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August 3, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Sweden - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Sweden, which is proposed for discussion on Friday, September 2, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Knöbl (ext. 74984) or Mr. Hedfors (ext. 75205).

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INTERNATIONAL MONETARY FUND

SWEDEN

Staff Report for the 1983 Article IV Consultation

Prepared by Staff Representatives for the 1983 Consultation with Sweden

Approved by Brian Rose and Subimal Mookerjee

August 2, 1983

I. Introduction

A staff team consisting of Messrs. A. Knöbl, O. Evans (EP), P. Hedfors, and S. Mitra (all EUR) with, as secretary, Mrs. K. Rochelle (LEG) held Article IV consultation discussions in Stockholm from June 13 to 23. 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 mission also met with the Minister of Finance, Mr. Kjell-Olof Feldt. Mr. Arne Lindå, Alternate Executive Director for Sweden, attended the meetings as an observer. The last regular consultation discussions were held in September 1981 (SM/81/201, 10/27/81) and concluded by the Executive Board on November 18, 1981 (EBM/81/173). Special consultation discussions under Article IV were held in November 1982 (EBS/82/222, 12/3/82) following a 15.9 percent devaluation of the krona on October 8, 1982 and concluded by the Board on December 22, 1982 (EBM/82/165). Sweden accepted the obligations of Article VIII, Sections 2, 3, and 4 on February 15, 1961.

II. Background

For several years now, the Swedish economy has exhibited marked imbalances, which have been manifest in large deficits on the external current account and in the central government budget. These have become apparent since the mid-1970s when expansionary economic policies (the so-called "bridging policies" pursued in the wake of the first oil price increase) resulted in excessive wage pressures, with a consequent loss of external competitiveness and reduced market shares for tradable goods and weak private investment. Domestic activity was supported by a rapid expansion of public expenditure, financed by borrowing. As a consequence, the share of manufacturing in output fell, while the public sector grew sharply.

Since the mid-1970s economic growth in Sweden has been slow compared with that of other industrial countries (Chart 1). This is true in particular for industrial output, which in 1982 was 6 percent below its peak in 1974. However, open unemployment has remained low by international standards, through the extensive use of labor market measures (i.e., various kinds of public sector employment-support schemes). Over the same period, consumer price inflation has been running at an average annual rate of around 10 percent.

The imbalances in the economy have been reflected in a declining level of domestic savings. Gross domestic savings fell from around 24 percent of GDP in the mid-1970s to some 14 percent in 1982 reflecting in particular poor savings performance in the public sector. Since gross investment declined less rapidly, the economy had to resort increasingly to foreign financing, and in 1982 the deficit on the external current account had risen to 3.7 percent of GDP (Chart 2). The deterioration of the public sector's financial balance was only partly compensated by an improvement in that of the private sector, reflecting mainly the weak investment propensity of enterprises and--recently--rising profitability.

III. Recent Economic Developments and Short-Term Outlook

In 1980-81 the Government then in office adopted a strategy to deal with the imbalances in the Swedish economy, which included a fiscal policy designed to reduce gradually the budget deficit through expenditure cuts and a devaluation of the krona by 10 percent in September 1981. Moreover, in the spring of 1982, broad political support was mustered in Parliament for an income tax reform consisting of a general reduction in marginal rates and a limitation on the deductibility of interest payments against taxable income. The reform aimed at ensuring that the marginal tax rate for the majority of tax payers would be no higher than 50 percent and the package was to be implemented in stages between 1983 and 1985. It was expected that the reform would help moderate wage demands and improve incentives. To avoid adverse effects on the budget balance, it was decided that the tax reform would have to be financed in full by tax increases elsewhere. The revenue loss for the first year (1983) was recouped through the adoption of a 2 percent payroll tax.

Public expenditures, in particular transfer payments--which represent about 75 percent of central government expenditure--continued to rise sharply because of increases in outlays on industrial subsidies and other employment-supporting measures as well as the automaticity inherent in many types of transfer spending. Accordingly, the central government budget deficit actually rose and in 1982 reached a level equivalent to 13 1/2 percent of GDP. The 1981 devaluation, combined with relatively moderate wage increases under a two-year settlement for 1981 and 1982, produced a significant improvement of Sweden's external competitiveness in 1982.

When the new Government came into office, it immediately devalued the krona by a further 15.9 percent on October 8, partly in response to speculative pressure on the currency that had been building up in the early autumn. The action also reflected the view that the 1981 devaluation had not been large enough to initiate the requisite transfer of resources back to the exposed sector. The immediate price effects of the devaluations as well as rising interest payments on the large and growing foreign debt raised the current account deficit to SKr 23 billion (3.7 percent of GDP) in 1982 compared to SKr 14.2 billion (2.5 percent of GDP) in 1981 (Table 1 and Chart 3).

