July 2003
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Sweden: 2003 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 2003 Article IV consultation with Sweden, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 15, 2003,** 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 26, 2003.** 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 **July 25, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 25, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Sweden.

The document(s) listed below have 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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SWEDEN

Staff Report for the 2003 Article IV Consultation

Prepared by Staff Representatives for the 2003 Consultation with Sweden

Approved by Ajai Chopra and Martin Fetherston

June 26, 2003

- A staff team comprising Messrs. Thakur (Head), Bonato, Ms. Cerra (all EU1), and Mr. Annett (FAD) visited Stockholm during May 6–15, 2003. The mission met Riksbank Governor Mr. Heikensten, Minister for International Economic Affairs and Financial Markets Mr. Lund, State Secretary of the Ministry of Finance Mr. Henriksson, other senior officials, as well as representatives of the Confederation of Trade Unions, the Confederation of Swedish Enterprises, the private financial sector and the academic community. Mr. Farelius, Advisor, Nordic-Baltic Executive Director's Office, 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 to a four-year term. A referendum on Sweden's entry into the European Monetary Union is scheduled for September 14. Public opinion remains sharply divided, with recent polls giving a significant edge to opponents of entry.

- 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).

- In concluding the last Article IV Consultation Executive Directors considered the fiscal target of a general government surplus of 2 percent of GDP over the cycle as appropriate and called for strengthened efforts to rein in public spending in order to achieve a durable reduction in the tax burden. Directors also saw the necessity of a renewed momentum for structural reforms, particularly in labor, product and rental housing markets, so as to strengthen the supply side of the economy.

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Sweden—Executive Summary: Staff Report for the 2003 Article IV Consultation

Background and Outlook: Economic growth, supported by a sizeable fiscal stimulus, recovered in 2002 but is projected to slow again in 2003, reflecting mainly weaker external demand. While rising energy prices pushed up headline inflation temporarily, **underlying inflation pressures are declining,** given unutilized resources, moderate wage settlements, strong productivity gains, and an appreciating exchange rate. The Riksbank has cut interest rates four times since November 2002, responding quickly to signs of economic weakness. **The fiscal position, although sound, has weakened markedly**, with structural surplus of the general government declining sharply from over 4 percent of GDP in 2000 to about ¾ percent of GDP in 2002, partly due to discretionary spending increases. Ahead of a referendum on entry into the European Monetary Union scheduled for September 14, public opinion remains sharply divided.

Policy discussions centered on the following key issues:

- The implications of the slowdown in economic growth for the macroeconomic policy stance;
- The reasons behind the **erosion of the recent strength of the public finances** and the risks to the framework of fiscal rules;
- The necessity of addressing the emerging tensions between the rising demand for public services and generous welfare provisions through a bolder approach to **streamlining the social insurance regime**;
- The consequences of **a possible euro entry** for competitiveness, stabilization policy and the framework of fiscal rules;
- Reinvigorating the **structural policy agenda**, particularly in the areas of tax, product, and labor market reform.

Authorities and staff agreed that:

- With underlying inflation expected to fall below the 2 percent target in 2004, room for further monetary easing was emerging.
- The fiscal position had weakened due to mounting pressures on local government expenditure and the social insurance system. While showing signs of strain, the fiscal framework was fundamentally sound. It was important to maintain a strong commitment to it, with particular attention on preserving the credibility of the expenditure ceilings.
- In the event of a decision to join EMU, Sweden's sound macroeconomic fundamentals position it well for a smooth transition.
- Despite some deterioration in bank profitability due to increased loan losses, the financial system remained sound and stable.
- There was an urgent need to contain the erosion of labor supply due to absenteeism, and to continue strengthening competition.

The staff recommended that:

- The recent ratcheting up of public spending should be reversed to create room for reducing the high tax burden. A reform of the local government financing arrangements would strengthen the fiscal framework. The design of the expenditure ceilings within the fiscal framework could be improved.
- A new impetus to reforms aimed at streamlining the welfare system, reducing disincentives to labor supply, and strengthening competition was needed. These reforms would help raise potential growth and ease emerging tensions in the public finances.

Main Websites for Swedish Data

Data in this Staff Report reflects information received by June 12, 2003. 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.se/

Ministry of Finance...http://www.finans.regeringen.se/

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

Additional information and documentation on Swedish economic statistics can be found at the Fund's SDDS website................................ http://dsbb.imf.org/country/swecats.htm
and at
Statistics Sweden's Economic Data Portal: http://www.scb.se/ekonomi/ekonomieng.asp#area

I. Economic Background

1. **Supported by a sizeable fiscal stimulus, the Swedish economy recovered from the 2001 slowdown, substantially outperforming the euro area in 2002 (Figure 1).** Despite the continued weakness in the telecom sector[1] and depressed business investment on account of persisting excess capacity, household consumption strengthened as tax cuts and government transfers boosted disposable income. After a strong first half, external demand weakened rapidly in the second half of the year with the worsening global outlook and GDP growth slowed sharply. Although economic activity picked up in early 2003, driven by net exports, industrial production and manufacturing orders remained weak and consumer confidence depressed.

Sweden: GDP by Expenditure Category, 2000-2004

(percentage changes)

	2000	2001	2002	2003 proj.	2004 proj.
Real GDP	4.4	1.1	1.9	1.3	2.4
Domestic demand	3.8	0.1	0.7	1.3	2.2
Consumption	2.9	0.4	1.6	1.5	1.9
Private	5.0	0.2	1.3	1.7	2.4
Government	-1.1	0.9	2.1	1.0	1.0
Gross fixed capital formation	6.6	0.8	-2.5	0.4	3.5
Exports	11.3	-0.8	0.4	2.2	3.7
Imports	11.5	-3.5	-2.7	2.4	3.7

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

1/ Includes statistical discrepancy.

2. **Persistent weakness in the labor market restrained wage increases while their impact on costs was offset by strong productivity gains.**[2] With the manufacturing sector continuing to shed labor, employment stagnated despite increased demand from the construction and the public sectors, and the rate of unemployment remained virtually unchanged in 2002 (Figures 2 and 3). However, rising sickness absenteeism, and a cyclical contraction of overtime led to a fall in the number of hours worked, while indicators of vacancies declined. Nominal wages rose somewhat less rapidly than a year earlier. Wage pressures in the local government sector continued to be strong, as evidenced by a protracted nationwide strike by the municipal service workers in April-May 2003.

Sweden: Labor Market Indicators, 2001-04

(Annual change in percent)

	2001	2002	2003	2004
Nominal wage	4.3	4.0	4.0	4.0
Labor productivity	0.4	4.1	2.0	2.7
Unit labor costs	4.7	0.0	2.0	1.4
Employment	1.9	0.1	-0.5	0.5
Hours worked	0.5	-1.2	-0.6	0.6
Open umployment rate 1/	4.0	4.0	4.5	4.2
Total unemployment rate 1/ 2/	6.5	6.6	7.0	6.6

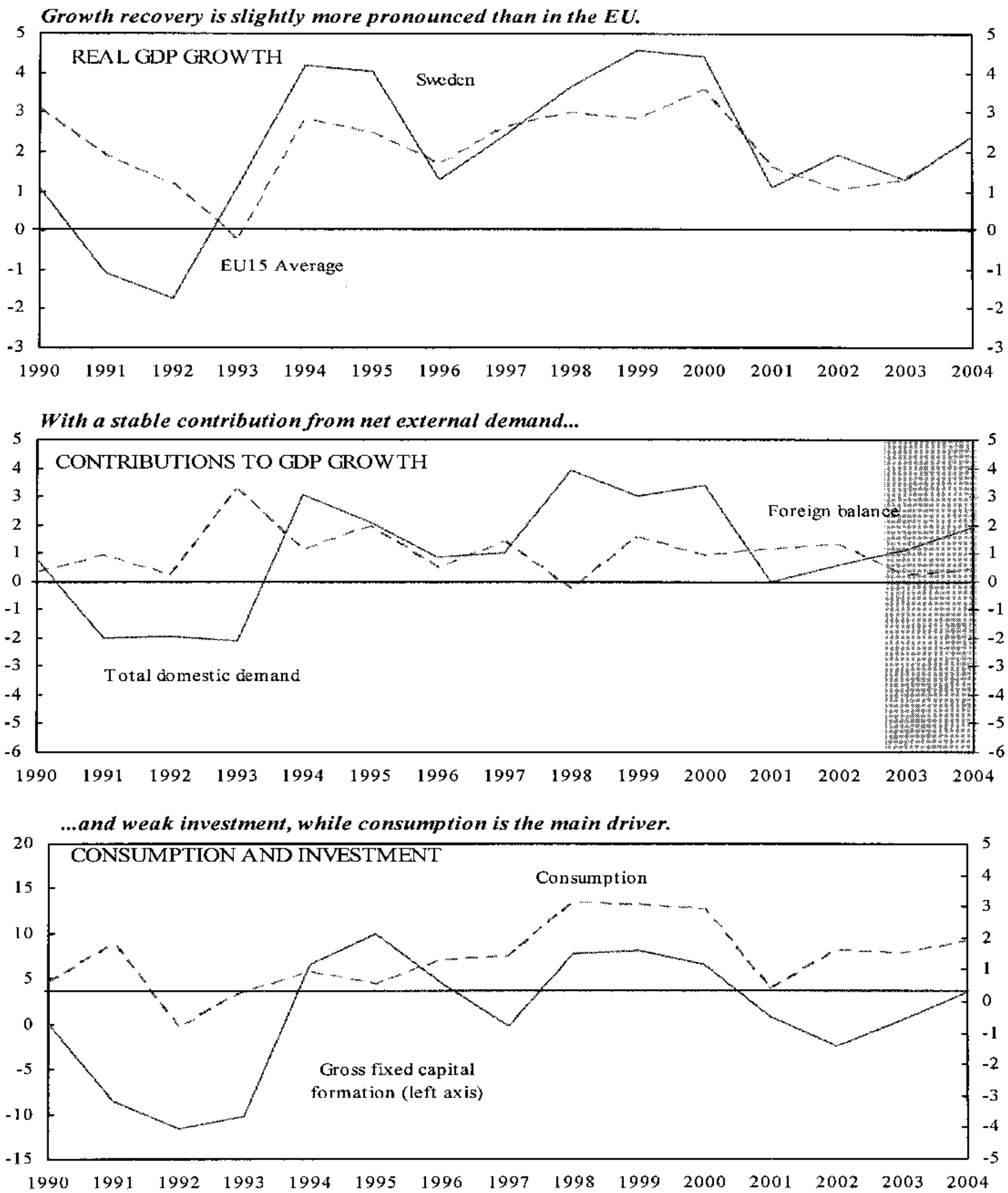
1/ In percent of labor force.

2/ Including participants in labor market programs.

[1] Ericsson, the world's largest producer of mobile telecom infrastructure and the largest Swedish exporter—accounting for 9 percent of total exports in 2002, down from 20 percent in 2000—continues to go through a painful restructuring, resulting in a halving of its workforce. The market price of its shares—which are held widely by Swedish households—has fallen by around 90 percent since 2000 and the company has yet to return to profitability.

[2] Recent revisions to the national accounts suggest that labor productivity growth in the period 1994–2001 was on average 3 percent, 0.6 percent higher than previously estimated.

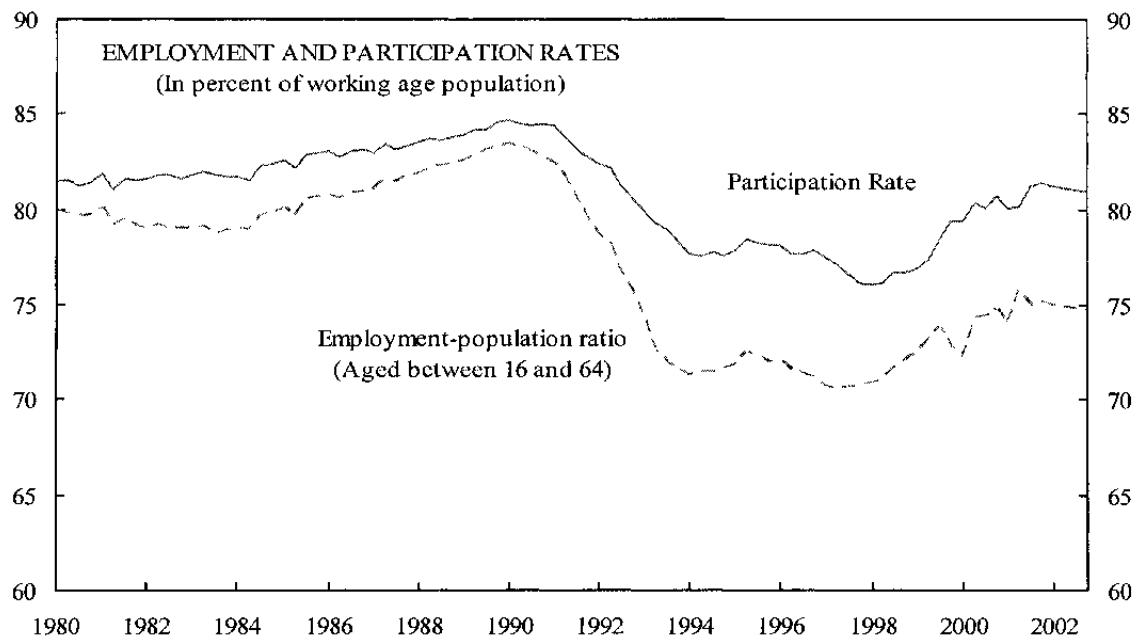
Figure 1. Sweden: Output Developments and Prospects
(Annual percentage change)



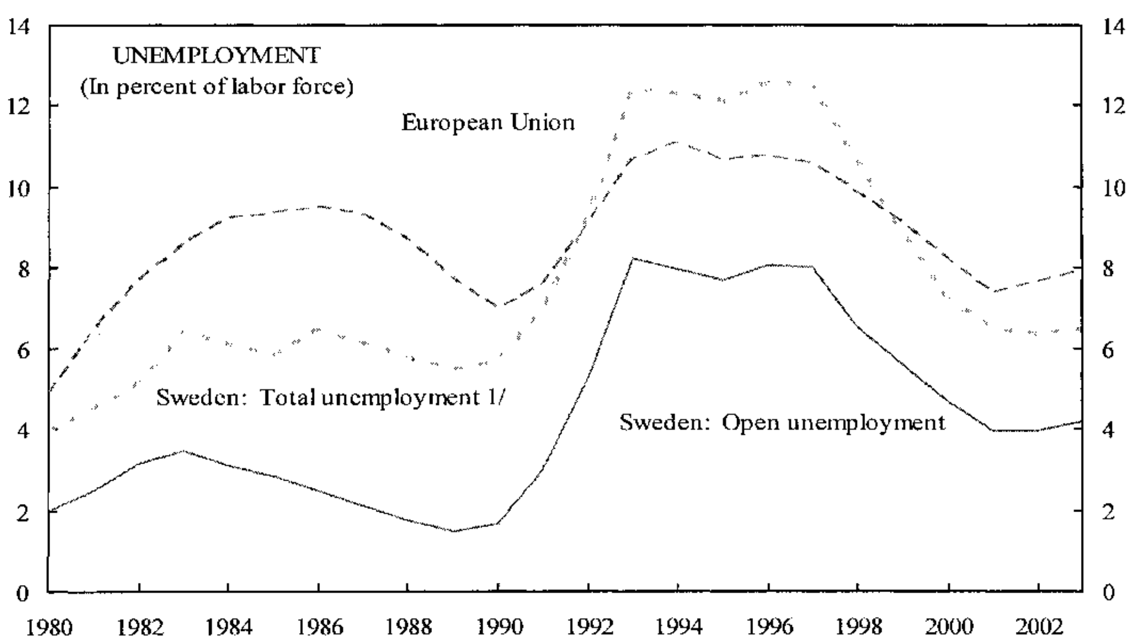
Sources: Statistics Sweden; and staff projections.

