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SWEDEN

September 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

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 2013 Article IV consultation with Sweden, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 31, 2013, 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 July 26, 2013. 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.
- **Press Release** summarizing the views of the Executive Board as expressed during its August 30, 2013 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 2013 ARTICLE IV CONSULTATION

July 26, 2013

KEY ISSUES

After leading much of Europe in the recovery from the crisis, Sweden's economy is slowing together with its main Nordic and European trading partners. The outlook is for a sluggish return to moderate growth, but there are sizable downside risks compounded by financial fragilities. Notwithstanding ambitious financial reforms, Sweden's large banking system remains a potential vulnerability, and household debt is high and still rising.

The priorities are supporting growth and buttressing financial stability.

- In the short term, **monetary and fiscal policy support** should continue to support the recovery, and there is room for additional stimuli if downside risks materialized.
- However, Sweden's main challenge is to further **strengthen financial stability**. This requires additional steady improvements of banks' funding and liquidity positions, and—over the medium term—addressing high household debt and accelerating mortgage amortization.
- Given the importance of Swedish banks for the region, improving financial stability in Sweden would also contribute to **financial stability across the Nordics**, as would additional progress toward cross-border burden-sharing agreements.

There is scope to improve the fiscal framework, by ensuring it remains sufficiently countercyclical and introducing an explicit long-term anchor to safeguard a prudent borrowing capacity adequate for countries with large financial sectors such as Sweden.

Structural reforms would add to resilience and growth. To strengthen the impact of recent reforms on employment, it will be important to improve the matching between workers and vacancies, in particular for vulnerable groups. Additional steps to reduce housing market rigidities will open bottlenecks for re-location and support growth.

The Article IV discussions were coordinated with the Nordic Regional Report discussions; the latter covers cross-border financial sector issues in the region and house prices and household debt in a cross-country context.

Approved By
Mahmood Pradhan (EUR) and Ranil Salgado (SPR)

Discussions took place in Stockholm May 20–31, 2013. The staff comprised of Mr. Berger (head), Mr. Agarwal and Ms. Batini (all EUR) and Mr. Cerutti (RES). Mr. de Imus (SPR) joined the mission for one day. Ms. Meyersson, Alternate Executive Director, (OEDSWE) attended for the duration of the mission. Ms. Christiansen and Mr. Dowling (both EUR) provided support from headquarters.

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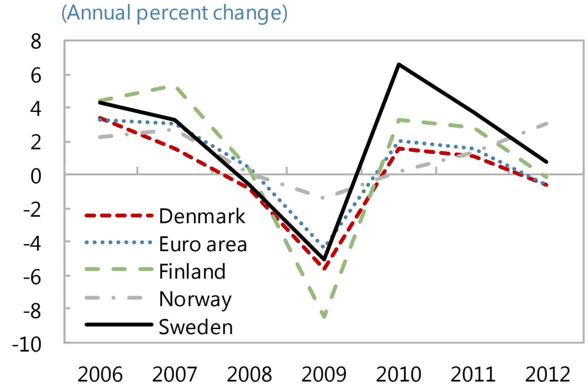
RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Economic Developments

1. After a strong recovery from the crisis, growth has moderated. Following two years of robust economic performance ahead of most of Europe, Swedish growth decelerated in 2012, dropping to 0.7 percent (from 3.7 in 2011 and 6.6 in 2010) (Table 1). There are indications that the downward momentum might have halted, but the overall growth trend has been one of moderation. To a large degree, this reflects Sweden's openness and tight trade and financial links with the rest of the Nordic region and the euro area. Exports declined as economic activity cooled abroad, and continued uncertainty about developments in the euro area contributed to weakening domestic investment. While housing credit continued to expand, pushing household debt to around 170 percent of disposable income, it did little to support aggregate demand, and a small negative output gap opened up again (see Chapter I of Selected Issues).

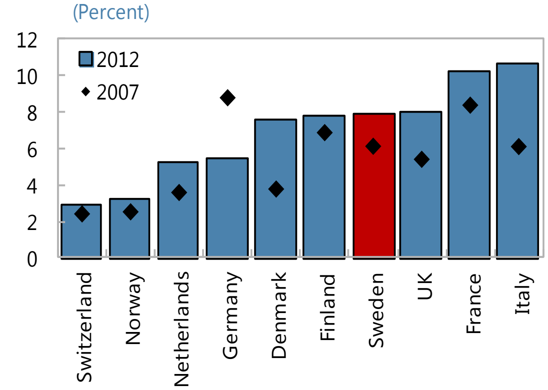
Real GDP Growth
(Annual percent change)



Sources: IMF World Economic Outlook and Fund staff calculations.

2. Unemployment remains elevated. The unemployment rate reached 8 percent, on average, in 2012—above the rates seen in many of Sweden's peers—and rose further early in the year before declining back to just below 8 percent in May (in seasonally adjusted terms). The increase during the crisis was largely driven by job losses among the young, immigrants, and the disabled, though about 2 percentage points of the overall unemployment rate is accounted for by full-time students seeking employment. And while the labor market reforms since 2007 continue to have a positive effect on labor force growth, the employment rate remained largely unchanged in 2012. With the output gap significantly smaller than at the height of the Great Recession, a large share of the unemployment rate is likely structural, consistent with the National Institute of Economic Research's estimate of close to 7 percent in 2012 and 2013 (also see chapter I of Selected Issues).[1]

International Unemployment Rates
(Percent)



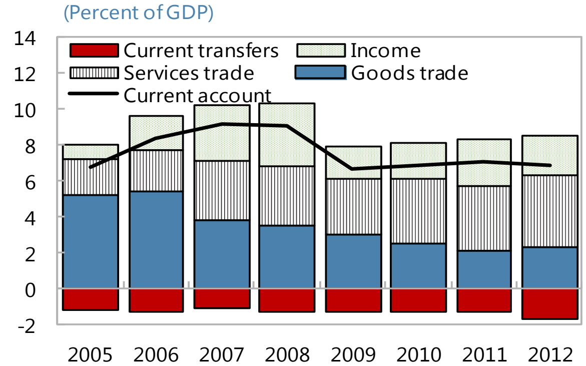
Sources: Eurostat, Haver Analytics, and Fund staff calculations.

[1] National Institute of Economic Research, 2013, "*The Swedish Economy,*" Summary, March.

3. The krona continued to appreciate. Notwithstanding the economic slowdown, the krona reached a ten-year high in nominal effective terms in early 2013, as Sweden remained attractive to international investors. Foreign demand also contributed to low yields for Swedish sovereign and covered mortgage bonds. While it lost some of its more recent gains at the time of the "tapering" discussion in June, the krona still trades about 5 percent above its pre-crisis levels against the euro. In real effective terms, the currency still stands between 3½ and 8½ percent below levels suggested by medium-term fundamentals and export shares have not deviated markedly from trends (see Box 1).

4. The external balance remains in surplus. At around 7 percent, the current account remains strongly positive, but has come down from its pre-crisis peak of above 9 percent in 2007–08. The smaller surplus reflects weakening global demand, with the value of goods exports declining 3 percent in 2012. Net capital inflows into portfolio investment in government and corporate securities balanced large but falling net outflows through FDI and other investments. This shift seems to reflect ongoing uncertainty about Europe, strong confidence in Sweden's macroeconomic policies, and ample global liquidity (Figure 1, Tables 2 and 3).

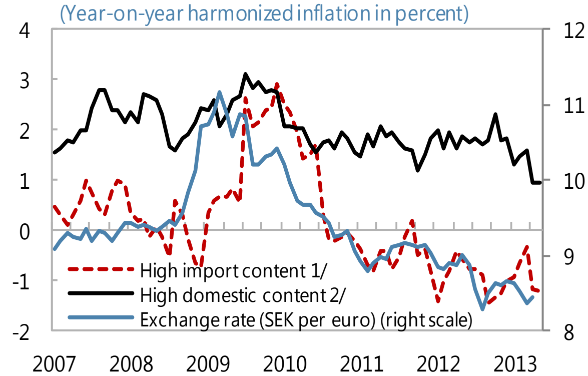
Balance on the Current Account
(Percent of GDP)



Sources: Haver Analytics, the Riksbank, and Fund staff calculations.

5. Inflation has declined, but largely due to external factors. Consumer price inflation has eased markedly, reaching -0.2 percent (year-on-year) in May 2013. This was driven, to a large degree, by the strengthening of the krona, which added to lower energy price and falling imported inflation. Declining household mortgage rates created further downward pressure. Measures of underlying inflation at a constant interest rate dropped to an all-time low in April 2013.[2] In contrast, measures of domestic inflation (e.g., services and processed food) and hourly labor cost growth remained firmly in positive territory at around 0.6 and 2.5 percent, in May and March respectively, likely reflecting the small size of the output gap and the credibility of the Riksbank's inflation target of 2 percent (Figure 2).

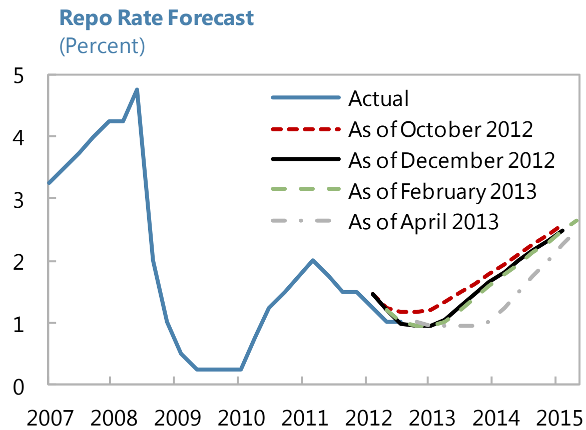
Inflation and the Exchange Rate
(Year-on-year harmonized inflation in percent)



Sources: Eurostat, Haver Analytics, Statistics Sweden, and Fund staff calculations. 1/ Non-energy industrial goods inflation. 2/ Services inflation.

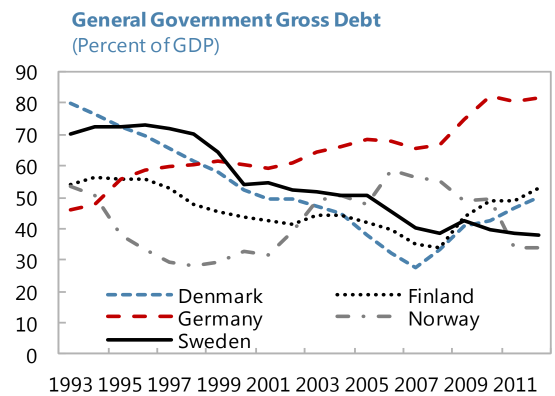
[2] The consumer price index at constant interest rates is the Riksbank's preferred indicator of underlying inflation.

6. Monetary policy remained accommodative. As the domestic outlook for 2012–13 deteriorated in tandem with the global economy, the Riksbank appropriately lowered the policy rate by 100 basis points since December 2011, with the most recent cut in December 2012. The Riksbank's latest interest rate forecast signals no tightening before the second half of 2014—broadly in line with market expectations. Also, interest rates for borrowers, an important indicator of the overall stance, are slightly below their medium-term averages.



Sources: Haver Analytics, the Riksbank, and Fund staff calculations.

7. Fiscal policy further supported growth. Fiscal policy reacted to counter the deteriorating outlook, with the structural balance dropping from -0.8 percent of GDP in 2012 to -1.4 percent of GDP in 2013, with automatic stabilizers fully at work. The 2013 Budget Bill (issued in September 2012 and with measures largely reaffirmed in spirit and scope in the April 2013 Spring Bill—see Box 2) added another slight expansion, including from a large corporate tax cut as well as infrastructure investment and labor market measures to tackle youth unemployment. At 38 percent of GDP at end-2012, public debt remains low (Figure 3, Tables 4 and 5).



Sources: IMF World Economic Outlook and Fund staff calculations.

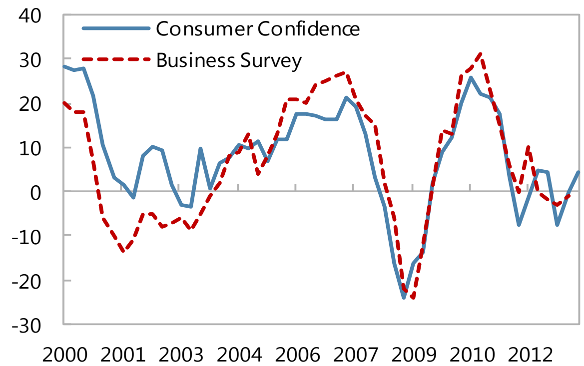
8. Financial policy reforms continued. In line with staff's primary recommendations in the past, including from the 2011 FSAP Update (see Annex I), the authorities have continued to pursue an ambitious agenda of improving banking system health. This has included increasing capital and liquidity buffers and introducing Loan-to-Value (LTV) caps and a risk-weight floor for mortgages. While these efforts have had some traction and have in many cases been implemented well in advance of the Basel III time table, the recent improvements in bank capitalization were largely driven by a reduction in risk-weighted assets, with bank leverage remaining stable. Also, credit to households continues to expand faster than disposable income, with mortgage amortization low by international standards. For example, the average Swedish mortgage amortizes over a period of more than 140 years.[3]

[3] The average is for mortgages with an LTV below 75 percent and positive amortization.

B. Outlook and Risks

9. The near-term outlook points to a gradual recovery. Despite accommodative fiscal and monetary conditions, the outlook under the baseline is only for a marginal improvement in growth to 1.1 percent in 2013. But activity should gather speed by 2014, with growth averaging 2.3 percent for the year. This assumes that net-exports will profit from a gradual recovery of the global economy and that fixed investment will pick up as the uncertainty associated with the euro area crisis slowly recedes. However, unemployment is expected to decline only gradually, reflecting the lingering impact of the 2009 crisis and the time required for recent reforms to translate into employment gains. Inflation will remain below 1 percent in 2013, but pick up again in 2014, along with the economic recovery and the closing output gap.

Confidence Surveys
(Percent balance)



Sources: NIER and Fund staff calculations.

10. Downside risks are compounded by financial fragilities and regional spillovers. While growth could surprise on the upside, domestic downside risks and vulnerabilities remain sizeable, especially in the banking and household sectors—a risk highlighted repeatedly by the Riksbank. Mirroring Sweden's tight regional trade and financial links, external risks relate mainly to developments in the other continental Nordic countries (Finland, Denmark, and Norway) and the euro area (see also Table 6 with the Risk Assessment Matrix).

- *Domestic risks*. The factors driving high household debt remain in place, including continuing easy access to low-amortization mortgages, very low interest rates, strong tax preferences for housing assets, and still elevated property prices (see Box 3).[4] As a consequence, a sudden and sizeable fall in house prices could have a flow-on effect to consumption—especially if it occurred against a background of normalizing interest rates from their current very low levels in Sweden and internationally in the medium term—raising unemployment and lowering inflation further. This would translate into pressure on banks by pushing up non-performing loans and bank funding costs (see Chapter III of Selected Issues). Given the extensive activities of Swedish banks in Denmark, Finland, and Norway, such a scenario would also have spillovers across the Nordic region.

- *External risks*. The Nordic exposure of the Swedish banking sector also implies that a sudden deterioration of household financial health elsewhere in the region poses a risk, with possible adverse regional feedback loops (see Box 4, the 2013 Nordic Regional Report (NRR), and Chapter II of Selected Issues). However, euro area spillovers are still the primary concern.

[4] House prices and household balance sheets are considered in a cross-country context in the Nordic Regional Report. See International Monetary Fund, 2013, "*Nordic Regional Report*."

Critically, a sudden and severe re-intensification of the crisis could impact banks, with potentially systemic implications in Sweden and across the Nordics. Under less extreme circumstances, a longer-than-expected continuation of euro area tensions could generate further krona appreciation and make it difficult to adjust interest rates once the recovery takes hold. Conversely, an excessive reversal of safe-haven flows beyond a normalization of market conditions—while a lower-probability event—might lead to a premature tightening of financial conditions, which could exacerbate the domestic and Nordic risk scenarios.

The Authorities' Views

11. The authorities broadly agreed with staff on the outlook and balance of risks. Given the weak external environment, they expect domestic demand to play a larger role than in past recoveries. They view the main risks to the economy as linked to external developments, including disruptions to European financial markets and the threat of sharper-than-expected fiscal contraction in the United States. At home, a main concern is a sudden slowdown in household consumption as they attempt to deleverage their stretched balance sheets. The situation could become particularly problematic in the case of a major house-price correction, although the authorities were not overly concerned about this as a stand-alone risk in the short term.

POLICY AGENDA

12. Sweden's challenge is to sustain economic activity while continuing to bolster resilience against downside shocks:

- *Short-term policy support remains important.* With a clouded growth outlook, a continuation of the current macroeconomic policy mix would helpfully support growth this year. And there would be room for additional monetary and fiscal stimulus if downside risks materialized and growth and inflation fell significantly below the baseline projections.
- *Further strengthening of financial stability is key.* Notwithstanding recent progress, Sweden's large banking system remains a potential vulnerability, especially since household debt is high and still increasing. Further gradual reforms addressing both areas would not only help minimize financial fragilities, they would also lower the need for fiscal buffers and allow monetary policy to pursue its inflation target with fewer concerns about financial stability.
- *There is scope to explore improvements in the fiscal framework*, by ensuring it remains sufficiently countercyclical and introducing an explicit long-term anchor to safeguard fiscal buffers, not least to retain a prudent borrowing capacity adequate for a country with such a large financial sector.
- *Finally, structural reforms would add to resilience*. To strengthen the impact of recent reforms on employment, it will be important to further improve the matching process between workers at high risk of unemployment and available vacancies. Additional steps to make the supply of housing more responsive to demand will aid this process and boost longer-term growth.

A. Sustaining Short-Term Growth

13. Fiscal policy should remain supportive. The government has made supporting the recovery a policy priority. The moderately expansionary fiscal stance in 2013 (see Box 2), followed by a planned period of gradual consolidation starting in 2014, is appropriate under staff's baseline. While the resulting worsening of the deficit means that the budget balance will stay below the government's 1 percent surplus target over the cycle for now, the fiscal framework is geared towards improvements in the balance in the medium-term. The authorities plan for revenues to remain largely unchanged as a percentage of GDP. In combination with the 4-year nominal expenditure ceilings in place, this will, on staff's numbers, take the structural balance from -1.4 percent of GDP in 2013 to -0.8 percent of GDP in 2014, and improve it to 1.1 percent of GDP by 2017.

14. The accommodative monetary policy stance should continue. As inflation is expected to remain well below the target during the policy horizon, the Riksbank has reason to maintain an expansionary policy stance until the recovery is firmly on track, assuming household credit growth remains contained.

15. There would be room to react if growth disappoints. The Riksbank could quickly reduce interest rates further, as well as signal its intention to keep rates at low levels for an extended period. Likewise, Sweden's modest public debt gives the authorities room to delay their planned return to surplus. In the event of a more extreme scenario, non-standard monetary policy measures—including quantitative and qualitative easing to support growth and deal with impaired markets (e.g., through the purchase of sovereign and private bonds)—could complement substantial discretionary fiscal stimulus. Simulations produced for the NRR indicate that, if a large external growth shock hit the Nordic region as a whole, there might be significant gains for Sweden from coordinating its fiscal reaction with other Nordic countries given the region's strong trade and financial links.

The Authorities' Views

16. The Riksbank stressed that monetary policy will remain accommodative. With inflation projected to return only gradually back to target, the official policy rate was not expected to increase before the third quarter of 2014. Any further cut would have to account for the evolution of household debt, given that ongoing credit growth was likely spurred, at least in part, by the easing of monetary conditions since the onset of the global financial crisis.

17. Fiscal policy will continue to be framed around the medium-term surplus target. The authorities suggested that the modest stimulus in 2013 strikes the right balance between the need to support growth and, thus, preventing unemployment from becoming entrenched at already high levels—with the Ministry of Finance estimating higher spare capacity than staff—and returning to surplus. In case of a major adverse shock, there would be fiscal space to respond. However, returning to surplus and maintaining fiscal discipline is important for sustaining investor confidence in the strength of Sweden's public finances, also given its potentially large contingent liabilities from the financial sector.

B. Safeguarding Financial Stability

18. The banking system is large, highly concentrated, and regionally interconnected. With bank assets above 400 percent of GDP, Sweden's banks are among the largest in the world relative to the size of the economy. About 85 percent of these assets are on the balance sheet of four major banks alone, which mostly lend across the Nordic region. More than 80 percent of the credit extended by these four banks goes to households and firms in Denmark, Finland, Norway, and Sweden. In contrast, with a credit share of just about 4 percent, the Baltic region plays a much smaller role (see chapter II of Selected Issues).

