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Sweden: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for 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 2006 Article IV consultation with Sweden, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 14, 2006, 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 January 5, 2007. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 26, 2007, discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for Sweden.

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SWEDEN

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with Sweden

Approved by Ajai Chopra and Adnan Mazarei

January 5, 2007

Executive Summary

- **A new center-right coalition has launched an ambitious reform program to address exclusion from the labor market.** The program focuses on increasing incentives to work by cutting taxes for low and average earners and pruning generous unemployment and sickness benefits. Privatization of part of the large state-owned enterprise sector is also planned.

- **The reform is initiated against the backdrop of a strong upswing,** with growth at close to 5 percent in 2006. While the upswing is broad-based, household consumption is expected to serve as the engine of growth going forward. The recovery, however, has failed to make a durable dent in unemployment. Over a fifth of the working age population remains economically inactive.

- **The authorities appropriately intend to further reduce Sweden's high tax burden.** However, further cuts in public spending will be needed to alleviate the pro-cyclical bias of fiscal policy in the near term and create room for tax cuts in the medium term. Greater use of private suppliers to deliver some public services would help relieve coming age-related pressures on public spending.

- **The fiscal framework could be refined further to improve its transparency and accountability.** The government's intention to adhere to the structural surplus target of 2 percent of GDP and to clarify the framework is therefore welcome. The staff advocates an independent economic agency to monitor compliance and assess performance.

- **The Riksbank will need to tighten monetary policy further.** With inflation rising toward the target rate, output above capacity, and a substantial fiscal stimulus in the pipeline, there is scope for continued tightening. Recent changes to the inflation targeting framework have improved policy communication. Further changes, such as the use of the Riksbank's own interest rate forecast, would better anchor inflation expectations.

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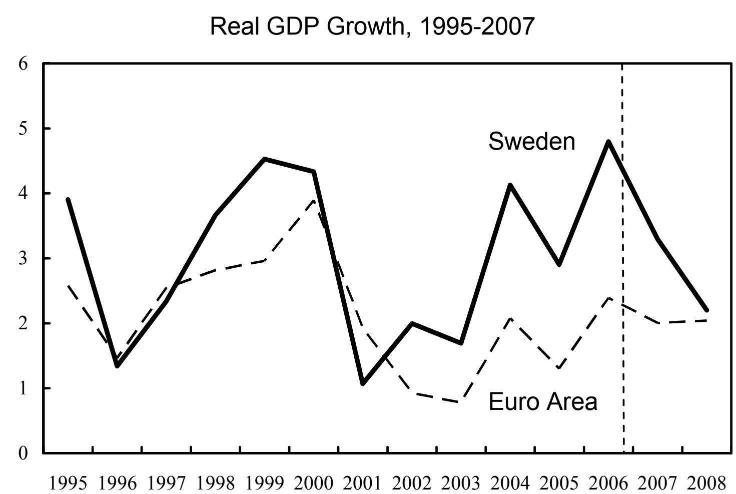
I. Background and Outlook[1]

1. **A new center-right coalition government has launched an ambitious economic reform program, aimed at addressing widespread exclusion from the labor market.** The exclusion is underlined by the fact that despite strong growth in recent years, set to reach almost 5 percent in 2006, over a fifth of the working-age population remains economically inactive—unemployed, underemployed, or dependent on social benefits. The government's first budget, unveiled soon after it took office in October 2006, is centered on proposals to cut taxation for low and average income earners, reduce generous unemployment and sickness benefits, and redefine the scope of labor market policies. The broad contours of this program are in tune with the IMF's advice in recent years to streamline Sweden's extensive welfare state (see Table 1).

2. **The reform is initiated against the backdrop of a broad-based economic upturn, far outpacing the euro area.** Spurred by strong global growth and supportive fiscal and monetary policies, the momentum of the current recovery is expected to continue, although easing back in 2007-08 in the face of capacity constraints and fading policy stimulus. With continued robust gains in household wealth and disposable income, private consumption has served as the engine of expansion, supported by a resurgence in investment and buoyant exports.



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[1] A staff team comprising Messrs. Thakur (Head), Brunner, and Gray (all EUR), joined by Ms. Roos Isaksson, Senior Advisor for the Nordic Baltic Executive Director, visited Stockholm during November 7–14, 2006 to conduct a streamlined consultation. The mission met Finance Minister Anders Borg, Riksbank Governor Stefan Ingves and other senior economic officials, as well as representatives of labor and business, the private financial sector, and the academic community. Sweden is on a 12-month consultation cycle. It has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on current international payments and transfers. However, it maintains exchange restrictions solely for security reasons, which have been notified to the Fund.

Table 1. Sweden : Fund Policy Advice

Past Staff Recommendations[1]	The New Government's Program
The Fiscal framework	
Clarify the definition of the fiscal target of 2 percent surplus over the cycle. Establish clearer linkages between expenditure ceilings and the surplus target. Abstain from tax expenditures. Some form of independent monitoring of compliance desirable.	The new government concurs with the staff position and would like to try enshrining the fiscal framework into its overall macroeconomic framework.
Tax Policies	
Critical mass of tax cuts needed. The high tax wedge on labor should be reduced to raise labor supply.	The government's first budget initiated a program of tax cuts aimed at low and average income earners. Further cuts are planned subject to maintaining the fiscal surplus target.
Welfare Benefits	
Welfare benefits could be cut back with due regard to the objective of social protection. Sickness benefits should be reduced and eligibility criteria tightened.	The new government has implemented measures to reduce unemployment and sickness benefits with the aim of steering more people into work.
Inflation Targeting	
Scope for improving communication further. Riksbank should use its own forecast of interest rates.	Riksbank has started using market expectation of interest rates and is considering using its own interest rate forecast.
Competition Policies	
Scope for privatization. Reduce barriers to entry into the construction and pharmaceutical sectors.	The new government, in a departure from past policies, is planning to privatize part of the state-owned enterprise sector.
Labor market Policies	
Scope for making extensive labor market programs more effective.	The government is planning to rationalize extensive active labor market programs, refocusing them on steering people back into work.

[1] Staff's extensive work on the analysis and rationale for reform of the Swedish model is set out in "*Sweden's Welfare State: Can the Bumblebee Keep Flying*?" by Subhash Thakur, Michael Keen, Balazs Horvath, and Valerie Cerra, 2003, IMF. See also "Fiscal Policy in a Decentralized Economy" by Stephan Danninger, "Sickness Absence: Sweden in an International Perspective" by Leo Bonato and Lusine Lusinyan in IMF Country Report No. 04/245 and "The Swedish Fiscal Framework: Towards Gradual Erosion?" by Fabrizio Balassone, "The Tax-Benefit System and Labor Supply in Sweden" by Evridiki Tsounta and Leo Bonato in IMF Country Report No. 05/344.

Sweden: Output and Demand, 2002-2008
(percent change)

	2002	2003	2004	2005	Projection 2006	2007	2008
GDP	2.0	1.7	4.1	2.9	4.8	3.3	2.2
Consumption	1.8	1.4	1.6	1.6	3.2	2.6	2.2
Private	1.5	1.8	2.2	2.4	4.0	3.5	3.0
Public	2.3	0.7	0.3	0.3	1.4	0.7	0.5
Investment	-2.6	1.1	6.4	8.1	9.0	6.0	3.0
Exports	1.2	4.5	11.1	6.6	8.5	5.5	4.5
Imports	-1.9	5.0	7.0	6.9	9.6	6.0	4.9
Total Domestic Demand	0.8	1.7	2.0	2.7	4.3	3.3	2.4
Foreign balance [1]	1.3	0.2	2.5	0.6	0.5	0.4	0.3

Sources: Statistics Sweden and staff calculations.
[1] Contributions to Growth

3. **Strong growth has yet to translate into a durable revival in employment.** While employment has recently begun to rise, the boom has also encouraged new entrants to the labor market. The headline unemployment rate has thus declined only gradually. Total unemployment has edged up, as participation in active labor market programs has continued to rise, boosted in part by pre-election public spending. Employment is expected to continue rising in 2007-08, reflecting the normal lag behind activity, and as policy reforms put in place create incentives for firms to hire new workers. Headline unemployment may rise initially before declining over the medium term, as participants in labor market programs are gradually drawn into gainful work.

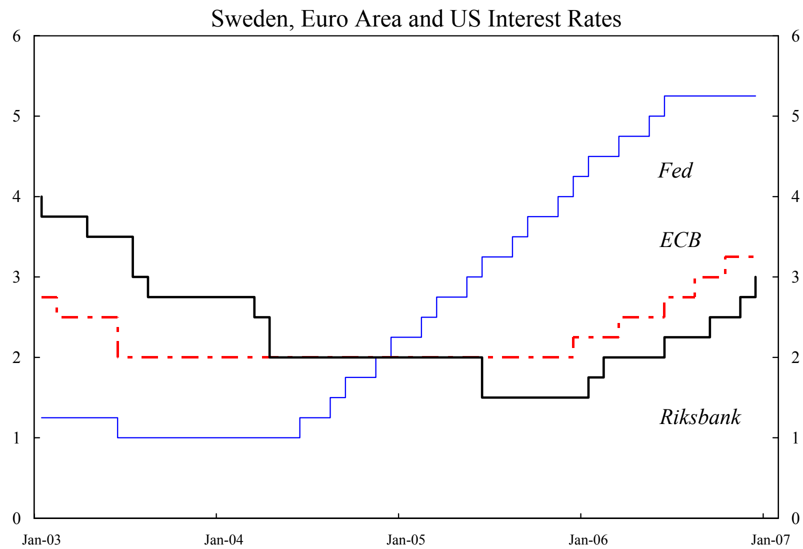
Sweden: Labor Market Indicators, 2002-2008
(percent change)

	2002	2003	2004	2005	Projection 2006	2007	2008
Labor Force	0.1	0.7	0.2	1.3	0.1	0.5	0.2
Employment	0.1	-0.2	-0.4	1.0	0.4	0.2	1.1
Total Unemployment Rate [1]	6.6	7.0	7.9	8.5	8.6	8.3	7.0
Open Unemployment Rate	4.0	4.9	5.5	5.8	5.5	5.8	5.0
Participation in ALPs	2.6	2.1	2.4	2.7	3.1	2.5	2.0
Labor Force Participation [2]	78.0	78.0	77.8	78.3	77.7	77.7	77.7

Sources: Statistics Sweden, Riksbank, and staff calculations.
[1] As a percent of the labor force
[2] As a percent of the working-age population

4. **Inflation is edging up toward the Riksbank's target of 2 percent**. During 2005–06, wage inflation has remained moderate and coupled with unexpectedly strong productivity gains, especially in manufacturing, has helped contain labor costs (Figure 1). However, cost pressures have begun to emerge in recent months, reflecting the pass-through of higher energy prices and incipient wage pressures. With capacity utilization at an all-time high and a sizeable positive output gap projected to open, measures of expected inflation have been rising toward the inflation target (Figure 2).