Figure 2. Sweden: Labor Market Developments

Participation declined slightly...



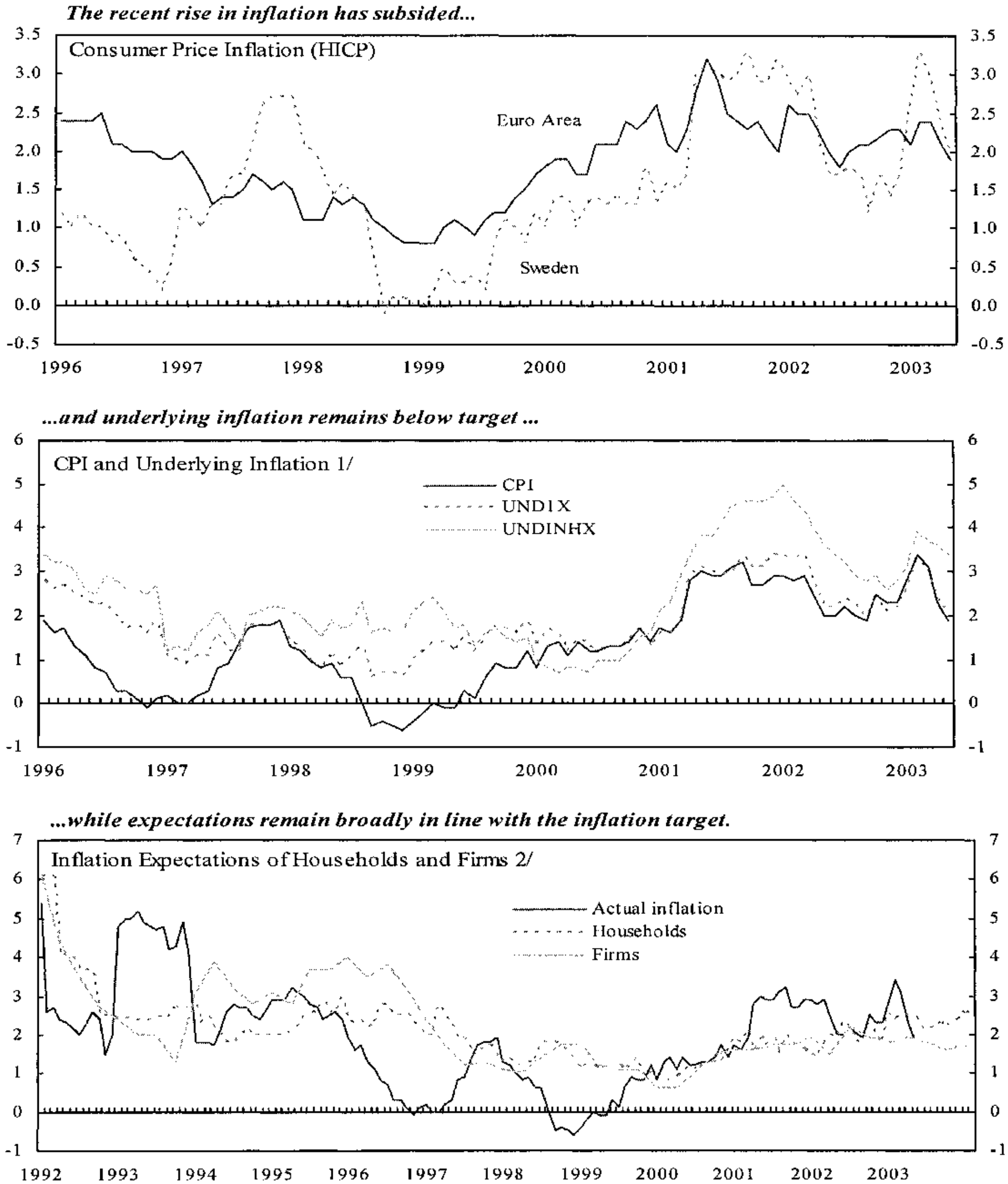
...while unemployment is stable.



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).

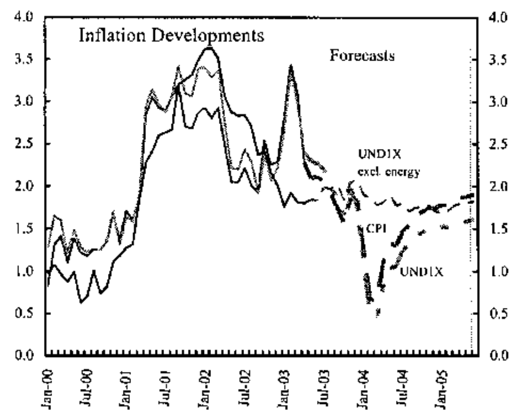
Figure 3. Sweden: Inflation Developments
(Percent change from a year ago)



Source: Statistics Sweden; and Riksbank
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.

3. **Inflation, after a temporary rise in early 2003 driven by energy prices, has receded below the 2 percent target.** With high demand—reflecting the unusually cold winter—and exceptionally low reservoir levels in Nordic hydroelectric power plants pushing up energy prices, headline inflation reached 3.4 percent in February 2003, before falling back to 1.9 percent in May as energy prices began to decline.[3] Underlying inflation excluding energy prices remained well under 2 percent. Inflation expectations, despite edging up slightly following the recent spike in headline inflation, remain around the 2 percent target. Equity prices have fallen substantially in the last two years, while property prices have started weakening after a steady rise since 1997 (Figure 5).

4. **Despite the appreciating krona, competitiveness remained strong and large current account surpluses persisted.** The krona appreciated by more than 5 percent in effective terms in 2002, gradually reversing some of the sharp decline of the previous two years (Figure 4). Helped by improved relative growth prospects, rising interest rate differentials (Figure 5), and a slowdown in portfolio outflows, the krona appreciated vis à vis the euro in the first part of 2002 and remained stable thereafter, while appreciation vis à vis the U.S. dollar continued well into this year. The unit labor cost-based real exchange rate appreciated almost 6½ percent in 2002. However, the current account surplus rose further to 4.2 percent of GDP as the lagged effects of the 2001–02 depreciation boosted exports—mainly in the first part of the year—and imports fell. As the portfolio reallocation following the crisis of the technology sector is likely coming to an end, the slowdown in outflows is expected to continue, giving additional support to the currency. Markets expect the krona to appreciate by another 5 percent vis à vis the euro in 2003.



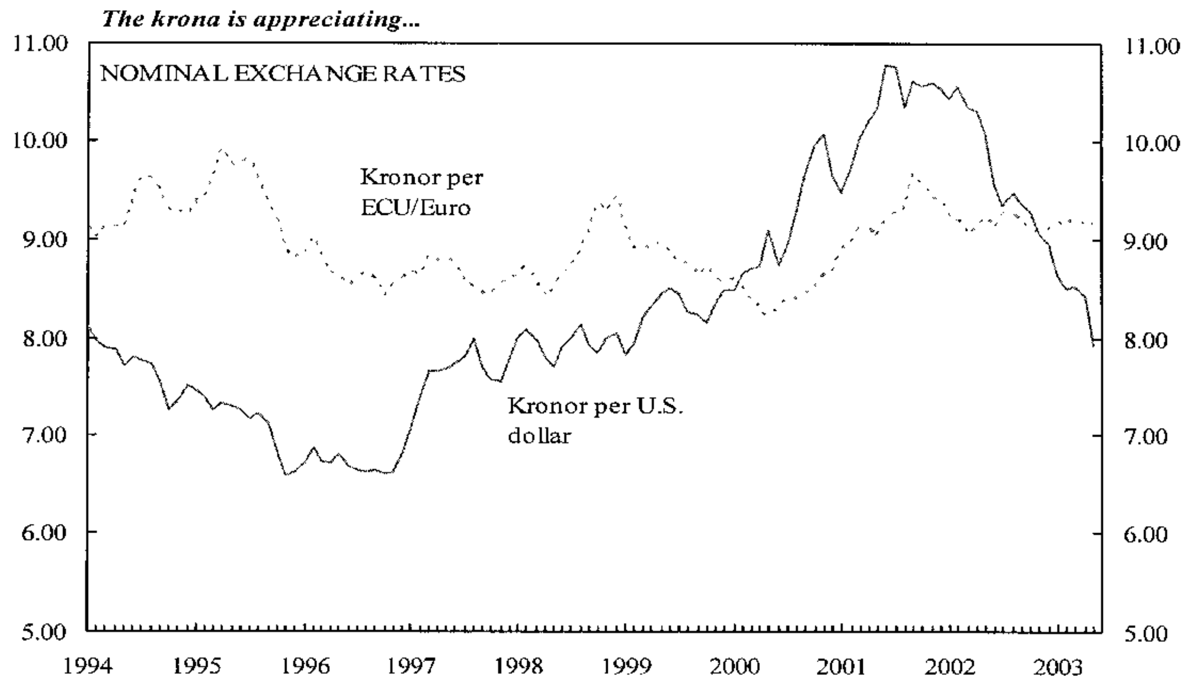
Source: Riksbank, Inflation Report 2003:2

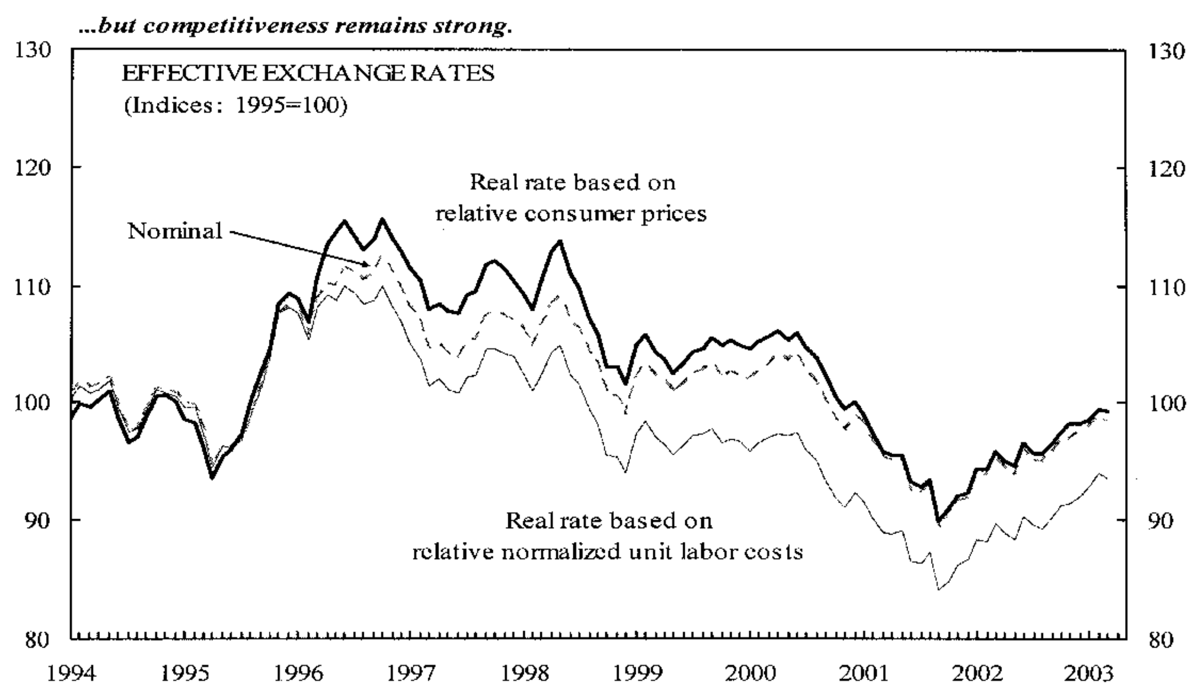
II. The Policy Setting and The Short-Term Outlook

5. **Monetary policy has been implemented proactively, consistent with the Riksbank's credible inflation targeting framework.** After tightening in the first part of 2002, monetary policy eased on signs of weakness in the economy and heightened risks to

[3] The UND1X index, a measure of underlying inflation that excludes mortgage interest costs and the direct effects of changes in indirect taxes and subsidies, exhibited a similar pattern. This index, as well as the one excluding energy prices, has been used by the Riksbank to guide monetary policy decisions.

