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SWEDEN

2012 ARTICLE IV CONSULTATION

June 2012

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 2012 Article IV consultation with Sweden, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 14, 2012, 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 June 4, 2012. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its June 18, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Sweden.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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SWEDEN

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

June 4, 2012

KEY ISSUES

Context. Sweden's recovery from the global crisis has been spectacular but underlying growth has now slowed sharply, unemployment remains above pre-crisis levels and the outlook is clouded given weaknesses in European trading partners.

Focus. Discussions centered on the economic policy mix to manage near-term risks and to buttress the resilience of Sweden's outsized financial system.

Financial stability. Staff emphasized the importance of, alongside Sweden's commendable strive to adopt higher capital requirements than provided under Basel III, ensuring that supervisors are able to make effective use of "Pillar 2", strengthening early intervention and resolution powers of the supervisors, assessments (as for capital) of the adequacy of international liquidity standards for Sweden, extension of resolution planning to all major banks, and deepening regional supervisory coordination and crisis management under the Nordic-Baltic arrangements.

Near-term macroeconomic policy mix. Given Sweden's strong fiscal position automatic stabilizers are rightly left to operate unimpeded. And given tail risk of large jumps in public debt, this budget stance also retains appropriately large fiscal buffers. On the monetary side, policy should continue to be set according to the baseline scenario, as it can be adjusted rapidly if tail risks are realized. Macroprudential instruments should be deployed further if the housing market reflates once again.

Medium-term policy frameworks. The framework of fiscal rules targeting 1 percent of GDP surplus over the cycle and nominal expenditure ceilings remain appropriate. However the tax structure could be more "growth friendly" and better targeted to vulnerable groups. The monetary framework also remains credible but could be improved by greater clarity on the Riksbank's financial stability mandate as well as publication of market-rates-based forecasts.

Structural reforms. With labor market entrants particularly exposed to European tail risks, steps being actively considered by the social partners to increase the accommodation of new entrants in employment contract structures are strongly supported. And in the housing sector, deregulation of rental market could reduce shortages and improve employment prospects, notably in the main cities.

Approved By
Mahmood Pradhan and Taline Koranchelian

Discussions took place in Stockholm May 3–14, 2012. The staff comprised of Mr. Doyle (head), Ms. Batini and Mr. Ishi (all EUR) and Ms. Jaramillo (FAD). Mr. Berger (EUR) joined the mission for two days. Mr. Holmberg (OEDNO) attended for the duration of the mission.

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THE SETTING

1. Sweden's macro financial performance over two decades has been strong: robust growth, low inflation, declining trend unemployment, and rising incomes, low government bond yields, and strong external positions. But there are vulnerabilities and concerns looking ahead.

2. In particular, growth prospects in coming years in its major trading partners Germany, Norway, the United Kingdom, the United States and Denmark—are in question. In Advanced Europe, cyclical recovery appears to have already run its course and estimates of trend growth have been lowered from pre-crisis. And in the United States, the cyclical recovery is weaker than usual after recessions. And while there are upside risks associated with these global projections—notably progress towards a durable resolution in the Euro Area (EA)—the risks are largely to the downside: a possible sharp resurgence of strains in the EA; or/and a « lost decade » of growth there; and in either context, possible further oil supply shocks. And despite some improvement, the global financial system remains vulnerable (See the Risk Assessment Matrix). In this light, can Sweden's strong performance continue?

Sweden: Risk Assessment Matrix

	Up/down side	Risk	Impact	Policy response
Risks to the economic outlook				
• Strong intensification of euro area crisis • Slowdown of world growth	↓	M	H	• Revisit pace of fiscal consolidation if domestic growth prospects weaken • Use monetary policy supportively
• Disorderly default in one or several EA economies	↓	L	H	• Support economic activity via fiscal and monetary stimuli • Provide liquidity for the financial sector and public backstop as needed for bank recapitalization
• Oil price hike	↓	M	M	• Set monetary conditions to head off second round effects only
• Sharp fall in Swedish house prices	↓	L	M	• Ease monetary conditions • Inject liquidity if needed
Risks to the financial sector				
• Exposure to and contagion from further escalation of financial stress in the euro area	↓	H	H	• Reduce vulnerabilities of the financial sector, provide public backstop

Note: L, M, H denote low, medium and high.

There are reasons for concern

3. Sweden's record has largely been achieved in the context of a buoyant global economy. Sweden is small and open, and so is highly exposed to its trading partners, notably Europe, which purchases some 70 percent of its exports of goods and services. Furthermore, the particular composition of Swedish exports—dominated by investment and intermediate goods—exposes it to the most cyclical components of demand in the European and global economies, which up to 2008, were in upswing. But trend and cyclical external prospects have weakened (Box 1). Furthermore, as an oil importer, global oil supply shocks matter (despite being an European Union leader on renewable energy), directly and—if oil shocks compound global weakness—indirectly.

4. And Sweden features an outsized financial sector, some 5½ times GDP. Though direct exposure to the EA periphery is low, Sweden's assets are dominated by claims on core EA and the Nordic-Baltic region, both of which are vulnerable to tail risk strains in the EA. And well over half of banking liabilities are wholesale, exposing Sweden directly to liquidity shocks in global financial markets (Box 1).

5. Furthermore, even the strength of Sweden's sovereign may be proving to be a mixed blessing—by causing appreciation of the krona. The fiscal rules targeting a 1 percent of GDP surplus across the cycle alongside multi-year nominal expenditure ceilings, all scrutinized by a stridently independent fiscal council, are long established and credible. And the downward trajectory for debt they imply is resilient to standard shocks (See Box 2 and the 2011 Selected Issue Paper). But this is attracting capital inflows. Though not yet to the extent of Japan or Switzerland, these inflows have recently taken the krona to historic highs vis-à-vis the dollar and euro, further curbing export prospects.

And recent developments underscore the spillovers from the global economy

6. As global demand recovered, Sweden grew by 6.1 percent in 2010 and 4 percent in 2011. And reflecting the small employment gap and a negative output gap (estimated by staff at around ¾ percent for 2011), headline Consumer Price Index (CPI) has remained above the 2 percent target. But, as elsewhere in the region and Advanced Europe, momentum has weakened. After growing by a cumulative 2.1 in the first three quarters of 2011, Sweden's Q4 2011 GDP surprised markets on the downside by contracting1.0 percent in Q4, and then by growing 0.8 percent in Q1 2012.

Sweden: Near Term Economic Developments, 2009–11
(Q/Q percent change, seasonally adjusted)

	2009					2010					2011				
	Q1	Q2	Q3	Q4	***Annual***	Q1	Q2	Q3	Q4	***Annual***	Q1	Q2	Q3	Q4	***Annual***
Real GDP	-2.4	0.1	0.0	1.0	***-5.0***	2.1	2.0	1.6	1.7	***5.9***	0.4	1.1	0.7	-1.0	***4.0***
Private Consumption	0.0	1.3	0.4	0.4	***-0.2***	1.8	-0.2	1.8	0.8	***3.6***	0.3	1.0	-1.0	0.5	***2.0***
Public Consumption	1.1	-0.1	0.6	0.3	***2.0***	0.2	0.8	0.4	0.9	***1.7***	0.3	0.5	0.2	0.1	***1.9***
Gross Fixed Capital Formati	-7.8	-2.5	-2.7	1.0	***-14.8***	3.6	2.2	4.5	2.3	***6.9***	-0.5	2.9	0.8	1.5	***7.0***
Exports	-5.9	-2.6	0.0	1.4	***-12.4***	4.1	4.6	1.9	4.3	***10.3***	0.6	1.1	2.7	-3.8	***7.2***
Imports	-8.2	-5.0	4.6	2.5	***-14.1***	3.4	4.4	4.1	0.3	***12.2***	3.0	0.2	-0.2	-0.4	***6.4***
CPI	0.2	1.1	0.3	0.7	***2.0***	0.5	0.3	-0.2	1.2	***1.9***	0.0	0.7	-0.3	0.5	***1.4***
GDP Deflator	-1.3	1.9	4.5	-4.4	***2.0***	-0.7	1.2	4.8	-3.5	***1.3***	-1.6	1.9	4.6	-4.5	***0.9***
Nominal GDP	-3.6	2.0	4.6	-3.4	***-3.1***	1.4	3.3	6.5	-1.8	***7.2***	-1.2	3.0	5.3	-5.5	***4.9***

Sources: Statistics Sweden and IMF staff calculations.

7. In particular, exports, which surged back in 2010, softened through 2011 (albeit with a similar volatile quarterly path as GDP in Q4 2011 and Q1 2012)—with high frequency indicators suggesting that this overall muted performance continues. Alongside, fixed investment has also eased from 2010. Though the level of private consumption has not fallen, its growth remains lackluster despite resilient employment and incomes into the early part of 2012—in part reflecting that unemployment remains elevated relative to the immediate pre-crisis period. Excluding 2008–09, household confidence is low historically, while household credit growth has slowed by over 3 percentage points from a year earlier to 5½ percent. Declining wealth and a low confidence have led to further increases in household saving rates.

8. At the same time, while both temporary and permanent employment increased in 2010, with permanent jobs numbers now significantly surpassing pre-crisis levels, job creation seems to have slowed. And both labor force participation and unemployment remain high (the latter at around 7½ percent—some 1½ percentage points above 2008 levels). Within this, the proportion of young, older and long-term unemployed in total unemployment have all increased considerably relatively to pre-crisis, with flexibility—including via increasing use of temporary employment agencies—at a premium in hiring.

9. These output and labor market trends have also affected fiscal developments. Strong growth in 2011 was reflected through automatic stabilizers in a strengthening of the overall balance in 2011 by 0.2 of a percentage point of GDP, shifting to a small surplus of 0.1 percent from a deficit of 0.1 percent GDP in 2010. In this context, the temporary fiscal stimulus measures were phased out, including support to municipalities and county councils and investments in infrastructure and training. This, combined with the ongoing effects of previous reforms (including the reduction in sick-leave payments), reduced expenditure by 1.1 percentage points of GDP.

10. But the underlying fiscal stance remained supportive—notably reflecting the tax reduction for pensioners in 2011—with staff calculations suggesting that the 2011 outcome fell short of the 1 percent structural surplus target by 0.8 percentage points. Data for the first months of 2012 show

a slowdown in central government tax revenue compared to the previous year, indicating that economic slowdown in the last quarter of 2011 is already taking a toll on revenues.

11. Meanwhile, demand for credit has held up. Corporate credit has recovered, albeit slowly, from the credit slump in the aftermath of the Great Recession. In the household sector, credit growth was very strong, but has decelerated to around 5 percent over the past year, reflecting in part the tightening of macroprudential regulations—such as LTV regulations, applying interest rate surcharges on loans above 85 percent of LTV.

12. In 2011 inflation averaged around 3 percent but underlying inflation measured by the CPIF (that is the CPI with a fixed mortgage rate) was lower at 1.4 percent, while CPIF excluding energy was lower still averaging around 1 over the year. The annual rate of increase of the CPIF amounted to only ½ percent in December 2011—as the economy slowed and the krona gained strength. The gap between the various measures of inflation remains wide as mortgage rates have led the CPI to increase more rapidly than the CPIF.

13. In line with these developments, following a series of steps between January and July 2011 that brought the repo rate from 1.25 to 2 percent alongside various macro prudential actions to cool housing markets, the Riksbank paused in August-September as Europe sovereign debt market strains intensified. It then lowered the policy rate by 25 basis points both in December 2011 and February 2012, reflecting the deteriorating external environment and benign inflation indicators. The pass-through of these actions to households' mortgage rates has been less than complete, however (Box 3).

14. In that context, inflation expectations remain anchored near the target, and inflation fell below 2 percent Jan-Mar 2012—while core inflation (measured by the CPIF excl. energy) has averaged 1.1 percent. Growth in unit labor costs has been low, although it picked up slightly in the second half of 2011, reflecting a pause in the upward trend in labor productivity since the recovery began.

15. And conditions in Swedish banking markets have tracked the ebb and flow of those in European banking. Swedish banks' risk-weighted capital ratios remain relatively high with negligible exposures to strained EA countries. In addition, earnings have increased—thanks to increased lending on the back of strong domestic growth—and loan losses have fallen to low levels—mainly reflecting an improved situation in the Baltic countries. As a result, access to international capital markets has remained secure.

16. But as stresses again mounted in Europe, CDS spreads and expected default frequency measures rose. This was most notable for Nordea, the largest Swedish bank, reflecting its exposures to the region and core advanced Europe. And in May 2012, Moody's downgraded the long-term debt ratings for Nordea and Handelsbanken by one notch to Aa3, in part reflecting their reliance on wholesale funding. Moreover, generally poor capital market conditions have hit non-bank financial institutions, such as insurance. The average solvency ratio of life insurance firms has fallen sharply since the middle of 2011, although its level remains around 8 times minimum requirements.

17. On the external side, with weakening global demand since mid 2011, Sweden's trade surplus shrank to its narrowest in more than a year at the end of 2011—as exports of goods fell after the summer. Nevertheless, with imports of investment goods also weak, Sweden's current account remains positive (in 2011 Q4 at 7.2 percent of GDP), albeit still weaker than 2007 levels. In part, this is because the positive net income contribution has increased following a rebound in returns on portfolio investment in Europe.

18. In the financial accounts, capital inflows were concentrated into portfolio investment in government and corporate securities, balancing large but falling outflows through FDI and other investments. This shift seems to reflect growing uncertainty about Europe, strong confidence in Sweden's macroeconomic policies, and ample global liquidity.

19. These recent macrofinancial developments all underscore the importance of spillovers into Sweden. But developments in capital flows and hence in the krona underscore that indeed "this time may be different". In particular, with portfolio inflows strong, the krona was little changed vis-à-vis the euro during the first four months of 2012, after strengthening 1.6 percent in 2011, a marked contrast to 2008–09 when the krona weakened sharply as external conditions softened. While apparently still in the neighborhood of levels suggested by medium-term fundamentals—but indeed possibly with room for further appreciation—the contrast to 2009 in the krona's response to deteriorating external circumstances could not be more marked (Box 4).

20. So continued weakness of activity is likely in 2012. Staff projects GDP growth to drop from 4 percent in 2011 to 1 percent in 2012, then to rebound to 2 ⅓percent in 2013, broadly tracking projections for activity in Advanced Europe and somewhat more optimistic than the Riksbank's projection and consensus (both around ½ percentage point less, but based on information prior to the release of the Q1 2012 National Accounts).

21. Activity in 2012 is projected to be sustained by steady personal consumption (despite moderating house prices and some rise in unemployment, accommodative fiscal conditions, continued non-residential property investment, and strong international non-oil commodity prices). But net exports and business investment will remain sources of weakness, reflecting global demand and actions to tighten domestic bank regulations. Overall, the output gap is estimated at around zero in 2011 Q4, and under these projections, will open up again in 2012 (-0.4 percent), subduing core inflation.

Sweden: Near Term Economic Developments, 2012-13
(Q/Q percent change, seasonally adjusted)

	2012					2013				
	Q1	Q2	Q3	Q4	***Annual***	Q1	Q2	Q3	Q4	***Annual***
Real GDP	0.8	0.0	0.4	0.5	***1.0***	0.7	0.7	0.7	0.7	***2.3***
Private Consumption	1.1	0.2	0.2	0.2	***1.5***	0.5	0.5	0.5	0.5	***1.6***
Public Consumption	0.0	0.2	0.3	0.3	***0.2***	0.2	0.2	0.3	0.2	***0.8***
Gross Fixed Capital Formati	3.4	-2.5	-0.5	0.1	***3.5***	1.5	1.5	1.5	1.5	***3.0***
Exports	1.1	-0.1	0.5	0.5	***0.0***	1.5	1.5	1.5	1.5	***4.4***
Imports	-0.4	-0.3	-0.2	-0.2	***-1.2***	1.5	1.5	1.5	1.5	***3.5***
CPI	0.1	0.5	0.5	0.5	***1.2***	-0.1	-0.1	-0.1	-0.1	***2.0***
GDP Deflator	-0.5	2.0	5.3	-3.6	***1.9***	-1.5	2.0	5.3	-3.6	***2.0***
Nominal GDP	0.2	2.0	5.7	-3.1	***2.9***	-0.8	2.7	6.0	-2.9	***4.4***

Sources: Statistics Sweden and IMF staff calculations.

22. For 2013, stronger European and global growth alongside continued momentum in consumption are projected to lift growth, closing the output gap again by end 2013. Inflation is expected to remain contained throughout the projection period thanks to a small and slowly-closing output gap.

23. Potential growth is projected to recover gradually to around 2½ percent, after falling an estimated ¾ of a percentage point from the pre-crisis trend, owing to the sharp decline in investment in 2009. Thereafter, the catch-up for investment "lost" during the crisis is expected to raise potential growth further.

24. But even apart from the strength of the krona, two elements in the domestic economy could amplify the impact of external slowdown and downside tail risk.

- First, price-to-income ratios in the housing market remain elevated, with staff estimates suggesting overvaluation in the region of 10 percent. Thus, domestic housing fragilities could amplify the macroeconomic effects of external developments (Box 5).

- Second, and despite some strengths—including the covered bond arrangements and the tier 1 capital ratios—the financial sector remains a concern. The system is large, concentrated, complex, and reliant on short-term wholesale funding. It also has significant domestic and regional exposure to real estate, with elevated level of household debt in Sweden (170 percent of disposable income), softening house prices, and a high share of interest-only mortgages. Furthermore, curbs in welfare insurance in recent years could make mortgage lending less secure than formerly. These fragilities could raise the prospect of increased credit losses in the event of a sustained regional recession.

THE IMPLICATIONS FOR POLICY

25. The core issue is the extent to which policies should now be set to anticipate downside tail risks or the central slow-growth EA scenario. The former would call for aggressive further accrual of buffers now in fiscal and financial sector policies while the latter would call for an accommodative stance now.

26. Policies have been set to address both near-term weakness and downside tail risks. In particular, in the financial sector, various steps have been taken to bolster resilience, with more underway. Alongside, the government budget remains firmly guided by its medium-term rules, thereby allowing stabilizers free rein to reflect the economic cycle. And with medium-term inflation expectations anchored at the target, the monetary policy stance remains accommodative with the policy rate negative in real terms. Both fiscal and monetary policy instruments have room to make decisive adjustments should tail risks materialize.

A. Financial Stability

27. Given the large size of the sector and its direct exposure to core EA countries, the financial sector represents a key contingent fiscal risk, given European tail risks. Efforts to contain the impact of these risks on Sweden are nested within the Basel III and broader EU initiatives, including CRD IV, while acknowledging that Swedish financial sector contingent risks may not be fully reflected in EU-wide prescriptions.

28. The system has a number of strengths**:**

- In domestic markets, historically low mortgage losses, limited buy-to-let markets, open-ended personal liability, and well-developed welfare and social security systems (albeit some erosion in recent years), all curtail risks of major credit losses.
- Externally, direct exposures to the most vulnerable peripheral countries are small, and market indicators also suggest small spillover risks arising from these countries.
- Furthermore, over the past few years, banks increased capital ratios including through rights issues, retained earnings, and reductions of higher risk assets. As of end March 2012, under the Basel II definition, core Tier 1 capital ratios range between 12 and 16 percent, and even under much stricter new Basel III definition, common equity Tier 1 capital ratios are estimated to be between 11 and 15 percent.
- And banks have strengthened overall liquidity—including as indicated by the Riksbank's short-term liquidity measure—by increasing longer-term funding and liquid assets.
- A stability fund was established in 2008, and the Deposit Insurance System was reformed in July 2011 to be fully consistent with the revised EU Deposit Insurance Directive.

- And the 2008–09 crisis confirmed that the authorities' crisis readiness is high.