19. Banks are well-capitalized. Swedish banks' core Tier I capital buffers are among the highest in Europe, with the core Tier I capital ratio increasing to 15 percent as of December 2012. This has been driven by a reduction in risk-weighted assets—due to a decrease in the proportion of corporate loans in favor of mortgages, a decline in lending to the Baltic countries, and the fact that a larger proportion of assets are now classified on the basis of banks' own internal models—and increases in retained earnings in a context of high profits. The major banks' return on equity is over 12 percent. While leverage ratios are stable and similar to those elsewhere in Europe, access to international capital markets has remained secure and at rates close to or even lower than core European banking systems. In contrast with the early phase of the financial crisis, when Swedish banks faced some difficulties accessing foreign markets, the euro area crisis has had little impact. On the contrary, Swedish banks have profited from a "safe-haven" bonus and lower CDS spreads than many other European banks (Figures 4 and 5, Tables 7–9).

20. But banks are also highly dependent on wholesale funding. With a loan-to-deposit ratio of about 200 percent, about one third of total bank funding depends on wholesale activities, most of which are conducted in foreign currency. Wholesale funding comes, in about equal shares, from long-term covered and senior unsecured bonds on the one hand, and short term wholesale financing on the other. About half of the long-term and almost all of the short-term market funding is conducted in euro and US dollar—in all, about 55 percent of GDP. The improvement of banks' net stable funding ratio (NSFR) after the financial crisis has mostly come to a halt at just above 80 percent, on average, for the major Swedish banks.

21. Long-standing structural issues create vulnerabilities. The May 2013 Riksbank stress tests suggest that major banks can absorb direct loan losses triggered by large macroeconomic shocks. This resilience stems from banks' strong earnings as well as past low default and loss-given-default rates. However, in a context of historically high household debt and elevated house prices, household rebalancing would affect banks also indirectly through the impact of falling consumption.[5] Furthermore, the wholesale dependence of Sweden's banks—whose evolution has

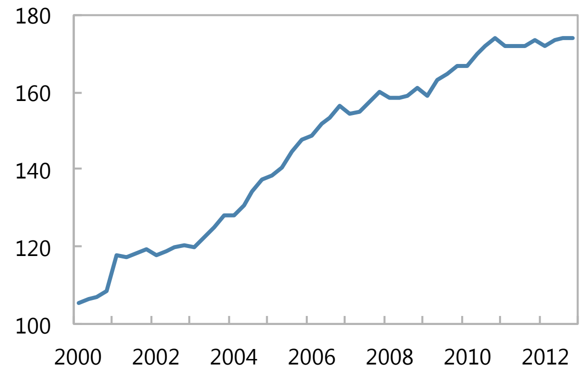
[5] While debt among non-financial corporations is sizeable, it has fallen from its recent peak, and the share of bank lending to non-financial corporations is much lower than before the 1990s crisis as a result of the increased

(continued)

been highly dependent on global financial conditions as analyzed in Chapter II of Selected Issues—introduces significant funding and foreign liquidity risks that could quickly become systemic. It is therefore difficult to exclude scenarios where the combination of a severe shock with a possible sudden increase in funding stress would expose banks to a very difficult situation with potentially drastic consequences throughout the Nordic region.

22. A comprehensive but gradual strategy would be most effective. Additional reforms should aim to improve financial stability both from the banking and household side. The approach should be gradual so as to limit any negative impact on growth. This suggests steady improvements of banks' funding and liquidity positions, as well as further increases of mortgage risk weight minima over the medium term. On the household side, a phased-in reduction of tax incentives would contain the buildup of excessive household debt, and improving mortgage amortization would add to financial stability, again over the medium term (Figure 6).

Household Debt
(Percent of disposable income)



Sources: The Riksbank, Statistics Sweden, and Fund staff calculations.

23. Specific measures include:

- *Raising funding stability standards*. Establishing firm interim targets for reaching the minimum level of 100 percent of the Basel III NSFR by 2018—a goal also explicitly recommended by the Riksbank—will help reduce structural liquidity risks. Given the lack of progress in 2012, a faster pace of improvement is needed in order to meet this target.
- *Improving foreign currency liquidity*. Making banks bear some of the costs of maintaining the recently increased foreign currency reserves at the Riksbank (see next section) via a fee, ideally in proportion to each bank's foreign liquidity gap, would provide the right incentives to manage foreign currency liquidity risks. Introducing bank reserve requirements in foreign currency to be held at the Riksbank would create similar incentives and reduce the need for official reserves.
- *Fortifying capital buffers.* The formal introduction of the 15 percent floor in May 2013 moved the risk weights for Swedish mortgages up from the lowest in Europe, bringing about an increase in both banks' regulatory minimum capital buffers and the relative cost of mortgage lending. However, the very high level of household debt merits gradual movement over the medium term to the more conservative 35 percent risk weight under the standardized Basel

share of bank lending to households (see Table 7). In addition, a large share of non-financial corporations' debt is accounted for by intra-company loans (for a more detailed discussion, see European Commission, 2013, "*Macroeconomic Imbalances – Sweden 2013*," European Economy, Occasional Papers, 141, April, Brussels).

III approach. This standard is generally considered a conservative estimate of the risk level for the mortgage portfolio of an average internationally-active bank in a developed country.

- *Raising mortgage portfolio quality*. Complementing the 85 percent mortgage LTV cap introduced in October 2010, financial stability would be enhanced from a steady reduction of mortgage amortization schedules over the medium term. This could be achieved, for example, through introducing minimum amortization requirements on new mortgages. To strengthen monitoring, the measure should be accompanied by additional improvements in disaggregated credit data collection by the government.
- *Re-considering tax incentives*. Consideration should be given to a phased-in reform to better balance the tax treatment of household assets. For example, lowering tax deductions for mortgages and increasing residential property taxation would reduce the incentives towards the build-up of excessive household debt over the medium term.

24. Clear lines of responsibility would enhance the effectiveness of macroprudential policy. The authorities are continuing to discuss the organization of macroprudential policymaking in Sweden, and recent proposals rightly stress the importance of continuing the information exchange between all relevant parties. And timely and well-coordinated implementation of the policy tools can be ensured by putting all instruments at the disposal of either the Riksbank—which is well-placed to oversee the macroeconomic and financial stability issues—or the Financial Supervisory Authority (FSA). Alternatively, the final approval of macroprudential decisions taken by the relevant agencies could be delegated to a Council, with clear voting rules and with a composition similar to that suggested by the Financial Crisis Committee. Allocating different responsibilities and instruments to different decision makers would instead likely complicate rather than strengthen necessary macroprudential coordination.

25. A robust bank resolution framework nationally and regionally would reduce the risk of financial spillovers. Legal certainty for the FSA to take corrective and remedial action against weak banks would mark an important improvement of the bank resolution framework—a point also raised in the 2011 FSAP. Given the size of Sweden's banks and their regional orientation, additional progress towards explicit burden-sharing agreements among the continental Nordic countries is another important element, especially with regard to systemic financial institutions. Here the recent agreement between the authorities of the Nordea Crisis Management Group on how to effectively handle cross-border bank resolution is an important step in the right direction. As highlighted in the NRR, regional cooperation along these lines will go a long way to reduce the risk of financial spillovers within the region. In addition, given the substantial international aspect of Sweden's banking operations, supervisory and regulatory coordination could eventually benefit from Banking Union membership.

The Authorities' Views

26. The authorities broadly concurred with staffs' assessment of financial vulnerabilities and recognized the benefits of additional, gradual reforms. They acknowledged that banks are large in relation to Swedish GDP, that household indebtedness is high from both a historical and international perspective, and that house prices might be vulnerable if Sweden is hit by a large macroeconomic shock. At the same time, they noted that more stringent regulatory standards, some of them well in advance of the Basel III timetable, had improved the resilience of bank balance sheets overall. They also stressed that mortgages are contracted mostly for primary residences and noted that bankruptcy is not a viable option to shake off debts. While progress along all aspects of the financial reform agenda was on the table, the approach should be gradual, as suggested by staff.

C. Financial Reform and Monetary Policy

27. Further financial reforms will help the Riksbank focus on macroeconomic goals. In principle, financial stability risks should be addressed through macroprudential policy tools. However, if mortgage credit growth returned to unsustainable levels despite best efforts, the Riksbank might have to tighten monetary policy beyond what macroeconomic considerations would warrant.[6] The gradual implementation of the financial reform agenda would also permit monetary policymakers to worry less about financial stability risks emanating from keeping interest rates at very low levels for long.

28. The recent increase of Riksbank foreign currency reserves supports financial stability. Even with liquidity standards improving, Sweden's banking system remains vulnerable to sudden shortages of foreign currency liquidity. To ensure ready access, the Riksbank decided to boost its borrowed currency reserves by about 1/3 to around USD55 billion (10 percent of GDP)—broadly in line with staff recommendations (see Box 5). As discussed in the previous section, sharing some of the fiscal costs with the banks will create the right incentives to manage these risks at the bank level.

The Authorities' Views

29. The authorities agreed that financial stability was foremost a macroprudential responsibility. While the modalities of increasing Riksbank reserves continue to be discussed, the need to incentivize sound foreign currency liquidity risk management within banks was supported by all. The Riksbank considered that a high and rising level of household debt should be taken into account in setting monetary policy as high debt levels can jeopardize macroeconomic stability and possibly create long-lasting difficulties in attaining the inflation target.

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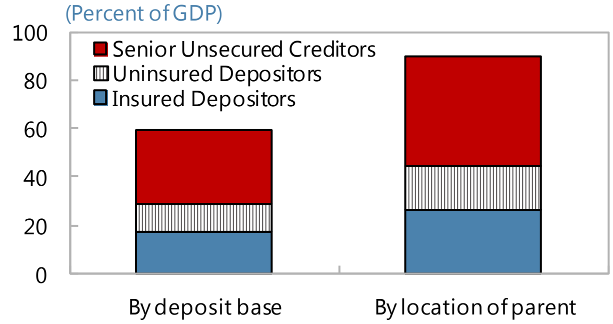
[6] See, for example, the Riksbank's recent report (Sveriges Riksbank, 2013, "*Monetary Policy Report,*" pp. 42–48, July), which discusses the role that monetary policy can play in reducing financial imbalances.

D. Calibrating the Fiscal Framework

30. Exploring adjustments to a successful model. Sweden's fiscal framework has been in place since the late 1990s (see Box 6). Together with a strong culture of fiscal responsibility it helped bring down gross general government debt from 73 percent of GDP after the banking crisis in the early 1990s to 38 percent of GDP in 2012. However, a discussion has begun on how to ensure the framework's countercyclicality as well as the absence of an explicit long-term anchor to take into account Sweden's potentially large contingent liabilities from the financial sector (see also Annex II).[7]

31. Making fiscal buffers explicit. While strong financial sector policies can and should be deployed to reduce taxpayers' contingent liabilities from financial risks (see previous section), they are likely to remain sizable even under the best of circumstances. This suggests that the fiscal framework could be improved further by introducing an explicit long-term anchor to retain prudent borrowing capacity (or fiscal buffer) adequate for a country with a large financial sector. In that context, staff emphasized the advantages of a debt target range well below the 60 percent debt-to-GDP ratio defined in the Maastricht treaty. Depending on the debt-target range selected (see below), the current surplus target of 1 percent over the cycle would have to remain in place for longer, but the authorities could explore adjusting the target rule once the debt-target range has been reached. A well-calibrated structural balance rule along these lines should also provide for higher public savings in case of larger-than-budgeted debt accumulation to help preserve the fiscal buffer while avoiding the accumulation of very large net-assets in the public sector.

Potential Fiscal Costs to Sweden of Bailing Out the Six Largest Nordic Banks 1/
(Percent of GDP)



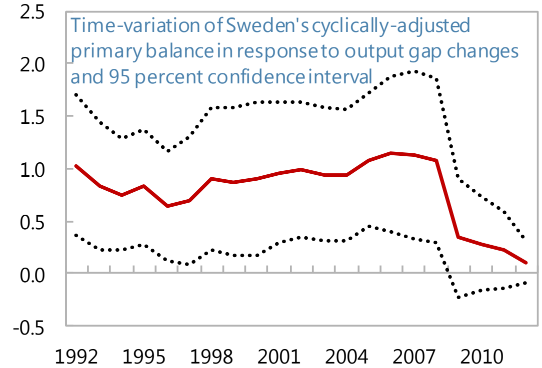
Sources: SNL Financial and Fund staff calculations.
1/ Bailout costs cover different types of creditors and depositors under alternative burden sharing rules across the Nordic countries involved.

32. Any debt target range would have to be very carefully selected. Assessing contingent liabilities is difficult—requiring robust assumptions about the size of the underlying exposures, the national, Nordic, and EU-wide resolution regimes in place, and the economic and financial circumstances under which they might be realized (see Chapter V of Selected Issues). Staff estimates that the direct fiscal costs of a potential systemic banking failure could be in the range of 17 to 90 percent of GDP, depending on whether government support would cover only insured depositors or uninsured depositors and bond holders as well, and whether support would be extended based on depositor or bank location. In addition to contingent liabilities, the debt range would need to account for aging costs and cyclical budget swings.

[7] For example, the mission engaged with a new government-appointed commission—the Inquiry on Swedish Government Debt Management—to explore the issue of long-term debt targets.

33. Ensuring countercyclicality of the fiscal framework. There are indications that fiscal policy has become less sensitive to the ups and downs of the business cycle since the mid-2000s. This reflects, among other things, a lower effective unemployment insurance replacement rate that has reduced the size of the automatic stabilizers.[8] Another factor—at least in hindsight—is the cautious use of discretionary fiscal stimuli during the crisis.

Degree of Countercyclicality of Fiscal Policy
(Rolling regression coefficient on output gap)



Sources: OECD and Fund staff calculations.

34. Greater countercyclicality can be achieved in several ways.

- Local governments have been operating under balance budget rules since the introduction of the current fiscal framework, which can force them to raise revenue or curtail spending during downturns. Instead the new "rainy day" funds allow the buildup of savings in good times that can be used in bad times, helping the operation of automatic stabilizers. This is a very welcome development. For the "rainy day" funds to be effective, it will be important that they be administered under rules that make sure they are used as intended. In a similar vein, the recent reform of inter-regional revenue redistribution should also help enhance fiscal risk sharing through revenue equalization across urban and rural areas.
- The countercyclicality of the central government budget could be enhanced by making the operation of budgetary safety margins contingent on a clear set of rules. For example, allowing use of the additional fiscal space incorporated into the expenditure ceiling path could be linked to economic indicators (e.g., GDP growth or measures of capacity utilization) undershooting a pre-set threshold for a period of time, subject to judgment by the independent Fiscal Policy Council. Moreover, in addition to continuing to use active labor market policies extensively, and maintaining fiscal incentives to work, there might be scope for a targeted reinforcement of income-support policies to the more vulnerable members of the workforce.

The Authorities' Views

35. The authorities welcomed the discussion of long-term fiscal buffers and the relation between fiscal policy and the business cycle. However, they were careful to point out the difficulty of evaluating discretionary countercyclical policies. In 2008–09, there were substantial concerns about a severe recession, which they felt called for retaining some fiscal

[8] The National Institute of Economic Research, 2013, "*The Swedish Economy*," Summary, March, finds that the elasticity of the general government's budget to changes in the output gap dropped by half—from about 0.8 to 0.4—between 1995–2006 and 2007–12. The impact of recent tax reforms (e.g., corporate tax cuts and earned income tax credit) is less clear. On the one hand, they might work to lower the tax ratio and, with it, the budget's reaction to the cycle. On the other hand, these reforms should improve competitiveness, growth, and employment.

space after letting the automatic stabilizers work. However, as the economic downturn—even though large in GDP-terms—mainly hit through a large fall in external demand, the effect on public finances was smaller than expected, leaving the ex-post relationship between the cycle and the fiscal policy stance less clear cut. The authorities were generally receptive to the idea of creating sufficient fiscal buffers to protect against financial sector contingent liabilities, even though they shared staff's recommendation to first deploy strong financial sector policies to reduce such fiscal risks. They felt that any re-calibration of the fiscal framework should take these risks into account and include the preservation of the surplus target.

E. Facilitating Structural Change

36. Additional structural reforms would strengthen the economy. Owing to extensive reforms in the 1990s, Sweden ranks high in international comparisons of many structural indicators.[9] However, there are indications that potential growth has slowed (see chapter I of Selected Issues and Figure 7). In particular, housing market rigidities have contributed to high house price levels and have distorted location choices of households and firms, with negative repercussions for growth. And even though recent labor market reforms have increased participation rates, it will take time for unemployment to improve. At the same time, the risk of labor market exclusion has increased, in particular for the young, low-skilled, and immigrants.

37. Addressing rigidities hampering the housing market. The demand for housing is outstripping supply—especially in urban areas—owing to several constraints, including the monopoly enjoyed by local municipalities over planning and zoning, a highly-regulated rental market, lengthy bureaucratic processes for permits, and strict zoning and environmental regulations. This, combined with low financing rates for consumers, has contributed to elevated house prices (see the NRR). Well-coordinated steps to gradually increase land supply and to raise the incentives to invest in residential construction would help ease supply-side restrictions, for example through additional reforms of the rental market, simplifying building regulations, and increasing competition in the construction sector. Stronger construction activity and tackling bottlenecks for re-location would, in turn, support growth both in the short and longer term.

38. Continuing labor market reform. Vulnerable groups such as the young, low-skilled, and foreign born are particularly exposed to an unexpected slowdown in growth. They also face a higher risk than others of long-term unemployment, which could potentially lead to loss of skills and earning capacity. Stimulating demand for these groups in a targeted way and continuing to help them improve their job skills through vocational training and education would improve the matching process between workers and available vacancies, and facilitate transition, especially from school to work. This would help reduce unemployment and support growth. Easing the still high levels of job protection on permanent job contracts could reduce labor market duality and improve labor market efficiency overall.

[9] OECD, 2012, "*OECD Economic Surveys: Sweden 2012*," OECD Publishing, December.

The Authorities' Views

39. The authorities are well aware of the supply constraints in the housing market and are looking very closely at labor market developments. They recognized the difficulty in implementing reforms to increase housing supply in urban areas since many decisions are located at the municipality level. With respect to labor market reforms, the authorities have already started taking steps to improve training and education for jobs as reflected in both the Budget Bill and Spring Bill of 2013. Nevertheless, they noted that further steps will be necessary to address the elevated level of unemployment, especially among the young and foreign-born facing the risk of becoming long-term unemployed.

STAFF APPRAISAL

40. Sweden's economy performed well through the crisis, but growth has moderated. Sweden led much of the rest of Europe in the recovery, but the economy decelerated in 2012 together with its main trading partners. Uncertainty about euro area developments contributes to weak investment. And while housing credit continues to expand faster than disposable income, consumers remain cautious overall. Headline inflation has turned negative, reflecting the strengthening of the krona amidst safe-haven flows, as well as the opening of a small output gap. In real effective terms, the krona remains below and the external position appears stronger than those suggested by medium-term fundamentals, likely reflecting structural factors such as higher saving rates following past pension reforms.

41. The outlook is for gradual improvement. At about 1.1 percent, growth will remain modest this year. The economy is expected to gather speed by 2014, reaching 2.3 percent for the year, with exports and private expenditure picking up as the external uncertainty recedes. Meanwhile, unemployment will only gradually decline from current elevated levels, and inflation will remain subdued in the near term before picking up again in 2014.

42. Financial fragilities compound downside risks and spillovers. A re-intensification of the euro area crisis could hurt growth through negative trade and confidence shocks. Importantly, it could adversely affect Sweden's very large and wholesale-dependent banking sector. Financial fragilities are also a key risk at home. With household debt now at more than 1.7 times of disposable income, a sudden and sizeable fall in house prices would not only affect unemployment and consumption, it could also push up non-performing loans and bank funding costs. Given the strong cross-Nordic activities of Swedish banks, such a scenario would have spillovers across the Nordics. Conversely, sudden deteriorations of household financial health elsewhere in the region pose risks for Sweden, with possible negative regional feedback loops.

43. Short-term macroeconomic policies are appropriately supportive. Monetary policy rates are low and the fiscal stance is mildly expansionary. If growth disappointed and inflation remained subdued for longer than expected, there would be room for additional interest rate cuts, assuming household credit growth remains contained, and consideration should be given to slowing the pace of structural consolidation. In case of a more extreme adverse shock, non-standard monetary policy measures could be implemented along with sizeable discretionary fiscal stimulus.

44. Securing financial stability is the main challenge ahead. The authorities continue to take ambitious steps to foster financial stability, including by strengthening capital requirements, introducing a LTV cap for household mortgages, and introducing a floor for minimum risk weights on mortgages. However, given the high level of household debt and the size of Sweden's banking system, further reforms would help minimize financial fragilities. They would also lower the need for fiscal buffers and allow monetary policy to pursue its inflation target with fewer concerns about financial stability.

