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July 13, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Sweden - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Sweden. This subject has been tentatively scheduled for Executive Board discussion on Monday, August 6, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Knöbl (ext. (5)8821) or Mr. Mitra (ext. (5)8825).

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SWEDEN

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the
1984 Consultation with Sweden

Approved by L.A. Whittome and Subimal Mookerjee

July 13, 1984

I. Introduction

Article IV consultation discussions with Sweden took place in Stockholm from June 5 to 15, 1984. The Swedish representatives included officials of the Ministry of Finance, the Ministry of Foreign Affairs, the Riksbank, the National Debt Office, and the National Institute of Economic Research. The staff team consisted of Messrs. P. de Fontenay, A. Knöbl, J. Hauvonen, and S. Mitra (all EUR) with, as secretary, Ms. P. Watson (RES). Mr. de Fontenay and Mr. Knöbl also met with the Minister of Finance, Mr. Kjell-Olof Feldt and with the Governor of the Riksbank, Mr. Bengt Dennis. Mr. Arne Lindå, Alternate Executive Director for Sweden, attended the meetings as an observer. Sweden accepted the obligations of Article VIII, Sections 2, 3, and 4, on February 15, 1961.

During last year's Board discussion of the Staff Report on the 1983 Article IV consultation with Sweden (EBM/83/128, 9/2/83), Directors stressed inter alia the need to back up exchange rate policy with firm adjustment measures. They noted that the level of wage settlements could put the achievement of the official inflation target in jeopardy and called for adequately restrictive financial policies.

II. Report on the Discussions

1. Background

During the second half of the 1970s Sweden's economic performance deteriorated significantly relative to that of most other industrial countries (Chart 1). Growth of real GDP, of industrial production and of productivity lagged behind the industrial countries' average; profitability and competitiveness of the industrial sector worsened, leading to a decline in the relative size of the sector (Chart 2); both the government budget and the external current account deficits widened and had to be financed through official borrowing abroad; consequently, external debt began to accumulate to a level which, although not alarmingly high, implied a sizable burden of service payments.

The causes of this relatively poor performance are varied, but the priority given by the Swedish Government to the maintenance of a low level of unemployment in the face of an unfavorable international environment contributed to the rise of labor costs and to the decline of competitiveness and profitability; this, in turn, implied a slower growth of budgetary receipts and rising expenditure on public employment and employment maintenance programs. Attempts to stabilize the budget deficit involved a higher tax burden on enterprises, thereby worsening their financial position. The effects of the deterioration in competitiveness and in the public finances thus reinforced each other during that period.

2. The Government's strategy

The strategy adopted by the Government which took office in October 1982 was intended to correct the imbalances that had emerged during the 1970s. It consisted of a large (16 percent) devaluation, following a 10 percent devaluation a year earlier, aimed at improving competitiveness and profitability so as to reverse the relative decline of manufacturing production and employment, and of supporting policies. Various social measures were adopted in order to gain acceptance for a higher level of business profits, such as the institution of wage earners' funds (see RED) and an improvement in certain social benefits, and labor market support measures were also expanded.

Fiscal policy was to provide room for an expansion of exports and, subsequently, of investment. The central government budget deficit, which had risen rapidly for six years in succession was to be reduced both in 1983 and 1984, notwithstanding a rising burden of interest payments. Curbing inflation in order to preserve the gains in competitiveness was also a key element of the Government's strategy. Monetary policy was to play an important role in achieving this objective, in particular by preventing an excessive buildup of liquidity which, in the past, had resulted largely from monetary financing of the budget deficits. Finally, incomes and supply side policies, in a wide sense, were also to make a contribution.

3. Implementation of the strategy

As the recovery of exports proceeded faster than had been expected, increased emphasis had to be placed upon shifting resources to the tradeables sector and preventing a reacceleration of inflation. The stance of fiscal policy was tightened by the adoption in the autumn of 1983 of a package of measures that cut expenditures and increased revenues, and also by the presentation in January 1984 of a cautious central government budget for 1984/85. 1/ The Government also sought to influence expectations by reaffirming a 4 percent target for inflation in the course of 1984 and by announcing a 3 percent target for 1985. The budget further announced that the growth of broad money was to be limited to a 5 to 6 percent range during 1984.

1/ The fiscal year begins on July 1.

Fiscal policy has played an important role in dampening domestic demand and reducing public sector dissavings in 1983 and 1984 (Table 1). The outturn for the central government budget for 1983/84 indicates a strong rise in revenues (nearly 16 percent) despite the first full year effect of the income tax reform that provides for a reduction in the hitherto very high marginal rates of taxation. 1/ Total expenditures were reined back to show a rise of only 7 1/2 percent implying a reduction in volume terms of noninterest expenditures by about 4 percent. This performance reflected the operation of a 2 percent across-the-board reduction in current expenditures, as well as a "one-time" modification of indexation provisions on pensions and other household transfers. Expenditures on industrial subsidies and capital contributions to "ailing" industries were reduced from SKr 12 billion in 1982/83 to SKr 2 billion in 1983/84.

The central government budget for 1984/85 makes an attempt to consolidate the progress achieved in 1983/84; its stated strategy is to support the authorities' counter-inflation objectives. Total central government expenditures are estimated to rise by 4 percent in 1984/85 whereas revenues are estimated to increase by 10 1/2 percent to yield a deficit equivalent to 8 1/2 percent of GDP (compared with 10 3/4 percent of GDP in 1983/84). On the expenditure side the 2 percent reduction in current expenditure has been repeated and reduced indexation for expenditure on goods and services and certain transfers achieved by linking such outlays to the target rate of inflation for 1984 rather than to the actual inflation rate. Additional cuts have been made in various outlays, particularly on relief work (as the economic upturn is projected to lead to an increased demand for labor) and housing subsidies. The budget estimates for 1984/85 imply a reduction in the central government deficit since 1982/83 equivalent to 4 1/2 percent of GDP. The overall deficit of the public sector (including net lending) is projected to fall to the equivalent of 5 1/2 percent of GDP in 1984 from 8 1/2 percent of GDP in 1982, with over two-thirds of the decline accounted for by expenditure restraint.

Measures of a nonrecurrent nature, such as changes in the timing of tax collections, have made an important contribution to the improvement in the budget since 1982/83, but even abstracting from these extraordinary measures, the reduction in the underlying deficit as a ratio of GDP has been significant. Part of the improvement has resulted from an upturn in economic activity that has produced a strong growth in revenues. The mission argued that, as the scope for nonrecurrent measures diminished, attention should shift to discretionary cuts in expenditures, especially in transfer payments, and to reductions in the automatic indexation of various outlays, for the improvement in the public finances to be sustainable. The Swedish representatives pointed out that their own medium-term projections indicated the need to take further discretionary actions but

1/ Details of the reform of marginal tax rates can be found in SM/83/189, 8/18/83, page 36.

the Government believed that it was too early to specify the fiscal objectives beyond 1984/85. However, it was clear that with the high burden of taxation in Sweden, restraint would have to center on expenditure.

Table 1. Sweden: Public Finances

(In percent of GDP)

	1981/82	1982/83	1983/84 Projected outturn	1984/85 Estimates
Central Government				
Revenue	28.0	28.9	30.5	31.1
Expenditure	39.4	42.0	41.2	39.7
Budget balance	-11.4	-13.1	-10.7	-8.6
	1981	1982	1983	1984 Projection
Public sector				
Revenue	60.9	61.8	62.5	62.3
Expenditure (incl. net lending)	65.9	68.2	67.7	66.0
Balance	-7.2	-8.6	-7.4	-5.5
Volume growth in percent				
Revenue	2.8	1.9	4.2	2.8
Expenditure	4.5	4.0	2.2	0.6

Source: Sweden, Ministry of Finance.

Monetary policy has achieved a marked slowdown in the rate of credit expansion since mid-1982 (Chart 3). In part this reflects weak demand for credit from the business sector whose profit and liquidity position was improving rapidly. During 1983 and the first quarter of 1984 the business sector actually reduced its net indebtedness vis-à-vis commercial banks and interest rates have come down slightly (Chart 4). The introduction of new borrowing instruments in each year since 1982 (see RED) has facilitated a sharp increase in the share of the budget deficit financed by the nonbank public. This was seen by the Swedish representatives as an important development which put the monetary authorities in a better position to control credit expansion.