29. Nevertheless, given heightened European tail risks, recognition of large fiscal contingent liabilities, and lack of a common European backstop, the authorities have not rested, moving ahead of European norms in some areas. In particular, in November 2011, the financial regulator (FI) proposed that the common equity Tier 1 capital requirements for four major banks would be at least 10 percent from the beginning of 2013, and 12 percent from the beginning of 2015. The move preceded the recent CRD IV consensus. Further, since July 2011, banks have been subject to new liquidity reporting requirements, which enable the authorities to monitor Basel III-type liquidity indicators. The next step planned is the introduction of the Liquidity Coverage Ratio (LCR) requirements in total currency position and for euro and US dollar currency positions separately in January 2013. Resources of the FI are being raised over the next few years, while legislative amendments have been made to clarify FI autonomy. And the Council for Cooperation on Macroprudential Policy (CCMP), comprising the Riksbank and the FI has been established to strengthen cooperation among supervisors and held its first meeting in February 2012. One of the CCMP's tasks includes coordinating Sweden's response to recommendations made by the ESRB and Basel committees.

30. In this light, the authorities' recent stress tests suggest that even under severe EA recession scenarios, banks would be able to maintain a 10 percent core Tier 1 capital ratio under the Basel II definition— although one bank's common equity Tier 1 capital ratio could go under 10 percent under the Basel III definition. This coincides with the broadly reassuring assessment provided by the 2011 FSAP Update.

31. However, while standard stress tests reassure the resilience of the Swedish banking system, current European circumstances suggest that a shock beyond historical experience could not be disregarded. Furthermore, the comfort of high risk-weighted assets is qualified by the fallibility of the measure. Raw common equity ratios are as low as 4 percent for some banks, while risk weighted assets continue to fall to around 25 percent of total assets—among the lowest in Europe. Further, direct and indirect exposures to the core EA and associated tail risks are significant. And despite progress, banks liquidity risks remain substantial, due in part to reliance on short-term funding, including on their US dollar books. Likewise, household debt continues to rise and is now 1.7 times disposable income, as highlighted in the 2012 EC Alert Mechanism Report.

32. Accordingly, further progress is needed urgently beyond simply focusing on capital ratios, to bolster financial system resilience:

Strengthen bank capitalization further, specifically by raising risk weights

- High risk-weighted capital ratios in part reflect low risk weights for residential mortgages—reflecting Internal Rate Based (IRB) models. But these may overlook tail risks outside of historical experience, and so exaggerate resilience. Joint efforts by the regulators and the private sector to review the appropriateness of risk-weight calibration are underway. In this light, as a potential measure, imposing a regulatory floor on risks weights on residential

- mortgages can be considered. More broadly, the appropriate use of IRB models should be under constant scrutiny by supervisors, and disclosure of methodology and assumptions can be further enhanced.

Strengthen liquidity requirements

- A step following the planned introduction of the LCR regulation in 2013 includes preparation to introduce a Basel III net stable funding ratio (NSFR)-type measure in the medium term. Meanwhile, banks should continue to raise their NSFRs towards 100 percent and publish them. But the pace of balance sheet adjustments to meet the NSFR should be set in light of a review of their short-term impact on banks' ability to collect deposits and issue longer debts and on the availability of "safe" assets under regulatory rules. In this regard, there are merits of reviewing the adequacy of Basel III liquidity standards for Sweden but any issues should be addressed in the context of ongoing international review of the Basel III standards.

- Going forward, the stability fund may be reformulated to introduce a risk-based contribution so that a bank taking a higher risk should bear appropriately higher contributions. This should discourage banks from risky activity. However, this should be coordinated with EU-level initiatives.

All these regulatory reform actions should be coordinated regionally

- All major Swedish banks operate extensively in the Nordic-Baltic region, with Swedish authorities as the home supervisor. Sweden's approach to regulatory reform is most advanced in comparison with other regional supervisors. Thus, notably with respect to the EU, the practice of extensive prior consultation and coordination with other authorities should continue, especially when regulatory standards are set beyond the ex-ante agreed margins, to minimize unintended regulatory arbitrage and to anticipate consequence to other jurisdictions.

And supervision intensity and crisis management needs to be further upgraded

- If there are legal impediments to the FI's authority to use Pillar II, these should be removed.

- In addition, as recommended in the 2011 FSAP Update, legal certainty related to the FI's power to take corrective and remedial against a weak bank should be resolved, while a special resolution framework for non-systemic financial institutions should be established.

- With increased resources, the FI should further increase its accountability on resource uses. At the same time, a common understanding is needed that the additional resources should maybe used for FI's financial stability mandate, rather than being driven into other areas including into the international regulatory reform agenda.

- There are merits of formalizing the meeting procedures of the Domestic Standing Committee for crisis management, including by regularizing meeting schedule.
- On the cross-border side, various bilateral and regional Memoranda of Understanding (MOU) and EU-wide arrangements provide the basis for cooperation. Importantly, the 2010 Nordic-Baltic MOU provides the principles of burden sharing. However, this has not been tested. As recommended in 2011 FSAP Update, the authorities are developing a framework to assess how the burden-sharing principles work, especially taking account of fiscal positions of each country. In this light, "war games" could be conducted.
- But given that the existing cross border arrangements, mostly based on various MOUs, are not legally binding, more assurance is needed. And the ongoing efforts to establish "a resolution and recovery plan" for the largest Swedish banks can be extended to other major banks.

Extension of the CCMP is needed

- Developing a macroprudential policy institution involves a learning-by-doing process. Given establishment of the CCMP, next steps include establishing a formal macroprudential authority, with a clear financial stability mandate, a set of authorized tools, and accountability obligations. The merits of including a mechanism to reflect regional perspectives are also worth considering.
- To the extent that the sum of these initiatives slows credit supply and growth, monetary policy should take it into account in the setting of the repo rate and fiscal policy should also accommodate it via automatic stabilizers (see below).

Summary of the Performance and Operation of Swedish Four Major Banks

(In percent unless otherwise indicated, end of period)

	Nordea			SEB			Handelsbanken			Swedbank			Median of 44 European and US banks
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011	2011
Capital													
Tier 1 core capital ratio to risk weighted assets 1/	10.3	10.3	11.2	11.7	12.2	13.7	11.7	13.8	15.6	12.0	13.9	15.7	10.2
Tier 1 ratio to risk weighted assets 1/	11.4	11.4	12.2	13.9	14.2	15.9	14.2	16.5	18.4	13.5	15.2	17.2	12.3
Total capital to risk weighted assets 1/	13.4	13.4	13.4	14.7	13.9	15.2	20.2	20.9	20.9	17.5	18.4	18.9	15.1
Leverage (Tier 1 as a percent of total assets)	4.1	4.0	3.8	4.0	4.3	4.2	3.5	3.6	3.4	4.3	4.6	4.4	...
Assets													
Gross impaired loans to total loans at amortized costs 2/	1.9	1.9	2.0	1.5	1.3	0.8	0.6	0.6	0.4	5.9	5.2	3.4	3.7
Net impaired loans to total loans at amortized costs	0.9	0.9	1.1	0.5	0.5	0.3	0.2	0.2	0.2	2.9	2.5	1.7	...
Earnings and profitability													
Return on assets	0.5	0.5	0.4	0.0	0.3	0.5	0.5	0.5	0.5	-0.6	0.4	0.7	0.7
Return on equity	11.4	11.5	10.6	1.2	6.9	10.8	13.1	13.0	13.8	-12.7	8.2	12.2	8.4
Liquidity													
Loans to customers deposits	197.6	198.7	199.5	148.3	151.1	137.7	320.6	322.5	325.1	269.9	234.7	236.9	89.5
Deposits maturing less than 3 months to total deposits	17.0	19.4	22.1	28.7	69.4	36.5	3.2	...	...	9.8	11.8	16.7	...
On demand deposits to total deposits	74.7	71.9	68.9	55.4	14.7	49.0	93.7	...	...	82.1	82.6	76.3	...
Memorandum item:													
Total assets in percent of GDP	173.5	166.3	185.1	74.3	65.4	67.6	68.4	64.7	70.3	57.8	51.5	53.2	...

Sources: Banks' annual reports, SNL Financial, and Fund staff calculations.

1/ With the transition rules. Under the Basel II capital adequacy rules, Swedish banks are allowed to substantially reduce capital adequacy requirements due to their large mortgage portfolios. However, currently, the FSA applies transitional regulations, allowing banks to reduce capital requirements only in stages.

2/ Data for SEB are gross impaired loans to total loans.

B. Fiscal Policy Framework

33. Given that output is close to potential, strong sovereign access to markets, alongside downside external risks and the modest deviation of the fiscal balance from its structural surplus

target, the appropriate setting for 2012 would be a mildly supportive stance anticipating a phased return to the structural surplus target thereafter. Along this trajectory, automatic stabilizers would operate in case of moderately weaker/stronger than anticipated activity, with scope to reset the structural fiscal trajectory as well if the global economy deviates markedly from projections.

34. This fiscal stance would not only support near term activity in the face of downside risks, but also boost fiscal buffers by further lowering the public debt-to-GDP ratio in the central case. This would further increase the capacity of the Swedish economy to cope with a sharp and sustained shock by further increasing the likelihood that the sovereign could maintain market access even under severe adverse scenarios (See Box 2).

35. This fiscal trajectory is planned by the authorities. For 2012, as a result of the deceleration of growth and new discretionary measures being introduced as part of the 2012 Budget Bill, thebudget balance is expected to remain at -0.3 percent of GDP in 2012. Revenues would remain subdued in line with weak employment and consumption trends. Expenditures would rise modestly, driven mainly by higher social benefits. The structural balance would on the authorities' estimates fall to 1.2 percent of GDP implying a stimulus of 0.2 percent of GDP. Based on staff estimates, the structural balance falls to -0.3 percent of potential GDP, implying a stimulus of 0.5 percent of potential GDP. The difference between staff and authorities' estimates reflects different output gap estimates and different methodologies to calculate the structural balance.

36. Alongside, they have increased the expenditure ceiling between 2014–15 by SEK 20 billion. With this, the expenditure ceiling is expected to increase by 1½ percent in nominal terms over the next four years, which would leave a budgetary margin of about 1 ½ percent of GDP, based on the authorities' assumptions.

37. Overall, the Budget Bill contains measures of about 0.4 percent of GDP, partly offset as some previous measures expire. Some of this relates to reforms enacted in 2011 which were reinforced by ancillary measures in Budget 2012. The main expansionary measures for 2012 are a lowering of the VAT rate for restaurant and catering services, extra funding for infrastructure investment and a package of active labor market measures (Box 6). Spending will continue to be reined in part due to the non-indexation of key expenditures, a further phasing out of temporary stimulus measures, a decline in unemployment expenditure as the economic recovery takes hold, and the effects of previous reforms (such as reforms of the sickness insurance system).

Sweden: Medium-Term Fiscal Outlook

(Percent of GDP)

	2011	2012		2013		2014		2015		2016	
	Prelim.	SB	IMF	SB	IMF	SB	IMF	SB	IMF	SB	IMF
Revenues	49.7	50.1	49.5	49.7	49.8	49.4	49.9	49.5	49.7	49.3	49.8
Expenditures	49.6	50.4	49.7	49.3	49.2	47.8	48.4	46.5	47.5	45.7	47.2
Net lending	**0.1**	**-0.3**	**-0.2**	**0.3**	**0.6**	**1.6**	**1.5**	**3.0**	**2.1**	**3.7**	**2.6**
Central government balance	-0.1	-0.3	-0.1	0.7	0.9	1.7	1.7	3.1	2.3	3.8	2.8
Pension system balance	0.5	0.2	0.2	-0.2	-0.2	0.0	0.0	0.0	0.0	-0.1	-0.1
Local government balance	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Structural balance (percent of potential GDP) 1/	0.2	...	-0.3	...	0.5	...	1.5	...	2.1	...	2.6
Structural balance (percent of potential GDP) 2/	-0.3	1.2	0.1	1.6	0.8	2.1	1.6	3.2	2.2	3.7	2.6
Output gap (percent of potential)	0.8	-2.7	-0.4	-2.1	-0.3	-0.9	-0.2	-0.4	-0.1	0.0	0.0
Employment gap (percent of potential)	-0.3	...	0.6	...	0.3	...	0.1	...	0.1	...	0.0

Sources: Ministry of Finance and Fund staff calculations.

Note: SB: 2012 Spring Bill.

1/ Structural balance takes into account output and employment gaps.

2/ Overall balance adjusted for the output gap, based on authorities' measure.

38. Over the medium term, the authorities plan for revenues as a percentage of GDP to remain largely unchanged, with the fiscal balance strengthening to target due to a declining expenditure ratio—in line with the 4-year nominal spending ceilings. The overall balance would exceed 1 percent of GDP by 2014, and continue to strengthen further over the medium term.

39. Alongside, the authorities have outlined a number of additional measures, contingent on the availability of fiscal space, that focus mainly on increasing labor supply and include further strengthening the "in-work" tax credit and further raising the lower threshold for the state income tax. They also propose reviewing corporate taxation, and tax cuts for pensioners.

40. In this context, the tax structure can be further improved to support growth in the more challenging global context. Tax expenditures are considerable—including multiple VAT rates which significantly curb VAT collections despite one of the highest standard VAT rates in the OECD. With distributional concerns attenuated by strong Gini coefficient scores of 0.23 and the possibility of direct support to low-income households through targeted spending, a restructuring of the VAT could improve the efficiency of the tax system. The resulting additional VAT collections would create room to implement reforms that reduce further the overall wedge between employers' gross pre tax labor costs and real take-home pay.

41. Tax and expenditure measures aimed at supporting employment of vulnerable groups should be better targeted. Though it is too soon to measure the employment impact of recent reductions in employer social security contributions for young workers and of the VAT on restaurants, measures more specifically designed to affect workers with greater difficulties in entering the labor market would likely be more effective.

42. Additional measures could be put in place to reduce the procyclicality of local governments' fiscal position. In view of the balanced budget rules at the local level, the authorities should consider

the merits of allowing them greater flexibility to establish and manage rainy-day contingency funds. This is particularly important if, under current policy, the structural surplus target rule for the central government is procyclical ex-post (with the actual structural surplus exceeding historically the 1 percent target).

43. More generally, adherence to the fiscal surplus target rule over the medium term remains fully appropriate. Absent shocks, the rule will keep debt on a downward trajectory, but this is unlikely—as simple extrapolation might suggest—to make the Swedish sovereign a net creditor. Instead, that trajectory will be disturbed by standard business cycle downturns, pushing debt back up, and may be further disturbed by tail risk shocks. As evident from the global crisis, several countries with large financial systems experienced leaps in public debt, both reflecting the impact of automatic stabilizers and direct financial sector support. With those tail risks still evident in Europe, it remains appropriate for Sweden to maintain a determined effort—as reflected in its surplus target rule—to build buffers to increase its ability to withstand such risks, until those risks are eliminated (See Box 2). The Fiscal Policy Council continues to play an effective role in promoting public awareness of fiscal issues. Further increases in its resources and its focus on sustainability would reinforce the credibility of the fiscal framework. These fiscal policy settings would also allow monetary policy to respond to possible external developments—easing if capital inflows continue alongside weak external demand, and tightening if activity and domestic inflationary pressures surge.

C. Monetary Policy and Framework

44. With the repo rate above the lower effective bound and a fully flexible exchange rate and the krona likely to depreciate in an adverse tail risk scenario, monetary policy instruments have room to make decisive adjustments should tail risks materialize. Monetary policy should thus continue to be set according to the baseline scenario.

45. Under that baseline scenario, for now, given the benign inflation outlook, modest cost pressures and the prospect of a temporary slowdown in demand, the repo rate is appropriately set at 1½ percent. The rate path should, however, be adjusted to reflect the potential impact of stricter banking regulation and fiscal withdrawal as long as economic slack persist. Macroprudential instruments—e.g. tightening LTV rules further, adjusting risk-weighted assets, limiting loans' length—should be deployed further if the housing market reflates once again.

46. The monetary and free floating exchange rate frameworks remain credible, as indicated by inflation expectations and recent reviews. However, persistent deviations of market forward rates (and survey expectations) from the projected official rate have occurred. Although inflation expectations have remained firmly anchored around the Riksbank's medium-term target, continued credibility relies on markets believing the monetary authorities, to ensure an effective transmission of the short term policy rate to market rates, other asset prices, and the real economy. For these reasons, persistent and significant disbelief concerning the authorities' projected policy rate outlook could, eventually impair the monetary transmission mechanism and, possibly, undermine broader credibility.

47. To address this issue, the Riksbank could start publishing macroeconomic forecasts conditioned on market-implied domestic and foreign forward rates, in addition to forecasts conditioned on its preferred path for the policy rate, and keep the commitment to publish its expected policy rate path under review (See Chapter III of the Selected Issue Paper).

48. Alongside, and in the context of initiatives to establish a macroprudential council, consensus on the mandate of the Riksbank with regard to asset prices and financial stability should be sought. And the Riksbank should raise its research efforts further in the area of equilibrium unemployment, including analysis of its composition, and of macrofinancial linkages as key inputs into policy rates setting.

49. And while gross international reserves are 50.4 USD or 344.7 SEK billion, some 23 percent of imports, and 14.8 percent of short term external debt, the liquidity gap approach developed by staff last year suggests that there is a case to increase foreign exchange reserves now.[1] In particular, the probability that reserves might be exhausted in the context of a tail risk event, such as default by one of the European sovereigns now under market pressure, has risen relative to that likelihood a year ago. Should this probability rise further, the authorities should match their efforts to boost resilience in other areas by raising reserve cover also.

D. Structural Reform Policy

50. Sweden's extensive structural reforms since the early 1990s have boosted trend growth and employment, as well as strengthening resilience to shocks. Thus, increases in unemployment in 2008–09 fell far short of expectations, and employment recovered promptly thereafter. And participation rates held up throughout, in contrast to a number of OECD countries.

51. However there are areas of concern:

- The reforms could be better targeted at helping those particular groups of workers facing the most challenges, including workers with weak attachment to the labor market (for example, the reduction in payroll taxes for new entrants applies to the entire population of young potential workers, but only a fraction of these needs help in finding a job).

- Recent reforms also reduced the scope and resources for active labor market policies. But shortfalls in the effectiveness of these programs likely reflected their particular design—elsewhere, such as in Denmark, reforms have better focused these initiatives rather than curtailing them.

52. In contrast to broad initiatives in other sectors, the Swedish housing market is substantially unreformed, notably the rental and sub-let markets which are subject to severe regulations. Given Sweden's fast and ongoing urbanization trend, particularly toward the greater cities (Stockholm,

[1] See the chapter in the Selected Issues Paper by Kotaro Ishi.

Gothenburg and Malmo), the lack of rental property on the market has been one key determinant of house price surges (and house price resilience) over the past years. In this light:

- Deregulation of rental markets could reduce shortages and improve employment prospects as well as skill shortages, particularly in the main cities, with likely impacts on potential output growth in the medium term;

- This would help to raise investment in residential property—where Sweden scores amongst the lowest in the EU. This will require initiatives at the local and central government level to raise the amount of land available for construction, in order to ensure that supply rises in line with fundamentals and to prevent a further acceleration in prices.

THE AUTHORITIES' VIEWS

53. The authorities agreed with the overall assessment of economic developments in Sweden and internationally, and the implications for policy including in the financial sector.

54. More specifically, they noted concerns with the macrofinancial implications of high household debt, and in this context sought early strengthening of bank capital and various improvements in the macroprudential policy architecture. In addition, they emphasized need to build fiscal buffers further, while, in that context, also seeing scope for free application of automatic stabilizers in the near term. This stance, and the recent relaxation of monetary policy would support activity, with macroprudential measures in place to stabilize the housing market. Policymakers stand ready to adjust policy settings in the event of a major global shock.

55. Within that overall agreement, however, some differences of emphasis from the staff were noted:

Financial Sector Policies

- The authorities do not see strong evidence that the quality of new mortgage lending raises prudential concerns because borrowing households have sufficient capacity to repay debt even under macroeconomic stress scenarios, while more marginal borrowers are unlikely to have access to credit—so that, for instance, increases in temporary employment contracts in recent years would not materially affect overall risk of credit losses. Nevertheless, these matters would remain under close scrutiny.

