September 2005
IMF Country Report No. 05/343

# Sweden: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Sweden

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Sweden, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 25, 2005, with the officials of Sweden on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 24, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of September 2, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 7, 2005 discussion of the staff report that concluded the Article IV consultation.

- a 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.

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

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INTERNATIONAL MONETARY FUND

SWEDEN

**Staff Report for the 2005 Article IV Consultation**

Prepared by Staff Representatives for the 2005 Consultation with Sweden

Approved by Reza Moghadam and Michael Hadjimichael

June 24, 2005

- A staff team comprising Messrs. Thakur (Head), Bonato, Ms. Tsounta (all EUR), and Mr. Balassone (FAD) visited Stockholm during May 16–25, 2005. The mission met senior officials of the Riksbank and the Ministry of Finance, members of the Parliamentary Finance Committee, representatives of the main opposition party, and of the associations of local authorities, trade unions, Swedish enterprises, private financial sector and the academic community. Mr. Farelius, Alternate Executive Director for the Nordic-Baltic countries, participated in the discussions.

- The authorities published the Concluding Statement of the mission and have expressed their intention to publish this staff report.

- A minority Social Democratic Party government was re-elected in September 2002 and governs with the support of the Left and Green Parties. Next elections are due in Fall 2006. Swedish voters rejected entry into the European Monetary Union in a referendum held in September 2003.

- Sweden has accepted the obligations of Article VIII of the Articles of Agreement; and subscribes to the Special Data Dissemination Standard. Data provision is timely and facilitates effective surveillance (Appendix I).

- The last Article IV consultation was concluded on August 4, 2004, with Executive Directors commending Sweden's strong economic record and the authorities' well-designed macroeconomic framework. Directors, however, expressed concern that efforts to attain the target of a fiscal surplus of 2 percent of GDP over the cycle had slackened in the recent past, and emphasized that adherence to the target was central to maintaining confidence in the framework. Directors underscored the need to reform the tax-benefit system to improve work incentives, if the authorities' ambitious employment and social policy objectives were to be reached. Public Information Notice No. 04/86 can be found at http://www.imf.org/external/np/sec/pn/2204/pn0486.htm

**Main Websites for Swedish Data**

Data in this Staff Report reflects information received by June 20, 2005. In many cases, more recent data can be obtained directly from the following internet sources:

Statistics Sweden.............................................................................http://www.scb.se/eng/index.asp

The Riksbank..........................................................................................http://www.riksbank.com/

Ministry of Finance..................................................................http://www.sweden.gov.se/sb/d/2062

National Institute of Economic Research............http://www.konj.se/4.2f48d2f18732142c7fff4422.html

Additional information and documentation on Swedish economic statistics can be found at the Fund's SDDS website http://dsbb.imf.org/Applications/web/sddscountrycategorylist/?strcode=SWE and at Statistics Sweden's Economic Data Portal: http://www.scb.se/ekonomi/ekonomieng.asp#area

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## Executive Summary

**Background and Outlook:** Supported by the global recovery and a stimulative monetary stance, **growth accelerated significantly in 2004**, but the labor market remained subdued. Strong productivity gains, wage moderation and falling non-energy import prices contributed to reducing inflation, creating room for **aggressive monetary easing.** The Riksbank cut its policy rate to a historic low of 2 percent in early 2004, and kept it on hold for over a year. The outlook for growth in 2005 remains generally favorable. However, recently the downside risks have risen, and in response, the Riksbank cut the policy rate by 50 basis points in June 2005. The fiscal position remains strong in a comparative EU context, but **the policy stance for 2005–06 is strongly expansionary**, notwithstanding the favorable outlook, and the attainment of the medium–term surplus target of 2 percent of GDP has shifted beyond the planning horizon..

**Policy discussions centered on the following key issues:**

- **Stance of short-term policies:** While sharing the view that the case for easing was weak at the time of the discussions, the staff and the authorities also agreed that if downside risks began to materialize, a rate cut should be considered. **The Riksbank's decision to cut the policy rate by 50 basis points in June** reflected a significant worsening of the outlook for growth in 2005 and the consequent downward revision of the inflation forecast. With the sizeable fiscal sitmulus planned for 2005–06, the macroeconomic **policy stance is now fully supportive of demand.**

- The **gradual erosion in the framework of fiscal rules**: The stimulus planned for 2005–06 is inconsistent with the objectives of the fiscal framework and the general government balance is drifting away from the 2-percent surplus target. While recognizing that **Sweden is in a favorable position to meet its long-term demographic challenges**, the mission underscored the **risks arising from continued slippage** and argued for adherence to the framework.

- The **need to revive the structural agenda**: Sweden ranks high in terms of the structural indicators monitored under the Lisbon strategy, but **the momentum of reform is waning.** The authorities agreed that **encouraging effective labor supply** is the most important policy challenge in the face of demographic changes and globalization. They shared the mission's concern about the growing number of persons on sickness and disability. The authorities also agreed that there exists scope for **promoting greater competition in product markets.**

- The risks to financial stability: The **financial system is sound,** but the risks stemming from high household debt require particular attention.

## I. ECONOMIC BACKGROUND

1. **The Swedish economy has performed remarkably well in recent years.** Since emerging relatively unscathed from the 2001 global technology crash which severely impacted Ericsson, Sweden's largest exporter, growth has recovered strongly, substantially outperforming the euro area, and ranking high even in the Nordic league. Sustained productivity gains, spearheaded by a resilient high technology sector, and a rules-based macroeconomic framework, grounded in a well-designed inflation targeting regime and a medium-term fiscal strategy, have underpinned this impressive record.

Sweden Growth Perfomance, 2000-2004

(GDP annual percentage change)

| | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| Denmark | 2.8 | 1.3 | 0.5 | 0.7 | 2.4 |
| Finland | 5.1 | 1.1 | 2.2 | 2.4 | 3.7 |
| Norway | 2.8 | 2.7 | 1.1 | 0.4 | 2.9 |
| Sweden | 4.3 | 1.0 | 2.0 | 1.5 | 3.6 |
| Euro area | 3.7 | 1.7 | 0.9 | 0.7 | 2.0 |

Source: Eurostat

2. **The acceleration in growth in 2004 was driven by the global recovery and supported by a stimulative monetary stance.** (Figure 1). Even allowing for the sizeable "calendar effect," equivalent to ½ percent of GDP—reflecting the unusually large number of working days compared with 2003—the Swedish economy grew much faster than the euro area. Export growth was led by a strong recovery in the telecommunications and automobile sectors, and, combined with rising capacity utilization and record low interest rates, helped sustain a revival of business investment after a three-year slump.[1] Rising disposable incomes and an expansionary monetary stance helped support consumer confidence.

Growth and Demand

(annual percentage changes)

| | 2001 | 2002 | 2003 | 2004 | 2005 proj. | 2006 proj. |
|---|---|---|---|---|---|---|
| Real GDP | 1.0 | 2.0 | 1.5 | 3.6 | 2.6 | 2.8 |
| Calendar-adjusted | 1.0 | 2.0 | 1.6 | 3.0 | 2.6 | 3.0 |
| Domestic demand | -0.2 | 0.7 | 1.1 | 1.4 | 2.8 | 2.3 |
| Consumption | 0.6 | 1.7 | 1.3 | 1.3 | 1.7 | 1.9 |
| Private | 0.4 | 1.4 | 1.5 | 1.8 | 2.2 | 2.1 |
| Government | 0.9 | 2.3 | 0.8 | 0.3 | 0.8 | 1.5 |
| Gross fixed capital formation | -1.0 | -2.6 | -1.5 | 5.5 | 8.3 | 3.8 |
| Exports | 0.5 | 1.2 | 5.0 | 10.5 | 4.0 | 5.5 |
| Imports | -2.6 | -1.9 | 4.9 | 6.9 | 4.8 | 5.0 |

Sources: Statistics Sweden, and staff projections.

3. **Despite the strong cyclical upturn, employment continued to decline and unemployment rose further.** While the employment rate is high in international comparison, it is well short of the authorities' ambitious target of 80 percent. Apart from the usual lags in a cyclical upswing, the subdued

Labor Market Indicators

(Annual change in percent)

| | 2002 | 2003 | 2004 | 2005 proj. | 2006 proj. |
|---|---|---|---|---|---|
| Nominal wage | 3.9 | 3.3 | 1.9 | 3.2 | 4.2 |
| Labor productivity | 4.1 | 3.7 | 3.7 | 2.6 | 2.3 |
| Unit labor costs | -0.2 | -0.4 | -1.8 | 0.6 | 1.9 |
| Employment | 0.1 | -0.2 | -0.5 | 0.3 | 0.7 |
| Hours worked per employee | -1.2 | -1.3 | 1.3 | -0.3 | 0.0 |
| Open umployment rate 1/ | 4.0 | 4.9 | 5.5 | 5.2 | 4.9 |
| Total unemployment rate 1/ 2/ | 6.6 | 7.0 | 7.9 | 7.9 | 7.6 |

Source: Riksbank

1/ In percent of labor force.

2/ Including participants in labor market programs.

[1] An important factor in the dynamism of exports was the exceptionally high contribution from "merchanting", comprising the margin between purchases and sales made by Swedish enterprises of goods produced and then sold abroad without crossing Swedish borders. Such margins, classified as export of services, which in recent years have contributed about 0.1 percent to annual GDP growth, accounted for 0.4 percentage points of growth in 2004.

labor market reflected the interplay of several factors. Hours worked rose as the very high level of sickness absence observed in recent years began to decline. The momentum of productivity gains was maintained as restructuring continued apace in the business sector. High tax wedges and a relatively compressed wage structure continued to weigh on the labor market. The unemployment rate hovered around 5½ percent; however, accounting for the growing numbers in subsidized labor market programs, unemployment reached almost 8 percent at the end of 2004 (Figure 2). Recent labor market indicators portray a mixed picture.[2]

4. **Strong productivity growth and the subdued labor market kept inflation below target, creating the room for monetary easing in early 2004.** Wage moderation, combined with continued strong productivity gains, reduced unit labor costs, keeping underlying inflation pressures in check. Headline inflation was also kept low by declining non-energy import prices and, more recently, falling food prices, reflecting intensified foreign competition in the retail trade sector. Against this background, the recent high oil prices have not significantly affected inflation and expectations have remained close to the inflation target (Figure 3).

Inflation indicators 1/
(annual percent change)

| | 2003 | 2004 | 2005 proj. | 2006 proj. | 2007 proj. |
|---|---|---|---|---|---|
| CPI | 1.9 | 0.4 | 0.3 | 1.2 | 1.8 |
| Underlying inflation | 2.2 | 0.8 | 0.5 | 1.1 | 1.6 |
| Underlying domestic inflation | 3.5 | 1.6 | 1.1 | 1.7 | 2.2 |

Source: Riksbank.

1/ 2007 projections refer to June.

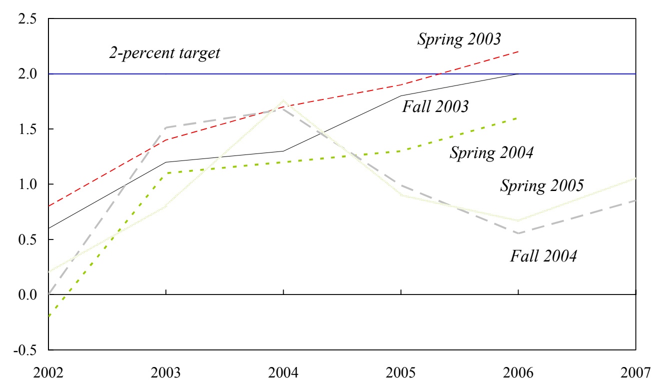
5. **The strong competitive position is reflected in large current account surpluses.** Despite some recent depreciation in early 2005, the krona remained broadly stable in nominal as well as real effective terms over the year to May 2005 (Figure 4). The krona's stability reflects market forces, consistent with a transparent inflation targetting regime. The strong external position is underlined by the large actual and projected current account surpluses, presaging a net external creditor status by 2008 (Tables 3 and 6). The stock market continued its steady recovery on the back of strong corporate earnings. Long-term interest rates declined, with the yield on 10-year government bonds falling below that on corresponding German bonds in recent months compared with a premium of 50 basis points at the beginning of 2004 (Figure 5).

[2] Interpretation of labor market development is complicated by statistical issues. The first EU-harmonized Labor Force Survey (LFS) was introduced at the end of May 2005. This methodological change has caused a break in comparability of the LFS data over time. In addition, only annual comparisons will be possible pending the introduction of linked seasonally adjusted data.

## II. THE POLICY SETTING AND THE SHORT-TERM OUTLOOK

6. **The general government balance has been drifting away from the 2 percent structural surplus target** (Box 1). The large surplus recorded in 2000 (almost 4 percent of GDP) allowed room for expansionary fiscal policy during the subsequent mild downturn, with the sizeable fiscal expansion of 2001–02 reducing the structural surplus to 0.2 percent of GDP in 2002. Since then, despite initial budgetary plans to bring the balance closer to the target, subsequent revisions have gradually pushed the attainment of the 2 percent surplus beyond the medium-term policy horizon. The outturn for 2004 has been significantly better than expected, but the budget for 2005 fails to build on this result and foresees a sharp fall in the structural surplus.

Structural Fiscal Balances: Outturns and Projections




7. **The fiscal stance for 2005–06 is strongly expansionary, notwithstanding the projected continued strength of activity and the narrowing output gap** (Table 2, Figure 6). Cuts in income and wealth taxes are only partially offset by expenditure restraint. The Spring Budget reinforces the focus on short-term job creation through increased spending on public and subsidized employment. Margins under the expenditure ceilings for the central government have been under growing strain in recent years and are now too narrow to provide leeway in the event of unexpected shocks. Reliance on tax expenditures for compliance with the ceilings is set to increase further.

General Government Financial Accounts
(In percent of GDP)

| | 2003 | 2004 | 2005 proj. | 2006 proj. | 2007 proj. |
|---|---|---|---|---|---|
| Total revenue | 55.8 | 55.6 | 54.9 | 54.5 | 54.2 |
| Total expenditure | 55.9 | 54.5 | 54.2 | 53.9 | 53.1 |
| Overall balance | -0.1 | 1.1 | 0.7 | 0.6 | 1.1 |
| of which: Pension system | 1.9 | 1.9 | 2.0 | 2.0 | 1.9 |
| Output gap | -1.3 | -0.9 | -0.3 | -0.1 | 0.0 |
| Structural balance | 0.8 | 1.8 | 0.9 | 0.7 | 1.1 |

Source: Ministry of Finance, Spring Budget Bill 2005.

8. **After an aggressive expansionary shift in early 2004, monetary policy has remained stimulative.** Surprisingly persistent productivity growth and low import prices kept inflation lower than forecast, prompting the Riksbank to cut policy rates to their lowest level in more than 50 years in April 2004. With projections for inflation close to the target, the Riksbank saw risks to its central scenario evenly balanced and accordingly left the policy rate unchanged in late April.

**Box 1: Effectiveness of IMF Surveillance**

**The main themes of recent IMF surveillance have been the necessity of preserving the credibility of the fiscal framework and giving new impetus to structural reforms.**

**Fiscal Framework and Policies**: The framework comprises of the surplus target for general government, expenditure ceilings for the central government, and a balanced budget rule for local authorities. The Board and the staff have commended the framework as generally well-designed and the target of a 2 percent structural fiscal surplus as appropriate.While publicly committed to the fiscal framework, the authorities are reluctant to tighten policy before unemployment has been substantially reduced. The authorities do not envisage attaining the 2 percent surplus until after 2007. While not disputing the adverse effects on employment of high labor taxes—among the highest in the developed world—they underline the positive impact on labor supply of large public spending on subsidized child care and elderly care.

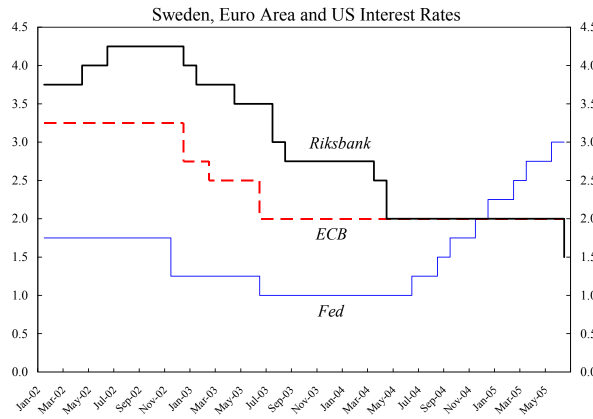
**Monetary Framework and Policies:** The Fund has praised the inflation targeting framework implemented by the Riksbank for its overall design and operation.[1] The recent changes in the Riksbank's communications strategy aimed at enhancing its already high transparency are in line with Executive Board and staff suggestions.