45. This calls for a comprehensive but gradual financial reform agenda. It will be most effective if applied to both the banks and households, and in a gradual manner to limit any negative impact on growth: (*i*) There is a need for further improvements of banks' funding and liquidity positions, including through raising funding stability standards and making banks bear some of the costs of maintaining the recently increased foreign currency reserves at the Riksbank. (*ii*) In addition, there is reason to consider further increases of mortgage risk weight minima over the medium-term. Risk weights should increase faster if credit and house prices heat up significantly again. On the household side, over the medium term, (*iii*) a phased-in reduction of tax incentives towards the buildup of excessive household debt and (*iv*) improving mortgage amortization will add to financial stability.

46. Better coordination of macroprudential policy is also key. Information exchange between all parties involved is important, but it will be just as crucial to ensure that macroprudential policy is implemented in a timely and well-coordinated manner. The first option would be to put all policy tools into the hands of a single agency. The Riksbank is well-placed to monitor macroeconomic and financial stability but alternatively, the FSA could be put in charge. Close consultation with others would be required in both cases. A third option could involve final approval of decisions taken by individual authorities by a Council, with clear voting rules and with a composition similar to that suggested by the Financial Crisis Committee. Sharing instruments and responsibilities between decision makers would instead likely complicate the necessary coordination of macroprudential policy.

47. Internationally, further progress towards clear ex ante burden sharing arrangements in the Nordic-Baltic region would reduce the risk of financial spillovers. Similarly, keeping an open mind toward Banking Union membership could eventually allow improvements in supervisory and regulatory coordination across the entire area of operation of Sweden's large banks.

48. Implementation of the financial reform agenda would allow the Riksbank to focus on its macroeconomic policy goals. Financial stability risks should be addressed foremost through macroprudential policy tools. But a return of unsustainable mortgage credit growth despite strong macroprudential efforts might mean that the Riksbank will have to raise interest rates higher than warranted by macroeconomic considerations alone. Similarly, with strong macroprudential policies in place, it would be free to counter risk scenarios, for example by committing to keeping interest rates low for longer or dealing with impaired markets.

49. Foreign currency reserves help support financial stability. Even with the recent progress in improving banks' liquidity standards, Swedish banks remain vulnerable to sudden shortages of foreign currency liquidity. This calls for readily usable foreign liquidity broadly in line with the recent increase in borrowed reserves held at the Riksbank.

50. The need for a fiscal buffer could be made more explicit. The existing framework has served Sweden well. However, it could be strengthened by including a longer-term anchor to ensure the government maintains room to borrow adequate for countries with large financial sectors such as Sweden, while taking into account cyclical budget swings and aging costs. Explicitly providing for such a fiscal buffer could mean, for example, keeping actual debt ratios in a range well below the Maastricht treaty criterion of 60 percent of GDP. In this context, the authorities could explore the introduction of a debt target range with a well-calibrated structural balance rule that also provides for higher public savings in case of larger-than-budgeted debt accumulation.

51. In addition, it will be important to ensure that the fiscal framework remains sufficiently countercyclical. This could be achieved in several ways: First, the new "rainy day" funds at the local level should be administered under rules that promote their countercyclical use as intended. Second, the safety margins incorporated in the central government budget could be made contingent on a clear set of rules to enhance countercyclicality. Finally, active labor market policies should continue to be used extensively, and there might be scope for a targeted re-enforcement of income-support policies to the more vulnerable members of the workforce.

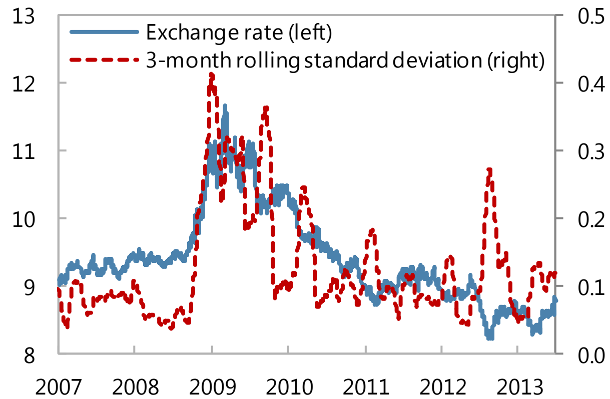
52. Structural reforms to strengthen the labor market and relieve housing bottlenecks will add to the resilience of the economy. To strengthen the impact of recent reforms on jobs and growth, it will be essential to improve the matching between workers and available vacancies and facilitate transition—especially for vulnerable groups. This can be accomplished by stimulating demand for young and foreign born workers in a targeted way and by continuing to help them improve their job skills. At the same time, further steps to address housing market rigidities would also be helpful in supporting growth, including by increasing land supply and raising incentives to invest in residential construction.

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

Box 1. Exchange Rate and Current Account[1]

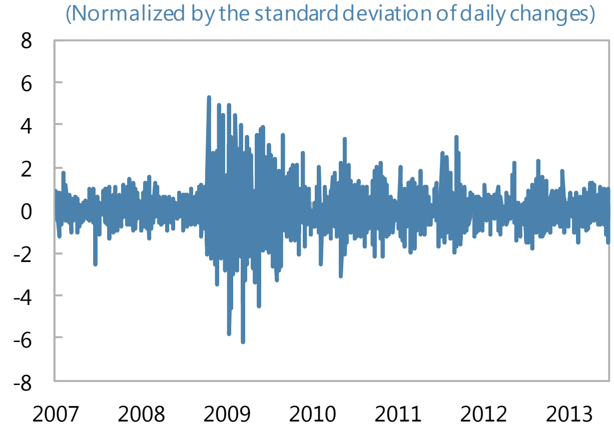
Strength and volatility. The Swedish foreign currency exchange market is relatively small, subjecting the krona to substantial volatility. The krona's recent decline in response to the discussion of "tapering" the Federal Reserve's quantitative easing program is a case in point. While the krona dropped by close to 3 percent against the euro within a week, the move was well within historical patterns. Relative to pre-crisis levels, the krona remains in a relatively strong position. Between its trough in March 2009 and May 2013, it appreciated by 23 percent against the euro and by about 20 percent in nominal effective terms. Based on medium-term fundamentals, there is further room for strengthening. Staff estimates suggest that, as of May 2013, the krona was about 3½ to 8½ percent below its equilibrium level in real effective terms, which is also in line with IMF's EBA and CGER based methodology.

Nominal Exchange Rate
(Daily spot exchange rate, SEK per euro)



Sources: Haver Analytics, Riksbank, and Fund staff calculations.

Daily Changes in the SEK-per-Euro Rate
(Normalized by the standard deviation of daily changes)



Sources: Haver Analytics, Riksbank, and Fund staff calculations.

Current account surplus. At around 7 percent of GDP, the current account remained in strong surplus in 2012, almost unchanged from 2011. This, in part, reflects Sweden's continued strong export competitiveness, especially in the investment good, forestry, and steel categories. According to staff estimates, the current account surplus is 2–4 percent of GDP stronger in cyclically-adjusted terms than what is suggested by medium-term fundamentals.

Underlying factors. The finding of an undervaluation along with still large current account surpluses comes despite the absence of distortions and no foreign exchange rate intervention for over a decade. This is in part explained by social protection reforms and also by measurement issues in the Net Foreign Assets (NFA) position. First, pension and other social protection reforms—notably a phased shift to a defined contributions pension scheme and a progressive shrinkage in transfers—since the mid-1990s have increased household net saving. At the same time, although the measured net international investment (net IIP) position stands at around -15 percent of GDP, the cumulative sum of current account surpluses over the past decade suggests that the (notional) net IIP should be closer to around 50 percent of GDP. The difference is potentially due to the accounting treatment of equity securities (which dominate the foreign asset positions), as well of equity holdings in subsidiaries.

[1] Prepared by Ruchir Agarwal and Nicoletta Batini (EUR).

Box 2. Key Elements of the 2013 Budget and Spring Bills[1]

The central government's 2013 budget. The Government's 2013 Budget Bill reports the central government budget, while the 2013 Spring Fiscal Policy Bill (Spring Bill) provides updates and contains the government's proposed economic policy and budget guidelines over the near to longer term. Combined, the two Bills will, on staff's projections, result in general government net lending of -1.6 percent of GDP in 2013, improving to -0.9 percent in 2014, and returning to surplus by 2016. While this is closely aligned with the authorities' near-term projections, the authorities project a faster improvement over the medium term with expenditures in percent of GDP declining more rapidly than under staff's projections.

Mildly expansionary stance. As growth deteriorated, the 2013 budget became more expansionary than anticipated in the 2012 Spring Bill, which had projected a net lending surplus of 0.3 percent of GDP in 2013. Overall, the budgets taken together now contain additional measures of SEK 25.7 billion (about 0.7 percent of GDP), of which SEK 3 billion in 2013–14 were included in the Spring Bill. Key elements of the 2013 budget centered on strengthening growth and lowering unemployment:

- *Growth and competitiveness:* increasing investments in infrastructure (additional SEK 700 million in the Spring Bill for railway operations and maintenance in 2013), research and innovation; lowering corporate taxes from 26.3 percent to 22 percent; introducing a tax credit for investors; redistributing measures for regional growth (SEK 40 million invested in both 2013 and 2014 in the Spring Bill).

- *Employment:* targeting integration measures for young and those born abroad; increasing the number of places for vocational adult education centers (the Spring Bill assigns SEK 700 million in both 2013 and 2014), work experience and employment training, and engineering and nursing programs.

- *Equitable distribution:* lowering taxes for pensioners, implemented by raising the higher basic income tax allowance, aiming at increasing the net income of a pensioner by approximately SEK 700 per year.

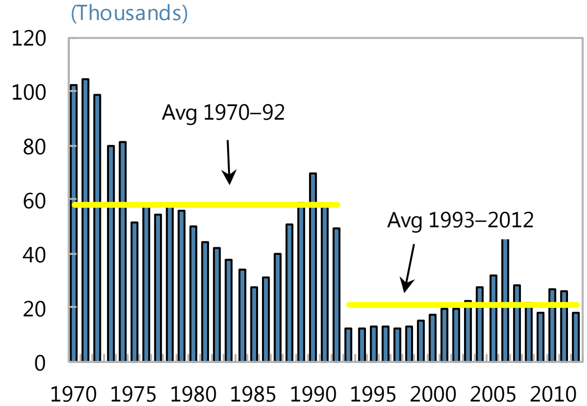
[1] Prepared by Ruchir Agarwal (EUR).

Box 3. Sweden's Housing Market and Financial Vulnerabilities[1]

Elevated house prices. Swedish house prices are potentially overvalued by more than 15 percent. House prices have more than doubled since the mid-1990s, increasing by about 140 percent in real terms between 1995 and 2007 and remaining broadly stable since then. Current estimates suggest that house prices are overvalued by 15 to 18 percent, accounting for rental regulations (see NRR).

Factors behind the increase since the mid-1990s. A number of factors explain the house price increases. In addition to high and stable pre-crisis income growth, supply constraints played a large role. Housing construction decreased substantially after the 1990s crisis and remained subdued since then due to several structural factors (see section on Facilitating Structural Change). For example, the number of average housing starts from 1993 to 2012 was only 1/3 of the average amount during 1970–92. More recently, very low interest rates helped sustain credit growth and housing demand. Other factors such as population growth due to immigration and the low-interest environment have also contributed to the house price increases.

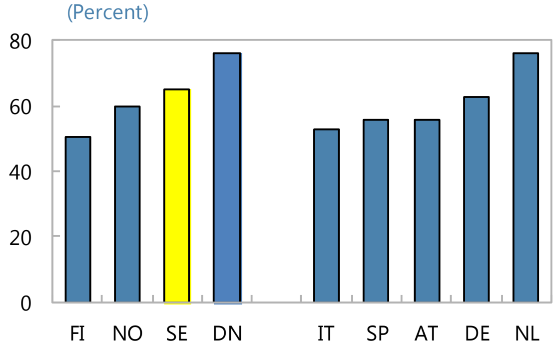
Sweden: Number of Housing Starts
(Thousands)



Sources: Statistics Sweden and Fund staff calculations.

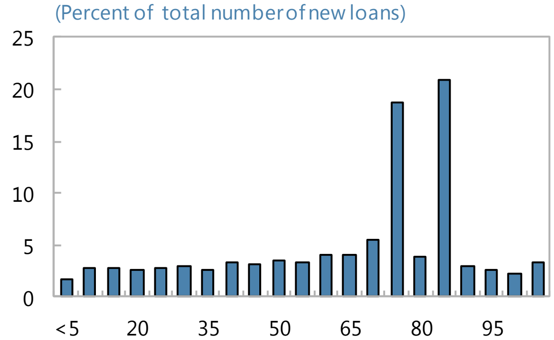
Mortgage credit has high Loan-to-Value (LTV) ratios. Despite the large appreciation in house prices, the Swedish mortgage LTV distribution is not skewed to the left but is centered on its mean of 63 percent—above most countries in the region. This is driven partly by new mortgage loans (including refinancing operations), which are concentrated around high LTV ratios. Specifically, most new mortgage loans in Sweden are concentrated around the 75 percent level (the Swedish Bankers' Association recommends that mortgages with LTV ratios exceeding 75 percent should be amortized) or the LTV cap of 85 percent.

Average Loan-to-Value Ratio for Mortgages
(Percent)



Sources: National central banks, FSAs, and Fund staff calculations.
Notes: For Finland estimated using distribution calculated by Bank of Finalnd using data from 2012 survey; for Norway, data correspond to Average LTV in Cover Pools as of 2009; for Denmark estimated using distribution calculated by Danmarks Nationalbank using data from 2012; for Sweden, the estimate corresponds to volume-weighted loan-to-value ratio in the Swedish mortgage stock as of 2012. For the other euro area countries, the data refer to residential mortgages from 2010.

Sweden: Loan-to-Value Ratio of New Mortgages, 2012
(Percent of total number of new loans)



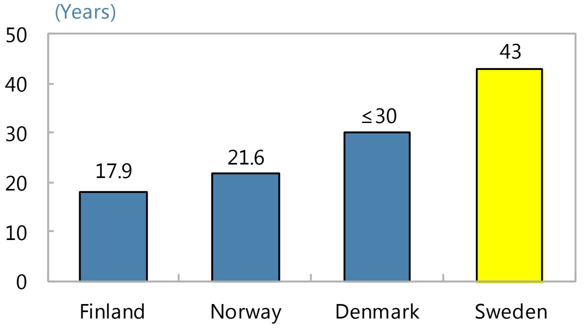
Sources: The Riksbank and Fund staff calculations.
Notes: The data correspond to the "sample" in "The Swedish Mortgage Market 2013" published by the FSA, March 7, 2013.

[1] Prepared by Ruchir Agarwal (EUR) and Eugenio Cerutti (RES).

Box 3. Sweden's Housing Market and Financial Vulnerabilities (Concluded)

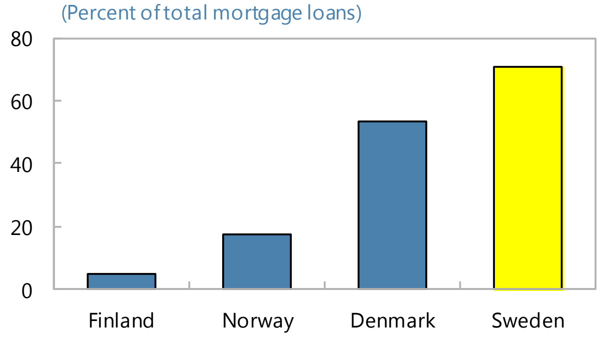
Long amortization profiles also contribute to high LTV ratios. Amortization levels in Sweden are very low at 43 years for mortgages with LTV ratios below 75 percent and positive amortization, or more than 140 years if the unamortized mortgages are included (by assuming that borrowers amortize the same volume in SEK per year on these loans as they actually amortize on their positive amortization mortgages). In fact, the share of interest only loans in Sweden is about 71 percent for mortgages with LTV ratios below 75 percent in 2012, well above that in other Nordic countries.

Average Repayment Period in Mortgage Contracts
(Years)



Sources: FSAs, National central banks, and Fund staff calculations.
Notes: For Finland and Norway we report average of new loans granted during 2007–12 and 2005–12 respectively; mortgage loans in Denmark have a maximum repayment period of 30 years; for Sweden the estimate corresponds to the repayment period in the mortgage stock that have positive amortization and LTV below 75 percent.

Fraction of Interest-Only/Deferred Amortization Loans
(Percent of total mortgage loans)



Sources: FSAs, National central banks, and Fund staff calculations.
Notes: Typically, Finnish mortgages include an amortization schedule, and reported loans correspond to bullet bridge-loans (connected to buying-selling chains), which have maturity under one year; for Denmark, the share of interest only loans (both as a share of total loans and new loans) correspond to the fraction of deferred amortized loans; for Sweden the estimate corresponds to mortgage stock that have LTV below 75 percent.

Box 4. Nordic Regional Report: Key Messages[1]

The Nordics as a Region. Robust social and economic institutions and a high degree of trade and financial openness have characterized the structure of the four continental Nordic economies (Denmark, Finland, Norway, and Sweden) since the 1990s, generating important benefits in the form of high income equality, strong labor markets, and low public debt. While there are also important differences—notably monetary and exchange rate regimes and resource endowments— the countries also share a large, concentrated, and highly integrated banking sector. When combined with high household debt and house prices, the region is increasingly susceptible to shocks both from within and beyond its borders. The pilot Nordic Regional Report (NRR), scheduled for presentation to the Board on August 30, 2013, is set to examine these common links and challenges.

Challenges of a large, interconnected banking sector. Six banks dominate the region—four of them headquartered in Sweden—accounting for approximately 95 percent of the assets of all publicly-listed Nordic banks and with close to 85 percent of their combined credit exposures and deposits within the four countries. In addition, the total assets of publicly-traded banks in Denmark and Sweden stand at around 230 and 360 percent of GDP, respectively. The overall scale, concentration, and integration of the banking sector, as well as its reliance on wholesale funding (both short term and covered bonds), translate into a need for strong national policies to mitigate vulnerabilities, complemented by common regional strategies to tackle cross-border issues. The former implies a complete macroprudential toolkit with strong fiscal buffers at the national level, while the latter suggests regional macroprudential minima and binding frameworks for common resolution and ex ante burden sharing.

Implications for Sweden. With most of the largest Nordic banks operating out of Sweden, the country acts as a regional financial hub with implications for Swedish financial sector policies (see also Chapter II of Selected Issues). While Swedish borrowers draw from a relatively large number of creditors, Swedish banks are lending predominantly to Nordic and, to a smaller degree, Baltic borrowers. Therefore, events triggering (large enough) spillovers and credit losses in these key markets would generate significant pressure to deleverage and reduce lending in Sweden, with potentially severe real economic repercussions. Hence, as will be stressed in the NRR, robust national policies that secure the soundness of Swedish international banking groups will benefit borrowers not only in Sweden but across the Nordic-Baltic region.

[1] Prepared by Aqib Aslam (EUR).

Box 5. Increasing Insurance against Banks' Foreign Exchange Funding Exposures[1]

Higher reserves. In December 2012, the Riksbank decided to increase its foreign exchange reserves (FXR) by SEK 100 billion. The central bank explained that external risks remained high and that banks' potential foreign exchange liquidity needs had increased in nominal terms.[2] The increase is being financed via sovereign debt issuance, and will eventually raise reserves to SEK 414 billion ($55 billion) or about 10 percent of GDP.

Liquidity needs during the crisis. The measure came against a background of Sweden's experience after the Lehman Brother's shock. During the global financial crisis, authorities provided over SEK 450 billion in liquidity support to banks as global interbank funding and FX markets dislocated.[3] The Riksbank used its FXR, and the Swedish National Debt Office (SNDO) provided guarantees to certain institutions in order for them to issue foreign currency debt themselves. Ultimately, FXR were replenished and increased via an FX swap line with the U.S. Federal Reserve and foreign currency borrowing by the SNDO.

Limiting liquidity risk within banks is crucial. For example, building on recent progress in improving liquidity standards (see Annex I), further progress towards a net stable funding ratio (NSFR), as well as improvements in the macroprudential framework should help reduce the need for holding foreign currency reserves at the Riksbank. However, given their size and wholesale dependence overall, Swedish banks will likely remain vulnerable to sudden shortages of foreign liquidity, and some form of backstop seems appropriate.

International options are desirable but not certain. Ideally international coordination and support, such as through official foreign exchange swap lines, would serve as a buffer and lower self-insurance needs. However, it is uncertain under what conditions such liquidity support would be provided. During the global financial crisis, the speed with which such arrangements were introduced and maintained, and their amounts differed among countries.

