General government balance	0.1	-4.1	-2.8
Structural balance 1/	5.3	4.2	4.1
General government debt	71.8	64.8	57.0
Balance of payments:			
Current account balance	2.9	3.5	2.6
Trade balance	9.1	8.3	7.8
Capital and financial account balance	0.1	-3.4	-2.6
Reserves (gold valued at SDR 35 per ounce, end of period, in billions of SDRs)	14.3	15.3	15.1

Source: Statistics Sweden; Riksbank; IMF, IFS; and staff calculations.

1/ Structural balance is in percent of potential GDP.

Statement by the IMF Staff Representative
August 31, 2001

Information on economic and financial developments that has become available since the release of the staff report (SM/01/257, 8/15/01) does not change the thrust of the staff appraisal.

1. **National accounts data for the second quarter of 2001 show some further slowdown in economic activity**. Year-on-year growth in GDP was 1.4 percent, consistent with the staff's projection of 1.9 percent growth for 2001.

2. **Headline inflation in July held steady at a 12-month rate of 2.9 percent.** Domestic underlying inflation rose to 4.1 percent. However, inflation expectations declined from 2.4 percent in June to 2.1 percent in July.

3. **The krona has remained broadly stable since end-June in nominal effective terms.** While it has appreciated by 5 percent against the U.S. dollar, it remained weak against the euro. The Riksbank has not intervened in support of the krona since late June.

4. **The Riksbank's policy interest rate has remained unchanged.** At its meeting on August 23, the Riksbank decided to keep its policy interest rate at 4.25 percent. Short and long-term interest differentials with Germany have remained at their end-June levels.

5. **The Minister of Finance has announced some tax cuts that will be included in the forthcoming budget for 2002.**

- As foreshadowed earlier (see paragraph 14 of the staff report), the third step of the phased income tax reduction will occur next year.

- The property tax rate will be reduced from 1.2 to 1.0 percent, while the threshold for the wealth tax will be raised, reducing significantly the number of taxpayers paying this tax.

6. **As regards the OECD Anti-Bribery Convention**, Sweden acceded to the convention and adopted implementing legislation in 1999.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 01/98
FOR IMMEDIATE RELEASE
September 25, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Sweden

On August 31, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sweden.[1]

Background

Sweden's strong growth and financial stability of recent years are rooted in the macroeconomic and structural reforms put in place in the wake of the crisis of the early 1990s. The crisis laid bare the adverse effects of high public sector employment, generous welfare benefits, high tax rates, and the strong sensitivity of government finances to the business cycles, it led to a consensus to streamline the large public sector role in Sweden. The dramatic policy transformation was anchored in the Riksbank's successful switch to inflation targeting; deregulation in key markets induced by EU membership; and a major fiscal adjustment entailing a substantial reduction in public spending, but also a further rise in the high tax burden. The economic revival of the past three years has been marked by a booming high technology sector, real growth averaging around 4 percent, buoyant incomes and employment, and low inflation and wages.

Economic activity slackened in the first half of 2001, albeit from a rapid pace. Export growth receded, reflecting primarily the sharp slowdown in the United States and the gathering weakness in Europe. Equity prices, dominated by Ericsson, mirrored the ascent and later decline in global technology stocks. The consequent adverse wealth effects have dampened consumption, and both consumer and business confidence have fallen more

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 31, 2001 Executive Board discussion based on the staff report.

markedly than in the euro area. Employment has continued to grow, but is expected to taper off.

Headline and underlying (which excludes indirect taxes and interest costs) inflation surged unexpectedly in recent months to around 3 percent—at the upper edge of the Riksbank's tolerance band—mostly reflecting the effect of supply shocks and the weak krona. Domestic underlying inflation (which in addition excludes import prices) climbed to nearly 4 percent. Notwithstanding strong fundamentals, the krona has weakened substantially since mid-2000: from June 2000 to June 2001, the krona fell by 11 percent against the euro (15 percent in trade-weighted terms) pushing the real effective exchange rate close to its six-year low.