**Reform of the Welfare State:** While the authorities and the staff see eye to eye on the main challenges facing the Swedish model, the authorities prefer to address them at a gradual and politically feasible pace, in consonance with their overall policy objectives.[2] While there are no plans to further streamline the benefit system, the authorities intend to begin a comprehensive review of the tax system in 2006. In contrast to Fund advice to consider reducing the generosity of sickness benefits, they have placed emphasis on alternative means such as workplace reforms to reduce sickness absence.

[1]The Riksbank's target of 2 percent of CPI inflation is over a 1–2 year horizon with a tolerance band of +/- 1 percent.

[2]The staff's case for streamlining the Swedish model has been set out at length in the Fund publication, *Sweden's Welfare State—Can the Bumblebee Keep Flying?* By Subhash Thakur, Michael Keen, Balazs Horvath, and Valerie Cerra, 2003, IMF. The issues addressed in the book continue to be debated in Sweden and were the topic of a conference held in Stockholm last year, in which Fund staff participated.

9. **With a downward revision of the outlook for growth and inflation, the Riksbank cut its policy rate by 50 basis points in June 2005.** While a cut was widely expected, its magnitude took the market by surprise. The weaker than expected outturn for the first quarter prompted the Riksbank to sharply lower its forecast for growth in 2005 (to below 2 percent from over 3 percent). Its latest assessment (June 2005) also projects lower CPI inflation of 1.2 percent one year ahead and 1.8 percent in two years, still below the inflation target of 2 percent. The risks to the central scenario for inflation were now seen to be on the downside.




10. **The outlook for growth and inflation in 2005–06 is generally favorable.** With export growth expected to slow, domestic demand will be the main driver of growth in 2005. The macroeconomic policy stance in both years is set to be strongly stimulative. Household consumption is expected to gather speed on the back of tax cuts, continued low inflation, and rising confidence, while business investment is set to pick up strongly reflecting emerging capacity constraints, continuing low interest rates, and favorable profit opportunities. Several indicators point to an imminent recovery of the labor market, which so far has been elusive. The weakness of growth in the first quarter of 2005 indicated by preliminary national account estimates is primarily due to temporary factors. In response to this weakness, the Riksbank revised its forecasts for growth sharply downward from over 3 percent to under 2 percent in 2005. The staff's revision is more moderate, to around 2½ percent from 3¼ percent. The staff forecast gives more weight to the reasonably strong retail sales data, the strength of private investment and the strong fiscal stimulus in the pipeline. With the output gap continuing to narrow and productivity growth decelerating, CPI inflation is projected both by the staff and the authorities to rise gradually, but is still expected to remain close to 2 percent, despite the rise in oil prices.

11. **Downside risks to the growth outlook have increased.** The risks stem primarily from external sources: lower growth in the euro area than currently projected, a further depreciation of the U.S. dollar, and persistent high oil prices. The adverse impact of the failure of euro area growth to pick up as expected is likely to be cushioned to some extent by the recent diversification of Swedish exports towards emerging markets in Europe, Asia and the Middle East. The most prominent domestic risk is a further delay in the expected recovery of the labor market, with possible damage to consumer confidence which could prolong the slowdown in the first quarter of 2005.

## III. The Policy Discussions

12. **Against the recent impressive record of strong growth and low inflation, rising concerns about declining employment and signs of slippage from the fiscal framework provided the backdrop to the discussions.** The key questions the consultation tried to address were:

- What is the appropriate stance of macroeconomic policies in the light of the economic outlook for 2005–06 ?
- What are the risks of a gradual erosion of the framework of fiscal rules that has served Sweden well over the past decade, and what could be done to prevent such an erosion?
- What further structural reforms are necessary and feasible to promote greater labor supply so as to sustain the welfare state in the face of multiple long-term challenges at home and abroad?

### A. Monetary Policy and the Financial Sector

13. **Riksbank officials underlined the role of transitory factors in the recent exceptionally low inflation.** Although consistently below the 2 percent target since mid-2003, inflation is expected to rise steadily over the coming two years, yet remaining below the target. The central scenario, shared by most major forecasters, assumes a gradual improvement in the labor market. As employment recovers, the output gap is expected to close within the forecast horizon, while productivity growth is likely to taper off and the benign impact of temporary factors, such as falling nonenergy import prices and increased competition in the food sector, is likely to fade. Although market expectations pointed to a strengthening of the krona in the medium term, officials did not view the krona as significantly undervalued. They acknowledged, however, that the present large current account surpluses were unlikely to be sustained in the long run. The staff reiterated its view that the krona was somewhat undervalued. [3]

14. **Riksbank officials explained that their operation of the inflation targeting framework was guided by an eclectic assessment of risks and a measure of flexibility.** In the recent period, with a variety of supply shocks—many of which transitory—affecting inflation, officials have taken into account a broader set of indicators than just the inflation rate. The Riksbank was at pains to underscore to the markets and the public that it had never intended to follow a mechanical rule in making policy decisions and took into consideration

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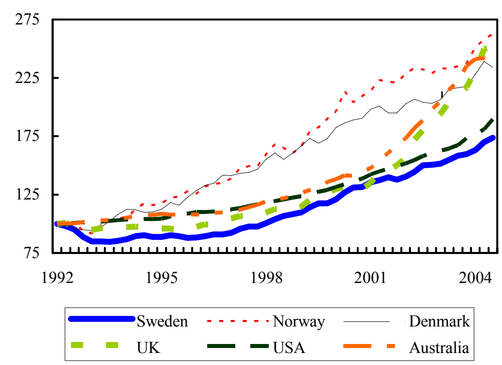
[3] Model-based estimates, such as those of the IMF's Research Department suggest an undervaluation in the range of 10–20 percent.

developments in the real economy as well as in asset prices. With a view to clarifying its policy response to various transitory shocks and to underscore the role of judgment in policy-making, the Riksbank has recently begun to present an inflation forecast over a three-year horizon based on market interest rates, in addition to the main scenario for the path of inflation two years ahead, based on an unchanged policy rate.

15. **The staff and the authorities agreed at the time of discussions that if downside risks began to materialize, there was scope for easing.** The mission and the Riksbank officials shared the view that the case for further easing was weak, with the mission stressing that an easing will have to be reversed quickly if the central scenario of solid growth holds. The demand components most directly affected by monetary policy—private consumption and investment—were already growing strongly. The persistent strength of household borrowing and rising house prices also pointed to caution in lowering interest rates further.

16. **Assessing the downside risks to growth to have worsened substantially, the Riksbank cut its policy rate by 50 basis points on June 21.** At 1.5 percent, the policy rate is now among the lowest in Europe. The surprisingly subdued growth in private consumption and exports in the first quarter of the year led to a significant downward revision of the inflation forecast for 2006–07 in the central scenario. Reflecting the uncertainty surrounding the cyclical upswing, the Riksbank perceived the risk to inflation as also being on the downside, as opposed to its previous balanced risk assessment in the April Inflation Report.

Nominal House Prices, 1992-2004
(Index: 1992:1=100)




Sources: Ecowin and the Riksbank.

17. **The financial system is in good health, but the continued rapid rise in household borrowing is a source of some concern.** Cost reductions and a sizeable decline in loan losses have steadily improved bank profitability in the last few years (Table 4). While strong profits and abundant liquidity had restrained corporate borrowing, household borrowing continued apace, reaching historic highs and contributing to the steady rise in house prices, especially in the large metropolitan areas. House price inflation, however, has remained subdued by international comparison. Low interest rates have contained mortgage payments as a share of household disposable income, and the ability of the household sector as a whole to service debt is unlikely to be undermined by even significant increases in interest rates, given the high household saving rate. Supervisory authorities noted that while they did not expect an abrupt adjustment in house prices, if it were to occur, it could have a considerable impact on household wealth. There was consensus, however, that in view of the solid financial position of banks, any systemic risks were remote.

## B. Fiscal Policy and the Fiscal Framework

18. **The authorities underscored their continued strong political commitment to sound public finances.** The mission wondered whether the drift away from the 2 percent surplus target and the rising strains on the expenditure ceilings suggested a possible shift in policy priorities (Box 2), even as the long-term demographic challenges which originally motivated the design of the fiscal framework were coming into sharper focus. Officials stressed that there was no intention to fritter away the political capital invested in building strong public finances. The present deviation from the 2 percent surplus target in part reflected the intention to achieve the objective of reducing the unemployment rate to 4 percent, also a major commitment of the authorities. The mission underscored the risks involved in a strategy that would limit the margins for countercyclical policy in the event of a downturn. Failure to maintain a tighter stance in good times may force the authorities into a painful choice between having to forfeit stabilization policies and repudiating their medium-term fiscal target, in the event of an unexpected downturn. Indeed, the need to provide ample room for countercyclical policy played a role in setting the medium-term surplus target at 2 percent of GDP.

19. **The mission noted that the definition of the 2 percent surplus target allows different interpretations and stressed that this is inimical to transparency and accountability**. The 2 percent surplus target has been interpreted both as a yearly structural balance and as an average balance—nominal or structural—over the cycle. This has made it difficult to assess the consistency of annual budgetary targets with the prescriptions of the fiscal framework.[4] It has also left the expenditure ceilings without an anchor, making their level somewhat arbitrary and allowing compliance through tax expenditures. The mission advised the authorities to resolve the ambiguity surrounding the definition of the 2 percent target and to make the link between such target and the expenditure ceilings explicit. Officials argued that the target definition was already sufficiently precise, but recognized that reliance on multiple indicators for the assessment of compliance had not helped with transparency. They also pointed out that, in principle, the expenditure ceilings are expected to be set consistent with the surplus target, though they acknowledged that there are no formal guidelines to this effect.

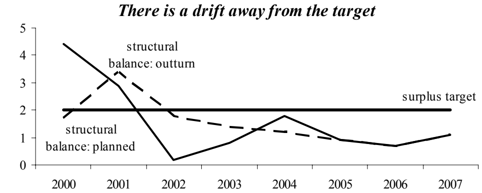
[4] For example, while the structural balance was close to zero in 2002, its average over 2000–02 clearly exceeded the target of 2 percent of GDP.

## Box 2. A Gradual Erosion of the Fiscal Framework[1/]

**The fiscal framework has so far adequately supported the government commitment to sound fiscal policies; however, signs of pressure are emerging.** An erosion of the framework, with admittedly minor consequences in the short term, could be costly at a later stage when fiscal pressures from population ageing intensify.

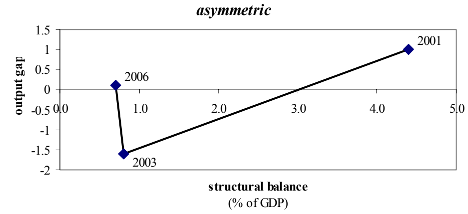
**As currently defined, the 2 percent surplus target lends itself to different interpretations.** The target is referred to as an "average over the cycle", which can be operationalized in a number of ways, ranging from an annual value in cyclically adjusted terms to an average value in nominal terms over a period of unspecified length. This ambiguity can impair the assessment of compliance and compromise the effectiveness of the framework. Since 2001 both budgetary plans and outcomes have gradually drifted away from the surplus target.

*There is a drift away from the target*



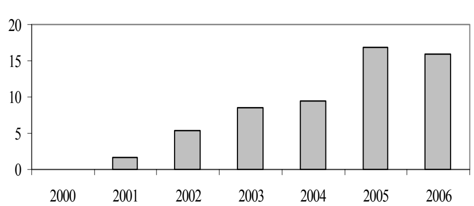

**The definition of the target as an average over the cycle, if not further specified, may lead to the acceptance of lax policies in relatively favorable economic conditions.** The definition provides flexibility in the face of changing economic circumstances, but the availability of flexibility says nothing about its use. While the fiscal balance reacted timely to the widening output gap over 2001–03, there are no plans for a symmetric response to the foreseen narrowing of the gap over 2003–06.

*Reactions to changes in the output gap can be asymmetric*

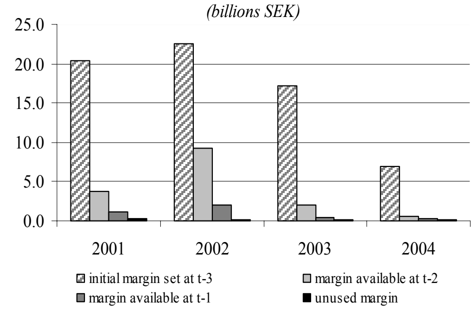



**The lack of a precise anchor in terms of annual budget balances also undermines the discipline of expenditure ceilings.** Central government expenditure ceilings should in principle be set at a level consistent with the 2 percent surplus target. However, the elusive definition of the latter has so far provided an obstacle to the implementation of formal guidelines. The ceilings' level has become somewhat arbitrary. It has been possible to ensure compliance through tax expenditures and to almost exhaust the contingency margins available under the expenditure ceilings, without regard to their effects on the budget balance.

*Tax expenditures are rising*
*(billions SEK)*




*Contingency margins are being exhausted*
*(billions SEK)*




1/ The Selected Issues Paper: "The Swedish Fiscal Framework: Towards Gradual Erosion?", prepared by Fabrizio Balassone, offers a more detailed analysis and discusses possible modifications of the framework.

20. **The mission suggested setting up an independent body to assist with translating the prescriptions of the fiscal framework into annual nominal targets so as to enhance transparency and strengthen enforcement.**[5] As the framework aims at reconciling soundness and flexibility of fiscal policy, its consistent implementation ultimately relies on variables such as the output gap and the cyclically adjusted balance. Given the complexity of the task of assessing and measuring such variables, transparency is critically important. Officials stressed that several independent institutions already regularly comment and report on budgetary assumptions, plans and outcomes. While acknowledging the open debate on fiscal issues, the mission pointed out that none of the institutions involved is formally responsible for assessing the consistency of policies with the overall fiscal framework. The mission argued that delegation of this task would help foster a clearer medium- and long-term policy perspective. Officials, while not disputing the rationale behind the mission's proposal, argued that its implementation would entail an undesired loss of flexibility in the conduct of policy and did not regard it as viable at present.

21. **The authorities and the mission agreed that the fiscal consolidation of the past decade had vastly strengthened long-term fiscal health.** The reforms implemented in 1999 have placed the public pension system on a sound financial footing in anticipation of the expected sharp rise in the dependency ratio. As gross debt has fallen below 50 per cent of GDP and the net asset position has turned positive, the sustainability of government finances appears to be on a solid footing (Table 5). The mission, nevertheless, warned against underestimating the risks entailed in continued slippages from the fiscal framework. Sweden's spending on health and long-term care—at around 9 percent of GDP, already the highest in the EU—is projected to rise faster than in most other countries over the next decades.[6] This will put substantial pressures on public finances, particularly on local government budgets. The mission argued that in order to meet these pressures, existing mandates to local authorities may have to be reassessed and the mechanisms governing central government grants may have to be revised accordingly to provide incentives for an efficient use of resources. Officials agreed that, since the cost of service provision varied significantly across municipalities, there appeared to be scope for efficiency gains.

22. **The authorities attach priority to preserving the generous welfare state and meeting the growing demand for public services rather than to reducing the tax burden.**

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[5] The introduction of an independent fiscal agency to monitor cyclical developments and give recommendations on the stance of fiscal policy on the basis of guidelines laid down by the parliament and the government was also discussed in the 2002 Report by the Committee on Stabilization Policy, SOU (2002); "Stabilization Policy in the Currency Union".

[6] While the projected rise in pension outlays as a share of GDP is below the EU average (2.6 and 3.2 percent respectively at peak), the increase in spending on health and long-term care, 3.3 percent of GDP, is above the average of 2.7 percent. See "Budgetary Challenges Posed by Ageing Populations", *Economic Policy Committee*, European Commission, 2001.

Having cut income taxes to some extent during 2000–04, the official view of the desirability of further tax cuts seems to have shifted. While confirming plans for continued reductions in the taxation of personal income in the short term, the authorities did not rule out raising taxation in the longer run in response to the expected rise in demand for public services induced by demographic changes.

## C. Structural Policies and Other Issues

23. **The authorities envisage their gradual approach to structural reforms to continue.** While Sweden ranks high in terms of the structural indicators used by the European Commission to monitor progress under the Lisbon strategy, officials agreed that this should not be a cause for complacency. They acknowledged the importance of efforts to raise effective labor supply and promote greater flexibility in labor and product markets to position the economy better in meeting the challenges arising from globalization and population aging.

24. **The recent trend of eroding labor supply is raising concerns** (Box 3)**.** Indeed, taking account of the large number of employees on sick leave, social assistance, labor market programs, and on benefits such as mid-life sabbaticals, effective employment is significantly lower. While partly driven by demographics, the constrained labor supply also reflects an institutional setup that discourages work effort. The mission's discussions focused on some key facets of the issue and the authorities' new initiatives.