Implementation. An important consideration is to what extent FX reserve needs should be met on a contingent basis or be immediately in hand. Having reserves in hand entails a cost since as they are borrowed, and the returns on reserves are not likely to compensate fully for the debt issuance. However, FX reserves provide insurance as the funds are readily available, thereby strengthening the authorities' ability in managing crisis. Additionally, this approach lowers the risk that the cost of borrowing the funds during periods of stress may be higher compared to more benign periods, as well as minimizes any lags between when needs arise and reserves are available. Similar considerations apply to the extension of direct government guarantees for bank lending, which require time to process and could introduce an explicit—and potentially adverse—feedback link between banks and the Swedish sovereign.

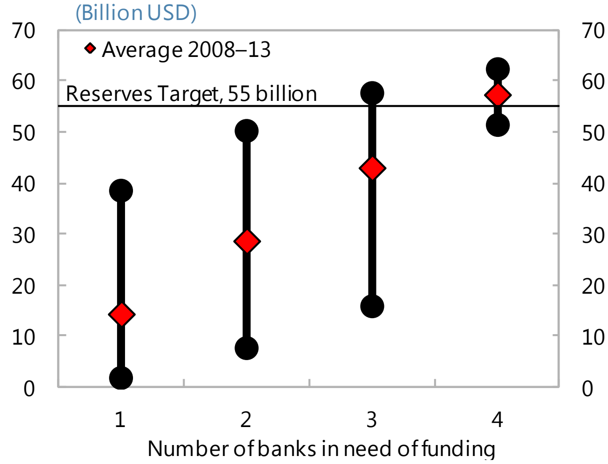
Quantification. The Riksbank's increased FXR need is broadly in line with severe but not impossible scenarios. The scenarios were calculated based on banks' consolidated balance sheets and focused on risks to euro and dollar liquidity used to finance foreign currency assets.[4] The results are broadly compatible with staff estimates of the potential foreign liquidity needs of Sweden's four largest banks.[5] The approach assumes that tail risks materialize in European financial markets, triggering a failure of banks' to fund their foreign liquidity needs. The analysis estimates that, contingent on such tail risk having realized, financing needs exceeding $55 billion could occur with a probability of about 6 percent.

[1] Prepared by Thomas Dowling, Kotaro Ishi (both EUR), and Phil de Imus (SPR).
[2] See Riksbank, "*Financial Stability Report 2012:2*" and "*Monetary Policy Report,*" October 2012. The Riksbank also pointed to increased commitments to the IMF.
[3] See Riksbank, Annex A: "*The Riksbank's need for foreign exchange reserves*," November 30, 2012.

Box 5. Increasing Insurance against Banks' Foreign Exchange Funding Exposures (Concluded)

Getting incentives right. Banks should share the cost of this liquidity insurance. Fees on banks to at least partially cover the cost of borrowed FX reserves would help to reduce the burden on the government and ultimately tax payers. They could be linked to an individual bank's FX funding exposure, thus incentivizing a reduction in these exposures. Other modalities could be considered which will encourage banks to limit their liquidity risks, such as FX reserve requirements or ratios.

Funding Gaps, 2008–13 1/
(Billion USD)



Sources: Bank annual reports, Datastream, and Fund staff calculations.
1/ Range endpoints refer to the largest/smallest funding gap, given the number of banks in need of liquidity support, in any single year (2008–13). The marker refers to the simple average over all 6 years. On average, only the case in which 4 banks are in distress do the funding needs exceed the reserves target.

[4] The method starts with banks' reported liquidity coverage ratios (LCRs) and implicit liquidity needs beyond the 30-day window. Foreign funding swapped into local currency to fund SEK assets were excluded. The base case assumes that half of banks' most liquid assets are already used or are not convertible, that some of the Riksbank's IMF commitment is used, that banks cannot issue government-guaranteed debt, and that the Riksbank gets involved only after 30 days.

[5] This analysis updates the liquidity gap approach used in the selected issues paper on reserve adequacy in the 2011 Article IV staff report (Ishi, 2011, "Reserve Adequacy", Attachment III in IMF Country Report No. 11/171). The approach calculates probabilities of default for each bank, both in turn and jointly. Along with estimates of the liquidity gap, an average expected funding gap for each scenario is derived given the number of banks in need of funding.

Box 6. Sweden's Fiscal Framework[1]

The key elements of the Swedish budgetary policy framework are:

- **Surplus target for the general government.** Introduced in 1997 with full effect from 2000, the target states that the surplus in net lending shall be 1 percent of GDP over a business cycle. Setting a target that is to be met over a business cycle is intended to prevent a pro-cyclical fiscal policy. Over the years, various arguments have been used to motivate the surplus target and the weights attached to each argument have changed. Debt reduction was highlighted in the early stages, followed later by demographic issues.

- **Central government expenditure ceiling.** Introduced in 1997, the ceiling covers the primary expenditures of the central government together with expenditure of the old age pension system. The ceiling, set by Parliament on the basis of a government proposal in the Budget Bill, was used by the government on a voluntary basis up to 2010. Since 2010, the government is required by law to propose an expenditure ceiling for year *t+3* in the Budget Bill for year *t+1* (presented in the autumn of year *t*). For example, in the Budget Bill for 2010 presented in the autumn of 2009, the government proposed a ceiling for 2012. The Swedish Government is obliged by law to take necessary measures to ensure that actual expenditures do not exceed the ceiling. The practice is that once a ceiling has been set, it should not be changed unless technically motivated. This secures a medium-term planning horizon. It is possible to change set ceilings for non-technical reasons, but this has only occurred twice and on both occasions the ceiling was lowered.

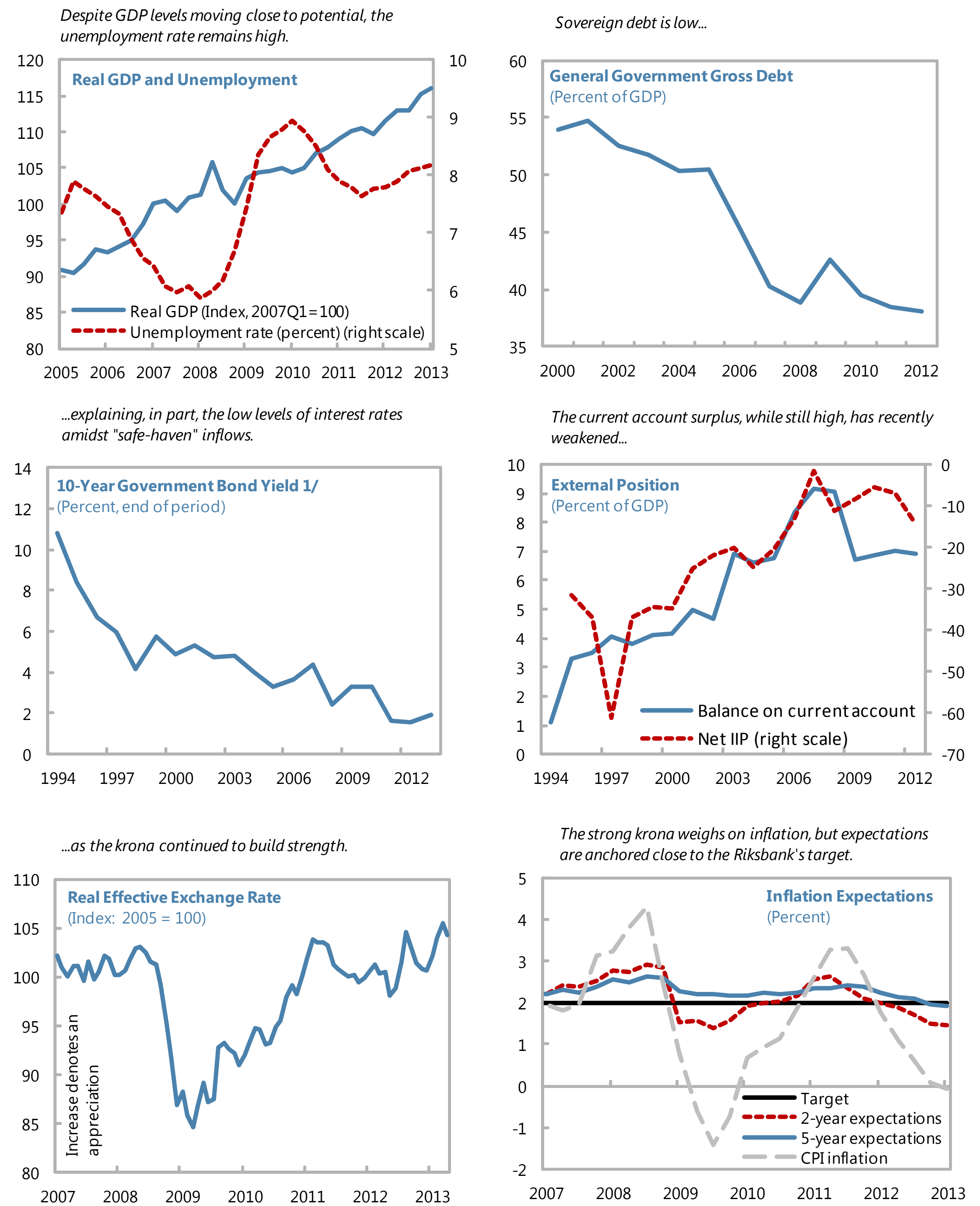
- **Buffers.** Normally the ceiling is set to include a "budgeting" or "safety margin" that can be used for expenditure arising from unforeseen cyclical factors. The government's practice has been for the budgeting margin to be at least 3 percent of forecast expenditure for year *t+3*, at least 2 percent for year *t+2*, at least 1.5 percent for year *t+1*, and at least 1 percent for the current budget year. The ceilings are set in nominal terms (thus they are not adjusted for inflation, which imparts a trend consolidation of around ½ percentage point of GDP annually, unless accounted for when setting the ceilings themselves).

- **Local government balanced budget requirements.** To strengthen the budget process at the local level, a balanced budget requirement for the local government sector has been in place since 2000. The requirement means that each municipality and county council must budget for a balanced outcome and good financial management in its activities.

- **Strict budget process.** The surplus target and the expenditure ceiling set the total economic scope in the budget process. The guiding principle is that expenditure increases within an area must be covered by expenditure cuts within the same area. The draft budget must include all revenues and expenditures, as well as other payments that affect the borrowing needs of the central government (the completeness principle). Expenditures are to be reported on the expenditure side of the budget, while revenues are to be reported on the revenue side of the budget.

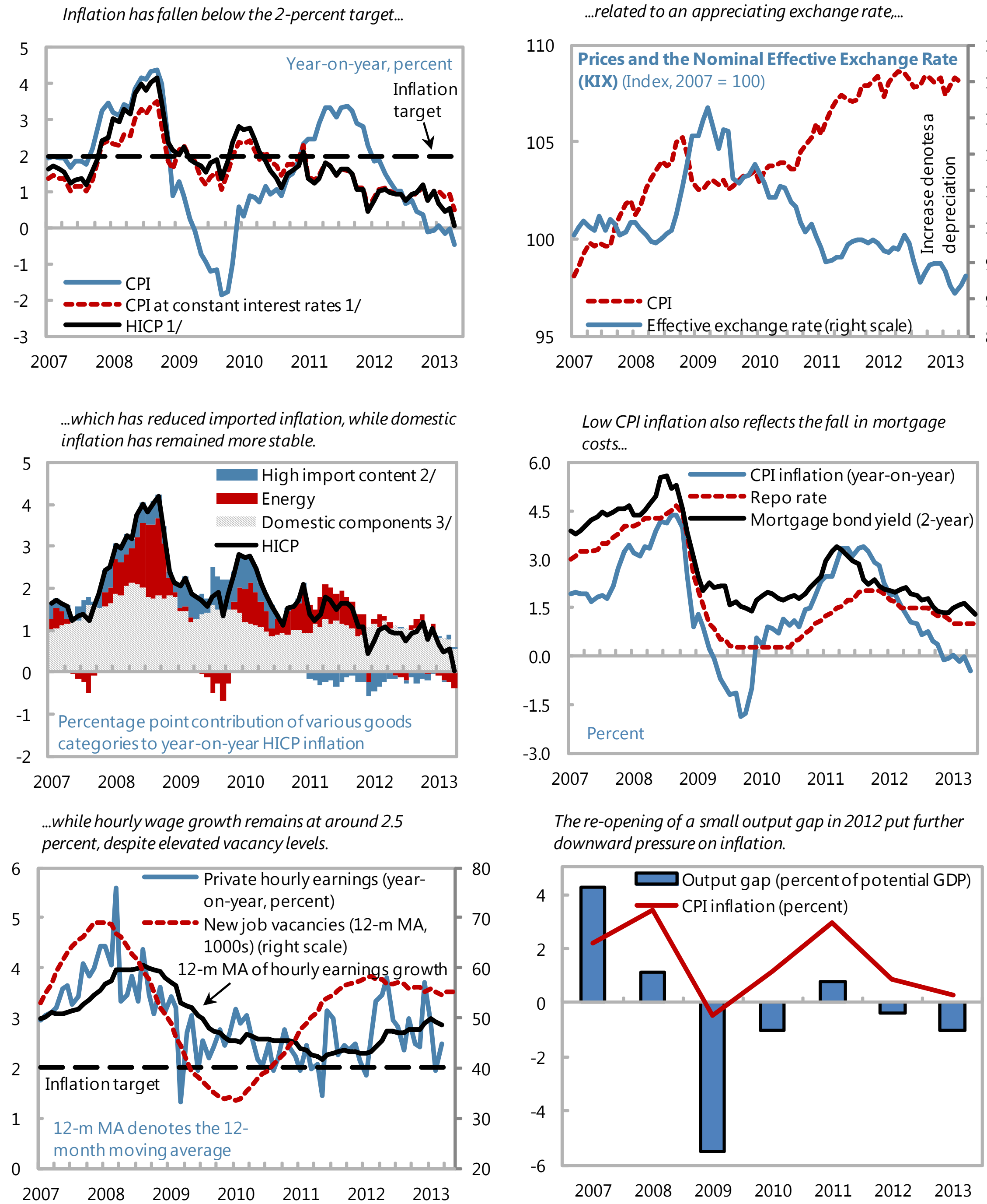
[1] Prepared by Nicoletta Batini (EUR).

Figure 1. Sweden: The Bird's-Eye View



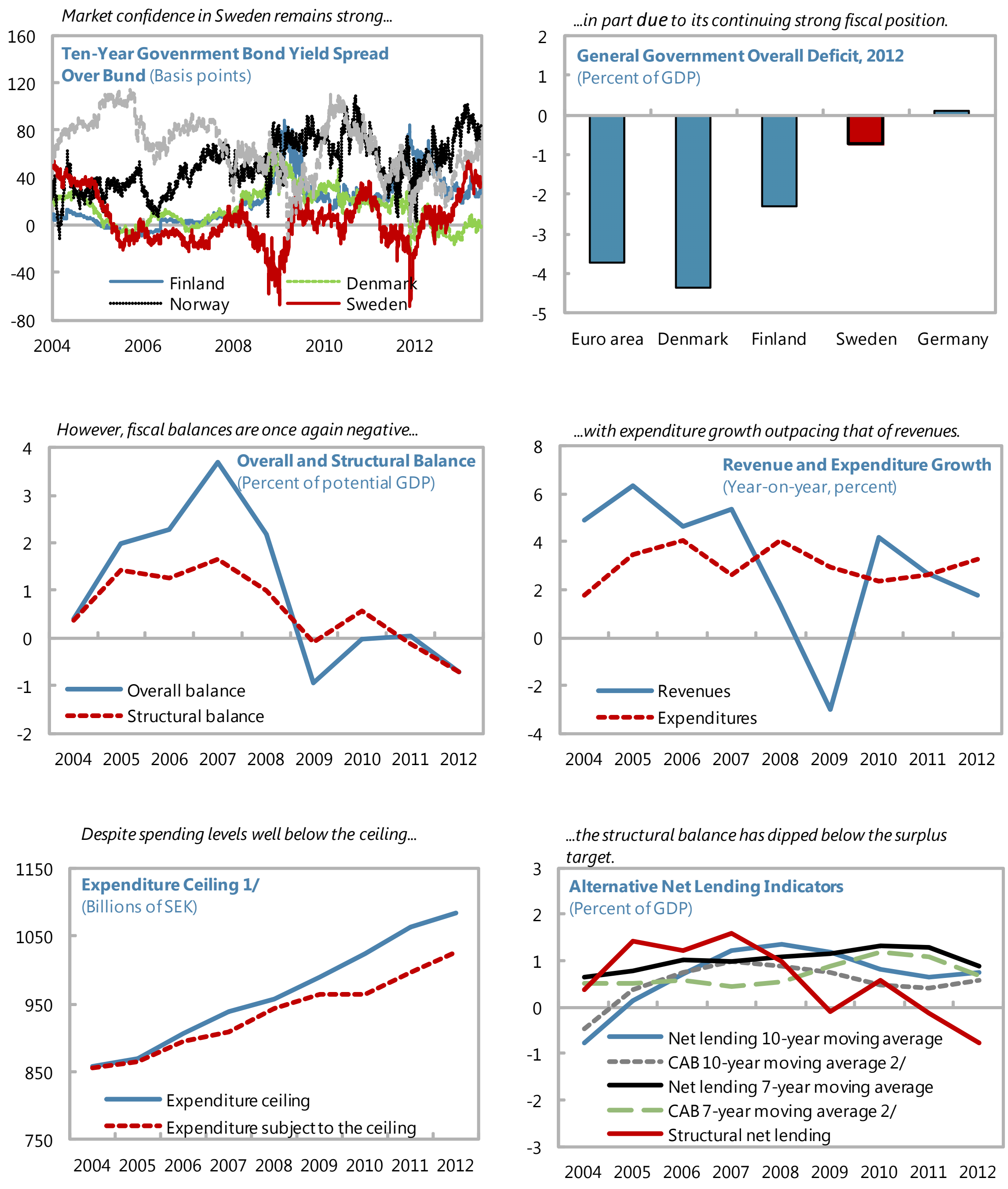
Sources: IMF Information Notice System, IMF World Economic Outlook, Statistics Sweden, and Fund staff calculations.
1/ Last observation as of May 2013.

Figure 2. Sweden: Inflation, 2007–13



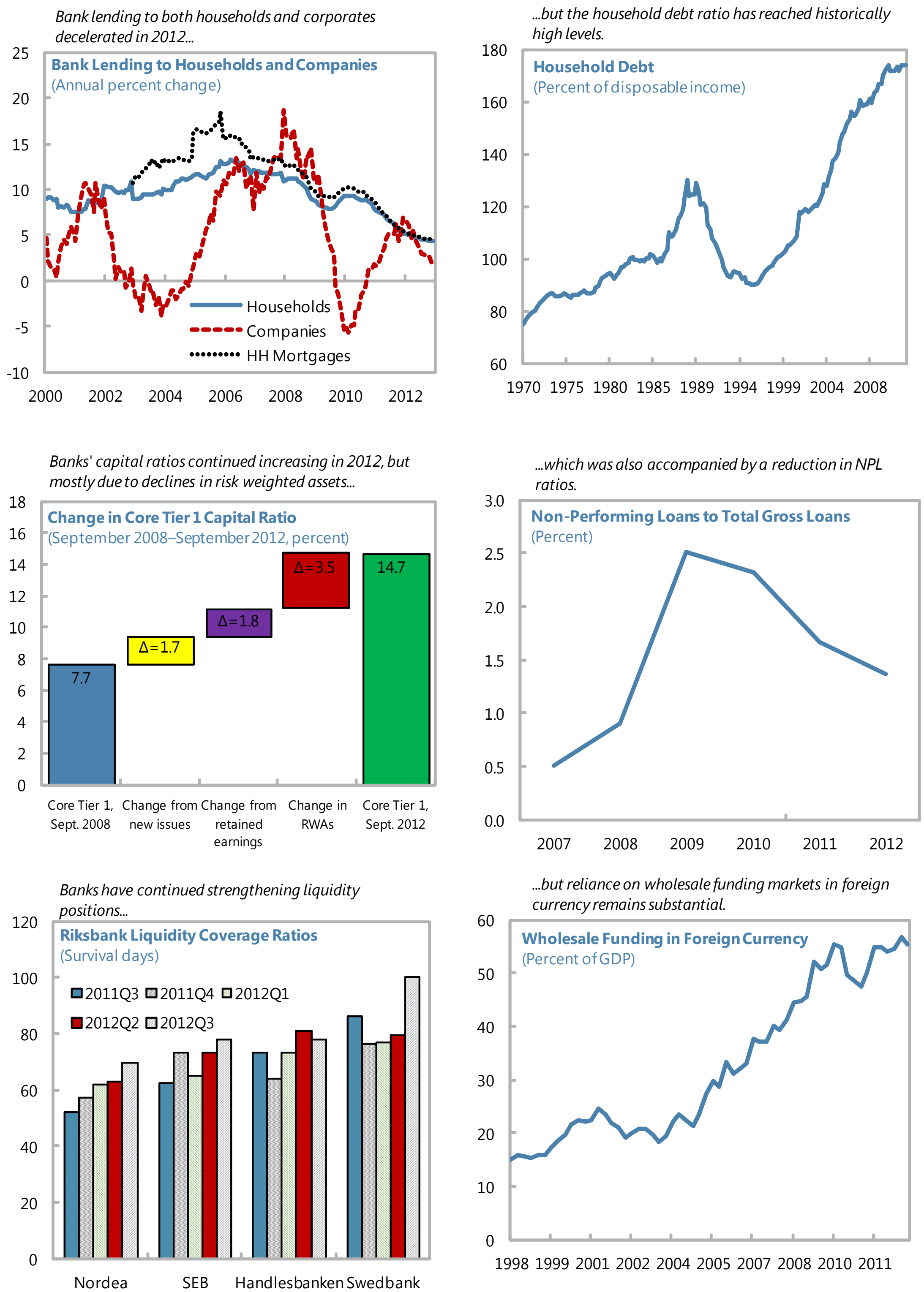
Sources: Eurostat, Haver Analytics, Statistics Sweden, and Fund staff calculations.
1/ Measures of underlying inflation, excluding certain mortgage interest costs.
2/ Non-energy industrial goods and unprocessed food.
3/ Processed food, alcohol, tobacco, and services.