As in previous years, currency outflows through the balance of payments resulted in a slower growth of the money supply than of domestic credit expansion (DCE) both in 1983 and in the first half of 1984. The current account continued to be in deficit in 1983 and the private capital account recorded a sizable net outflow. While acknowledging that the reduction in the differential between Swedish and foreign interest rates contributed to the private capital outflow, the Swedish representatives did not regard the outflows as an indication that monetary policy was lax. They explained that Swedish firms had been induced by their ample liquidity to reduce their indebtedness vis-à-vis foreign lenders and that the expansion of export credits, linked to the upswing in export activity, was another factor.

Table 2. Sweden: Monetary Survey

(In billions of Swedish kronor)

	1980	1981	1982	1983	1984 1/
	(12 months to end-June)				
Central government	35	42	51	26	20
Budget deficit	(53)	(61)	(67)	(88)	(78)
Domestic borrowing outside banks	(-18)	(-19)	(-16)	(-62)	(-58)
Bank lending	20	5	24	24	15
Other	-7	-4	-5	-8	-8
Total domestic contribution to money creation	48	43	70	42	27
Balance of payments	-19	-13	-16	-11	...
Current account	(-17)	(-13)	(-16)	(-19)	...
Private capital	(-2)	(--)	(-1)	(7)	...
Increase in M_3	30	30	54	30	...
As a percentage of M_3 at the beginning of period:					
Domestic contribution	19	15	23	11	7
M_3	12	11	17	8	5

Source: Sweden, Riksbank.
1/ Preliminary.

The Swedish authorities have announced an objective for the growth of M3 of 5-6 percent during 1984. For the twelve months ending June 1984, the growth of DCE is estimated at only 7 percent of the money stock at the beginning of the period, compared with 23 percent for the corresponding period of 1982 (Table 2). The reduction in the share of the government deficit financed by borrowing from the banking system and from abroad accounted for most of the change. As the balance of payments continued to absorb a small and declining share of the domestically-created liquidity, the growth of M3 for the same period is estimated at only 5 percent. This slow growth must be judged, however, in the light of the fact that the economy is highly liquid: some of the public debt instruments recently introduced have a high degree of liquidity and enterprises have used them to invest their large cash holdings.

Financial markets have been strengthened, especially the stock market (where share prices rose by more than 300 percent in the four years 1980-83) and deregulation of the money markets has taken place (see RED). However, certain direct controls on banks and credit institutions and priority for credit allocation to certain borrowers, especially for housing, remain in force. In present circumstances, given that households--the main private borrowers from the banking system--are relatively insensitive to interest rate changes, despite the recent reduction in the deductibility of interest payments from taxable income, the Swedish representatives saw no scope for relying entirely on interest rate movements as a means of controlling credit expansion.

4. The results (1983-84)

a. External

The turnaround in the trade balance and the current account during 1983 was swifter than the Swedish authorities had expected. In part this was due to a strong recovery of world trade and a sharp rise in the export price and volume of some raw materials like wood products. But gains in market shares as a result of the 1981 and 1982 devaluations were also larger than expected, particularly as regards manufactured exports to industrial countries, which increased by 13.5 percent in volume in 1983, while market growth is estimated at only 4.5 percent. Export performance vis-à-vis developing countries was, however, less strong.

Although rising interest payments contributed to a deterioration in the balance on invisibles, the current account recorded a large improvement (Table 3). For 1984, a small deficit is officially forecast but the staff expects a small surplus. The backlog of foreign orders which was expanding very rapidly at the end of 1983 and the beginning of 1984 appears to have stabilized at a high level and further gains in market shares are projected both by the Swedish authorities and the staff, suggesting that the effects of the exchange rate adjustments are not yet exhausted.

Table 3. Sweden: Current Account Balance

(In billions of Swedish kronor)

	1980	1981	1982	1983	1984 Forecast Official	1984 Forecast Staff
Trade balance	-11.4	-2.0	-7.1	9.6	14.6	22
Invisibles (including transfers)	-7.8	-12.2	-15.1	-17.8	-15.6	-17
Current account	-19.2	-14.2	-22.2	-8.2	-1.0	5
(in percent of GDP)	(-3.7)	(-2.5)	(-3.6)	(-1.2)	(-0.1)	(0.6)

Sources: Figures supplied by the Swedish authorities; and staff forecast.

The Swedish representatives welcomed the improvement in the current account and the gains in market shares. They noted that among neighboring countries, Norway and Finland had been insulated by their exchange rate regimes, which maintain the effective exchange rate constant, and by their own devaluations, from the impact of Sweden's exchange rate adjustments, and Sweden's trade balance with both countries had deteriorated in 1983. The bilateral trade balance with Denmark had improved in 1983 but the improvement was partly due to slower growth of domestic demand in Sweden than in Denmark. As far as other countries were concerned, the Swedish representatives noted that the effect on them of a reduction in Sweden's current account deficit, which they regarded as desirable inter alia because of the need to halt the growth of foreign debt, was the same whether it came from an exchange rate change or from deflationary policies. They added that some of the gains to Swedish enterprises from the devaluation had been offset in part by a large reduction in subsidies to "ailing" firms (see RED) and by increases in payroll taxes and in nonwage costs. 1/

Since the October 1982 devaluation, the effective exchange rate of the Swedish krona has remained largely unchanged (Chart 5) but exchange market interventions have kept the krona within the upper half of the

1/ The real effective exchange rate (relative unit labor costs) remained virtually unchanged between the last quarters of 1982 and 1983. The reduction in industrial support in 1983/84 is equivalent to 7 1/2 percent of value added in mining and manufacturing.

narrow band maintained vis-à-vis the reference basket, in line with the Swedish authorities' commitment to follow an asymmetrical exchange rate policy in case of pressure in the exchange markets (see SM/83/170, 8/3/83, p.10).

Sustained upward pressure on the exchange rate has not developed so far: during 1983 and the first half of 1984, capital outflows prevented the improvement in the current account from being fully reflected in the overall balance of payments; official borrowing abroad financed both the current account deficit and the private capital outflow.

b. Domestic

Developments in 1983 and prospects for 1984 show that the Swedish authorities' goal of restoring profitability of industry, thereby setting the stage for a recovery of investment and employment in that sector, has been reached. Industrial production has recovered smartly since the second half of 1982 and a further strong growth is forecast for 1984. The combination of higher output and prices, while cost increases remained moderate, has pushed up profits to peak levels (Chart 6). Price performance, however, has fallen short of the target (see next section).

Table 4. Sweden: GDP and Expenditure Component

(Volume changes in percent)

	1974-81 Average	1982	1983	1984 Forecast Official	1984 Forecast Staff
Private consumption	1.1	1.1	-1.6	0.3	1/2
Public consumption	3.4	0.7	0.9	1.0	1
Fixed investment	-0.3	-1.6	-1.1	3.5	5
Of which:					
Private nonresidential	-1.4	-2.5	0.4	12.0	16
Inventories 1/	-0.4	-0.1	-0.1	1.2	1 1/2
Total domestic demand	1.0	0.4	-0.9	2.4	2 3/4
Exports (goods and services)	1.4	4.3	11.5	7.4	8 1/2
Imports (goods and services)	0.9	4.0	1.6	6.5	7
Foreign balance 1/	0.2	0.1	3.2	0.4	1
GDP	1.2	0.5	2.3	2.8	3 3/4

Sources: Figures supplied by the Swedish authorities, and staff forecast.

1/ Contribution to GDP growth.