Following the devaluation, the Government announced that all income earners would have to accept the loss of real income associated with it. In order to limit wage increases and share the burden of the devaluation, a 20 percent tax on corporate dividends was introduced for 1983. In addition, 20 percent of company profits in 1983 were required to be deposited in interest-free accounts with the Riksbank; these could be drawn for investment after consultation with the local trade unions. Moreover, previous cuts in certain social benefits were reversed, with the additional spending financed through an increase in indirect taxes. Major wage settlements concluded in early 1983 indicate that the Government's intentions were largely respected as contractual increases were limited to around 2 percent.

The combined effect of the 1981 and 1982 devaluations led to a considerable improvement in the profitability of Swedish industry and in its competitive position. It has been officially estimated that the return on equity in manufacturing has risen from 9 percent in 1981 to 17 percent in 1982 and an estimated 22 percent in 1983. In late 1982, relative unit labor costs in manufacturing (adjusted for exchange rate changes) were about 20 percent lower than at any time in the 1970s (Chart 4). In 1983, despite moderate wage settlements, actual wage rates will rise by significantly more, owing to additional increases in 1983 under 1982 contracts and wage drift. In industry, the total increase is estimated at 8 percent, implying a decline in real wages for the third consecutive year. The cost to employers will rise by an additional 2 percent because of the new payroll tax. Since the increase in costs will be partly offset by the strong rise in productivity, which is expected when output begins to grow more quickly, unit labor costs are forecast to rise by about 4 percent, or less than in 1982. On present trends, therefore, the competitive position prevailing at the end of 1982 should be largely intact by the end of 1983.

In 1983, the improvement in competitiveness on official estimates is projected to lead to gains in market shares of 4 1/2 percent for Swedish manufactured exports (Chart 5); imports are expected to grow by less than 1 percent reflecting weak domestic demand. The trade account is forecast to be in balance, and the current account deficit is expected to fall to SKr 18.8 billion (2.7 percent of GDP), with the remaining deficit almost entirely accounted for by net interest payments on the foreign debt. As developments in early 1983 suggest that exports are growing faster than expected, the current account deficit may turn out to be lower than projected. Following a substantial surplus on the private sector capital account in the month following the devaluation, net outflows began to recur and have continued in early 1983. In the first five months of the year they amounted to about SKr 4 1/2 billion.

The policy of official borrowing to finance fully the external deficit has resulted in little change in gross foreign exchange reserves in this period. The krona, in terms of its basket index, has been slightly stronger than its "benchmark" rate; the effective (MERM) exchange rate has been essentially unchanged so far during 1983.

Total output is officially forecast to rise by 2 percent in 1983. The improvement of the external balance will constitute the main impetus to growth, as domestic demand is expected to remain stagnant. While a turnaround in the inventory cycle should provide some stimulus, both private consumption and business fixed investment are projected to decline. The continued fall in fixed investment reflects the expectation that the projected increase in output in 1983 can be accommodated through improved capacity utilization and related productivity gains, though a recent business survey suggests a somewhat faster upward revision of investment plans than first thought likely. As a bridging operation until an export-led recovery is firmly established, the Government has also adopted an investment program for the public sector. Open unemployment is expected to change little from the present 3 1/2 percent of the labor force as a result of increased labor market measures. A freeze on domestic prices (other than imports) introduced at the time of the devaluation was lifted in March 1983, and consumer prices are officially forecast to rise by 9 1/2 percent (8.6 percent in 1982) on average for the year and slightly less in the course of the year. Discretionary policy measures, including the 1982 devaluation, and the increases in the value-added tax and in other indirect taxes are estimated to contribute 4 1/4 percentage points to the increase in the course of the year.

The outlook for 1984 depends crucially on the prospects for containing inflation. Continuation of high rates of inflation would rapidly erode the competitive gains made in 1981 and 1982. Thus moderate wage settlements in early 1984 are vital. The authorities have, therefore, adopted a target of a 4 percent increase in consumer prices during 1984. If realized, this would permit a relatively strong growth of output--estimated at 3.5-4 percent in 1984--an improvement in employment, and a reduction in the current account deficit to 1 percent of GDP.

IV. Economic Policies

The Swedish authorities recognize that devaluation by itself will not be sufficient to achieve their aim of restructuring the Swedish economy, and that adequate supporting policies are required. Their emphasis has now shifted to curbing inflation, as they view low inflation as a precondition for a sustained economic recovery.