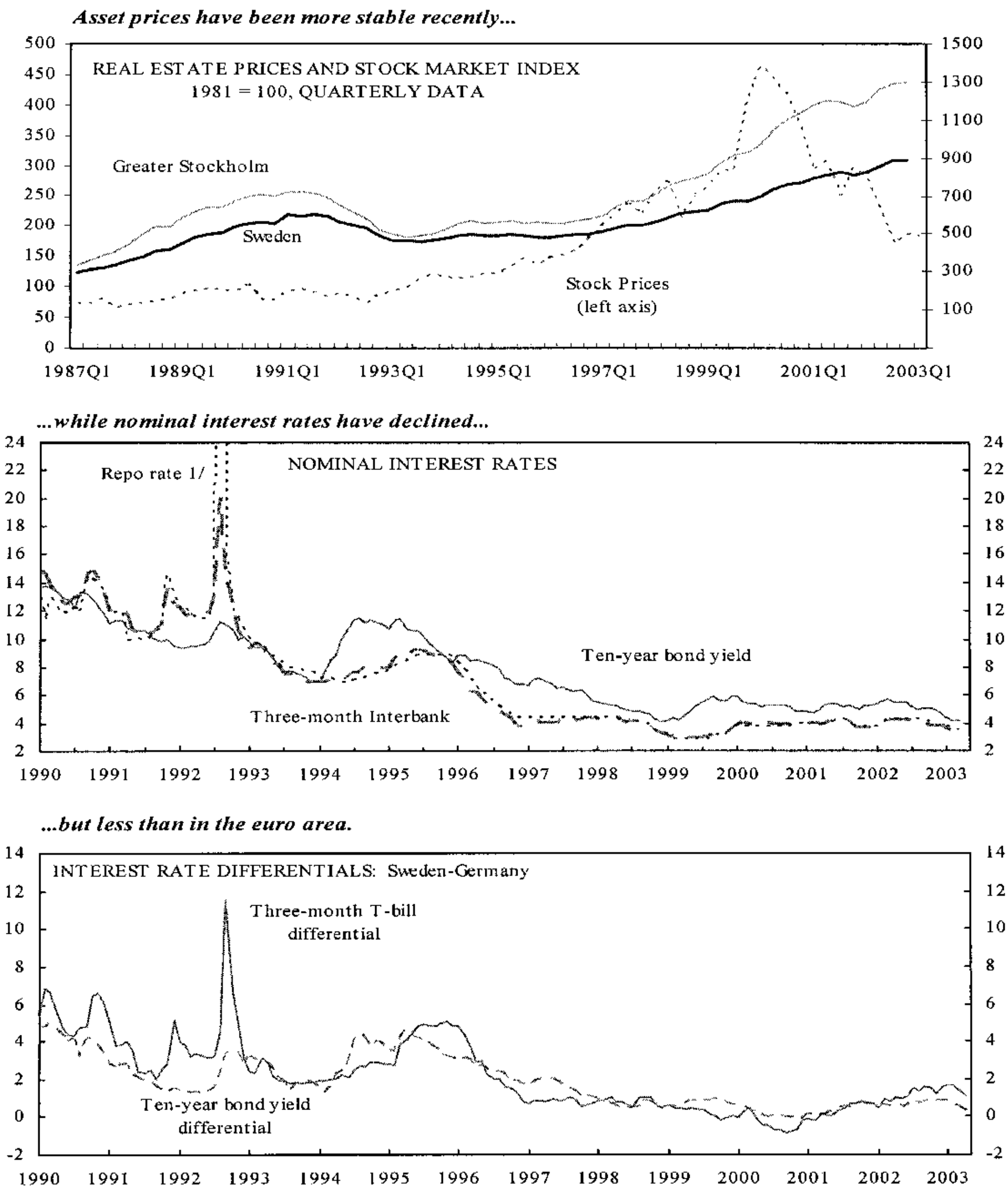
Figure 4. Sweden: Exchange Rate Developments





Source: IMF, International Financial Statistics

Figure 5. Sweden: Asset Price and Interest Rate Developments



Sources: Statistics Sweden; Riksbank; IMF, International Financial Statistics, and INS.
1/ Repo rate was 63 percent in September 1992.

the global outlook. With accelerating inflation in 2001 and early 2002, the Riksbank raised interest rates by 50 basis points in March-April. However, disappointing growth prospects in the euro area and increasing geopolitical uncertainties led to a reassessment of the outlook for inflation. Judging the spike in inflation fueled by energy prices as temporary, the Riksbank reversed course toward year-end, restoring the policy rate to its level of early 2002. With the rapidly worsening external outlook, these cuts were followed by a 25 basis point reduction in March 2003, and a further easing of 50 basis points in early June to a level of 3 percent. (See below).

6. **The exceptional strength of the public finances—especially in a comparative EU context—has begun to erode, primarily due to a rising trend of discretionary spending (Figure 6).** The overall surplus this year is expected to be 3 percentage points of GDP lower than in 2000, half of which is due to expenditure increases. Mainly reflecting the discretionary loosening, the structural balance is projected to be 2¾ percentage points of GDP weaker over this same period. A marked decline in the revenue ratio—due partly to the first three stages of the phased income tax reduction that the Fund supported—masks an upward trend in local taxation. Local government consumption rose by more than 1½ percent of GDP over three years.[4] This accounted for most of the ratcheting up of expenditure (Figure 7), as increases in both sickness related transfers and investment (0.6 percent of GDP each) are largely offset by the decline in interest payments.

Sweden: General Government Financial Accounts, 2000-03

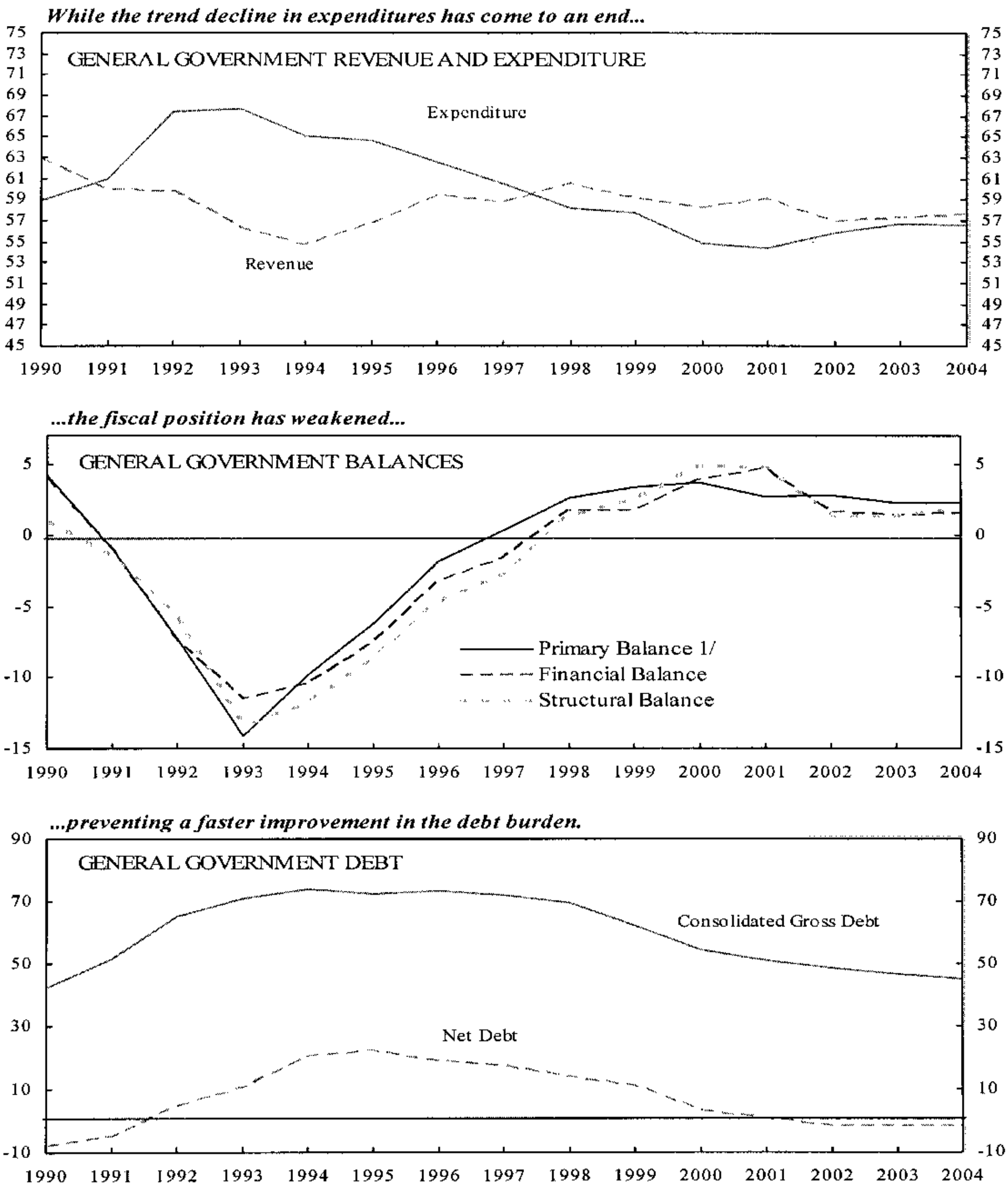
	2000	2001	2002	2003
	(in percent of GDP)			
Revenue	58.2	59.0	56.8	56.8
Taxes and charges	51.8	53.5	51.3	51.2
o/w local government	15.4	15.9	16.4	17.0
Other	6.4	5.5	5.5	5.6
Expenditure	54.8	54.4	55.8	56.4
Transfers	21.3	21.2	21.4	22.2
o/w illness related	4.0	4.3	4.5	4.6
Consumption	26.8	27.2	28.0	28.2
o/w local government	18.7	19.3	20.0	20.3
Capital	2.6	2.8	3.1	3.1
Interest payments	4.0	3.2	3.2	2.8
Overall balance	3.4	4.6	1.1	0.4
Cyclical adjustment	-0.3	0.4	0.5	1.0
Timing of tax receipts	1.5	-2.1	-0.8	0.1
Temporary effects	-0.5	0.0	0.0	0.0
Structural balance	4.1	2.8	0.8	1.4
Memo item:				
Output gap	0.4	-0.5	-0.7	-1.4

Source: Ministry of Finance

7. **Fiscal policy remains anchored to the medium-term framework, centered on the target of a surplus of 2 percent of GDP over the cycle.** The fiscal policy stance in 2003 is expected to be moderately contractionary. The structural surplus is projected to rise to almost 1½ percent of GDP, despite further discretionary spending increases of ½ percent of GDP, reflecting increases in net capital income and local government taxes—the latter rising by

[4] From 2003 onwards, both revenue and expenditure as a share of GDP rise by around ½ percentage points, as the tax allowance for pensioners is replaced by a tax guaranteed pension. Any comparison with past years needs to take this into account.

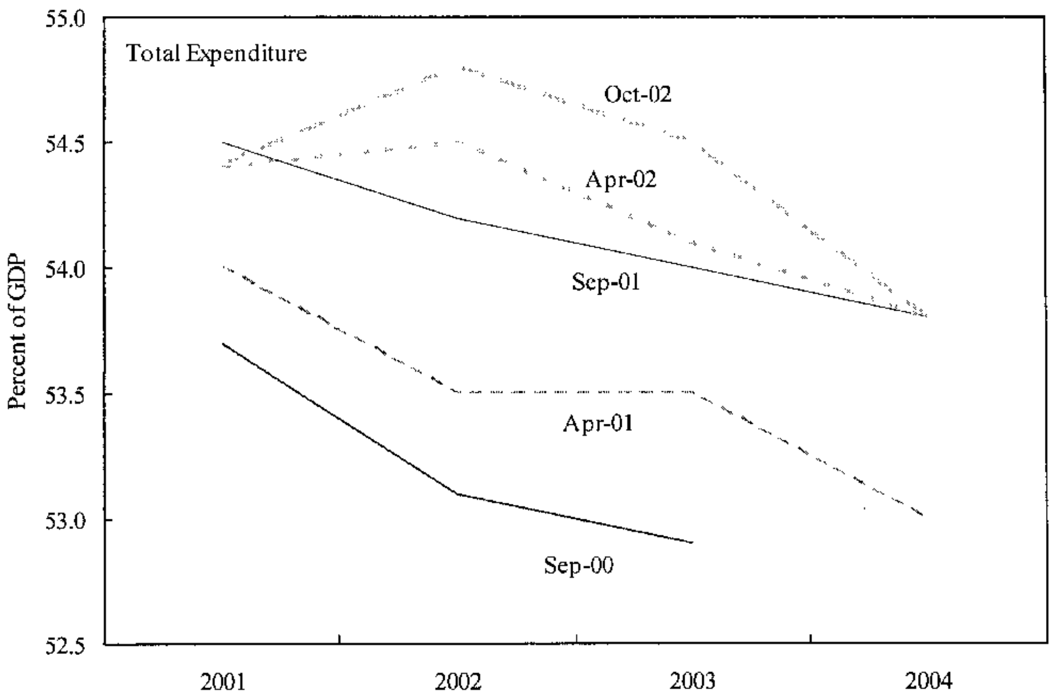
Figure 6. Sweden: Fiscal Developments and Prospects
(In percent of GDP)



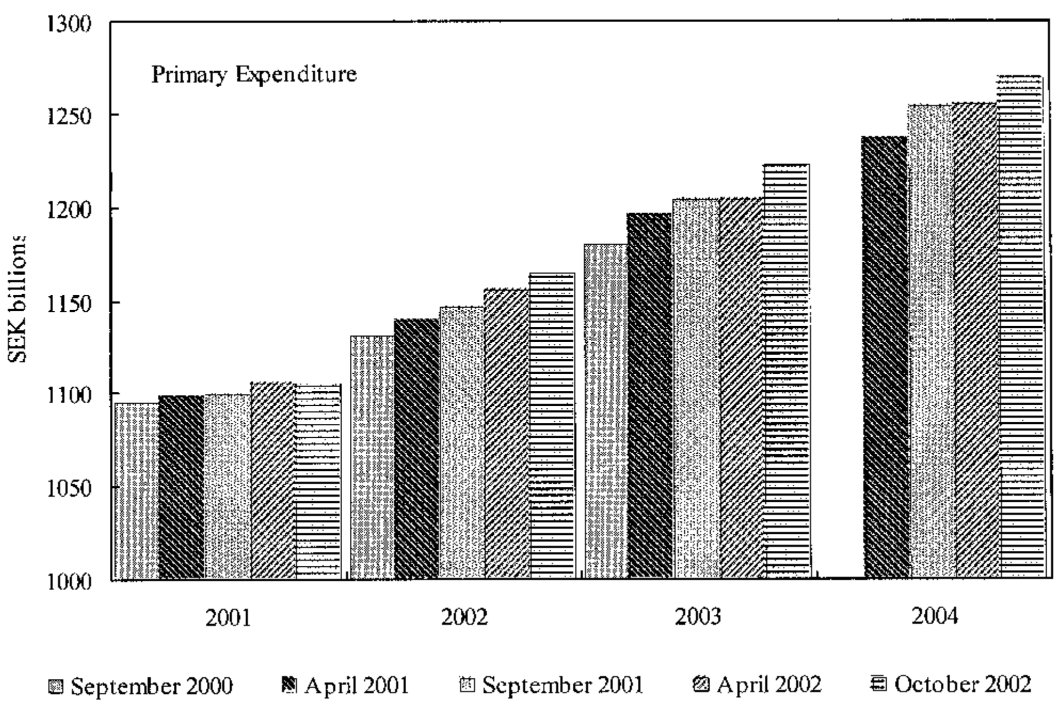
Sources: Statistics Sweden and Ministry of Finance.
1/ Excluding interest expenditure and income.