- The authorities agreed with staff that the status quo of the macroprudential supervisory architecture is not satisfactory, but they noted that the proper role of the Ministry of Finance in any better structures remains open. While all agree that the Ministry should be deterministic in resolution and crisis management, and that it should not be responsible for making stability assessments and recommendations at other times, there is not yet agreement on where to draw the line between those two circumstances, nor on how that line should be drawn. The matter will be considered further in the "Government Investigation on Financial Crisis Prevention and Management Issues" (the Franzén Commission), though the authorities intend, in the meantime, to put the Consultation group[2] on a more solid footing.

- The fiscal authorities emphasized need make progress to further reinforce financial sector stability but also cautioned that steps taken should not risk, inadvertently, causing disorderly adjustments in credit markets or financial institutions. In securing this balance, they inclined to proceed in a sequence, with initiatives phased according to the strength of economic conditions—accelerating in good times when markets could more easily absorb them, and being prudently paused otherwise.

Fiscal Policy and Framework

- The authorities estimate a stronger underlying fiscal position than the staff for 2011–12. This reflects the authorities' use of the OECD aggregate elasticity of 0.55, in contrast to the staff's disaggregated adjustments using both output and employment gaps. Specifically, the fiscal authorities' estimates of the cyclically adjusted balance in 2011–12 are 0.7 and 1.2 percent of potential GDP, respectively. Meanwhile, staff's estimates are 0.1 percent of potential GDP for 2011 and -0.4 percent of potential GDP for 2012.

- In contrast to staff's view that further stimulus in 2013 should be contingent on weaker than expected activity, the authorities indicated that they see scope, partly reflecting their estimate of the structural surplus, to implement discretionary measures in 2013, specifically to undertake greater investment spending.

- The authorities see recent measures to address youth unemployment, such as the reduction in employer social security contributions and the reduction of the rate of VAT on restaurants, as a way to increase the opportunities of young workers entering the labor market, while staff believes that better targeted measures would be more appropriate.

Monetary Policy and Framework

- The authorities see the existence of a large and persistent wedge between their projected official rate and markets' implied interest rate expectations as somewhat problematic, while emphasizing that measurements of implied expectations are inherently imprecise and uncertain. The wedge is not seen as harming the central bank's credibility on the grounds that inflation expectations continue to remain anchored around the inflation target. They intend to continue publishing their own preferred policy paths, as it has served well as a communication tool.

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[2] The Consultation group was established in accordance with the Memorandum of Understanding signed in 2009 between the Government Offices (Ministry of Finance), Sveriges Riksbank, Finansinspektionen, and the Swedish National Debt Office regarding cooperation in the fields of financial stability and crisis management.

- The current understanding in the majority on the MPC is that it is appropriate to take into consideration financial stability issues. This stance will be reviewed in the context of initiatives to establish a macroprudential council.

- The monetary authorities have participated in a domestic discussion on estimates of the long-run sustainable rate of unemployment. Further analysis will be made, even though the returns in terms of improved information for rate setting are seen as low.

STAFF APPRAISAL

56. Sweden has long secured strong growth, low inflation, declining government debt, rising incomes, and a strong external position. But trade and financial linkages mean that prospects are closely tied to those of Europe—reflected in the V-shaped passage through the Great Recession, and rising stresses in the banking system and declining underlying growth momentum since mid-2011.

57. Monetary and fiscal policies have responded well to this cycle, both tightening appropriately as output recovered in 2010–11 and easing in the latter parts of 2011. And on the structural side, various actions were launched in support of employment. Nonetheless, with exports likely soft, muted annual GDP growth is projected in 2012, albeit with activity regaining steam from mid-year, with European fragilities implying significant tail risks.

58. Policies are well calibrated. In particular, the government budget remains firmly guided by its medium-term rules, thereby allowing automatic stabilizers to operate. And with medium-term inflation expectations anchored at the target, the monetary policy stance remains accommodative. And policies have room to make decisive adjustments should tail risks materialize.

59. But the challenges are extensive.

60. On the financial stability side, though direct exposures to strained Euro Area economies are negligible and risk-weighted bank capital is high, the financial system is large, directly exposed to Europe, highly concentrated, and reliant on wholesale funding, with low raw capital ratios. Furthermore, vulnerabilities are apparent in elevated household debt, the soft housing market, and employment and income uncertainties. While standard financial sector stress tests reassure, shocks could go well beyond the historical norms they assume.

61. In this light, the EU-wide banking regulations under the Fourth Capital Requirements Directive will be key. Given the common floor, the particular risks in Sweden and the lack of a common European banking backstop argue for full use of the flexibility for national regulators given in that agreement to implement country-specific macroprudential policies.

62. So the authorities rightly plan to raise capital requirements for the four major banks in steps in 2013 and 2015, augmented by needed increases in risk weights for mortgages, alongside tighter liquidity regulations and strengthened supervisory resources, focus, and coordination. In this

context, the practice of extensive prior consultation and coordination with European partners should continue.

63. But considerably more remains to be done. Additional steps include ensuring that supervisors are able to make effective use of "Pillar 2", and securing an appropriate application of the additional regulatory resources that have been provided. Other necessary steps include strengthening early intervention and resolution powers of the supervisors, assessments (as for capital) of the adequacy of international liquidity standards for Sweden, extension of resolution planning to all major banks, and deepening regional supervisory coordination and crisis management under the Nordic-Baltic arrangements. Establishment of a macroprudential authority is under consideration. It will be key to have clarity on the stability mandate, decision-making structure, tools, and accountability—all respecting the independence of the Riksbank and bank supervisors.

64. On the fiscal side, output close to potential, strong access to market financing, risks tilted to the downside, and the credibility of the medium-term fiscal rules framework all call for and allow for the automatic stabilizers to operate unimpeded. And given tail risk of large jumps in public debt, this budget stance also retains appropriately large fiscal buffers.

65. In this context, both the modest relaxation of the fiscal deficit in 2012 which leaves public debt on a downward trajectory, and the framework of rules targeting 1 percent of GDP surplus over the cycle and nominal expenditure ceilings are appropriate.

66. In addition, the tax structure could be more "growth friendly", notably via better-targeting of tax and expenditure measures. And actions to bolster further the Fiscal Policy Council—notably by further increasing its resources and its focus on sustainability—would reinforce the credibility of the fiscal framework.

67. On the monetary side, the stance is appropriately accommodative given the benign inflation outlook, modest cost pressures, and a temporary slowdown in demand. Monetary policy should continue to be set according to the baseline scenario—offsetting any drag on activity emanating from prudential actions while slack in the economy remains. The stance of policy can be adjusted rapidly if tail risks are realized. Macroprudential instruments should be deployed further if the housing market reflates once again.

68. The monetary and free floating exchange rate frameworks remain credible. However, given persistent deviations of market forward rates from the projected official rate, the Riksbank could also start publishing macroeconomic forecasts conditioned on market implied forward rates, and keep the commitment to publish its expected policy rate path under review. Alongside, consensus on the role of asset prices and financial stability in monetary policy objectives should be sought.

69. And on structural reforms, with labor market entrants particularly exposed to European tail risks, steps being actively considered by the social partners to increase the accommodation of new entrants in employment contract structures are strongly supported. And in the housing sector,

deregulation of rental market could reduce shortages and improve employment prospects, notably in the main cities.

70. It is recommended that Sweden remains on the standard 12-month Article IV consultation cycle.

Box 1. Should Sweden Be Concerned of Adverse Inward Spillovers from Europe?

So far Europe's sovereign debt turmoil had modest financial and trade effects on Sweden. While Sweden's stock and credit market volatility increased as the crisis erupted in the summer of 2011, corporate bond spreads have increased modestly since early September, and short-term funding markets have been largely unaffected, owing to the economy's relatively strong fundamentals. In addition, government yields have declined benefiting from investors' flight to quality. However, in the last quarter of 2011, Sweden's trade account has been significantly impacted by the European crisis due to its considerable exposure to European trade.

Going forward, a scenario of increased financial market stress in Europe, could trigger larger effects. With 70 percent of Swedish total exports going to the EU, Sweden's direct trade exposure is large. In addition, spillovers of Europe to the rest of the world may affect Sweden's exports indirectly. Further developments could increase uncertainty of the global recovery, soften the EU demand for Swedish exports, and dampen global demand for commodities—which Sweden exports.

Sweden: Exports to Europe

(Percent of GDP, merchandise exports)

	2011
European Union	19.3
Euro area	13.1
Greece	0.1
Ireland	0.2
Italy	0.9
Portugal	0.2
Spain	0.6
United Kingdom	2.4

Sources: IMF Direction of Trade Statistics and Fund staff calculations.

Despite recent pressures in European banking markets, there have been no material dislocations in Swedish financial markets. Sweden's banks' total financial claims on peripheral European economies are modest as a share of assets and Tier-1 capital. Claims on smaller European economies (like Denmark and Finland) linked to the Euro Area as well as on larger European economies, including the U.K., are significantly larger, however.

Sweden: Banks' Total Financial Claims on the Nordic-Baltic Region, 2011

	Billions of USD	Percent of total assets
Nordics		
Denmark	180.9	15.2
Finland	146.2	12.2
Norway	129.9	10.9
Baltics		
Latvia	16.0	1.3
Lithuania	15.7	1.3
Estonia	17.5	1.5

Sources: Bank of International Settlements, Haver Analytics, Statistics Sweden, and Fund staff's calculations.

Box 2. Fiscal Buffers: How Big Are They? How Big Should They Be?

Fiscal buffers are adequate if the Swedish sovereign is able to maintain market access through and after a "large" shock. This critically depends on the impact on public debt of the shocks that could occur, and the threshold debt level at which market access is lost.

In this regard, a useful exercise is to replicate the experience of countries severely affected by the global financial crisis, within the Swedish fiscal framework. Specifically, the exercise entails using as macroeconomic assumptions for the fiscal forecast the observed growth, employment, consumption, financial sector support, and real exchange rate developments of the United Kingdom, the United States, and Iceland since 2008. The main advantage of this approach is that the shock is plausible (and has in fact taken place elsewhere recently, in the contest of the global turmoil) and would allow each macroeconomic factor to respond in a distinct manner to the shock. This exercise does not assume any type of fiscal policy response, either to contain the decline in growth or to reverse the deterioration of the fiscal accounts.

Table 1 shows the projections. If economic activity were to behave as it did in the United Kingdom and the United States, the fiscal deficit would deteriorate by about 3 percentage points of GDP, through a combination of lower revenues as consumption contracts, and higher expenditure in response to the decline in employment. Debt to GDP would rise to about 50 percent of GDP, including the cost of the banking sector support.

In contrast, the impact of a shock like that faced by Iceland would be more severe. The fiscal balance would deteriorate by about 8½ percent of GDP, mainly due to a collapse in consumption and employment. In this case, debt to GDP would rise above 80 percent of GDP, including the financial sector support (assumed to be only half that of Iceland, in proportion to the size of Sweden's financial sector).

The second step in the analysis is to consider at what level of public debt Sweden risks losing market access. Determining such a threshold is difficult. Sweden's experience during the 1990s crisis showed that the sovereign was able to retain market access with debt to GDP ratios close to 75 percent, but at a high cost. This suggests that debt ratios beyond this level could result in market pressures. Furthermore, under a tail scenario affecting Europe in coming years, this threshold could well be optimistic, as many countries would simultaneously be seeking to finance large borrowing requirements in the context of disorderly global financial markets.

This analysis has clear implications for the authorities' current policy stance. While Sweden would be able to accommodate a shock similar to that recently faced by the United Kingdom and the United States without losing market access, it is unlikely to be able to absorb a shock as large as seen in Iceland. In this light, the authorities' preference to continue to build buffers is cautious, but given the scale of the impact of possible European tail risks, appropriately so.

Sweden: Alternative Fiscal Shocks

	"United Kingdom" Shock				"United States" Shock				"Iceland" Shock			
	2011	2012	2013	2014	2011	2012	2013	2014	2011	2012	2013	2014
					(In percent)							
Real GDP growth	4.0	-1.1	-4.4	2.1	4.0	-0.3	-3.5	3.0	4.0	1.3	-6.8	-4.0
Consumption growth	2.0	-0.7	-2.6	1.3	2.0	0.0	-1.1	1.8	2.0	-4.2	-10.7	-1.4
Employment growth	2.2	0.8	-1.5	0.1	2.2	-0.5	-3.8	-0.6	2.2	0.9	-6.2	-0.2
Exchange rate depreciation		16.4	11.9	-3.7		7.3	-5.2	-5.0		64.1	20.1	-6.2
					(In percent of GDP)							
Total revenues	49.7	50.0	51.0	50.4	49.7	49.6	49.9	48.9	49.7	48.5	47.8	49.1
Total expenditures	49.6	51.3	54.5	53.4	49.6	50.9	53.5	51.9	49.6	50.0	55.5	58.4
o/w interest payments	1.2	1.3	1.8	2.1	1.2	1.3	1.7	1.9	1.2	1.3	2.5	3.3
Net lending	0.1	-1.3	-3.5	-3.0	0.1	-1.3	-3.6	-3.0	0.1	-1.5	-7.7	-9.3
Banking sector bailout		6.8				5.3				22.1		
Debt	38.4	47.3	52.8	53.4	38.4	45.0	49.0	49.3	38.4	64.4	77.2	87.3
Domestic currency	33.0	41.0	45.5	46.8	33.0	39.3	43.5	44.3	33.0	55.7	66.3	76.9
Foreign currency	5.4	6.3	7.2	6.7	5.4	5.8	5.5	5.0	5.4	8.7	10.9	10.5
Memorandum item												
Nominal GDP (SEK bn)	3,492	3,496	3,413	3,553	3,492	3,523	3,471	3,645	3,492	3,579	3,407	3,338

Sources: IMF World Economic Outlook and Fund staff calculations

Box 3. How Strong is the Pass-through from Repo Rates to Mortgage Rates in Sweden?

As emphasized by analysis by the Riksbank in the February 2012 Monetary Policy Report, the pass-through of monetary policy impulses from the policy rate to mortgage rates has weakened according to various measurements over the past year. When assessed relative to before the crisis this phenomenon is milder but still not equaled in peer countries, with the exception of the United Kingdom.

Prior to the crisis, mortgage pass-through, measured by the simple correlation coefficient between the repo rate and the effective interest rate on housing loans to households and NIPSHs, indicated that Sweden had a very strong transmission to long-term rates in this category of lending. The correlation coefficient of 0.99 compares favorably with the U.K. (0.82) and well above that of the U.S. (0.67) and Germany (0.65).

Since 2008Q1, the pass-through in Sweden (measured by the correlation coefficient between the policy and mortgage rates) has dropped marginally, though, according to this metric (to 0.96), even if it remains higher than that of any of the comparators.

Mortgage Interest Rate Passthrough from Repo Rates

	Sweden		United States		Germany		United Kingdom	
	Before 2008	After 2008	Before 2008	After 2008	Before 2008	After 2008	Before 2008	After 2008
Mortgage Rate Passthrough[1]	0.99	0.96	0.67	0.63	0.65	0.88	0.82	0.95

Sources: Haver Analytics and Fund staff calculations.

[1] Calculated as the correlation coefficient of the effective interest rate on housing loans to households and repo rates.

Box 4. Competitiveness and the Equilibrium Real Exchange Rate

Since September 2008, the Swedish krona has fluctuated substantially, and the krona has now (end March 2012) appreciated in real effective terms by over 25 percent since its trough in early 2009 (and by around 30 percent against the euro).

According to OECD PPP-measures of February 2012, the krona is at its highest level for 40 years.

However, staff's estimates based on the IMF's new External Balance Assessment (EBA) methodology, suggest that the krona remains undervalued relative to its long-run equilibrium, broadly in line with the assessment arrived at using the IMF's old CGER methodology using data up to Fall 2011.

	EBA Estimates	CGER Estimates	
	April 2012	Fall 2011	Spring 2012
		(in percent)	
Macro Balance[1]	2-4	-7	-14
Equilibrium RER	-5	-9	-10
External Stability	-25	-17	-25

There are caveats to these results:

1. Staff's longstanding finding of undervaluation sits uneasily with the absence of distortions and no foreign exchange rate intervention for over a decade

2. Pension and other social protection reforms—notably a phased shift to defined contributions pension scheme and a progressive shrinkage in transfers, like unemployment benefits—since the mid 1990s have raised household net saving—but these factors are not reflected in the CGER or EBA.

3. While the EBA is based on a NFA of 20 percent of GDP, the cumulative sum of current account surpluses over the past decade suggests NFAs around 100 percent of GDP—qualifying Sweden as a financial centre. This would raise its CA/GDP norm in the EBA analysis.

4. So great caution is needed when inferring krona misalignments based on the sustainability of the country's NFA/GDP trajectory. Alongside other indicators the staff assessment is that the currency is competitive, although there are wide margins of uncertainty.

In line with these considerations, the staff's overall assessment is that Sweden's structural current account is now around 2–4 percent higher than what suggested by medium-term fundamentals, which, in turn, have been strong relative to the Euro Area, including from wage moderation, and safe-haven flows.

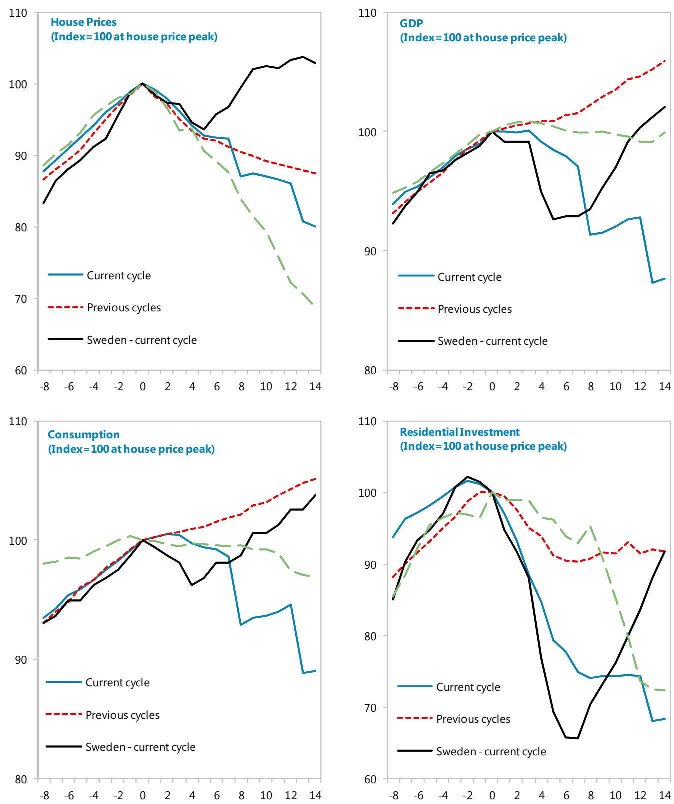
The strength of the external sector suggests an undervaluation. However this likely reflects some structural factors such as higher savings rates following the phased-in pension reform, which are unlikely to adjust quickly.

[1] The range in the first cell captures differences in the cyclically-adjusted current account and the current account norm in the new EBA estimates.

Box 5. How Vulnerable Is Sweden's Housing Market?

The residential real estate cycle may have reached its long-predicted peak in Sweden. Housing starts halved over 2011 while the real prices dropped substantially in the second half of 2011 (-3.5 percent cumulatively) and remained flat in 2012 Q1 (q-o-q). The surge in late 2010 and early 2011, following the decline through 2008, appears to have been due to buyers taking advantage of the low interest rate environment and to the abolition of the real estate tax in 2008 in favor of a municipal tax set at the lower of SEK 6,825 (around 969 euros) or 0.75 percent of the property's assessed value. Indeed, in the two years to 2011 Q2, residential investment (+37 percent) took off again, contrary to more muted developments during the previous recovery, offsetting the sharp drop in new homebuilding experienced during the global crisis.