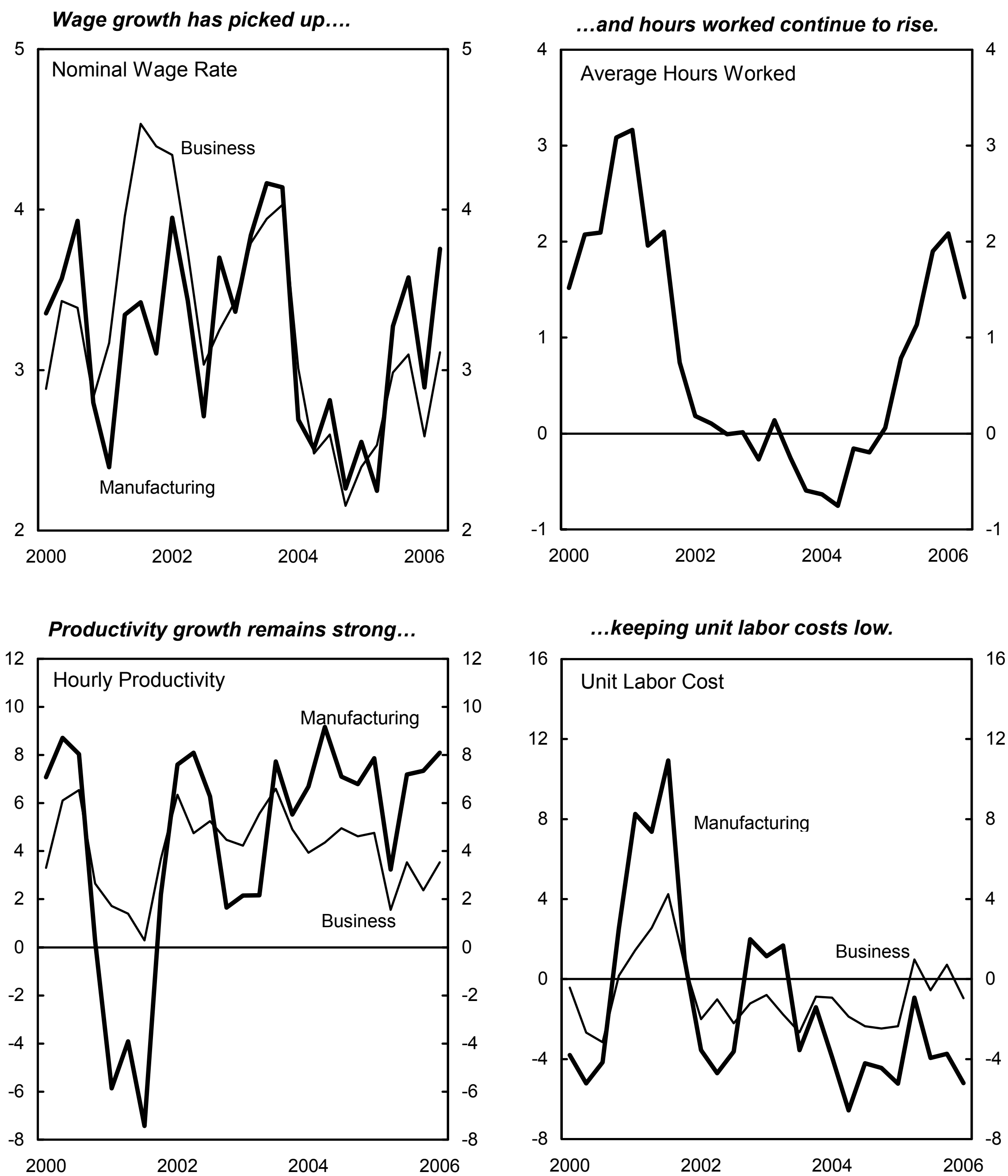
5. **The Riksbank has begun to gradually withdraw the strong monetary stimulus in place for the past two years.** In response to rising underlying inflation and higher expected inflation over the policy horizon, the key policy rate was raised in steps from a historic low of 1.5 percent in January 2006 to 3 percent in December. Markets expect continued further tightening—of about 100 basis points—in 2007.



6. **Sweden's competitive position remains strong despite the appreciating krona** (Figure 3). The krona has remained broadly unchanged against the euro in recent years; however, it has appreciated 5 percent in effective terms over the past year and about 14 percent since late 2001. With low inflation and strong productivity gains over the past five years, real appreciation has been less, at around 8 to 10 percent. Large actual and projected current account surpluses are expected to lead to a positive international investment position by 2009 (Table 5).

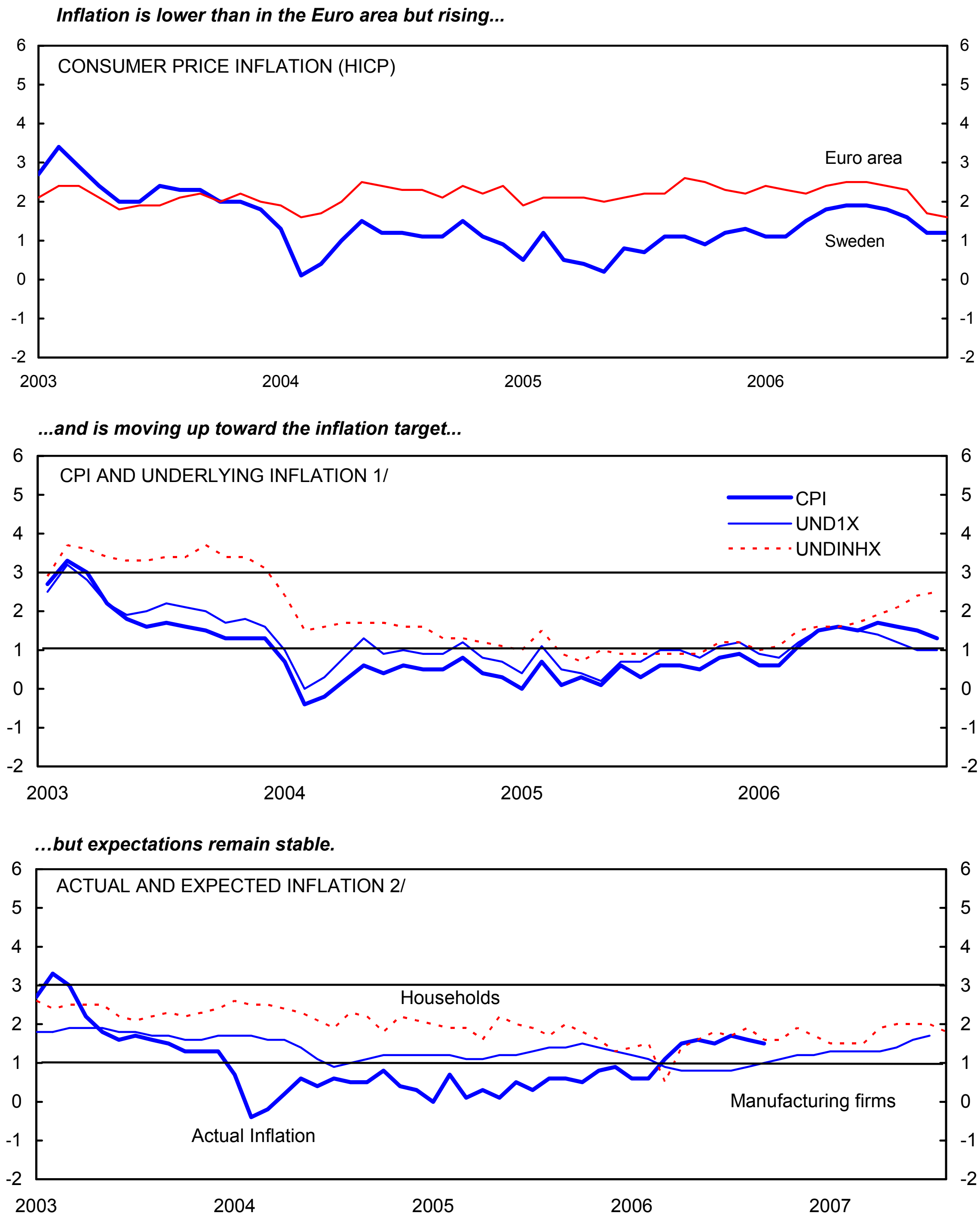
7. **Fiscal policy is strongly pro-cyclical in 2006–07.** The structural surplus is likely to fall below the 2 percent target in 2006, as buoyant tax revenues are offset by pre-election spending on job-creation programs by the previous government. The tax cuts in the budget for 2007, including those in income, wealth and property taxes, amount to around 2 percent of GDP and would be financed partially by lowering welfare benefits, raising unemployment insurance contributions, and reducing spending on labor market programs. However, the net fiscal impact is expansionary, with the structural surplus projected to weaken substantially in 2006–07.