- **Sickness and Disability:** Officials stressed that reducing sickness absence and disability retirement were the most difficult policy challenges, especially given the current shift from sickness to long-term disability. Recognizing that sickness and disability absences are much higher than in most OECD countries, particularly among the younger population, the authorities reiterated their goal of halving the sick-listed days between 2002 and 2008 by focusing partly on prevention of ill-health at the workplace and partly on enabling people on sick leave to return to work promptly (Figure 7). Officials hoped that the increase in employers' co-financing of full-time sickness absence and the centralization of the social insurance administration, both introduced in January 2005, would help alleviate the problem. Reducing the current level of benefits was not under consideration.

- **Immigration:** The projected rise in the working-age population over the coming five decades is entirely due to immigration. Given their current low participation rates, efforts to enhance economic integration of immigrants are receiving considerable attention. The authorities are focusing on language training programs and subsidies to employment, but strong wage compression continues to hinder opportunities for new, and especially low-skilled, entrants into the labor market.

## Box 3. The Challenge of Raising Effective Labor Supply

Enhancing effective labor supply is key to the long-term viability of the welfare state, in view of population aging. In order to achieve this objective, several dimensions of the challenge need to be addressed.

**A generous child and elderly care benefit regime has contributed to the high female labor supply** (Figure 8).[1] Sweden's generous public spending on child and elderly care enables higher labor supply by women, despite the high tax wedge. The net tax-benefit wedge constructed in the staff study suggests that the high female labor supply can be explained by a combination of generous employment-friendly benefits and a low tax wedge for secondary earners. In many other ways, however, the benefit system acts as disincentive to effective labor supply.

Labor Force Participation (15-64) by Gender, 1983-2003

| | Total | Male | Female |
|---|---|---|---|
| **Sweden** | **81.1** | **83.5** | **78.6** |
| Nordic Countries | 78.5 | 82.5 | 74.5 |
| EU15 | 67.5 | 79.2 | 55.8 |
| G7 | 72.0 | 82.3 | 61.8 |
| OECD | 69.6 | 81.7 | 57.7 |
| US | 76.2 | 84.6 | 68.1 |

Source: Employment Outlook, OECD (2004).

**The high incidence of sickness absence and disability retirement:** On an average day, around 18 percent of the labor force is on sick leave or disability benefit. Despite some decline since 2003, sickness absence remains high by international standards. Moreover, the decline is largely due to a shift into long-term disability schemes. Total disability pensioners increased by 12 percent in 2004, with almost 30 percent of the increase accounted for by pensioners below 40 years of age.[2]

**Reversing the declining trend in youth participation**: Young people take longer time to complete tertiary education and start their studies at a later age, partly as a response to incentives stemming from the education system. Since 1987, the age at which young people establish themselves in the job market has increased by about 5 years.

**The effectiveness of active labor market programs (ALMPs):** Sweden has one of the world's most extensive ALMPs. As the recovery in the labor markets lags behind growth, more resources are being devoted to these programs. The findings of many studies in Sweden suggest that only programs involving employment subsidies seem to be effective. Moreover, their net impact on employment is limited by large substitution effects, which account for about 60 percent of subsidized employment.[3]

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[1] Selected Issues Paper:Tsounta, E. and L. Bonato, "The Tax-Benefit System and Labor Supply in Sweden".

[2] The staff explored the issue of sickness absence in the Article IV consultation discussions last year. See IMF Country Report No. 04/245 and IMF Working Paper No. 04/193.

[3] "The Effects of Active Labor Policy", *Swedish Economic Policy Review*, Vol. 8 (2), 2002.

- **Sabbatical Leave Program:** A paid sabbatical leave scheme was introduced this year, whereby 10,000 employees can take up to a year off and be replaced by an unemployed person. Officials explained that the aim of this program was to provide workers with a chance for rest and personal development while giving the unemployed entry into the labor market. In the mission's view, the benefit for the unemployed remains uncertain, while the scheme entails a significant fiscal cost.

25. **Staff and the authorities agreed that competition in product markets needed to be strengthened further.** Despite the progress achieved in the last decade, competition remains limited in some important sectors either due to entry barriers (construction, pharmaceuticals)[7] or to excessive regulation (housing, retail trade). Lack of competition is reflected in prices significantly above the EU average or in supply-demand mismatches, particularly evident in the housing market. While acknowledging that more needed to be done, the authorities argued that some of the impediments to competition were elusive, as in the construction sector, or the consequence of deliberate policies aimed at social goals, as in housing. They also pointed out that earlier policy changes were now bearing fruit, as in retail trade, where the entrance of a large foreign competitor had recently contributed to a fall in food prices. The authorities reiterated that privatization of public enterprises is not on the agenda.

26. **The Swedish authorities remain staunch advocates of closer engagement with developing countries and further liberalization of world trade.** Sweden is committed to a revitalization of the Doha Development Agenda and supports further reduction of subsidies to agriculture in advanced economies. Sweden's official development assistance, which reached close to 0.9 percent of GNI in 2004, is among the highest in the world.

## IV. Staff Appraisal

27. **The Swedish economy recorded a year of strong economic expansion in 2004, outpacing the euro area by a wide margin.** This remarkable performance was underpinned by large gains in productivity, continued low inflation and a comfortable competitive position. A stable policy regime, supported by healthy public finances and a credible inflation targeting framework, continues to anchor macroeconomic stability.

28. **Prospects for growth in 2005–06 remain favorable, albeit with increased downside risks.** The main risks center on the uncertainty surrounding the strength of the upturn in the euro area, the persistence of high oil prices, and a further delay in the expected pick-up in employment.

29. **The Riksbank's decision to cut its policy rate by 50 basis points in June reflects a significant downward revision to the outlook for growth in 2005.** The weaker than

[7] The European Court of Justice ruled on May 31 that the state pharmaceutical monopoly violates EU laws.

expected outturn for GDP in the first quarter appears to have weighed heavily in the Riksbank's assessment. With the sizeable fiscal stimulus planned for 2005–06, the macroeconomic policy stance is now fully supportive of demand, The persistent weakness of the labor market has played an important role in shaping this policy stance.

30. **The substantial fiscal stimulus planned for this year and next, despite continued favorable prospects for growth, is inconsistent with the objectives of the fiscal framework.** This stimulus reflects a significant widening of the central government deficit and a sharp decline in the structural surplus of the general government to just above half a percent of GDP by 2006. The remaining margins under the expenditure ceilings provide little shelter if the economic outlook were to be less favorable than assumed.

31. **Public finances continue to be sound, but the gradual drift away from the spirit of the fiscal framework is a cause for concern.** Sweden's fiscal performance over the past decade remains impressive, especially in the international context. However, when assessed against its ambitious targets, the fiscal framework shows signs of stress. An erosion of the framework, with admittedly minor consequences in the short term, could be costly at a later stage when fiscal pressures from population aging intensify.

32. **The strains on the fiscal framework are evident in a number of symptoms.** A series of downward revisions of the annual budget targets for the general government has pushed the attainment of the 2 percent surplus beyond the medium-term policy horizon. Margins under the expenditure ceilings for central government have gradually narrowed. Moreover, compliance with the ceilings has increasingly relied on ad hoc measures such as tax expenditures and the postponement of outlays. Central government finances have progressively deteriorated, moving into deficit since 2002.

33. **Resolving the ambiguity surrounding the surplus target for the general government will strengthen its transparency and promote accountability.** As currently defined, the target lends itself to different interpretations, making it difficult to assess compliance. Ambiguous targets may lead to the acceptance of lax policies in relatively favorable economic conditions. An unchecked procyclical bias in good times may require a procyclical correction during a downturn to ensure compliance with the fiscal framework.

34. **The lack of a precise anchor in terms of the budget balance undermines the discipline of expenditure ceilings.** The elusive definition of the surplus target has made it difficult to implement formal guidelines for central government spending, consistent with the surplus target. The level of the ceilings has become somewhat arbitrary. Moreover, it has been possible to ensure compliance through tax expenditures, despite their effects on the budget balance.

35. **Setting up an independent body to assist with the implementation of the fiscal framework could further enhance transparency and strengthen enforcement.** Consideration could be given to appointing an independent body for translating the prescriptions of the framework into annual budgetary goals and assessing outcomes.

36. **While the short-term outlook for local government finances is favorable, longer-term challenges remain.** With the prospect of rising demand for public services, existing mandates may need to be reassessed and arrangements for determining the level of transfers revised accordingly. Encouraging local authorities to specify more clearly their medium-term spending plans could go some way toward improving fiscal coordination across levels of government. Greater coordination would facilitate attaining the general government surplus target as well as containing the overall tax burden.

37. **The task of raising labor utilization is becoming more pressing as demographic trends increasingly bear down on potential growth and public finances.** The high taxation of labor continues to have adverse effects on labor supply. Moreover, the compressed wage structure prevents efficient utilization of labor, particularly at the lower end of the skill spectrum. A reduction of the tax burden for low-income workers would be supportive of the authorities' ambitious labor market objectives and could be more cost effective than the job creation measures currently in place.

38. **The shrinking labor supply, while driven in part by demographics, is also a reflection of the institutional setup that discourages work effort.** Features of Sweden's benefit regime, notably the generous provision of child and elderly care, have clearly contributed to raising participation rates, particularly that of women. However, other elements of the benefit system discourage work effort. The marked rise in disability pensioners, especially among the younger population, is particularly worrisome. Some streamlining of the current benefit system and a tightening of its administration are necessary steps to stimulate labor supply and buttress the viability of the extensive social insurance system.

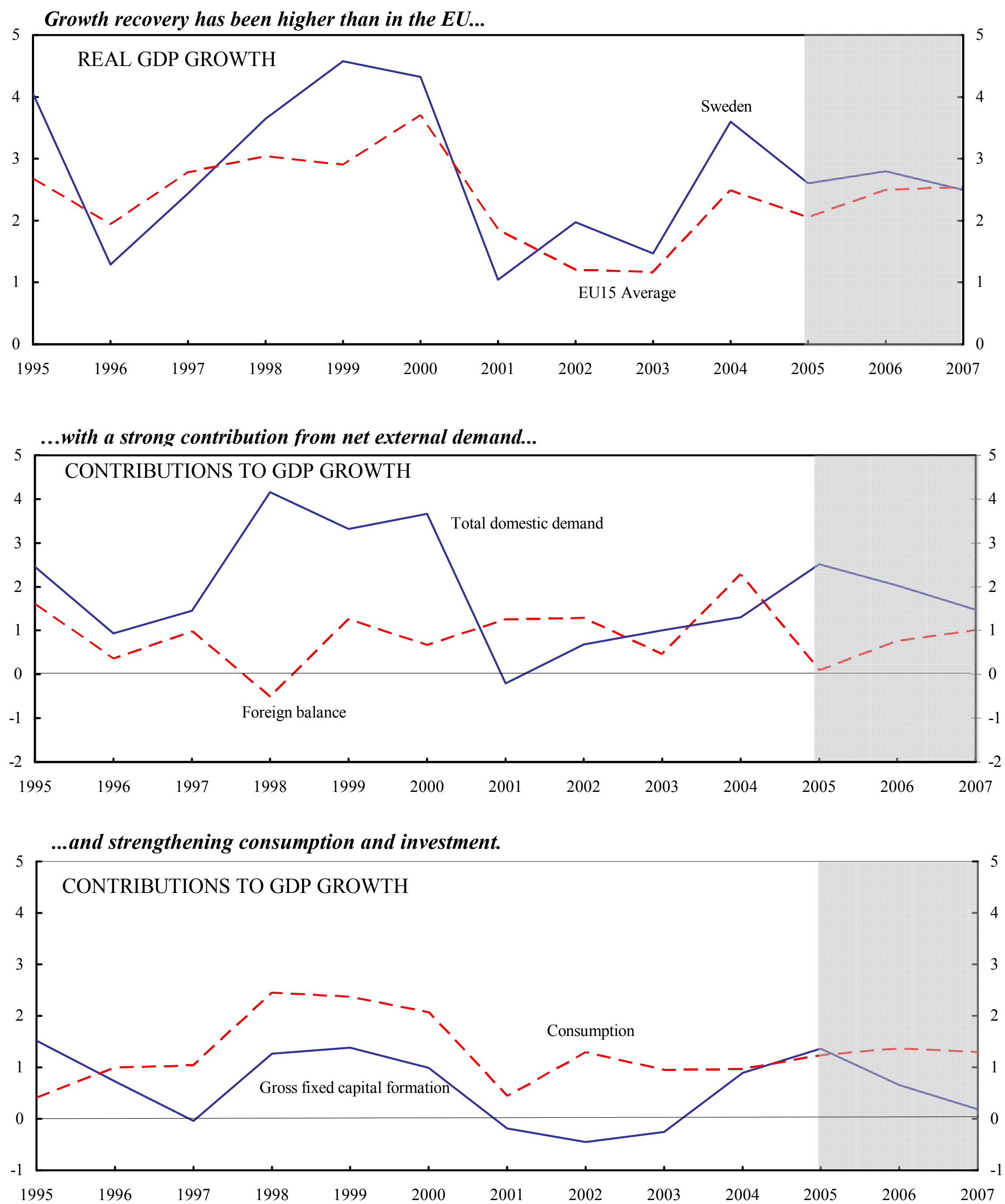
39. **The financial system has strengthened further**. Cost reductions and a sizeable decline in loan losses have improved bank profitability and the corporate sector has consolidated its financial position considerably. However, the high level of household borrowing, contributing to the steady rise in house prices, entails risks in the event of a rise in interest rates or an abrupt adjustment in house prices. Close monitoring of these risks therefore remains essential.

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

41. The authorities deserve to be commended for their high level of official development assistance.

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

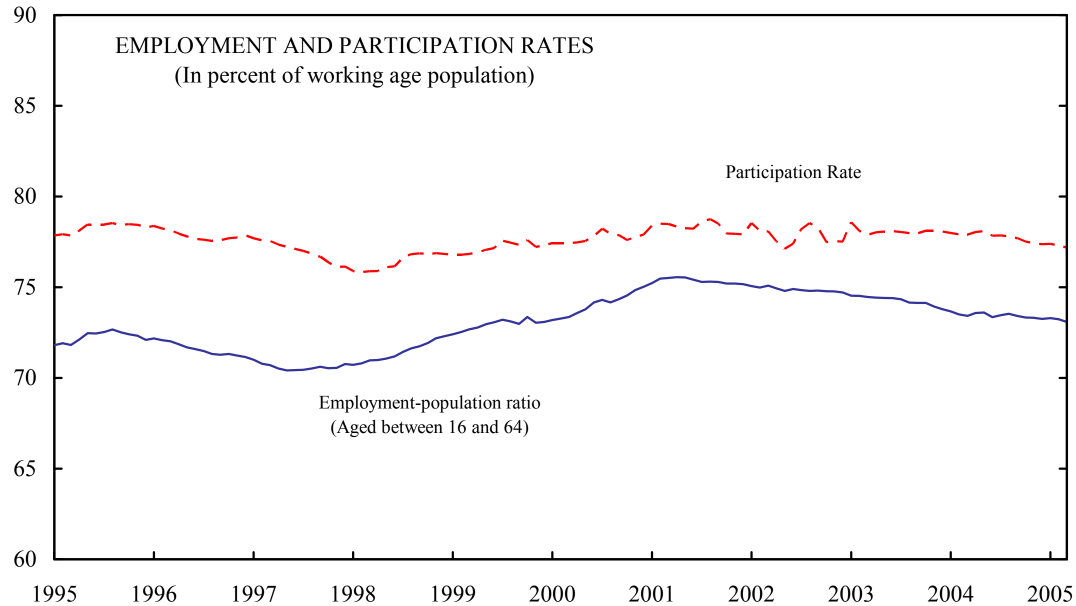
Figure 1. Sweden: Output Developments and Prospects
(Annual percentage change)



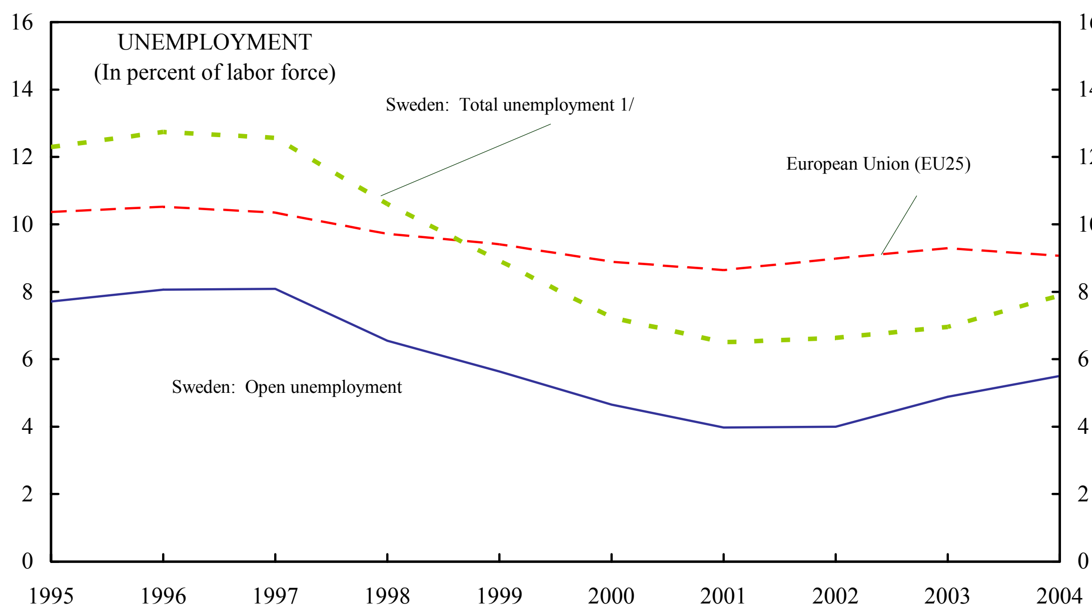

Sources: Statistics Sweden; and Fund staff projections.