Figure 7. Sweden: Expenditure Forecasts, 2001-2004

In each successive budget bill, the expenditure ratio path has ratcheted up higher.



The increased path is due to consistent upward revisions to planned nominal primary expenditure.



Source: Budget Bill: Swedish Economy, various issues almost ½ percent of GDP. Faced with budgetary pressures, the authorities have postponed the fourth and final phase of the income tax reduction. In line with the fiscal rule specifying a 2 percent surplus over the cycle, the structural surplus is now projected to return to this level by 2005 as the output gap narrows, and the public debt-to-GDP ratio is projected to continue declining.

8. **On the backdrop of fragile prospects for a robust global recovery, Sweden faces subdued economic growth and rising unemployment in the near term.** The external sector is expected to contribute little, if anything, to growth in 2003 as weak external demand holds back exports, and imports recover from recent unusually depressed levels. Public consumption is projected to slow sharply after the high growth of last year, and an upturn in business investment will be hampered by the continued weakness of the telecom sector. With high house prices and low interest burden providing ample support to household financial positions despite losses in stock market wealth, and the sharp rise in household saving rate over the past two years, private consumption is likely to hold up well, barring any unexpected shocks to confidence. All in all, economic growth is likely to remain significantly below potential, with continued unutilized resources. The risks to the outlook are mainly on the downside, stemming primarily from a weaker-than-expected global recovery. Inflation is expected to remain well below target over the next year as energy prices return to normal levels and wage demands in the autumn bargaining round remain moderate.

III. The Policy Discussions

9. **The authorities' strategy in recent years has focused on consolidating their strong macroeconomic policy framework and preserving Sweden's generous welfare state.** The Fund has viewed the medium-term fiscal and monetary frameworks as consistent with best practices. In the years of high growth, the staff and the Executive Board have consistently urged using the room for maneuver provided by strong public finances to reduce the high tax burden, especially on labor, and to carry forward the process of streamlining the welfare state. The authorities have implemented a phased program of tax cuts, but have disagreed on the need for a reduction in the size of the public sector. While agreeing on the desirability of improving the incentive structure to encourage greater work effort and promoting competition, the authorities have preferred to follow a gradualist course.

10. **The discussions centered on the following key themes:**

- ***The implications of the slowdown in economic growth for the macroeconomic policy stance;***

- ***The reasons behind the erosion of the recent strength of the public finances and the risks to the framework of fiscal rules;***

- ***The necessity of addressing the emerging tensions between the rising demand for public services and generous welfare provisions through a bolder approach to streamlining the social insurance regime;***[5]
- ***The consequences of a possible euro entry for competitiveness, stabilization policy and the framework of fiscal rules;***
- ***Reinvigorating the structural policy agenda, particularly in the areas of tax, product, and labor market reform.***

A. Monetary Policy and the Financial Sector

11. **The Riksbank saw a subdued economic outlook this year and a decline in medium-term inflation pressures**. Although the cessation of the Iraq war had reduced uncertainty, and stock prices had risen since the beginning of the year, consumer confidence had deteriorated and other indicators, such as manufacturing growth and capacity utilization, remained weak. The Riksbank marked down its outlook for growth since its March inflation report, and officials noted that the growth outlook in trading partners, particularly in the euro area, continued to worsen. The spike in electricity prices had already reversed, eliminating the main source of upward inflation pressure. Moreover, headline inflation for April was significantly below expectations. The authorities were hopeful that the recent labor unrest in the local government sector would not trigger higher wage demands in the autumn bargaining round. Rather, wages were expected to be moderate given a likely pickup in unemployment and subdued economic conditions. With continued economic slack suggested by many indicators, underlying inflation forecast to be below the symmetric target of 2 percent,[6] and downside risks to the global outlook, the mission saw scope for a further reduction in interest rates.

12. **The Riksbank agreed that room for monetary easing was emerging, as evident in its decision to cut interest rates by 50 basis points in early June and shift to a downward bias**. In its June inflation report, the Riksbank pointed to a continued deterioration in international economic activity, which was expected to have a dampening effect on the Swedish economy. The forecast for growth in 2003 was revised down by ½ percentage point to 1.2 percent, due to the weak external conditions and a delay in the expected investment

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[5] These tensions are symptomatic of the underlying longer-term pressures faced by the Swedish model in the presence of the forces of demography and globalization, and have been explored by the staff at length in its recent work on Sweden. See Thakur, S., Keen, M., Horvath, B. and Cerra, V., 2003. *Sweden's Welfare State—Can the Bumblebee Keep Flying?*, (Washington, International Monetary Fund).

[6] The Riksbank aims at the inflation target over a two-year horizon, with a tolerance band of +/- 1 percent.

upturn. Forecasts for underlying inflation have also been revised down—the 12-month rate two years ahead is projected below target, at 1.6 percent—given the postponement of the economic recovery and a downward revision to import prices after the unexpected rapid fall in oil prices. The Riksbank judges the downside risks stemming from the external sector to outweigh any lingering upside risks from wages or electricity prices.

13. **The financial system remains sound and stable.** Banks have responded quickly to a decline in profitability—from 13 percent return on equity to 10.7 percent—with cost-cutting measures. Loan losses have increased only marginally, and capital adequacy remains at sound levels. Although the recent decline of commercial property prices has reduced bank loan collateral values, and depressed equity prices have adversely affected the balance sheets of pension institutions and insurance companies, risks in the financial sector remain limited. Bankruptcies of non-financial companies and loan losses have been rising, but the levels are still low and credit to this sector has been stagnant. Household indebtedness has risen in recent years, but its impact on credit risk has been mitigated by low interest expenses and higher home values, the latter viewed as reflecting fundamentals. Strict personal bankruptcy laws and extensive social insurance schemes further limit credit risks from the household sector. Steps to improve regulation and enhance supervisory capacities are under way, in line with the Fund's FSAP recommendations (IMF Country Report No. 02/161). Improvements of the interbank settlement system are expected by year end. The division of responsibilities between the Financial Supervisory Authority and the Riksbank has been clarified, and cooperation continues with other Nordic supervisory authorities for enhancing cross-border supervision and delineating emergency liquidity arrangements for large regional financial groups.

B. Fiscal Policy and the Fiscal Framework

14. **The authorities' overriding priority is to preserve the generous welfare state and provide quality public services rather than to reduce the tax burden.**[7] The mission noted that the room for implementing the fourth stage of the income tax reform had been used to raise expenditures, while the increase in local government taxes had undercut the central government's income tax reductions. Officials observed that the rise in spending on public services such as healthcare, childcare and education was in response to growing demands for such services and reflected the government's policy priorities. Within the constraints set by these priorities, tax cuts would be considered if they can be afforded, but there was no commitment to cut income taxes on any given time scale. They would, however, curb some of the generosity of the transfer system to pay for needed public services, if that became necessary.

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[7] Sweden's tax and expenditure ratios are almost 20 percentage points of GDP higher than the OECD average, and around 10 percentage points higher than the average for the euro area.

15. **Pressures on local government expenditure show no signs of abating, foreshadowing unrelenting pressures on the public finances.** The authorities conceded that, given that more than 70 percent of local government services depend on the size and age structure of the population, the rising costs of elderly care over the upcoming decade will strain expenditures further. Furthermore, it is becoming increasingly difficult to retain well qualified staff in social service provision, as wages are perceived to be too low. In response, local government wages grew around ½ percent faster than the economy-wide average over the past few years. The authorities recognized that the cost of the social insurance system was beginning to strain their ability to provide quality public services while simultaneously keeping the public finances healthy.

16. **Acknowledging the procyclicality of local government finances, the authorities were nevertheless reluctant to modify the system.** The mission was concerned that the balanced budget requirement without expenditure ceilings and the constitutional right of local governments to tax had resulted in both an upward trend and procyclicality in public spending (Box 1). In response, the authorities made several points. Most importantly, the Swedish public understood that a higher tax burden was the price that had to be paid for quality public services. While accepting that local governments expanded too rapidly, officials stressed that there was large pent-up demand for public services after the retrenchment of the mid-1990s. They also conceded the problem of local government procyclicality but argued that the effect of the cycle on local government finances was mild, partly because benefits were taxable. They did not favor moving to a less cyclically sensitive tax base, such as one relying on property taxes, as this would increase regional revenue disparities and require more drastic redistribution. However, they noted that a government appointed committee to discuss stabilization options in the event of Sweden joining EMU had recommended that local government revenue be stabilized over the cycle, by averaging it over a number of years. This could prove sensitive, however, as the constitution enshrined the right of local governments to tax their citizens. Despite its evident disincentive effects, the authorities were also not keen to alter the revenue equalization scheme between local governments, as they felt it served a valid redistribution function. Moreover, it is a complex system which has evolved over time and is not easily amenable to change.

Box 1. Will Sweden's Fiscal Rules Remain Effective? 1/

Sweden's medium-term fiscal framework is anchored to three separate fiscal rules. In 1997, the authorities announced a target of a general government surplus of 2 percent of GDP over the cycle while simultaneously establishing comprehensive central government nominal expenditure ceilings set three years in advance. The surplus target was viewed as consistent with the expected long-term cost associated with an aging population. The framework was enhanced in 2000, when a balanced budget requirement for local governments was introduced, with the understanding that any deficits must be cleared within two years.

A revenue boom allowed the fiscal framework to be compatible with a steadily rising primary expenditure path. The early years of the fiscal framework coincided with high economic growth and a revenue boom, so that the rules were never seriously tested. The government also continued to ratchet up spending in every budget over the past few years (Figure 7), mainly, on local government consumption. As the estimates of the surplus in 2000 and 2001 continued to increase with each revision, the government responded by raising spending plans, especially for 2002 onwards. The room under the ceilings engendered by favorable cyclical conditions made this discretionary expansion possible. Moreover, buoyant local revenue meant that the balanced budget rule could be respected while increasing spending at this level of government.

The fiscal framework is coming under increasing pressure. The recent downturn exposed some of the strains within the system, especially as expenditure rose rapidly in 2002. The local government sector ran a deficit of almost ½ percent of GDP and was forced to recoup it losses by raising taxes by this amount in 2003. Central government is also feeling the pinch, as the Spring budget implemented a number of cutbacks to prevent an outright breach of the expenditure ceiling. Even so, the strains persist as there is practically no margin left under the ceilings. At the same time, the last budget bill postponed setting expenditure ceilings for these years.

Well designed fiscal rules should limit procyclicality, especially in good times. The political economy literature stresses that politically induced deficit or expenditure biases are often characterized by profligacy in good times, followed by difficulty tightening in bad times. Some commentators argue that fiscal frameworks often work best when they include a rule specifying how to respond to shocks, especially positive ones. For Sweden, this would at a minimum require that cyclical margins not be used for discretionary increases in spending. Going a step further, it could specify how higher than expected revenue could be divided between saving and cutting taxes.

There are particular problems with the balanced budget rule for local governments. The large size of the local government sector combined with the cyclical nature of its revenues—based, unlike in many countries, on income taxes—means that the balanced budget rule fosters procyclicality. There is nothing in the framework to prevent local governments from spending any extra revenue. When the revenue boom peters out, the inability to cut spending means that taxes have to be raised, as in 2003. The incentives inherent in the revenue equalization scheme among local governments add to the problem, as the benefits of broadening the tax base are dissipated to other regions, while higher revenues from raising tax rates are retained.

1/ See Selected Issues paper.

17. **The authorities remain firmly committed to the expenditure ceilings.** The authorities viewed the ceilings on central government expenditure as having played a key role in restraining the growth of spending over the past few years, and as central to maintaining credibility. The 2003 Spring budget announced a series of expenditure cuts and postponements, totaling 0.2 percent of GDP in 2003 and 0.4 percent of GDP in 2004, to prevent a breach of the expenditure ceilings. The authorities have shifted expenditure between years and made increasing use of tax expenditures to provide subsidies to local governments outside the purview of the ceilings. Even so, the room for maneuver is limited as the cyclical margins under the ceilings have been effectively exhausted. The authorities cited a number of key risks in the upcoming months: higher unemployment, a greater influx of refugees, and most importantly, a less than anticipated decline in sick leave costs. Further cuts later in the year could not be ruled out. The authorities recognized the importance of maintaining a sufficient margin under the expenditure ceiling to allow for cyclical variations of expenditure. The mission also argued that the expenditure ceilings should be linked more explicitly to the surplus target.

18. **The authorities were optimistic that the measures taken in the recent Spring budget would curb the growth in sickness payments.** Around a third of the estimated expenditure savings for 2003 and 2004 come from reaping the benefits of these sick leave measures. For the first time, the authorities had recognized that incentives were a part of the problem. The measures included lowering the benefit (by reducing the replacement ratio marginally from 80 percent to 77.6 percent), preventing the unemployed from resorting to higher sickness benefits when they become sick, and passing on a third week of costs to employers. The mission welcomed these steps, but argued that stronger measures might be called for making a decisive dent on the issue and to ensure that the expenditure ceilings are not breached.

C. The Debate on EMU Membership

19. **The deterioration in the public finances has taken a back seat to a debate on the adequacy of stabilization instruments in the event of Sweden joining the EMU.** The debate is focused on whether fiscal policy will be able to stabilize the economy in the face of asymmetric shocks in the absence of an independent monetary policy. Some have also advocated raising the fiscal surplus target.[8] The main labor union federation (LO) had proposed establishing buffer funds financed by social security contributions to be used as a cushion in a downturn. The authorities have rejected this proposal and view the emphasis on the possibility of asymmetric shocks as excessive and somewhat misguided. They would prefer to see the debate focus on the tangible economic benefits of joining the EMU, such as exchange rate stability, associated gains through enhanced trade and investment, and greater

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[8] This was proposed by the government-appointed Committee on Stabilization Policy in the EMU. For a detailed discussion, see last year's Staff Report (IMF Country Report No. 02/159) and Selected Issues (IMF Country Report No. 02/160).

financial integration. Recognizing that many voters are concerned with the stabilization issue, however, the government has not ruled out compensatory measures, and is giving some thought to the idea of varying the VAT rates over the cycle as a stabilization instrument. The mission argued that the concerns about the lack of adequate stabilization policy tools was misplaced, and that Sweden's strong automatic stabilizers—given the large size of public consumption and transfers relative to the economy, and the taxation of benefits, stabilizers are among the largest in the EU—would be sufficient to enable adjustment to most adverse shocks without additional discretionary measures.[9]

20. **The implications of EMU for wage formation and the Swedish welfare state are also under debate.** There is a widespread conviction that the Riksbank's inflation targeting regime has provided an indispensable discipline to wage formation. Nevertheless, proponents of EMU are optimistic that competitive pressures in a monetary union would ultimately prompt a strong awareness of the need for wage moderation, especially since the use of devaluation to restore competitiveness would be precluded. While euro skeptics argue that the market discipline of a floating exchange rate would provide better incentives for sound public finances than would transpire in a monetary union, proponents of EMU counter that the Stability and Growth Pact would subject fiscal policy to greater international scrutiny. The Swedish position on tax policy in the EU has been to support tax autonomy to a great extent, except where tax competition introduces distortions. Proponents of EMU argue that membership in the monetary union would contribute to growth and strong public finances that would further support the Swedish welfare system. However, groups that would stand to lose from a reduction in the welfare state tend to have the most serious misgivings about joining. The effect of EMU on the rest of the structural policy agenda is generally not considered to be large.