On the demand side, the main stimulus to production in 1983 came from exports while consumption and investment remained depressed (Table 4). Real disposable income fell, as in 1982, by more than 2 percent and although the household savings rate declined further to zero (see RED), private consumption also fell in real terms. For 1984, the revised official forecast (presented in April) projects a continued strong growth of exports while stockbuilding and investment would make sizable contributions to the growth of domestic demand. With a recovery of imports--linked to that of investment--the contribution of the foreign balance to GDP growth would decline from 3 percent in 1983 to 0.4 percent in 1984. Real GDP is projected to increase by about 3 percent in 1984. The staff forecasts for 1984 a somewhat stronger growth of investment and exports, and consequently of GDP, and the Swedish representatives did not regard this as improbable. 1/

Achievement of the authorities' aim of strengthening the labor market and of reversing the decline of employment in the private sector recorded during the 1970s and in 1980-82, is also in sight. Employment rose in 1983, with part of the increase being due to hiring by local authorities. The contraction of industrial employment came to an end during the year and the decline in the number of vacancies, which had started in 1980, also ceased. A substantial increase in industrial employment is projected for 1984. Registered unemployment, which had risen from 2 percent in 1980 to 3.5 percent in 1983, is projected to decline slightly in 1984. However, the number of persons in employment schemes increased during 1983, and averaged the equivalent of 3.7 percent of the labor force. Emphasis has been placed on programs for young people--the rate of unemployment for those between 16 and 19 years old was reduced from 8.4 percent in March 1983 to 3.9 percent in March 1984--and on training programs.

5. Emerging difficulties and policy response

Cost and price developments, which had been restrained during 1983, have become an increasing source of concern for the Swedish authorities and led to the adoption in April 1984 of a package of measures designed to curb inflation, and to the preparation of additional measures to influence costs and prices in 1985.

Inflation in 1983 was little changed from 1982 (9 percent on average), despite the effects of the October 1982 devaluation and increases in indirect taxes. The impact of the devaluation on import prices was less than had been expected and unit labor costs in manufacturing rose by only one percent, as the spring 1983 wage round produced moderate settlements. Inflation, however, did not slow down during 1983 and in the first four months of 1984, although labor costs remained moderate, suggesting a widening of profit margins. Furthermore, since

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1/ National accounts statistics for the first quarter of 1984 (released at the end of June) suggest that the economy is fairly buoyant (see RED).

the June 1983 settlement for white-collar workers, wage settlements have been progressively higher and in the first months of 1984 the increases in earnings implied by the agreements reached in early 1984 ranged between 7 percent (public sector) and 10 percent (metal workers). Such wage increases were incompatible with the Government's target of reducing inflation to about 4 percent during 1984. In response, the Swedish authorities announced in early April a package of measures including a freeze on prices, rents and dividends, the sterilization of some of the enterprises and local authorities' cash holdings through compulsory two-year deposits at the Riksbank equivalent to 6 percent and 3 percent of their payroll, respectively, and compulsory three-year deposits equivalent to 3 percent of exports by the forest industries. The Swedish representatives explained that the price freeze was to be seen as a token of the Government's determination to prevent a worsening of inflation and as a means of influencing wage settlements and wage drift. They accepted that this type of measure had to be temporary.

In the discussion of the causes of the renewed inflationary pressures, the staff team suggested that the pace of expansion, particularly in the export sector, was straining productive capacity, in particular the supply of labor, and contributed to pushing up prices and wages. Data through the first four months of 1984 suggest a continued strengthening of economic activity. New export orders have expanded markedly during the final quarter of 1983 and the first quarter of 1984. The number of vacancies has been rising rapidly and shortages of skilled workers and engineers have been spreading. Some sectors, such as forest products, were already operating at full capacity (see RED). The Swedish representatives replied that the number of firms reporting full capacity utilization or shortages of skilled workers was below what it had been during previous economic upswings, though they acknowledged that some of those earlier periods of expansion had been associated with excessive inflationary pressures. Higher rates of capacity utilization were in any case desirable in order to encourage firms to invest in new capacity. They emphasized that, in contrast with previous cycles, the firm demand management policies pursued by the authorities should prevent an overheating of the economy.

Since the April measures, the authorities have been discussing with unions and employers' organizations alternatives for securing more moderate wage settlements. The Government has proposed a limit of 5 percent for increases in average earnings in 1985, which, given the carryover from 1984 would leave practically no room for new contractual wage increases. The discussions have proved difficult: after several years of declining real wages, workers want a share of the large profits business is making. Furthermore, in 1984, wage negotiations took place in a decentralized framework which encouraged "leap-frogging." While most settlements do not provide explicitly for price indexation, they generally feature (as in the public sector) a clause that guarantees maintenance of existing differentials in line with Sweden's tradition of egalitarian wage increases.

Should negotiations with the social partners reach a stalemate, the Swedish authorities stood prepared to tighten financial policies. The Swedish representatives agreed with the staff team that at any rate, the prospects for strong growth of exports and investment in both 1984 and 1985 required that room be provided by reducing public sector dissaving and raising private savings. They viewed the results of staff calculations suggesting a need for a reduction in the public sector deficit equivalent to 2 percent of GNP in 1985 as not inconsistent with their own medium-term strategy (see next section) and they recognized that a significant part of the improvement would have to come from discretionary measures.

The Swedish representatives also agreed with the staff team that the authorities' target for the growth of M_3 in 1984 implied a need for higher interest rates. A rise in domestic interest rates would widen the differential between Swedish and foreign nominal rates, which had narrowed over the past eight months, and contribute to a better balance in the private capital account (Chart 4). It would also stabilize the large amount of liquidity held by the nonbank sector, some of it in the form of short-term Treasury bills, and prevent its use for transaction purposes. With the likelihood that the current account would be in balance or even in surplus in 1984, credit expansion would need to be slowed roughly to the same rate of growth as that targeted for M_3.

The Swedish representatives did not regard an exchange rate adjustment as an effective way of influencing wage developments presently under way. Should a current account surplus emerge, they saw repayment of official external debt or relaxation of exchange controls as two possible options. A revaluation of the krona could be considered if both the strength of the balance of payments and the competitiveness of Swedish industry proved durable. But the Swedish representatives noted that so far the current account was only barely in equilibrium despite very favorable conditions, both in terms of competitiveness and foreign demand. The staff mission agreed with the Swedish representatives that in certain circumstances it could be appropriate for Sweden to run a current account surplus and a private capital account deficit so long as the latter did not reflect credit conditions easier than those required by domestic price objectives. However, given the strength in the current and prospective underlying current account position, and the benefits of an appreciation of the exchange rate in terms of lower inflation and reduced pressures on productive capacity, it would be desirable to allow upward pressure in the exchange market to be reflected in the exchange rate.

After the completion of the consultation discussions, the Swedish authorities, on June 28, lifted the price freeze and raised the official discount rate by 1 percentage point (to 9.5 percent) and the so-called penalty rate on borrowing above a certain level by commercial banks from the central bank by 2 percentage points (to 13.5 percent). It was also announced that agreement with the main labor market partners had been reached on the Government's proposal that wage increases for 1985 should not raise average earnings by more than 5 percent. Discussions will continue on ways to implement the proposal, including the Government's request that all settlements for 1985 be completed before the opening of the next Parliamentary session in October 1984. The Minister of Finance is reported to have said that the agreement was not a guarantee that wage rises would be held to an acceptable level and that the Government would intervene if increases clearly exceeded the target.

Given the uncertainties surrounding wage and price developments and the outcome of the negotiations with labor market partners, the Swedish representatives were reluctant to present an economic forecast for 1985. They agreed that investment and exports should remain buoyant next year, with further gains in export market shares likely to take place. The main uncertainty concerned the behavior of earnings. Should the Government be successful in limiting earnings, the recovery would be broadly based, with the rate of growth of GDP around 3 percent, according to staff estimates.

Prospects for inflation and the balance of payments are also linked to wage developments. By the end of 1984, the rate of inflation is expected to be down to about 6 percent (from 9.2 percent at the end of 1983). A ceiling of 5 percent on increases in wage earnings in 1985 would be consistent with the Government's objective of reducing the rate of inflation to 3 percent during the year, but some slippage is likely. If that slippage remains modest, and the growth of domestic demand does not accelerate, staff projections show a somewhat larger current account surplus in 1985.

6. Medium-term issues

The Swedish authorities have stated that they aim to achieve a surplus on the current account of the balance of payments in order to reduce external indebtedness. The Ministry of Finance has analyzed the implications for macroeconomic policy of the target of a current account surplus equivalent to 1 percent of GDP by 1990 in the form of medium-term scenarios which also aim at a return to full employment and low inflation. The scenarios point out the need to reduce the public sector financial deficit to less than 1 percent of GDP by 1990 to make room for the current account surplus and the recovery in investment, and to develop a new system of wage determination if full employment and low inflation are to be achieved simultaneously. Otherwise, the relationships that obtained during the 1970s would indicate that the recent gains in competitiveness would be eroded, as the economy moved closer to full employment. Measures directed at greater labor mobility and better training facilities would also be necessary. The Government has not yet taken a position on these projections.