Figure 1. Sweden: Labor Market Developments, 2000-06
(percent change)



Source: Statistics Sweden and staff calculations.

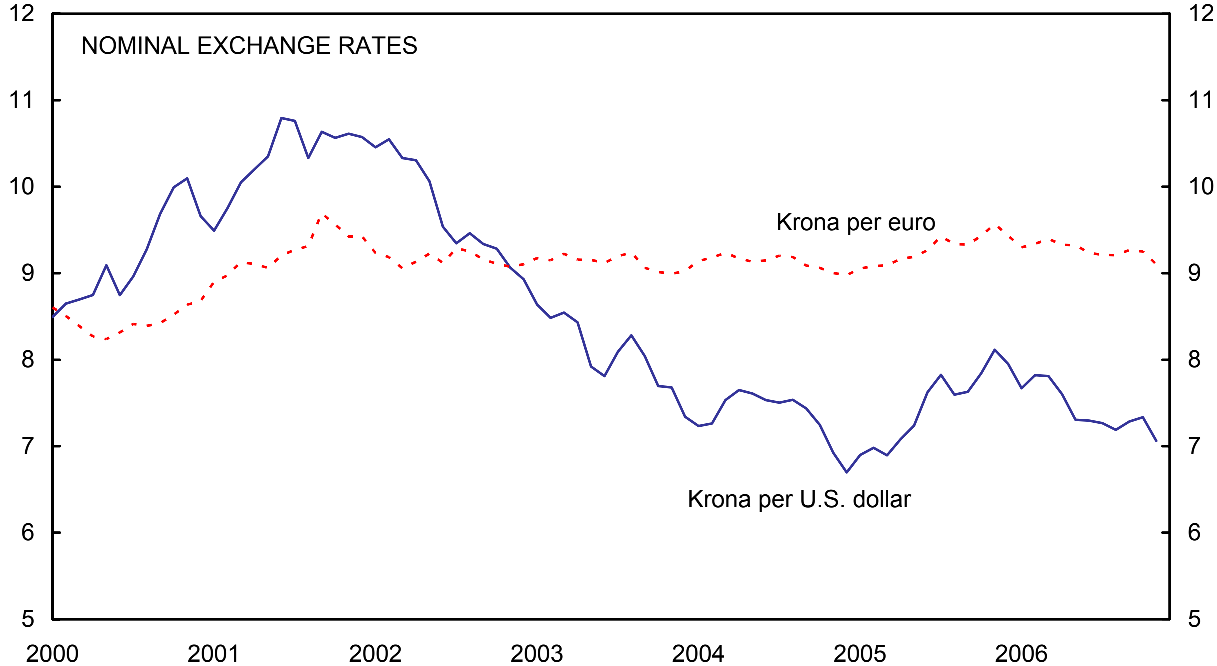
Figure 2. Sweden: Inflation Developments
(Percent change from a year ago)



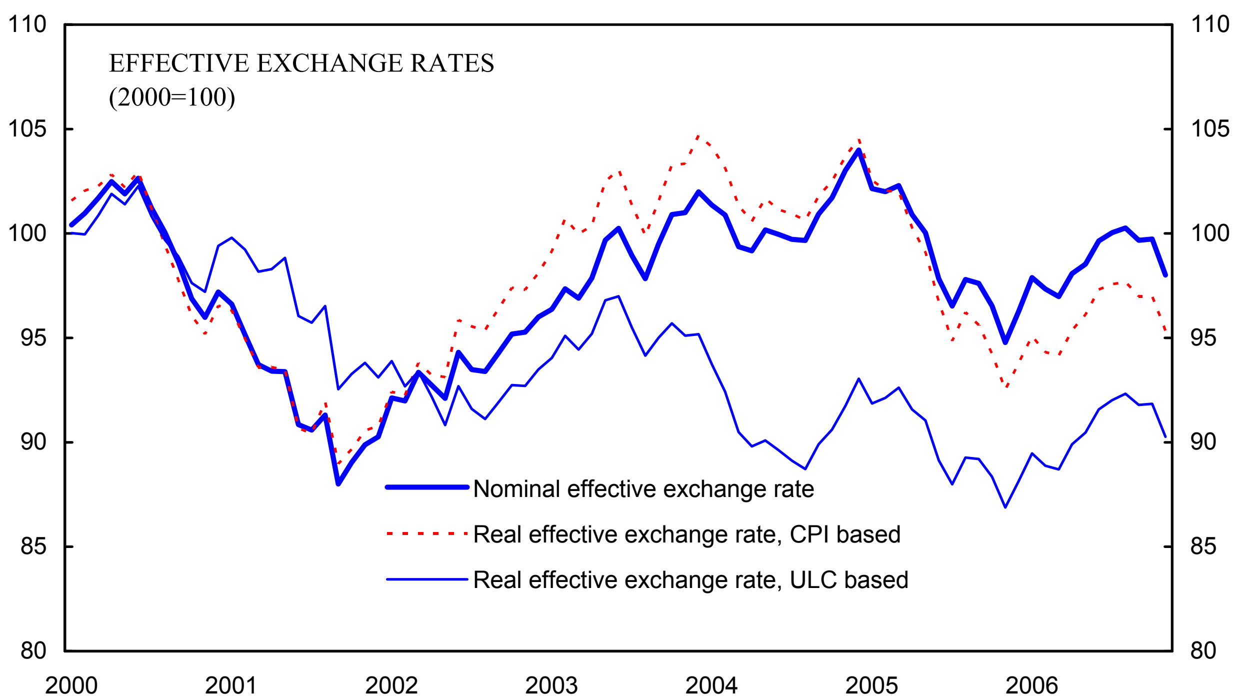
Sources: Statistics Sweden; the Riksbank and NIER.
1/ UND1X = CPI excluding changes in indirect taxes and subsidies and interest costs for owner-occupied housing; UNDINHX also excludes changes in import prices; the horizontal lines indicate a 1 percent range around the 2 percent inflation target.
2/ Inflation expected one year ahead.

Figure 3. Sweden: Exchange Rate Developments

The krona has appreciated against the US dollar over the past year, while remaining broadly stable against the euro...



...but Sweden's competitveness position remains strong.



Sources: IMF, International Financial Statistics.

Sweden: General Government Balances, 2004-2009
(as a percentage of GDP)

	2004	2005	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Total Revenue	55.6	56.3	55.6	53.6	53.1	52.8
Total Expenditure	54.0	53.6	52.8	51.3	50.5	49.8
Overall Balance	1.6	2.8	2.8	2.3	2.6	3.1
Cyclical Adjustment	0.2	0.2	-1.1	-1.5	-1.4	-0.6
Structural Balance	1.8	3.0	1.7	0.8	1.2	2.5
Fiscal Stimulus	-0.9	-1.2	1.2	1.0	-0.4	-1.3
Output Gap (percent of potential GDP)	-0.2	-0.3	1.5	2.2	2.0	0.8

Sources: Fall Budget 2006 and staff estimates.

8. **Growth is expected to ease back in 2007–08** (Table 3)**.** As the stimulative effects of monetary and fiscal policy fade, domestic demand is expected to slow and the positive output gap will start to close. With continued solid gains in disposable incomes and wealth, consumption is projected to support activity. Investment, growing much faster than potential GDP during the recovery, is likely to decelerate sharply. Net exports will continue to make a small positive contribution to growth, sustained by a strong competitive position. The risks are broadly balanced, with a possible slowdown in world growth offset by the likelihood of stronger-than-projected domestic demand.

9. **Over the medium term, potential growth is expected to slow markedly, primarily reflecting the coming demographic transition**. Potential growth has been boosted over the past several years by a rise in total factor productivity growth and increased labor participation. However, in the absence of further changes to the institutional and incentive structures, adverse demographics are set to soon offset these positive influences. With working age population expected to begin shrinking by the end of the decade, despite significant immigration, potential growth is projected to fall from recent rates of around 2¾ percent to barely 2 percent by the end of the decade.

II. The Policy Debate

10. **The pace and sequencing of reforms are at the center of the debate.** The staff and the authorities see eye-to-eye on the broad philosophy underlying the reform agenda and the importance of sustaining a consensus behind the new policy paradigm (Box 1). Looking ahead over a four-year electoral horizon and beyond, considerations of timing and tactics are equally important elements in the authorities' thinking. The opportunity to shape the longer-term design of the Swedish model—indeed influence the broader debate on the European social model—makes the change of policy direction in Sweden of particular interest to the international community.[2]

[2] See, for example, "Globalisation and the Reform of European Social Models" by Andre Sapir, 2005, http://www.bruegel.org/Files/media/PDF/Publications/Papers/EN_SapirPaper080905.pdf).

Box 1: Sweden: The New Government's Program

Taxation

- **A 'job deduction' from income taxes for low and middle income earners** will reduce marginal tax rates. The income tax deduction, amounting to about 1½ percent of GDP, is intended to be raised in a second stage of tax cuts in 2008.
- **Introduction of "New Start Jobs"** in the form of a subsidy to the employer, with a view to returning those outside the labor market to work.
- **Employers' social security contributions for young and older workers will be reduced** so as to make it more attractive for employers to recruit and retain them. Employer contributions are also to be lowered in selected service sectors. This may not be feasible until 2008, inter alia due to EU rules on state aid.
- **Tax reductions for purchase of household-related services** are proposed.
- **Wealth tax rates will be halved** to 0.75 percent as a prelude to their elimination.

Welfare and Labor Market

- **Unemployment benefit**s **will be reduced,** with the replacement ratio falling to 70 percent from 80 percent after 200 days.
- **Sickness benefits** will be cut and subject to stricter enforcement to reduce their overuse and eliminate fraud.
- **Labor market programs will be substantially reduced** and made more efficient, abolishing programs such as sabbaticals that run counter to the "work-first" principle.