Figure 2. Sweden:  Labor Market Developments

***Participation and employment declined slightly...***



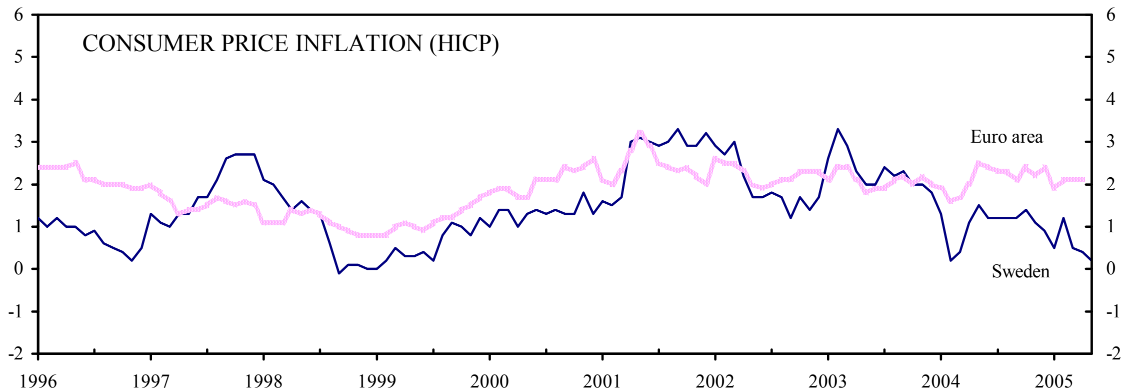

***...while unemployment has been rising.***



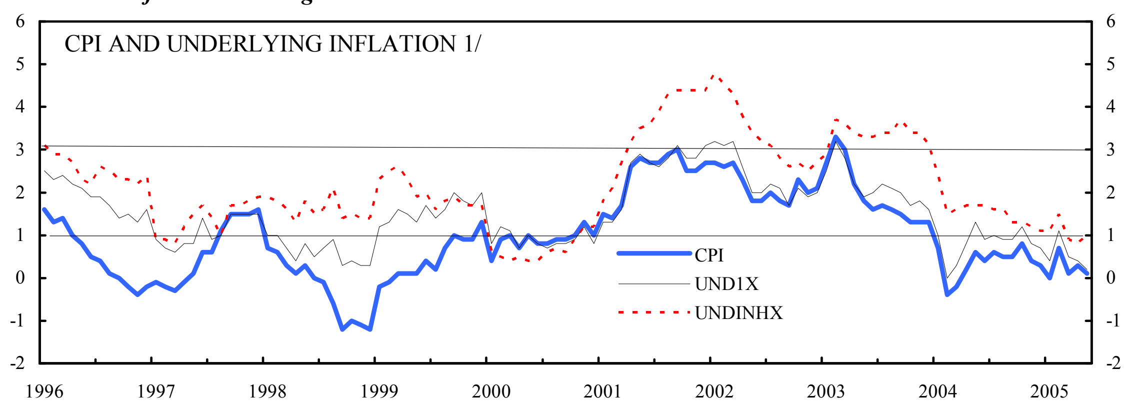

Sources:  Statistics Sweden and OECD.
1/  Open unemployment plus participants in active labor market programs that are excluded from open unemployment (e.g., retraining, and youth employment schemes).

Figure 3. Sweden: Inflation Developments
(Percent change from a year ago)

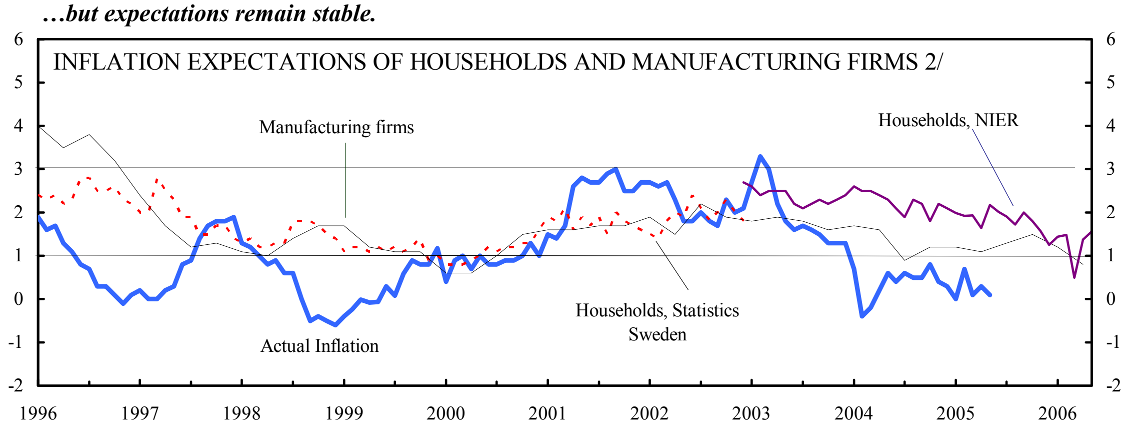
***Inflation is lower than in the Euro area...***




***...and has fallen below target...***



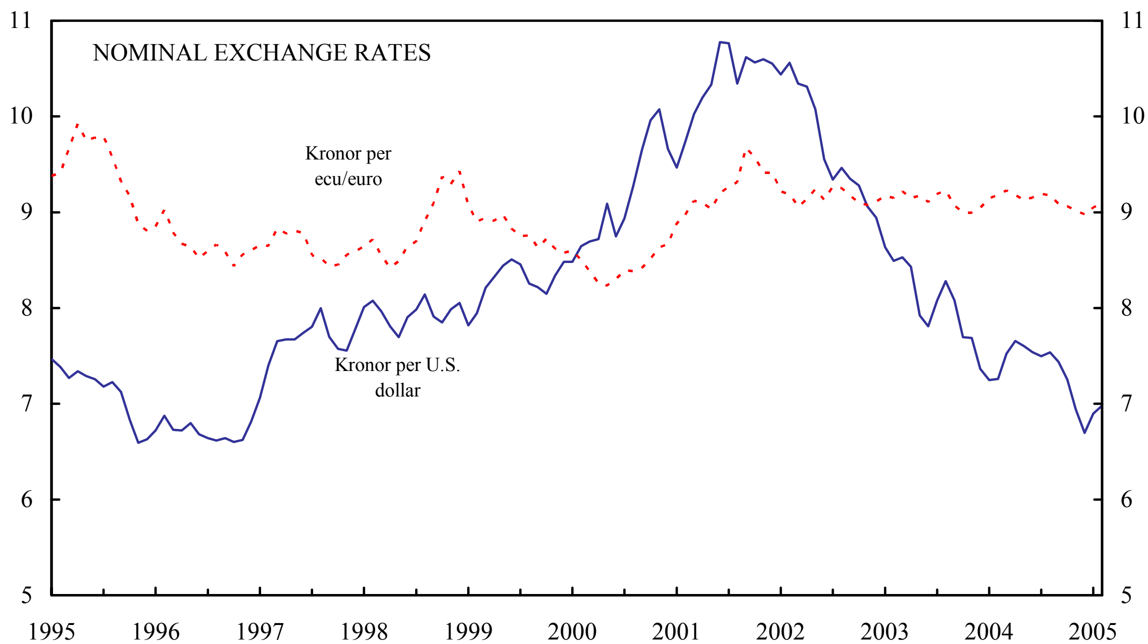

***…but expectations remain stable.***



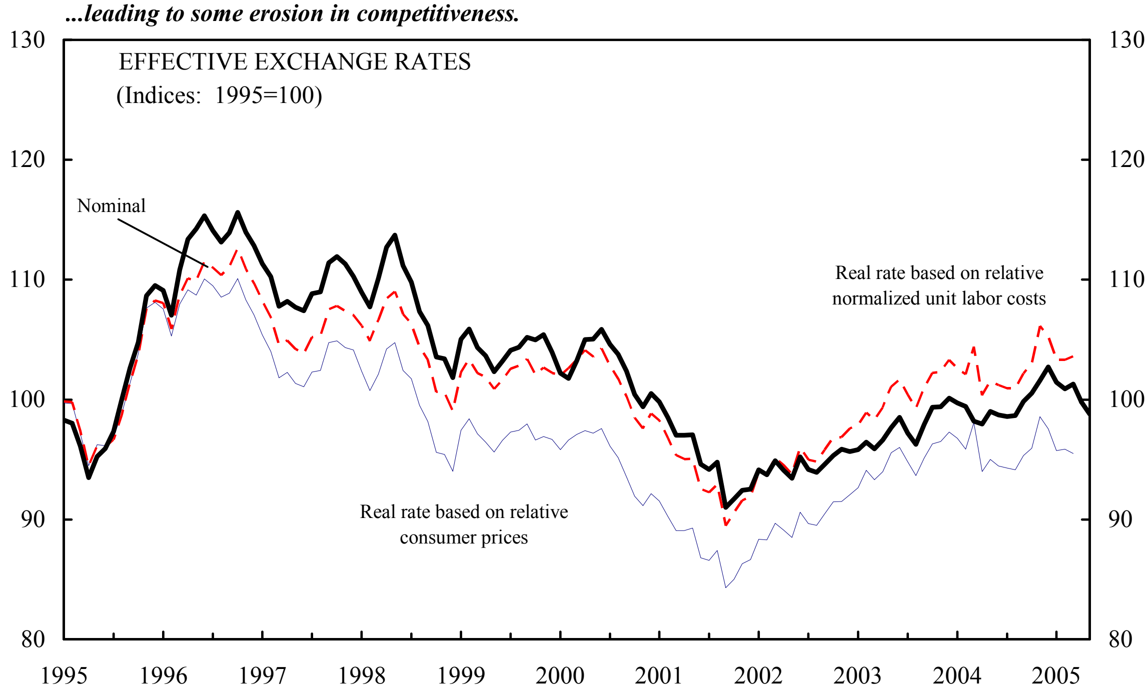

Sources: Statistics Sweden; the Riksbank and NIER.
1/ UND1X = CPI excluding changes in indirect taxes and subsidies and interest costs for owner-occupied housing; UNDINHX also excludes changes in import prices; the horizontal lines indicate a 1 percent range around the 2 percent inflation target.
2/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