The Swedish representatives believed that Sweden's disappointing economic performance since the mid-1970s was largely explained by persistent macroeconomic imbalances. They noted that it had been found difficult to establish clear causal links between the size of the public sector or the ratio of taxes to GDP and the general performance of the economy. Nevertheless, they recognized that certain structural problems hindered the efficient functioning of labor and capital markets. In particular, geographical and occupational mobility of the labor force was too low, and the endemic shortage of skilled workers and technicians was related to low wage differentials, particularly in post-tax terms. In this connection, the income tax reform was believed to be of assistance; it would also sharpen savings incentives and reduce the incentive to borrow. At the same time the Swedish representatives pointed out some of the strengths of Swedish industry, including a high level of Research and Development expenditure and a highly qualified labor force.

Total gross medium- and long-term external debt stood at US$29 billion (34 percent of GDP) and the net total debt (including short-term items) at US$21 billion (23 1/2 percent of GDP) at the end of 1983. The Swedish representatives felt that Sweden did not have an external debt problem and faced no difficulty in raising funds abroad, but that nevertheless the debt burden would have to be reduced over time. Staff estimates suggest that developments in 1985 and subsequent years will depend significantly on the stance of domestic policies relative to those abroad. Assuming unchanged competitiveness, and demand growth in Sweden being no higher than abroad, total net debt would decline relative to GDP from 23 1/2 percent in 1983 to 12 percent by 1990 (Table 5 and Chart 7). The debt service ratio, would fall from 18 percent in 1983 to 13 percent in 1990. Of course, these projections are sensitive to the assumptions made and should serve as no more than an indication of trends. Indeed, the present calculations are based on the end-1983 maturity structure, which showed a bulge in amortization payments in the mid-1980s; some major refinancing operations in mid-1984 have in fact increased the average maturity of debt and virtually removed this bulge.

7. Trade and aid

Sweden is committed to a policy of free trade. Through EFTA and the trade agreement with the EC, trade in industrial goods with the EC and EFTA members is duty-free. Sweden has also implemented several measures to facilitate trade with developing countries, including a General System of Preference. It is participating in the current "roll-back" process, notwithstanding the fact that Sweden did not introduce any new restriction during the recession, and it has endorsed the proposal for a new GATT round.

The only sectors of importance where restrictions are in force are textiles and agriculture. Restrictions on textiles imports are taken under the Multi-Fiber Agreement and they have not prevented imports from supplying more than four-fifths of domestic consumption. As already indicated, Sweden has reduced sharply industrial as well as export credit subsidies. As far as trade in services is concerned, the question of the establishment of foreign banks in Sweden is under study by a special commission. Another commission has proposed opening the insurance sector to foreign companies but the Government has not yet acted on the proposal.

Table 5. Sweden: Illustrative Medium-Term Debt Projections 1/

	1983	1984	1985	1986	1988	1990
Gross total debt in percent of GDP	50.2	46.1	45.2	43.5	40.0	36.0
Net total debt in percent of GDP	23.6	21.2	20.2	18.7	15.5	11.7
Current account in percent of GDP	-1.2	0.6	0.7	1.0	1.5	2.1
Gross debt service ratio 2/	18.2	16.8	17.9	19.2	16.6	13.3
Net debt service ratio 3/	13.3	11.7	12.1	13.8	11.1	8.2
Net interest payment ratio 4/	7.2	6.4	6.3	5.6	4.7	3.5

Sources: Data provided by the Swedish authorities; staff calculations and estimates.

1/ The figures correspond to moderate demand management in Sweden (see Chart 7), assuming unchanged competitiveness.
2/ Interest payments on total debt plus amortization of medium- and long-term debt relative to exports of goods and services. The amortization figure for 1983 was adjusted to remove the distorting effect of early repayments.
3/ Total interest payments less receipts plus amortization payments less receipts on medium- and long-term debt and assets relative to exports of goods and services. The 1983 figure is adjusted to remove the distorting effects of early repayments.
4/ Total interest payments less receipts as a ratio to exports of goods and services.

Sweden's official development aid is budgeted at SKr 7 billion in 1984/85 (0.95 percent of GDP) or well in excess of the official UN target; in 1983/84 aid expenditure was equivalent to 1 percent of GDP. The authorities have adopted an internal target of 1 percent of GDP, to which they intend to revert within a short period. Only about 15 percent of total ODA is tied to purchases in Sweden. Nearly all assistance is in the form of grants.

III. Staff Appraisal

In the past 18 months, Sweden has made rapid progress toward correcting some of the major imbalances which had affected its economy since the mid-1970s. The external current account, in deficit equivalent to 3 1/2 percent of GDP in 1982, is likely to record a surplus this year for the first time since 1973, which should allow net official foreign borrowing to be halted; competitiveness and profitability of industry have been restored and, as a result, a strong recovery in investment activity is now under way, which will begin to reverse the relative decline of the tradeable sector over the past decade; and the budget deficit of the Central Government has been reduced from a peak equivalent to more than 13 percent of GDP in FY 1982/83 to an expected 8 1/2 percent in FY 1984/85. At the same time unemployment remains well below what it is in most other industrial countries and employment has begun to rise.

The staff is concerned, however, about the sustainability of the recent improvement. Its views, which differ from those of the Swedish authorities, are that the combination of two sizable devaluations and the upturn in the world economy have imparted too strong a stimulus to the industrial sector, straining productive capacity in certain branches and generating tensions in the labor market. The escalation of wage claims and settlements and the widening of profit margins are worrisome manifestations of such tensions. The Government's objective of lowering Sweden's rate of inflation in order to safeguard the recent gains in competitiveness is thus in danger.

The authorities reacted in the spring to the worsening prospects for inflation by freezing prices and a portion of enterprises' and local authorities' cash holdings, and by initiating discussions with unions and employers' organizations on wage moderation. These talks are reported to have made good progress and resulted in an agreement in principle on limiting the rise in wage costs to 5 percent on average in 1985. The staff would, however, caution against excessive reliance on incomes policy to contain inflationary pressures. Unless these pressures are curbed through appropriate financial policies, they are likely to surface in the form of wage drift or even of a breakdown of the agreement.

The Swedish authorities have, at an early stage, recognized the need for supportive financial policies if their economic strategy was to be successful. By contrast with most previous expansions, demand management has been generally firmer. Fiscal policy has been tightened--the reduction in the public sector deficit in 1983 and 1984 together is estimated at about 3 percent of GDP--and there has also been a marked deceleration in credit expansion since mid-1982. The efficiency of monetary policy has been enhanced in recent years by the introduction of new instruments, though reliance on direct controls has continued.

The staff believes, however, that the likelihood of a stronger foreign trade performance and investment recovery than expected and the danger signs appearing on the wage and price front call for further tightening in both 1984 and 1985. The magnitude of the desirable reduction in the public sector deficit which was discussed with the Swedish representatives (about 2 percent of GDP in 1985) implies a considerable discretionary effort, particularly in view of the various nonrecurrent budgetary measures taken so far. Given the high level of taxation, restraint needs to be concentrated on the expenditure side. The Swedish authorities have indicated that if the agreement with the social partners was not moderating wages and prices sufficiently they would take new measures to ensure that inflation was reduced. The staff believes that it would not be prudent to wait until evidence of slippage is overwhelming and that firmer policies are required in any case.

On June 28, the Swedish authorities ended the price freeze and raised domestic interest rates by 1-2 percent. The staff welcomes these actions. The price freeze could only be of temporary benefit and the combination of a highly liquid economy and rising interest rates abroad had been reflected in a higher level of capital outflows. The rise in interest rates should allow a further reduction in credit expansion, which must be consistent with the target for price developments, and stabilize the liquidity held by the nonbank sector. It may prove necessary, however, to take further action, either because foreign interest rates continue to rise or because inflation does not decline sufficiently.