21. **There was agreement that Sweden's competitive position remained strong.** While model-based estimates of equilibrium exchange rates are highly uncertain, most estimates from the Riksbank, the IMF, and other institutions indicate that the krona has some room for real appreciation (Box 2). In choosing an entry rate, the Riksbank underlines the need to weigh the risk of economic stimulus from an unduly weak rate, which would require contractionary fiscal policy, against the risk of an overly strong rate, which could entail a costly adjustment associated with restoring competitiveness.

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[9] The balanced budget rule for local governments, however, partly offsets the stabilizers (see para. 16 above).

Box 2. EMU Membership and the Krona

If the EMU referendum results in a decision to join, Sweden could enter ERM2 as early as January 1, 2004. Sweden's output and unemployment have followed similar trends (Figures 1 and 2) to the EU. Its business cycle has been relatively well synchronized with the euro area in the last decade, especially in recent years. Based on this synchronization and current economic forecasts, an early entry into ERM2 would not pose difficulties on cyclical grounds. In the event of a "No" vote, markets do not anticipate any lasting effects on interest rates or the exchange rate.

The Riksbank considers the risk of conflict between the inflation and exchange rate criteria in ERM2 to be limited. 1/ Once Sweden and the euro area countries agree to a central rate that is viewed as a credible entry rate, the scope for exchange rate speculation would be small, especially given the expected short duration of the ERM2 transition. Only shocks large enough to bring the central rate into question would likely undermine even a narrow band. The risk of currency speculation would be further reduced by maintaining strong economic policy fundamentals. The Riksbank has also simulated the scope for independent short-term interest rate policy in ERM2 and the ability to achieve both inflation and exchange rate criteria in the event of an unexpected shock. Preliminary results have suggested that a moderate wage shock would be compatible with the convergence criteria. However, very large wage and fiscal shocks, such as those experienced in the 1980s due to policy mistakes after financial liberalization, could potentially undermine the band or inflation criteria. Historically, other countries have experienced a variety of interest rate convergence speeds on the path toward adopting the euro, suggesting that Sweden would have some scope for interest rate policy directed at low and stable inflation. (See "Swedish Monetary Policy and EMU", Riksbank brochure, www.riksbank.com)

Most econometric models estimate that the krona has been weaker than its equilibrium exchange rate. The Riksbank published analytical work in the December 2002 Inflation Report that could provide the basis for an assessment of a reasonable central rate in ERM2. Projections of the real exchange rate through 2006 were presented based on three models that considered fundamentals such as relative GDP versus the euro area, terms of trade, net foreign assets as a percent of GDP, ratio of consumer to producer prices, relative demographics, budget deficits, and a regime shift in 1993. The three models predicted that the real exchange rate would appreciate by between 1.5 percent and 11.3 percent by the end of 2006. Given expectations for broadly similar inflation rates, the Riksbank estimated that the nominal exchange rate would be in the range of about 8.2 and 9.0 krona per euro in 2006. The staff has estimated the equilibrium exchange rate based on a multilaterally-consistent macroeconomic balance approach as well as panel estimation of purchasing power parity adjusted for some fundamental factors such as changes in relative productivity between traded and non-traded sectors, relative output in manufacturing, income flows on net foreign assets, and commodity terms of trade. The krona was estimated to be 11 percent and 12 percent weaker than its equilibrium level relative to the euro at the end of January on the basis of the macroeconomic balance approach and PPP approach, respectively. Actual exchange rate changes in recent years have also been affected by capital account factors, such as equity outflows responding to the shifting prospects of the telecom sector, outward portfolio investment, and repayments on the government's foreign debt.

1/ See the November 13, 2002 speech by the Riksbank Governor Lars Heikensten (www.riksbank.com).

D. Structural Policies and Other Issues

22. **The authorities see the need to contain the erosion of labor supply due to rising absenteeism**. The growing adverse impact of the escalating use of sickness leave—as well as of early and disability retirement—on public finances, labor supply, and, ultimately, growth is being increasingly acknowledged in the public debate. The negative impact of this trend on labor costs could also jeopardize the authorities' ambitious employment objective. The authorities believe that the phenomenon of absenteeism is driven by complex socio-economic forces, most notably the ageing workforce, as suggested by the rising share of workers on long-term sick leave. This aspect of the problem is best addressed by measures to improve rehabilitation and new opportunities for part-time work. While stressing the importance of their objective to protect those in need, the authorities recognize that the generosity of sickness benefits may give rise to incentives for excessive use of the system, particularly if eligibility criteria are too broad and controls too loose. However, while some reduction in sick leave is expected in the near term from the spring budget measures, the number of people on disability pensions is likely to increase further, as there is likely to be some shift from long-term sick leave to disability.

23. **The authorities agree that the lack of competition in some sectors is harmful to consumers**. They noted that competition in all sectors of the economy had increased substantially in the past decade. Following EU entry in 1995, Sweden has been quick to adopt most internal market directives and has now reached, together with Denmark, the highest rate of implementation in the EU. However, the price level remained about 20 percent above the EU average, with half of the differential attributed to lack of competition. After initial progress, price convergence to the EU has in fact stalled. Lack of competition is evident in sectors such as retail trade, pharmaceuticals and construction. However, the authorities believe that there is no obvious barrier to entry in these sectors and that competition will increase with further integration in the EU. The authorities have continued to strengthen the conditions for competition, making available new resources for the Competition Authority, issuing new legislation against cartels, and improving the complaint procedures to ensure fair treatment in public procurement. The large public ownership of housing, particularly in the rental sector, has led to depressed housing investment and impeded labor mobility. The authorities were trying to address the problem through the provision of loans and grants to certain categories (e.g., students), but were not in favor of significant deregulation of rental housing.

24. **The Swedish government is strongly committed to free trade, particularly with poorer countries.** In the recent EU discussion on the reform of the Common Agricultural Policy, the authorities have reiterated their position that advanced countries should take the initiative to reduce tariffs on agricultural goods and substantially cut down agricultural support in the medium term. The government is working with EU partners to advance the objective of phasing out tariffs on goods imported from poorer countries, with particular emphasis on textile, clothing, and footwear. In the current Doha Round, Sweden supports the US proposal for the total elimination of tariffs on industrial goods within ten years.

IV. Staff Appraisal

25. **The Swedish economy was able to ride out the global slowdown in 2002, comfortably outpacing growth in the euro area.** This resilience in the face of a continuing slump in the telecom sector was made possible by a strong stimulus from fiscal policy and substantial support from external trade, sustained in part by the weak krona. While the well-designed fiscal and monetary frameworks continued to ensure policy credibility, the exceptional strength of public finances built up over the boom years enabled the authorities to implement the third consecutive step of income tax reduction, helping to dampen the downturn. Looking ahead, as the room for policy maneuver shrinks rapidly in the face of slower growth, the challenge facing the authorities will be to preserve the credibility of the fiscal policy framework.

26. **The inflation targeting framework has gained considerable credibility in recent years.** The Riksbank's clear and transparent communication of its inflation forecast and policy reaction has increasingly guided expectations, thereby providing a strong anchor to wage formation. Over the past year, monetary policy has responded with agility to changes in economic conditions and assessment of inflation prospects.

27. **With a hesitant global recovery and the inflation forecast below target, the Riksbank appropriately cut the policy rate further.** With most indicators pointing to continued economic slack and wage demands in the autumn bargaining round expected to be moderate, there appears to be some room for additional easing, if that becomes necessary. However, excessive wage demands in the autumn round will leave monetary policy little room to respond to a deterioration in the economic outlook.

28. **The financial system remains fundamentally sound**. Despite a decline in profitability and a marginal increase in loan losses, bank profitability and capital adequacy remain at sound levels. While credit risks have been well contained, those associated with a significant decline in property values or a rise in unemployment bear continued monitoring. The authorities have taken welcome steps to improve the settlement system, to clarify the division of responsibilities between supervisory institutions, and to meet the Basle II requirements and new EU directives.

29. **In the event of a decision to join the EMU, Sweden's sound macroeconomic fundamentals position it well for a smooth transition.** Public finances are fully consistent with entry requirements, and indeed, are on a firmer footing than in many euro area countries. Strong automatic fiscal stabilizers should be sufficient to enable adjustment to most negative shocks, without additional fiscal stabilization instruments or a higher fiscal surplus target. The government's decision not to adopt the proposal for a buffer fund is therefore appropriate. Moreover, Sweden's competitive position has strengthened following several years of high productivity growth and moderate wage increases, helping keep unemployment low and underpinning export growth despite the decline in the telecom sector. Indeed, sizeable current account surpluses would be expected in the medium term even if the

real exchange rate were to appreciate moderately. Low inflation is also in line with criteria for EMU entry and would facilitate smooth monetary management during a transition period.

30. **The marked deterioration in the public finances in 2002, albeit partly cyclical, reflected a continued ratcheting up of public spending.** Much of this increase is taking the form of higher local government spending, and to a lesser extent, higher payments for sickness leave. Indeed, the path of primary spending has shifted up in each new budget bill since autumn 2000.

31. **The trend of higher public spending has stalled the long-overdue process of lowering Sweden's high tax burden.** The delay in the implementation of the fourth and final stage of the income tax reform, and the local authorities' increasing resort to raising tax rates to meet the unabated pressures on local spending point to the risks of a reversal of direction. As demographic forces increase pressures on age-related spending over the coming years, the prospect of a reduction in the tax burden is becoming increasingly elusive. Indeed, there is a risk of a steadily rising tax burden, with all its attendant efficiency costs.

32. **A reform of the local government financing arrangements would strengthen the fiscal framework**. Given the large size of the local government sector and the balanced budget rule, the cyclicality of local government revenue sources risks undermining the objectives of the overall fiscal framework and prompting a general upward trend in tax burden. Moreover, such policy responses risk leading to a procyclical fiscal policy behavior, similar to that observed in parts of the euro area. Therefore, it is essential to restructure the local government tax base to reduce its current sensitivity to the economic cycle. Given their perverse incentive effects, reform of the revenue sharing arrangements is becoming imperative to provide incentives to maintain the quality of services, which will be all the more important through the upcoming demographic transition.

33. **The credibility of the expenditure ceilings should be preserved.** The ceilings have restrained spending growth and contributed to healthier public finances. Maintaining the ceilings depends on the authorities' ambitious goal of significant savings in sick leave expenses. The proposals in the Spring budget, such as marginally reducing the generosity of the sickness benefit and restricting the unemployed from receiving higher benefits when they become sick, are necessary and welcome. However, these measures are unlikely to be sufficient to curtail the steep rise in sickness payments. Stronger measures to affect incentives may well be needed, such as reducing the replacement ratio significantly and shifting a portion of the cost of long-term sick leave to the employer.

34. **The design of the expenditure ceilings within the fiscal framework could be improved.** Cyclical margins under the ceilings have repeatedly been used up by discretionary spending increases. Moreover, the ceilings have yet to be tested in a serious downturn. The decision to postpone setting a ceiling for 2005 until the autumn budget is also unhelpful. Going forward, margins under the ceiling should only be used for cyclical spending. In addition, expenditure ceilings should be linked explicitly to the surplus target

and a consistent fiscal strategy incorporating spending and tax plans should be devised to ensure that the surplus target remains credible.

35. **The recent strains on public finances have brought into sharp relief the urgency of renewed efforts to streamline the generous welfare state.** Over the medium and longer term, demographic pressures will intensify age-related spending and make it impossible to meet the rising demands for public services without straining the framework of fiscal rules to a breaking point. A choice needs to be made between generous social insurance benefits and provision of adequate public services, if the tax burden is not to be raised to unsustainable levels. An early commitment to trim back the generous welfare provisions to strengthen incentives would help avoid future strains on the fiscal framework.

36. **The current policy setup discourages work effort in the short run and risks lowering further the effective supply of labor in the long run.** In particular, the high level of taxation on labor income and the high replacement ratios for social benefits discourage labor force participation and work effort. Similar disincentive effects flow from the generosity of the sickness and early retirement schemes, while the compressed wage structure serves to discourage acquisition of skills. A concerted effort to address these issues is necessary to raise sustainable long-term growth.

37. **Strengthening competition and opening up markets would help enhance economic growth.** Despite the progress made since participation in the EU internal market, significant barriers to competition remain in areas like pharmaceuticals, retail trade, and construction. Measures to encourage competition and liberalize the housing market should be accelerated.