Figure 4. Sweden: Exchange Rate Developments

***The krona continued appreciating against the US dollar while remaining broadly stable against the euro...***



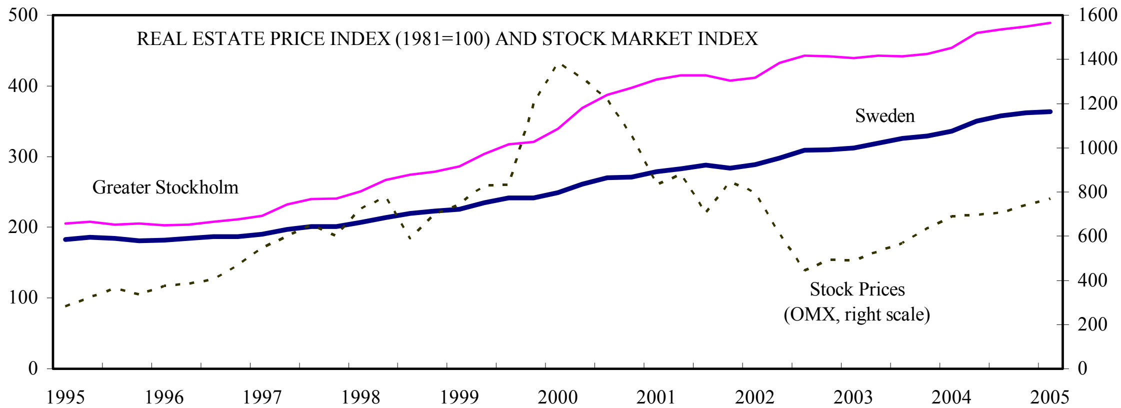

***...leading to some erosion in competitiveness.***



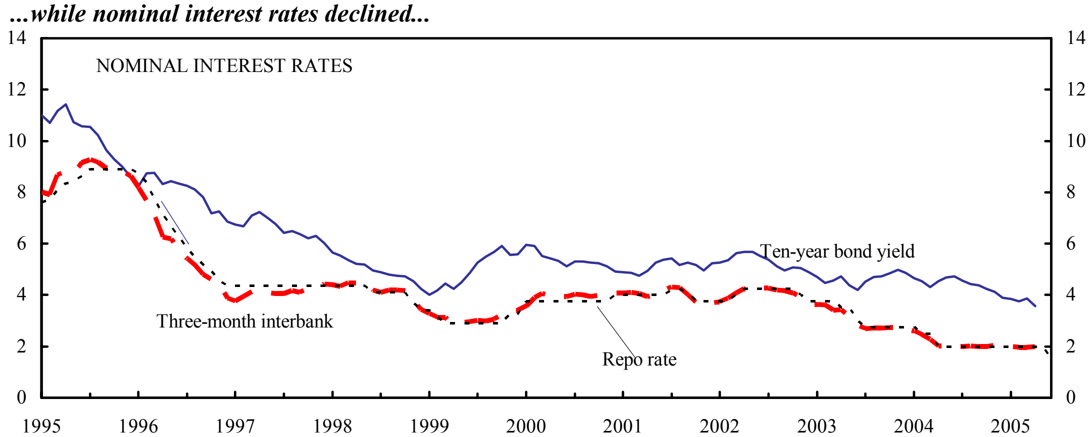

Source: IMF, International Financial Statistics

Figure 5. Sweden: Asset Price and Interest Rate Developments

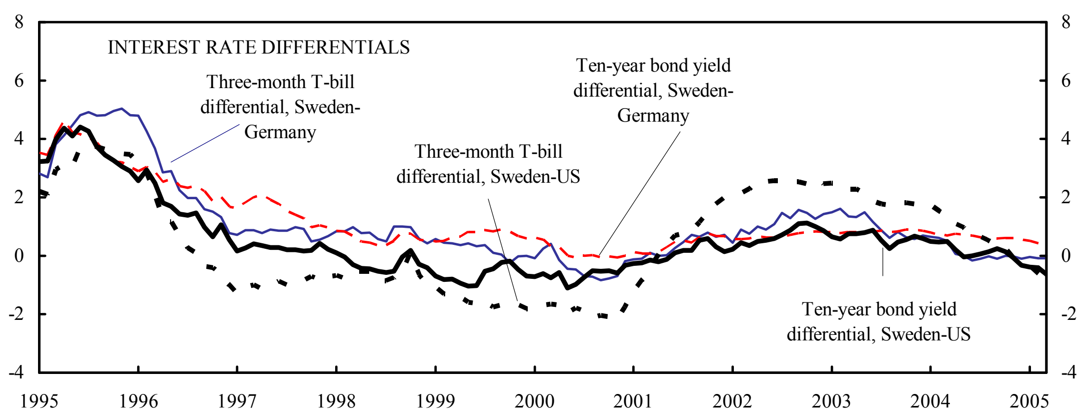
***Asset prices continued rising...***




***...while nominal interest rates declined...***

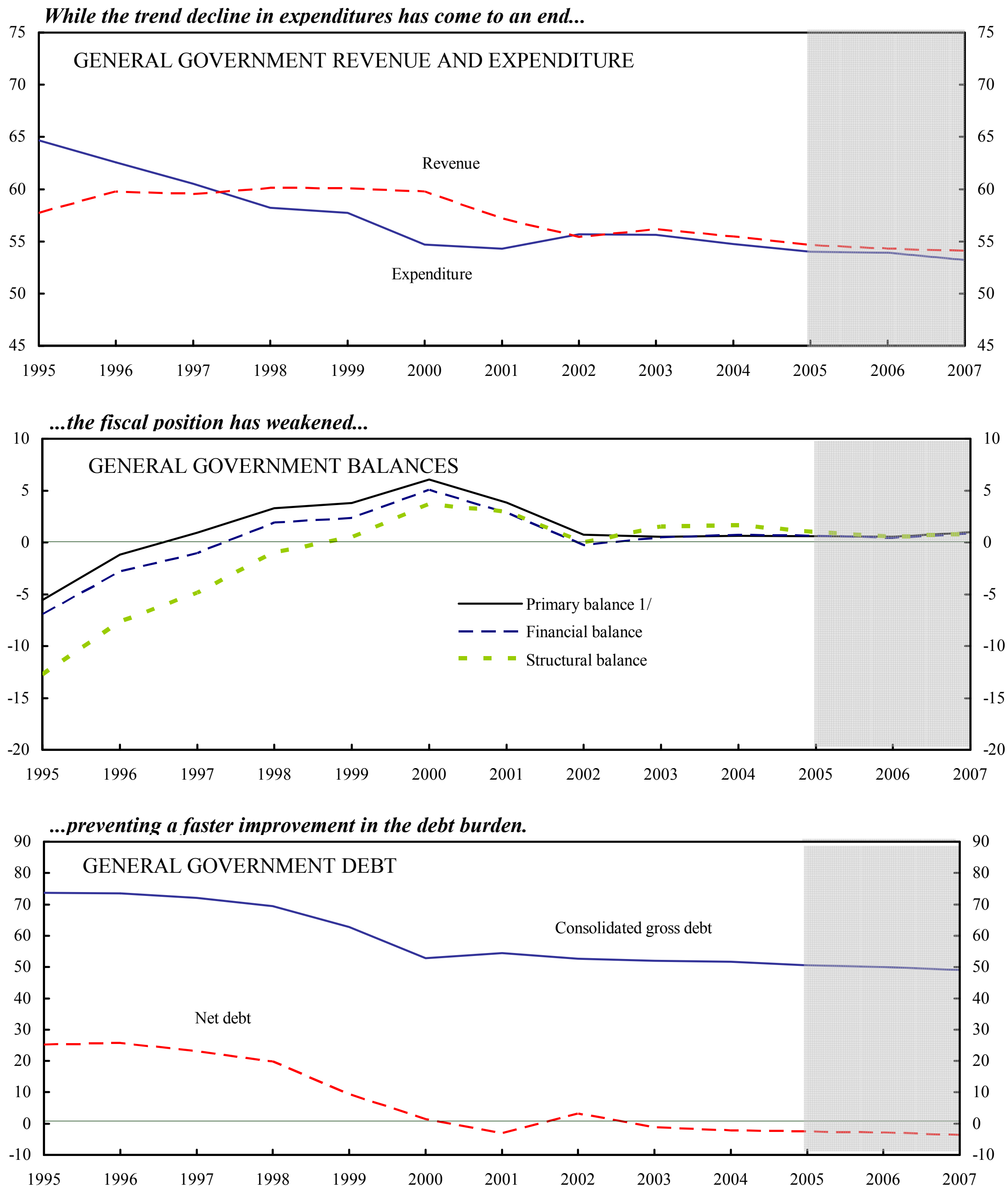



***…to international levels.***




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

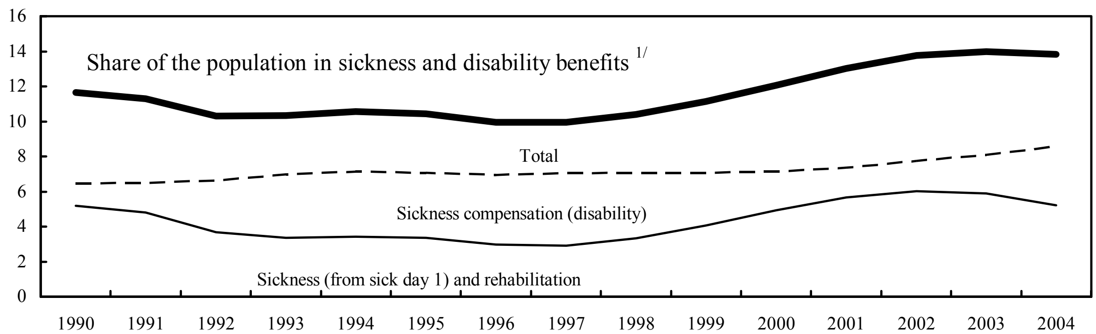
Figure 6. Sweden: Fiscal Developments and Prospects
(In percent of GDP)



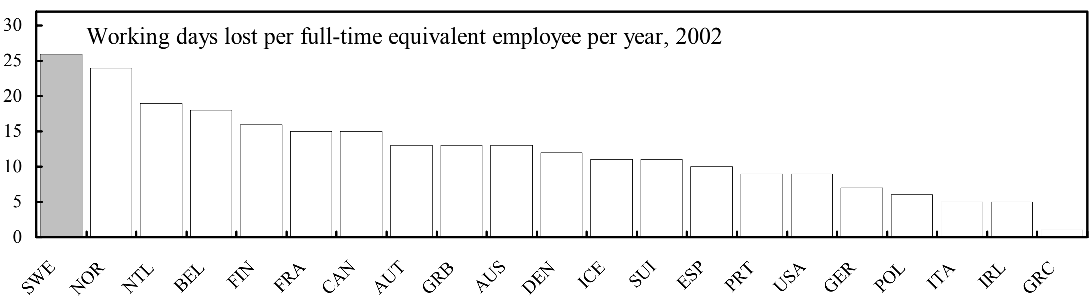

Sources: Statistics Sweden and Ministry of Finance.
1/ Excluding interest expenditure and income.

Figure 7. Sweden: the Sickness Absence Problem

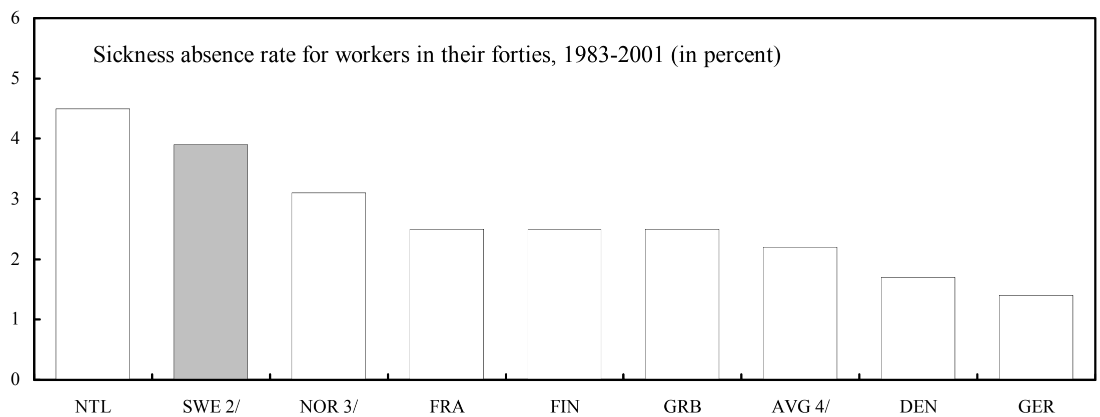
***Despite some leveling off in sickness absence due to a shift into long-term disability. . .***




***. . . sickness absence remains high in international comparisons. . .***




***. . . particularly among the younger population.***




Sources: Ministry of Finance, Employment Outlook, OECD (2004); and "Sickness Absence in Europe- A Comparative Study" by Sisko Bengendorff (2003), Swedish National Social Insurance Board.

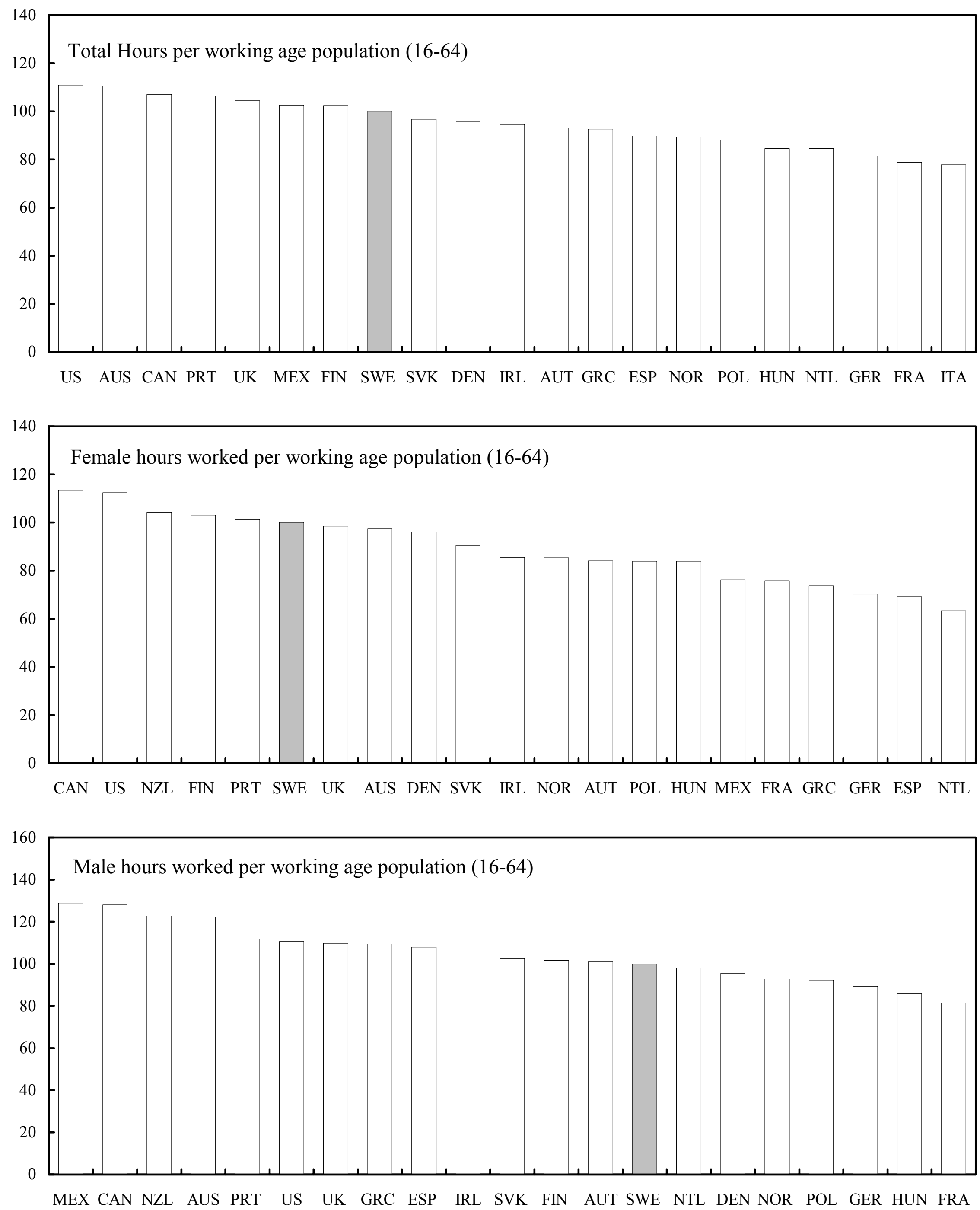
1/ Population aged 20-64 in full-time equivalents.

2/ Average of 1987-2001.

3/ Average of 1989-2001.

4/ Weighted Average.

Figure 8. Hours Worked per Working Age Population in Selected OECD Countries, 2002
(Sweden=100)




Sources: OECD and Fund staff calculations.

Table 1. Selected Economic Indicators

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 1/ | Average 2006–08 1/ |
|---|---|---|---|---|---|---|---|
| Real economy (in percent change) | | | | | | | |
| Real GDP | 4.3 | 1.0 | 2.0 | 1.5 | 3.6 | 2.6 | 2.6 |
| Domestic Demand | 3.9 | -0.2 | 0.7 | 1.1 | 1.4 | 2.8 | 1.8 |
| CPI inflation | 0.9 | 2.4 | 2.2 | 1.9 | 0.4 | 0.3 | 2.0 |
| Open unemployment rate (in percent) | 4.7 | 4.0 | 4.0 | 4.9 | 5.5 | 5.2 | 4.5 |
| Participation in labor market programs (in percent) | 2.6 | 2.5 | 2.6 | 2.1 | 2.4 | 2.7 | 2.5 |
| Gross national saving (percent of GDP) | 22.6 | 22.1 | 21.9 | 23.8 | 24.4 | 24.2 | 23.8 |
| Gross domestic investment (percent of GDP) | 18.5 | 17.7 | 16.7 | 16.2 | 16.1 | 16.8 | 16.5 |
| Public finance (in percent of GDP) | | | | | | | |
| General government balance | 5.0 | 2.6 | -0.5 | -0.1 | 1.1 | 0.7 | 1.0 |
| Structural balance 2/ | 3.9 | 2.9 | 0.2 | 0.8 | 1.8 | 0.9 | 1.0 |
| General government debt | 52.8 | 54.3 | 52.4 | 52.0 | 51.2 | 49.9 | 47.2 |
| Money and credit (12-month, percent change) | | | | | | | |
| M0 | 2.0 | 8.8 | -0.9 | 2.7 | -0.2 | ... | ... |
| M3 | 2.8 | 6.7 | 4.5 | 3.1 | 4.6 | ... | ... |
| Credit to non-bank public | 9.1 | 8.8 | 4.2 | 2.7 | 7.3 | ... | ... |
| Interest rates (year average) | | | | | | | |
| Three-month treasury bill rate | 3.6 | 3.7 | 3.6 | 2.6 | 2.0 | … | … |
| Ten-year government bond yield | 5.6 | 5.2 | 4.6 | 4.7 | 3.8 | … | … |
| Balance of payments (in percent of GDP) | | | | | | | |
| Trade balance | 5.7 | 6.2 | 6.7 | 7.1 | 8.6 | 8.3 | 9.5 |
| Current account | 4.1 | 4.4 | 5.1 | 7.6 | 8.2 | 7.3 | 7.3 |
| International reserves (in billions of US dollars) | 16.3 | 14.8 | 19.1 | 22.4 | 24.8 | … | … |
| Reserve cover (months of imports of goods and services) | 2.0 | 2.1 | 2.5 | 2.4 | 2.3 | … | … |
| Exchange rate (period average, unless otherwise stated) | | | | | | | |
| Exchange rate regime | | | Floating exchange rate | | | | |
| Skr per U.S. dollar (May 31, 2005) | | | 7.4291 | | | | |
| Nominal effective rate (2000=100) | 100.0 | 91.7 | 93.4 | 98.2 | 99.7 | ... | ... |
| Real effective rate (2000=100) 3/ | 100.0 | 92.4 | 92.0 | 94.9 | 96.8 | ... | ... |

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

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

Table 2. General Government Financial Accounts, 2000-2007

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 Proj. | 2006 Proj. | 2007 Proj. |
|---|---|---|---|---|---|---|---|---|
| | | | | (in percent of GDP) | | | | |
| Total revenue | 59.7 | 56.8 | 55.2 | 55.8 | 55.6 | 54.9 | 54.5 | 54.2 |
| Primary revenue | 56.6 | 54.6 | 53.1 | 53.7 | 53.5 | 52.6 | 52.3 | 52.0 |
| Tax revenue (incl. charges) | 53.4 | 51.3 | 49.7 | 50.4 | 50.3 | 49.4 | 49.1 | 48.9 |
| Nontax revenue | 3.2 | 3.3 | 3.4 | 3.4 | 3.2 | 3.2 | 3.2 | 3.2 |
| Interest receipts | 3.1 | 2.2 | 2.1 | 2.1 | 2.1 | 2.3 | 2.2 | 2.1 |
| | | | | | | | | |
| Total expenditure | 54.7 | 54.2 | 55.7 | 55.9 | 54.5 | 54.2 | 53.9 | 53.1 |
| Primary expenditure | 50.6 | 51.1 | 52.4 | 53.5 | 52.5 | 52.0 | 51.7 | 50.9 |
| Current transfers | 21.1 | 20.9 | 21.0 | 21.9 | 21.7 | 21.4 | 21.3 | 20.8 |
| Consumption | 26.6 | 27.0 | 27.9 | 28.3 | 27.8 | 27.5 | 27.3 | 27.1 |
| Investment | 3.0 | 3.1 | 3.4 | 3.3 | 3.0 | 3.1 | 3.1 | 3.0 |
| Interest payments | 4.1 | 3.1 | 3.3 | 2.4 | 2.0 | 2.2 | 2.2 | 2.2 |
| | | | | | | | | |
| Overall balance | 5.0 | 2.6 | -0.5 | -0.1 | 1.1 | 0.7 | 0.6 | 1.1 |
| Central government | 2.6 | 7.4 | -1.9 | -1.7 | -0.8 | -1.6 | -1.7 | -1.0 |
| Pension system | 2.2 | -4.6 | 1.9 | 1.9 | 1.9 | 2.0 | 2.0 | 1.9 |
| Local governments | 0.2 | -0.2 | -0.5 | -0.3 | 0.1 | 0.3 | 0.3 | 0.2 |
| Primary balance | 6.0 | 3.5 | 0.7 | 0.2 | 1.0 | 0.6 | 0.6 | 1.2 |
| | | | | | | | | |
| **Structural adjustment** | | | | | | | | |
| Cyclical adjustment | -0.6 | 0.4 | 0.8 | 0.9 | 0.6 | 0.2 | 0.1 | 0.0 |
| Cyclically adjusted overall balance | 4.4 | 2.9 | 0.2 | 0.8 | 1.8 | 0.9 | 0.7 | 1.1 |
| Temporary effects | -0.5 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Structural balance | 3.9 | 2.9 | 0.2 | 0.8 | 1.8 | 0.9 | 0.7 | 1.1 |
| Fiscal stimulus | -1.5 | 1.0 | 2.7 | -0.6 | -1.0 | 0.9 | 0.2 | -0.4 |
| | | | | | | | | |
| *Memorandum items:* | | | | | | | | |
| Gross public debt (in percent of GDP) | 52.8 | 54.3 | 52.4 | 52.0 | 51.2 | 49.9 | 48.6 | 47.3 |
| Net public debt (in percent of GDP) | 1.2 | -3.0 | 3.1 | -1.5 | -5.8 | -6.0 | -6.4 | -7.1 |
| Nominal GDP (in billion of kronor) | 2,195 | 2,269 | 2,353 | 2,438 | 2,543 | 2,664 | 2,796 | 2,927 |
| Output gap (in percent of potential) | 0.9 | -0.5 | -1.1 | -1.3 | -0.9 | -0.3 | -0.1 | 0.0 |

Source: Ministry of Finance, Spring Budget Bill 2005.