Privatization

- **Government stake in state-owned companies will be reduced.** Sales are expected to total around 7 percent of GDP over the next 3 years .

A. Toward a More Inclusive Labor Market

11. **The government's labor market strategy is well designed to promote sustainable growth.** The authorities stress that the package is aimed at addressing simultaneously unemployment and poverty traps. The decision to cut taxes for low and average earners is intended to make employment more attractive for those now outside the labor market. Reductions in unemployment and sickness benefits are intended to underline the dual role of social insurance as a safety net and as a support to facilitate the transition back to work. A scheme to lower social security contributions for young and older workers should encourage

employers to recruit and retain these groups. Programs will focus on matching jobseekers with vacancies and raising competition in employment services.

12. **The authorities do not underestimate the challenge of changing entrenched behavior patterns.** Officials acknowledge that the implementation of measures to stimulate labor demand, such as the planned cuts in social security contributions for selected sectors, such as services, face challenges (related, for instance, to EU rules on state aid). The time lag before the policy changes will start affecting behavior also remains uncertain. The authorities, nevertheless, express confidence that employment will rise substantially over the next few years.

13. **The authorities plan further cuts in taxation, subject to the overriding constraint of maintaining a healthy fiscal surplus.** In the staff's view, the high tax burden—among the highest in the world—suggests ample scope for reducing taxation. The government's expectation is that future tax reforms would be financed partly from the dynamic economic gains arising from the first wave of cuts. In the staff's view, cutbacks in either public consumption or transfers will be necessary to create room for further strategic tax cuts. The authorities have ruled out cuts in public services, limiting their room for maneuver. While the intention to increase competition in health care and social services is welcome, potential exists for using private suppliers to deliver the same quality of services at lower cost, for instance in childcare, healthcare, and eldercare. The government may, nevertheless, need to seek cuts in public consumption as well.

14. **In a departure from past policies, the new government plans to privatize some state-owned enterprises.** It intends to sell a sizeable share of its stake in state enterprises—around 7 percent of GDP—with the proceeds to be used to repay foreign debt. Due to the sheer size of the divestment, it is expected that a substantial portion will be taken up by foreign investors, raising foreign interest in Swedish capital markets. The privatization could enhance competition in sectors where the state currently plays a major role, such as real estate, mortgage finance, and alcoholic beverages.

B. Fiscal Policy and Framework

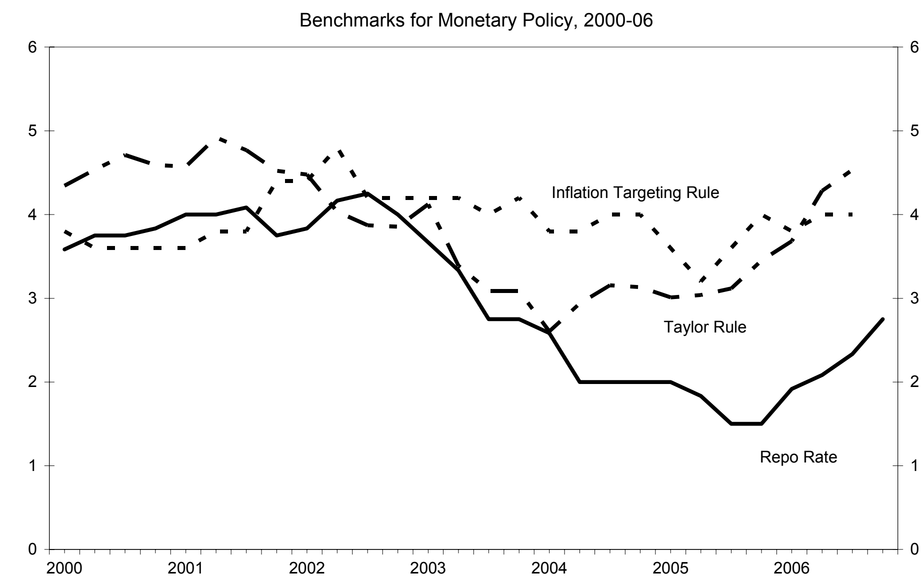
15. **The recent trend of pro-cyclical fiscal policy is set to continue in 2007** (Table 4). Staff estimates that the general government structural surplus will fall well below the 2 percent target, mainly reflecting the tax cuts. While conceding that the fiscal stance might be procyclical in the short term, the authorities view the fiscal outcome for 2007 in the broader context of their agenda to streamline the welfare state and raise sustainable growth and employment.

16. **The government intends to refine the fiscal framework while preserving the target of a surplus of 2 percent of GDP over the cycle.** Staff and the authorities view the target as appropriate to ensure fiscal sustainability in the face of the demographic challenges. In line with past Fund advice, the 2007 budget has reduced reliance on tax expenditures and

restored a three-year horizon for expenditure ceilings. The authorities hope to embed the fiscal framework within their wider policy agenda of raising employment. They see merit in the staff's view that an independent economic agency could derive the annual structural surplus target in a macroeconomic context and translate it into a headline budget target. Such a setup would eliminate ambiguous targets that can lead to lax policies in good times and to a procyclical correction in bad times, thereby undermining public confidence in the framework. The authorities intend to move in this direction in the Spring 2007 Budget.

C. Monetary Policy and Framework

17. **With inflation expected to rise over the next two years, the Riksbank is expected to tighten monetary policy further.** Real interest rates remain close to zero and the monetary stance remains quite accommodative. Riksbank officials do not contest the staff's view that a neutral policy rate—consistent with an inflation target of 2 percent—would be about 4 percent. In their view, the degree of slack in the labor market would also have a bearing on the pace of tightening. As for the level of the krona, officials concur that conventional model-based indicators suggest that the krona is undervalued. They note that the Riksbank has not intervened in exchange markets with a view to influencing the exchange rate in recent years.



18. **Recent changes to the inflation targeting framework have improved the clarity of monetary policy communication.** The changes also provide a more internally consistent forecast and enrich the policymaking debate. The Riksbank is considering switching to using its own forecasts for interest rates that are consistent with achieving the inflation target. The staff welcomes this as another step that would keep the Riksbank at the forefront of international best practice. A recent evaluation of the Riksbank's inflation targeting

framework commissioned by the parliament arrives at a similar conclusion and should contribute to the further evolution of the framework.[3]

D. The Financial Sector

19. **The financial sector remains stable.** Bank profitability is high, and capital levels are adequate to absorb moderate economic shocks.[4] Asset quality has improved significantly, as household and corporate balance sheets have strengthened in recent years. While household debt has risen sharply, the authorities view the debt service burden as manageable, and estimate that it will remain so even if interest rates rise beyond current market expectations. Equity markets have recovered from their slump earlier this year, and house price inflation is showing signs of slowing to a more moderate pace (Figure 4). Nevertheless, financial supervisors acknowledge that asset prices, especially those for real estate, need to be monitored closely, along with banks' exposure to highly leveraged transactions. Regional cross border supervisory cooperation is well-established and continues to be enhanced.

20. **The 2002 FSAP had noted certain weaknesses in the supervisory regime.** Recent difficulties in revoking licenses of two small deposit-taking institutions in a timely fashion underscore the need to improve the legislative framework for bank resolution. While neither institution posed a systemic risk, the authorities are addressing this deficiency by drafting legislation to create an integrated framework for managing and unwinding troubled institutions.[5]

III. Staff Appraisal

21. **The new government's ambitious reform agenda is timely and welcome.** The economy is on course for another year of strong growth, despite some slowing as output approaches capacity limits. The incipient recovery in employment is expected to strengthen, supported by the new policy initiatives, and total unemployment, including persons in labor market programs, should begin to fall as well. Both monetary and fiscal policies are set to remain supportive of demand.

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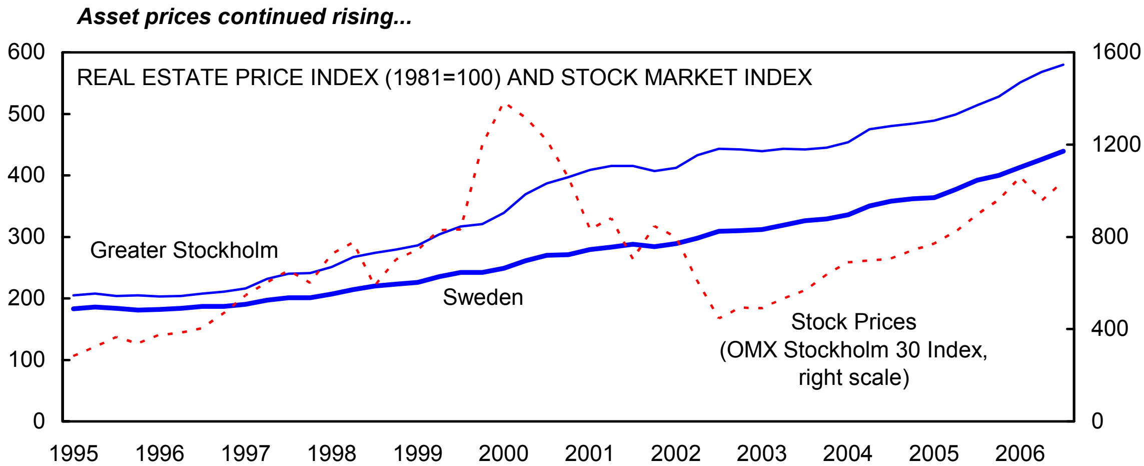
[3] The report reviews the Riksbank's experience of inflation targeting over the past decade and makes a number of recommendations. Francesco Giavazzi and Fredric Mishkin "An Evaluation of Monetary Policy Between 1995 and 2005", November 2006, www.riksdagen.se/upload/Dokument/utskotteunamnd/200607/FiU/200607_RFR1_eng.pdf.