Advanced Economies: Previous versus Current Housing Cycles



Sources: OECD and Fund staff calculations.

Going forward, several factors may indicate further downward pressure on house prices. First, price-to-income and price-to-rent ratios remain 1.1 and 1.4 standard deviations respectively above historical averages. Second, staff's model-based estimates from the Early Warning Exercise (EWE) and Vulnerability Exercise for Advanced Countries (VEA) suggest an overvaluation around 11–12 percent, exceeding the 10 percent threshold. (The EWE real estate model combines these three indicators to create a heat map for house price valuation.) Moreover, the predicted path of house prices based on WEO income projections suggests a decline of almost 5-6 percent through 2017.

These indicators put Sweden among the advanced countries where a house price correction is most likely to take place. Yet, the point estimate for the house price disequilibrium (the difference between actual prices and estimated equilibrium or long-run prices) is not large by historical standards, and Sweden ranks only 9th among 22 advanced economies in the VEA sample in terms of potential overvaluation.

Furthermore, other components of residential real estate vulnerability (namely, potential impact on GDP, household balance sheets, and mortgage market characteristics) remain moderate or low in Sweden, compared to other advanced economies. That said, with most mortgages being "rollover" mortgages with terms of at most five years, any future interest rate increases could put additional strains on already highly indebted households.

Box 6. Key Measures in the 2012 Budget Bill

With ongoing global uncertainty, the 2012 Budget Bill announced the implementation of temporary measures that balance the need to address the slowdown in economic activity while keeping public finances in good order. These measures, some of which are temporary, are estimated at about 0.4 percent of GDP for 2012 and 2013. The measures with the largest fiscal impact include:

Lowering of VAT rate of restaurant and catering services: Reduction of the VAT rate from 25 percent to 12 percent. This would bring it in line with the VAT rate on food and hotel services.

Infrastructure investment: Temporary augmentation of funds for infrastructure maintenance and investments on road and railway networks, giving priority to the most economically important routes.

Labor market measures: Structural measures to improve employment services and monitoring of job seeking activities, and more places in labor market programs for people at risk of long-term unemployment. Temporary increases in the number of employment training and work experience places, and in the number of places in vocational education.

Tax measures of business and savings: Simplification of taxation of foreign experts, changes in the rules of closely held companies (3:12 rules), introduction of investment savings account, changes to the taxation of endowment insurance, and increase the deduction for research and development expenditure.

Sweden: Reforms in the 2012 Budget Bill

(Percent of GDP)

	2012	2013	2014	2015
Infrastructure initiatives	0.10	0.06		
Labor market package	0.10	0.06	0.03	0.01
Lower VAT on restaurants and catering services	0.15	0.11	0.11	0.11
Tax measures for business and savings	-0.03	0.09	0.07	0.06
Other	0.10	0.14	0.14	0.12
Total	**0.42**	**0.46**	**0.36**	**0.30**

Sources: Ministry of Finance and Fund staff calculations.

Table 1. Sweden: Selected Economic Indicators, 2009—13

	2009	2010	2011	Forecast 2012	Forecast 2013
Real economy (in percent change)					
Real GDP	-5.0	5.9	4.0	1.0	2.3
Domestic Demand	-4.3	5.7	3.5	0.5	1.7
CPI inflation	2.0	1.9	1.4	1.2	2.0
Unemployment rate (in percent)	8.3	8.4	7.5	7.5	7.7
Gross national saving (percent of GDP)	23.5	25.5	26.6	24.3	23.3
Gross domestic investment (percent of GDP)	16.5	18.6	19.6	17.2	15.7
Output Gap (as a percent of potential)	-4.9	-1.2	0.8	-0.4	-0.3
Public finance (in percent of GDP)					
Total Revenues	51.9	50.6	49.7	49.7	50.0
Total Expenditures	52.9	50.6	49.6	50.0	49.5
Net lending	-0.8	0.0	0.1	-0.3	0.5
Structural balance (as a percent of potential GDP)	-0.8	1.0	0.2	-0.4	0.4
General government gross debt, official statistics	36.8	36.6	37.3	37.6	37.1
Money and credit (12-month, percent change)					
M1	8.2	6.6	...	...	...
M3	-1.3	4.7	...	...	...
Credit to non-bank public	6.0	7.4	...	...	...
Interest rates (year average)					
Repo rate	0.3	1.3	...	...	...
Three-month treasury bill rate	0.4	0.5	...	...	...
Ten-year government bond yield	3.3	2.9	...	...	...
Balance of payments (in percent of GDP)					
Current account	7.0	6.9	7.0	7.1	7.6
Trade balance	6.5	6.0	6.2	8.2	8.4
Foreign Direct Investment, net	-30.0	-30.1	-1.5	-8.3	-11.6
International reserves (in billions of US dollars)	44.0	45.9	53.1	51.3	51.4
Reserve cover (months of imports of goods and services)	3.0	2.7	2.9	2.9	2.8
Exchange rate (period average, unless otherwise stated)					
Exchange rate regime			Free Floating Exchange Rate		
Skr per U.S. dollar (January 10, 2012)			6.88		
Nominal effective rate (2000=100)	90.7	97.8	...	...	...
Real effective rate (2000=100) 1/	77.8	77.3	...	...	...
Fund Position (December 31, 2011)					
Holdings of currency (in percent of quota)			72.11		
Holdings of SDRs (in percent of allocation)			97.96		
Quota (in millions of SDRs)			2,395.5		

Sources: IMF Institute, Riksbank, Sweden Ministry of Finance, Thomson Reuters Datastream, and Fund staff calc

1/ Based on relative unit labor costs in manufacturing.

Table 2. Sweden: Financial System Structure, 2002–11

	2002				2007				2009				2010				2011			
	Number of institutions	Total assets (in millions of SEK)	Percent of total assets	Percent of GDP	Number of institutions	Total assets (in millions of SEK)	Percent of total assets	Percent of GDP	Number of institutions	Total assets (in millions of SEK)	Percent of total assets	Percent of GDP	Number of institutions	Total assets (in millions of SEK)	Percent of total assets	Percent of GDP	Number of institutions	Total assets (in millions of SEK)	Percent of total assets	Percent of GDP
Four Major Banks, consolidated																				
Nordea	1	2,284,713	24.9	93.5	1	3,679,361	24.9	117.7	1	5,212,530	30.3	167.8	1	5,207,511	30.0	156.4	1	6,382,811	33.3	182.8
Handelsbanken	1	1,277,514	13.9	52.3	1	1,859,382	12.6	59.5	1	2,122,843	12.3	68.4	1	2,153,530	12.4	64.7	1	2,454,366	12.8	70.3
S.E.B	1	1,241,112	13.5	50.8	1	2,344,462	15.9	75.0	1	2,308,227	13.4	74.3	1	2,179,821	12.6	65.4	1	2,362,653	12.3	67.6
Swedbank	1	957,503	10.4	39.2	1	1,607,984	10.9	51.4	1	1,794,687	10.4	57.8	1	1,715,681	9.9	51.5	1	1,857,065	9.7	53.2
Total Top Four Banks	4	5,760,842	62.7	235.7	4	9,491,189	64.3	303.6	4	11,438,287	66.5	368.3	4	11,256,543	64.9	338.0	4	13,056,895	68.1	373.9
Four major banks in Sweden 1/																				
Banks	4	2,780,140	30.3	113.8	4	6,079,039	41.2	194.5	4	7,040,183	40.9	226.7	4	5,464,340	31.5	164.1	4	6,016,174	31.4	172.3
Insurance companies	8	297,262	3.2	12.2	9	529,765	3.6	16.9	8	509,691	3.0	16.4	8	544,463	3.1	16.3	8	500,273	2.6	14.3
Mortgage credit institutions	3	945,606	10.3	38.7	3	1,497,436	10.1	47.9	3	1,899,919	11.0	61.2	3	1,971,472	11.4	59.2	3	2,098,457	11.0	60.1
Securities firms	3	1,181	0.0	0.0	3	20,339	0.1	0.7	3	30,242	0.2	1.0	3	14,109	0.1	0.4	3	14,112	0.1	0.4
Other credit market companies	5	107,520	1.2	4.4	9	195,326	1.3	6.2	8	235,297	1.4	7.6	8	167,768	1.0	5.0	8	170,213	0.9	4.9
Top four banks in Sweden	23	4,131,709	45.0	169.1	28	8,321,905	56.4	266.2	26	9,715,332	56.5	312.8	26	8,162,152	47.1	245.1	26	8,799,229	45.9	251.9
Other Banks in Sweden																				
Of which:																				
Banks	27	153,122	1.7	6.3	24	404,711	2.7	12.9	30	481,797	2.8	15.5	29	546,619	3.2	16.4	29	578,692	3.0	16.6
Savings banks	77	95,689	1.0	3.9	65	146,450	1.0	4.7	53	164,177	1.0	5.3	49	147,512	0.9	4.4	50	157,045	0.8	4.5
Mortgage credit institutions	11	459,923	5.0	18.8	4	315,522	2.1	10.1	4	436,302	2.5	14.0	3	338,789	2.0	10.2	3	361,378	1.9	10.3
Member bank	2	878	0.0	0.0	2	1,246	0.0	0.0	2	1,521	0.0	0.0	2	1,621	0.0	0.0	2	1,757	0.0	0.1
Other credit market companies	63	368,080	4.0	15.1	45	587,840	4.0	18.8	43	790,385	4.6	25.4	40	722,164	4.2	21.7	39	772,237	4.0	22.1
Total other banks in Sweden	180	1,077,692	11.7	44.1	140	1,455,769	9.9	59.6	132	1,874,182	10.9	60.3	123	1,756,705	10.1	52.7	123	1,871,109	9.8	53.6
Nonbank credit institutions																				
Insurance companies	165	1,654,032	18.0	67.7	247	2,226,389	15.1	71.2	253	2,351,945	13.7	75.7	254	2,536,287	14.6	76.2	217	2,555,220	13.3	73.2
Life insurance	38	1,289,888	14.0	52.8	45	1,678,359	11.4	53.7	43	1,782,371	10.4	57.4	44	1,965,284	11.3	59.0	40	1,987,109	10.4	56.9
Nonlife insurance 2/	127	364,144	4.0	14.9	202	548,030	3.7	17.5	210	569,574	3.3	18.3	210	571,003	3.3	17.1	177	568,111	3.0	16.3
Pension funds	12	80,251	0.9	3.3	15	126,767	0.9	4.1	14	105,567	0.6	3.4	13	117,511	0.7	3.5	11	123,277	0.6	3.5
Mutual funds 3/	615	565,102	6.2	23.1	793	1,416,210	9.6	45.3	849	1,393,337	8.1	44.9	896	1,635,074	9.4	49.1	911	1,534,817	8.0	43.9
Other nonbank credit institutions																				
Asset management firms	67	3,398	0.0	0.1	82	8,160	0.1	0.3	82	7,346	0.0	0.2	80	7,662	0.0	0.2	...	...	...	...
Securities firms	100	45,500	0.5	1.9	126	40,149	0.3	1.3	132	28,895	0.2	0.9	132	23,817	0.1	0.7	129	22,467	0.1	0.6
Total financial system	1,143	9,186,817	100.0	375.9	1,407	14,764,633	100.0	472.3	1,466	17,199,559	100.0	553.8	1,502	17,333,599	100.0	520.4	1,395	19,163,785	100.0	548.7
of which: Total banking sector 4/		6,838,534	74.4	279.9		10,946,958	74.1	350.2		13,312,469	77.4	428.6		13,013,248	75.1	390.7		14,928,004	77.9	427.4
Memorandum item:																				
Foreign bank branches in Sweden	...	...	...	...	25	753,482	5.1	24.1	24	686,265	4.0	22.1	26	760,045	4.4	23.7	27	789,061	4.1	24.6
Swedish bank branches in abroad	...	...	...	...	52	1,324,288	9.0	42.4	55	1,411,402	8.2	45.4	61	1,456,017	8.4	45.4	61	2,063,291	10.8	64.4
Nominal GDP (in millions of SEK)				2,443,630				3,126,018				3,105,790				3,330,581				3,492,471

Sources: Financial Supervisory Authority, Riksbank, and Fund staff calculations.

1/ Including branches in abroad.

2/ Not including minor local companies

3/ Market value of funds

4/ Number of institutions is computed on unconsolidated basis.

Table 3. Sweden: Financial Soundness Indicators: Banks, 2003–11

(End of period, in percent)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Capital Adequacy									
Regulatory capital to risk-weighted assets 1/	10.5	10.6	10.5	10.5	10.2	10.7	13.0	12.6	12.2
of which: Four major banks 2/	10.0	10.1	10.1	10.0	9.8	10.2	12.7	12.0	11.5
Regulatory Tier I capital to risk-weighted assets 1/	8.0	8.3	7.7	7.8	7.5	8.1	10.9	11.0	11.3
of which: Four major banks 2/	7.4	7.6	7.0	7.1	7.0	7.6	10.5	10.4	10.7
Regulatory common equity Tier I capital to risk-weighted assets	...	...	...	...	...	...	...	...	...
of which: Four major banks 2/	...	...	...	...	...	...	...	11.3	11.6
Capital as percent of assets (leverage ratio)	5.1	4.8	4.8	4.8	4.7	4.6	5.0	4.8	4.1
of which: Four major banks 2/	5.0	4.8	4.8	4.9	4.7	4.7	5.0	4.7	4.0
Asset quality and exposure									
Nonperforming loans to total gross loans	2.0	1.2	0.9	0.8	0.6	1.1	2.0	1.9	1.6
of which: Four major banks 2/	1.9	1.1	0.8	0.8	0.6	1.0	2.0	1.9	1.5
Nonperforming loans net of loan-loss provisions to capital	11.9	4.8	3.1	4.3	3.4	7.4	10.7	9.9	9.5
of which: Four major banks 2/	11.5	4.0	2.7	3.9	3.1	6.5	11.0	10.6	9.9
Loan-loss provisions to nonperforming loans	49.4	66.2	69.7	56.1	58.3	49.1	55.4	44.3	41.3
of which: Four major banks 2/	50.3	70.6	73.6	58.0	60.4	47.1	53.7	43.8	40.7
Distribution of MFI credit (percent) 4/									
Sweden	87.3	86.2	83.8	82.2	81.5	79.1	80.1	81.3	80.9
Financial corporation	2.9	2.1	1.5	2.0	2.1	1.1	1.1	2.0	1.7
Non financial corporations	38.0	36.0	35.0	33.2	34.1	33.9	31.4	31.0	31.1
Public sector	3.3	3.2	3.0	3.1	3.4	3.1	3.8	2.6	2.9
Households	43.1	44.9	44.3	43.8	41.9	41.0	43.8	45.7	45.2
Outside Sweden	12.7	13.8	16.2	17.8	18.5	20.9	19.9	18.7	19.1
Other EUs	6.1	6.9	7.3	8.4	8.7	11.0	9.4	9.5	9.5
Rest of the world	6.6	7.0	8.9	9.4	9.8	9.9	10.5	9.3	9.6
Large exposures as percent of tier 1 capital 3/	26.4	11.1	17.5	18.3	13.4	34.1	12.3	40.1	37.2
of which: Four major banks 3/	22.2	12.4	12.0	13.3	6.5	30.9	8.1	36.8	31.4
Earnings and profitability									
Return on assets (net income as percent of average total assets)	0.6	0.7	0.8	0.8	0.8	0.5	0.3	0.4	0.5
of which: Four major banks 2/	0.6	0.7	0.7	0.8	0.8	0.6	0.2	0.4	0.5
Return on equity (Net income as percent of average equity capital)	12.5	15.9	18.1	19.9	18.5	12.7	13.0	9.8	10.6
of which: Four major banks 2/	13.3	16.0	18.7	21.0	19.7	14.3	5.4	10.1	11.1
Net interest income as percent of gross income	64.4	58.9	52.4	49.2	52.4	55.2	56.8	52.7	54.4
of which: Four major banks 2/	64.6	59.2	52.6	49.4	52.7	56.9	57.7	55.3	57.3
Trading income and foreign exchange gains (losses) to gross income	3.0	5.1	9.6	10.5	8.3	8.6	11.7	11.6	9.4
of which: Four major banks 2/	3.5	5.4	10.0	11.2	9.6	9.8	13.6	12.6	10.0
Personnel expenses as percent of noninterest expenses	54.0	53.7	56.0	57.4	57.1	55.0	53.2	52.6	53.6
of which: Four major banks 2/	55.9	55.7	58.4	60.3	60.0	59.2	57.1	57.4	57.8
Liquidity									
Liquid assets as percent of total assets	4.4	5.2	5.0	5.0	5.0	4.0	6.3	4.8	6.2
of which: Four major banks 2/	4.4	5.3	4.6	5.1	5.4	4.3	6.7	5.2	6.7
Liquid assets as percent of short-term liabilities	29.3	30.6	31.6	32.1	34.1	23.6	43.6	44.4	66.7
of which: Four major banks 2/	32.1	34.7	33.3	37.5	43.8	30.5	54.7	58.9	87.9
Customer deposits as a percent of total (non-interbank) loans	50.6	52.6	50.2	53.8	51.4	46.1	47.1	47.8	49.8
of which: Four major banks 2/	49.1	50.8	49.1	53.4	51.3	45.5	45.3	46.6	48.5
Noninterbank loans to noninterbank deposits	142.6	130.8	137.4	135.7	139.8	139.6	144.8	155.0	153.8
of which: Four major banks 2/	150.2	139.6	145.1	143.1	148.4	149.7	156.1	165.9	163.5
Foreign exchange risk									
Foreign currency loans as percent of total loans	18.7	17.7	20.9	22.8	25.4	27.9	27.3	26.7	27.9
Foreign currency assets as percent of total assets	24.4	27.2	29.2	29.3	31.6	33.0	31.2	31.4	34.5
Foreign currency-denominated liabilities as percent of total liabilities	32.6	34.7	36.0	34.3	33.9	35.4	29.8	31.4	35.1
Exposure to derivatives									
Gross asset position in derivatives as percent of Tier 1 capital	152.6	176.7	164.7	110.7	132.0	336.8	210.8	222.3	351.2
Gross liability position in derivatives as percent of Tier 1 capital	168.2	188.5	165.2	117.3	136.1	320.7	198.9	217.9	335.2

Sources: Financial Supervisory Authority, Riksbank, and Fund staff calculations.
1/ From 2007, the calculation of capital base follows rules under Basel II.
2/ On consolidated basis
3/ From 2010 onward, exposures to credit institutions are included.
4/ Non consolidated bases, and parent banks only. Monetary financial institutions include banks and housing credit institutions.

Table 4. Sweden: Financial Soundness Indicators: Non-Banks, 2003–11

(End of period, in percent)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Insurance sector									
Solvency ratio (margin/required margin)									
Life insurance companies	9.0	8.4	11.2	13.8	14.9	8.4	7.8	14.2	8.0
Non-life insurance companies	6.5	5.1	7.7	8.5	9.5	6.8	7.7	10.6	10.6
Return on equity									
Life insurance companies	20.3	21.0	22.6	18.9	14.2	-86.3	45.3	20.3	-30.1
Non-life insurance companies	21.1	23.9	35.2	16.8	-0.1	-21.4	29.7	35.4	3.5
Households									
Household debt as percent of GDP	61.9	64.6	68.1	71.2	73.2	79.1	85.5	83.8	86.4
Household debt as percent of disposable income	123.3	130.9	139.6	146.9	152.2	157.4	159.6	167.3	170.7
Household interest expense as percent of disposable income	3.9	3.6	3.3	3.9	4.6	5.3	3.0	3.5	4.5
Corporate sector									
Debt stock as percent of GDP (non-financial sector borrowing from financial sector)	53.9	51.6	54.0	54.2	60.8	65.7	65.1	61.1	62.2
Total debt stock as percent of GDP	74.5	70.5	72.5	69.4	79.4	92.6	91.7	85.6	85.0
Equity risk									
OM Stockholm Stock Exchange Index (annual percent change)	29.8	17.6	32.6	23.6	-6.0	-42.0	46.7	23.1	-16.7
Market capitalization in percent of GDP	...	...	230.5	262.1	257.1	136.2	189.8	212.9	166.9
Real estate markets (prices; year on year percent change)									
One- or two dwelling buildings	6.1	10.0	10.5	10.5	11.3	-2.0	7.1	5.2	3.4
Greater Stockholm region	0.7	8.8	9.1	11.6	15.6	-3.2	5.9	7.0	3.3
Buildings for seasonal and secondary use	7.9	9.4	13.7	7.6	13.3	-2.8	12.2	3.4	5.5

Sources: Financial Supervisory Authority, Riksbank and Fund staff calculations.