Figure 3. Sweden: Fiscal Developments, 2004–12



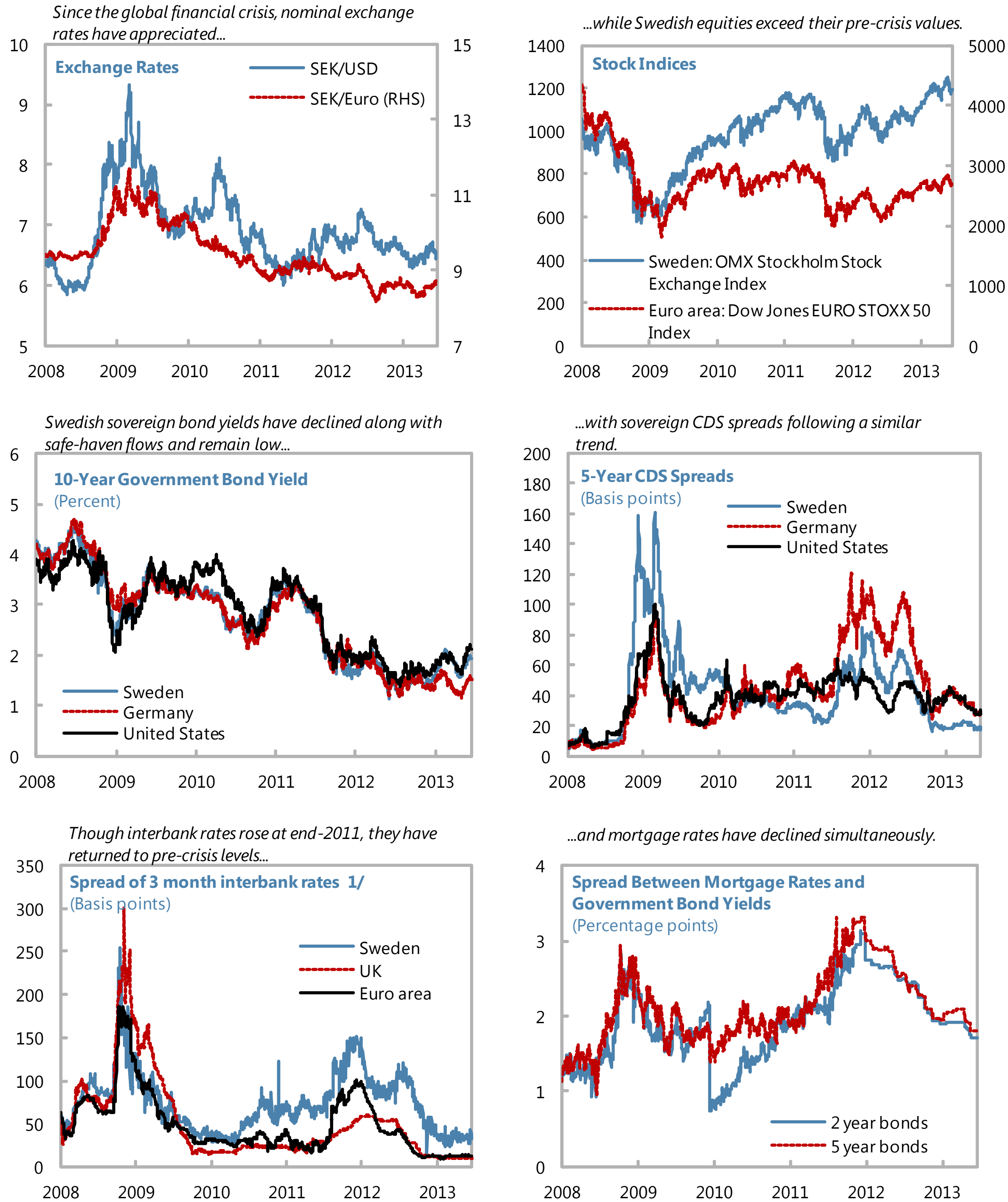
Sources: Bloomberg LP, Ministry of Finance, IMF World Economic Outlook, and Fund staff calculations.
1/ Expenditures and ceilings as reported by the authorities in Budget and Spring Bills.
2/ CAB denotes the cyclically adjusted balance.

Figure 4. Sweden: Performance of the Banking System, 1970–2013



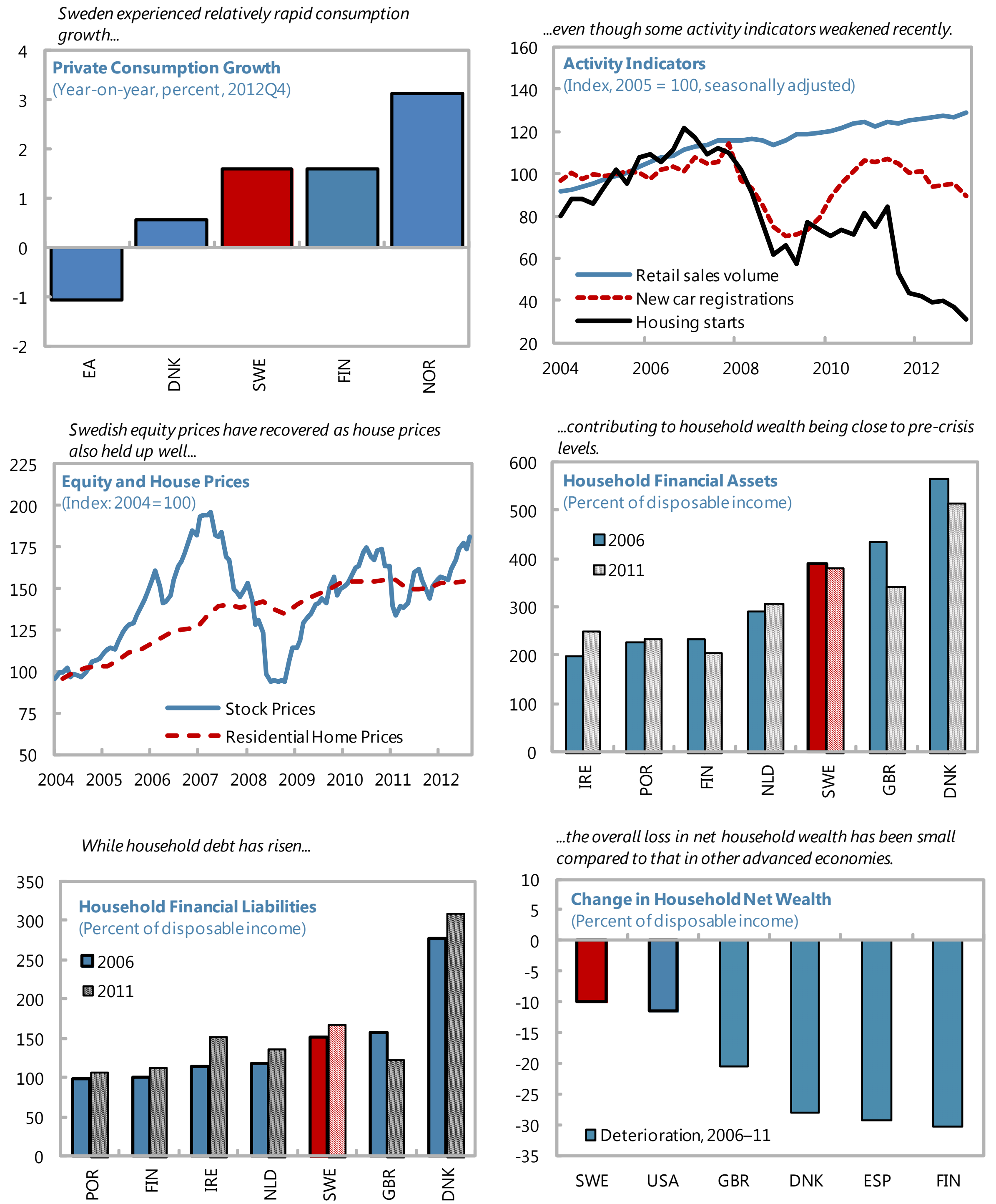
Sources: SNL Financial, Sveriges Riksbank, and Fund staff calculations.

Figure 5. Sweden: Selected Financial Markets Indicators, 2008–13



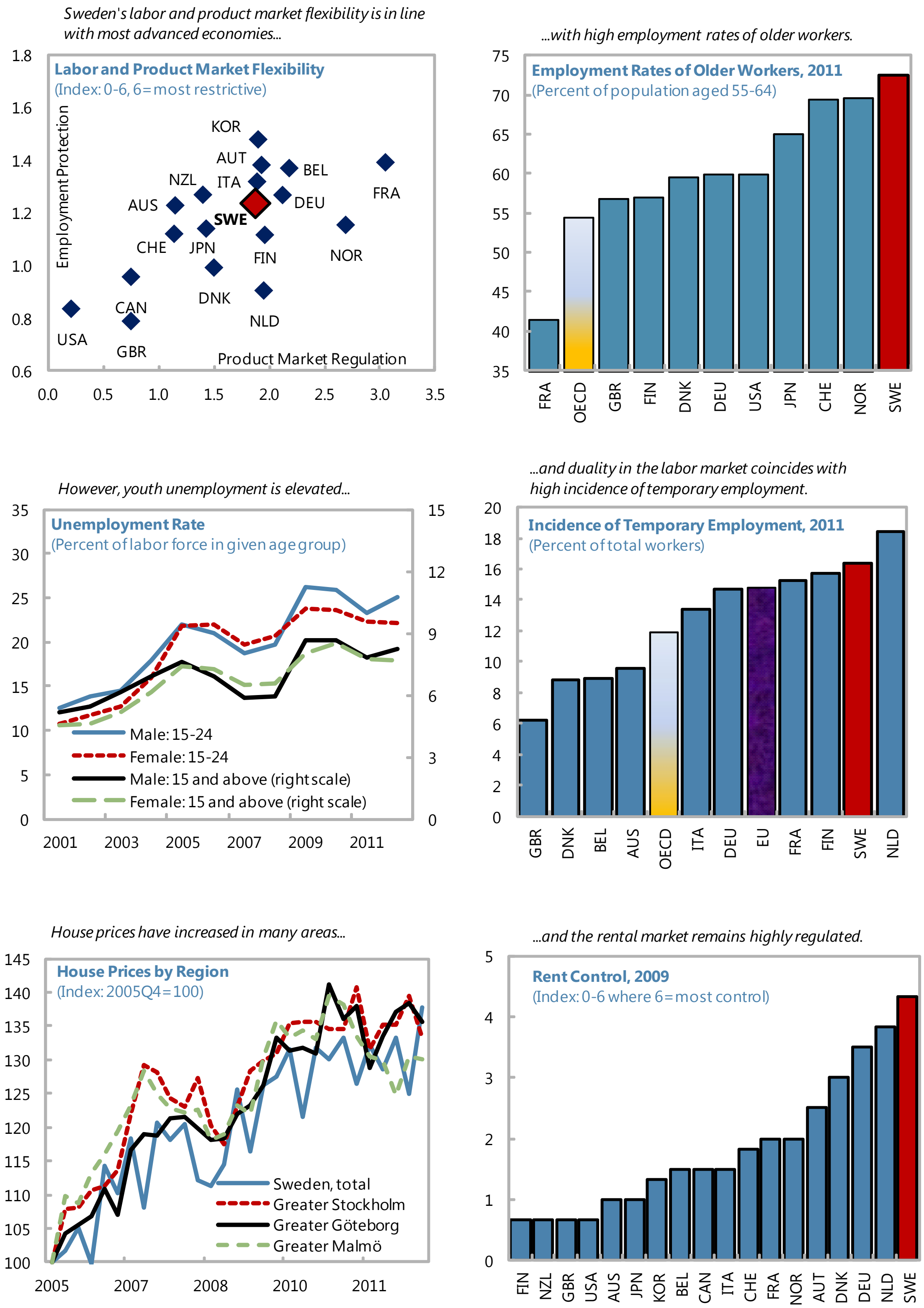
Sources: Haver Analytics, Thomson Reuters Datastream, and Fund staff calculations.
1/ Spread is taken over 90-day Treasury bill rate (Sweden), U.K. Pound 3-month OIS (U.K.), or Euro Overnight Index Average 3-month swap rate (Euro Area).

Figure 6. Sweden: Household Balance Sheets and Consumption, 2004–13



Sources: Eurostat, Haver Analytics, Statistics Sweden, and Fund staff calculations.

Figure 7. Sweden: Structural Indicators, 2001–12



Sources: Haver Analytics, OECD, Statistics Sweden, and Fund staff calculations.

Table 1. Sweden: Selected Economic Indicators, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
			Projections					
Real economy (percent change)								
Real GDP	3.7	0.7	1.1	2.3	2.3	2.4	2.4	2.4
Domestic Demand	3.2	0.4	1.2	2.2	2.3	2.4	2.5	2.5
CPI inflation	3.0	0.9	0.3	1.6	2.4	2.4	2.1	2.0
Unemployment rate (percent)	7.8	8.0	8.2	7.8	7.5	7.1	6.7	6.4
Gross national saving (percent of GDP)	26.6	25.7	25.2	25.6	26.1	26.5	26.8	27.1
Gross domestic investment (percent of GDP)	19.4	18.7	18.3	18.5	19.0	19.4	19.9	20.4
Output Gap (percent of potential GDP)	0.8	-0.4	-1.0	-0.7	-0.3	-0.1	0.0	0.0
Public finance (percent of GDP)								
Total Revenues	51.2	51.2	51.5	51.4	51.3	51.1	51.2	51.2
Total Expenditures	51.2	51.9	53.1	52.3	51.3	50.5	50.1	49.7
Net lending	0.0	-0.7	-1.6	-0.9	0.0	0.6	1.1	1.5
Structural balance (percent of potential GDP)	-0.1	-0.8	-1.4	-0.8	0.1	0.6	1.1	1.5
General government gross debt, official statistics	38.4	38.1	42.3	41.7	39.5	37.0	34.1	30.9
Money and credit (year-on-year, percent change, eop)								
M1	0.9	5.9	...	...	...	...	...	...
M3	6.2	1.9	...	...	...	...	...	...
Bank lending to households	6.0	11.7	...	...	...	...	...	...
Interest rates (year average)								
Repo rate (end of period)	1.8	1.0	...	...	...	...	...	...
Three-month treasury bill rate	1.7	1.3	...	...	...	...	...	...
Ten-year government bond yield	2.6	1.6	...	...	...	...	...	...
Balance of payments (percent of GDP)								
Current account	7.0	6.9	6.9	7.1	7.0	7.0	6.9	6.7
Goods and Services balance	5.8	6.3	6.3	6.5	6.5	6.5	6.3	6.2
Foreign Direct Investment, net	-3.5	-3.2	-3.1	-3.1	-3.1	-3.1	-3.1	-3.1
International reserves, changes (billions of US dollars)	-0.7	-0.5	-15.3	0.0	0.0	0.0	0.0	0.0
Reserve cover (months of imports of goods and services	2.8	2.8	3.6	3.5	3.3	3.1	2.9	2.7
Exchange rate (period average, unless otherwise stated)								
Exchange rate regime				Free floating exchange rate				
SEK per U.S. dollar June 20, 2013				6.5				
Nominal effective rate (2005=100)	104.2	105.5	...	...	...	...	...	...
Real effective rate (2005=100) 1/	91.0	92.3	...	...	...	...	...	...
Fund Position (May 31, 2013)								
Holdings of currency (percent of quota)				73.40				
Holdings of SDRs (percent of allocation)				94.59				
Quota (millions of SDRs)				2395.50				

Social Indicators (reference year)

GDP per capita (in 2012 constant USD): 55,158; **Population** (2012, million): 9.5; **Main products and exports**: Machinery, motor vehicles, paper products, pulp and wood; **Key export markets**: Germany, Norway, United Kingdom

Sources: Haver Analytics, IMF Institute, Sveriges Riksbank, Sweden Ministry of Finance, and Fund staff calculations.

1/ Based on relative unit labor costs in manufacturing.

Table 2. Sweden: Balance of Payments Accounts, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
			Projections					
				(Billions of SEK)				
Current Account Balance	246	246	249	266	278	289	297	305
Goods and Services Balance	201	225	228	245	256	267	274	281
Exports of G&S	1709	1706	1686	1752	1855	1973	2107	2252
Imports of G&S	-1508	-1481	-1458	-1508	-1600	-1706	-1833	-1971
Factor income, net	90	80	80	82	84	86	88	90
Current Transfers, net	-46	-59	-59	-61	-62	-64	-65	-67
Financial Account Balance [1]	-314	-106	-240	-259	-272	-285	-289	-302
Investment Abroad [2]	310	373	100	2	-21	-39	-75	-101
Investment in Sweden	-619	-475	-240	-261	-250	-246	-214	-201
Reserves, change	-5	-4	-100	0	0	0	0	0
				(Percent of GDP)				
Current Account Balance	7.0	6.9	6.9	7.1	7.0	7.0	6.9	6.7
Goods and Services Balance	5.8	6.3	6.3	6.5	6.5	6.5	6.3	6.2
Exports of G&S	48.8	47.9	46.6	46.5	47.0	47.7	48.7	49.9
Imports of G&S	-43.1	-41.6	-40.3	-40.0	-40.5	-41.2	-42.4	-43.7
Factor income, net	2.6	2.2	2.2	2.2	2.1	2.1	2.0	2.0
Current Transfers, net	-1.3	-1.7	-1.6	-1.6	-1.6	-1.5	-1.5	-1.5
Financial Account Balance	-9.0	-3.0	-6.6	-6.9	-6.9	-6.9	-6.7	-6.7
Investment Abroad [1]	8.9	10.5	2.8	0.1	-0.5	-0.9	-1.7	-2.2
Direct Investment	-5.2	-5.9	-6.0	-6.0	-6.0	-6.0	-6.0	-6.0
Portfolio Investment	25.3	18.7	13.0	10.5	9.9	9.5	8.5	8.0
Financial Derivatives	27.4	24.9	17.0	15.5	14.9	14.5	13.5	13.0
Other Investment	-11.3	-2.3	-4.2	-4.4	-4.4	-4.4	-4.2	-4.2
Reserves	-0.1	-0.1	-2.8	0.0	0.0	0.0	0.0	0.0
Investment in Sweden [1]	-17.7	-13.3	-6.6	-6.9	-6.3	-5.9	-4.9	-4.4
Direct Investment	1.7	2.7	2.9	2.9	2.9	2.9	2.9	2.9
Portfolio Investment [3]	-21.0	-14.9	-9.8	-10.3	-9.7	-9.3	-8.3	-7.8
Financial Derivatives	-27.9	-23.9	-17.0	-15.5	-14.9	-14.5	-13.5	-13.0
Other Investment	1.6	-1.1	0.3	0.5	0.5	0.5	0.5	0.5
Errors and Omissions	0.3	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
				(Percent change, in USD terms)				
Exports of G&S								
Value	17.8	-4.3	2.3	4.1	7.2	7.4	7.7	7.8
Volume	19.1	-2.9	2.4	4.7	7.3	7.2	7.1	7.1
Deflator	-1.1	-1.5	-0.1	-0.6	-0.2	0.2	0.6	0.7
Imports of G&S								
Value	18.9	-5.9	1.9	3.6	7.4	7.8	8.4	8.5
Volume	19.3	-4.9	2.4	4.7	7.9	7.8	8.0	7.9
Deflator	-0.3	-1.0	-0.5	-1.1	-0.5	0.0	0.4	0.5
Memorandum								
Nominal GDP (SEK billions)	3500	3562	3616	3765	3946	4136	4324	4516

Sources: Statistics Sweden and Fund staff calculations.

[1] Positive number indicates an accumulation of foreign assets or a reduction in foreign liabilities.