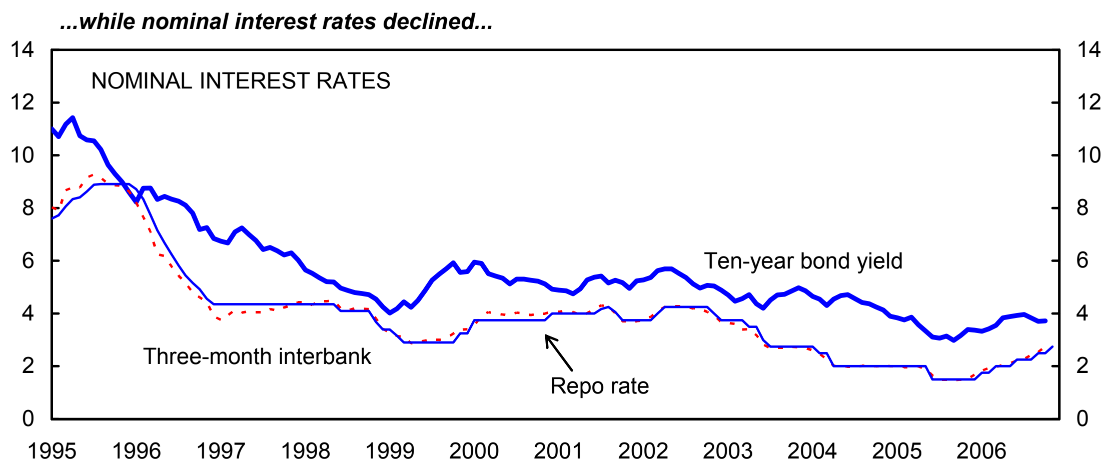
[4] Recent stress tests by the Riksbank indicate that Swedish banks are well positioned to absorb either adverse domestic economic shocks or a significant deterioration in their foreign loan portfolios.

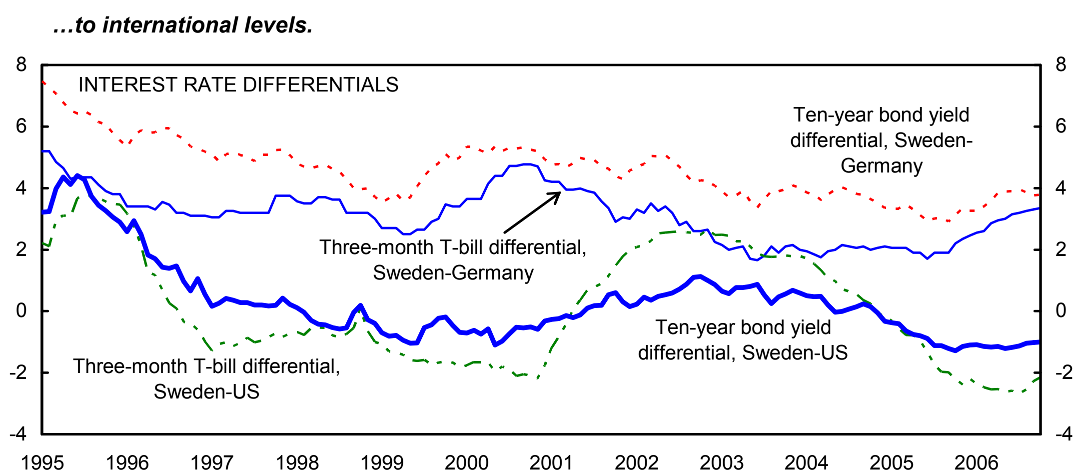
[5] A staff mission from the Monetary and Capital Markets Department will visit Stockholm in January 2007 to explore this issue in depth and make recommendations.

22. **The reform program is rightly centered on restructuring the extensive tax and benefit systems to steer more people toward gainful employment.** The tax cut aimed at low and average income earners, together with the reduction in unemployment and sickness benefits, and a revamping of the extensive labor market programs should boost employment. Although the magnitude and timing of the impact of these complementary initiatives are uncertain, they are expected to alleviate the adverse effects of the compressed wage structure on the employment prospects of low-skilled workers.

Figure 4. Sweden: Asset Price and Interest Rate Developments







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

23. **The high tax wedge needs to be reduced to raise incentives to work, but room for further tax cuts will need to be found within the constraints of the fiscal framework.** The new government's strong political commitment to sound public finances is welcome and reinforces the credibility of its economic program with the markets and the public. Expenditure restraint will be critical to create room for additional tax cuts over the medium term.

24. **The fiscal framework could be refined further to improve its transparency and accountability and to reduce procyclical policy bias.** The framework has served Sweden well in ensuring fiscal discipline, and the new government has rightly decided to preserve it. However, the fiscal surplus target lends itself to different interpretations, compromising the effectiveness of the framework. The government's intention to refine and clarify the framework is therefore welcome, as are the decisions to restore the three-year horizon of spending ceilings and reduce reliance on tax expenditures.

25. **With inflation expected to rise over the next two years, the Riksbank will need to tighten monetary policy further.** With inflation rising toward the target, output at or above capacity, and a substantial fiscal stimulus in 2006-07, there is scope for continued tightening, broadly in line with current market expectations. As for the real exchange rate, conventional model-based indicators suggest that the krona remains undervalued.

26. **Recent changes to the framework have helped improve the clarity and transparency of monetary policy communication.** Further modifications to the framework—using its own forecasts for interest rates that are consistent with achieving the inflation target, for example—would keep the Riksbank at the forefront of international best practice. An evolution of the framework in this direction can be expected, as already signaled by the Riksbank.

27. **The financial system has strengthened further and remains stable.** Asset prices, especially those for real estate, need to be monitored closely. The recent difficulties in revoking the license of two small deposit-taking institutions on a timely basis suggest a need for improving the legislative framework for bank resolution. The authorities' plans to do so are therefore welcome.

28. **The pay-off from labor market reforms could be enhanced by initiatives to promote competition and reduce the burden of regulation.** Although Sweden ranks well on many international indicators of business climate, evidence of informal barriers to entry in sectors such as construction suggests scope for improving competition and encouraging entrepreneurship. The government's plans to sell some of its holdings in state-owned enterprises are welcome in this context. Deregulation in the housing market would make an important contribution to raising efficiency and promoting labor mobility.

29. **The government has embarked on a course that is both courageous and necessary.** Its success will help ensure that the much admired Swedish model of an inclusive society thrives in the face of the challenges of demographics and globalization. The international community will be watching the progress of this endeavor with keen interest.

30. Sweden is expected to remain on the standard 12-month consultation cycle.

Table 2. Sweden: Selected Economic Indicators

	2001	2002	2003	2004	2005	2006 1/	Average 2007–09 1/
Real economy (in percent change)							
Real GDP	1.1	2.0	1.7	4.1	2.9	4.8	2.3
Domestic Demand	-0.2	0.7	1.7	2.1	2.7	4.3	2.1
CPI inflation	2.7	1.9	2.3	1.0	0.8	1.6	1.9
Open unemployment rate (in percent)	4.0	4.0	4.9	5.5	5.8	5.5	5.2
Participation in labor market programs (in percent)	2.5	2.6	2.1	2.4	2.7	3.1	2.0
Gross national saving (percent of GDP)	21.9	21.7	23.7	23.1	24.2	24.2	25.3
Gross domestic investment (percent of GDP)	17.5	16.6	16.4	16.3	17.1	18.3	18.8
Public finance (in percent of GDP)							
General government balance	2.6	-0.5	-0.2	1.6	2.8	2.8	2.7
Structural balance 2/	2.1	-0.4	0.9	1.8	3.0	1.7	1.5
General government debt	53.8	52.0	51.8	50.7	50.4	46.3	37.9
Money and credit (12-month, percent change)							
M0	8.8	-0.9	2.7	-0.2	2.2	...	...
M3	-0.3	8.3	3.4	4.0	12.9	...	...
Credit to non-bank public	8.8	5.4	4.8	6.3	10.7	...	...
Interest rates (year average)							
Three-month treasury bill rate	3.7	3.7	2.7	2.0	1.7	…	…
Ten-year government bond yield	5.2	4.9	4.9	3.9	3.4	…	…
Balance of payments (in percent of GDP)							
Trade balance	6.3	6.9	6.8	8.3	7.6	7.2	6.8
Current account	4.4	5.1	7.3	6.8	7.1	6.0	6.5
International reserves (in billions of US dollars)	15.3	17.4	20.0	22.4	26.5	…	…
Reserve cover (months of imports of goods and services)	2.1	2.3	2.1	2.0	2.1	…	…
Exchange rate (period average, unless otherwise stated)							
Exchange rate regime			Floating exchange rate				
Skr per U.S. dollar (Dec. 5, 2006)			6.7975				
Nominal effective rate (2000=100)	91.8	93.7	99.0	100.8	98.7	...	...
Real effective rate (2000=100) 3/	96.9	92.6	95.2	99.2	97.9	...	...

Sources: Statistics Sweden; Riksbank; Ministry of Finance; Datastream; INS; and staff estimates.

1/ Staff projections.
2/ In percent of potential GDP, also adjusted for one-off effects.
3/ Based on relative normalized unit labor cost in manufacturing.