Table 5. Sweden: General Government Statement of Operations, 2007-17

											IMF Staff Projections				
					2011			2012							
						2011			2012						
					2011	Spring		2012	Spring						
	2007	2008	2009	2010	Budget	Bill	Prelim.	Budget	Bill	IMF	2013	2014	2015	2016	2017
							(in billions of SEK)								
Revenue	**1,643**	**1,662**	**1,612**	**1,684**	**1,704**	**1,731**	**1,735**	**1,763**	**1,773**	**1,780**	**1,868**	**1,969**	**2,061**	**2,159**	**2,256**
Tax revenue	1,180	1,210	1,188	1,236	1,252	1,269	1,299	1,285	1,332	1,330	1,393	1,465	1,532	1,604	1,676
Taxes on income, profits, and capital gains	663	635	609	641	638	654	654	671	669	676	717	762	799	841	881
Payable by individuals	545	542	517	528	526	533	534	548	553	552	588	626	657	692	725
Payable by corporations	118	93	91	113	112	121	120	124	116	123	129	136	142	149	155
General taxes on goods and services	517	575	580	595	614	616	645	614	663	654	675	703	732	763	795
Social Contributions	292	271	251	274	279	284	247	295	252	255	272	289	303	319	335
Other revenue	171	181	172	174	173	178	190	183	190	195	204	214	225	235	246
Interest income	72	79	66	64	...	67	74	69	74	76	79	84	88	92	96
Other revenue	98	102	107	111	...	111	116	114	115	119	124	131	138	144	150
Expenditure	**1,531**	**1,592**	**1,642**	**1,686**	**1,718**	**1,718**	**1,731**	**1,764**	**1,783**	**1,786**	**1,845**	**1,910**	**1,971**	**2,045**	**2,125**
Compensation of employees	461	466	466	481	493	495	486	485	493	493	506	520	542	566	591
Intermediate consumption	337	369	394	410	421	422	442	451	459	459	474	491	505	516	539
Interest payments	55	53	38	37	38	44	42	36	42	42	43	42	35	37	31
Subsidies	44	46	47	50	69	49	52	69	51	51	51	52	53	54	56
Grants	42	49	49	52	59	51	53	55	56	56	58	61	65	67	69
Social benefits	502	513	546	547	531	541	544	553	567	569	594	615	629	656	685
Net acquisition of nonfinancial assets	90	96	103	109	103	116	113	115	115	115	119	129	142	150	153
Gross operating balance	202	165	72	107	89	129	117	114	105	109	143	188	231	264	284
Net lending / borrowing	**112**	**69**	**-30**	**-2**	**-14**	**13**	**4**	**-1**	**-10**	**-6**	**23**	**59**	**89**	**114**	**132**
Net financial worth, transactions	128	74	-34	-13	...	...	4	...	...	-6	23	59	89	114	132
Net acquisition of financial assets	1	-67	4	-6	...	...	-6	...	...	-12	18	54	84	109	127
Net incurrence of liabilities	-127	-142	38	7	...	...	10	...	...	7	5	5	5	5	5
							(in percent of GDP)								
Revenue	**52.5**	**51.9**	**51.9**	**50.6**	**49.4**	**50.1**	**49.7**	**50.1**	**50.1**	**49.5**	**49.8**	**49.9**	**49.7**	**49.8**	**49.9**
Tax revenue	37.7	37.8	38.3	37.1	36.3	36.7	37.2	36.5	37.6	37.0	37.1	37.1	36.9	37.0	37.0
Taxes on income, profits, and capital gains	21.2	19.8	19.6	19.3	18.5	18.9	18.7	19.1	18.9	18.8	19.1	19.3	19.3	19.4	19.5
Payable by individuals	17.4	16.9	16.7	15.9	15.3	15.4	15.3	15.6	15.6	15.4	15.7	15.9	15.8	16.0	16.0
Payable by corporations	3.8	2.9	2.9	3.4	3.3	3.5	3.4	3.5	3.3	3.4	3.4	3.4	3.4	3.4	3.4
General taxes on goods and services	16.5	17.9	18.7	17.9	17.8	17.8	18.5	17.5	18.7	18.2	18.0	17.8	17.7	17.6	17.6
Social Contributions	9.3	8.4	8.1	8.2	8.1	8.2	7.1	8.4	7.1	7.1	7.2	7.3	7.3	7.4	7.4
Other revenue	5.5	5.7	5.5	5.2	5.0	5.2	5.4	5.2	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Interest income	2.3	2.5	2.1	1.9	...	2.0	2.1	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Other revenue	3.1	3.2	3.4	3.3	...	3.2	3.3	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Expenditure	**49.0**	**49.7**	**52.9**	**50.6**	**49.8**	**49.7**	**49.6**	**50.1**	**50.4**	**49.7**	**49.2**	**48.4**	**47.5**	**47.2**	**47.0**
Compensation of employees	14.7	14.6	15.0	14.4	14.3	14.3	13.9	13.8	13.9	13.7	13.5	13.2	13.1	13.1	13.1
Intermediate consumption	10.8	11.5	12.7	12.3	12.2	12.2	12.6	12.8	13.0	12.8	12.6	12.4	12.2	11.9	11.9
Interest payments	1.8	1.6	1.2	1.1	1.1	1.3	1.2	1.0	1.2	1.2	1.1	1.1	0.9	0.8	0.7
Subsidies	1.4	1.4	1.5	1.5	2.0	1.4	1.5	2.0	1.5	1.4	1.3	1.3	1.3	1.2	1.2
Grants	1.4	1.5	1.6	1.6	1.7	1.5	1.5	1.6	1.6	1.6	1.5	1.5	1.6	1.5	1.5
Social benefits	16.0	16.0	17.6	16.4	15.4	15.6	15.6	15.7	16.0	15.8	15.9	15.6	15.2	15.1	15.1
Net acquisition of nonfinancial assets	2.9	3.0	3.3	3.3	3.0	3.4	3.2	3.3	3.2	3.2	3.2	3.3	3.4	3.5	3.4
Gross operating balance	6.5	5.2	2.3	3.2	2.6	3.7	3.3	3.3	3.0	3.0	3.8	4.8	5.6	6.1	6.3
Net lending / borrowing	**3.6**	**2.2**	**-1.0**	**-0.1**	**-0.4**	**0.4**	**0.1**	**0.0**	**-0.3**	**-0.2**	**0.6**	**1.5**	**2.1**	**2.6**	**2.9**
Net financial worth, transactions	4.1	2.3	-1.1	-0.4	...	...	0.1	...	...	-0.2	0.6	1.5	2.1	2.6	2.9
Net acquisition of financial assets	0.0	-2.1	0.1	-0.2	...	...	-0.2	...	...	-0.3	0.5	1.4	2.0	2.5	2.8
Net incurrence of liabilities	-4.1	-4.4	1.2	0.2	...	...	0.3	...	...	0.2	0.1	0.1	0.1	0.1	0.1
Structural Balance (percent of potential GDP) 1/	**2.2**	**1.1**	**-0.8**	**1.0**	**...**	**...**	**0.2**	**...**	**...**	**-0.3**	**0.5**	**1.5**	**2.1**	**2.6**	**2.9**
Fiscal Impulse (expansionary +)	-0.2	1.1	1.9	-1.8	...	...	0.9	...	...	0.5	-0.8	-0.9	-0.7	-0.5	-0.3
Memorandum items:															
Compliance with fiscal rule															
Overall balance ten-year average	1.2	1.4	1.2	0.8	0.7	0.8	0.7	0.6	0.6	0.8	1.0	1.1	1.1	1.2	1.1
Overall balance 7-year rolling average (±3 years)	1.3	1.3	1.0	0.8	1.9	1.3	0.5	0.7	1.2	0.5	1.0	1.4	...	...	...
Structural balance (percent of potential GDP) 2/	1.3	1.2	1.7	0.6	1.0	1.4	-0.3	2.0	1.2	0.1	0.8	1.6	2.2	2.6	2.9
Gross Public Debt	40.2	38.8	42.6	39.4	37.1	36.8	38.4	36.2	37.7	37.5	35.3	32.0	28.4	24.5	20.6
Real GDP growth (percent)	3.4	-0.8	-5.0	5.9	3.7	4.6	4.0	1.3	0.4	1.0	2.3	3.2	3.0	2.4	2.4
Output gap (percent of potential)	4.2	1.7	-4.9	-1.2	-2.5	-1.9	0.8	-3.6	-2.7	-0.4	-0.3	-0.2	-0.1	0.0	0.0
Employment gap (percent of potential)	0.6	1.7	0.7	-2.2	...	...	-0.3	...	...	0.6	0.3	0.1	0.1	0.0	0.0
Nominal GDP (in billions of SEK)	3,126	3,204	3,106	3,331	3,449	3,459	3,492	3,517	3,540	3,592	3,750	3,948	4,148	4,332	4,525

Sources: 2008, 2009, 2010, and 2011 Fiscal Policy Bills and Fund staff calculations.

1/ Structural balance takes into account output and employment gaps.

2/ Overall balance adjusted for the output gap, based on authorities' measure.

Table 6. Sweden: Public Sector Balance Sheet

	2003	2004	2005	2006	2007	2008	2009	2010	2011
				(In billions of SEK)					
Assets	**2,750**	**2,926**	**3,190**	**3,525**	**3,704**	**3,724**	**3,966**	**4,141**	**4,299**
Financial assets	1,328	1,439	1,638	1,873	1,950	1,835	2,054	2,142	2,184
Stocks	692	740	880	1,009	1,036	874	1,022	1,076	1,043
Other	637	698	758	865	913	960	1,032	1,066	1,141
Capital stock net of depreciation	1,421	1,487	1,552	1,652	1,754	1,889	1,913	1,999	2,114
Liabilities	**1,819**	**1,887**	**1,967**	**1,898**	**1,881**	**1,923**	**1,966**	**1,958**	**2,095**
Financial liabilities	1,445	1,502	1,576	1,461	1,403	1,433	1,445	1,446	1,542
Gross debt	1,316	1,339	1,396	1,333	1,257	1,243	1,322	1,313	1,341
Other	129	162	180	128	146	190	122	132	201
Pension liabilities	373	385	391	436	478	489	521	512	553
Net worth	**931**	**1,039**	**1,223**	**1,628**	**1,823**	**1,801**	**2,000**	**2,184**	**2,204**
Financial net worth	**-117**	**-63**	**62**	**412**	**547**	**402**	**609**	**697**	**643**
				(In percent of GDP)					
Assets	**108.1**	**110.0**	**115.2**	**119.7**	**118.5**	**116.2**	**127.7**	**124.3**	**123.1**
Financial assets	52.2	54.1	59.1	63.6	62.4	57.3	66.1	64.3	62.5
Stocks	27.2	27.8	31.8	34.3	33.2	27.3	32.9	32.3	29.9
Other	25.0	26.2	27.4	29.4	29.2	30.0	33.2	32.0	32.7
Capital stock net of depreciation	55.9	55.9	56.1	56.1	56.1	58.9	61.6	60.0	60.5
Liabilities	**71.5**	**70.9**	**71.0**	**64.4**	**60.2**	**60.0**	**63.3**	**58.8**	**60.0**
Financial liabilities	56.8	56.4	56.9	49.6	44.9	44.7	46.5	43.4	44.1
Gross debt	51.7	50.3	50.4	45.3	40.2	38.8	42.6	39.4	38.4
Other	5.1	6.1	6.5	4.4	4.7	5.9	3.9	4.0	5.7
Pension liabilities	14.7	14.5	14.1	14.8	15.3	15.3	16.8	15.4	15.8
Net worth	**36.6**	**39.1**	**44.2**	**55.3**	**58.3**	**56.2**	**64.4**	**65.6**	**63.1**
Financial net worth	**-4.6**	**-2.4**	**2.2**	**14.0**	**17.5**	**12.5**	**19.6**	**20.9**	**18.4**
Memorandum items:									
GDP (SEK billions)	2,545	2,661	2,769	2,944	3,126	3,204	3,106	3,331	3,492

Sources: Swedish authorities and Fund staff calculations.

Table 7. Sweden: Balance of Payments Accounts, 2008-17

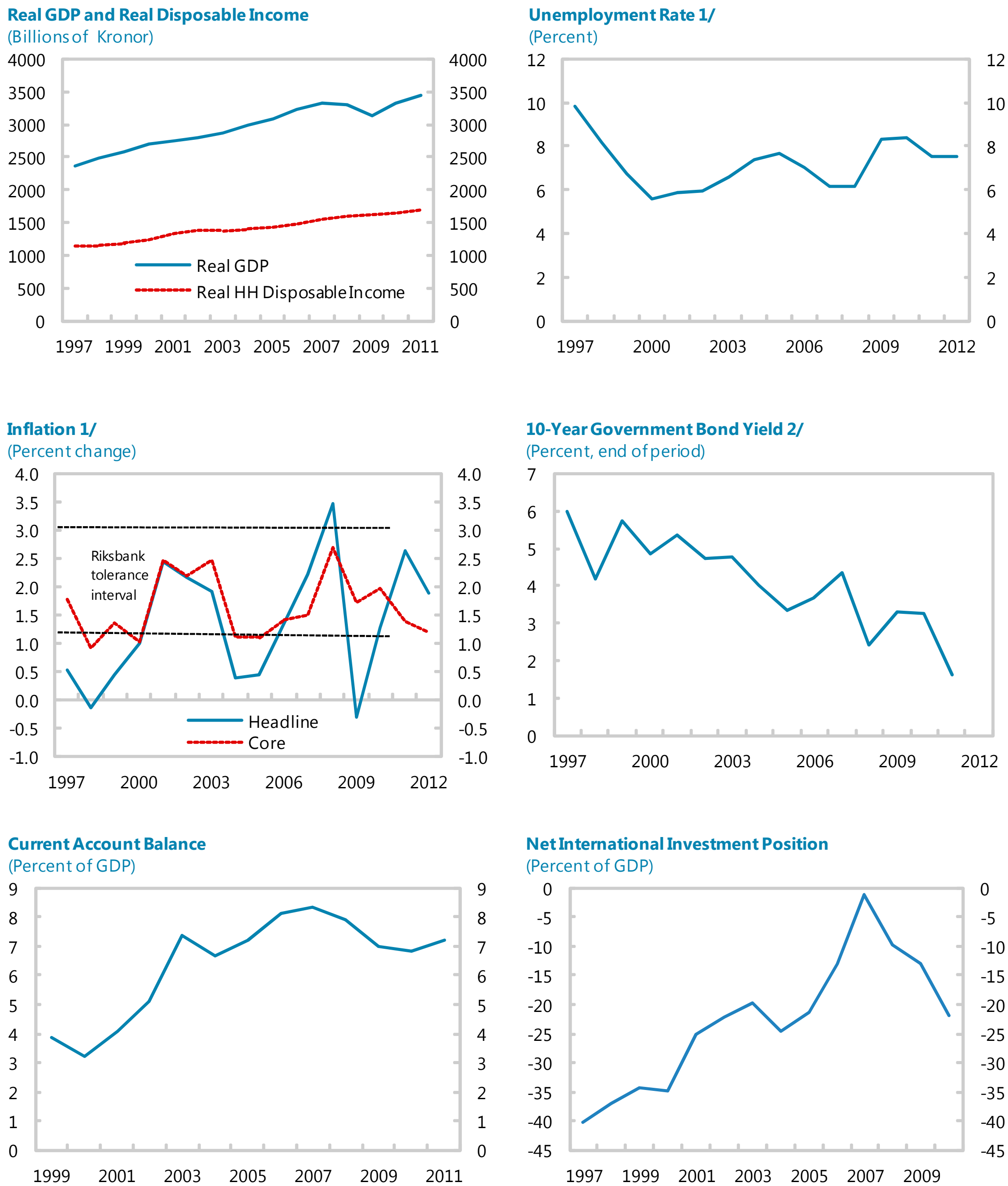
	2008	2009	2010	2011	Projections 2012	2013	2014	2015	2016	2017
					(in SEK billions)					
Current Account Balance	281	219	229	245	255	284	301	316	316	317
Trade Balance	211	203	200	215	294	316	326	329	317	305
Exports of G&S	1,670	1,467	1,624	1,715	1,727	1,786	1,880	1,974	2,031	2,178
Imports of G&S	1,459	1,264	1,423	1,500	1,433	1,470	1,554	1,644	1,715	1,873
Factor income, net	112	55	69	81	2	10	20	34	49	64
Current Transfers, net	-42	-39	-46	-45	-41	-43	-45	-47	-49	-52
Financial Account Balance	155	-82	-260	-224	-293	-298	-321	-351	-361	-365
Investment Abroad [1]	246	563	280	-266	-375	-411	-496	-699	-768	-789
o/w Reserves	4	-116	2	-5	0	0	0	0	0	0
Investment in Sweden [2]	-91	-645	-540	42	83	113	175	348	406	425
					(in percent of GDP)					
Current Account Balance	8.8	7.0	6.9	7.0	7.1	7.6	7.6	7.6	7.3	7.0
Trade Balance	6.6	6.5	6.0	6.2	8.2	8.4	8.3	7.9	7.3	6.7
Exports of G&S	52.1	47.2	48.7	49.1	48.1	47.6	47.6	47.6	46.9	48.1
Imports of G&S	45.5	40.7	42.7	43.0	39.9	39.2	39.4	39.6	39.6	41.4
Factor income, net	3.5	1.8	2.1	2.3	0.1	0.3	0.5	0.8	1.1	1.4
Current Transfers, net	-1.3	-1.3	-1.4	-1.3	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Financial Account Balance	4.8	-2.6	-7.8	-6.4	-8.2	-7.9	-8.1	-8.5	-8.3	-8.1
Investment Abroad [1]	7.7	18.1	8.4	-7.6	-10.5	-10.9	-12.6	-16.8	-17.7	-17.4
Direct Investment	-6.4	-6.4	-3.9	-5.6	-6.6	-7.1	-7.1	-7.1	-7.1	-7.6
Portfolio Investment	-3.2	-4.5	-4.0	-5.1	-5.7	-5.6	-6.0	-6.0	-4.6	-3.1
Financial Derivatives	16.9	29.5	23.0	7.8	7.5	8.2	8.5	4.8	3.3	2.6
Other Investment	0.4	3.2	-6.8	-4.6	-5.7	-6.4	-7.9	-8.6	-9.3	-9.3
Reserves	0.1	-3.7	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Investment in Sweden [2]	-2.8	-20.8	-16.2	1.2	2.3	3.0	4.4	8.4	9.4	9.4
Direct Investment	7.6	2.5	-0.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Portfolio Investment	-3.1	20.2	8.3	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Financial Derivatives	-16.4	-30.2	-22.1	-14.2	-13.1	-12.4	-11.0	-7.0	-6.0	-6.0
Other Investment	9.0	-13.2	-2.1	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Errors and Omissions	-13.4	-4.3	1.2	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Exports of G&S										
Value	5.3	-12.2	10.7	5.7	0.7	3.4	5.3	5.0	2.9	7.2
Volume	0.0	-11.4	9.8	7.2	-4.0	2.0	5.0	4.5	4.0	3.9
Deflator	5.4	-0.8	0.8	-1.4	4.9	1.4	0.3	0.4	-1.0	3.2
Imports of G&S										
Value	7.3	-13.4	12.7	5.4	-4.5	2.5	5.7	5.8	4.3	9.2
Volume	2.4	-13.4	12.5	5.8	-5.3	5.3	7.4	7.9	6.4	6.4
Deflator	4.7	0.1	0.1	-0.4	0.9	-2.6	-1.6	-2.0	-2.0	2.7

Sources: Statistics Sweden and Fund staff calculations.