The authorities agreed that the inflation target for 1984 needs to be backed by financial restraint. In particular, they felt that an important component of the fight against inflation was the need to bring down the budget deficit through containing public spending, so as to avoid excessive domestic liquidity creation and leave room for a recovery in private investment. A further goal is to eliminate the external current account deficit over the next few years, in order to reduce the external debt burden over time, and to achieve this improvement against the background of rising domestic investment. Domestic savings would have to rise substantially if these objectives were to be met, and it was clear that for this purpose public sector dissavings would have to be reduced significantly over the medium term. The authorities felt, however, that the improvement needed to occur only gradually, as the investment recovery was unlikely to proceed very quickly.

1. Fiscal policy

Strongly expansionary fiscal policies, aimed at securing a high level of employment, continued improvement in the real value of social benefits and services, and a decision to cushion the impact on industry of structural change, have resulted in a sharp rise in public expenditure and the public sector deficit since the mid-1970s. Public sector spending in relation to GDP has risen from 50 percent in 1975 to an estimated 70 percent in 1983, and the financial balance of the public sector has moved from a surplus of almost 3 percent of GDP to an estimated deficit of 8 percent over the same period. The deterioration in public finances has been particularly pronounced in the central government accounts, with the budget deficit having risen from 1 percent of GDP in 1975/76 (fiscal year July-June) to 14 percent in 1982/83. It was chiefly transfer payments that rose strongly over that period, in part due to automatic mechanisms. Moreover, with the rising level of the national debt, interest payments rose sharply in recent years. As a percentage of GDP, the national debt rose from just over 20 percent at the beginning of the 1970s to 61 percent at the end of 1982, above the previous historically high level of the mid-1940s.

A recurring feature of recent years has been a sharp overshooting of expenditures and deficits from initial estimates. Thus the central government budget deficit for 1982/83 had originally been budgeted at 11 1/2 percent of GDP compared to the estimated outturn of 14 percent (Table 2). The new Government took various measures to raise expenditures that were not fully compensated by tax increases, but the Swedish representatives argued that these accounted only partly for the overshooting of the budget deficit. Higher spending on industrial support--arising mainly from the settlement of obligations outstanding under government guarantees--and interest on debt were the major factors. They said that the present estimates for 1982/83 could be considered to be reasonably firm; if anything, spending late in the fiscal year appeared to be running slightly below the estimates.

The authorities recognized that the present fiscal deficit could not be compatible with the goals of a recovery in domestic investment accompanied by a restoration of external balance. The large accumulation of public debt over the past few years has strongly raised the interest burden of the budget, making the task of correction more difficult. With the budget for 1983/84, which aims at a reduction in the central government deficit to 12 1/2 percent of GDP, the authorities have made a beginning in the task of reversing the trend of growing deficits. Total spending is budgeted to rise by 6 1/2 percent and noninterest expenditures by about 4 percent in 1983/84, representing a significant reduction in real terms. This is to be achieved despite increased outlays on labor market measures, public investment, and certain social benefits. However, very few new programs have been approved, less than full compensation for anticipated wage and price developments has been budgeted, and outlays on industrial support are to be reduced sharply. While the authorities have not yet fully determined all the areas of stringency, they stated their intention to adhere to the budget estimates and to take additional steps should developments deviate from the spending targets. In addition the authorities are currently preparing fiscal measures, to be introduced in the fall of 1983, that would affect the fiscal outcome in both 1983/84 and 1984/85. They intend to eliminate indexation of most social transfer payments from the beginning of 1984 so as to make changes in this type of spending subject to discretionary decision. They plan to limit the adjustment in such benefits to the official inflation target of 4 percent during 1984. Pension benefits, however, would continue to be indexed to past price developments, though with a deduction for the price effect of the 1982 devaluation. The Swedish representatives said that this was likely to limit the adjustment to pensions in 1984 to a rate close to that envisaged for other benefits. On the revenue side, the Government intended to finance the second year of the income tax reform through increased energy taxes rather than through an additional payroll tax. However, the proposal was accepted only in part by Parliament; this issue therefore remained to be resolved in the fall.