Table 3. Sweden: Medium-Term Scenario, 2002-11
(percent change)

					Projection					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
GDP	2.0	1.7	4.1	2.9	4.8	3.3	2.2	1.5	0.7	2.0
Consumption	1.8	1.4	1.6	1.6	3.2	2.6	2.2	0.4	0.7	0.9
Private	1.5	1.8	2.2	2.4	4.0	3.5	3.0	1.0	1.0	1.0
Public	2.3	0.7	0.3	0.3	1.4	0.7	0.5	-0.7	0.0	0.8
Investment	-2.6	1.1	6.4	8.1	9.0	6.0	3.0	2.0	1.5	2.0
Construction	1.6	-2.1	6.0	6.5	9.0	6.0	3.0	2.0	1.5	2.0
Machinery & other	-4.8	2.9	6.7	8.9	9.0	6.0	3.0	2.0	1.5	2.0
Exports	1.2	4.5	11.1	6.6	8.5	5.5	4.5	4.3	4.2	4.1
Imports	-1.9	5.0	7.0	6.9	9.6	6.0	4.9	3.8	4.6	4.3
Total Domestic Demand	0.8	1.7	2.0	2.7	4.3	3.3	2.4	0.8	0.9	1.2
Final Domestic Demand	0.8	1.7	2.0	2.7	4.3	3.3	2.4	0.8	0.9	1.2
Inventory Accumulation [1]	-0.2	0.3	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance [1]	1.3	0.2	2.5	0.6	0.5	0.4	0.3	0.7	0.3	0.4
Memorandum:										
Output Gap	-0.1	-1.4	-0.2	-0.3	1.5	2.2	2.0	1.3	0.0	0.0
CPI Inflation	1.9	2.3	1.0	0.8	1.6	1.8	2.0	2.0	2.0	2.0
Unemployment Rate	4.0	4.9	5.5	5.8	5.5	5.8	5.0	4.7	4.7	4.7

Sources: Statistics Sweden and staff calculations.

[1] Contributions to Growth

Table 4. Sweden: General Government Financial Accounts, 2001-09
(as a percentage of GDP)

	2001	2002	2003	2004	2005	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.
Total Revenue	56.4	54.8	55.3	55.6	56.3	55.6	53.6	53.1	52.8
Primary Revenue	54.1	52.7	53.1	53.5	54.2	53.3	51.3	51.0	50.7
Direct Taxes	19.9	18.0	18.7	19.6	20.0	19.9	17.8	17.8	17.9
Indirect Taxes	16.4	16.8	17.0	16.9	17.0	17.2	17.2	17.1	17.0
Social Security Contributions	14.6	14.5	14.1	13.9	13.8	13.1	12.9	12.7	12.5
Interest Receipts	2.2	2.1	2.2	2.1	2.2	2.3	2.3	2.1	2.1
Total Expenditure	53.7	55.3	55.4	54.0	53.6	52.8	51.3	50.5	49.8
Primary Expenditure	47.9	48.9	50.2	49.3	48.9	48.1	46.5	45.9	45.3
Current Transfers	21.0	21.2	22.1	21.8	21.6	21.2	19.9	19.4	19.0
Consumption	26.9	27.8	28.1	27.5	27.2	26.8	26.6	26.4	26.3
Investment	2.8	3.1	2.9	2.8	2.7	2.9	2.9	2.8	2.8
Interest Payments	3.0	3.2	2.4	1.9	1.9	1.9	1.9	1.8	1.7
Overall Balance	2.6	-0.5	-0.2	1.6	2.8	2.8	2.3	2.6	3.1
Pension system	-4.5	1.9	1.9	1.9	1.9	2.8	1.8	1.6	1.4
Central government	7.4	-1.8	-1.8	-0.5	0.4	-0.7	0.1	0.6	1.5
Local governments	-0.2	-0.5	-0.2	0.2	0.5	0.7	0.5	0.4	0.3
Primary balance	3.4	0.7	0.0	1.5	2.6	2.4	2.0	2.3	2.6
Structual Adjustment									
Cyclical Adjustment	-0.5	0.1	1.1	0.2	0.2	-1.1	-1.5	-1.4	-0.6
Structural Balance	2.1	-0.4	0.9	1.8	3.0	1.7	0.8	1.2	2.5
Fiscal Stimulus	1.0	2.5	-1.3	-0.9	-1.2	1.2	1.0	-0.4	-1.3
Memorandum:									
Gross Public Debt (percent of GDP)	53.8	52.0	51.8	50.7	50.4	46.3	41.7	38.0	34.1
Net Public Debt (percent of GDP)	-2.9	3.0	-1.5	-5.7	-12.4	-15.4	-17.0	-19.0	-21.5
Nomimal GDP (in billions of SEK)	2288.4	2371.6	2459.4	2565.1	2670.5	2843.5	2990.2	3117.1	3211.3
Output Gap (percent of potential GDP)	0.7	-0.1	-1.4	-0.2	-0.3	1.5	2.2	2.0	0.8

Sources: Spring Budget 2006 and staff estimates.

Table 5. Sweden: Balance of Payments Accounts, 2002-11

					Projection					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
					(as a percent of GDP)					
Current Account Balance	5.1	7.3	6.8	7.1	6.0	6.1	6.4	7.2	7.6	8.1
Trade Balance	6.9	6.8	8.3	7.6	7.3	6.9	6.8	7.1	7.0	7.0
Exports of G&S	44.4	43.7	46.3	48.8	53.5	53.6	53.3	53.4	53.4	53.4
Imports of G&S	37.5	36.9	38.0	41.2	46.2	46.7	46.6	46.3	46.3	46.4
Factor income, net	-0.5	1.3	-0.1	0.8	-0.1	0.4	0.9	1.3	1.8	2.3
Current Transfers, net	-1.3	-0.7	-1.3	-1.3	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Financial Account Balance	-2.1	-6.2	-9.1	-7.4	-6.1	-6.1	-6.5	-7.3	-7.7	-8.1
Investment Abroad [1, 2]	7.0	-1.7	-10.5	-6.1	-5.8	-5.8	-6.2	-7.0	-7.4	-7.8
Direct Investment	-4.4	-6.9	-5.9	-7.5	-6.6	-6.1	-6.1	-6.1	-6.6	-6.6
Portfolio Investment	-1.7	-4.4	-7.0	-3.6	-5.3	-5.3	-5.8	-5.8	-5.8	-6.3
Other Investment	-2.1	-2.9	-5.7	-3.4	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Reserves	-0.3	-0.7	0.3	-0.2	0.5	0.0	0.1	-0.7	-0.6	-0.5
Investment in Sweden [1]	-9.1	-4.5	1.3	-1.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Direct Investment	5.0	1.6	0.8	2.6	3.0	3.0	3.0	3.0	3.0	3.0
Portfolio Investment	-2.2	2.2	0.4	4.7	1.6	1.6	1.6	1.6	1.6	1.6
Other Investment	3.7	4.5	4.5	0.2	3.1	3.1	3.1	3.1	3.1	3.1
Errors and Omissions	-3.0	-1.1	2.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0
					(percentage change)					
Exports of G&S										
Value	0.8	2.2	10.7	9.5	15.8	4.6	3.8	4.0	4.0	4.1
Volume	2.5	4.1	11.0	6.1	8.6	5.5	4.5	4.3	4.2	4.1
Deflator	-1.7	-1.9	-0.2	3.3	6.6	-0.9	-0.7	-0.3	-0.2	0.0
Imports of G&S										
Value	-1.3	2.2	7.6	12.8	18.4	5.5	4.0	3.2	4.2	4.2
Volume	-1.4	4.6	6.8	7.7	9.6	6.0	4.9	3.8	4.6	4.3
Deflator	0.1	-2.2	0.7	4.7	8.0	-0.5	-0.9	-0.6	-0.4	-0.1
Memorandum (percentage change):										
Real Effective Exchange Rate	-4.4	2.9	4.2	-1.3	1.6	1.2	0.0	0.0	0.0	0.0
World Import Demand	3.8	4.6	10.8	8.7	9.7	7.0	6.1	5.6	5.8	5.4
Real GDP	2.0	1.7	3.7	2.7	4.0	2.6	2.2	1.8	2.1	2.0
Nominal GDP (blns of SEK)	2371.6	2459.4	2573.2	2673.0	2824.4	2950.0	3075.2	3191.8	3323.2	3456.8
(percent change)	*3.6*	*3.7*	*4.6*	*3.9*	*5.7*	*4.4*	*4.2*	*3.8*	*4.1*	*4.0*

[1] Includes investments in financial derivatives (not shown).

[2] Positive number indicates an accumulation of foreign assets.

Table 6. Sweden: Indicators of External and Financial Vulnerability, 2000-2006
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006 1/	
External Indicators								
Exports of goods and services (annual percentage change, in U.S. dollars)	3.9	-9.2	7.1	23.0	21.7	7.9	16.2	
Imports of goods and services (annual percentage change, in U.S. dollars)	6.2	-10.5	4.8	23.0	18.3	11.1	18.9	
Current account balance	4.1	4.4	5.1	7.3	6.8	7.1	6.0	
Capital and financial account balance	-1.1	-2.1	-2.1	-6.2	-9.2	-7.3	-6.0	
Direct investment, net	-7.2	1.6	0.6	-5.3	-5.2	-4.9	-3.6	
Portfolio investment, net	-1.8	-6.9	-3.9	-2.2	-6.6	1.1	-3.7	
Central Bank reserves (end of period, in billions of U.S. dollars)	18.4	15.3	17.4	20.0	22.4	26.5	25.1	June
Exchange rate against US dollar (SEK, period average)	9.1	10.3	9.7	8.1	7.3	7.4	7.1	November
Exchange rate against Euro (SEK, period average)	8.4	9.2	9.2	9.1	9.1	9.3	9.1	November
Effective exchange rate (annual percentage change)	-0.8	-8.2	2.0	5.7	1.8	-2.1	3.7	July
Real effective exchange rate (based on ULC, annual percentage change)	-3.3	-3.1	-4.4	2.9	4.2	-1.3	5.1	July
Financial Markets Indicators								
Consolidated public sector gross debt (end of period)	52.3	53.8	52.0	51.8	50.7	50.4	46.3	
3-month T-bill yield (nominal, in percent per annum)	4.0	3.6	4.1	2.7	2.0	1.5	2.7	October
3-month T-bill yield (ex post real, in percent per annum)	2.7	1.0	2.2	0.4	1.0	0.7	1.4	October
Spread of 3-month T-bill vs. Germany (percentage points, end of period)	-1.0	0.0	0.9	0.6	-0.1	-0.8	-0.2	October
Spread of 10-year T-bill vs. Germany (percentage points, end of period)	0.0	0.5	0.6	0.5	0.6	0.1	-0.1	October
General stock index (annual percentage change)	-11.9	-42.9	-35.9	29.9	21.3	26.3	17.5	December
Real estate price index (annual percentage change)	11.1	7.7	6.4	6.7	9.4	9.8	...	
Commercial property price index (annual percentage change)	6.9	0.9	11.4	-4.7	11.0	2.5	...	
Credit to households (growth rate in percent, end of period)	7.5	9.0	9.1	10.1	11.6	12.9	12.6	September
Financial Sector Risk Indicators								
Tier 1 capital ratio in four major banks	6.9	7.0	7.1	7.4	7.7	7.1	7.0	September
Banks' return on equity after tax in four major banks	16.6	13.6	10.9	13.1	15.0	17.7	18.5	September
Nonperforming loans in four major banks (percent of lending)	1.6	1.5	1.2	1.2	0.9	0.7	0.6	September
Loan loss provisioning in four major banks (percent of lending)	0.3	0.4	0.4	0.2	0.2	0.1	0.1	September
Ratio of corporate debt to total assets in percent	50.1	52.2	53.7	53.3	50.7	53.9	50.0	September
Ratio of households' financial liabilities to disposable income in percent	104.2	104.4	107.0	113.5	121.7	131.7	...	
Ratio of households' interest payments to to disposable income in percent	4.2	4.0	4.1	3.8	3.6	3.3	...	