The Swedish authorities' commitment to an asymmetrical exchange rate policy in case of pressure in the exchange market remains appropriate, in combination with firm counter-inflationary financial policies. Notwithstanding reductions in industrial subsidies and increases in enterprises' wage and nonwage costs, the competitive position remains strong and the underlying current account may improve further, particularly if the agreement reached between the Government and the labor market partners is effective in limiting wage increases in 1985. In these circumstances, any upward pressures which might develop on the exchange rate should be allowed to be reflected in an appreciation of the Swedish krona, rather than be offset by a relaxation of monetary policy. This would also contribute to reducing inflation and relieving pressures on productive capacity in the export sector.

The staff welcomes the sharp reduction in industrial subsidies which has taken place in the past 12 months and notes that Sweden's commitment to an open foreign trade system and to a high level of foreign aid remains strong.

It is recommended that the next Article IV consultation with Sweden be held on the standard 12-month cycle.

Fund Relations with Sweden

(As of end-June 1984; in millions of SDRs)

I. Membership status

(a) Date of membership: August 31, 1951.

(b) Status: Article VIII from February 15, 1961.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 1,064.3 million

(b) Total Fund holdings of kronor: SDR 830.6 million (78.0 percent of quota).

(c) Fund credit: none.

(d) Reserve tranche position: SDR 250.7 million.

(e) Current operational budget: the krona is in the current budget; maximum use SDR 25.1 million.

(f) Lending to the Fund: Sweden has agreed to participate in the new facility via the BIS.

III. Stand-by or extended arrangements and special facilities

None.

IV. SDR Department

(a) Net cumulative allocation: SDR 246.5 million.

(b) Holdings: SDR 143.0 million or 58.0 percent of net cumulative allocation of SDR 246.5 million.

(c) Current designation plan: the krona is included in the current plan to a maximum amount of SDR 39.7 million.

V. Administered accounts

Sweden has made a total donation of SDR 2.2 million to the supplementary financing facility subsidy account.

VI. Overdue obligations to the Fund

None.

VII. Sweden has not used Fund resources to date.

B. Nonfinancial Relations

VIII. Exchange rate arrangements

The Swedish krona has been pegged to a basket of 15 of Sweden's main trading partners since August 29, 1977 when Sweden left the European common margins arrangements, having undertaken three devaluations totaling 16 percent in 1976-77. The benchmark index for the krona was changed to 111 (August 29, 1977 = 100) on September 14, 1981, implying a devaluation of 10 percent; and again to 132 on October 8, 1982, representing a devaluation of 15.9 percent.

IX. Last Article IV consultation

Discussions for the 1983 Article IV consultation were held in Stockholm during the period June 13-23, 1983. The Staff Report (SM/83/170, 8/3/83) was discussed by the Executive Board on September 2, 1983 (EBM/83/128). It is expected that the next consultation will be held on the standard 12-month cycle.

Sweden - Basic Data

Area and population

Total area	486,661 square kilometers
Total population	8.33 million

Composition of GDP (in 1983, at current prices)	In billions of kronor	In percent of GDP
Private consumption	361.3	52.0
Public consumption	203.7	29.3
Investment	119.1	17.1
Exports of goods and services	252.2	36.3
Imports of goods and services	240.9	-34.7
Gross domestic product	695.4	100.0
(In SDRs per capita)	(10,186)	

	1980	1981	1982	1983 Est.
	(Annual percentage changes)			
National accounts (at constant prices)				
GDP	1.9	-0.6	0.5	2.3
Domestic demand	2.8	-2.8	0.4	-0.9
Private consumption	0.2	-0.7	1.1	-1.6
Public consumption	2.3	2.2	0.7	0.9
Gross fixed investment	3.4	-5.3	-1.6	-1.1
Imports of goods and nonfactor services	1.1	-5.5	4.0	1.6
Exports of goods and nonfactor services	-1.6	2.0	4.3	11.5
Employment and prices				
Unemployment rate (in percent of labor force)	2.0	2.5	3.1	3.5
Total employment	0.2	-0.6	0.1	0.7
Mining and manufacturing employment	-1.2	-3.7	-3.2	-1.8
Other private employment	1.8	1.2	0.9	0.2
Public service employment	2.9	1.7	1.7	1.6
GDP deflator (average)	11.7	9.4	8.5	9.2
Consumer prices (average)	13.7	12.1	8.6	8.9
Unit labor costs (manufacturing, fourth quarter)	12.4	9.6	2.4	0.9
Labor productivity	1.9	0.4	0.2	1.4
Labor productivity (mining and manufacturing)	1.5	0.2	0.7	7.7

Sources: Data provided by the Swedish authorities; and staff calculations and estimates.

Sweden - Basic Data (continued)

	1980	1981	1982	1983 Est.
	(Annual percentage changes)			
External sector				
Export volume 1/	-2.3	0.9	3.8	12.0
Market growth 2/	5.5	1.3	1.4	2.7
Market share	-7.8	-0.4	2.4	9.3
Effective exchange rate (fourth quarter)				
Nominal (MERM)	-0.6	-12.0	-14.7	-3.1
Real (unit labor costs)	--	-6.8	-17.8	-0.1
Monetary sector				
Broad money	12.3	14.3	7.8	8.1
Contributions from				
Central Government	14.1	15.2	8.4	7.4
Bank lending	7.6	2.6	6.3	6.5
Other domestic	-1.5	-0.9	-1.4	-2.2
External balance	-7.9	-2.6	-5.6	-3.5
	(In percent of GDP)			
Public sector				
Financial balances				
Central government	-7.0	-8.2	-9.5	-7.8
Local authorities	--	--	0.2	--
Social security	3.2	3.3	3.0	2.7
Overall public sector	-3.8	-5.0	-6.4	-5.2
Net lending financed by budget	2.7	2.1	2.2	2.2
Central government deficit	10.1	11.6	13.4	11.5
Public sector deficit	6.5	7.2	8.6	7.4
	(In billions of SDRs)			
Exports, f.o.b.	23.6	24.0	24.0	25.4
Imports, c.i.f.	25.6	24.4	25.0	24.3
Trade balance	-2.1	-0.3	-1.0	1.2
Services and transfers, net	-1.4	-2.0	-2.3	-2.2
Current balance	-3.4	-2.4	-3.3	-1.0
(in percent of GDP)	(-3.7)	(-2.5)	(-3.6)	(-1.2)
Capital account (excluding Central Government and Riksbank)	-0.3	1.4	0.9	-0.7
Overall balance	-3.7	-1.0	-2.4	-1.7

1/ Total export of goods.
2/ Sweden-weighted world non-oil imports volumes.

Sweden - Basic Data (concluded)

	1980	1981	1982	1983 Est.
	(In billions of SDRs)			
Gross external debt (end-period)	26.9	31.6	35.2	41.7
Net external debt (end-period)	9.0	12.8	16.9	19.6
Debt service ratio (gross, relative to exports of goods and services, in percent)	11.1	15.6	18.5	18.2

Sweden - Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

		Latest Date in July 1984 IFS
Real sector	- National accounts	1983
	- Prices	April 1984
	- Production	March 1984
	- Employment	March 1984
	- Earnings	1st Qtr. 1984
Government finance	- Deficit/surplus	1982
	- Financing	1982
	- Debt	1982
Monetary accounts	- Central bank	May 1984
	- Deposit money banks	December 1983
	- Other financial institutions	4th Qtr. 1983
External sector	- Merchandise trade: Values	May 1984
	- Merchandise trade: Prices	April 1984
	- Balance of payments	4th Qtr. 1983
	- International reserves	May 1984
	- Exchange rates	May 1984

During the past year, the reporting record of the IFS correspondent has been excellent.