38. **The authorities' efforts to champion more open trade policies overseas aptly complement their generous development assistance, which at 0.74 percent of GNP, remains among the highest in the world.**

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

Table 1. Sweden: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 1/	2004 1/	Average 2005–07 1/
Real economy (in percent change)									
Real GDP	2.4	3.6	4.6	4.4	1.1	1.9	1.3	2.4	2.3
CPI	1.8	0.4	0.3	1.3	2.6	2.4	2.0	1.8	2.0
Open unemployment rate (in percent)	8.0	6.5	5.6	4.7	4.0	4.0	4.5	4.2	4.0
Participation in labor market programs (in percent)	4.5	4.1	3.3	2.6	2.5	2.6	2.5	2.4	2.2
Gross national saving (percent of GDP)	20.4	21.1	21.7	22.4	22.0	21.4	21.0	21.4	22.6
Gross domestic investment (percent of GDP)	15.7	16.4	17.5	18.5	18.1	17.2	17.4	17.6	18.6
Public finance (in percent of GDP)									
General government balance	-1.7	2.3	1.3	3.4	4.6	1.1	0.4	1.0	1.8
Structural balance 2/	-2.8	1.4	2.5	4.1	2.8	0.8	1.4	1.7	2.0
General government debt	71.9	69.3	62.2	52.9	54.4	52.4	51.0	50.0	46.5
Money and credit (12-month, percent change)									
M0	3.0	5.1	12.0	1.9	8.8	-0.4	4.1 /3	...	...
M3	1.3	2.1	9.9	2.1	6.2	4.2	4.5 /3	...	...
Credit to non-bank public	6.4	6.8	5.6	9.1	8.9	6.5	-3.5 /3	...	...
Interest rates (year average)									
Three-month interbank rate	4.1	4.2	3.1	4.0	4.3	3.8	3.6 /3	...	...
Ten-year government bond yield	6.7	5.0	5.0	5.4	5.4	5.1	4.7 /3	...	...
Balance of payments (in percent of GDP)									
Trade balance	7.1	6.2	6.1	5.6	5.7	6.1	5.6	5.7	6.0
Current account	4.2	3.9	4.2	3.9	3.9	4.2	3.6	3.8	4.0
Reserves (in billions of dollars)	14.9	21.6	20.7	17.7	15.6	19.3	20.0 /3	...	...
Reserve cover (months of imports of goods and services)	2.1	2.7	2.7	2.5	2.5	3.3	...	...	...
Exchange rate (period average, unless otherwise stated)									
Exchange rate regime	Floating exchange rate								
Present rate (May 30, 2003)	US$ 1 = SKr 7.7100								
Nominal effective rate (1995=100)	105.5	103.2	101.8	102.7	93.5	94.9	98.6 /3	...	...
Real effective rate (1995=100) 4/	109.8	108.0	104.5	103.7	94.0	96.0	100.4 /3	...	...

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

1/ Staff projections, unless otherwise indicated.
2/ In percent of potential GDP, also adjusted for timing of tax revenues.
3/ April.
4/ Based on relative normalized unit labor cost in manufacturing.

Table 2. Sweden: General Government Financial Accounts, 1997–2006

	1997 Act.	1998 Act.	1999 Act.	2000 Act.	2001 Act.	2002 Act.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.
					(In percent of GDP)					
Total revenue	58.8	60.5	59.0	58.2	59.0	56.8	56.8	56.5	56.1	56.1
Primary revenue	54.6	56.3	55.7	55.1	56.7	54.7	54.6	54.3	53.9	53.8
Tax revenue (incl. charges)	51.2	52.9	52.2	51.8	53.5	51.3	51.2	51.0	50.6	50.5
Nontax revenue	3.4	3.5	3.4	3.3	3.3	3.3	3.4	3.4	3.4	3.4
Interest receipts	4.2	4.1	3.3	3.1	2.2	2.2	2.2	2.1	2.2	2.2
Total expenditure	60.5	58.2	57.7	54.8	54.4	55.8	56.4	55.5	54.7	53.9
Primary expenditure	54.2	52.7	52.9	50.7	51.2	52.6	53.5	53.2	52.1	51.4
Current expenditure	51.1	50.6	50.0	48.1	48.4	49.5	50.4	49.9	48.9	48.3
Transfers	23.8	23.0	22.5	21.3	21.2	21.4	22.2	22.1	21.4	21.1
Consumption	27.3	27.5	27.5	26.8	27.2	28.0	28.2	27.9	27.5	27.2
Capital expenditure	3.2	2.1	2.9	2.6	2.8	3.1	3.1	3.2	3.1	3.1
Interest payments	6.3	5.5	4.8	4.0	3.2	3.2	2.8	2.3	2.7	2.6
Overall balance	-1.7	2.3	1.3	3.4	4.6	1.1	0.4	1.0	1.4	2.1
Primary balance	0.4	3.6	2.8	4.4	5.5	2.1	1.0	1.2	1.9	2.5
Structural adjustment										
Cyclical adjustment	...	...	...	-0.3	0.4	0.5	1.0	0.7	0.3	0.0
Cyclically adjusted overall balance	...	...	...	3.2	4.9	1.6	1.4	1.6	1.7	2.1
Periodization of taxes	...	...	...	1.5	-2.1	-0.8	0.1	0.1	0.2	0.1
Temporary effects	...	...	...	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance	...	...	...	4.1	2.8	0.8	1.4	1.7	1.9	2.2
Memorandum items:										
Gross public debt										
in percent of GDP	71.9	69.3	62.6	52.9	54.4	52.4	51.0	50.0	48.4	46.4
Nominal GDP (in billion krona)	1,890	1,974	2,079	2,197	2,267	2,340	2,426	2,532	2,652	2,773
Output gap	...	...	...	0.4	-0.5	-0.7	-1.4	-1.0	-0.4	0.0

Sources: National authorities; and Fund staff calculations.

Table 3. Sweden: Balance of Payments, 1997-2008
(In billions of dollars)

	1997	1998	1999	2000	2001	2002	2003 proj.	2004 proj.	2005 proj.	2006 proj.	2007 proj.	2008 proj.
Current account	10.3	9.7	10.6	9.4	8.5	10.0	10.9	11.9	13.3	14.0	14.4	14.7
as a percentage of GDP	4.2	3.9	4.2	3.9	3.9	4.2	3.6	3.8	4.0	4.1	4.0	4.0
Goods and services	17.7	15.5	15.3	13.4	12.5	14.6	16.7	18.1	19.6	20.4	21.0	21.4
Exports of goods and services	102.5	105.5	106.9	110.2	99.1	104.4	118.9	125.3	133.8	142.7	152.3	162.5
Goods	84.1	85.8	85.2	87.5	76.1	81.1	92.6	97.5	103.7	110.1	117.0	124.2
Services	18.4	19.7	21.7	22.7	23.0	23.3	26.3	27.8	30.1	32.6	35.3	38.2
Imports of goods and services	-84.8	-90.0	-91.6	-96.8	-86.6	-89.8	-102.2	-107.2	-114.2	-122.3	-131.3	-141.0
Goods	-65.1	-68.7	-68.5	-72.7	-63.0	-65.9	-75.3	-78.9	-84.1	-89.6	-95.7	-102.2
Services	-19.7	-21.3	-23.1	-24.1	-23.6	-23.8	-27.0	-28.3	-30.1	-32.7	-35.6	-38.8
Income	-4.9	-3.3	-2.0	-1.4	-1.4	-1.8	-2.4	-2.6	-2.7	-2.8	-2.8	-2.9
Compensation of employees	-0.2	-0.3	-0.3	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Investment income	-4.7	-3.0	-1.8	-1.2	-1.2	-1.6	-2.1	-2.3	-2.4	-2.5	-2.5	-2.6
Current transfers	-2.4	-2.6	-2.7	-2.6	-2.5	-2.8	-3.4	-3.5	-3.6	-3.7	-3.7	-3.8
Official	-1.9	-2.0	-2.1	-2.1	-2.1	-2.3	-2.7	-2.8	-2.9	-2.9	-3.0	-3.0
Capital and financial account	-0.1	-1.4	-8.4	-0.9	1.4	-14.6	-10.9	-11.9	-13.3	-14.0	-14.4	-14.7
Capital account	-0.9	-0.1	-3.1	-0.4	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial account	0.8	-1.3	-5.3	-0.5	1.6	-14.5	-10.8	-11.8	-13.2	-13.9	-14.3	-14.6
Direct investment	-1.7	-4.5	38.9	-17.4	5.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Abroad	-12.7	-24.4	-21.9	-40.6	-6.6	-10.9	-13.7	-14.6	-15.2	-15.9	-16.6	-17.4
In Sweden	11.0	19.8	60.8	23.3	11.8	11.1	13.9	14.9	15.5	16.2	16.9	17.7
Portfolio investment excl. fin. derivatives	-11.8	-14.9	-35.7	-3.1	-13.1	-11.2	-14.0	-14.9	-15.6	-16.3	-17.0	-17.8
Other investment	7.6	21.4	-6.5	20.3	8.5	-2.8	-3.4	-3.4	-3.4	-3.4	-3.4	-3.4
Reserve assets	6.6	-3.3	-2.0	-0.3	1.0	-0.8	6.3	6.2	5.5	5.5	5.8	6.2
Net errors and omissions	-10.2	-8.2	-2.2	-8.6	-10.0	4.6	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items												
GDP at current prices	247.6	248.4	251.5	240.0	219.6	241.2	298.5	316.2	329.4	342.8	356.6	371.0
Central Bank reserves	14.9	21.6	20.7	17.7	15.6	19.3	...	...	...	...	...	...

Sources: Riksbank, and staff projections.

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

	1997	1998	1999	2000	2001	2002	2003 1/	
External Indicators								
Exports of goods and services (annual percentage change, in U.S. dollars)	-0.2	3.0	1.4	3.0	-10.1	5.3	13.9	
Imports of goods and services (annual percentage change, in U.S. dollars)	0.0	6.1	1.8	5.7	-10.5	3.6	13.9	
Current account balance	4.2	3.9	4.2	3.9	3.9	4.2	3.6	
Capital and financial account balance	-0.1	-0.6	-3.3	-0.4	0.7	-6.1	-3.6	
Direct investment, net	-0.7	-1.8	15.5	-7.2	2.4	0.1	0.1	
Portfolio investment, net	-4.7	-6.0	-14.2	-1.3	-6.0	-4.6	-4.7	
Central Bank reserves (end of period, in billions of U.S. dollars)	14.9	21.6	20.7	17.7	15.6	19.3	20.0	Apr
Exchange rate against US dollar (SEK, period average)	7.6	7.9	8.3	9.2	10.3	9.7	7.9	May
Exchange rate against Euro (SEK, period average)	8.7	8.9	8.8	8.4	9.3	9.2	9.2	May
Effective exchange rate (annual percentage change)	-3.3	-7.1	4.3	-3.0	-7.4	5.4	4.6	Apr
Real effective exchange rate (based on ULC, annual percentage change)	-2.2	-8.0	3.4	-4.6	-7.7	6.3	5.5	Apr
Financial Markets Indicators								
Consolidated public sector gross debt (end of period)	69.3	62.6	52.9	54.4	52.4	51.0	50.0	
3-month T-bill yield (nominal, in percent per annum)	4.1	4.2	3.1	4.0	4.3	3.8	3.4	Apr
3-month T-bill yield (ex post real, in percent per annum)	2.2	3.2	2.6	2.6	1.6	1.8	1.1	Apr
Spread of 3-month T-bill vs. Germany (percentage points, end of period)	0.8	0.7	0.2	-0.4	0.4	1.6	0.9	Apr
Spread of 10-year T-bill vs. Germany (percentage points, end of period)	1.0	0.4	0.5	0.1	0.5	0.8	0.8	Apr
General stock index (annual percentage change)	47.0	16.2	29.2	-11.9	-19.9	-41.7	-62.6	Apr
Real estate price index (annual percentage change)	7.0	9.6	9.2	11.0	6.6	9.5	6.9	Feb
Commercial property price index (annual percentage change)	8.0	11.5	13.0	29.2	-12.0	-8.4	-3.7	Apr
Credit to households (growth rate in percent)	5.5	6.6	9.0	7.5	8.9	9.0	9.1	Feb
Financial Sector Risk Indicators								
Risk-weighted capital adequacy ratio (CAR) in four major banks	10.9	10.4	11.4	9.9	10.0	10.0	...	
Tier 1 capital ratio in four major banks	7.0	6.9	7.7	6.8	7.1	7.1	...	
Ratio of nonperforming loans in four major banks	3.5	2.6	1.7	1.7	1.6	1.4	...	
Share of foreign exchange loans in percent	14.2	15.2	14.7	17.2	17.8	16.4	...	
Share of foreign exchange deposits in percent	19.6	18.9	16.1	23.8	22.7	23.1	...	
Banks' return on capital after tax in percent	18.9	14.2	16.0	15.7	13.0	10.7	...	
Ratio of households' financial liabilities to disposable income	95.2	99.1	102.1	107.0	111.7	112.1	...	
Ratio of households' interest payments to disposable income	5.3	4.9	4.6	4.8	4.8	4.7	...	

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

1/ Staff projections, unless otherwise indicated.

Table 5. Sweden: Public Sector Debt Sustainability Framework, 1997–2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						I. Baseline Medium-Term Projections					
1 Public sector debt 1/	71.9	69.3	62.6	52.9	54.4	**52.4**	**51.0**	**50.0**	**48.4**	**46.4**	**44.4**
2 Change in public sector debt	-1.5	-2.6	-6.7	-9.7	1.5	-1.9	-1.4	-0.9	-1.6	-2.0	-2.0
3 Identified debt-creating flows (4+7+12)	-1.1	-5.3	-4.8	-10.1	-6.3	-2.8	-2.7	-3.2	-4.1	-4.7	-4.1
4 Primary deficit 2/	-4.6	-7.8	-6.1	-7.5	-7.7	-4.2	-3.2	-3.3	-4.1	-4.7	-4.6
5 Revenue and grants	58.8	60.5	59.0	58.2	59.0	56.8	56.8	56.5	56.1	56.1	56.1
6 Primary (noninterest) expenditure	54.2	52.7	52.9	50.7	51.2	52.6	53.5	53.2	52.1	51.4	51.5
7 Automatic debt dynamics 3/	3.5	2.4	1.3	0.7	1.5	1.5	1.1	0.7	0.5	0.5	0.5
8 Contribution from interest rate/growth differential 4/	3.5	2.4	1.3	0.7	1.5	1.5	1.1	0.7	0.5	0.5	0.5
9 Of which contribution from real interest rate	5.2	5.0	4.3	3.3	2.1	2.5	1.9	1.7	1.7	1.6	1.5
10 Of which contribution from real GDP growth	-1.7	-2.5	-3.0	-2.6	-0.6	-1.0	-0.8	-1.0	-1.1	-1.1	-1.1
11 Contribution from exchange rate depreciation 5/	...	...	...	...	...	...	...	...	...	...	...
12 Other identified debt-creating flows	...	...	...	-3.3	-0.1	0.0	-0.6	-0.6	-0.6	-0.5	0.0
13 Privatization receipts (negative)	...	...	...	-3.3	-0.1	0.0	-0.6	-0.6	-0.6	-0.5	0.0
14 Recognition of implicit or contingent liabilities	...	...	...	...	...	...	...	...	...	...	...
15 Other (specify, e.g. bank recapitalization)	...	...	...	...	...	...	...	...	...	...	...
16 Residual, including asset changes (2-3)	-0.4	2.7	-1.9	0.4	7.8	0.8	1.3	2.3	2.5	2.7	2.1
Public sector debt-to-revenue ratio 1/	122.3	114.7	106.0	90.8	92.2	92.3	89.8	88.6	86.3	82.8	79.2
Gross financing need 6/	1.7	-2.3	-1.3	-3.4	-4.6	-1.1	-0.4	-1.0	-1.4	-2.1	-2.1
in billions of U.S. dollars	4.3	-5.6	-3.3	-8.3	-10.0	-2.5	-1.1	-2.8	-4.3	-6.8	-7.1
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	2.4	3.6	4.6	4.4	1.1	1.9	1.6	2.1	2.4	2.4	2.4
Average nominal interest rate on public debt (in percent) 7/	9.0	8.0	7.3	6.8	6.2	6.0	5.6	4.8	5.6	5.5	5.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	7.4	7.2	6.6	5.6	4.2	4.7	3.8	3.5	3.6	3.5	3.5
Nominal appreciation (increase in US dollar value of local currency, in percent)	-12.8	-2.3	-5.4	-10.6	-10.6	20.9	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.5	0.8	0.7	1.3	2.0	1.3	1.7	1.3	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.8	0.7	5.0	0.0	2.1	4.6	3.8	2.3	0.6	1.2	2.6
						II. Stress Tests for Public Debt Ratio					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						**52.4**	**52.8**	**54.2**	**55.9**	**57.9**	**59.9**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						**52.4**	**53.8**	**56.0**	**54.4**	**52.4**	**50.4**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**52.4**	**52.6**	**53.3**	**51.3**	**48.9**	**46.6**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						**52.4**	**62.1**	**72.6**	**71.1**	**69.3**	**67.5**
5. Combination of 2-4 using one standard deviation shocks						**52.4**	**59.8**	**68.7**	**64.9**	**60.5**	**56.2**
6. One time 30 percent real depreciation in 2003 8/						**52.4**	**51.0**	**50.0**	**48.3**	**46.2**	**44.1**
7. 10 percent of GDP increase in other debt-creating flows in 2003						**52.4**	**61.0**	**60.2**	**58.6**	**56.7**	**54.9**
Historical Statistics for Key Variables (past 10 years)		Historical Average		Standard Deviation				Average 2002-07			
Primary deficit		-2.4		5.2				-4.0			
Real GDP growth (in percent)		2.5		2.0				2.1			
Nominal interest rate (in percent) 7/		8.5		1.4				5.5			
Real interest rate (in percent)		6.8		1.4				3.8			
Inflation rate (GDP deflator, in percent)		1.7		0.9				1.7			
Revenue to GDP ratio		58.8		1.0				56.4			