The pressing need for further restrictive fiscal measures extending into 1984/85 and beyond is clearly indicated by official estimates suggesting that the central government budget deficit would rise again to 13 1/2 percent of GDP in 1984/85, if none were taken. Moreover, estimates of medium-term budgetary developments also indicate the need for strong discretionary measures to bring down the budget deficit. Almost 85 percent of central government spending (including debt interest) is now determined by automatic mechanisms, such as indexation to wage and price changes. The simulations show that with moderate growth, and allowing only for existing spending decisions and undertakings, and on the assumption of unchanged tax rules, the central government deficit would not decline over the next five years, but would stabilize around 13 percent of GDP. 1/ Although the Government had not yet formulated an explicit target for the size of the budget deficit in 1984/85, it intends to reduce it as a share of GDP from the level foreseen for this fiscal year. The Swedish representatives said that the restraint would have to come from the expenditure side, mainly in the area of transfers. For this, the efforts to modify the indexation of most transfer payments would be crucial but considerable restraint would also have to be exercised

1/ For details on the simulation see Recent Economic Developments, Chapter 3.

in other spending programs. The authorities believed that taxation has reached a level that made it no longer possible to raise the overall level of taxation, though the shift from direct to indirect taxes initiated with the income tax reform would be continued.

2. Monetary policy

The main tasks of monetary policy in recent years have been the financing of rising budget deficits and keeping the private external capital account in broad balance over time. Monetary policy has succeeded only in part in meeting these aims. Excessive domestic credit expansion, related to strongly rising bank financing of the budget deficit, has at times put pressure on the external balance which was then relieved by sharp, but temporary, increases in domestic short-term interest rates. The exchange rate devaluations of September 1981 and October 1982 were an integral part of the measures aimed at stabilizing the external balance.

During the first half of 1982, domestic credit was allowed to expand excessively, with the contribution of domestic credit expansion to the growth of broad money rising to 22 percentage points in the year to June 1982, mainly on account of a strong increase in the monetary financing of the escalating budget deficit. This rapid expansion led to a sharp rise of foreign exchange outflows (Chart 6). In an attempt to contain the foreign exchange drain, the Riksbank raised its penalty interest rate on excess borrowing in two steps from 14 to 17 percent thereby engineering a significant rise in short-term interest rates in the early fall. But the tendency toward capital outflows intensified as speculative pressures built up until the exchange rate of the krona was devalued in October 1982. Since then domestic interest rates have been allowed to decline again as foreign rates fell, though in nominal terms they have remained above those abroad. In real terms, Swedish interest rates are now positive, but less so than in some other countries.

The monetary financing of widening budget deficits in recent years has resulted in an increasingly liquid economy. The Swedish representatives said that the long-run trend had been for the income velocity of broad money to increase by about 1/2 percent annually, though with large cyclical variations. Since 1977 velocity had however fallen as broad money had increased substantially faster than nominal incomes, implying that liquidity in the economy had become quite high.

Since mid-1982 the Swedish authorities have greatly increased their efforts to finance a larger share of the budget deficit outside the banking sector. Large amounts of special Treasury bills have been sold mainly to the business sector. This instrument has also been used to influence the general course of interest rates, in combination with the use of the penalty and discount rates. Consideration has been given to the introduction of a tender system for the special Treasury bill issues, but no decision has yet been taken. The authorities also plan to tap household savings to an increasing extent as part of a general scheme to encourage such savings. It is likely that from the beginning of 1984 households would be permitted to hold deposit accounts directly with the Government through the National Debt Office; interest on these accounts would be tax free.

With increased nonbank financing of the budget, the growth of domestic bank credit and broad money has come down sharply since mid-1982. In the year to May 1983 broad money rose by 9 1/2 percent, compared with 17 1/2 percent in the year to June 1982. Although there is no official monetary target, the authorities intend to keep the growth of broad money below 9 percent during 1983. However, in interpreting these figures, it has to be borne in mind that the budget deficit still has been financed in fairly liquid form (the maturity of the special Treasury bills range from 6 to 18 months). The staff emphasized that sufficient interest rate flexibility will be required to ensure not only rolling over the bills at maturity, but also a continued high share of nonbank financing of the budget deficit. This is essential if monetary restraint is to adequately support the official inflation target.

3. Incomes policy

The Swedish labor market is characterized by strong central organizations and, in recent years, a general preference for jobs over real wage increases. The Government avoids direct interference in the wage bargaining process. Instead, it has aimed at achieving a social consensus in favor of wage restraint. The devaluation of last October was buttressed by measures aimed at enhancing the social consensus and facilitating wage negotiations; these included the temporary price freeze, the restoration of certain social benefits, and the dividend tax. The Government was planning to introduce profit sharing in the form of wage earners' funds perhaps next year, though the plans had not yet been finalized. The Swedish representatives said that the main purpose of the wage earners' funds would be to moderate the struggle over income shares: they hoped that the scheme would make it possible to provide for high profits in the business sector, without provoking compensating wage demands. They stressed that if wage earners did not accept a strong improvement of business profitability, the Government's economic strategy would run into difficulties. At present the question of how the money accumulated in the funds could best be channeled back into the market for equity capital was being studied.