Sweden faces continued slower economic growth in the rest of 2001, followed by a return to potential output in 2002 with the projected global recovery. However, continuing weakness of the technology sector and depressed confidence may keep growth soft into 2002, risking a weaker rebound. Three-year wage agreements for 2001–3 embody moderate negotiated wage increases. Inflation is nevertheless projected to be slightly above the Riksbank's target over a two-year horizon, mainly due to the weak krona, and the effect of supply shocks.

Fiscal policy is anchored in a structural surplus target of 2 percent of GDP for the general government. The surplus target was exceeded by a substantial margin during 2000, as revenues continued to outpace budget estimates, contributing to a faster reduction in public debt than was earlier envisaged. The budget for 2001 continued the authorities' strategy of gradual reduction in the tax burden. The Riksbank's intervention in support of the krona in mid-June was followed by an increase in policy rates by 25 basis points in early July.

Executive Board Assessment

Executive Directors praised Sweden's recent impressive growth record and the deft macroeconomic management that underpinned it, consolidating the policy gains of the past decade. Directors noted that 2000 was the third consecutive year of buoyant activity, which had helped reduce unemployment sharply, and edged the economy closer to its productive potential. Inflation remained below the Riksbank's target, the fiscal surplus again exceeded the authorities' announced aim, and the public debt continued its downward trajectory.

Directors noted, however, increasing signs that Sweden is beginning to feel a downdraft from the worldwide slowdown in activity—reflecting particularly the key role of its high technology sector. They expressed concern that softening confidence and attempts by households to rebuild savings could add to the adverse external impulses, keeping growth subdued into early 2002. Directors considered, nevertheless, that the recent upturn in inflation and the prolonged fall in the krona illustrate the medium-term risks to inflation, especially given the current high rate of resource use in the economy.

Directors praised the design and steadfast implementation of Sweden's medium-term fiscal framework, and strongly endorsed the authorities' commitment to its structural surplus targets. They advised using the room provided by overperformance in relation to these targets for a reduction in the tax burden, focusing on distortionary taxes. Directors stressed that early tax cuts would help extend the downward trend in the size of government, and, at this juncture, would be well timed to counter any unexpectedly steep slowdown in growth. Directors considered it important to maintain the medium-term ceilings on nominal central government spending, and called upon the authorities to offset mandatory inflation-induced increases in some components of spending by discretionary cuts in others, if needed.

Directors concurred with the Riksbank's assessment that the spectrum of inflation risks had shifted to the upside, and that the degree of uncertainty in the forecast remained large. They emphasized the importance of a continued clear commitment to the Riksbank's inflation targeting framework, and, given the above target forecast for medium-term inflation, concurred with the decision to raise interest rates by 25 basis points in early July.

Noting both the successes and the drawbacks of the Swedish model, Directors felt that the structural reform agenda should aim to lift the potential rate of growth above its recent range of 2-2½ percent, while ensuring that the essential achievements of the welfare state were preserved and enhanced. They noted that the current strength of public finances and the recent broadly-shared gains in income and employment offered a window of opportunity to press ahead with reforms—in taxation, public spending, the labor market, and competition—that the forces of globalization, European integration, and demography made inevitable in the longer run.

Directors called for a medium-term program of balanced reduction in taxes and spending, aiming to maximize gains in efficiency and economic growth, while respecting distributional concerns. They saw a reduction in the high marginal effective tax rates on labor as a key priority. Coupled with reforms of the wealth tax, this would greatly improve incentives. In this context, they welcomed recent indications that the wealth tax threshold would be raised in 2002. On the spending side, concern was expressed about the rapid increase in sickness benefit payments during the recent upswing and Directors called for reassessing their extent and design, as well as the allocation of their financing between employer and state. They also noted that additional measures were needed to offset the fiscal impact of the demographic shock. While commending the built-in safeguards of the reformed pension system, Directors noted the need for further measures such as raising the effective retirement age to respond to a rising dependency ratio and the impact of population aging on non-pension expenditures.

Directors commended the authorities for implementing, from 2000, a balanced budget rule for local governments, noting their key role in the strategy of fiscal reform. They called for an early reassessment of the fiscal equalization system, which hampers the incentives for local authorities to increase their tax bases or to moderate their tax rate increases. It was noted that measures were being taken to mitigate these effects.