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ The primary balance is calculated as revenue minus primary expenditure. This differs from Table 2, where the primary balance is defined as primary revenue minus primary expenditure.
3/ 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; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 6. Sweden: External Debt Sustainability Framework, 1997–2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						I. Baseline Medium-Term Projections					
External debt (net foreign liabilities)	40.7	37.2	34.4	35.4	26.4	**23.6**	**16.5**	**12.5**	**8.2**	**3.6**	**-1.0**
Change in external debt	2.8	-3.5	-2.8	1.1	-9.0	-2.7	-7.2	-4.0	-4.3	-4.5	-4.7
Identified external debt-creating flows (4+8+11)	-17.7	-17.0	-12.9	-24.9	-53.0	-17.6	-4.8	-22.4	-22.0	-21.6	-21.1
Current account deficit, excluding interest payments	-8.4	-7.9	-7.9	-7.5	-8.1	-8.0	-6.6	-6.1	-5.8	-5.5	-5.1
Deficit in balance of goods and services	-7.1	-6.2	-6.1	-5.6	-5.7	-6.1	-5.4	-5.5	-5.8	-6.1	-6.4
Exports	41.4	42.5	42.5	45.9	45.1	43.3	38.4	39.6	40.5	41.3	42.2
Imports	34.3	36.2	36.4	40.3	39.5	37.2	33.0	34.1	34.7	35.2	35.8
Net non-debt creating capital inflows (negative)	-3.5	-8.1	-2.7	-1.5	-24.9	-22.5	-18.9	-18.4	-17.7	-17.0	-16.4
Net foreign direct investment, equity	15.3	17.4	13.5	12.7	14.0	13.2	11.1	10.8	10.4	10.0	9.6
Net portfolio investment,equity	-11.7	-9.3	-10.8	-11.2	10.9	9.3	7.8	7.6	7.3	7.1	6.8
Automatic debt dynamics 1/	-5.7	-1.0	-2.3	-15.9	-20.0	12.9	20.7	2.1	1.4	0.9	0.4
Contribution from nominal interest rate	4.2	4.1	3.7	3.6	4.2	3.8	3.1	2.5	1.9	1.2	0.6
Contribution from real GDP growth	-1.0	-1.5	-1.7	-1.6	-0.4	-0.5	-0.3	-0.3	-0.3	-0.2	-0.1
Contribution from price and exchange rate changes 2/	-8.9	-3.5	-4.3	-17.9	-23.8	9.5	17.9	-0.1	-0.2	-0.1	-0.1
Residual, incl. change in gross foreign assets (2-3)	20.5	13.5	10.0	25.9	44.0	14.8	-2.4	18.4	17.7	17.0	16.4
External debt-to-exports ratio (in percent)	98.3	87.5	80.8	77.1	58.4	54.6	43.0	31.6	20.2	8.8	-2.5
Gross external financing need (in billions of US dollars) 3/	-10.3	-2.2	2.5	-3.0	-1.0	7.7	1.6	1.1	-0.4	-2.0	-3.6
in percent of GDP	-4.2	-0.9	1.0	-1.3	-0.5	3.2	0.6	0.4	-0.1	-0.6	-1.1
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	2.4	3.6	4.6	4.4	1.1	1.9	1.6	2.1	2.4	2.4	2.4
Exchange rate appreciation (US dollar value of local currency, change in percent)	-12.2	-4.0	-3.8	-9.8	-11.3	6.1	14.9	-0.6	-0.5	-0.5	-0.5
GDP deflator in US dollars (change in percent)	-10.8	-3.2	-3.1	-8.7	-9.5	7.5	16.9	0.7	1.5	1.5	1.5
Nominal external interest rate (in percent)	10.2	10.0	10.1	10.0	10.9	15.8	15.8	15.8	15.8	15.8	15.8
Growth of exports (US dollar terms, in percent)	-0.3	2.9	1.4	2.9	-10.0	5.0	5.3	6.2	6.2	6.1	6.1
Growth of imports (US dollar terms, in percent)	-0.1	6.1	1.8	5.5	-10.5	3.3	5.3	6.3	5.7	5.5	5.7
						II. Stress Tests for External Debt Ratio					
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2007						**23.6**	**36.6**	**47.5**	**59.0**	**71.1**	**84.0**
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						**23.6**	**16.1**	**12.0**	**7.6**	**3.0**	**-1.8**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						**23.6**	**17.9**	**14.9**	**10.8**	**6.6**	**2.2**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						**23.6**	**40.2**	**53.8**	**54.2**	**54.9**	**56.0**
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						**23.6**	**20.4**	**20.3**	**16.9**	**13.4**	**9.8**
6. Combination of 2-5 using one standard deviation shocks						**23.6**	**33.1**	**38.3**	**36.9**	**35.7**	**34.6**
7. One time 30 percent nominal depreciation in 2003						**23.6**	**-60.3**	**-73.9**	**-88.1**	**-103.6**	**-120.5**
Historical Statistics for Key Variables (past 10 years)		Historical Average		Standard Deviation				Average 2002-07			
Current account deficit, excluding interest payments		-6.8		2.1				-6.1			
Net non-debt creating capital inflows		5.1		7.6				18.5			
Nominal external interest rate (in percent)		11.0		1.9				15.8			
Real GDP growth (in percent)		2.5		2.0				2.1			
GDP deflator in US dollars (change in percent)		-3.1		10.4				4.9			

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) 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.

Sweden: Fund Relations
(As of April 30, 2003)

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	1,362.92	56.89
Reserve position in Fund	1,032.59	43.11
Financial Transaction Plan transfers (net)	31.00	

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	246.53	100.00
Holdings	135.28	54.87

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				
	2003	2004	2005	2006	2007
Principal					
Charges/Interest	1.46	1.97	1.96	1.97	1.97
Total	1.46	1.97	1.96	1.97	1.97

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

VIII. **Article IV Consultation:** Discussions for the 2002 Article IV consultation were held

in Stockholm, May 5–15, 2002 and the staff report (IMF Country Report 02/159) was issued on July 8, 2002. The consultation was completed by the Executive Board on July 31, 2002.

IX. **Technical Assistance:** None

X. **Resident Representative:** None

Sweden: Core Statistical Indicators
(As of June 5, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	General Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	June 5, 2003	March 31, 2003	March 29, 2003	Apr 2003	Apr 2003	June 5, 2003	May 2003	March 2003	March 2003	End - 2002	1st Quarter 2003	End-2002
Date Received	June 5, 2003	April 15, 2003	April 15, 2003	May 29, 2003	May 29, 2003	June 5, 2003	June 1, 2003	May 29, 2003	June 1, 2003	April 5, 2003	May 10, 2003	April 10, 2003
Frequency of Data	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually
Frequency of Reporting	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually
Source of Update	Commercial	Riksbank	Riksbank	Riksbank	Riksbank	Commercial	Statistics Sweden	Statistics Sweden	Riksbank	Ministry of Finance	Statistics Sweden	Riksbank
Mode of Reporting	On Line	Publication	Publication	On-Line	On-Line	On-Line	On-Line	On-Line	On-Line	Publication	On-Line	On-Line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annually	Quarterly	Annually

Statement by the IMF Staff Representative
July 25, 2003

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.

1. **Economic activity remains generally subdued.** Although preliminary national accounts estimates for the first quarter of 2003 showed a pick-up in the growth rate of GDP, data on trade volumes suggested lower net exports, and therefore the possibility of a downward revision to estimates of GDP growth. Industrial production and orders remained flat or weakened through May. Notwithstanding a rise in the unemployment rate to 4.2 percent in May, private consumption is holding up and household confidence is improving gradually.

2. **Headline inflation continued to fall below the 2 percent target.** Helped by receding energy prices and declining interest costs, 12-month CPI inflation fell to 1.8 percent in June from 1.9 percent in May. Underlying inflation, as measured by the UND1X index, edged up to 2.1 percent in June.

3. **The Riksbank cut its policy interest rate by a further 25 basis points to 2.75 percent on July 3.** In announcing this latest easing, following the reduction by 50 basis points in early June, the Riksbank cited lower-than-expected inflation and the risk of a weaker recovery in the euro area than earlier anticipated. Reflecting in part the narrowing interest rate differential, the krona has weakened against the euro since mid-June by about 2 percent. Its trade-weighted index has appreciated by about 4 percent in the first half of 2003.

4. **In line with the worldwide recovery in stock markets, equity prices have rebounded.** As of July 21, the Stockholm All Share Index was up by 9 percent since the beginning of the year, and almost 6 percent since early June. However, it is still about 11 percent below its level a year earlier.

INTERNATIONAL MONETARY FUND

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FOR IMMEDIATE RELEASE
August 5, 2003

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

IMF Concludes 2003 Article IV Consultation with Sweden

On July 25, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Sweden.[1]

Background

The Swedish economy recovered in 2002, assisted by a sizeable fiscal stimulus. While continued weakness in the telecom sector and persisting excess capacity held back business investment, household consumption strengthened as tax cuts and government transfers boosted disposable income. After an early upturn in 2002, external demand weakened rapidly with the worsening global outlook, contributing to the deceleration of economic activity in the second half of the year. Driven by net exports and consumption, GDP growth picked up in the first quarter of 2003.

Inflationary pressures are receding rapidly after a temporary surge. Due to high demand—reflecting the unusually cold winter—and exceptionally low reservoir levels in Nordic hydroelectric power plants, energy prices rose sharply, pushing headline inflation up to 3.4 percent in February 2003. However, ample spare capacity and wage moderation are keeping underlying inflation—excluding energy— well under 2 percent. As energy prices began to decline, headline inflation fell back below the 2 percent target and inflation expectations remain well anchored around that level.

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

Wage increases have been restrained by persistent weakness in the labor market. With the manufacturing sector continuing to shed labor, employment stagnated despite increased demand from the construction and the public sectors, and the rate of unemployment remained virtually unchanged in 2002. However, rising sickness absenteeism and a cyclical contraction of overtime led to a fall in the number of hours worked. Nominal wages rose somewhat less rapidly than a year earlier, but strong productivity gains offset their impact on costs.

Despite the appreciation of the krona, competitiveness remains strong, reflected in the persistence of large current account surpluses. Helped by improved relative growth prospects, rising interest rate differentials, and a slowdown in portfolio outflows, the krona appreciated by more than 5 percent in effective terms and the unit labor cost-based real exchange rate by almost 6½ percent in 2002, gradually reversing some of the sharp decline of the previous two years. However, the current account surplus rose further to 4.2 percent of GDP as the lagged effects of the 2001–02 depreciation boosted exports—mainly in the first part of the year—and imports fell. Markets expect the krona to appreciate by another 5 percent vis-à-vis the euro in 2003.

Monetary policy has been quick to react to signs of weakness in the economy and heightened risks to the global outlook. After tightening in early 2002 on the back of accelerating inflation, the Riksbank reversed course toward year-end, when disappointing growth prospects in the euro area and increasing geopolitical uncertainties led to a reassessment of the inflation outlook. Judging the spike in inflation fueled by energy prices as temporary, the Riksbank cut rates twice in November and December. With the rapidly worsening external outlook, these cuts were followed by another 25 basis point easing in March 2003. As the international recovery appeared to be delayed and inflation prospects improved further, the Riksbank eased policy by a further 50 basis points in early June.

The rising trend of spending has eroded the exceptional strength of the public finances. The overall balance this year is expected to be 3 percentage points lower than in 2000, half of which is due to expenditure increases, mostly discretionary. In fact, with the structural balance projected to be 2¾ percentage points of GDP weaker over this same period, only part of this deterioration can be accounted for by cyclical conditions. The first three steps of a four-step program of tax cuts were accompanied by the ratcheting up of expenditure, particularly by local governments, and tax increases at the local level.

Fiscal policy remains anchored to the medium-term framework, centered on the target of a surplus of 2 percent of GDP over the cycle. The fiscal stance in 2003 is expected to be moderately contractionary. Despite the expected slowdown in economic activity and further discretionary spending increases, the structural surplus is projected to rise to almost 1½ percent of GDP. Faced with budgetary pressures, the authorities have postponed further income tax reductions indefinitely. In line with the fiscal rule specifying a 2 percent surplus over the cycle, the structural surplus is now projected to return to this level by 2005, as the output gap narrows.