Table 3. Balance of Payments, 2000-2010 1/
(in billions of dollars)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 proj. | 2006 proj. | 2007 proj. | 2008 proj. | 2009 proj. | 201 pro |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Current account | 9.9 | 9.7 | 12.4 | 23.0 | 28.6 | 26.9 | 26.3 | 28.6 | 32.0 | 35.7 | 39. |
| as a percentage of GDP | 4.1 | 4.4 | 5.1 | 7.6 | 8.2 | 7.3 | 7.0 | 7.2 | 7.8 | 8.3 | 8. |
| Goods and services | 13.8 | 13.6 | 16.4 | 21.5 | 29.8 | 30.6 | 33.0 | 37.0 | 42.2 | 47.8 | 53. |
| Exports of goods and services | 110.7 | 100.2 | 107.1 | 133.2 | 161.7 | 181.2 | 191.8 | 200.8 | 211.8 | 224.3 | 238. |
| Goods | 88.3 | 77.5 | 83.1 | 102.1 | 122.9 | 137.3 | 145.4 | 152.3 | 160.6 | 170.1 | 180. |
| Services | 22.4 | 22.7 | 24.0 | 31.2 | 38.8 | 43.9 | 46.3 | 48.5 | 51.2 | 54.2 | 57. |
| Imports of goods and services | -96.9 | -86.7 | -90.8 | -111.8 | -131.9 | -150.6 | -158.8 | -163.9 | -169.6 | -176.5 | -184. |
| Goods | -72.7 | -63.0 | -66.8 | -83.0 | -98.8 | -113.0 | -119.1 | -123.0 | -127.2 | -132.4 | -138. |
| Services | -24.2 | -23.6 | -24.0 | -28.8 | -33.1 | -37.6 | -39.6 | -40.9 | -42.3 | -44.0 | -46. |
| Income | -1.4 | -1.4 | -1.2 | 3.6 | 3.7 | 0.9 | -1.7 | -2.8 | -4.0 | -5.2 | -6. |
| Compensation of employees | -0.3 | -0.3 | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 | -0.4 | -0.5 | -0.5 | -0. |
| Investment income | -1.2 | -1.2 | -0.9 | 3.8 | 3.9 | 1.2 | -1.4 | -2.4 | -3.5 | -4.7 | -6. |
| Current transfers | -2.4 | -2.4 | -2.8 | -2.1 | -4.9 | -4.6 | -5.0 | -5.6 | -6.2 | -6.9 | -7. |
| Official | -2.1 | -2.1 | -2.3 | -1.7 | -3.2 | -3.5 | -3.7 | -4.1 | -4.5 | -4.9 | -5. |
| Capital and financial account | -1.0 | -3.0 | -12.0 | -28.8 | -33.5 | -26.9 | -26.3 | -28.6 | -32.0 | -35.7 | -39. |
| Capital account | -0.4 | -4.6 | -0.4 | -0.6 | -0.3 | -0.1 | -0.2 | -0.4 | -0.7 | -1.3 | -2. |
| Financial account | -0.6 | 1.6 | -11.6 | -28.2 | -33.2 | -26.8 | -26.0 | -28.1 | -31.3 | -34.4 | -37. |
| Direct investment | -17.4 | 5.5 | 1.3 | -20.0 | -15.5 | -15.0 | -13.3 | -14.0 | -14.6 | -15.3 | -16. |
| Abroad | -40.7 | -6.4 | -10.7 | -21.3 | -15.2 | -14.5 | -14.9 | -15.6 | -16.3 | -17.1 | -17. |
| In Sweden | 23.3 | 11.9 | 11.9 | 1.3 | -0.4 | -0.5 | 1.6 | 1.6 | 1.7 | 1.8 | 1. |
| Portfolio investment excl. fin. derivatives | -3.1 | -13.1 | -11.1 | -9.1 | -24.3 | -16.9 | -17.4 | -18.2 | -19.0 | -19.9 | -20. |
| Other investment | 20.5 | 13.3 | -0.9 | 1.8 | 5.8 | 2.3 | -0.2 | 2.1 | 4.7 | 7.5 | 10. |
| Reserve assets | -0.3 | 1.0 | -0.8 | -2.0 | 1.1 | 2.8 | 4.9 | 1.9 | -2.3 | -6.7 | -11. |
| Net errors and omissions | -8.9 | -6.8 | -0.4 | 5.8 | 5.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0. |
| Memorandum items | | | | | | | | | | | |
| GDP at current prices | 239.9 | 219.8 | 242.5 | 302.6 | 347.1 | 366.5 | 376.4 | 394.4 | 412.3 | 431.0 | 450. |
| GDP at current prices (Euro) | 259.9 | 245.2 | 256.9 | 267.3 | 279.1 | 287.1 | 376.4 | 312.9 | 326.8 | 341.4 | 356. |
| Central Bank reserves | 16.3 | 14.8 | 19.1 | 22.4 | 24.8 | | | | | | |
| External debt (as a percentage of GDP) | 176.9 | 191.9 | 196.3 | 207.9 | | | | | | | |
| Net external debt (as a percentage of GDP) | 24.5 | 24.3 | 26.2 | 24.0 | | | | | | | |

Sources: Riksbank, and staff projections.

1/ Medium-term projections are based on a constant real effective exchange rate.

Table 4. Indicators of External and Financial Vulnerability, 2000-2005
(In percent of GDP, unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 1/ | |
|---|---|---|---|---|---|---|---|
| **External Indicators** | | | | | | | |
| Exports of goods and services (annual percentage change, in U.S. dollars) | 3.5 | -9.4 | 6.9 | 24.4 | 21.3 | 12.1 | |
| Imports of goods and services (annual percentage change, in U.S. dollars) | 5.9 | -10.5 | 4.8 | 23.1 | 18.0 | 14.2 | |
| Current account balance | 4.1 | 4.4 | 5.1 | 7.6 | 8.2 | 7.3 | |
| Capital and financial account balance | -0.4 | -1.4 | -4.9 | -9.5 | -9.7 | -7.3 | |
| Direct investment, net | -7.3 | 2.5 | 0.5 | -6.6 | -4.5 | -4.1 | |
| Portfolio investment, net | -1.3 | -6.0 | -4.6 | -3.0 | -7.0 | -4.6 | |
| Central Bank reserves (end of period, in billions of U.S. dollars) | 16.3 | 14.8 | 19.1 | 22.4 | 24.8 | 24.9 | April |
| Exchange rate against US dollar (SEK, period average) | 9.2 | 10.3 | 9.7 | 8.1 | 7.3 | 7.2 | May |
| Exchange rate against Euro (SEK, period average) | 8.4 | 9.3 | 9.2 | 9.1 | 9.1 | 9.2 | May |
| Effective exchange rate (annual percentage change) | -0.2 | -8.3 | 1.9 | 5.2 | 1.5 | 1.2 | May |
| Real effective exchange rate (based on ULC, annual percentage change) | -1.5 | -7.6 | -0.5 | 3.2 | 2.0 | 1.7 | May |
| **Financial Markets Indicators** | | | | | | | |
| Consolidated public sector gross debt (end of period) | 52.8 | 54.3 | 52.4 | 52.0 | 51.2 | 49.9 | |
| 3-month T-bill yield (nominal, in percent per annum) | 4.0 | 3.7 | 3.6 | 2.6 | 2.0 | 1.9 | May |
| 3-month T-bill yield (ex post real, in percent per annum) | 3.0 | 1.0 | 1.5 | 1.3 | 1.7 | 1.7 | May |
| Spread of 3-month T-bill vs. Germany (percentage points, end of period) | -0.8 | 0.4 | 0.7 | 0.5 | -0.1 | -0.3 | May |
| Spread of 10-year T-bill vs. Germany (percentage points, end of period) | -0.1 | 0.4 | 0.5 | 0.4 | 0.1 | -0.1 | May |
| General stock index (annual percentage change) | -11.9 | -19.8 | -41.7 | 29.0 | 16.6 | 17.6 | May |
| Real estate price index (annual percentage change) | 11.0 | 8.0 | 6.3 | 6.6 | 9.6 | ... | |
| Commercial property price index (annual percentage change) | 6.9 | 0.9 | 11.4 | -5.2 | 2.4 | ... | |
| Credit to households (growth rate in percent, end of period) | 7.5 | 8.9 | 9.3 | 10.1 | 11.6 | 11.5 | April |
| **Financial Sector Risk Indicators** | | | | | | | |
| Tier 1 capital ratio in four major banks | 6.9 | 7.1 | 7.1 | 7.2 | 8.2 | ... | |
| Return on equity after tax in four major banks | 15.7 | 13.0 | 10.9 | 13.1 | 15.1 | ... | |
| Nonperforming loans in four major banks (percent of lending) | 1.6 | 1.5 | 1.2 | 1.2 | 0.9 | ... | |
| Loan loss provisioning in four major banks (percent of lending) | 0.4 | 0.4 | 0.3 | 0.4 | 0.2 | ... | |
| Corporate borrowing ratio in percent | 69.8 | 72.2 | 67.7 | 63.5 | 62.6 | ... | |
| Ratio of households' financial liabilities to disposable income in percent | 106.1 | 106.4 | 109.9 | 116.8 | 124.4 | ... | |
| Ratio of households' interest payments to to disposable income in percent | 4.3 | 4.1 | 4.2 | 3.9 | 3.7 | ... | |

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

1/ Staff projections unless otherwise indicated.

Table 5. Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | | | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | |
| | | | | | | | | I. Baseline Projections | | | | | | **Debt-stabilizing primary balance 10/** |
| **Public sector debt 1/** | 52.8 | 54.3 | 52.4 | 52.0 | 51.1 | | | **50.4** | **49.0** | **47.7** | **44.4** | **41.0** | **37.2** | **0.4** |
| o/w foreign-currency denominated | 9.9 | 10.5 | 8.9 | 14.0 | 13.7 | | | 13.6 | 13.2 | 12.8 | 11.9 | 11.0 | 10.0 | |
| Change in public sector debt | -9.9 | 1.5 | -1.9 | -0.4 | -0.9 | | | -0.7 | -1.4 | -1.3 | -3.3 | -3.4 | -3.8 | |
| Identified debt-creating flows (4+7+12) | -10.1 | -3.3 | -3.6 | -4.7 | -4.7 | | | -3.7 | -3.3 | -3.1 | -3.3 | -3.4 | -3.9 | |
| Primary deficit | -9.2 | -6.0 | -2.9 | -2.7 | -2.8 | | | -2.8 | -2.8 | -3.3 | -3.6 | -3.9 | -4.4 | |
| Revenue and grants | 59.8 | 57.1 | 55.3 | 56.1 | 55.5 | | | 55.7 | 55.2 | 54.9 | 54.4 | 54.7 | 55.2 | |
| Primary (noninterest) expenditure | 50.6 | 51.1 | 52.4 | 53.5 | 52.7 | | | 52.8 | 52.4 | 51.6 | 50.8 | 50.9 | 50.9 | |
| Automatic debt dynamics 2/ | 2.4 | 2.8 | -0.7 | -1.4 | -1.2 | | | -0.3 | 0.0 | 0.2 | 0.3 | 0.4 | 0.5 | |
| Contribution from interest rate/growth differential 3/ | 0.7 | 1.4 | 1.2 | 0.3 | -0.1 | | | 0.4 | -0.1 | 0.2 | 0.3 | 0.4 | 0.6 | |
| Of which contribution from real interest rate | 3.3 | 2.0 | 2.3 | 1.1 | 1.7 | | | 1.8 | 1.3 | 1.3 | 1.5 | 1.5 | 1.6 | |
| Of which contribution from real GDP growth | -2.6 | -0.5 | -1.0 | -0.7 | -1.8 | | | -1.4 | -1.3 | -1.2 | -1.1 | -1.1 | -1.0 | |
| Contribution from exchange rate depreciation 4/ | 1.7 | 1.3 | -2.0 | -1.8 | -1.1 | | | -0.7 | 0.1 | 0.0 | 0.0 | 0.0 | -0.1 | |
| Other identified debt-creating flows | -3.3 | -0.1 | 0.0 | -0.6 | -0.6 | | | -0.6 | -0.5 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Privatization receipts (negative) | -3.3 | -0.1 | 0.0 | -0.6 | -0.6 | | | -0.6 | -0.5 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes (2-3) | 0.2 | 4.8 | 1.8 | 4.3 | 3.8 | | | 3.0 | 1.9 | 1.8 | 0.0 | 0.0 | 0.1 | |
| Public sector debt-to-revenue ratio 1/ | 88.4 | 95.1 | 94.9 | 92.6 | 92.0 | | | 90.6 | 88.8 | 86.9 | 81.6 | 74.9 | 67.4 | |
| **Gross financing need 5/** | -5.1 | -2.9 | 0.3 | -0.5 | -0.7 | | | -0.6 | -0.4 | -0.9 | -1.2 | -1.5 | -2.0 | |
| in billions of U.S. dollars | -12.2 | -6.3 | 0.6 | -1.5 | -2.6 | | | -2.4 | -1.7 | -3.6 | -5.2 | -6.8 | -9.5 | |
| **Key Macroeconomic and Fiscal Assumptions** | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | Projected Average |
| Real GDP growth (in percent) | 4.3 | 1.0 | 2.0 | 1.5 | 3.6 | 2.8 | 1.3 | 2.8 | 2.8 | 2.5 | 2.5 | 2.5 | 2.5 | 2.6 |
| Average nominal interest rate on public debt (in percent) 6/ | 6.9 | 6.2 | 6.1 | 4.3 | 4.2 | 7.1 | 1.9 | 4.5 | 4.9 | 5.1 | 5.2 | 5.6 | 6.0 | 5.2 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | 5.6 | 3.9 | 4.4 | 2.2 | 3.4 | 5.5 | 1.9 | 3.6 | 2.7 | 2.9 | 3.2 | 3.6 | 4.0 | 3.4 |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | -10.6 | -10.6 | 20.9 | 22.8 | 8.7 | 2.0 | 13.2 | 5.3 | -0.7 | 0.0 | 0.0 | 0.0 | 1.0 | 0.9 |
| Inflation rate (GDP deflator, in percent) | 1.3 | 2.3 | 1.7 | 2.1 | 0.8 | 1.6 | 0.8 | 0.8 | 2.2 | 2.2 | 2.0 | 2.0 | 2.0 | 1.9 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | -0.3 | 2.0 | 4.6 | 3.6 | 2.2 | 1.3 | 2.6 | 3.0 | 2.1 | 0.8 | 1.0 | 2.5 | 2.5 | 2.0 |
| Primary deficit | -9.2 | -6.0 | -2.9 | -2.7 | -2.8 | -4.7 | 2.8 | -2.8 | -2.8 | -3.3 | -3.6 | -3.9 | -4.4 | -3.5 |
| | | | | | | | | II. Stress Tests for Public Debt Ratio | | | | | | **Debt-stabilizing primary balance 10/** |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2005-09 7/ | | | | | | | | **50.4** | **48.4** | **46.7** | **43.1** | **39.5** | **35.8** | **0.8** |
| A2. No policy change (constant primary balance) in 2005-09 | | | | | | | | **50.4** | **48.9** | **48.1** | **45.5** | **43.2** | **40.9** | **0.5** |
| A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 8/ | | | | | | | | **50.4** | **49.0** | **47.7** | **44.4** | **41.0** | **37.2** | **0.4** |
| A4. Selected variables are consistent with market forecast in 2005-09 | | | | | | | | **50.4** | **49.0** | **47.7** | **44.4** | **41.0** | **37.2** | **0.4** |
| **B. Bound Tests** | | | | | | | | | | | | | | |
| B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | | | | | | **50.4** | **52.2** | **54.1** | **50.9** | **47.5** | **43.8** | **0.5** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **50.4** | **51.8** | **54.4** | **53.7** | **53.0** | **51.9** | **0.6** |
| B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **50.4** | **52.7** | **55.7** | **52.4** | **49.1** | **45.4** | **0.5** |
| B4. Combination of B1-B3 using one standard deviation shocks | | | | | | | | **50.4** | **52.9** | **55.8** | **52.6** | **49.3** | **45.6** | **0.5** |
| B5. One time 30 percent real depreciation in 2005 9/ | | | | | | | | **50.4** | **55.5** | **54.2** | **51.0** | **47.6** | **43.9** | **0.5** |
| B6. 10 percent of GDP increase in other debt-creating flows in 2005 | | | | | | | | **50.4** | **59.0** | **57.7** | **54.5** | **51.2** | **47.5** | **0.5** |

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ The implied change in other key variables under this scenario is discussed in the text.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ 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.