Sources: Statistics Sweden; Riksbank; Ministry of Finance; Datastream; INS; and staff calculations.

1/ Staff projections unless otherwise indicated.

APPENDIX I. SWEDEN: FUND RELATIONS

(As of November 30, 2006)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	2,395.50	100.00
Fund holdings of currency	2,184.4	91.91
Reserve position	211.10	8.81

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	246.53	100.00
Holdings	164.70	66.81

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

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest		3.33	3.33	3.32	3.32
Total		3.33	3.33	3.32	3.32

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. **Exchange Arrangements:** The Krona has been floating since November 19, 1992. Sweden has accepted the obligations of Article VIII (Sections 2(a), 3, and 4) and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, apart from those imposed for security reasons, which have been duly notified to the Fund by the Riksbank on June 1, 2006 (EBD/06/79, June 23, 2006) in accordance with Executive Board Decision No. 144-(52/51).

VIII. **Article IV Consultation:** Discussions for the 2005 Article IV consultation were held in Stockholm, May 16-25, 2005 and the staff report (IMF Country Report 05/343) was issued on September 15, 2005. The consultation was concluded by the Executive Board on September 2, 2005.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Statement by Tuomas Saarenheimo, Executive Director for Sweden and Ms. Roos-Isaksson, Senior Advisor to Executive Director
January 26, 2007

The Swedish authorities would like to convey their appreciation for yet another high-quality report on the Swedish economy. In evaluating and pursuing their policy objectives, they find the Article IV consultations instrumental and valuable. We would also like to especially thank Mr. Thakur for his time as Mission Chief for Sweden. During the years the Swedish authorities have had very positive and constructive discussions with him and his team, and the recent streamlined consultation in Stockholm in November, 2006, was no exception. It provided an excellent opportunity for the Fund to engage in a dialogue with the new Swedish Government which took office in October 2006, on its economic policy initiatives.

The new Government is facing three major challenges, namely demographic changes, globalization and structural changes, and - the single greatest one – to increase employment. Despite high growth and low inflation over the past few years, durable revival in employment has not yet been seen and the high exclusion from the labor market is a concern. In recognition of this, the policy agenda of the new Government emphasizes the importance of economic incentives. The reforms are aimed at fostering labor supply and increasing labor demand by making it easier and cheaper to employ people. Recent estimates by the National Institute of Economic Research (NIER) show that the effects of the measures presented in the budget bill for 2007 are likely to be significant as well as lasting, resulting in a lower unemployment rate and a higher potential labor force, thus increasing employment.

Nonetheless, as noted in the staff report, the existing fiscal and monetary policy frameworks have served the Swedish economy very well. A sound and stable macroeconomic framework has been essential in fostering high and sustainable economic growth and stability in Sweden in recent years. While it is important to preserve the credibility of the framework, the Swedish authorities welcome a discussion on how it can be further refined.

Recent Economic Developments

The Swedish authorities broadly agree with staff's overall assessment of the near-term prospects for the Swedish economy, although with a markedly different view of the resource utilization for 2006 and for the next two years. GDP growth is expected to be high and around 4.5 percent in 2006 and then decline somewhat in 2007 and 2008. This is primarily driven by private consumption growth due to the increase in private wealth and disposable income, but also, to some extent, by increases in private investments and exports. Developments in the labor market lag behind, partly due to the unexpectedly high productivity growth rate, but employment growth has been strong during 2006 and is expected to continue to be high in the coming years. At the same time, unemployment is expected to gradually decline, although with some delay due to cutbacks in labor market programs and a strong increase in labor supply. Compared to the Swedish authorities' assessment, however, staff expects a lower employment growth in 2006 and 2007, together with a smaller increase in the labor force.

Fiscal Policy

The authorities concur with staff that the fiscal stance for 2007 and the successive years should be seen in a broader context of reforms. Maintaining a healthy fiscal budget surplus is of utmost importance to the Swedish Government. The commitment to the fiscal targets, i.e. the surplus target and the expenditure ceilings, remains intact and future reforms will be designed to attain these targets. At the same time, the Government has high confidence in positive effects from the tax reforms presented in the budget bill which, together with planned reforms, are assumed to lower equilibrium unemployment and increase labor supply and thus improve the long-run fiscal position of the economy. In other words, while the Government's reforms have some expansionary effects on the budget, strong developments in the labor market are expected to broaden the tax bases and lower the unemployment and sickness benefits, thereby reducing expenditures and transfers as a share of GDP.

The Swedish authorities do not agree with staff's assessment of the output gap, the structural balance and, as a consequence, the assessment of the fiscal stance. Staff estimates a positive output gap of 1.5 percent of potential GDP in 2006 and 2.2 percent in 2007, and a structural surplus of less than 1 percent of GDP in 2007 and 2008. These estimates clearly stand out in comparison with estimates made by Swedish institutions. By comparison the NIER and the Ministry of Finance both estimate the output gap to become close to zero in early 2007. In the Swedish authorities' view, the large discrepancy between staff's view of the structural balance and the Swedish estimates is due to staff's assessment of the output gap in 2006.

These kinds of estimates are, of course, subject to uncertainty, but there are other indicators supporting the authorities' view on resource utilization. The Riksbank assesses that the Swedish economy, despite a relatively high growth in recent years, still has a certain amount of unutilized recourses in the labor market according to various measures. Furthermore, there is currently no evidence of wages accelerating and, with the exception of some sectors, labor shortages are in general still rare. In construction labor shortages have risen to a high level, but even so wage increases have remained moderate.

In view of an output gap close to zero, the structural balance is expected to be close to the actual net lending level. By way of example, the NIER estimates a structural balance as high as 3.1 percent of GDP in 2007 and, like the Ministry of Finance, assesses the fiscal stance to be broadly neutral. For the coming years, an explanation for the discrepancy in relation to staff's estimates is that the Government's economic policy is expected to contribute to an increase in employment in the long run, without leading to strained resources utilization on the labor market. This also means that level of GDP growth can increase in the long run.

Staff has correctly observed that the Government will by and large adhere to the current fiscal framework. Looking at the experience over the past ten years while the framework has been in force, the authorities find that our fiscal framework has been serving us well and there are strong reasons to maintain it in all essentials. Although they have been under pressure for some years, the expenditure ceilings have consistently been met since they were first introduced in 1997. The Government's latest assessment included in the budget bill for 2007 shows that the net lending surplus reached 2 percent of GDP on average in 2000-2006.

Having said that, it is important to learn from the experiences gained in the past decade. The view of the Government is that there is a need to examine the fiscal framework with a view to further improve and develop its functioning. An important aspect of this is to increase the degree of transparency and to facilitate ex-post evaluation of the fiscal targets. Moreover, the authorities are scrutinizing how to clarify the link between the nominal expenditure ceiling and the surplus target. They are also aiming to develop clear principles for technical adjustments of the expenditure ceilings and how to analyze the effects of, for example, future demographic developments and the distribution between generations. Measures to tackle these aspects of the framework are to be presented in future budget bills.

In the staff report, the possible role of an independent economic agency is also mentioned. However, the Government would like to emphasize that the role of such a body should not be ex ante to suggest budget targets. In their view, an independent economic agency could possibly evaluate ex post the fulfillment of fiscal targets. Thereby the opportunity to hold the Government accountable for the development of public finances would improve. Such a body could also have a role to evaluate the quality of methods, models etc. used in the implementation of the fiscal policy. The Government will take this suggestion under consideration.

Structural Policies

The Swedish authorities agree with staff's assessment on the need to strengthen competition in some markets and to reduce the burden of regulation. The Government has initiated a wide strategy for improving the Swedish business climate. This strategy includes measures such as: lowering the regulatory burden for enterprises, reducing the number of state-owned enterprises and halving the wealth tax. The aim is to abolish the wealth tax altogether within this Government's term in office, the main objective being to increase the availability of venture capital. This strategy also includes measures to open the public sector to competition as a means to encourage higher quality, greater accessibility and increase the diversity of provision in healthcare and social services. The first step will be in elderly care through a "Freedom of Choice" reform.