[2] Less reserves.

[3] Includes financial derivatives.

Table 3. Sweden: Net International Investment Position, 2005–12

	2005	2006	2007	2008	2009	2010	2011	2012
				(Percent of GDP)				
Assets	223.9	238.3	265.6	274.2	293.3	281.3	278.6	276.2
Direct investment	81.8	81.1	92.8	106.7	110.7	102.0	99.8	96.7
Equity & investment fund shares	55.1	57.0	64.1	74.7	78.9	73.3	70.7	69.8
Debt instruments	26.6	24.2	28.7	32.0	31.9	28.8	29.0	26.9
Portfolio investment	85.7	92.5	99.1	78.7	98.7	99.1	86.2	89.4
Equity & investment fund shares	58.1	60.6	63.9	45.0	64.1	67.1	58.0	60.4
Debt securities	27.6	32.0	35.2	33.8	34.6	32.0	28.2	29.0
Fin. deriv. (other than reserves)	7.6	5.9	7.1	16.8	11.6	10.6	14.1	13.6
Other investment	41.7	52.2	60.1	64.6	61.4	59.8	68.6	67.0
Reserve assets	7.1	6.5	6.4	7.3	10.9	9.7	9.9	9.5
Liabilities	244.6	250.0	267.1	285.5	302.5	287.7	286.2	291.2
Direct investment	71.4	72.9	85.1	96.0	105.9	96.8	93.4	91.1
Equity & investment fund shares	36.2	35.9	41.2	42.7	49.6	47.6	46.1	50.3
Debt instruments	35.2	37.0	43.9	53.2	56.3	49.2	47.3	40.8
Portfolio investment	108.2	110.3	108.8	92.9	118.5	122.8	121.9	132.6
Equity & investment fund shares	40.6	48.7	41.9	21.2	32.1	40.7	33.6	40.8
Debt securities	67.6	61.6	66.9	71.7	86.4	82.0	88.3	91.8
Fin. deriv. (other than reserves)	8.1	6.2	7.3	15.2	9.6	8.1	10.6	10.8
Other investment	56.9	60.6	65.9	81.4	68.6	59.9	60.4	56.8
Net International Investment Position	-20.7	-11.7	-1.5	-11.3	-9.1	-6.4	-7.6	-15.0
Direct Investment	10.3	8.2	7.7	10.8	4.9	5.2	6.4	5.6
Portfolio Investment	-22.5	-17.8	-9.7	-14.2	-19.7	-23.7	-35.7	-43.2
Fin. deriv. (other than reserves)	-0.5	-0.2	-0.2	1.6	2.1	2.5	3.5	2.9
Other Investment	-15.1	-8.4	-5.8	-16.8	-7.2	-0.1	8.2	10.1

Sources: International Financial Statistics and Fund staff calculations.

Table 4. Sweden: General Government Statement of Operations, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
			Projections					
				(Billions of SEK)				
Revenue	1,793	1,825	1,861	1,937	2,024	2,114	2,213	2,311
Tax revenue	1,294	1,309	1,348	1,403	1,469	1,536	1,609	1,681
Taxes on income, profits, and capital gains	638	642	652	682	720	759	801	836
Payable by individuals	525	539	557	581	610	640	673	703
Payable by corporations	113	103	96	101	110	119	128	133
General taxes on goods and services	450	451	458	473	490	507	525	549
Other Taxes	207	217	238	248	259	269	283	296
Social Contributions	267	275	269	279	289	299	312	326
Grants	3	3	3	3	3	3	3	3
Other revenue	229	238	242	252	264	277	289	302
Interest income	32	32	33	34	36	38	39	41
Expenditure	1,792	1,850	1,920	1,971	2,024	2,091	2,165	2,243
Compensation of employees	487	504	521	536	550	569	595	621
Intermediate consumption	316	323	350	364	382	400	418	437
Interest payments	41	33	38	38	37	38	39	39
Social benefits	618	645	660	670	682	698	714	730
Expense not elsewhere classified	295	307	315	330	340	351	361	376
Net acquisition of nonfinancial assets	34	39	36	33	33	35	38	39
Gross operating balance	35	14	-23	-1	33	58	86	107
Net lending / borrowing	1	-25	-59	-34	0	24	49	68
Net financial worth, transactions	-3	-12						
Net acquisition of financial assets	-73	-23						
Net incurrence of liabilities	-70	-11						
				(Percent of GDP)				
Revenue	51.2	51.2	51.5	51.4	51.3	51.1	51.2	51.2
Tax revenue	37.0	36.8	37.3	37.3	37.2	37.1	37.2	37.2
Taxes on income, profits, and capital gains	18.2	18.0	18.0	18.1	18.2	18.4	18.5	18.5
Payable by individuals	15.0	15.1	15.4	15.4	15.4	15.5	15.6	15.6
Payable by corporations	3.2	2.9	2.6	2.7	2.8	2.9	2.9	2.9
General taxes on goods and services	12.9	12.7	12.7	12.5	12.4	12.3	12.2	12.2
Other Taxes	5.9	6.1	6.6	6.6	6.6	6.5	6.6	6.6
Social Contributions	7.6	7.7	7.4	7.4	7.3	7.2	7.2	7.2
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenue	6.5	6.7	6.7	6.7	6.7	6.7	6.7	6.7
Interest income	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Expenditure	51.2	51.9	53.1	52.3	51.3	50.5	50.1	49.7
Compensation of employees	13.9	14.2	14.4	14.2	13.9	13.8	13.8	13.8
Intermediate consumption	9.0	9.1	9.7	9.7	9.7	9.7	9.7	9.7
Interest payments	1.2	0.9	1.1	1.0	0.9	0.9	0.9	0.9
Social benefits	17.7	18.1	18.2	17.8	17.3	16.9	16.5	16.2
Expense not elsewhere classified	8.4	8.6	8.7	8.8	8.6	8.5	8.4	8.3
Net acquisition of nonfinancial assets	1.0	1.1	1.0	0.9	0.8	0.8	0.9	0.9
Gross operating balance	1.0	0.4	-0.6	0.0	0.8	1.4	2.0	2.4
Net lending / borrowing	0.0	-0.7	-1.6	-0.9	0.0	0.6	1.1	1.5
Net financial worth, transactions	-0.1	-0.3						
Net acquisition of financial assets	-2.1	-0.6						
Net incurrence of liabilities	-2.0	-0.3						
Structural Balance (percent of potential GDP) 1/	-0.1	-0.8	-1.4	-0.8	0.1	0.6	1.1	1.5
Fiscal Impulse (expansionary +)	0.7	0.6	0.6	-0.6	-0.9	-0.5	-0.5	-0.4
Memorandum items:								
Compliance with fiscal rule								
Overall balance 10-year average	0.7	0.7	0.7	0.6	0.4	0.2	0.0	-0.1
Overall balance 7-year rolling average (±3 years)	-0.3	-0.6	-0.4	-0.2	0.0	…	…	…
Structural balance (percent of potential GDP) 2/	-0.4	-0.5	-1.1	-0.5	0.2	0.6	1.1	1.5
Gross Public Debt (percent of GDP)	38.4	38.1	42.3	41.7	39.5	37.0	34.1	30.9
Real GDP growth (percent change)	3.7	0.7	1.1	2.3	2.3	2.4	2.4	2.4
Output gap (percent of potential GDP)	0.8	-0.4	-1.0	-0.7	-0.3	-0.1	0.0	0.0
Nominal GDP (billions of SEK)	3500	3562	3616	3765	3946	4136	4324	4516

Sources: Eurostat, Fiscal Policy Bills, Government Finance Statistics, and Fund staff calculations.

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

2/ Overall balance adjusted for the output gap, using authorities' methodology.

Table 5. Sweden: Public Sector Balance Sheet, 2005–12

	2005	2006	2007	2008	2009	2010	2011	2012
				(Billions of SEK)				
Financial assets	**1,909**	**2,150**	**2,256**	**2,077**	**2,315**	**2,438**	**2,446**	**2,560**
Currency and deposits	52	76	73	119	79	65	90	75
Securities other than shares	262	317	349	362	366	399	397	425
Loans	355	376	383	406	499	504	533	548
Shares and other equity	931	1,074	1,116	921	1,088	1,150	1,128	1,203
Other financial assets	310	308	335	269	282	320	298	309
Financial liabilities	**1,696**	**1,600**	**1,555**	**1,601**	**1,621**	**1,645**	**1,730**	**1,732**
Currency and deposits	51	29	37	58	50	53	64	70
Securities other than shares	1,327	1,214	1,106	1,112	1,077	1,109	1,131	1,123
Loans	149	168	209	213	271	230	287	270
Other liabilities	170	189	203	218	223	253	247	269
Financial net worth	**213**	**551**	**701**	**476**	**694**	**793**	**716**	**828**
				(Percent of GDP)				
Financial assets	**68.9**	**73.0**	**72.2**	**64.8**	**74.5**	**73.1**	**69.9**	**71.9**
Currency and deposits	1.9	2.6	2.3	3.7	2.6	2.0	2.6	2.1
Securities other than shares	9.5	10.8	11.2	11.3	11.8	12.0	11.3	11.9
Loans	12.8	12.8	12.3	12.7	16.1	15.1	15.2	15.4
Shares and other equity	33.6	36.5	35.7	28.7	35.0	34.5	32.2	33.8
Other financial assets	11.2	10.5	10.7	8.4	9.1	9.6	8.5	8.7
Financial liabilities	**61.2**	**54.3**	**49.8**	**50.0**	**52.2**	**49.3**	**49.4**	**48.6**
Currency and deposits	1.8	1.0	1.2	1.8	1.6	1.6	1.8	2.0
Securities other than shares	47.9	41.2	35.4	34.7	34.7	33.2	32.3	31.5
Loans	5.4	5.7	6.7	6.6	8.7	6.9	8.2	7.6
Other liabilities	6.1	6.4	6.5	6.8	7.2	7.6	7.1	7.5
Financial net worth	**7.7**	**18.7**	**22.4**	**14.9**	**22.4**	**23.8**	**20.5**	**23.2**
Memorandum items:								
GDP (SEK billions)	2,769	2,944	3,126	3,204	3,106	3,338	3,500	3,562

Sources: Eurostat and Fund staff calculations.

Table 6. Sweden: Risk Assessment Matrix 1/

(Scale—high, medium, or low)

Source of Risks	Overall Level of Concern	
	Relative Likelihood 2/	**Impact if Realized**
Financial stress in the euro area (EA) re-emerges.	**Medium** Swedish banks are directly and indirectly (including through their activity in other Nordic economies) exposed to the EA and reliant on wholesale funding. Sweden is a small, very open economy and its export industry is tightly linked to EA and global markets.	**Medium** Bank losses and funding stress could translate into curtailed lending, with negative effects for investment, consumption, and growth.
Policy response:	Reduce financial sector vulnerabilities; backstop bank liquidity, including through the use of foreign currency liquidity buffers.	
Protracted period of slower European growth.	**High** Sweden's exports are tightly linked to EA markets.	**Medium** As exports and income decline, domestic demand will slow as well, further reducing growth.
Policy response:	Revisit pace of planned fiscal consolidation; provide additional monetary policy support.	
Adverse house price shock in Sweden (or an interconnected neighboring Nordic country).	**Medium** Household debt is high due to easy access to credit, low interest rates, and tax incentives for housing. Property prices remain elevated. Swedish banks are active throughout the Nordic region.	**Medium** The flow-on effect to consumption and employment will lower growth. Rising non-performing loans and bank funding costs could translate into curtailed lending, with negative effects on investment.
Policy response:	Backstop bank liquidity, including through the use of foreign currency liquidity buffers; provide fiscal and monetary support as needed.	
Reversal of safe-haven flows.	**Low** Excessive reversal of safe-haven flows beyond a normalization of market conditions, including to Sweden.	**Medium** An excessive reversal of inflows could result in premature tightening of financial conditions, potentially exacerbating domestic risks (e.g., from a house price correction).
Policy response:	Alleviate potential credit tightening by adjusting monetary conditions; inject liquidity in financial markets where needed.	

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline ("low is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

2/ In case the baseline does not materialize.

Table 7. Sweden: Financial System Structure, 2008–12

	2008				2009				2010				2011				2012			
	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	5,184,540	31.3	161.8	1	5,212,530	30.3	167.8	1	5,207,511	30.0	156.0	1	6,382,811	33.3	182.4	1	5,813,615	30.4	163.2
Handelsbanken	1	2,158,784	13.0	67.4	1	2,122,843	12.3	68.4	1	2,153,530	12.4	64.5	1	2,454,366	12.8	70.1	1	2,387,858	12.5	67.0
S.E.B	1	2,510,702	15.1	78.4	1	2,308,227	13.4	74.3	1	2,179,821	12.6	65.3	1	2,362,653	12.3	67.5	1	2,453,456	12.8	68.9
Swedbank	1	1,811,690	10.9	56.5	1	1,794,687	10.4	57.8	1	1,715,681	9.9	51.4	1	1,857,065	9.7	53.1	1	1,846,941	9.7	51.9
Total Top Four Banks	4	11,665,716	70.3	364.1	4	11,438,287	66.5	368.3	4	11,256,543	64.9	337.3	4	13,056,895	68.1	373.1	4	12,501,870	65.3	351.0
Four major banks in Sweden 1/																				
Banks	4	7,494,960	45.2	233.9	4	7,040,183	40.9	226.7	4	5,464,340	31.5	163.7	4	6,016,174	31.4	171.9	4	6,076,915	31.8	170.6
Insurance companies	8	451,878	2.7	14.1	8	509,691	3.0	16.4	8	544,463	3.1	16.3	8	500,273	2.6	14.3	8	554,856	2.9	15.6
Mortgage credit institutions	3	1,778,099	10.7	55.5	3	1,899,919	11.0	61.2	3	1,971,472	11.4	59.1	3	2,098,457	11.0	60.0	3	2,209,594	11.5	62.0
Securities firms	3	7,877	0.0	0.2	3	30,242	0.2	1.0	3	14,109	0.1	0.4	3	14,112	0.1	0.4	2	14,910	0.1	0.4
Other credit market companies	8	226,637	1.4	7.1	8	235,297	1.4	7.6	8	167,768	1.0	5.0	8	170,213	0.9	4.9	7	167,150	0.9	4.7
Top four banks in Sweden	26	9,959,451	60.1	310.8	26	9,715,332	56.5	312.8	26	8,162,152	47.1	244.6	26	8,799,229	45.9	251.4	24	9,023,425	47.2	253.3
Other Banks in Sweden																				
Of which:																				
Banks	28	422,682	2.5	13.2	30	481,797	2.8	15.5	29	546,619	3.2	16.4	29	578,692	3.0	16.5	29	656,814	3.4	18.4
Savings banks	154	151,046	0.9	4.7	53	164,177	1.0	5.3	49	147,512	0.9	4.4	50	157,045	0.8	4.5	49	171,406	0.9	4.8
Mortgage credit institutions	4	359,177	2.2	11.2	4	436,302	2.5	14.0	3	338,789	2.0	10.2	3	361,378	1.9	10.3	3	361,305	1.9	10.1
Member bank	2	1,381	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	2	1,909	0.0	0.1
Other credit market companies	44	734,725	4.4	22.9	43	790,385	4.6	25.4	40	722,164	4.2	21.6	39	772,237	4.0	22.1	35	818,635	4.3	23.0
Total other banks in Sweden	232	1,669,011	10.1	52.1	132	1,874,182	10.9	60.3	123	1,756,705	10.1	52.6	123	1,871,109	9.8	53.5	118	2,010,069	10.5	56.4
Nonbank credit institutions																				
Insurance companies	253	2,117,927	12.8	66.1	253	2,351,945	13.7	75.7	254	2,536,287	14.6	76.0	217	2,555,220	13.3	73.0	208	2,717,606	14.2	76.3
Life insurance	44	1,577,872	9.5	49.2	43	1,782,371	10.4	57.4	44	1,965,284	11.3	58.9	40	1,987,109	10.4	56.8	39	2,143,215	11.2	60.2
Nonlife insurance 2/	209	540,055	3.3	16.9	210	569,574	3.3	18.3	210	571,003	3.3	17.1	177	568,111	3.0	16.2	169	574,392	3.0	16.1
Pension funds	15	91,132	0.5	2.8	14	105,567	0.6	3.4	13	117,511	0.7	3.5	11	123,277	0.6	3.5	11	135,266	0.7	3.8
Mutual funds 3/	837	1,017,250	6.1	31.7	849	1,393,337	8.1	44.9	896	1,635,074	9.4	49.0	911	1,534,817	8.0	43.9	866	1,737,564	9.1	48.8
Other nonbank credit institutions																				
Asset management firms	84	6,923	0.0	0.2	82	7,346	0.0	0.2	80	7,662	0.0	0.2	0	0	0.0	0.0	75	7,731	0.0	0.2
Securities firms	132	14,986	0.1	0.5	132	28,895	0.2	0.9	132	23,817	0.1	0.7	129	22,467	0.1	0.6	125	22,615	0.1	0.6
Total financial system	1557	16,582,944	100.0	517.5	1466	17,199,559	100.0	553.8	1502	17,333,599	100.0	519.4	1395	19,163,785	100.0	547.6	1407	19,132,721	100.0	537.1
of which: Total banking sector 4/		13,334,727	80.4	416.1		13,312,469	77.4	428.6		13,013,248	75.1	389.9		14,928,004	77.9	426.5		14,511,939	75.8	407.4
Memorandum item:																				
Foreign bank branches in Sweden	28	877,859	5.3	27.4	24	686,265	4.0	22.1	26	760,045	4.4	22.8	27	789,061	4.1	22.5	27	832,627	4.4	23.4
Swedish bank branches abroad	52	1,538,319	9.3	48.0	55	1,411,402	8.2	45.4	61	1,456,017	8.4	43.6	61	2,063,291	10.8	59.0	61	1,993,116	10.4	56.0
Nominal GDP (in millions of SEK)				3,204,320				3,105,790				3,337,531				3,499,914				3,561,903

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 8. Sweden: Financial Soundness Indicators: Banks, 2008–12

	2008	2009	2010	2011	2012
(End of period, percent)					
Capital Adequacy					
Regulatory capital to risk-weighted assets 1/	10.7	13.0	12.6	12.2	12.5
of which: Four major banks 2/	10.2	12.7	12.0	11.5	11.7
Regulatory Tier I capital to risk-weighted assets 1/	8.1	10.9	11.0	11.3	11.7
of which: Four major banks 2/	7.6	10.5	10.4	10.7	11.1
Capital as percent of assets (leverage ratio)	4.6	5.0	4.8	4.1	4.4
of which: Four major banks 2/	4.7	5.0	4.7	4.0	4.2
Asset quality and exposure					
Nonperforming loans to total gross loans	1.1	2.0	1.9	1.6	1.5
of which: Four major banks 2/	1.0	2.0	1.9	1.5	1.4
Nonperforming loans net of loan-loss provisions to capital	7.4	10.7	9.9	9.5	9.3
of which: Four major banks 2/	6.5	11.0	10.6	9.9	10.0
Loan-loss provisions to nonperforming loans	49.1	55.4	44.3	41.3	39.8
of which: Four major banks 2/	47.1	53.7	43.8	40.7	38.7
Distribution of MFI credit (percent) 4/					
Sweden	79.1	80.1	81.3	80.9	80.1
Financial corporation	1.1	1.1	2.0	1.7	1.8
Non financial corporations	33.9	31.4	31.0	31.1	30.3
Public sector	3.1	3.8	2.6	2.9	2.8
Households	41.0	43.8	45.7	45.2	45.2
Outside Sweden	20.9	19.9	18.7	19.1	19.9
Other EUs	11.0	9.4	9.5	9.5	9.9
Rest of the world	9.9	10.5	9.3	9.6	10.0
Large exposures as percent of tier 1 capital 3/	34.1	12.3	40.1	37.2	29.5
of which: Four major banks 3/	30.9	8.1	36.8	31.4	22.0
Earnings and profitability					
Return on assets (net income as percent of average total assets)	0.5	0.3	0.4	0.5	0.5
of which: Four major banks 2/	0.6	0.2	0.4	0.5	0.5
Return on equity (Net income as percent of average equity capital)	12.7	13.0	9.8	10.6	11.4
of which: Four major banks 2/	14.3	5.4	10.1	11.1	12.0
Net interest income as percent of gross income	55.2	56.8	52.7	54.4	55.4
of which: Four major banks 2/	56.9	57.7	55.3	57.3	58.3
Noninterest expenses as percent of gross income	57.0	56.9	66.2	66.1	63.2
of which: Four major banks	54.2	55.4	65.1	65.7	61.0
Noninterest income as percent of total income	44.8	43.2	55.1	52.9	51.7
of which: Four major banks	43.1	42.3	53.5	51.0	49.7
Trading income and foreign exchange gains (losses) to gross income	8.6	11.7	11.6	9.4	10.7
of which: Four major banks 2/	9.8	13.6	12.6	10.0	11.2
Personnel expenses as percent of noninterest expenses	55.0	53.2	52.6	53.6	52.2
of which: Four major banks 2/	59.2	57.1	57.4	57.8	59.4
Liquidity					
Liquid assets as percent of total assets	4.0	6.3	4.8	6.2	8.5
of which: Four major banks 2/	4.3	6.7	5.2	6.7	9.1
Liquid assets as percent of short-term liabilities	23.6	43.6	44.4	66.7	97.2
of which: Four major banks 2/	30.5	54.7	58.9	87.9	121.6
Customer deposits as a percent of total (non-interbank) loans	46.1	47.1	47.8	49.8	52.9
of which: Four major banks 2/	45.5	45.3	46.6	48.5	50.9
Noninterbank loans to noninterbank deposits	139.6	144.8	155.0	153.8	148.8
of which: Four major banks 2/	149.7	156.1	165.9	163.5	158.0
Foreign exchange risk					
Foreign currency loans as percent of total loans	39.0	37.8	36.5	37.4	34.9
Foreign currency assets as percent of total assets	33.0	31.2	31.4	34.5	33.1
Foreign currency-denominated liabilities as percent of total liabilities	35.4	29.8	31.4	35.1	31.1
Exposure to derivatives					
Gross asset position in derivatives as percent of Tier 1 capital	336.8	210.8	222.3	351.2	243.9
Gross liability position in derivatives as percent of Tier 1 capital	320.7	198.9	217.9	335.2	232.8