Table 6. External Debt Sustainability Framework, 2000-2010

(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | | | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | |
| | | | | | | | | **I. Baseline Projections** | | | | | | **Debt-stabilizing non-interest current account 6/** |
| **External debt (net foreign liabilities)** | 24.5 | 24.3 | 26.2 | 24.0 | 26.7 | | | **17.9** | **10.4** | **2.5** | **-5.5** | **-13.7** | **-22.0** | **-14.6** |
| Change in external debt | -6.2 | -0.2 | 1.9 | -2.2 | 2.7 | | | -8.7 | -7.6 | -7.9 | -8.0 | -8.2 | -8.4 | |
| Identified external debt-creating flows (4+8+9) | -23.2 | -55.6 | -21.0 | -14.5 | -21.6 | | | -26.7 | -27.6 | -27.0 | -26.3 | -25.7 | -25.1 | |
| Current account deficit, excluding interest payments | -4.6 | -5.0 | -5.5 | -6.3 | -7.0 | | | -5.8 | -6.1 | -6.8 | -7.8 | -8.7 | -9.7 | |
| Deficit in balance of goods and services | -5.7 | -6.2 | -6.7 | -7.1 | -8.6 | | | -8.3 | -8.9 | -9.5 | -10.4 | -11.2 | -12.1 | |
| Exports | 46.1 | 45.6 | 44.2 | 44.0 | 46.6 | | | 49.4 | 50.9 | 50.8 | 51.3 | 51.9 | 52.8 | |
| Imports | 40.4 | 39.4 | 37.4 | 36.9 | 38.0 | | | 41.1 | 41.9 | 41.3 | 40.9 | 40.7 | 40.7 | |
| Net non-debt creating capital inflows (negative) | -1.5 | -27.8 | -23.8 | -24.0 | -21.8 | | | -20.5 | -20.0 | -19.1 | -18.3 | -17.5 | -16.7 | |
| Automatic debt dynamics 1/ | -17.1 | -22.9 | 8.3 | 15.8 | 7.2 | | | -0.3 | -1.5 | -1.0 | -0.2 | 0.5 | 1.3 | |
| Denominator: 1+g+ρ+gρ | 1.0 | 0.9 | 1.1 | 1.2 | 1.1 | | | 1.1 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | |
| Contribution from nominal interest rate | 0.5 | 0.5 | 0.3 | -1.3 | -1.2 | | | -1.4 | -1.0 | -0.6 | -0.1 | 0.3 | 0.7 | |
| Contribution from real GDP growth | -1.4 | -0.3 | -0.4 | -0.3 | -0.8 | | | -0.7 | -0.5 | -0.2 | -0.1 | 0.1 | 0.3 | |
| Contribution from price and exchange rate changes 2/ | -16.2 | -23.1 | 8.4 | 17.4 | 9.1 | | | 1.8 | 0.0 | -0.2 | 0.0 | 0.1 | 0.3 | |
| Residual, incl. change in gross foreign assets (2-3) | 17.0 | 55.5 | 22.9 | 12.3 | 24.3 | | | 18.0 | 20.0 | 19.1 | 18.3 | 17.5 | 16.7 | |
| External debt-to-exports ratio (in percent) | 53.1 | 53.3 | 59.4 | 54.5 | 57.3 | | | 36.4 | 20.4 | 4.9 | -10.7 | -26.3 | -41.8 | |
| **Gross external financing need (in billions of US dollars) 3/** | -3.6 | -2.2 | 6.0 | -11.0 | -24.7 | | | -21.3 | -21.5 | -23.8 | -27.3 | -31.0 | -35.0 | |
| in percent of GDP | -1.5 | -1.0 | 2.5 | -3.7 | -7.1 | | | -5.8 | -5.7 | -6.0 | -6.6 | -7.2 | -7.8 | |
| **Key Macroeconomic Assumptions** | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | Projected Average |
| Real GDP growth (in percent) | 4.3 | 1.0 | 2.0 | 1.5 | 3.6 | 2.8 | 1.3 | 2.8 | 2.8 | 2.5 | 2.5 | 2.5 | 2.5 | 2.6 |
| Exchange rate appreciation (US dollar value of local currency, change in percent) | -9.6 | -11.5 | 6.2 | 20.3 | 9.9 | 1.0 | 10.8 | 2.2 | -2.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| GDP deflator (change in domestic currency) | 1.3 | 2.3 | 1.7 | 2.1 | 0.8 | 1.6 | 0.8 | 0.8 | 2.2 | 2.2 | 2.0 | 2.0 | 2.0 | 1.9 |
| GDP deflator in US dollars (change in percent) | -8.4 | -9.4 | 8.0 | 22.9 | 10.8 | 2.6 | 11.2 | 3.0 | -0.1 | 2.2 | 2.0 | 2.0 | 2.0 | 1.8 |
| Nominal external interest rate (in percent) | 1.5 | 2.0 | 1.6 | -6.0 | -5.7 | 1.5 | 4.2 | -5.7 | -5.7 | -5.7 | -5.7 | -5.7 | -5.7 | -5.7 |
| Growth of exports (US dollar terms, in percent) | 3.6 | -9.5 | 6.7 | 24.3 | 21.4 | 8.7 | 12.6 | 12.2 | 5.7 | 4.7 | 5.4 | 5.9 | 6.2 | 6.7 |
| Growth of imports (US dollar terms, in percent) | 6.0 | -10.6 | 4.6 | 23.0 | 18.1 | 7.8 | 11.0 | 14.5 | 4.7 | 3.2 | 3.5 | 4.1 | 4.4 | 5.7 |
| Current account balance, excluding interest payments | 4.6 | 5.0 | 5.5 | 6.3 | 7.0 | 5.6 | 0.7 | 5.8 | 6.1 | 6.8 | 7.8 | 8.7 | 9.7 | 7.5 |
| Net non-debt creating capital inflows | 1.5 | 27.8 | 23.8 | 24.0 | 21.8 | 12.3 | 10.7 | 20.5 | 20.0 | 19.1 | 18.3 | 17.5 | 16.7 | 18.7 |
| | | | | | | | | **II. Stress Tests for External Debt Ratio** | | | | | | **Debt-stabilizing non-interest current account 6/** |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2005-10 4/ | | | | | | | | **17.9** | **18.8** | **18.6** | **17.5** | **15.5** | **12.6** | **-12.8** |
| A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation 5/ | | | | | | | | **17.9** | **10.4** | **2.5** | **-5.5** | **-13.7** | **-22.0** | **-14.6** |
| A3. Selected variables are consistent with market forecast in 2005-10 | | | | | | | | **17.9** | **10.4** | **2.5** | **-5.5** | **-13.7** | **-22.0** | **-14.6** |
| **B. Bound Tests** | | | | | | | | | | | | | | |
| B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | | | | | | **17.9** | **13.1** | **6.9** | **-1.6** | **-10.1** | **-18.8** | **-14.9** |
| B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **17.9** | **10.8** | **3.1** | **-4.9** | **-13.2** | **-21.6** | **-15.5** |
| B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **17.9** | **14.4** | **9.7** | **1.0** | **-7.8** | **-16.8** | **-24.9** |
| B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006 | | | | | | | | **17.9** | **12.4** | **7.0** | **-1.4** | **-10.0** | **-18.7** | **-14.9** |
| B5. Combination of B1-B4 using one standard deviation shocks | | | | | | | | **17.9** | **15.6** | **12.9** | **1.9** | **-9.1** | **-20.3** | **-18.9** |
| B6. One time 30 percent nominal depreciation in 2005 | | | | | | | | **17.9** | **16.9** | **8.4** | **-0.2** | **-8.9** | **-17.7** | **-21.6** |

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ The implied change in other key variables under this scenario is discussed in the text.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

## SWEDEN: FUND RELATIONS

(As of April 30, 2005)

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

| II. | **General Resources Account:** | **SDR Million** | **Percent of Quota** |
|---|---|---|---|
| | Quota | 2,395.50 | 100.00 |
| | Fund holdings of currency | 1,682.57 | 70.24 |
| | Reserve position in Fund | 712.93 | 29.76 |

| III. | **SDR Department:** | **SDR Million** | **Percent of Allocation** |
|---|---|---|---|
| | Net cumulative allocation | 246.53 | 100.00 |
| | Holdings | 116.33 | 47.19 |

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

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:**

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

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 | 2009 |
| Principal | | | | | |
| Charges/Interest | 2.39 | 3.26 | 3.26 | 3.27 | 3.26 |
| **Total** | 2.39 | 3.26 | 3.26 | 3.27 | 3.26 |

VII. **Exchange Arrangements:** The Krona has been floating since November 19, 1992. Sweden has accepted the obligations of Article VIII (Sections 2, 3, and 4) and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, apart from those in accordance with: (i) IMF Executive Board Decision No. 144-(52/51) and the relevant UN Security Council resolutions—measures have been taken to freeze the accounts of listed terrorist groups; and (ii) EU regulations and the relevant UN Security Council resolutions—certain restrictions are maintained on the making of payments and transfers for current international transactions with respect to: members of the government of Burma/Myanmar and any natural and legal persons, entities or bodies associated with them; certain individuals associated with the previous government of the former Republic of Yugoslavia and persons indicated by the International Criminal Tribunal for the former Yugoslavia;

persons and entities associated with Robert Taylor, former President of Liberia; individual members of the government of Zimbabwe and any natural and legal persons associated with them; and natural and legal persons, public bodies and entities of the previous government of Iraq. Furthermore, in accordance with EU regulations, financing of and financial assistance related to military activities in Somalia and Sudan are prohibited.

VIII. **Article IV Consultation:** Discussions for the 2004 Article IV consultation were held in Stockholm, May 10–19, 2004 and the staff report (IMF Country Report 04/244) was issued on August 9, 2004. The consultation was concluded by the Executive Board on August 4, 2004.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

## Statistical Issues

Sweden's economic statistics are satisfactory for surveillance purposes. Sweden subscribes to the Special Data Dissemination Standard. A data ROSC was published in September 2001 (Country Report No. 01/164), followed by un update in August 2002 (Country Report No. 02/162). The results are summarized in the accompanying TCIRS table."

## Sweden: Table of Common Indicators Required for Surveillance
As of June 15, 2005

| | Date of latest observation | Date received | Frequency of Data[6] | Frequency of Reporting[6] | Frequency of publication[6] | Memo Items: | |
|---|---|---|---|---|---|---|---|
| | | | | | | Data Quality – Methodological soundness[7] | Data Quality Accuracy and reliability[8] |
| Exchange Rates | 6/15/05 | 6/15/05 | D | D | D | | |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | 6/15/05 | 6/15/05 | W | W | W | | |
| Reserve/Base Money | 6/15/05 | 6/15//05 | W | W | W | LO, O, O, LO | O, O, O, NA |
| Broad Money | 4/30/05 | 4/30/05 | W | W | W | | |
| Central Bank Balance Sheet | 6/15/05 | 6/15/05 | W | W | W | | |
| Consolidated Balance Sheet of the Banking System | 4/30/05 | 4/30/05 | W | W | W | | |
| Interest Rates[2] | 6/15/05 | 6/15/05 | D | D | D | | |
| Consumer Price Index | May | 6/14/05 | M | M | M | O, O, O, O | O, O, O, NA |
| Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4] | 2004 | 4/14/05 | A | A | A | LNO, LO, O, O | O, O, O, NO |
| Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government | April | 6/9/05 | M | M | M | | |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | May | 6/8/05 | M | M | M | | |
| External Current Account Balance | Q1, 2005 | 5/27/05 | Q | Q | Q | O, O, O, O | O, O, O, LO |
| Exports and Imports of Goods and Services | Q1, 2005 | 5/27/05 | Q | Q | Q | O, O, O, O | O, O, O, O |
| GDP/GNP | Q1, 2005 | 6/10/05 | Q | Q | Q | O, O, O, O | O, O, O, LNO |
| Gross External Debt | Q1, 2005 | 5/27/05 | Q | Q | Q | | |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[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] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in September 2001, based on the findings of the mission that took place during May 2001for the dataset corresponding to the variable in each row, and on the update of the same ROSC published in August 2002. 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), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

**Statement by the IMF Staff Representative**
**September 7, 2005**

1. The following information on economic and financial developments, which has become available since the release of the staff report, does not change the thrust of the staff appraisal.

2. **Economic growth strengthened in the second quarter of 2005.** GDP growth recovered to a year-on-year rate of 2.2 percent while the provisional estimate for the first quarter was revised to 1.7 percent, up 0.3 percent. Growth was underpinned by the strength of household consumption and private investment. Indicators such as retail sales and consumer confidence suggest that consumer spending remained buoyant in July.

3. **The Riksbank, as expected, left the policy rate unchanged at 1.5 percent on August 23.** Inflation remained low with the 12-month rate at 0.3 percent in July, despite a faster rise in import prices, reflecting the rising price for oil.

4. **The authorities announced substantial new spending for job-creation in 2006–07.** The proposed spending of SEK 8 billion (around 0.3 percent of GDP) is focused particularly on reducing long-term unemployment. The government also announced its intention to implement in 2006 the last step of its 4-step plan to cut income taxes to offset an earlier rise in social security contributions. The authorities intend to initiate a comprehensive review of the tax system in 2006. The provisional budget estimates for July suggested that the central government surplus was larger than expected. The authorities' revised projections for 2005–08 suggest that the cost of sickness absence is likely to decline faster than expected earlier.

5. **The Krona appreciated** by about 5 percent against the U. S. dollar and over 1.5 percent against the euro since end-June. The stock market rose by 3 percent over the same period.

**Statement by David Farelius, Alternate Executive Director for Sweden**
**September 7, 2005**

1. First, my authorities convey their appreciation to staff for the constructive discussions in Stockholm last spring and for an accurate and useful report. The topics selected for analysis in the Selected Issues Paper are well motivated, and the discussion is interesting and relevant. The Government especially appreciates the analysis on the tax-benefit system and labor supply. My authorities share many of the views and conclusions expressed in the report. On some issues related to fiscal and structural policies, however, my authorities express divergent views.

2. The economic slowdown in the end of 2004 and in early 2005 was temporary and growth is now gradually improving. Private consumption and investment develop strongly. In the course of the fall, growth in local government consumption is expected to resume as well. Taken together, however, growth in 2005 is expected to be somewhat subdued, while growth in 2006 is forecasted to be higher. The labor market has developed weaker than expected. However, employment is expected to improve in 2006. Resource utilization in the economy is assessed not to change much between 2004 and 2005, but will improve substantially during 2006. Inflation pressures are currently low, inter alia, due to low unit labor costs, and consumer prices are not expected to increase rapidly in the coming years.

3. My authorities agree with staff that the fiscal and monetary policy frameworks have served Sweden well, and that it is important to preserve the credibility of this framework. A sound and stable macroeconomic framework is essential in order to promote high and sustainable economic growth and employment.