Directors noted the recent strong performance of the labor market. In this connection, they welcomed the encouraging outcome of the recent three-year wage agreements, as well as the strengthening of active labor market programs and a tightening of duration rules for the unemployment benefits. There was also support for easing distortions in the housing market created by de facto rent control, relaxing employment protection regulations, and further widening the compressed wage structure.

Directors stressed the critical importance of continuing the strides of recent years in deregulating the economy and in eliminating monopolies. They noted that the resulting higher level of competition would promote efficiency and growth. In this respect, rental housing, construction, transportation, and retail trade were cited as sectors which held the promise of substantial efficiency gains. Privatization of public enterprises operating in competitive markets would also be desirable.

Directors concurred that Sweden's financial system was well positioned to cope with the risk of a sharper downturn than now expected. They nevertheless encouraged expanded supervision and continued vigilance, and looked forward to the conclusions of the Financial Sector Assessment Program.

Directors praised the high level of Swedish official development assistance and welcomed Sweden's intention to further increase it in the coming years from the current level of 0.73 percent of GDP. They also commended the authorities for their pivotal role in the EU decision to grant improved market access to the exports of least developed countries.

Directors praised the high quality of statistics in Sweden, and deemed them adequate for surveillance purposes.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Sweden is also available.

Sweden: Selected Economic Indicators

	1997	1998	199	2000	2001 1/	2002 1/
Real economy (change in percent)						
Real GDP	2.	3.6	4.	3.	1.9	2.
Domestic demand	0.	4.2	3.	3.	1.8	2.
CPI	0.	-0.1	0.	1.	2.5	2.
Open unemployment rate (in percent)	8.	6.5	5.	4.	4.1	4.
Participation in labor market programs 2/	4.	4.1	3.	2.	2.5	2.
Gross national saving (percent of GDP)	19.	19.7	20.	20.	20.2	20.
Gross domestic investment (percent of GDP)	15.	16.0	16.	17.	17.7	18.
Public finance (in percent of GDP)						
General government balance	0.	0.1	-4.	-2.	-2.3	-2.
Structural balance 3/	1.	5.3	4.	4.	3.3	3.
General government debt	74.	71.8	64.	57.	52.4	49.
Money and credit (12-month, percent change)						
M0	3.	5.1	12.	1.	5.94/	...
M3	1.	2.1	9.	2.	-1.44/	...
Credit to non-bank public	6.	6.8	5.	9.1	11.5	...
Interest rates (year average)						
Three-month interbank rate	4.	4.2	3.	4.	4.35/	...
Ten-year government bond yield	6.	5.0	5.	5.	5.45/	...
Balance of payments (in percent of GDP)						
Trade balance	10.	9.1	8.	7.	6.8	6.
Current account	3.	2.9	3.	2.	2.4	2.
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	11.	14.3	15.	15.	...	...
Reserve cover (months of imports of goods and services)	2.	2.7	2.	2.5	...	...
Exchange rate						
Exchange rate regime			Floating exchange rate			
Present rate (August 2, 2001)			US$ 1 = SKr 10.4			
Nominal effective rate (1995=100)	106.	104.7	102.	101.6	95.1 4/	...
Real effective rate (1995=100) 6/	104.	101.7	97.	95.7	95.9 7/	...

Source: Statistics Sweden; Riksbank; International Financial Statistics; INS; and IMF staff estimates.

1/ Official projections, except where noted.
2/ Includes employment in active labor market programs.
3/ Structural balance is in percent of potential GDP.
4/ May 2001.
5/ June 2001.
6/ Based on relative normalized unit labor cost in manufacturing.
7/ Second quarter 2001.

Statement by Åke Törnqvist, Alternate Executive Director for Sweden
August 31, 2001

First, my authorities would like to convey their appreciation to the staff for constructive discussions in Stockholm and for a well-written, accurate and balanced report. They also welcome the thorough and interesting discussion of the Swedish welfare state in the Selected Issues paper, which provides a lot of food for thought.

The international slowdown has had a considerable impact on the Swedish economy. GDP growth has slowed noticeably in 2001. From 1998 through 2000 growth rates had well exceeded 3 per cent. But for the first half of 2001, GDP grew at only 1.8 per cent and GDP growth is expected to be around 2 per cent for the whole year. Conditions are likely to be in place for an upswing in economic growth again in 2002. Nevertheless, there are clear downside risks.

