Sweden—2013 Article IV Consultation: Concluding Statement of the Mission
Stockholm
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Sweden’s economy performed well through the crisis, but growth has moderated recently...

1. Growth has slowed in a difficult external environment. Recovering quickly from the Great Recession, Sweden led much of the rest of Europe in 2010-11, and its current account remains in strong surplus. But the economy decelerated in 2012 together with its main trading partners. Uncertainty about euro area developments contributes to weak investment. Housing credit continues to expand, despite the still high rate of unemployment. Headline inflation has recently turned negative and is well below the Riksbank’s target much due to the direct result of the Riksbank’s interest rate cuts. Core inflation as measured by the CPIF is somewhat higher, but still below target. This reflects the strengthening of the krona possibly exacerbated by safe-haven flows, as well as the opening of a small output gap. In real effective terms, the krona is still mildly below, but close to, its medium-term fundamentals.

2. The outlook is for gradual improvement. At about 1.1 percent, growth will remain modest this year. But it should gather speed by 2014, reaching 2.3 percent for the year, with exports and private expenditure picking up as the uncertainty associated with the euro area crisis slowly recedes. Unemployment is expected to decline only gradually, reflecting the lingering impact of the 2009 crisis and the time required for recent reforms to translate into employment gains.

...and there are downside risks compounded by financial fragilities

3. The economy will be faced with downside risks from both external and domestic sources. A re-intensification of the euro area crisis could hurt growth through negative shocks to trade and domestic demand. Importantly, it could also adversely affect Sweden’s banking sector, which at more than four times GDP is very large and relies heavily on wholesale funding. Financial fragilities are also a key risk at home. With household debt rising to more than 1.7 times of disposable income, a sudden and sizeable fall in house prices could have a flow-on effect to consumption and banks, raising unemployment and lowering inflation further, and pushing up non-performing loans and bank funding costs. Given the strong cross-Nordic activities of Swedish banks, such a scenario would also have spillovers across the Nordic region. Conversely, a sudden deterioration of household financial health elsewhere in the region poses risks for Sweden, with possible adverse feedback loops.
Policy priorities: supporting growth and buttressing financial stability

4. **Good policies are in place.** Monetary policy remains helpfully supportive and the fiscal stance of the 2013 Budget Fiscal Bill and Spring Fiscal Bill is appropriately mildly expansionary. If growth disappointed and inflation remained subdued for longer than expected, there could be room for additional interest cuts and consideration should be given to slowing the pace of structural consolidation. The authorities also continue to take ambitious steps to foster financial stability. Already in 2010, a Loan-to-Value (LTV) cap for household mortgages was introduced, as was more recently a risk weight floor for mortgages. The authorities have also strengthened capital requirements, in particular for systemically important banks.

5. **Securing financial stability is the main challenge ahead.** Notwithstanding the recent progress on financial regulation, household debt is still very high and increasing, and the large banking system remains a vulnerability to the economy. Strengthening the financial sector will help reduce the need for fiscal buffers, limit the requirement for stockpiling foreign liquidity at the Riksbank, and reduce excessive institutional reliance outside the Riksbank on monetary policy to address financial stability concerns.

Financial reform agenda

6. **Measures to minimize financial risk include gradual progress towards improving mortgage quality, bank capital, and funding stability.** In addition, consideration should be given to a phased-in reform to better balance the tax treatment of household assets—including through lowering tax deductions for mortgages and increasing residential property taxation—over the medium term to lower incentives towards the build-up of excessive household debt. As to financial reforms:

- Complementing the 85 percent mortgage LTV cap introduced in October 2010, financial stability would also be enhanced from a steady reduction of mortgage amortization schedules—currently averaging more than 140 years on mortgages with LTV below 75 percent and positive amortization—for example, through introducing minimum amortization requirements on new mortgages. This should be accompanied by additional improvements in the collection of disaggregated credit data collection by the authorities.

- While the introduction of the 15 percent floor for mortgage risk weights is an important and well-targeted measure, high household debt merits a considerably more conservative level in the medium term, by moving gradually towards the 35 percent risk weight of the standardized approach (Basel III).
In addition, banks’ high reliance on wholesale funding calls for launching gradual interim targets to ensure the implementation of the Net Stable Funding Ratio (as defined in the December 2010 publication of the Basel III regulatory frameworks for capital and liquidity) by 2018.