2. Outstanding statistical issues

Government finance

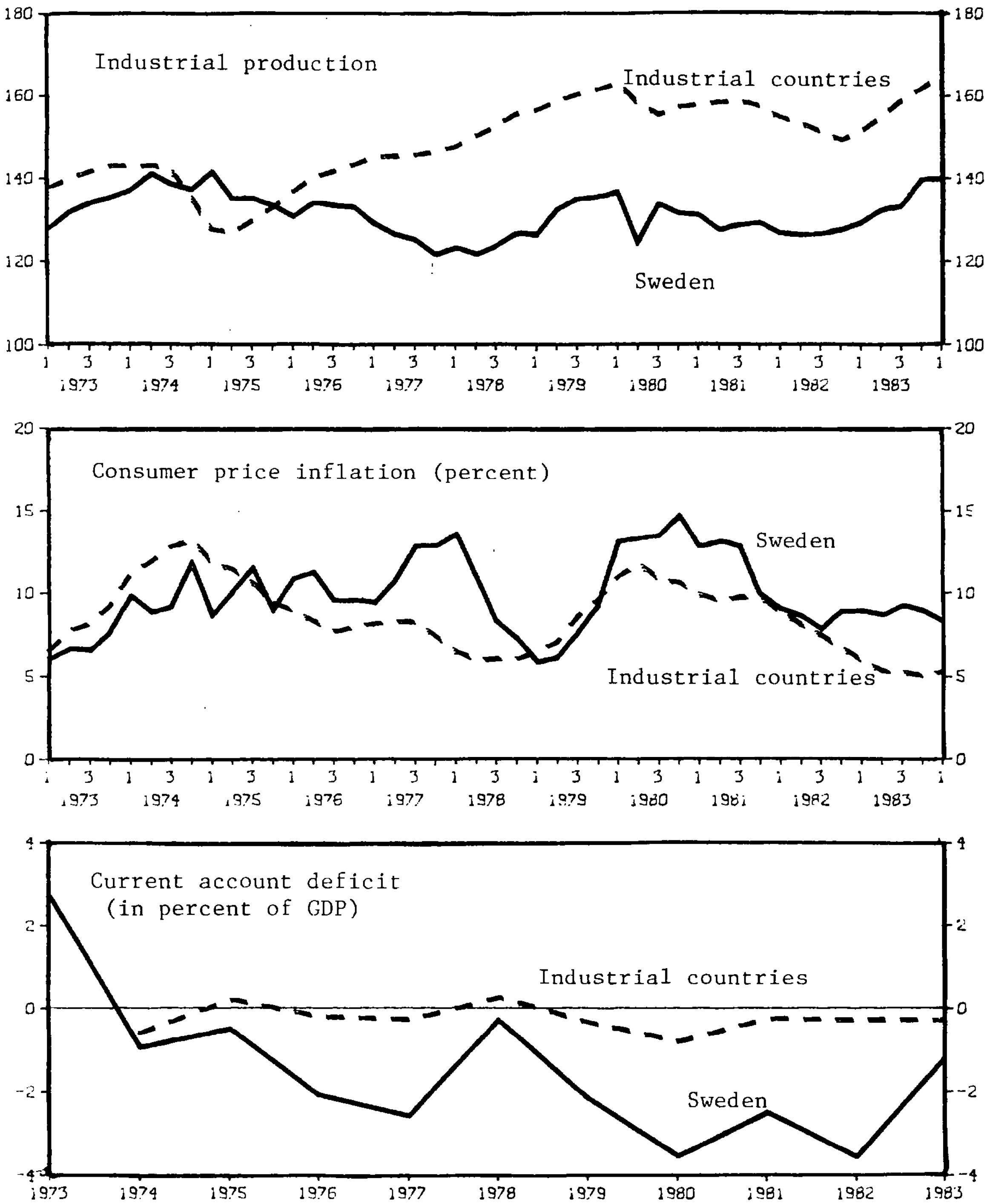
Monthly data in IFS relate only to the Central Government including lending transactions through the special funds. The possibility of adding monthly or quarterly data including the transactions of the National Insurance Fund and extrabudgetary operations of Central Government has been discussed with the GFS correspondent.

Monetary accounts

Since January 1983, the Swedish authorities have combined deposit money banks' demand deposits and time and savings deposits into one account due to a reform in their bank reporting system. Therefore, money and quasi-money data cannot be derived for the Monetary Survey on Sweden's page in IFS.

CHART 1

SWEDEN AND INDUSTRIAL COUNTRIES



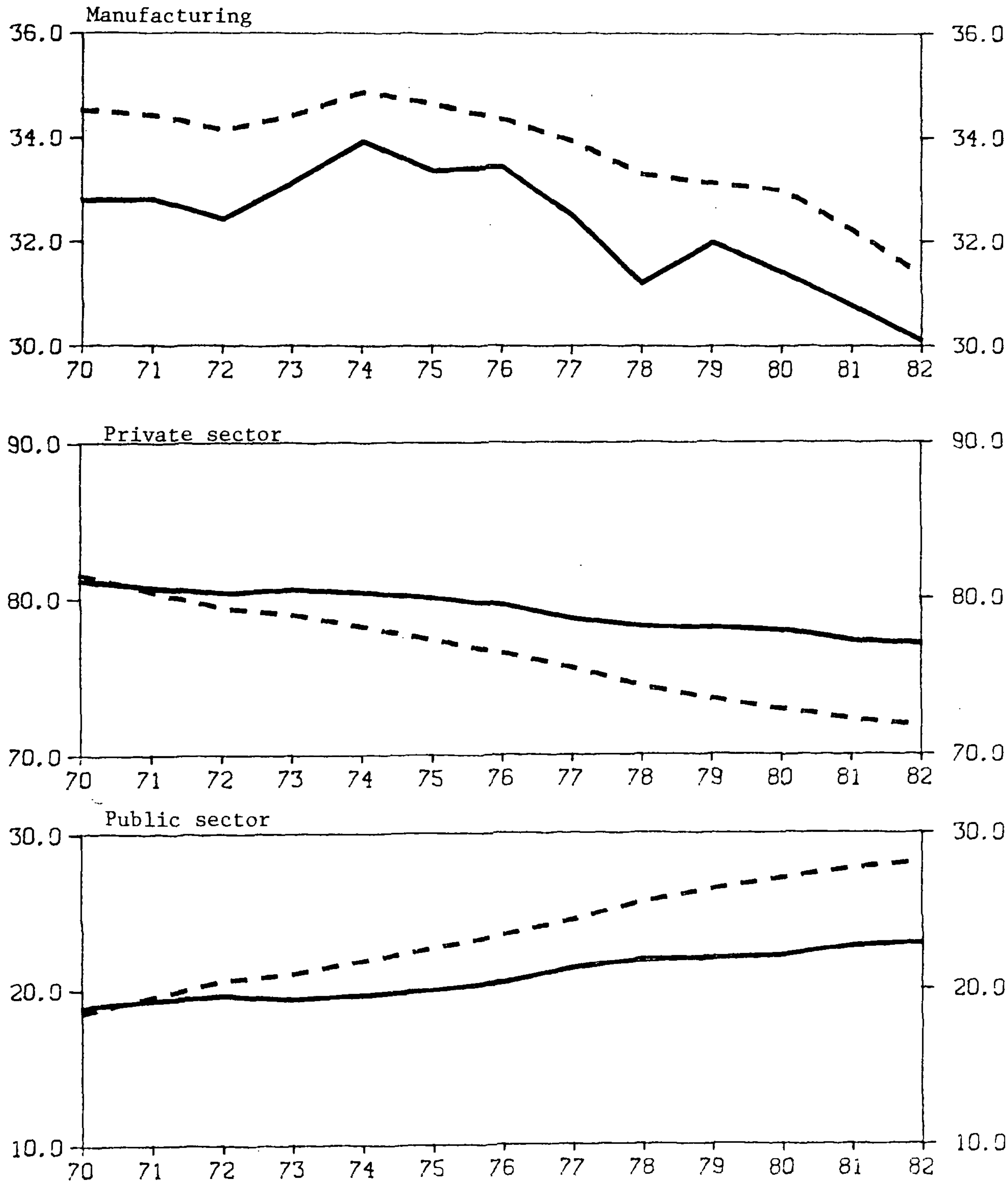
Source: Data provided by the Swedish authorities; and IMF, International Financial Statistics.

CHART 2

SWEDEN

SHARES IN TOTAL VALUE ADDED AND EMPLOYMENT

(— value added; --- employment)



Source: Central Bureau of Statistics; National Accounts.