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

1/ The calculations follow rules under Basel II, including transition rules as reported by the Riksbank. Without transition rules, the capital ratios would currently be higher due to lower risk-weighted assets (the result of banks' implementation of the IRB approach).
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 9. Sweden: Financial Soundness Indicators: Non-Banks, 2008–12

	2008	2009	2010	2011	2012
(End of period, percent)					
Insurance sector					
Solvency ratio (margin/required margin)					
Life insurance companies	8.4	7.8	14.2	8.0	9.9
Non-life insurance companies	6.8	7.7	10.6	10.6	10.8
Return on equity					
Life insurance companies	-86.3	45.3	20.3	-30.1	32.5
Non-life insurance companies	-21.4	29.7	35.4	3.5	40.0
Households					
Household debt as percent of GDP	75.8	82.0	80.4	82.9	85.0
Household debt as percent of disposable income	164.8	166.6	172.9	176.3	173.7
Household interest expense as percent of disposable income	5.2	3.5	3.2	4.4	4.4
Corporate sector					
Debt stock as percent of GDP (non-financial sector borrowing from financial sector)	65.6	64.9	60.7	61.8	62.0
Total debt stock as percent of GDP	92.5	91.5	85.0	84.5	87.0
Equity risk					
OM Stockholm Stock Exchange Index (annual percent change)	-42.0	46.7	23.1	-16.7	12.0
Market capitalization in percent of GDP	116.0	200.9	225.3	155.6	187.9
Real estate markets (prices; year on year percent change)					
One- or two dwelling buildings	-2.0	7.1	5.2	-2.9	2.3
Greater Stockholm region	-3.2	5.9	7.0	-2.1	2.2
Buildings for seasonal and secondary use	-2.8	12.2	3.4	-3.0	-2.5
Memorandum items					
GDP (year on year percent change, constant prices)	-0.6	-5.0	6.6	3.7	0.7
GDP bn SEK, current prices	3,204	3,106	3,338	3,500	3,562

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

Annex I. Recent Financial Policy Initiatives[1]

In line with past staff advice (see Table on following pages), the authorities are engaged in a number of policy measures to support financial stability:

- Banks have been asked to increase capital buffers (e.g., major banks' Core Tier I capital ratio should be 10 percent or more from January 2013 and 12 percent or more from January 2015) and address liquidity risks (e.g., implementing Basel III liquidity coverage ratios ahead of time).
- A maximum 85 percent loan-to-value ratio (LTV) for household mortgages was introduced in October 2010 to improve mortgage quality.
- Sweden's Financial Supervisory Authority (FSA), after a consulting period with banks, introduced minimum mortgage risk weights of 15 percent in May 2013.
- Since its creation in mid-2012, the Riksbank and the FSA have held three meetings of the Council for Cooperation on Macroprudential Policy (CCMP), in an attempt to foster cooperation on the management of macrofinancial risks.
- Major banks were requested to improve the transparency of their public reporting as regards information on maturity information per type of asset and liability and per currency, as well as on the degree of asset encumbrance.

[1] Prepared by Eugenio Cerutti (RES).

Sweden: Status of 2011 FSAP Update Recommendations	
Recommendation	**Status**
Financial Stability (Short Term (ST) or Medium Term (MT))	
Establish a high-level Systemic Financial Stability Council (SFSC). (ST)	The first Financial Crisis Committee (FCC) report was submitted to relevant authorities for consultation between February and the end of May 2013. The MOF is currently compiling the authorities' views and will thereafter present its own proposal (likely in 2013) to strengthen the framework. Sweden has already an established Financial Stability Council (FSC) with the participation of Finansinspektionen (FI), the Minisitry of Finance (MoF), the Riksbank (RB), and the Swedish National Debt Office. In January 2012, the Council for Cooperation on Macroprudential Policy was established between FI and RB. There is also cross-border cooperation in the form of the Nordic-Baltic Financial Stability Group and the Nordic-Baltic Macroprudential Forum.
Monitor closely the performance of mortgage loans. (ST)	FI and RB collect and analyze data on new mortgages. These are published annually in the FI report "The Swedish Mortgage Market". In addition to the data on new mortgages, RB has recently initiated a collection of micro-level data on the stock of all household liabilities.
Collect and monitor on a regular basis loan default rates and data on nonperforming loans (NPLs) by sector and geographical allocation. (MT)	FI quarterly reports on supervision of credit institutions' lending and credit conditions to companies and households. The authority collects, on a quarterly basis, aggregated data on non-performing loans and impairments (also divided by industry). For systemically important banks (covering approximately 75 percent of the Swedish financial sector), detailed data for the 25 largest exposures at risk is collected and the individual credits are discussed at quarterly risk meetings held with the banks. From January 1, 2014, FI will require reporting from financial institutions in accordance with the new reporting format FINREP, which will further enhance the granularity of the information. In addition, COREP-reporting (also to be introduced January 1, 2014) will add the geographical dimension. FI also reports on how and to what extent the credit institutions during 2013 have adjusted to the increased capital requirements and the effects on households and companies. By the end of the year, FI will report on measures to be taken to increase transparency of lending rates and present an action plan on measures to foster sound amortization, including amortization plans and implementation.

Source: Swedish authorities.

Continued on next page

Sweden: Status of 2011 FSAP Update Recommendations (cont'd)	
Recommendation	**Status**
Cross-Sector Issues (banking/insurance/securities)	
Increase FI's resources to ensure effective supervision. (ST)	Budget bill 2012: SEK 103 million over 3 years in additional resources.
Strengthen coverage and robustness of off-site monitoring and on-site inspections. (ST)	See above.
Consider explicit legal protection to FI and its staff against lawsuits for actions taken in good faith. (MT)	No legislative measures have been taken.
Enhance the operational independence of FI in discharging its supervisory responsibility. (MT)	Amendment to ordinance (2009:93): Clarification that the authority independently plans and makes its own decision on the distribution of resources. Revision to the decision competence in the area of bank and insurance: The decision competence is transferred in its entirety to FI. Legislative changes will come into force on July 15, 2013.
Broaden the scope of FI's discretion in issuing binding secondary regulations. (MT)	No legislative measures have been taken.
Enhance crime prosecution in the securities market sector such as insider dealing and market manipulation. (MT)	Government inquiry to analyze the effectiveness of the present system of sanctions related to the combating of market abuse. Presentation planned for December 31, 2013. In December 2011, a report was presented by the Financial Market Committee where the insider trade prohibition was evaluated. The comparison with other countries showed that the effectiveness (in prosecutions) of the Swedish system was not lower.
Payment and Market Infrastructure	
Address the legal uncertainty related to settlement finality and collateralization process. (ST)	A government enquiry presented its report in the spring of 2012. The proposal is undergoing a consultation process until mid-June 2013. Legislative changes are expected to come into force on January 1, 2014.
Enhance NOMX DM's risk management procedures and separate financial resources between NOMX DM and NOMX COM. (ST)	Activities for default funds were completed in 2012. The whole CCP, including commodities, is evaluated according to the CPSS / IOSCO. Analysis of liquidity risks is included in this assessment. The CCP will be authorized according to EMIR during 2013.
Review its act to allow RB to issue regulations, and clarify the division of responsibilities between the RB and FI. (MT)	RB and FI have reviewed their respective responsibilities. FI is responsible for the supervision while RB is responsible for the oversight of FMIs. The difference in mandate between the two authorities is reflected in the tools available to RB and FI to induce change. RB is by design not supposed to issue regulation.

Source: Swedish authorities.

Continued on next page

Sweden: Status of 2011 FSAP Update Recommendations (cont'd)	
Recommendation	**Status**
Anti-Money Laundering and Combating the Financing of Terrorism	
Establish measures in relation to the criminalization of terrorism financing to enable the freezing of all funds. (MT)	Pending EU legislative initiative.
Amend the legal framework to require current beneficial ownership information in relation to legal persons to be collected and made available in a timely manner. (MT)	A special investigator has been appointed to analyze and present ways of improving the Swedish compliance with regard to access to beneficial ownership. The investigator is supposed to report back in October 2013.
Crisis Management Arrangements	
Reconstitute the mandate of the Domestic Standing Group to focus on contingency planning and crisis management. (MT)	See above on "Establish a high-level SFSC".
Hold crisis simulation exercise with all four parties to the domestic MOU. (MT)	Because of the cross-border structure of the banking system, a larger Nordic-Baltic exercise is planned for 2015. The process for preparing such exercise is already ongoing.
Increase FI resources for running supervisory colleges it chairs. (ST)	See above on FI resources.
Develop and maintain supervisory and crisis management databases envisaged in group-specific MOUs. (MT)	A database has been developed for crisis management and is updated once a year with public data. A template has also been developed to be used and uploaded in the event of a crisis. The templates have been developed in co-operation with the Nordic and Baltic countries.
Carry out a reform of deposit insurance with an aim to shorten the payout, redefine a payout trigger and mandate banks to maintain insured deposit data. (ST)	Legislative revisions came into force on July 1, 2012.
Introduce a special bank insolvency regime with a possibility of deposit insurance fund to support bank restructuring. (MT)	Negotiations ongoing on EU-level.
Liquidity Risk Management	
Formalize communication between RB and FI in assessing solvency and viability of financial institutions in the context of emergency liquidity assistance (ELA). (ST)	Will be dealt with in the FSC, comprising the RB, FI, Swedish National Debt Office, and MoF.
Develop a formal process, in the context of the proposed SFSC, on international reserve management policy. (MT)	No formal process on reserve management has been developed in the context of the SFSC.
Source: Swedish authorities.	

Annex II. Public Sector Debt Sustainability[1]

Sweden: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(Percent of GDP, unless otherwise indicated)

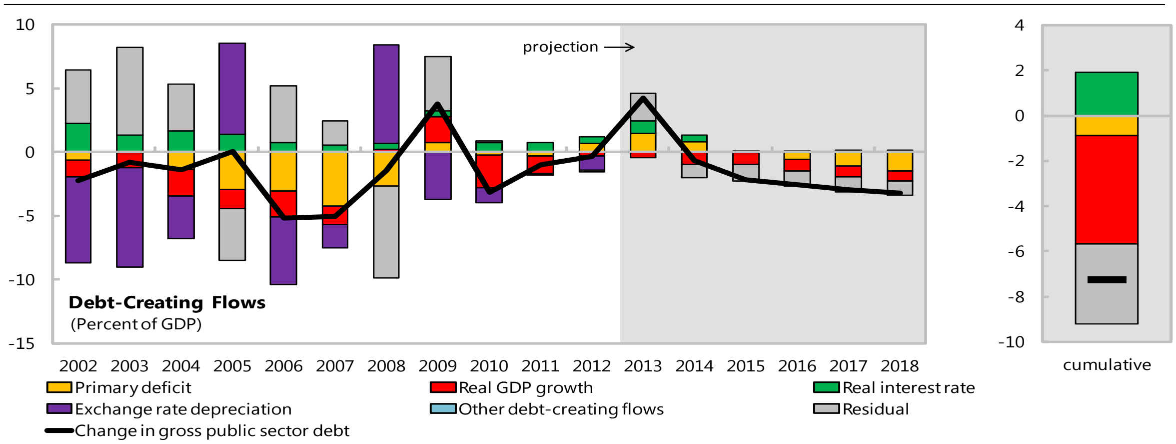
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018
Nominal gross public debt	45.7	38.4	38.1	42.3	41.7	39.5	37.0	34.1	30.9
Public gross financing needs	8.8	7.8	9.4	13.1	13.1	10.7	9.7	8.9	8.1
Net public debt	43.8	36.7	36.4	40.6	40.0	37.9	35.4	32.5	29.4
Real GDP growth (in percent)	2.3	3.7	0.7	1.1	2.3	2.3	2.4	2.4	2.4
Inflation (GDP deflator, in percent)	1.7	1.1	1.0	0.5	1.7	2.4	2.4	2.1	2.0
Nominal GDP growth (in percent)	4.0	4.9	1.8	1.5	4.1	4.8	4.8	4.5	4.4
Effective interest rate (in percent) [4/]	3.9	3.1	2.4	3.0	3.0	2.6	2.7	2.6	2.6

As of April 30, 2013		
Sovereign Spreads		
Spread (bp) 3/		-29
CDS (bp)		19
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.7	-1.01	-0.31	4.2	-0.7	-2.2	-2.5	-2.9	-3.2	-7.3	
Identified debt-creating flows	-3.3	-0.98	-0.19	1.9	0.0	-1.3	-1.6	-2.0	-2.3	-5.3	
Primary deficit	-1.6	-0.3	0.7	1.5	0.8	0.0	-0.6	-1.1	-1.5	-0.9	-0.8
Primary (noninterest) revenue and gra	53.3	50.3	50.3	50.5	50.5	50.4	50.2	50.3	50.3	302.2	
Primary (noninterest) expenditure	51.7	50.0	51.0	52.0	51.3	50.3	49.6	49.2	48.8	301.3	
Automatic debt dynamics [5/]	-1.7	-0.7	-0.9	0.4	-0.8	-1.2	-1.1	-0.9	-0.8	-4.4	
Interest rate/growth differential [6/]	0.0	-0.6	0.2	0.5	-0.4	-0.9	-0.8	-0.7	-0.6	-2.9	
Of which: real interest rate	1.1	0.7	0.5	0.9	0.5	0.1	0.1	0.2	0.2	1.9	
Of which: real GDP growth	-1.1	-1.4	-0.3	-0.4	-1.0	-0.9	-0.9	-0.8	-0.8	-4.8	
Exchange rate depreciation [7/]	-1.7	0.0	-1.1	...	...	...	...	...	...	...	
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	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows (specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.6	0.0	-0.1	2.2	-1.0	-1.3	-1.2	-1.1	-1.1	-3.5	



Source: Fund staff calculations. 1/ Public sector is defined as general government. 2/ Based on available data. 3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ 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).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

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

8/ For projections, this line includes exchange rate changes during the projection period.

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.

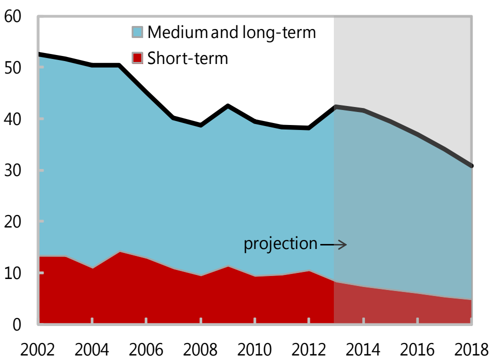
[1] Prepared by Ruchir Agarwal (EUR).

Sweden: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

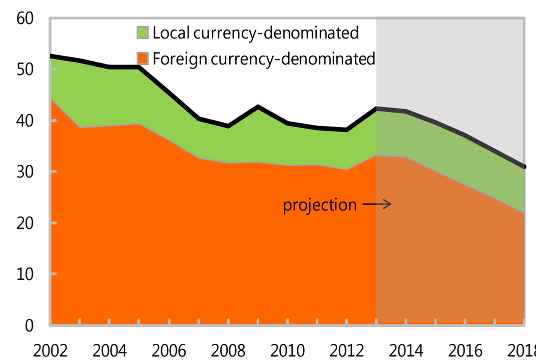
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

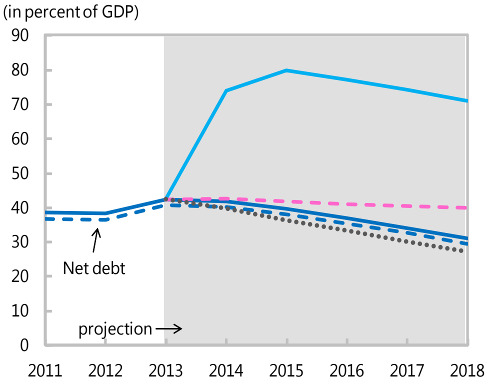


Alternative Scenarios 1/

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance

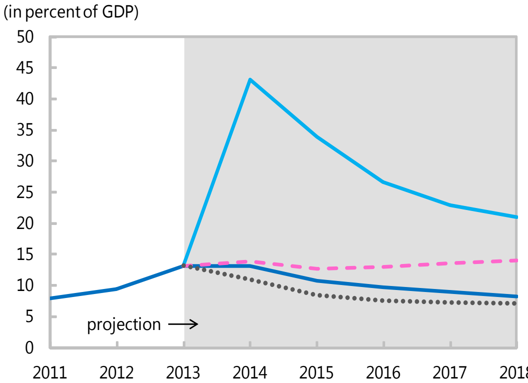
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	1.1	2.3	2.3	2.4	2.4	2.4
Inflation	0.5	1.7	2.4	2.4	2.1	2.0
Primary Balance	-1.5	-0.8	0.0	0.6	1.1	1.5
Effective interest rate	3.0	3.0	2.6	2.7	2.6	2.6
Constant Primary Balance Scenario						
Real GDP growth	1.1	2.3	2.3	2.4	2.4	2.4
Inflation	0.5	1.7	2.4	2.4	2.1	2.0
Primary Balance	-1.5	-1.5	-1.5	-1.5	-1.5	-1.5
Effective interest rate	3.0	3.1	2.7	2.8	2.8	2.8

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	1.1	2.3	2.3	2.3	2.3	2.3
Inflation	0.5	1.7	2.4	2.4	2.1	2.0
Primary Balance	-1.5	1.3	1.3	1.3	1.3	1.3
Effective interest rate	3.0	3.1	2.9	3.1	3.0	3.1
Contingent Liability Shock						
Real GDP growth	1.1	-4.1	-4.1	2.4	2.4	2.4
Inflation	0.5	0.1	0.8	2.4	2.1	2.0
Primary Balance	-1.5	-29.6	0.0	0.6	1.1	1.5
Effective interest rate	3.0	3.4	6.9	4.6	4.6	4.5

Source: Eurostat, Ministry of Finance, Statistics Sweden, Swedish National Debt Office, and Fund staff calculations.

1/ The Baseline is constructed from historical data on debt maturity, currency denomination of debt, and other characteristics of outstanding government debt. Projections are based on financing needs and other related variables from reports of the Swedish National Debt Office and the Ministry of Finance. In the Historical scenario, real GDP growth, the real interest rate, and the primary balance are set to historical averages. In the Constant Primary Balance scenario, the primary balance projection is kept constant at the 2013 Baseline proejction level. The Contingent Liability Shock scenario considers a one-time increase in non-interest expenditures equivalent to 10 percent of banking sector assets. In turn, this results in adverse effects on real GDP growth, which is reduced by 2 standard deviations for 2 consecutive years. The revenue-to-GDP ratio remains unchanged relative to the baseline; the deterioration in the primary balance leads to an increase in the interst rate; and the decline in growth results in lower inflation.

INTERNATIONAL MONETARY FUND

SWEDEN

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 26, 2013

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2013)

Mission: May 20–31, 2013 in Stockholm. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2013/053113b.htm. The staff report will be published.

Staff team: Mr. H. Berger (Head), Ms. N. Batini, Mr. R. Agarwal (all EUR), and Mr. E. Cerutti (RES). Mr. P. de Imus (SPR) joined the mission for one day. Ms. P. Meyersson, Alternate Executive Director, (OEDSWE) attended for the duration of the mission. Ms. L. Christiansen and Mr. T. Dowling provided support from headquarters.