[1] Positive number indicates a decumulation of foreign assets.

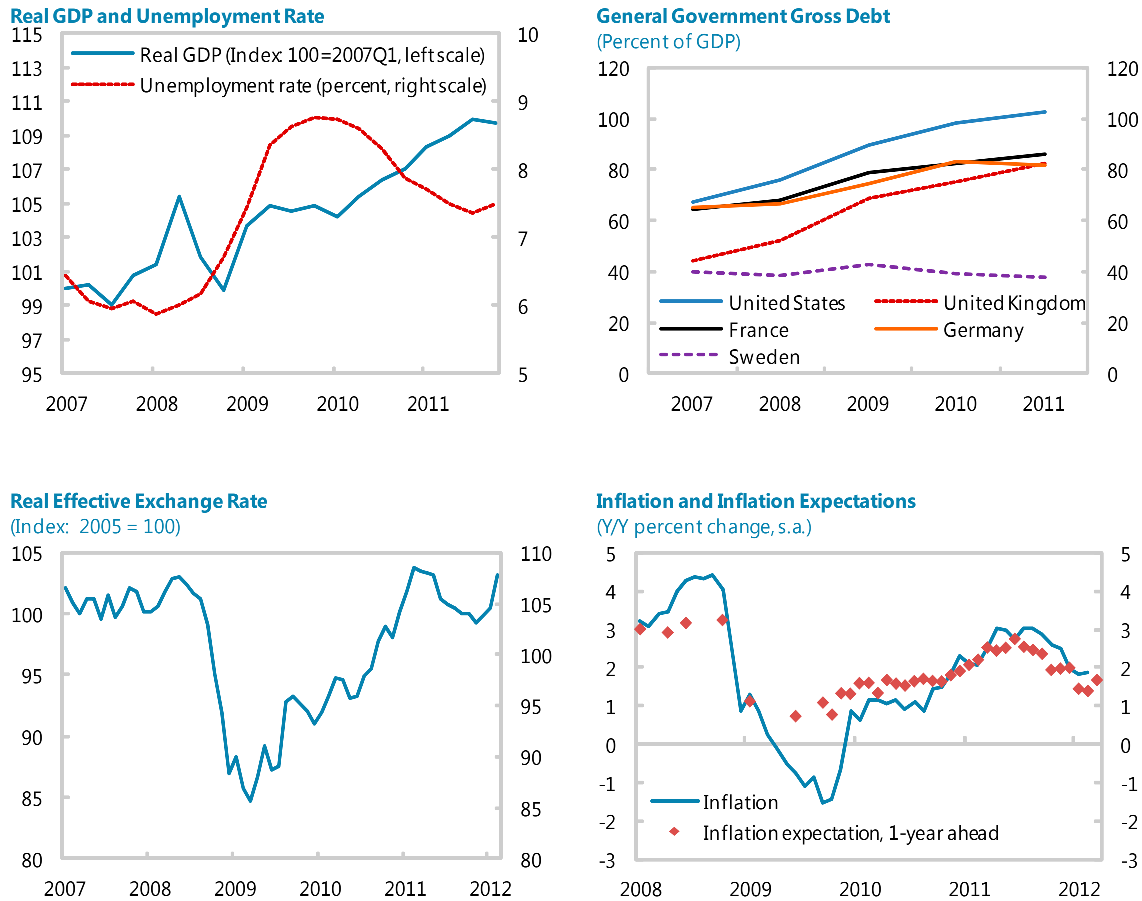
[2] Positive number indicates an accumulation of foreign assets.

Figure 1. Sweden: Long View, 1997–2012



Sources: Haver Analytics, Statistics Sweden, and Fund staff calculations.
1/ As of February 2012.
2/ As of March 2012.

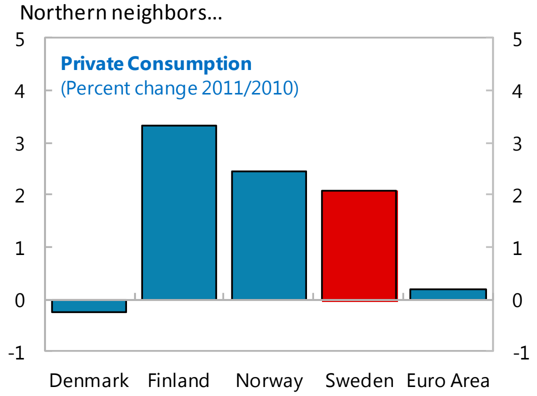
Figure 2. Sweden: The Short View, 2007–12



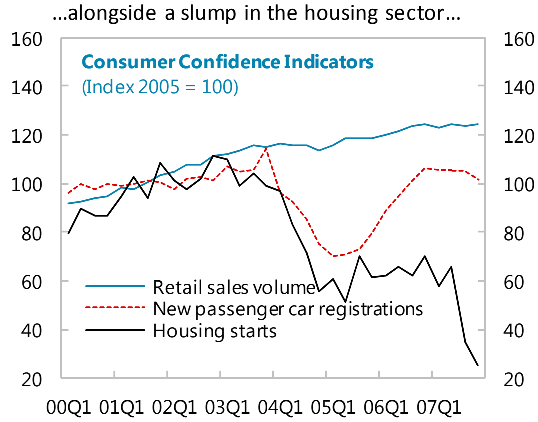
Sources: IMF Information Notice System, IMF World Economic Outlook, Prospera Research AB, Statistics Sweden, and Fund staff calculations.

Figure 3. Sweden: Household Balance Sheets and Consumption, 2004–11

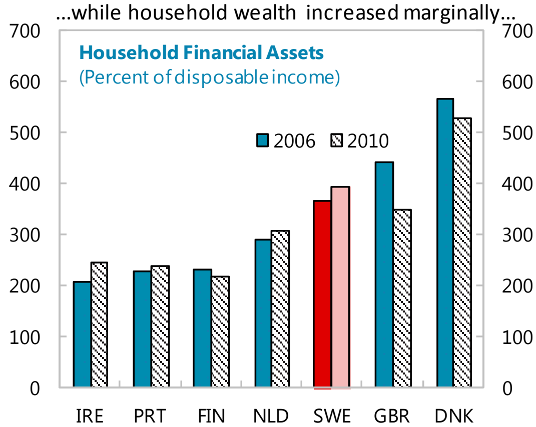
Private Consumption is falling behind Sweden's Northern neighbors...



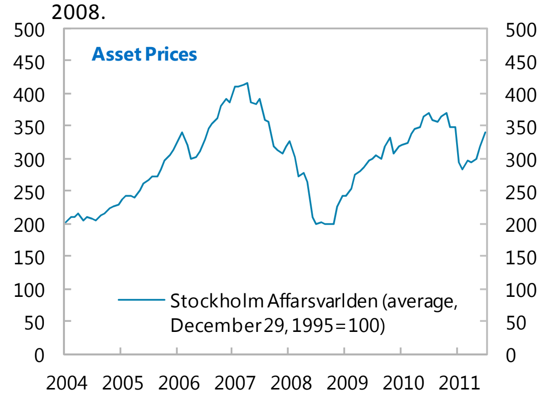
...alongside a slump in the housing sector...



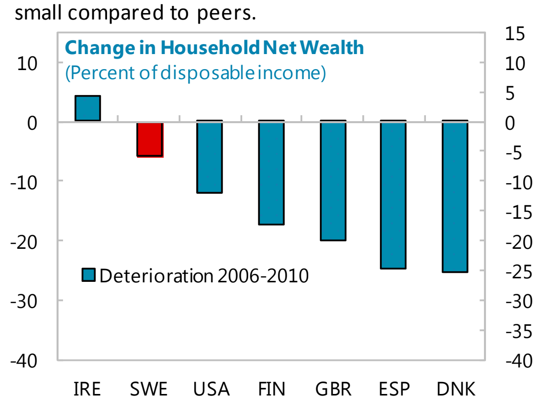
...while household wealth increased marginally...



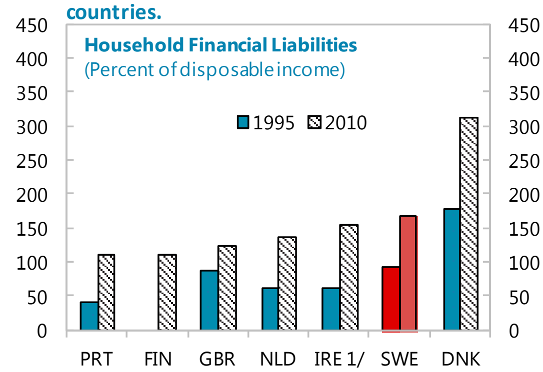
...and financial wealth quickly bounced back after 2008.



Overall, the decline in net household wealth was small compared to peers.



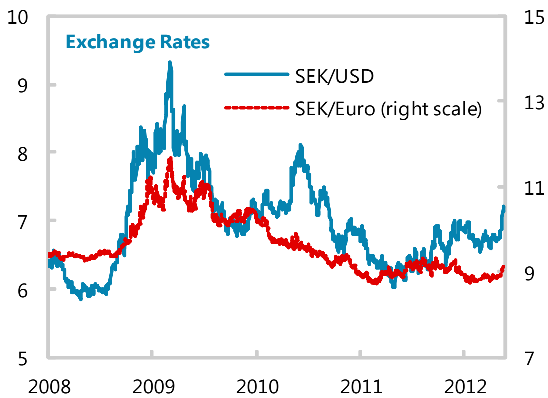
Household debt remains lower relative to Scandinavia but above some financially stressed countries.



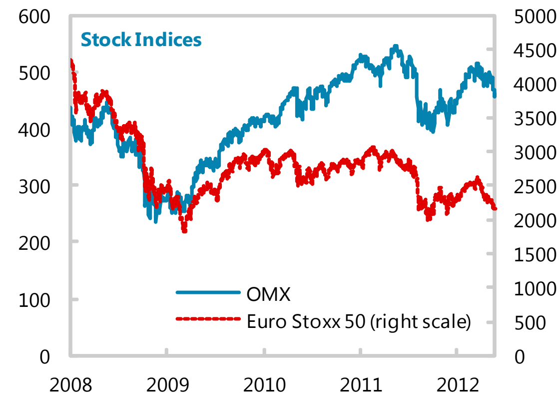
Sources: Eurostat; Haver Analytics; and IMF staff calculations.
1/ Data for Ireland starts in 2001.

Figure 4. Sweden: Selected Financial Markets Indicators, 2008–12

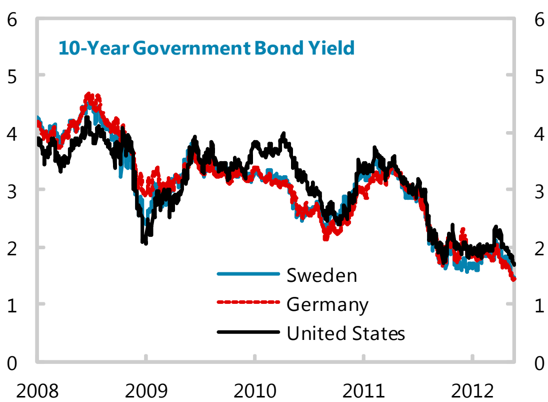
Exchange rates have returned to pre-crisis levels...



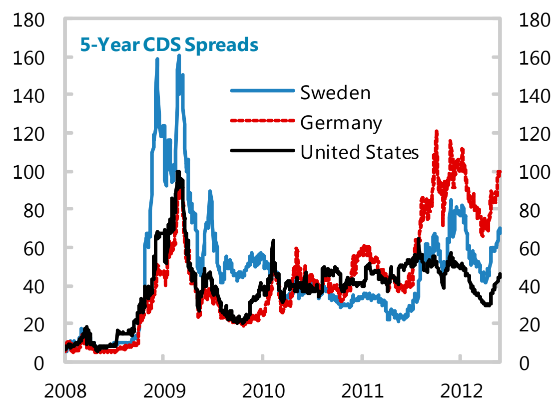
...as have stock indices.



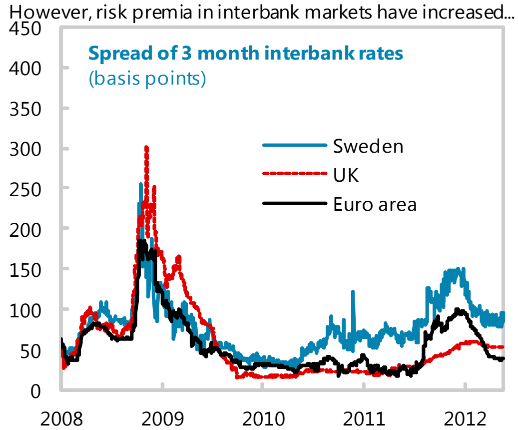
Swedish sovereign bond yields remain low...



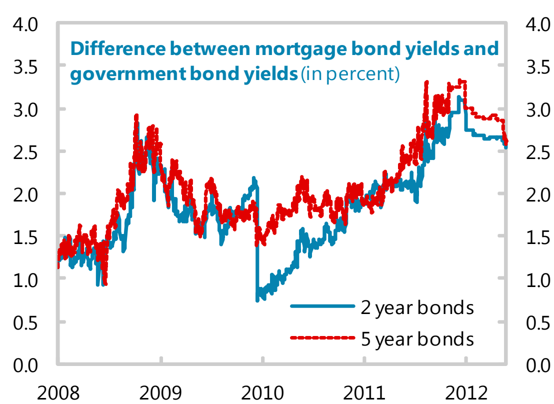
...as have sovereign CDS spreads.



However, risk premia in interbank markets have increased...

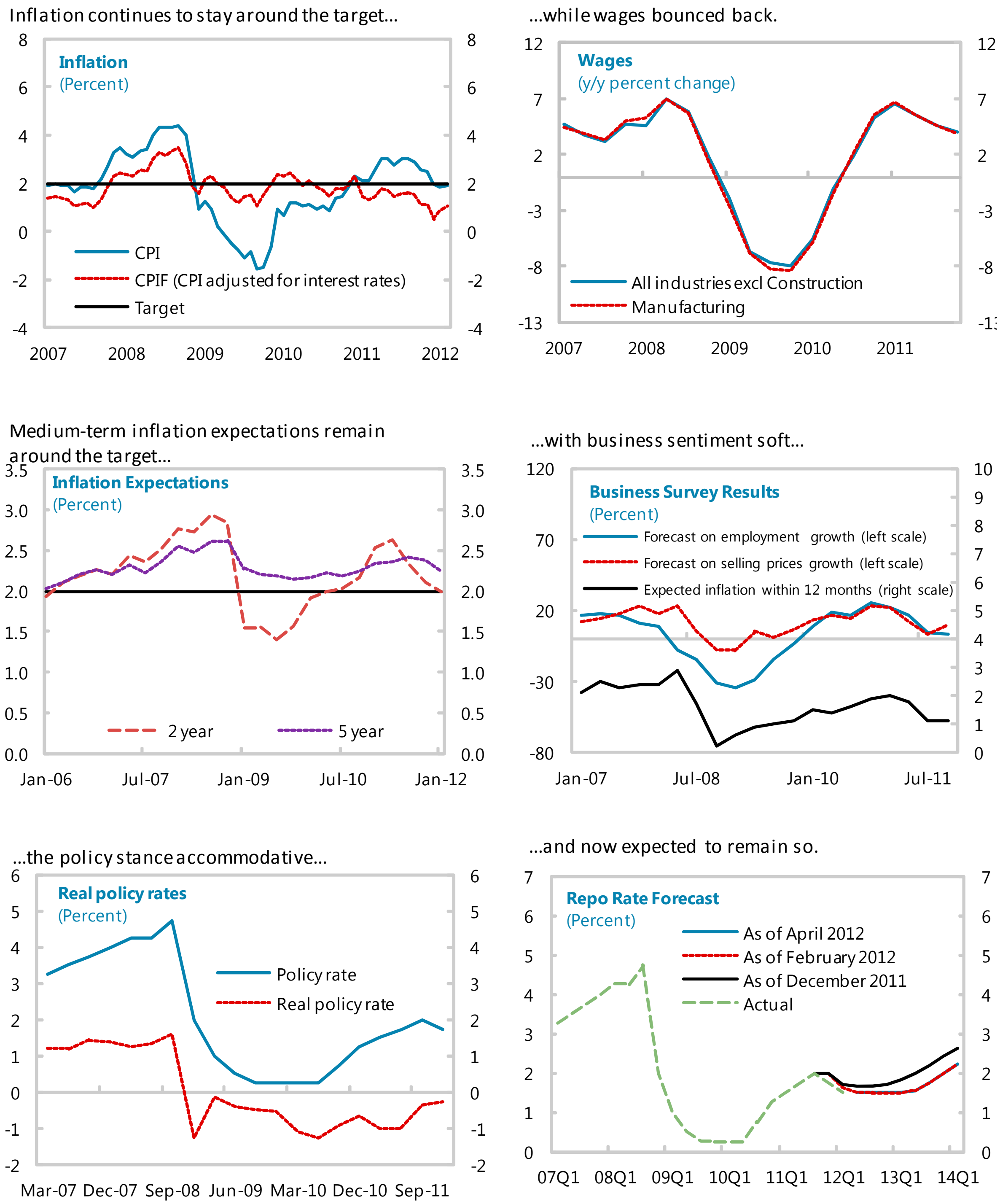


...as have risk premia in mortgage bond markets.



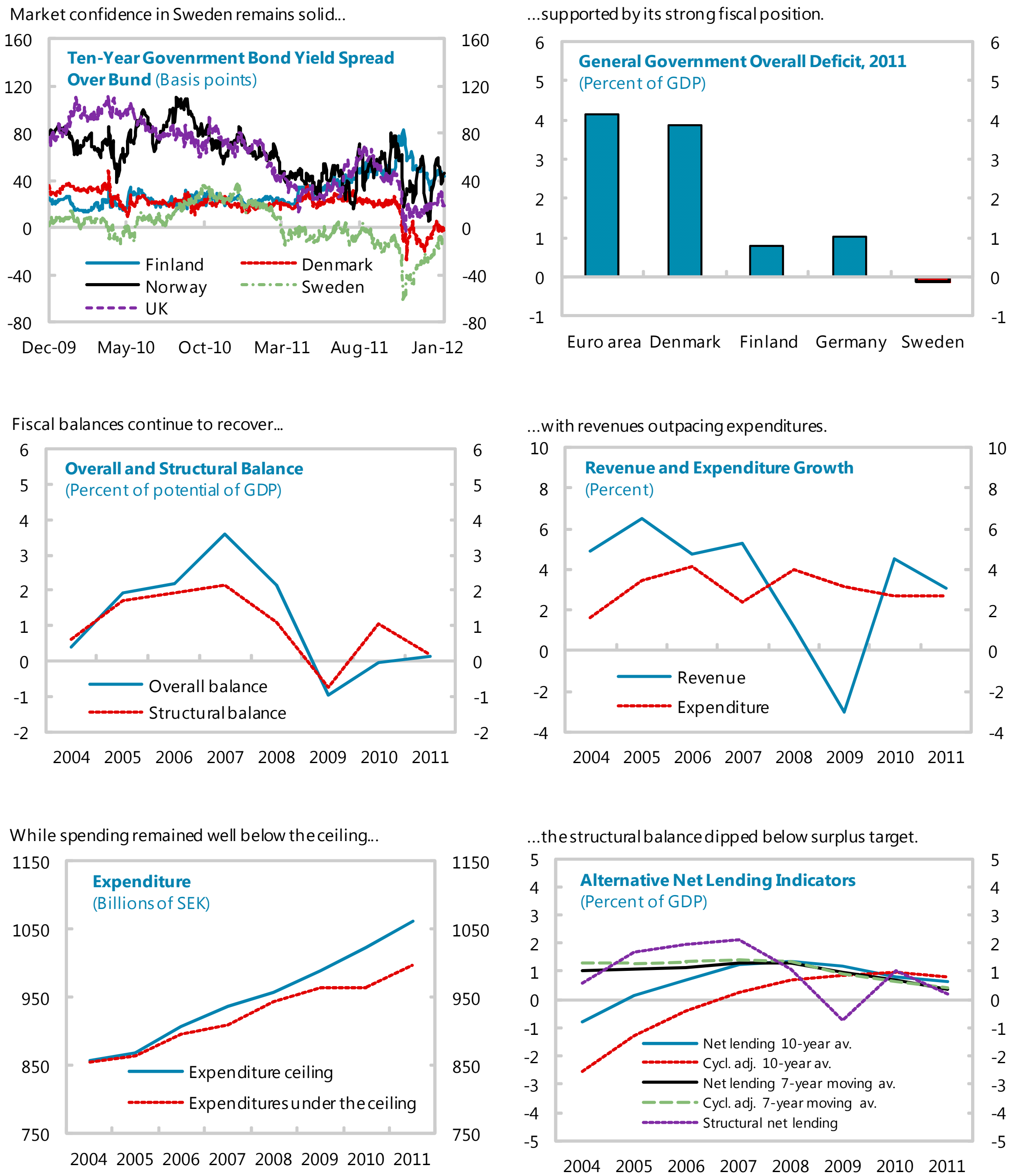
Sources: Haver Analytics, Thomson Reuters Datastream, and Fund staff calculations.