CHART 3

SWEDEN

CONTRIBUTIONS TO LIQUIDITY GROWTH 1/
(In percent)

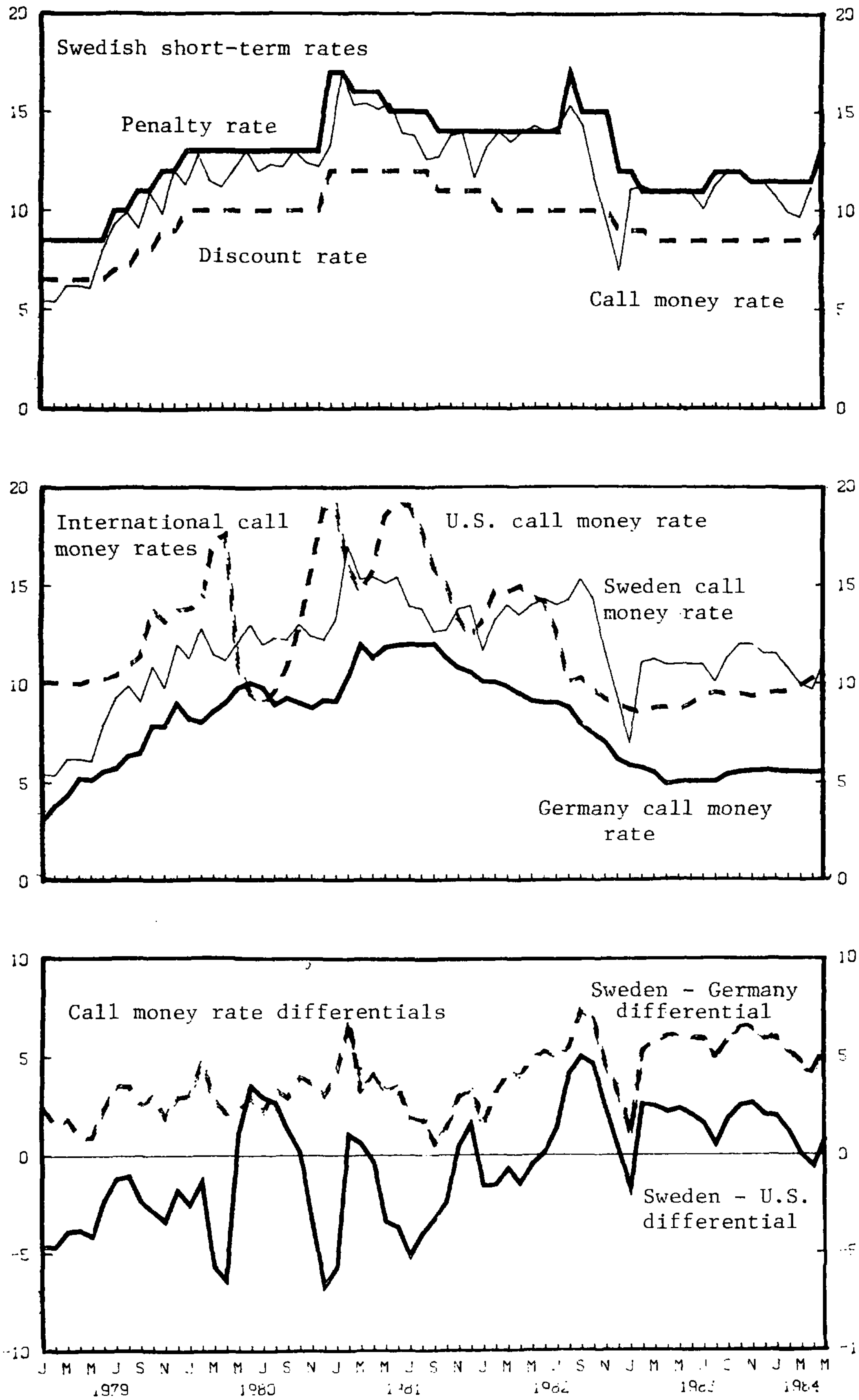
Source: Data provided by the authorities. 1984 data are preliminary.

1/ Twelve months change in percent of initial money stock.

CHART 4

SWEDEN

CALL MONEY INTEREST RATES
(In percent)

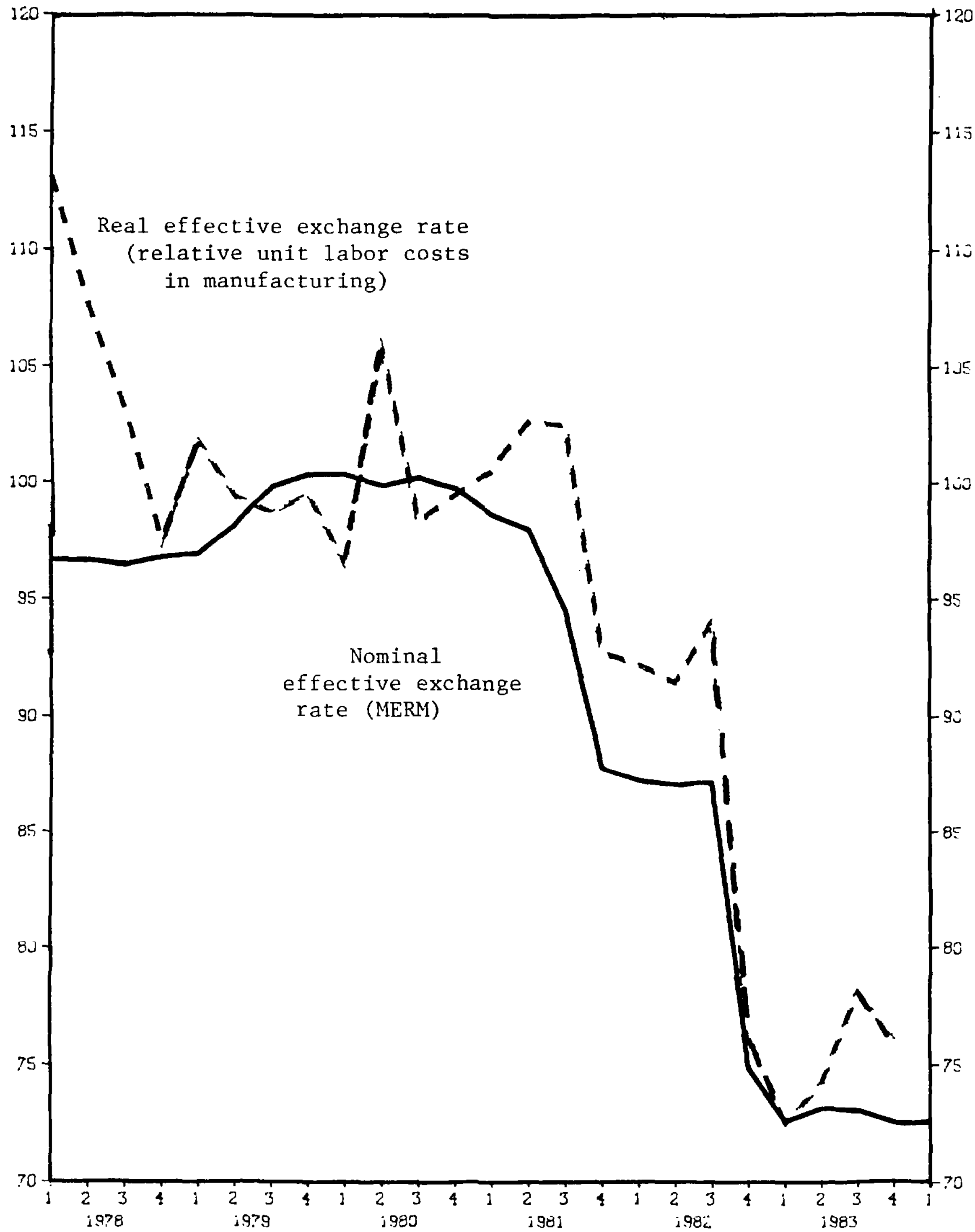


Sources: Data provided by the Swedish authorities; and IMF, International Financial Statistics.