Inflationary pressures in Sweden increased during the spring mainly as a result of a number of temporary supply-side factors. Wage agreements largely in line with the inflation target and the high credibility of economic policy have permitted the continuation of a supportive stance for monetary policy.

Fiscal Policy

The Government and the Parliament have adopted a medium-term goal of a general government surplus of 2 per cent of GDP per year over the cycle. Intermediate targets are set for each year. The target for 2001 is 2.5 per cent of GDP, but the surplus is now expected to be above 4 per cent of GDP, which is higher than earlier projections, in spite of slower economic growth. A strong structural improvement of the public finances sustained over a number of years provides scope to go ahead with the expenditure increases announced earlier – within previously set public expenditure ceilings - as well as further tax cuts in 2002, without jeopardizing the medium-term fiscal policy framework.

In line with staff recommendations, the Government has announced that it intends to propose tax cuts for 2002 amounting to around one per cent of GDP as part of the September Budget Bill. The largest part of the tax cuts is a further step in reducing income taxes to offset an earlier rise in social security contributions. But the intention is also to lower taxes for pensioners, to cut real estate tax rates and to reduce the wealth tax by raising the threshold value. Together with previously announced increases in public expenditure, these measures will result in a general government structural surplus close to two per cent of GDP in 2002 and onwards, in line with the medium-term fiscal policy framework. The expansionary stance of fiscal policy for 2002 seems justified against the background of the current slowdown in economic growth, the uncertainties surrounding the timing and strength of a global recovery and a negative output gap in the Swedish economy.

The pension system was thoroughly reformed in the nineties. Staff calls for further measures to offset the fiscal impact of demographic shock and increase the effective retirement age. The objective of a public sector surplus will be to improve the fiscal preparedness to deal with the demographic changes ahead by bringing down the ratio of debt to GDP. Furthermore, the Government has introduced a scheme, which allows working another two years after the regular retirement age of 65 for those who so desire.

Monetary Policy

There is full agreement between my authorities and staff on monetary policy. In 2000, it was conducted against the background of subdued inflationary expectations and a gradually shrinking negative output gap that warranted a reduction of the expansive stance of monetary policy in December – that is, an increase in the repo rate. The situation changed in spring 2001. Growth slowed while headline inflation increased to around 3 per cent, mainly due to temporary supply-side effects. A resource utilization that is relatively high despite the slowdown added to the risks of rising inflationary expectations. A considerable weakening of the krona resulted in relaxed monetary conditions and implied inflationary risks in the coming one to two years. The repo rate was accordingly increased in early July to 4.25 per cent after interventions in the foreign exchange market. Inflationary expectations, which rose somewhat in June, fell during the summer and are now judged to be in line with the inflation target.

The Riksbank agrees with the staff that the degree of uncertainty in the forecast remains large. The balance of risks to inflation in one to two years has to consider the possibility of a prolonged period of weak international demand as well as the possibility of a continued weak exchange rate eventually resulting in a higher pass-through to consumer prices. The Riksbank considers the monetary stance at present to be well balanced.

Structural Policies

The labor market situation continues to improve. Open unemployment is now below 4 per cent, down one percentage point compared to a year ago. Employment growth has been very strong, currently increasing at a rate of close to 2 per cent annually, but employment growth is expected to level out next year.

It is important to ensure that the current labor market improvement can be sustained. Education and training measures are expected to significantly promote employability, the number of people in active labor market programs is being reduced, while at the same time there is increased emphasis on the needs of the labor market in the design of these programs. The unemployment insurance rules have been reformed, inter alia to promote job search incentives and labor mobility.

The wage formation is the key to a lasting reduction of unemployment. The main responsibility for wage formation lies with the social partners. The recent round of wage negotiations has resulted in three-year agreements at moderate levels consistent with the inflation objective.

To sum up, my authorities agree with staff that, for the time being, with a moderate fiscal expansion, the fiscal and monetary stance is well balanced, although vigilance is needed in order to assess how different risks evolve. Moreover, they agree with the staff report that further measures may be needed in order to foster a high and sustainable rate of growth.