Figure 5. Sweden: Inflation and Monetary Policy, 2007–11



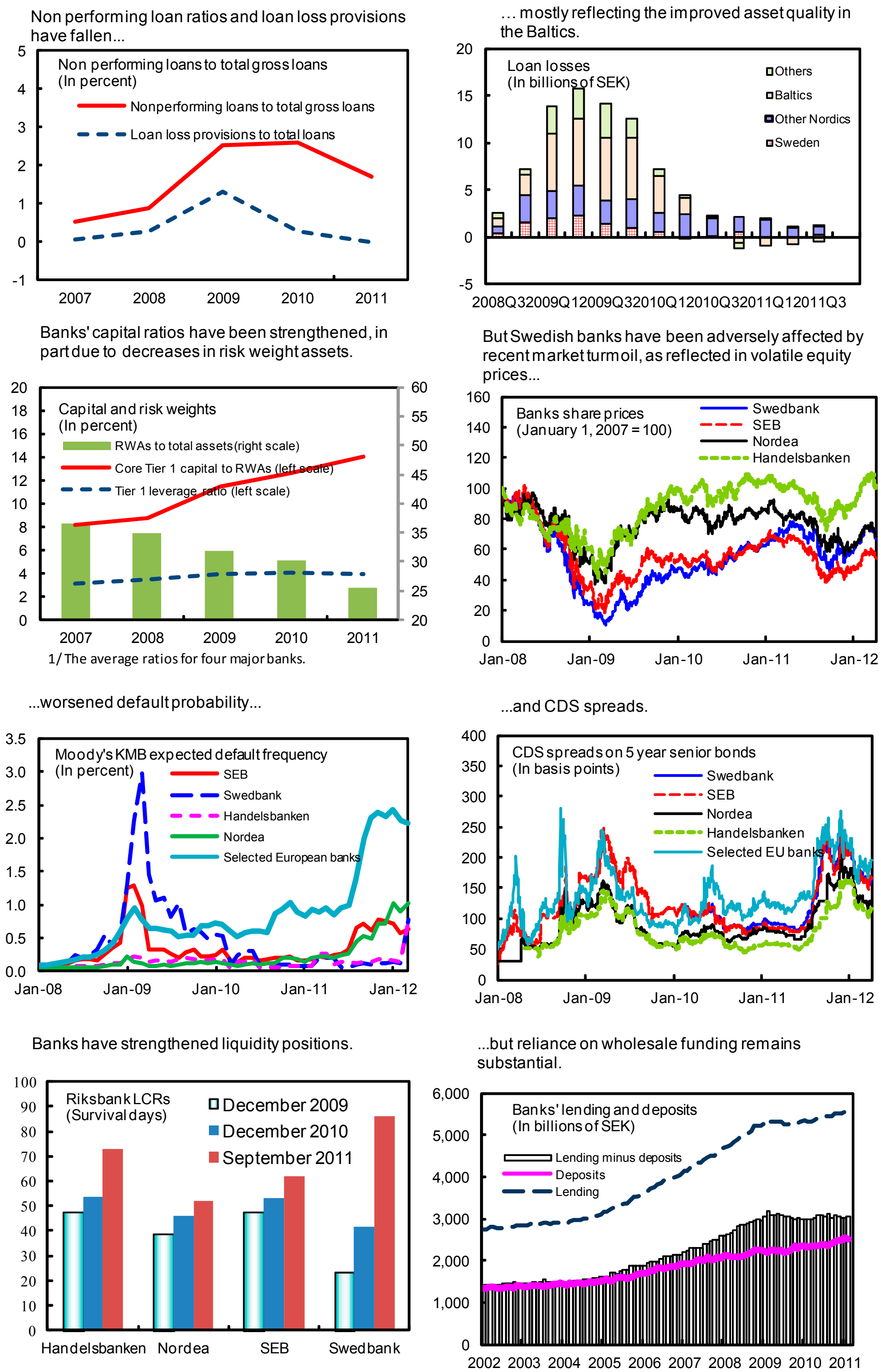
Sources: Bloomberg, LP, Haver Analytics, Riksbank, Thomson Reuters Datastream; and Fund staff calculations.

Figure 6. Sweden: Fiscal Developments



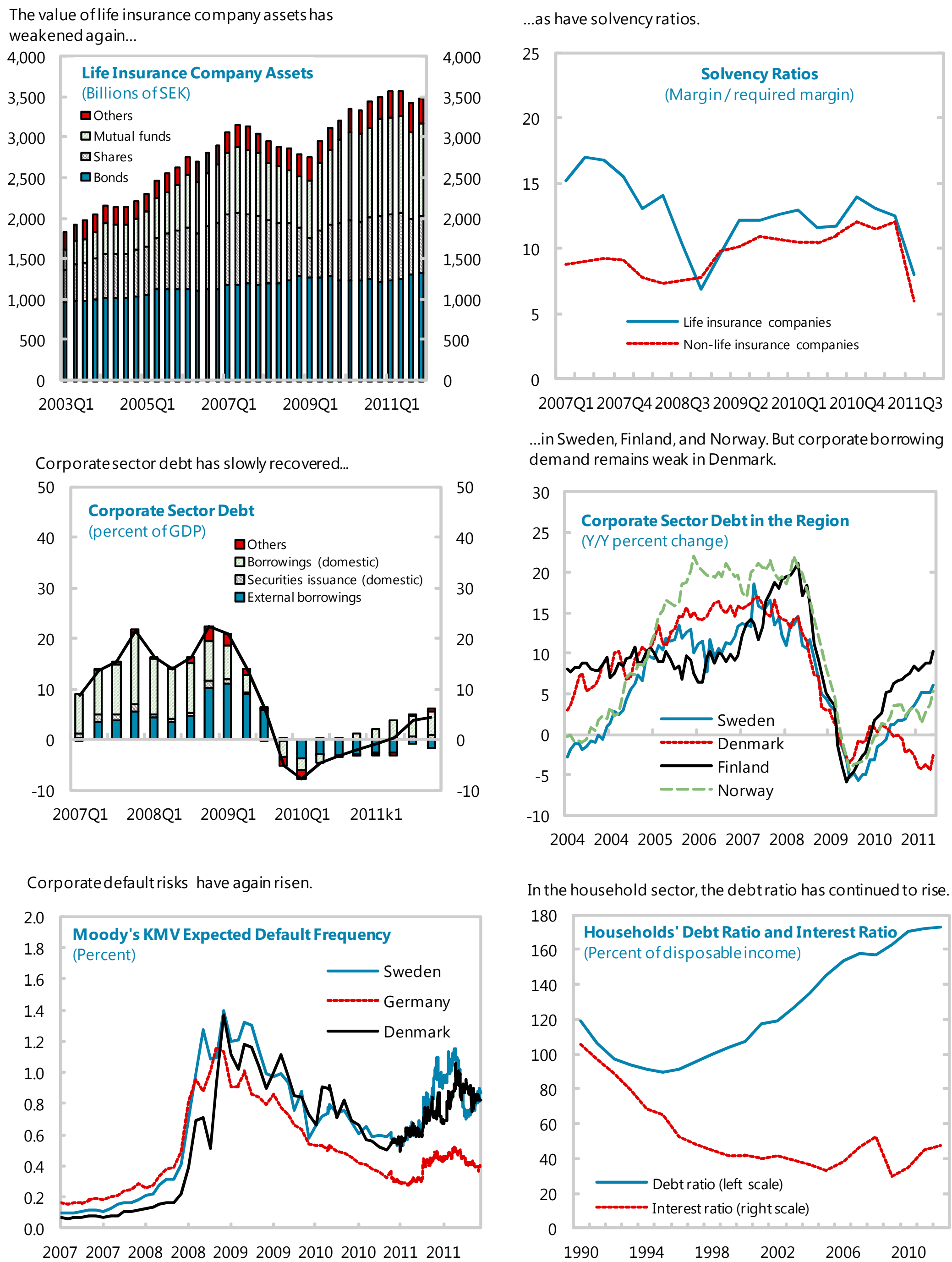
Sources: Bloomberg; IMF's World Economic Outlook database; and IMF staff calculations.

Figure 7. Performance of the Swedish Banking System, 2007—12



Sources: Thomson Financial/Data Stream; Bloomberg; Banks' Annual Reports; and WEO.

Figure 8. Sweden: Non Bank Financial Sector, 2007–12



Sources: Riksbank; Statistics Sweden; and Haver.

ANNEX I. SWEDEN: MEDIUM-TERM PUBLIC DEBT SUSTAINABILITY ANALYSIS

1. Sweden's fiscal position is expected to remain strong in the baseline scenario. As economic activity strengthens over the medium term, in line with an improvement in world growth, consumption and employment are expected to recover fully. This would improve tax collections, raising the revenue to GDP ratio, although still below the pre-crisis level due to the implementation of tax cuts in the interim. Expenditures to GDP would decline gradually over the medium-term, in part as a result of previous reforms. As a result, Sweden's overall balance would remain at a strong surplus of about 2½ percent of GDP over the medium term, bringing debt to GDP to 22 percent in 2017.

2. However, macroeconomic risks remain, emanating mainly from ongoing uncertainty regarding global growth and developments in the euro area. Sweden's exports depend critically on global demand for consumer durables, capital goods and inventories, and therefore are highly sensitive to global growth prospects. Continued strains in some euro area countries and banking systems, with potential spillovers to the core, could translate into significantly lower growth in Europe and the rest of the world, which would translate into weaker activity in Sweden and a deterioration of its fiscal position.

3. Standard scenarios show that debt in Sweden would continue on a downward trend even under less favorable conditions. Figure 1 illustrates a series of scenarios, including a permanent ½ standard-deviation shock to growth, interest rate and primary balance independently and a ¼ standard deviation shock to the three combined, a one-time 30 percent depreciation of the REER, and a one-time 10 percent of GDP shock to contingent liabilities. Under all scenarios, public debt remains on a downward trend and the increase in the level of debt compared to the baseline is moderate. Under the worst case scenario, based on a shock to growth, gross debt would reach 35 percent of GDP in 2017, which would still be below the 38.4 percent of GDP observed in 2011.

Annex I. Table. Sweden: Public Sector Debt Sustainability Framework, 2007-2017

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	40.2	38.8	42.6	39.4	38.4	**37.5**	**35.3**	**32.0**	**28.4**	**24.5**	**20.6**	**-0.3**
o/w foreign-currency denominated	3.2	2.5	5.0	4.7	3.4	3.4	3.2	2.9	2.5	2.2	1.8	
Change in public sector debt	-5.0	-1.4	3.8	-3.1	-1.0	-0.9	-2.2	-3.3	-3.7	-3.8	-4.0	
Identified debt-creating flows (4+7+12)	-6.4	-2.3	1.9	-3.0	-2.4	-0.9	-2.2	-3.3	-3.7	-3.8	-4.0	
Primary deficit	-5.3	-3.8	-0.2	-1.1	-1.3	-1.0	-1.8	-2.6	-3.0	-3.5	-3.6	
Revenue and grants	52.5	51.9	51.9	50.6	49.7	49.5	49.8	49.9	49.7	49.8	49.9	
Primary (noninterest) expenditure	47.2	48.0	51.6	49.5	48.4	48.5	48.0	47.3	46.7	46.4	46.3	
Automatic debt dynamics 2/	-1.1	1.5	2.1	-1.9	-1.1	0.1	-0.4	-0.7	-0.7	-0.4	-0.4	
Contribution from interest rate/growth differential 3/	-0.9	0.7	2.5	-1.8	-0.6	0.1	-0.4	-0.7	-0.7	-0.4	-0.4	
Of which contribution from real interest rate	0.6	0.4	0.5	0.6	0.9	0.5	0.4	0.4	0.2	0.3	0.2	
Of which contribution from real GDP growth	-1.5	0.3	2.0	-2.3	-1.5	-0.4	-0.8	-1.1	-0.9	-0.7	-0.6	
Contribution from exchange rate depreciation 4/	-0.2	0.9	-0.3	-0.2	-0.5	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	1.4	0.9	1.9	-0.1	1.4	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	76.6	74.8	82.0	78.0	77.3	75.7	70.9	64.3	57.1	49.2	41.2	
Gross financing need 6/	15.3	13.9	15.5	15.5	13.6	13.0	11.7	10.0	8.3	6.7	5.1	
in billions of U.S. dollars	70.6	67.7	62.9	71.7	73.0	69.3	65.5	59.0	51.5	43.2	34.6	
Scenario with key variables at their historical averages 7/						**37.5**	**35.0**	**32.5**	**30.0**	**27.5**	**25.0**	**-0.1**
Scenario with no policy change (constant primary balance) in 2012-2017						**37.5**	**36.0**	**34.3**	**32.6**	**31.1**	**29.7**	**-0.4**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.4	-0.8	-5.0	5.9	4.0	1.0	2.3	3.2	3.0	2.4	2.4	
Average nominal interest rate on public debt (in percent) 8/	4.1	4.2	3.1	2.8	3.2	3.1	3.2	3.2	2.8	3.1	2.9	
Average real interest rate (nominal rate minus change in GDP deflator, in	1.5	0.9	1.1	1.5	2.3	1.2	1.2	1.2	0.8	1.1	0.9	
Nominal appreciation (increase in US dollar value of local currency, in per	5.7	-19.3	12.6	4.0	11.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.6	3.3	2.0	1.3	0.9	1.9	2.0	2.0	2.0	2.0	2.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.4	1.0	2.2	1.5	1.6	1.3	1.3	1.6	1.6	1.7	2.2	
Primary deficit	-5.3	-3.8	-0.2	-1.1	-1.3	-1.0	-1.8	-2.6	-3.0	-3.5	-3.6	

1/ It covers gross debt of the general government

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

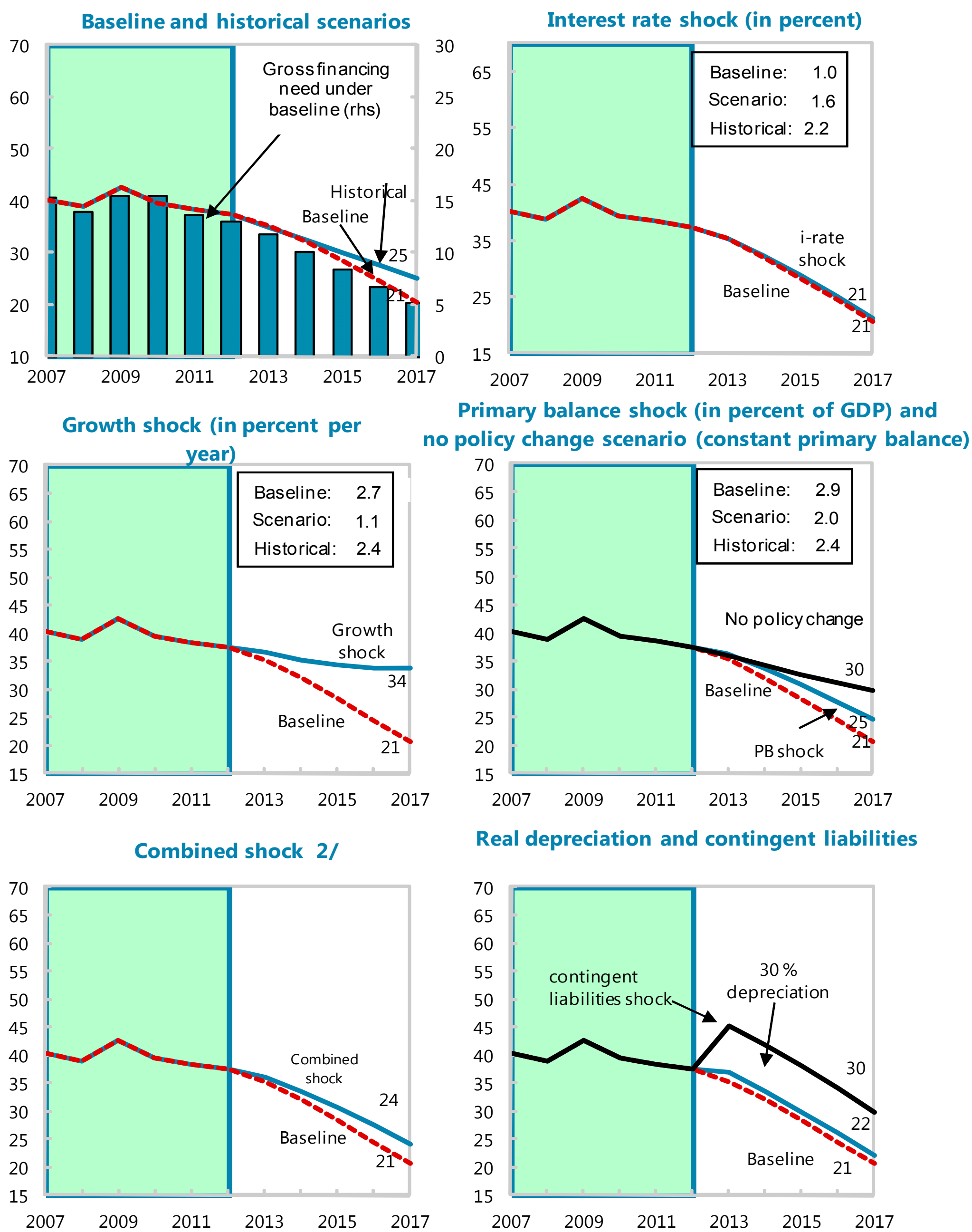
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Annex I. Figure. Sweden: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and IMF staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/2 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

SWEDEN

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 4, 2012

Prepared By European Department

CONTENTS

FUND RELATIONS

AS OF MAY 31, 2012

I. Membership Status: Joined: August 31, 1951; Article VIII

II. General Resources Account:

	SDR Million	Percent Quota
Quota	2,395.50	100.00
Fund holdings of currency (Exchange Rate)	1,671.90	69.79
Reserve Tranche Position	723.60	30.21
Lending to the Fund		
New Arrangements to Borrow	506.95	

III. SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	2,248.96	100.00
Holdings	2,181.31	96.99

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements: None

VI. Projected Payments to Fund[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.07	0.12	0.12	0.12	0.12
Total	0.07	0.12	0.12	0.12	0.12

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

VIII. 2012 Article IV Consultation: A staff team comprising P. Doyle (head, EUR), N. Batini, K. Ishi (all EUR) and Laura Jaramillo (FAD) visited Stockholm during May 3-14, 2012 to conduct the consultation discussions. Mr. Holmberg, Senior Advisor to Sweden's Executive Director, also attended the mission.