CHART 5

SWEDEN: EFFECTIVE EXCHANGE RATES

(1980 = 100)

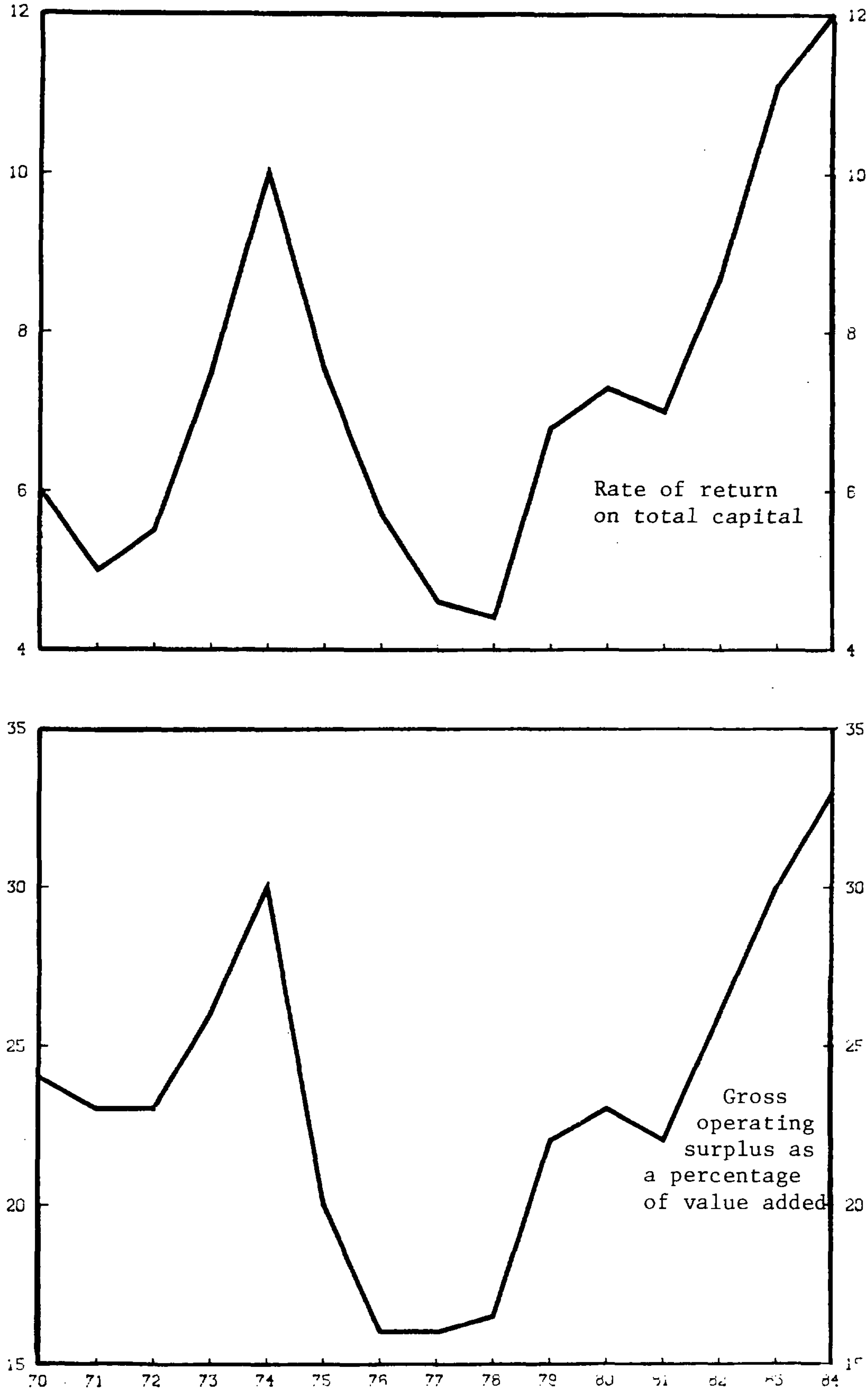


Source: IMF, International Financial Statistics.

CHART 6

SWEDEN

PROFITABILITY IN MANUFACTURING
(In percent)

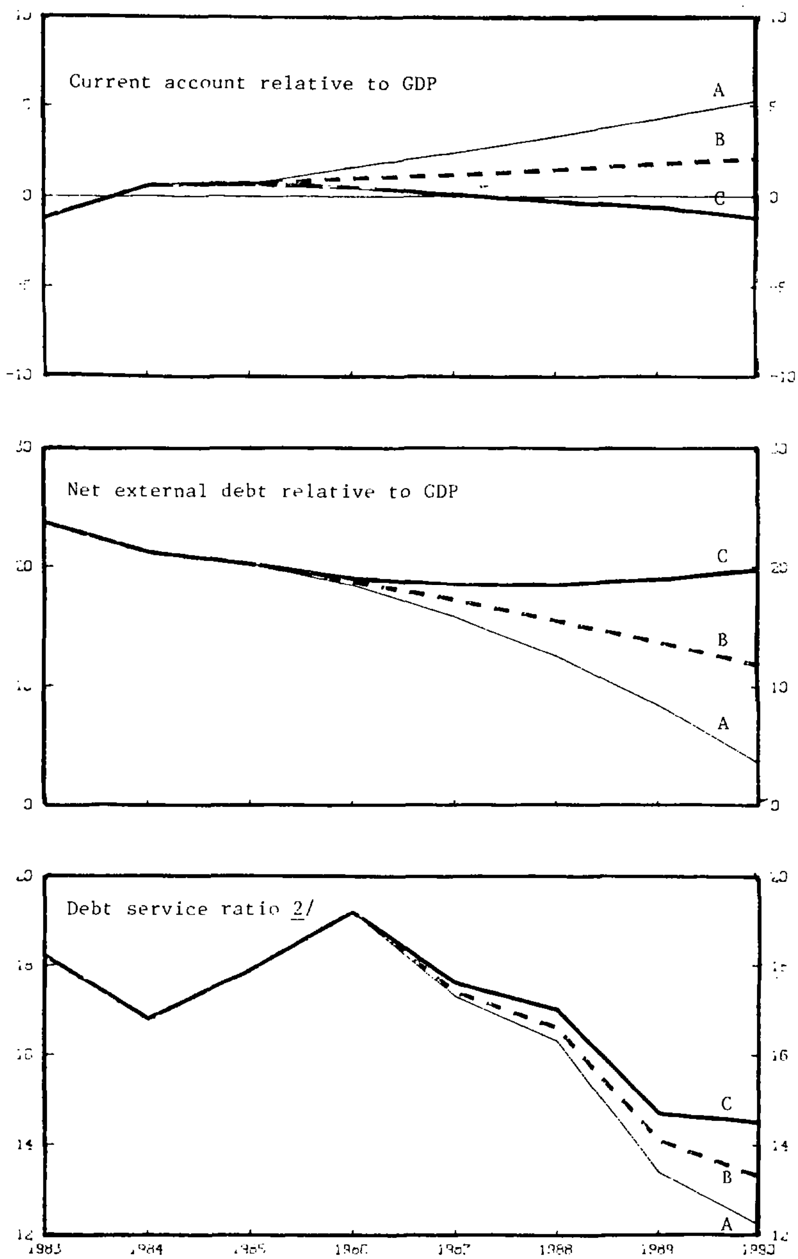


Source: Revised National Budget.

CHART 7

SWEDEN: ILLUSTRATIVE PROJECTIONS
OF EXTERNAL DEBT 1/

(In percent)



Source: Data provided by the Swedish authorities, staff calculations and estimates.

1/ The illustrative medium-term debt projections were based on the assumptions contained in the latest WEO paper for 1984 and 1985, and have further assumed that other industrial countries grow at an annual rate of 3 percent and experience inflation of 5 percent (in terms of the GDP deflator) in 1986-90. The trade projections assume that no further competitive effect from the 1981 and 1982 devaluations remains after 1985. From 1986-90, Swedish demand management is postul lated to follow one of three variants: (A) domestic demand is held back to increase by 1 percentage point less than in other industrial countries (by 2 percent); (B) domestic demand grows at the same rate in Sweden as abroad (3 percent); or (C) domestic demand rises by one point faster than abroad (4 percent). The relative competitive position of the economy is assumed unchanged from its present position. Interest rates are assumed to decline gradually from current levels to be positive in real terms by 4 1/4 percent in 1986-88 and by 3 1/4 percent in 1989-90.

2/ Total interest payments plus amortization of medium- and long-term debt relative to exports of goods and services.