Outreach: The team met with the parliamentary Finance Committee, the parliamentary Committee on Review of Regulatory Framework, representatives of the private sector, several large banks, the Swedish Trade Union Confederation, which represents blue-collar workers, the National Institute of Economic Research, state-owned pension, MoF Committee on Inquiry on Swedish Government Debt Management, academics, and the Fiscal Policy Council. The mission held a press conference at the Riksbank after the concluding meeting.

Fund relations: Discussions for the 2012 Article IV consultation were held in Stockholm during May 3–14, 2012 and the staff report was discussed by the Executive Board on June 18, 2012. The Executive Board's assessment and staff report (IMF country Report No. 12/154, June 2012) are available at http://www.imf.org/external/pubs/cat/longres.aspx?sk=26019.0. The Article IV discussions with Sweden are on the 12-month consultation cycle.

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

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	2,395.50	100.00
Fund holdings of currency (Exchange Rate)	1,758.31	73.40
Reserve Tranche Position	637.19	26.60
Lending to the Fund		
New Arrangements to Borrow	548.09	

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	2,248.96	100.00
Holdings	2,127.32	94.59

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund:

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

	Forthcoming				
	2013	2014	2015	2016	2017
Principal					
Charges/Interest	0.04	0.09	0.09	0.09	0.09
Total	0.04	0.09	0.09	0.09	0.09

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).

Resident Representative: None

STATISTICAL ISSUES

(As of July 9, 2013)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance. The country has a full range of statistical publications, many of which are on the internet. The quality and timeliness of the economic database are generally very good.	
II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May 31, 1996. Uses an SDDS flexibility option for timeliness on the data category production index. The authorities have expressed initial interest to adhere to the Special Data Dissemination Standard Plus.	A data ROSC was published in September 2001, followed by an update in November 2002.

Sweden: Table of Common Indicators Required for Surveillance
(As of July 9, 2013)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8] Data Quality – Methodological soundness[9]	Memo Items:[8] Data Quality Accuracy and reliability[10]
Exchange Rates	2013/06	2013/07	M	M	M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2013/05	2013/06	M	M	M		
Reserve/Base Money	2013/04	2013/06	M	M	M	LO, O, O, LO	O, O, O, NA
Broad Money	2013/04	2013/06	M	M	M		
Central Bank Balance Sheet	2013/04	2013/06	M	M	M		
Consolidated Balance Sheet of the Banking System	2013/04	2013/06	M	M	M		
Interest Rates[2]	2013/05	2013/06	M	M	M		
Consumer Price Index	2013/05	2013/06	M	M	M	O, O, O, O	O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2012 Q4	2013/05	Q	Q	Q	LNO, LO, O, O	O, O, O, NO
Revenue, Expenditure, Balance, and Composition of Financing[3]—Central Government	2011	2012/12	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2011	2012/12	A	A	A		
External Current Account Balance	2012 Q4	2013/06	Q	Q	Q	O, O, O, O O, O, O, O	O, O, O, LO O, O, O, O
Exports and Imports of Goods and Services	2013/04	2013/07	M	M	M		
GDP/GNP	2013 Q1	2013/06	Q	Q	Q	O, O, O, O	O, O, O, LNO
Gross External Debt							
International Investment Position[6]	2012 Q4	2013/06	Q	Q	Q		

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D), weekly (W), monthly (M), quarterly (Q), annual (A), irregular (I); and not available (NA).
8/ These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
9/ This reflects the assessment provided in the data ROSC or the Substantive Update (published on ..., and based on the findings of the mission that took place during...) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
10/ Same as footnote 9, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND
COM
COMMUNICATIONS DEPARTMENT

Press Release No. 13/325
FOR IMMEDIATE RELEASE
September 5, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with Sweden

On August 30, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sweden.[1]

Sweden recovered quickly from the Great Recession, leading much of the rest of Europe in 2010–11, but the economy has slowed more recently. Sweden faces a difficult external environment with growth decelerating to below 1 percent in 2012 despite continued monetary support and mildly expansionary fiscal policy. While the economy appears to have stabilized, the overall growth trend has been one of moderation, partly reflecting cooling activity abroad and Sweden's tight trade and financial links with the rest of the Nordic region and the euro area. Meanwhile, the unemployment rate remains elevated, reflecting cyclical and structural weaknesses. Consumer price inflation has eased markedly below the 2-percent target, primarily due to the strong krona amidst safe-haven flows, and the external balance remains strongly in surplus.

Downside risks stem from financial fragilities and regional spillovers. Domestically, household debt is high and rising, reflecting tax incentives, easy access to low-amortization mortgages, and very low interest rates. As a consequence, a sudden and sizeable fall in Swedish property prices could have a knock-on effect on consumption and unemployment, with negative repercussions on banks through non-performing loans and funding costs. Owing to the extensive activity of Sweden's very large and concentrated banking sector in Denmark, Finland, and Norway, this could have sizeable spillovers across the Nordic region. At the same time, a sudden deterioration of household financial health elsewhere in the region poses a risk to Sweden—as discussed in the Nordic Regional Report. A sudden and

[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.

severe re-intensification of the euro area crisis could impact banks as well, as would a large reversal of safe-haven flows.

Reforms are under way to address many of these concerns. Financial reforms that have been introduced include measures to increase capital and liquidity buffers and the introduction of loan-to-value caps and a risk-weight floor for mortgages. However, banks remain heavily dependent on wholesale funding and credit to households continues to expand, with mortgage amortization low by international standards. Against this background and given downside risks, the Riksbank boosted borrowed currency reserves to ensure ready access to foreign currency liquidity. While the fiscal framework has served Sweden well and helped reduce general government debt after the banking crisis in the early 1990s, the authorities are examining ways to strengthen the framework to ensure both its countercyclicality and a prudent borrowing capacity adequate for a country with a large financial sector.

Executive Board Assessment

Executive Directors appreciated the additional context provided by the Nordic Regional Report. They commended the Swedish authorities for their sound policy management, including a supportive fiscal and monetary stance and ongoing financial reforms. However, they noted that growth has slowed together with growth in Nordic and other European trading partners, and risks remain tilted to the downside. High household debt and financial fragilities pose important challenges, particularly given the large size of Sweden's financial sector and significant cross-Nordic linkages.

Directors welcomed the authorities' focus on the financial stability agenda and commended measures already taken to reduce vulnerabilities. They suggested a comprehensive but gradual strategy to further improve the health of the banking system and household finances, including measures to strengthen banks' funding and liquidity positions and a phased-in reduction of tax incentives to contain the buildup of household debt. Directors also underscored the need for clear lines of responsibility for macroprudential policy and for further progress toward a robust bank resolution framework, both domestically and in a cross-border context.

Directors concurred that monetary policy should continue to be accommodative, assuming household credit growth remains contained. They underscored that progress on the financial stability agenda would allow monetary policy to focus on macroeconomic goals and would reduce the need for foreign liquidity reserves and fiscal buffers.

Directors supported the moderately expansionary fiscal stance for 2013. They saw room for additional stimulus if downside risks materialize, but emphasized the need to return to the 1 percent structural target when conditions warrant. Directors agreed that the existing fiscal framework has served Sweden well and were encouraged by ongoing efforts to ensure its countercyclicality. Many Directors saw merit in an explicit longer-term anchor for fiscal policy, including a target debt range well below the Maastricht Treaty criterion of 60 percent of GDP. This would ensure adequate room for the government to borrow, given the large financial sector, the expected costs of aging and cyclical budget swings. A number of Directors, however, advised caution in changing a well-functioning framework, and noted that a target debt range would be difficult to determine and could give rise to moral hazard.

Directors recognized Sweden's consistently high level of competitiveness but encouraged additional reforms to further bolster potential growth. This should include continued strengthening of the labor market by stimulating demand for young and foreign-born workers, and relieving housing bottlenecks by increasing land supply and raising incentives to invest in residential construction.

Sweden: Selected Economic Indicators, 2011–14

	2011	2012	Projections 2013	Projections 2014
Real economy (percent change)				
Real GDP	3.7	0.7	1.1	2.3
Domestic Demand	3.2	0.4	1.2	2.2
CPI inflation	3.0	0.9	0.3	1.6
Unemployment rate (percent)	7.8	8.0	8.2	7.8
Gross national saving (percent of GDP)	26.6	25.7	25.2	25.6
Gross domestic investment (percent of GDP)	19.4	18.7	18.3	18.5
Output Gap (percent of potential GDP)	0.8	-0.4	-1.0	-0.7
Public finance (percent of GDP)				
Total Revenues	51.2	51.2	51.5	51.4
Total Expenditures	51.2	51.9	53.1	52.3
Net lending	0.0	-0.7	-1.6	-0.9
Structural balance (percent of potential GDP)	-0.1	-0.8	-1.4	-0.8
General government gross debt, official statistics	38.4	38.1	42.3	41.7
Money and credit (year-on-year, percent change, eop)				
M1	0.9	5.9	...	...
M3	6.2	1.9	...	...
Bank lending to households	6.0	11.7	...	...
Repo rate (end of period)	1.8	1.0	...	...
Three-month treasury bill rate (year average)	1.7	1.3	...	...
Ten-year government bond yield (year average)	2.6	1.6	...	...
Balance of payments (percent of GDP)				
Current account	7.0	6.9	6.9	7.1
Goods and Services balance	5.8	6.3	6.3	6.5
Foreign Direct Investment, net	-3.5	-3.2	-3.1	-3.1
International reserves, changes (billions of USD)	-0.7	-0.5	-15.3	0.0
Reserve cover (months of imports)	2.8	2.8	3.6	3.5
Exchange rate (period average)				
Exchange rate regime	Free floating exchange rate			
SEK per U.S. dollar (June 20, 2013)	6.5			
Nominal effective rate (2005=100)	104.2	105.5	...	...
Real effective rate (2005=100) 1/	91.0	92.3	...	...
Fund Position (May 31, 2013)				
Holdings of currency (percent of quota)	73.40			
Holdings of SDRs (percent of allocation)	94.59			
Quota (millions of SDRs)	2395.50			
Social Indicators (reference year)				

GDP per capita (2012, constant USD): 55,158; Population (2012, million): 9.5; Main products and exports: Machinery, motor vehicles, paper products, pulp and wood; Key export markets: Germany, Norway, United Kingdom

Sources: Haver Analytics, IMF Institute, Sveriges Riksbank, Sweden Ministry of Finance, and IMF staff calculations.

1/ Based on relative unit labor costs in manufacturing.

Statement by Pernilla Meyersson, Alternate Executive Director for Sweden
August 30, 2013

The Swedish authorities would like to thank IMF staff for the candid and constructive policy discussions during the Article IV consultation with Sweden. The authorities appreciate the comprehensive and in-depth analysis of the Swedish economy and broadly agree with the main conclusions of the staff report.

Economic development

- The authorities broadly share staff's assessment of the economic developments in Sweden and internationally. After the slowdown in the economy during 2012, there are some positive signs in the Swedish economy. While GDP growth in the second quarter of 2013 amounted to -0.1 percent (q/q), indicators suggest increasing growth for the third quarter and GDP growth is expected to pick up further in 2014 as the international environment improves.

- The Consumer confidence indicator is at a historically normal level and consumption is expected to grow at a normal rate whilst domestic investment remains subdued in the coming quarters. The development in the labor market is stable with slight increases in both employment and participation rates, implying roughly unchanged unemployment rates over the recent past. Compared to pre-crisis levels, however, unemployment has increased by about two percentage points. Resource utilization and the labor market are expected to improve in 2014. Inflation is below target at 1.2 percent mainly as a result of reduced price mark-ups and a strong krona. Inflation is expected to increase gradually to 2 percent over the next few years. The repo rate is at 1 percent and the Riksbank's repo rate path indicates that it will remain at this low level for around a year.

- The authorities also agree with staff that the current policy mix is appropriate given the economic development and that there is room for additional monetary and fiscal stimulus, should downside risks to the economy materialize.

Monetary policy

- The Riksbank agrees with staff that considerable uncertainties about the outlook remain. The situation in the euro area is fragile and a re-intensification of the crisis could have spillover effects on Sweden both through exports and through the banking system. In such a situation, the repo rate path may need to be lowered. At the same time, if household credit growth were to increase to unsustainable levels the repo rate path might have to be increased beyond what macroeconomic and inflationary considerations would warrant in the short run.

- Staff raises the issue of house prices and household debt in monetary policy decisions. As noted by staff, the Riksbank's monetary policy is currently accommodative. With inflation around one percentage point below target and the real economy recovering slowly, further repo-rate cuts could in principle be contemplated. However, high debt levels and high house prices may jeopardize macroeconomic stability in the longer term and could also have long lasting negative effects on inflation. The Executive Board of the Riksbank therefore needs to take such longer-term risks into account when making the repo-rate decisions. Having said this, the Riksbank agrees with staff that macroprudential policy should be the first line of defense for preventing imbalances in house prices and indebtedness.

Financial stability, macroprudential policy and financial reforms

- The authorities share staff's view that ensuring financial stability is key. Important steps have already been taken and further strengthening of financial stability will be on top of the agenda in the coming years.
- The authorities emphasize their commitment to make further progress on an appropriate macroprudential policy system.
- The authorities agree with staff's assessment that Sweden's large banking system remains a potential vulnerability for financial stability, especially in combination with the high levels of household debt. The Swedish banking sector is dependent on international wholesale funding markets, and therefore, a re-intensification of the euro area crisis remains a risk that could spill over to banks particularly in the form of a shortage of foreign currency liquidity. Because of the high levels of household debt, a fall in domestic house prices could lead to negative effects on the real economy, particularly through a negative effect on consumption. As stated in the assessment, such developments could also possibly push up bank funding costs and non-performing loans. In this context it should be noted that the Swedish banks are well capitalized on a risk-weighted basis, giving them a buffer if risks were to materialize. Swedish authorities have also strengthened the capital requirements for Swedish banks. First, by accelerating the implementation of the Basel III capital requirements, and later by establishing minimum requirements for risk weights on Swedish mortgages.
- The authorities agree with staff's view that the high level of household debt is a cause for concern. Recently the FSA increased risk weights on mortgages and, going forward, further increasing risk weights for mortgages could be one way to temper growth in household debt.
- The authorities agree with staff's assessment that the liquidity risks should be reduced. Important steps have, however, already been taken in this direction in the form of the early implementation of LCR by the FSA both in aggregate as well as separately in euro and US dollar, applicable from January 2013. To further push banks in the right direction, the Riksbank introduced a recommendation in its latest financial stability report that the Swedish banks should publish their NSFR at least every quarter.
- The authorities agree with the staff's assessment that a robust bank resolution framework could help to reduce potential spillovers in case of financial crises. Developments in the Nordea Crisis Management Group as well as in the Bank

Recovery and Resolution Directive are important improvements. As regards a potential Banking Union membership, Sweden participates actively in the discussions, but there are fundamental issues that remain to be agreed upon. Consideration of a potential membership can take place when all the rules are in place.

- The authorities agree with staff that a clear allocation of responsibility and mechanisms for coordination between the relevant authorities would be needed to ensure an effective macroprudential policy framework. Moreover, the authorities are of the view that any institutional arrangement should be designed in a way that takes into account the need for adequate democratic accountability. In this spirit, with a view to ensure a well-functioning coordination of macroprudential policy, the Government has recently announced a proposal on the establishment of a Financial Stability Council with representatives from the Ministry of Finance, the FSA, the Swedish National Debt Office and the Riksbank. Further, the government has proposed that the FSA be equipped with the primary responsibility for the implementation of macroprudential tools. Regarding the implementation of macroprudential tools, the authorities share staff's view that the approach should be gradual and take due account of the effects on the real economy.

Fiscal development and structural reforms

Fiscal stance

- Sweden's sound public finances have made it possible to meet the international downturn with expansionary measures, while preserving confidence and safeguarding the surplus target.
- The Ministry of Finance broadly agrees with staff's view of Sweden's fiscal stance, even though the Ministry's assessment of the structural balance and the output gap in the near term is noticeably higher. As is pointed out by staff, Sweden's fiscal position is fundamentally strong which allows for continued injections into the economy in the short term without jeopardizing either long-run sustainability or the ability to respond properly, should downside risks materialize.
- As opposed to many other European countries, Sweden's strong fiscal position has enabled the government to present budgets with expansionary measures in both 2012 and 2013. According to the authorities' assessment, there is still a clear need to support the economic recovery by taking an expansionary policy stance also in 2014.
- Future reform efforts will continue to focus on structurally warranted reforms that strengthen Sweden's long-term growth prospects by increasing employment, decreasing structural unemployment and increasing social cohesion. Expansionary fiscal policy in the current juncture is consistent with the fiscal framework. The surplus target allows for active stabilization policy when resource utilization is

below normal levels and the return to the target level should, in the absence of any new negative shocks to the economy, be undertaken gradually with the closing of the output gap.

Contingent liabilities, fiscal buffers and a long-term anchor for fiscal policy

- As staff points out, the Swedish fiscal framework has been serving Sweden well in the present down-turn. The surplus target has helped bring down the public debt to low levels and enhance the credibility of fiscal policy.
- The authorities acknowledge staff's opinion on the importance of retaining appropriately large fiscal buffers and find the discussion on the link between contingent liabilities and fiscal buffers important. However, as is shown by the large range in the staff's assessment of a possible debt limit, it should be noted that it is always difficult to make a precise estimation ex ante of the potential fiscal costs of a banking crisis. Moreover, there is a risk that explicitly linking fiscal targets to contingent liabilities could lead to moral hazard. Therefore, the authorities agree with staff's recommendation that strong financial market policies are the first-best response to protect against such fiscal risks.
- The authorities find that the discussion on introducing an explicit long-term anchor for fiscal policy should depart from the premise of preserving the surplus target. The latest evaluation of the surplus target (Ds 2010:4) dissuaded from introducing an explicit debt target, notably since public debt is affected by other factors beyond net lending and would decrease the effectiveness of fiscal policy.

Counter-cyclicality of the fiscal framework

- According to staff there are indications that fiscal policy has become less sensitive to the business cycle since the mid-2000s. It is the authorities' view that the fiscal policy framework does not give rise to pro-cyclicality and that it gives ample room to counteract downturns with discretionary measures. The construction of the surplus target allows net lending to fall when the economy slows and vice versa. Since it is a forward- looking target, discretionary measures are also consistent with the framework as the surplus target does not demand temporary deviations from the target level to be made up for by running corresponding surpluses, provided that the long-term sustainability of public finances is not threatened. The authorities would also like to underline that the estimates of the discretionary responsiveness of fiscal policy to the cycle from aggregate time-series, especially in the presence of a short sample period and extreme outliers, are associated with large uncertainty.
- In 2008-2009 there were considerable concerns about a protracted and even deeper recession that would imply large deficits. This called for retaining some fiscal room for maneuver. However, the effect on public finances turned out to be much smaller than expected as the fall in GDP mainly depended on a drop in external demand. In addition, output gaps widened to an extent that could not reasonably be fully counteracted by a weakening of net lending. Moreover, during

these years there was a substantial downward shift in expenditure due to the reforms of the labor market and the social insurance system that had been undertaken since 2006. This shift on the expenditure side, occurring at the same time as the downturn, upheld the level of net lending and is therefore likely to have concealed the automatic stabilizing effect of public expenditure. Going forward, corresponding benign effects on public finances are not to be expected, which calls for vigilance as regards the relationship between public finances and the cycle. All in all, the factors mentioned above created an ex post impression of a weak relation between discretionary policy and the cycle. The fiscal policy conducted during the 2008-2009 recession is therefore not readily comparable to the period prior to the crisis.

- It should also be noted that while the size of the public sector in relation to GDP has decreased somewhat in recent years, the introduction of the in-work tax credit has increased the progressivity of the tax system. In the Swedish context, it is also important to take into account the extensive use of semi-automatic stabilizers in the form of active labor market policies as an effective stabilization policy instrument. In addition, a proposal to reduce the risk of pro-cyclicality in local governments' finances was recently passed by Parliament, allowing them to use a portion of their surplus from good times to cover deficits incurred as a result of a recession. Moreover, the government has proposed a system of state support for short-time working schemes that can be deployed swiftly during a particularly serious crisis.

Facilitating structural change

- The authorities agree that further reforms are warranted to boost Sweden's growth potential. The government is looking closely at developments in the housing market and has taken measures to increase incentives for construction, to foster a more efficient use of the existing housing stock and to make planning and zoning processes more efficient.
- With respect to the labor market, important steps have been taken to increase demand and improve training and education for jobs, in particular for vulnerable groups. Such groups include the young and foreign-born that face the risk of becoming long-term unemployed. Further steps are necessary to increase employment and reduce structural unemployment. Since 2011 the Government has engaged in talks with the social partners about how the labor market could become more inclusive and flexible. These talks are now beginning to yield concrete results. A number of vocational introduction agreements have been signed and a proposal for state support to vocational introduction agreements will be presented in the Budget Bill.