Sweden faces subdued economic growth and rising unemployment in the near term. As weak external demand holds back exports, and imports recover from recent unusually depressed levels, the external sector is expected to contribute little, if anything, to growth in 2003. Public consumption is projected to slow sharply, and the continued weakness of the telecom sector will hamper an upturn in business investment. With high house prices and low interest burden providing ample support to household financial positions despite losses in stock market wealth, and the sharp rise in household saving rate over the past two years, private consumption is likely to hold up well, barring any unexpected shocks to confidence. All in all, economic growth is likely to remain significantly below potential, with continued unutilized resources. Inflation is expected to remain well below target over the next year.

Executive Board Assessment

Directors commended the authorities for the continued successful implementation of their well-designed fiscal and monetary frameworks, which have underpinned Sweden's strong macroeconomic performance of recent years. Despite some slowdown in growth, the economy has remained resilient in 2002 in the face of the global slowdown, with low unemployment and inflation and a large external current account surplus.

Directors concurred that short term economic growth is expected to be subdued, and that—with weak external demand holding back exports, and business investment hampered by spare capacity and uncertain prospects—demand appears increasingly dependent on the resilience of private consumption. While healthy household finances and low interest rates should continue to support consumer spending, increasing unemployment could, however, weaken confidence in the short term. Looking ahead, Directors considered that the Swedish economy is well placed to benefit from the projected global recovery, provided timely action is taken to further strengthen the economy's supply response by correcting rigidities in product and labor markets and the erosion of effective labor supply.

Directors commended the Riksbank for its skillful and proactive management of monetary policy and for its transparent communications strategy, which has enhanced the credibility of the inflation-targeting regime and provides a strong anchor to wage formation. They considered the recent substantial easing of monetary policy appropriate, in the light of an inflation forecast below target and the hesitant global recovery. The recent acceleration in headline inflation due to electricity prices is already reversing, and, with inflation expectations well anchored to the two-percent target and upside risks to inflation well contained, Directors saw room for some additional monetary easing if needed. They further noted that in view of Sweden's strong competitive position and provided wage moderation continues, a moderate appreciation of the krona would be sustainable over the medium-term.

Directors considered that in the event of a decision to join the European Monetary Union , Sweden's sound macroeconomic fundamentals position the country well for a smooth transition. Despite some recent deterioration, public finances remain strong and the available fiscal instruments appear adequate to protect the economy from asymmetric shocks in the absence of an independent monetary policy.

Directors agreed that Sweden's fiscal framework has generally worked well so far and remains fundamentally sound. At the same time, however, they cautioned that the strength of the public finances has begun to erode and that the framework has recently experienced strains, calling for appropriate policy responses in the period ahead. While the recent erosion is partly due to the cyclical slowdown, it also reflects a continued and—in the view of Directors—worrisome ratcheting up of discretionary public spending, in response to growing demand for higher public services, especially at the local government level. They therefore welcomed the authorities' firm commitment to preserve the credibility of the fiscal framework, and encouraged them to give careful consideration to proposals for further strengthening the framework with a view to reducing the pro-cyclicality in government finances, in particular at the local level.

Directors noted that the expenditure ceilings have so far been successful in restraining public spending growth at the central government level. They underscored, however, that preserving the credibility of the ceilings in the period ahead will require decisive action to curtail rising expenditure, particularly on sick leave expenses. They welcomed, in this context, the measures in the Spring 2003 budget to curb sickness leave costs, but many Directors felt that stronger efforts to affect incentives may well be needed. Some Directors regretted the authorities' decision to postpone setting an expenditure ceiling for 2005 until the autumn budget. Directors also encouraged the authorities to consider improvements in the fiscal framework to ensure that the margins under the ceilings are used only as a cyclical buffer and to link expenditure ceilings more explicitly to the surplus target.

Directors observed that the increase in public spending has stalled further progress on lowering the high tax burden, and that taxes might even rise further to meet pressures on local spending. They noted that prospects for a reduction in the tax burden may well recede as demographic pressures on public spending are expected to intensify in the coming years. Directors recognized that Sweden's welfare state continues to enjoy widespread support and that further tax rate cuts would be envisaged only if they can be afforded without jeopardizing the overall fiscal targets and the quality of public services. In view of the challenges arising from population aging, Directors, however, also considered that additional efforts to contain expenditure, particularly on social transfers, will be needed to preserve the welfare state and a strong fiscal position in the long run, while creating room for a desirable further reduction in the tax burden.

Directors underscored, in this context, that streamlining some of the generous social insurance provisions with a view to reducing disincentives to work would substantially improve long-term growth prospects. They considered that the high taxation of labor income and the high replacement ratios for social benefits, along with the generosity of the sickness and early retirement schemes, discourage labor force participation and work effort. Directors, therefore, encouraged the authorities to make a concerted effort to mobilize support for addressing these issues.

Directors also saw a need for a new impetus to structural reforms aimed at strengthening competition. Despite the progress made since participation in the European Union internal market, barriers to competition appear to remain in a number of sectors, as evidenced by the persistence of high price levels, which, Directors agreed, call for further measures to improve the functioning of markets. In this regard, they welcomed the recent strengthening of the Competition Authority.

Directors noted that Sweden's financial system is fundamentally sound and stable. While the decline in property values and rising unemployment are posing risks, bank profitability and capital adequacy remain at sound levels and non-performing loans low. Continued vigilance is, nevertheless, warranted, and Directors welcomed, in this context, the steps which the authorities are taking to further strengthen the financial system, following up on last year's Financial Sector Assessment Program recommendations.

Directors commended the authorities for their exemplary efforts to promote open trade policies and for the high level of official development assistance, which, at 0.74 percent of GNP, remains among the highest in the world.

It is expected that the next Article IV consultation with Sweden will take place on the standard 12-month cycle.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Sweden is also available.

Selected Economic Indicators

	1998	1999	2000	2001	2002	2003 1/	2004 1/
Real economy (in percent change)							
Real GDP	3.6	4.6	4.4	1.1	1.9	1.3	2.4
Domestic Demand	4.3	3.3	3.8	0.1	0.7	1.2	2.3
CPI	1.0	0.6	1.3	2.7	2.0	2.0	1.9
Open unemployment rate (in percent)	6.5	5.6	4.7	4.0	4.5	4.2	4.0
Participation in labor market programs (in percent)	4.1	3.3	2.6	2.5	2.6	2.5	2.4
Gross national saving (percent of GDP)	21.1	21.7	22.4	22.0	21.4	21.1	21.5
Gross domestic investment (percent of GDP)	17.2	17.5	18.5	18.1	17.2	17.5	17.9
Public finance (in percent of GDP)							
General government balance	2.3	1.3	3.4	4.6	1.1	0.4	1.0
Structural balance 2/	4.4	2.3	4.1	2.8	0.8	1.5	1.7
General government debt	69.3	62.6	52.9	54.4	52.4	51.0	50.0
Money and credit (12-month, percent change)							
M0	5.1	11.9	2.0	8.8	-0.9	3.3 3/	...
M3	2.1	9.9	2.8	6.7	4.5	5.0 3/	...
Credit to non-bank public	6.8	5.6	9.1	8.9	6.5	-5.5 3/	...
Interest rates (year average)							
Three-month interbank rate	4.2	3.1	4.0	4.3	3.8	2.8 3/	...
Ten-year government bond yield	5.0	5.0	5.4	5.4	5.1	4.1 3/	...
Balance of payments (in percent of GDP)							
Trade balance	6.2	6.1	5.6	5.7	6.1	6.5	6.5
Current account	3.9	4.2	3.9	3.9	4.2	4.5	4.6
Reserves (gold valued at SDR 35 per ounce end of period, in billions of SDRs)	14.3	15.3	15.1	14.2	17.4	19.1 4/	...
Reserve cover (months of imports of goods and services)	2.7	2.7	2.5	2.5	2.7	2.8 5/	...
Exchange rate (period average, unless otherwise stated)							
Exchange rate regime				Floating exchange rate			
Present rate (July 29, 2003)				US$ 1 = SKr 8.035			
Nominal effective rate (1995=100)	104.7	102.3	101.6	93.5	95.3	102.2 3/	...
Real effective rate (1995=100) 6/	107.9	104.5	103.7	94.0	96.0	102.6 4/	...

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

1/ Staff projections.

2/ In percent of potential GDP, also adjusted for timing of tax revenues.

3/ As of June 2003.

4/ As of May 2003.

5/ As of April 2003.

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

Statement by Benny Andersen, Alternate Executive Director for Sweden
and David Farelius, Advisor to Executive Director
July 25, 2003

Our authorities wish to express their appreciation to the staff for the constructive discussions in Stockholm and for an insightful and balanced report on the Article IV consultation. They also found the selected issues paper interesting and useful. Our authorities' views are largely in line with the assessments of the report.

After a period of strong growth and exceptionally good public finances the Swedish economy slowed down considerably in 2001, following the international downturn. Despite a relatively weak world economy the performance in 2002 was better, with a growth rate of 1.9 per cent, mainly due to a strong fiscal stimulus. A continued weak external demand, in combination with more restrictive fiscal policies, is expected to result in a renewed slowdown of economic activity in 2003. In response to lower inflation pressure the Riksbank has decided to reduce interest rates by 1.5 percentage points since the consultation in 2002. This means that the macroeconomic policy mix has shifted over the last year, with fiscal policy turning slightly contractionary, as a consequence of measures taken to preserve the credibility of the fiscal policy framework, while monetary policy has moved to a more expansionary stance.

Our authorities concur with the staff report that the risks to the economic outlook are mainly on the downside, stemming primarily from a weaker-than-expected global recovery. Our authorities agree with the staff that the fiscal and monetary policy frameworks have served Sweden well and that it is important to preserve the credibility of the policy framework. They also agree with the staff that further measures may be needed in order to foster a high and sustainable rate of economic growth and employment.

On September 14, a referendum on Sweden's entry into the European Monetary Union will take place. In the event of a "yes" vote in the referendum, the Swedish government has recommended that Sweden should strive to enter the EMU on January 1, 2006, and that this should be carried out through a direct changeover ("big bang") with the switch-over of all electronic transactions in society be made simultaneously with the cash changeover. A decision on participation in ERM2 and on the central rate and fluctuation bands at which the krona should join, in the event of a "yes" in the referendum, would be taken through common accord amongst the relevant EU and Swedish authorities.

Fiscal policy

The central target of fiscal policy, adopted by the government and the Parliament, is to maintain an average general government surplus equivalent to 2 percent of GDP over the business cycle. The main aim of this target is to strengthen the financial position of the general government sector in preparation for the consequences of the demographic changes that are expected over the coming decades. The surplus target is also important for maintaining sufficient scope for countercyclical variations of the fiscal balance without moving into a situation of excessive deficit as defined by the fiscal framework of the EU.

The fiscal policy framework is further underpinned by the system of nominal expenditure ceilings for the central government budget and a balanced budget requirement for the local authorities. The policy framework has worked very well so far, although it is not until recently that it has come under more considerable pressure, in the face of weaker economic activity and increasing expenditure pressures at the local level. The overall budget surplus is expected to reach 0.4 percent of GDP this year, down from 1.1 percent of GDP in 2002.

The government remains firmly committed to the fiscal framework. In the Spring Bill the government proposed a number of expenditure cut backs in order to avoid a breach of the expenditure ceilings. According to the projections of the Spring Bill the fiscal developments will be in line with the targets over the coming years. The average general government surplus over the period 2000-2006 is expected to be 2 per cent. According to the current expenditure plans the structural surplus is expected to be at the 2 per cent level in 2005. If the actual fiscal development turns out to be weaker than expected the government is prepared to take further measures in order to make sure that fiscal policy targets are respected.

The government has taken note of the proposals put forth in the staff report regarding possible measures to strengthen the fiscal policy framework and will consider them in the future process of refining the framework. The government, however, does not share the staff's view on the need to trim back the welfare state and to lower tax rates. Tax cuts will be considered if they can be afforded, without jeopardizing the fiscal policy targets and the quality of public services.

The government agrees with the staff report that there is a risk that the balanced budget requirement on the local authorities will have a pro-cyclical effect. The magnitude of the problem is, however, reduced by the fact that part of the local governments' tax base consists of taxable transfers to households, which tend to develop in a counter-cyclical manner.

Monetary Policy

Since the previous consultation, monetary policy has been conducted against the background of a prolonged period of international slowdown combined with a somewhat weaker domestic demand and a temporary increase in inflation due to higher electricity prices. Recurrent assessments that inflation one to two years ahead would be somewhat below the inflation target have warranted a more expansionary monetary policy. Consequently, the Riksbank has lowered the repo rate in five steps from November 2002 up to July 2003. The level of the repo rate has been brought down from 4.25 to 2.75 per cent.

The increase in inflation due to higher electricity prices occurred primarily in the period January to March 2003. However, the development had only a marginal effect on monetary policy since the increase was judged to be transitory with minor relevance for the forecast of inflation in the medium term. Moreover, this price increase appears to have had a very modest influence on general inflation expectations.

The appreciation of the krona since the previous consultation (some 4 per cent in terms of TCW) has reduced the expansionary effect of lower repo rates. The Riksbank assumes that some further strengthening of the krona will occur in the coming years primarily due to relatively favorable growth trends and a substantial surplus in the current account.

The Riksbank judges the degree of uncertainty in the forecast to remain large, although it has diminished somewhat recently. The probability of international economic activity growing at a lower rate than assumed is assessed as slightly higher than the probability of a higher rate of growth. The primary upside risks for inflation are still judged to be connected to electricity prices and wage costs. The future stance of monetary policy will as usually depend on new information on economic developments in Sweden and abroad and the effects this may have on inflation prospects in Sweden.

Structural policies

The main challenge of structural policies over the coming years is to raise and maintain a high level of employment. The financing of the Swedish welfare state is dependent on a high level of employment.

The government has adopted a target implying that at least 80 per cent of those between 20 and 65 years of age shall be employed by the year 2004. According to current projections the target is unlikely to be reached, partly due to unfavorable demographic conditions. The rate of employment is expected to fall slightly this year to 77.6 percent, down from 78.1 percent in 2002. A number of new measures, aiming to increase the supply of labor and employment, were announced in the government's Spring Bill. This includes a review of the marginal effects associated with moving from unemployment to employment.

The government shares the staff concerns about the sick leave developments. Several measures have been taken to curb the negative trend of the last years. In the Spring Bill the government proposed, among other things, a slight reduction of the replacement rate. These measures are expected to lead to a decline in the sick leave rate. There are already some signs that the number of people on sick leave may have started to decline.