**Fiscal policy**

4. The central target of fiscal policy, adopted by the Government and the Parliament, is to maintain a surplus in general government net lending equivalent to 2 percent of GDP on average over the business cycle. The main aim is to strengthen the wealth position of the general government sector in order to prepare for the demographic changes over the next few decades. Simultaneously, the surplus target creates sufficient scope to avoid excessive deficits in a recession. Annual targets deviating from 2 percent of GDP could be set in cases of high - respectively low - resource utilization, or when a rapid movement back towards the overarching target would imply an inappropriate fiscal stance. The fiscal policy framework is further underpinned by the system of multi-annual nominal expenditure ceilings for the central government budget and a balanced budget rule for local governments.

5. The Government agrees with staff that the fiscal policy framework has worked well andhas been an important factor behind the remarkably good performance of the Swedish economy in recent years. The Government remains committed to the fiscal framework and the fiscal targets and is prepared to take additional measures in order to respect the expenditure ceilings.

6. Currently, the resource utilization in the Swedish economy is weak. In particular, unemployment is relatively high. Price and wage pressures are low, and current account surpluses show historically high levels. Against this background, the Government has announced that it intends to propose an expansive policy in the September Budget Bill this year to support both the supply and demand of labor. This will lead to a structural surplus less than 2 percent of GDP in 2006. The view of the Government is that this policy will prevent unemployment from staying at a permanently high level, thus weakening public finances in the longer term. It is also of interest to add that new statistical information shows a substantially stronger fiscal position in 2005 than in the Spring Fiscal Policy Bill 2005, and a position in 2006 in line with the Spring Bill even including the Government's fiscal policy proposal for the Budget Bill for 2006.

7. The Government appreciates the careful analyses of the Swedish fiscal framework and notes the proposals regarding possible measures to refine it. However, the Government rejects the proposal to introduce an independent body to assist in the implementation of the fiscal framework. Such a body is alien to Swedish traditions and there exist also difficulties in separating the task of allocation, distribution and stabilization in practical policy-making. These problems are more complex for fiscal policy than for monetary policy.

**Monetary Policy**

8. Monetary policy has since the previous consultation been conducted against the background of a low inflation rate in 2004 and in the beginning of 2005. Both domestic and international factors have contributed to the low inflation rate. The low domestic cost pressure has been the result of a strong growth rate in productivity and contained wage increases. Recurrent assessments that inflation one to two years ahead would be somewhat below the inflation target have warranted an expansionary monetary policy.

9. A slow growth rate in the first quarter of the year was considered as largely temporarily although the assessment for resource utilization during the forecast horizon was lowered. Inflation over the coming two years was expected to be below the 2 percent inflation target. Consequently the Riksbank lowered the repo rate in June from 2.0 to 1.5 percent.

10. Looking ahead, inflation is expected to increase gradually from the current low level and to reach the Riksbank's target of 2 percent a couple of years ahead. The inflation outlook indicates that raising the repo rate is not urgent. There is reason to also take into account the continued developments in household borrowing and the house prices and the consequences these may have for the future development of the economy. The future stance of monetary policy will as usual depend on new information received and the effects this has on the Riksbank's assessment.

11. The Riksbank agrees with the staff report that the krona is expected to appreciate, although the extent of the undervaluation is quite uncertain. The most recent inflation forecast was based on an assumption of an appreciation of some 3 percent during the coming

two years (based on the standard scenario that the repo rate is held constant during the forecast period).

12. In line with the findings in the Financial Stability Report published in June, the Riksbank agrees with the staff report that the systemic risks in the financial system appear remote. However, low interest rates and increasingly favorable borrowing terms have contributed to a continued rise in household debt. This could give rise to problems for individual households, and it could affect the future scope for private consumption.

**Structural policies**

13. The effectiveness of the welfare system is of great importance to economic growth. The Government is well aware of the importance of a well designed structure of the public sector and how responsibilities of the different levels of the sector is formed, a problem the staff report dwells on. The Government has given the Committee of Public Sector Responsibilities (Fi 2003:03) the task to analyze and assess whether the structure and division of assignments within central government and between central government, county councils and municipalities need to change, in order to better meet welfare challenges.

14. The Government agrees with the staff report that the challenges of globalization and ageing must be met by efforts to raise the labor supply. The Government emphasizes that the financing of the Swedish welfare state depends on a high level of employment and has initiated a broad overview of ways to improve labor supply. It is also noted that the staff report gives a balanced view of the effects on labor supply of different features of Sweden's benefit system. The generous provisions of child and elderly care have clearly contributed to raise participation rates, particularly for women. The Government has great confidence in the extensive use of active labor market programs (ALMPs). There is evidence showing that ALMPs contribute to keep individuals from long term unemployment and to maintain high labor force participation.

15. The Government shares staff's concerns about sick leave developments. However, several measures have been taken to curb the raising trend of the last years. This year the Government introduced further measures. The employer will be responsible for the first two weeks (instead of three) of sickness plus 15 percent of costs for the remaining sickness period or until the person is granted a more permanent benefit. This measure will improve incentives for employers to take action to prevent and deal with work-related sickness. Taken together, the implemented measures have given positive effects. Short-term sick leave has decreased substantially since 2003.

16. The Government agrees with the staff report on the need to strengthen the competition in some markets. In the housing market, the challenge is to find an approach that improves competition, but does not compromise the fundamental principles of the Swedish housing policy. The competition in retail trade, telecommunications and aviation has improved over the last few years. A new law has taken effect intended to increase transparency in all goods and services marketed to consumers. A Government investigation into issues related to the

improvement of the implementation of the competition policy will present its proposals in November 2005. The Government intends to further increase the monitoring of the implementation of the legislation.

INTERNATIONAL MONETARY FUND
*Public Information Notice*
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/124
FOR IMMEDIATE RELEASE
September 15, 2005

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

# IMF Executive Board Concludes 2005 Article IV Consultation with Sweden

On September 7, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sweden.[1]

**Background**

Growth in the Swedish economy continued to exceed that in the euro area in 2004. The acceleration in growth was driven by the global recovery and supported by a stimulative monetary stance. Export growth was led by a strong recovery in the telecommunications and automobile sectors, and, combined with rising capacity utilization and record low interest rates, helped sustain a revival of business investment after a three-year slump.

Despite the strong cyclical upturn, employment continued to decline and unemployment rose further. Apart from the usual lags in a cyclical upswing, the subdued labor market reflected the interplay of several factors. Hours worked rose as the very high level of sickness absence observed in recent years began to decline. The momentum of productivity gains was maintained as restructuring continued apace in the business sector. High tax wedges and a relatively compressed wage structure continued to weigh on the labor market.

[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.

Strong productivity growth and the subdued labor market kept inflation below target, creating the room for monetary easing in early 2004. Wage moderation, combined with continued strong productivity gains, reduced unit labor costs, keeping underlying inflation pressures in check. Headline inflation was also kept low by declining non-energy import prices and, more recently, falling food prices, reflecting intensified foreign competition in the retail trade sector.

The strong competitive position of the Swedish economy is reflected in continued large current account surpluses. Despite some recent depreciation in early 2005, the krona remained broadly stable in nominal as well as real effective terms over the year to May 2005. The stock market continued its steady recovery on the back of strong corporate earnings. Long-term interest rates declined, with the yield on 10-year government bonds falling below that on corresponding German bonds in recent months compared with a premium of 50 basis points at the beginning of 2004.

The fiscal outturn for 2004 was significantly better than expected, but the budget for 2005 foresees a sharp fall in the general government structural surplus. Cuts in income and wealth taxes are only partially offset by expenditure restraint as additional resources are devoted to labor market programs and employment subsidy schemes. Prospects of achieving the 2-percent structural surplus target for the general government have receded beyond the medium-term policy horizon. Margins under the expenditure ceilings for the central government are too narrow to provide leeway in the event of unexpected shocks and reliance on tax expenditures for compliance with the ceilings has increased.

The Riksbank’s decision to cut the policy rate by 50 basis points in June 2005 reflected a significant worsening of the outlook for growth in 2005.The weaker than expected outturn for the first quarter and the consequent downward revision to the inflation forecast weighed heavily in the Riksbank’s assessment. While a cut was widely expected, its magnitude took the market by surprise.

The outlook for growth and inflation in 2005–06 remains generally favorable, although the risks are tilted to the downside. The staff sees the weakening of growth as temporary and forecasts growth to be sustained at 2 ½ percent. The macroeconomic policy stance in both years is set to be strongly stimulative. Household consumption is expected to gather speed on the back of tax cuts, continued low inflation, and rising confidence, while business investment is set to pick up strongly reflecting emerging capacity constraints, continuing low interest rates, and favorable profit opportunities. Several indicators point to an imminent recovery of the labor market, which so far has been elusive. The weakness of growth in the first quarter of 2005 indicated by preliminary national account estimates is primarily due to temporary factors. With the output gap continuing to narrow and productivity growth decelerating, CPI inflation is projected to rise gradually, but is still expected to remain close to 2 percent, despite the rise in oil prices.

Downside risks to the growth outlook have increased, primarily from external sources: lower growth in the euro area than currently projected, a further depreciation of the U.S. dollar, and persistent high oil prices. The adverse impact of the failure of euro area growth to pick up as expected is likely to be cushioned to some extent by the recent diversification of Swedish exports towards emerging markets in Europe, Asia and the Middle East. The most prominent domestic risk is a further delay in the expected recovery of the labor market.

**Executive Board Assessment**

Executive Directors commended Sweden's remarkable economic performance in recent years, underpinned by large productivity gains, persistently low inflation, and a comfortable external position. Directors noted that much of this performance can be traced to a stable policy regime of fiscal discipline and credible inflation targeting. They encouraged the authorities to build on their successes and pursue their structural reform agenda with renewed vigor in order to address the challenge of population aging and fully realize the benefits of global integration.

Directors considered that prospects for growth remain favorable in 2005-06, with macroeconomic policies fully supportive of demand. They noted, however, that a less favorable external environment, including persistently high oil prices, and a possible delay in the expected recovery of the labor market, pose risks to the prospects for growth. Some Directors also pointed to the risk of a slowdown in household consumption.

With inflation projected to be below target over the next two years, Directors viewed the Riksbank's decision to cut the policy rate by 50 basis points as appropriate. However, with the outlook for growth appearing to turn more favorable than perceived at the time of the decision, interest rates may need to be raised at some point to safeguard the inflation target. Directors welcomed the Riksbank's recent initiatives to refine its communication strategy.

Directors commended the authorities' continued strong political commitment to sound public finances and their strong record in this respect. Nevertheless, the substantial fiscal stimulus planned for this year and next, in spite of the favorable economic outlook, was seen by many Directors as indicating a gradual shift away from the spirit of the fiscal framework. In particular, they pointed to the postponement of the goal of achieving the 2-percent surplus target beyond the medium-term policy horizon and the narrowing of the contingency margins under the expenditure ceilings for the central government. Directors recognized that these strains are not likely to be costly in the short run, and were reassured by the authorities' continued commitment to the fiscal framework. Nevertheless, straining the fiscal framework in relatively favorable economic circumstances could reduce the room for fiscal maneuver in the event of a downturn, and could be costly later when fiscal pressures from population aging intensify.

Against this background, Directors considered various possible improvements to help preserve the credibility of the fiscal framework. Most Directors supported the view that clarifying the criteria for assessing compliance with the surplus target—by specifying the interpretation of "over the cycle"—would improve fiscal transparency and accountability, and avoid entrenching a procyclical bias to fiscal policy. To enhance the discipline imposed by the ceilings on central government expenditures, Directors suggested establishing a formal link between the surplus target and the expenditure ceilings. Directors also recommended reevaluating the existing framework for intergovernmental fiscal relations, with a view to enhancing the incentives for fiscal discipline and efficiency for local authorities. Some Directors saw merit in setting up an independent body to assist in the implementation of the fiscal framework, in order to enhance transparency and strengthen enforcement. Many other Directors, however, saw no need for creating such a body, given the authorities' strong commitment to sound public finances and the evidence of already considerable independent fiscal comment and debate.

Directors underscored that further reforms of the tax-benefit system should remain a priority in order to alleviate the disincentive effects on labor supply and employment creation, and achieve the authorities' ambitious labor market and social policy objectives. While Sweden's generous child and elderly care system is exemplary, especially as it encourages high female labor participation, Directors highlighted several other elements of the tax-benefit system that discourage work effort. In particular, they stressed the importance of lowering the tax burden at the lower end of the wage distribution, and of further steps to reduce sickness and disability absences, especially among younger workers. Directors also recommended some streamlining of the benefit system and tightening of its administration to foster work effort and to help ensure the viability of the extensive social insurance system in the face of increasing globalization. Some Directors suggested that active labor market programs be scaled down, given their limited effectiveness.

Directors encouraged the authorities to accelerate the pace of other structural reforms to enable Sweden to address long-term demographic challenges from a position of economic strength and reap the full benefits of enhanced global integration. They welcomed the progress in recent years, but pointed to the need to further raise competition in important sectors, including construction, pharmaceuticals, and retail trade. The authorities were also encouraged to consider steps to deregulate the housing market, and to open up the provision of services by local governments to greater competition.

Directors viewed Sweden's financial sector as sound, underpinned by the recent sizeable improvement in bank profitability and corporate financial positions. While systemic risks in the financial sector appear remote, Directors nevertheless supported the view that risks associated with the high level of household borrowing and the rise in property values call for continued close monitoring.

Directors praised Sweden's continued commitment to a liberal international trading system and its high level of official development assistance.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with Sweden may be made available at a later stage if the authorities consent.

Sweden: Selected Economic Indicators

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 1/ | 2006 1/ |
|---|---|---|---|---|---|---|---|
| Real Economy (in percent change) | | | | | | | |
| Real GDP | 4.3 | 1.0 | 2.0 | 1.5 | 3.6 | 2.6 | 2.8 |
| Domestic Demand | 3.9 | -0.2 | 0.7 | 1.1 | 1.4 | 2.8 | 2.3 |
| CPI Inflation | 0.9 | 2.4 | 2.2 | 1.9 | 0.4 | 0.3 | 1.2 |
| Open Unemployment Rate (in percent) | 4.7 | 4.0 | 4.0 | 4.9 | 5.5 | 5.2 | 4.9 |
| Participation in labor market programs (in percent) | 2.6 | 2.5 | 2.6 | 2.1 | 2.4 | 2.7 | 2.7 |
| Gross national saving (percent of GDP) | 22.6 | 22.1 | 21.9 | 23.8 | 24.4 | 24.2 | 23.8 |
| Gross domestic investment (percent of GDP) | 18.5 | 17.7 | 16.7 | 16.2 | 16.1 | 16.8 | 16.8 |
| Public finance (in percent of GDP) | | | | | | | |
| General government balance | 5.0 | 2.6 | -0.5 | -0.1 | 1.1 | 0.7 | 0.6 |
| Structural balance 2/ | 3.9 | 2.9 | 0.2 | 0.8 | 1.8 | 0.9 | 0.7 |
| General government debt | 52.8 | 54.3 | 52.4 | 52.0 | 51.2 | 49.9 | 48.6 |
| Money and credit (12-month, percent change) | | | | | | | |
| M0 | 2.0 | 8.8 | -0.9 | 2.7 | -0.2 | ... | ... |
| M3 | 2.8 | 6.7 | 4.5 | 3.1 | 4.6 | ... | ... |
| Credit to non-bank public | 9.1 | 8.8 | 4.2 | 2.7 | 7.3 | ... | ... |
| Interest rates (year average) | | | | | | | |
| Three-month treasury bill rate | 3.6 | 3.7 | 3.6 | 2.6 | 2.0 | ... | ... |
| Ten-year government bond yield | 5.6 | 5.2 | 4.6 | 4.7 | 3.8 | ... | ... |
| Balance of payments (in percent of GDP) | | | | | | | |
| Trade balance | 5.7 | 6.2 | 6.7 | 7.1 | 8.6 | 8.3 | 8.8 |
| Current account | 4.1 | 4.4 | 5.1 | 7.6 | 8.2 | 7.3 | 7.0 |
| International reserves (in billions of US dollars) | 16.3 | 14.8 | 19.1 | 22.4 | 24.8 | ... | ... |
| Reserve cover (months of imports of goods and services) | 2.0 | 2.1 | 2.5 | 2.4 | 2.3 | ... | ... |
| Exchange Rate (period average, unless otherwise stated) | | | | | | | |
| Exchange rate regime | | | Floating exchange rate | | | | |
| Skr per U.S. dollar (May 31, 2005) | | | 7.4291 | | | | |
| Nominal effective rate (2000=100) | 100.0 | 91.7 | 93.4 | 98.2 | 99.7 | ... | ... |
| Real effective rate (2000=100) 3/ | 100.0 | 92.4 | 92.0 | 94.9 | 96.8 | ... | ... |

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

1/ Staff projections.

2/ In percent of potential GDP, also adjusted for one-off effects.

3/ Based on relative normalized unit labor cost in manufacturing.