7. **Improving coordination of macroprudential policy is another key aspect of the financial reform agenda.** Recent proposals rightly stress the importance of information exchange between all relevant parties. But it will be just as crucial to ensure that all macroprudential policy tools are deployed in a timely and well-coordinated manner both in normal and crisis times. The first option would be putting all instruments at the disposal of the Riksbank, which is well-placed to oversee the macroeconomic and financial issues that may threaten stability. Alternatively, the FSA could be put in charge. In both cases, close consultation with others would be required. A third option would be to explore the possibility of delegating the final approval of decisions taken by individual authorities to a Council, with a composition similar to the one suggested by the Financial Crisis Committee, and with clear voting rules. Allocating different responsibilities and instruments to different decision makers would instead likely complicate rather than strengthen necessary macroprudential coordination.

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

*Monetary policy has to navigate a complex environment*

9. **Implementation of the financial reform agenda would allow the Riksbank to focus more on short-run macroeconomic stabilization.** In principle, household debt concerns should be addressed through macroprudential policy tools. However, if mortgage credit growth increases unsustainably, the Riksbank might have to raise the interest rate path relative to that warranted by short-run macroeconomic considerations alone. Similarly, with strong macroprudential policies in place, the need of the Riksbank in the future to resort to unconventional monetary policy will be minimized. And, at the same time, the Riksbank would be free to pursue its inflation target without being concerned about the long-term macroeconomic implications of its interest rate policy.

10. **Foreign currency reserves help support financial stability.** Even with the recent progress in improving banks’ liquidity standards, the Swedish banks remain vulnerable to sudden shortages of foreign currency liquidity. This calls for readily usable foreign liquidity broadly in line with the recent increase in borrowed reserves held at the Riksbank. Making
banks bear some of the costs of maintaining these reserves via a fee, ideally in a way proportional to each bank’s foreign liquidity gap, would provide the right incentives to manage liquidity risks. Introducing bank reserve requirements in foreign currency to be held at the Riksbank would create similar incentives and reduce the need for official reserves.

**Exploring improvements in the fiscal framework**

11. **The need for a fiscal buffer could be made more explicit.** The existing framework has been serving Sweden well, helping to bring general government debt to very low levels after the crisis of the early 1990s—a rare feat among advanced economies. The framework could be improved further by introducing an explicit long-term anchor that would ensure that the government’s fiscal buffer—that is, maintaining adequate room to borrow—is preserved. Explicitly providing for such a fiscal buffer could contribute to, for example, keeping actual debt ratios in a range well below the 60 percent debt-to-GDP ratio defined in the Maastricht treaty. The debt target range would have to be carefully selected. It would need to account for the changing needs to provide for cyclical budget swings, aging costs, and to retain a prudent borrowing capacity adequate for countries with large financial sectors such as Sweden. In this context, the authorities could explore the introduction of such a debt target range with a well-calibrated structural balance rule that also provides for higher public savings in case of larger-than-budgeted debt accumulation.

12. **In addition, it will be important to ensure that the fiscal framework remains sufficiently countercyclical.** There are indications that the general government budget has become less sensitive to the business cycle since the mid-2000s, with smaller automatic stabilizers and a more restrained discretionary response to shocks during the crisis. Greater countercyclical could be achieved in several ways: First, the new “rainy day” funds at the local government level should be administered under rules that promote their countercyclical use as intended. Second, the safety margins incorporated in the central government budget could be made contingent on a clear set of rules to enhance countercyclicality. In addition to continuing to use active labor market policy extensively, and maintaining in place the incentives to work, there might scope for a targeted re-enforcement of income-support policies to the more vulnerable members of the workforce.

**Structural reforms to boost resilience**

13. **Structural reforms to strengthen the labor market and relieve housing bottlenecks will add to the resilience of the economy.** Recent reforms have increased labor market participation, and eventually will reduce unemployment and further increase employment from current levels. To strengthen the impact on jobs and growth, it will be important to improve the matching process between workers and available vacancies and facilitate transition, especially from school to work. This is particularly important for vulnerable
groups such as those young and foreign born facing risk of long-term unemployment. This can be achieved, both by stimulating demand for these groups in a targeted way and by continuing to help them improve their job skills through training and education in the spirit of recent reforms. Further steps to make the supply of housing more responsive to demand would also be helpful, particularly to improve housing access in urban areas. This would involve several well-coordinated steps to increase land supply and to raise the incentives to invest in residential construction—for example through additional reforms of the rental market, simplifying building regulations, and increasing competition in the construction sector.

*The mission would like to thank the authorities and other counterparts for their hospitality and the high quality and openness of the discussions.*