Outreach: The team met with the parliamentary Finance Committee, representatives of the private sector, the general labor union, representatives of the blue collar union, Swedish manufacturers, the Confederation of Swedish Enterprises, the four largest banks, think tanks, academics and the Fiscal Policy Council.

Press conference: The mission held a press conference in the Riksbank after the concluding meeting.

Publication: The staff report will be published.

Last Article IV Consultation: Discussions for the 2011 Article IV consultation were held in Stockholm on May 19-June 1, 2011 and the staff report was issued on July 8, 2011 (IMF Country Report 11/171). The consultation was concluded by the Executive Board on July 13, 2011.

Financial Sector Assessment Program Update: Discussions for the 2011 FSAP Update were held in Stockholm in March 9-22, 2011. The Financial Sector Stability Assessment report was published on July 13, 2011 (IMF Country Reports 11/172).

IX. Resident Representative: None

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 12/63
FOR IMMEDIATE RELEASE
June 27, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Sweden

On June 18, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sweden.[1]

Background

Sweden's recovery from the global crisis was swift reflecting its strong position at the onset of the crisis, a supportive macro policy response, a flexible exchange rate, and robust demand for its exports from Germany, Asia, especially China, and other emerging markets as well. As global demand recovered, Sweden grew just under 6 percent in 2010 and 4 percent in 2011. And reflecting the small negative output gap (estimated by staff at around ¾ percent for 2011), headline Consumer Price Index (CPI) has remained above the 2 percent target.

But, as elsewhere in the region and Advanced Europe, momentum has weakened. After growing by a cumulative 2.1 in the first three quarters of 2011, Sweden's GDP declined by 0.1 percentage points on average in the subsequent two quarters (comprising a contraction of 1.0 percent in Q4, and an expansion of 0.8 percent in Q1 2012).

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

And though the level of private consumption has not fallen, its growth remains lackluster despite resilient employment and incomes into the early part of 2012—in part reflecting that unemployment remains elevated relative to the immediate pre-crisis period. Excluding 2008–09, household confidence is at its lowest since 1996, while household credit growth has slowed by over 3 percentage points from a year earlier to 5½ percent. Declining wealth and a low confidence have led to further increases in household saving rates. At the same time, while both temporary and permanent employment increased in 2010, with permanent jobs numbers now significantly surpassing pre-crisis levels, job creation seems to have slowed.

Macroeconomic policies have been set to support growth. While the temporary fiscal stimulus measures adopted during the global financial crisis were phased out, including support to municipalities and county councils and investments in infrastructure and training, the underlying fiscal stance remained supportive—notably reflecting the tax reduction for pensioners in 2011—with staff calculations suggesting that the 2011 outcome fell short of the 1 percent structural surplus target by 0.8 percentage points. On the monetary policy side, faced with a benign inflation outlook and an appreciating krona, the Riksbank lowered the policy rate by 25 basis points both in December 2011 and February 2012, reflecting the deteriorating external environment.

The economic outlook remains clouded, and the risks to growth are tilted to the downside. On staff projections, real GDP growth is expected to drop from 4 percent in 2011 to 1 percent in 2012, then to rebound to 2 percent in 2013, broadly tracking projections for activity in Advanced Europe and somewhat more optimistic than the Riksbank's projection and consensus (both around ½ percentage point less, but based on information prior to the release of the Q1 2012 National Accounts). Key downside risks are a possible sharp resurgence of strains in the euro area; or/and a "lost decade" of growth there; and in either context, possible further oil supply shocks. In this context, international funding markets could also exhibit significant strains.

Executive Board Assessment

Executive Directors commended Sweden's sustained strong macroeconomic performance, which has been underpinned by prudent policies and effective institutions. Nonetheless, Directors noted that significant downside risks weigh on the near–term outlook, and lingering vulnerabilities call for adaptive policymaking and further structural and financial reforms.

They welcomed efforts to strengthen the macroprudential framework and financial sector oversight through tighter capital and liquidity requirements, and encouraged the authorities to further their cross border collaboration with regional banking regulators. More broadly, Directors underscored the importance of strengthening "Pillar 2" of the Basel supervisory framework, as well as bank resolution and crisis management arrangements. An accountable macroprudential authority with a clear stability mandate and decision making structure would also buttress macrofinancial stability.

They supported the planned modest relaxation of the fiscal stance this year in the context of rules targeting a structural fiscal surplus over the business cycle. They agreed that automatic stabilizers should be allowed to operate unimpeded as activity slows, but a number of Directors saw also scope for discretionary counter cyclical stimulus in 2013. Directors considered that better targeted tax and expenditure measures could make the planned medium term fiscal adjustment more “growth friendly,” and that the credibility of fiscal plans could be enhanced by greater authority of the Fiscal Policy Council.

They considered the monetary stance appropriately accommodative, given the benign inflation outlook and the slack in the economy. Nonetheless, they encouraged the authorities to adapt policy flexibly as the conjuncture evolves. In particular, the monetary stance may need to be adjusted rapidly if external risks materialize, or macroprudential policies may need to be tightened further once the housing market reflates. Most Directors agreed that expanding the communication strategy with the publication of projections based on market interest rates could further boost the credibility of the monetary and exchange rate frameworks.

They commended Sweden’s track record in implementing structural reforms to boost growth and employment. They welcomed efforts underway to improve the functioning of the labor market, in particular measures to increase the absorption of new entrants. Directors agreed that deregulation of the rental market could stimulate residential investment, reduce shortages, and improve employment prospects.

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 2012 Article IV Consultation with Sweden is also available.

Sweden: Selected Economic and Social Indicators, 2006-2013

Population: 9.4 million (2010) | Literacy rate: 99.0 Poverty rate: n.a.
Per capita GDP: 49,077 USD (2011) | Key export markets: Germany, Norway, United Kingdom
Main products and exports: Machinery, motor vehicles, paper products, pulp and wood

	2006	2007	2008	2009	2010	2011	Projections 2012	2013
Real economy (in percent change)								
Real GDP	4.6	3.4	-0.8	-5.0	5.9	4.0	1.0	2.3
Domestic Demand	3.9	4.7	-0.1	-4.3	5.7	3.5	0.5	1.7
CPI inflation	1.5	1.7	3.3	2.0	1.9	1.4	1.2	2.0
Unemployment rate (in percent)	7.0	6.1	6.2	8.3	8.4	7.5	7.5	7.7
Gross national saving (percent of GDP)	27.2	29.6	29.0	23.5	25.5	26.6	24.3	23.3
Gross domestic investment (percent of GDP)	18.7	20.3	20.2	16.5	18.6	19.6	17.2	15.7
Output Gap (as a percent of potential)	3.6	4.2	1.7	-4.9	-1.2	0.8	-0.4	-0.3
Public finance (in percent of GDP)								
Total Revenues	53.0	52.5	51.9	51.9	50.6	49.7	49.7	50.0
Total Expenditures	50.8	49.0	49.7	52.9	50.6	49.6	50.0	49.5
Net lending	1.8	3.1	1.9	-0.8	0.0	0.1	-0.3	0.5
Structural balance (as a percent of potential GDP)	1.7	2.0	1.0	-0.7	1.0	0.2	-0.4	0.4
General government gross debt, official statistics	37.1	35.0	34.6	36.8	36.6	37.3	37.6	37.1
Money and credit (12-month, percent change)								
M1	11.5	8.2	6.5	8.2	6.6	...	...	...
M3	15.0	18.5	3.6	-1.3	4.7	...	...	...
Credit to non-bank public	14.3	61.5	10.7	6.0	7.4	...	...	...
Interest rates (year average)								
Repo rate	3.0	4.0	2.0	0.3	1.3	...	...	...
Three-month treasury bill rate	2.3	3.5	3.8	0.4	0.5	...	...	...
Ten-year government bond yield	3.7	4.2	3.9	3.3	2.9	...	...	...
Balance of payments (in percent of GDP)								
Current account	8.4	9.2	8.8	7.0	6.9	7.0	7.1	7.6
Trade balance	7.8	7.2	6.6	6.5	6.0	6.2	8.2	8.4
Foreign Direct Investment, net	4.3	-16.2	7.9	-30.0	-30.1	-1.5	-8.3	-11.6
International reserves (in billions of US dollars)	26.0	29.8	36.2	44.0	45.9	53.1	51.3	51.4
Reserve cover (months of imports of goods and services)	2.0	1.8	1.7	3.0	3.3	2.9	2.9	2.9
Exchange rate (period average, unless otherwise stated)								
Exchange rate regime	Free Floating Exchange Rate							
Skr per U.S. dollar (June 9, 2012)	7.19							
Nominal effective rate (2000=100)	101.5	99.2	99.5	101.3	99.5	90.7	97.8	...
Real effective rate (2000=100) 1/	87.3	82.6	78.4	81.9	81.9	77.8	77.3	...
Fund Position (December 31, 2011)								
Holdings of currency (in percent of quota)	72.11							
Holdings of SDRs (in percent of allocation)	97.96							
Quota (in millions of SDRs)	2,395.5							

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

**Statement by Benny Anderson, Executive Director for Sweden
and Martin Holmberg, Advisor to the Executive Director
June 18, 2012**

The Swedish authorities would like to express their appreciation of staff's comprehensive and in-depth analysis on the Swedish economy conducted during the 2012 Article IV consultation. Overall, the authorities agree with the main findings presented in the report.

Short-term outlook and risks

The authorities broadly share staff's assessment of the economic developments in Sweden and internationally. After an unexpectedly large GDP fall at the end of 2011, there are some positive signs in the Swedish economy. GDP growth in the first quarter of 2012 amounted to 0.8 percent. Consumption and investment growth are expected to continue to rise in the coming periods, but at a somewhat lower rate than normal. The labor market is expected to weaken temporarily, and resource utilization is lower than normal. Underlying inflation is currently low as a result of low cost pressures in recent years. Inflation is projected to increase gradually to 2 percent in the next few years. The repo rate remains at 1.5 percent and the Riksbank's repo rate path indicates that it will remain at this low level for around a year.

The authorities agree with staff that considerable uncertainties about the outlook remain. The situation in the euro area is fragile and sovereign debt problems could worsen. This would also have a negative impact on the Swedish economy. In such a situation, the repo-rate path may need to be lowered. At the same time, confidence in economic developments could return sooner than expected among households, companies, and financial markets. This would lead to higher domestic demand and to higher inflationary pressures, calling for a higher repo-rate path.

Sweden's public finances are sound. The Government has emphasized that the sovereign debt crisis in Europe means that there is still a need for strong safety margins in public finances. Over the past year, the growth in household indebtedness has continued to dampen due to the slow-down in the housing market, the rise in mortgage rates, and the introduction of loan-to-value regulation. Household debt is now expected to increase at a moderate rate in the coming period, albeit still slightly faster than households' disposable incomes.

Financial Stability

The authorities concur with staff's assessment that the main risks to financial stability in Sweden lie in the developments in the euro area. The Swedish banks' direct exposures to the fiscally weak euro-area countries are small. However, given the banks' large usage of short-term wholesale funding, in particular in US dollars, the Swedish banks are vulnerable to market disruptions and liquidity risks. Financial stability could thus be affected from indirect channels should the sovereign debt crisis in the euro area worsen. At the same time, Swedish banks are currently well capitalized from an international perspective, giving them an adequate cushion if risks were to materialize. According to the recent Riksbank stress tests, Swedish banks would only suffer a limited decline in capital ratios should a severe recession scenario develop. Moreover, the Swedish authorities have accelerated the implementation of Basel III capital requirements, and proposed higher capital requirements on the four largest banks. While the accelerated implementation of higher capital requirements is warranted, further macroprudential measures should be sequenced in a way that takes due account of economic conditions.

The authorities are currently reviewing the capital adequacy requirement for mortgages in Sweden. This will probably lead to higher risk weights for Swedish mortgages, and consequently lower capital ratios, all else being equal. Nevertheless, the capital ratios are still expected to be adequate and meet the required levels.

The authorities will also build upon the Swedish experience of early implementation of enhanced liquidity reporting by introducing LCR in all currencies, in aggregate, as well as in euro and USD separately, by 2013. In addition, the Riksbank recommends banks to reduce their structural liquidity risks and approach the minimum level of NSFR as well as improve the transparency on comparable key figures for public reporting on liquidity risks.

The Pillar 2 mandate for the Swedish FSA (Finansinspektionen, FI) is expected to be widened through the introduction of CRR/CRD IV (article 99a). This will allow FI to require higher capital charges, not only for idiosyncratic risks but also for risks to the system, even if the preferred option is to do so through Pillar 1. FI is also in the process of developing a more transparent process for Pillar 2, where information will be publicly available.

The argument that high house price-to-income levels present downward pressure on house prices going forward, needs further backing. The fact that the ratio is above historical average does not in itself imply that there is a long-term equilibrium below current levels. The price-to-rent ratio may be inappropriate as a measure of house price fundamentals due to the rent control regulation in Sweden.

Regarding the suggestion to establish a formal macroprudential authority with a clear financial stability mandate, a set of authorized tools and accountability obligations, the Swedish authorities would like to note that an inquiry committee – the Government Investigation on Financial Crisis Prevention and Management Issues – is currently looking into these issues. Regarding the suggestion to consider regional perspectives, the authorities would like to note that this is well in line with the cooperation within the Nordic-Baltic Macroprudential Group that has been further developed during the recent financial crisis.

Recently, a process to enhance cross-border cooperation has been started. Specifically, in accordance with the FSB agenda, the work on a cross-border cooperation agreement on crisis management for Nordea, the only Swedish G-SIFI, has been initiated, involving the relevant authorities in Denmark, Finland, Norway, Sweden, Estonia, Latvia, Lithuania, and Poland. Cross-border cooperation is likely to be enhanced further and extended to other financial institutions with the implementation of the forthcoming EU Directive on recovery and resolution of credit institutions and investment firms.

Fiscal Policy and Framework

The authorities broadly agree with staff's view of the Swedish fiscal position and the fiscal policy stance, even if our assessment of the structural saving ratio is somewhat higher at present. As is pointed out by staff, Sweden's fiscal position is strong which makes it possible to continue to support output in the short term without jeopardizing long-run sustainability or the ability to respond properly, should a downside external risk materialize. Sound public finances are also a corner stone in the work to achieve full employment and greater welfare.

The authorities welcome staff's opinion on the importance of retaining appropriately large fiscal buffers. By following a responsible policy where the surplus target is maintained and the expenditure ceiling is not exceeded, at the same time as automatic stabilizers are allowed to work freely, economic growth is supported and a basis created which will enable Sweden to meet future challenges from a strong position. As staff rightly points out, there is still considerable risk of new waves of international economic and financial unrest. Maintaining adequate safety margins in the public finances in order to have sufficient resources to manage a possible intensified crisis is a priority in Swedish fiscal policy making.

According to the Government's assessment, some scope for reform will likely emerge in 2013, and this will be compatible with a mildly supportive fiscal stance. Future reform efforts will primarily focus on structurally warranted measures that will strengthen Sweden's long-term growth prospects by increasing employment, decreasing unemployment and improving the functioning of the economy. However, as staff points out, a number of risks remain which, if realized, may affect the economy negatively. Any reform ambition is therefore conditional on a sustainable scope for new measures.

The authorities also agree with staff on the importance of a tax system which supports employment and growth. Full employment is a prerequisite for Sweden to remain a competitive country with long-term sustainable growth. Continuing to make jobs a priority in designing policy is of the utmost importance to the Government. To this end, a number of measures have been taken in the last few years, such as the introduction of an in-work tax credit and a reduction in social security contributions for young people. As staff points out, the Government views the reduction of the rate of VAT on restaurants as a way to increase the opportunities of young workers entering the labor market. This reform will be closely evaluated both from a tax and an employment perspective. So far it has shown promising effects on both prices and sales in the restaurant sector.

In line with staff recommendation, a proposal to reduce the risk for pro-cyclicality in local governments' finances was recently presented. The proposal means that local governments will be allowed to build balancing reserves, which makes it possible to use a portion of their surplus from good times to cover deficits incurred as a result of a recession.

Monetary Policy and Framework

The authorities welcome staff's assessment that the monetary and exchange rate framework remain credible. In the discussion of the monetary policy framework, staff notes the recent deviation of the interest expectations embedded in some asset prices from the Riksbank's published interest path, arguing that this deviation could eventually impair the monetary transmission mechanism and potentially undermine credibility. We note that measuring markets' interest rate expectations is difficult and any estimate imprecise and uncertain, especially in times of turbulence in asset markets. Inflation expectations, nevertheless, remain firmly anchored at around 2 percent and against that background, the difference between expectations estimated from asset prices and the Riksbank's published path is not viewed as harming credibility. The Riksbank endeavors to ensure that its communication is open, factual, comprehensible and up-to-date. This makes it easier for economic agents to make sound economic decisions. It also makes it easier to evaluate monetary policy. In this context, publishing the interest rate path has served as an effective communication tool.

Staff raises the issue of asset prices and financial stability in monetary policy decisions. In connection with every monetary policy decision, the Executive Board of the Riksbank makes an assessment of the repo-rate path needed for monetary policy to be well-balanced. A well-balanced monetary policy is normally a question of finding an appropriate balance between stabilizing inflation around the inflation target and stabilizing the real economy. According to the *Sveriges Riksbank Act*, the Riksbank's tasks also include promoting a safe and efficient payment system. Risks linked to developments in the financial markets are taken into account in the repo rate decisions. With regard to preventing an imbalance in asset prices and indebtedness, the most important factors, however, are effective regulation and supervision. Monetary policy only acts as a complement to these. In this context, the authorities look forward to the recommendations of the above-mentioned Government Investigation on Financial Crisis Prevention and Management Issues. However, regardless of the outcome of this investigation, it seems unlikely that monetary policy will not have a role in addressing financial stability issues going forward.

Staff proposes that the Riksbank should raise its research efforts in the area of equilibrium unemployment. Continued and enhanced analysis will be conducted as part of the regular analysis.

Structural Reform Policy

The authorities agree with staff that the structural reforms undertaken have boosted trend growth and employment. Staff also highlights some areas of concern, for example targeting of reforms towards groups with weak attachment to the labor market. The Government argues that broad and general reforms that increase incentives to work is the most effective way to improve labor market outcomes, including for groups with weak attachment to the labor market. But there are also extensive reforms undertaken directed towards vulnerable groups (including for example youth, immigrants, disabled and long-term unemployed). Hence, the general remark in the staff report concerning bad targeting seems somewhat misplaced. In general, there is a trade-off between simplicity and being able to pinpoint the most problematic groups. It is the Government's view that the reduction in pay-roll taxes for youth increases employment among this group.

In line with empirical evidence concerning active labor market policies (ALMPs), the Government has focused on job-search early in the unemployment spell, with access to training, education and subsidized jobs when necessary to enhance employment probabilities. Recently, a profiling system has been put in place which aims to identify those individuals who are in need of training early in the unemployment spell. It is the Government's view that active labor market programs are organized in an effective way. During the crisis, and also recently, extra funds were allocated to maintain quality and effectiveness in the setup of ALMPs.

Housing Policy

The Government has in the Spring Budget for 2012 announced changes in the sub-let market for owner occupied dwellings. This is expected to both increase the volume of rental apartments, and the flexibility in the housing market, thus improving the situation in large cities and fast growing regions where demand for housing is strong.

Also in the Spring Budget for 2012, the Government announced measures that are expected to increase the housing production. These include a prolongation of the time when rental apartments cannot be subject to a review of the rent in the "Rent and Tenancies Tribunal", and an exemption from real estate tax for newly built houses during the first 15 years. There are also two ongoing investigations that look at the municipal land designation policy in order to improve the availability of land for housing. We note that the average number of persons in each apartment in Sweden is about 2.1 (slightly higher in for example Stockholm), which is quite low compared to the situation in peer economies.