Monetary Policy

Sweden's monetary policy framework, a target of an annual change in the consumer price index of 2 percent with a tolerance interval of plus/minus 1 percentage point, continues to serve the economy well. The Riksbank continues, nevertheless, to evaluate and develop its monetary policy process. In 2006, a specific statement was published to clarify the goal and strategy of the Riksbank's monetary policy. Furthermore, on January 16, 2007 the Riksbank's Executive Board decided to present its own interest forecasts in its subsequent reports. This is a further refinement of the recent change from constant interest rates to market interest rates as the basis of the forecast.

Inflation was low and below target in 2005 and 2006. The Riksbank agrees with staff that this was mainly due to the unexpectedly high productivity growth rate, low pressure on wages and consequently low growth of unit labor costs. The slow growth rate of import prices and the appreciating krona have also contributed to the low rate of inflation. For 2007 and 2008 the high productivity growth is expected to slow down and employment is expected to grow faster than in previous years. This implies higher growth rates in unit labor costs as well as higher capacity utilization in product markets, generating a higher inflation pressure. At the same time, energy prices are expected to level off. The krona is still expected to appreciate somewhat further, both in real and nominal terms.

Inflation is expected to increase gradually and be close to the target two years from now. This presupposes a continued tightening of the monetary policy. In 2006, the Riksbank increased the policy rate from 1.5 percent in January to 3.0 percent in December and, as noted by staff, further increases are expected in 2007.

Financial Sector

In line with the findings in the latest Financial Stability Report published in December, the Riksbank agrees with the staff report that continued improvements in profitability have contributed to a further increase in the banking sector's resilience. The banking sector continues to be in a good position to cope with unexpected losses and adverse domestic economic shocks.

The Swedish authorities are well aware of certain shortcomings in the possibilities of managing distressed institutions, and agree with the staff report that improvements are needed in the legislative framework for bank resolution. The visit to Stockholm by the Fund's staff mission from the Monetary and Capital Markets Department this week is thus very welcome.

Conclusion

In conclusion, we look forward to conveying the outcome of this Board discussion to the Swedish authorities. This will complete the constructive dialogue in which they have been involved with the Fund's staff during this consultation. On behalf of the Swedish authorities, we also look forward to a fruitful cooperation in the years to come. The authorities intend to authorize publication of the staff report, in accordance with normal Fund procedures.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

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

IMF Executive Board Concludes 2006 Article IV Consultation with Sweden

On January 26, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sweden.[1]

Background

A new center-right coalition government has launched an ambitious program of economic reform, aimed at addressing widespread exclusion from the labor market. The government's first budget is centered on proposals to cut taxation for low and average income earners, reduce generous unemployment and sickness benefits, and redefine the scope of labor market policies.

A broad-based economic upturn is under way, spurred by strong global growth and supportive fiscal and monetary policies. Private consumption has served as the engine of expansion, supported by a resurgence in investment and buoyant exports. The momentum of the current recovery is expected to continue, although easing back in 2007-08 in the face of capacity constraints and fading policy stimulus.

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[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.

Wage inflation remained moderate during 2005–06 and, coupled with strong productivity gains, has helped contain labor costs. However, cost pressures have begun to emerge in recent months, reflecting the pass-through of higher energy prices and incipient wage pressures. With capacity utilization at an all-time high and a sizeable positive output gap projected to open, measures of expected inflation have been rising toward the inflation target.

The Riksbank has begun to gradually withdraw the strong monetary stimulus in place for the past two years. In response to rising underlying inflation and higher expected inflation over the policy horizon, the key policy rate was raised in steps from a historic low of 1.5 percent in January 2006 to 3 percent in December.

The structural surplus is estimated to fall below the 2-percent target in 2006, as buoyant tax revenues are offset by pre-election spending on job-creation programs. The tax cuts in the budget for 2007, including those in income, wealth and property taxes, amount to around 2 percent of GDP. They would be financed partially by lowering welfare benefits, raising unemployment insurance contributions, and reducing spending on labor market programs. The staff projects a further fall in the structural surplus in 2007.

The krona has remained broadly unchanged against the euro in recent years; however, it has appreciated 5 percent in effective terms over the past year. Large actual and projected current account surpluses are expected to continue in the medium-term.

Growth is expected to ease back in 2007–08**.** As the stimulative effects of monetary and fiscal policy fade, domestic demand is expected to slow and the positive output gap will start to close. The risks are broadly balanced, with a possible slowdown in world growth offset by the likelihood of stronger-than-projected domestic demand.

Executive Board Assessment

Directors commended the Swedish economy's strong performance in recent years, marked by rapid growth and a robust competitive position. Directors, however, noted that strong growth has yet to translate into a durable revival in employment, and that a large section of the workforce continues to be excluded from the labor market. They therefore welcomed the new government's program of reform, centered on restructuring the tax-benefit system to increase incentives to work. Directors considered that the thrust of the government's program is consistent with the aim of restructuring the extensive tax and benefit system to address the challenges of demographic change and globalization.

Directors noted that the economy is on course for another year of strong growth in 2007, following very buoyant growth last year, with both monetary and fiscal policies set to remain supportive. As the incipient recovery in employment strengthens, the complementary initiatives of tax cuts, cutbacks in welfare benefits, and the revamping of labor market programs should begin to steer more people into gainful employment.

Directors took note of the significant divergence in views between the staff and the authorities on the cyclical position, and consequently on the fiscal stance. A number suggested caution in assessing policies given the uncertainty surrounding estimates of the cyclical position, especially in times of major reforms.

Looking to 2008 and beyond, Directors underlined the need to achieve the surplus target of 2 percent of GDP over the cycle. The authorities' strong political commitment to adhere to the framework reinforces the credibility of their economic program with the markets and the public. Going forward, Directors viewed expenditure restraint as critical to the creation of room for additional tax cuts over the medium term.

Directors encouraged the authorities to refine further their fiscal framework to improve its transparency and accountability. The fiscal surplus target lends itself to different interpretations, compromising the effectiveness of the framework. The government's intention to refine and clarify the framework is therefore welcome, as are the decisions to restore the three-year horizon of spending ceilings and reduce reliance on tax expenditures. Addressing the value of establishing an independent economic agency to help strengthen confidence in the fiscal framework, a number of Directors agreed with the authorities that such an institution should provide ex post evaluations of adherence to fiscal targets.

Directors agreed that the Riksbank will need to tighten monetary policy further in the coming year. With inflation rising toward the target, and given the fiscal stimulus in 2006-07, Directors saw scope for continued tightening, broadly in line with current market expectations.

Directors viewed the recent changes to the inflation targeting framework as improving the clarity and transparency of monetary policy communication. Further modifications to the framework, such as the use of the Riksbank's own forecasts of interest rates consistent with achieving the inflation target, would keep the approach at the forefront of international best practice. Directors welcomed the recent decision by the Riksbank to make the framework evolve in this direction.

Directors considered the financial system sound and stable. They welcomed the authorities' plans to improve the legislative framework for bank resolution in light of the recent difficulties in closing a small deposit institution in a timely manner. Asset prices, especially those for real estate, need to be monitored closely.

Directors noted that the pay-off from labor market reforms could be enhanced by initiatives to promote competition, especially in sectors such as construction, and encouraging entrepreneurship. In this context, they welcomed the government's plans to sell some of its holdings in the large state-owned enterprise sector.

Directors praised Sweden's high level of official development assistance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2006 Article IV Consultation with Sweden is also available.

Sweden: Selected Economic Indicators

	2001	2002	2003	2004	2005	2006 1/	Average 2007-09 1/
Real Economy (in percent change)							
Real GDP	1.1	2.0	1.7	4.1	2.9	4.8	2.3
Domestic Demand	-0.2	0.7	1.7	2.1	2.7	4.3	2.1
CPI Inflation	2.7	1.9	2.3	1.0	0.8	1.6	1.9
Open Unemployment Rate (in percent)	4.0	4.0	4.9	5.5	5.8	5.5	5.2
Participation in labor market programs (in percent)	2.5	2.6	2.1	2.4	2.7	3.1	2.0
Gross national saving (percent of GDP)	21.9	21.7	23.7	23.1	24.2	24.2	25.3
Gross domestic investment (percent of GDP)	17.5	16.6	16.4	16.3	17.1	18.3	18.8
Public finance (in percent of GDP)							
General government balance	2.6	-0.5	-0.2	1.6	2.8	2.8	2.7
Structural balance 2/	2.1	-0.4	0.9	1.8	3.0	1.7	1.5
General government debt	53.8	52.0	51.8	50.7	50.4	46.3	37.9
Money and credit (12-month, percent change)							
M0	8.8	-0.9	2.7	-0.2	2.2	...	...
M3	-0.3	8.3	3.4	4.0	12.9	...	...
Credit to non-bank public	8.8	5.4	4.8	6.3	10.7	...	...
Interest rates (year average)							
Three-month treasury bill rate	3.7	3.7	2.7	2.0	1.7	...	...
Ten-year government bond yield	5.2	4.9	4.9	3.9	3.4	...	...
Balance of payments (in percent of GDP)							
Trade balance	6.3	6.9	6.8	8.3	7.6	7.2	6.8
Current account	4.4	5.1	7.3	6.8	7.1	6.0	6.5
International reserves (in billions of US dollars)	15.3	17.4	20.0	22.4	26.5	...	...
Reserve cover (months of imports of goods and services)	2.1	2.3	2.1	2.0	2.1	...	...
Exchange Rate (period average, unless otherwise stated)							
Exchange rate regime			Floating exchange rate				
Skr per U.S. dollar (Dec. 5, 2006)			6.7975				
Nominal effective rate (2000=100)	91.8	93.7	99.0	100.8	98.7	...	...
Real effective rate (2000=100) 3/	96.9	92.6	95.2	99.2	97.9	...	...

Sources: Statistics Sweden; Riksbank; Ministry of Finance; Datastream; INS; and IMF staff estimates.
1/ Staff projections.
2/ In percent of potential GDP, also adjusted for one-off effects.
3/ Based on relative normalized unit labor cost in manufacturing.