Wage agreements in 1983 have been moderate. Although wage settlements have turned out slightly higher than originally expected, wage drift seems to have been lower, so that the increase in nominal earnings may be moderately lower than anticipated. On the other hand, inflation may also be lower than feared earlier, so that the decline in real wages (now estimated at close to 3 percent in 1983), may be slightly less than envisaged earlier. A favorable feature of the new agreements is that they include no index clauses and that the role of earnings guarantees (in the form of linkages to wages of other groups) has been reduced.

Continued wage restraint will be crucial for the success of the economic strategy. Wage settlements so far have been encouraging, though the last major agreement of the 1983 wage round, concluded for white collar workers, showed a slight tendency toward acceleration. The authorities, therefore, thought it important to affect inflationary expectations before the crucial wage round in 1984. They hoped that the fiscal measures to be announced later in the year, in particular the modification of indexation provisions affecting transfer payments, would help in this respect. It was important, they agreed, to follow strict financial policies as a means of making the inflation target credible. All in all, the Swedish representatives felt that it was safe to assume that wage costs in 1984 would rise by no more than 6-7 percent, which would make the achievement of the inflation target feasible.

4. External debt and exchange rate policy

The succession of external current account deficits has transformed Sweden's external position from a net asset holder in the first half of the 1970s to a net debtor on an increasing scale. The total gross medium- and long-term debt of the economy amounted to US$27.5 billion (32 percent of GDP) and the net total debt (including short-term items) to US$18.7 billion (22 percent of GDP) at the end of 1982. The Swedish representatives felt that Sweden did not face a serious external debt problem; the country had no difficulty raising funds abroad. Nevertheless, it was clear that Sweden would have to bring down the debt burden over time, and it was the official aim to eliminate the current account deficit over the next few years. For 1983 the current account deficit seemed likely to be smaller than projected, and a further significant improvement was in prospect for 1984. Staff estimates also suggest that the current account is likely to improve sharply through 1984, principally as a result of the competitive gains flowing from recent devaluations. Thereafter, staff estimates underline the dependence of a sustained improvement in the current account and debt position on the pursuit of domestic policies that are not more expansionary than those abroad (Table 3 and Chart 7). In the event of the growth of demand in Sweden being no higher than abroad, net total debt in relation to GDP would stabilize at around 23 1/2 percent. The debt service ratio, after an initial rise, reflecting the amortization schedules of past contracted debt, would begin to fall marginally from 1987. It is, of course, recognized that the debt projections are very sensitive to the underlying assumptions; they should serve as no more than an indication of trends.

Since Sweden left the European common margins arrangement in August 1977, the krona has been pegged to a basket of 15 currencies. Through intervention in the exchange market the authorities maintain narrow but unannounced margins around the "benchmark" index. In recent years intervention has taken place more or less on a continuous basis. Using the proceeds of official foreign borrowing, the Riksbank generally has been selling U.S. dollars to the market in order to finance any currency outflow. The Riksbank on October 8, 1982 increased the benchmark for the exchange rate index from a level of 111 to 132 (August 1977 = 100), representing a devaluation of the krona of 15.9 percent, partly in response to speculative pressures, but more important in order to reverse the decline in the sector exposed to foreign competition. This followed a devaluation of 10 percent in September 1981.

The present competitive position, which is about 20 percent stronger in terms of relative unit labor costs than at any time in the 1970s, should provide more than ample room for Sweden to benefit from the international recovery now under way. The Swedish authorities, therefore, have found it possible to budget for a sharp decline in industrial subsidies (see below). They also have stated their intention to follow an asymmetric exchange rate policy in case of pressures in the exchange market. Should the exchange rate come under upward pressure they would allow it to be reflected in the rate within flexible margins rather than in a premature relaxation of financial policies. Thus, when substantial foreign exchange reflows occurred immediately following the devaluation last October the exchange rate index of the krona was held at just under 130, compared with the benchmark of 132. If the upward pressure was judged to be fundamental in nature, though this is not considered likely in the near future, the authorities would adjust the benchmark. However, should there be downward pressure on the exchange rate, the authorities would first defend the rate through increased intervention and then follow through with an appropriate adjustment of domestic financial policies. Thus, when the tendency toward foreign exchange outflows reasserted itself in early 1983 the authorities did not allow the exchange rate index to rise above the benchmark. The Swedish representatives observed that so far foreign exchange outflows had stayed within reasonable limits. Although private capital outflows had occurred in recent months, this had been compensated partly by a stronger current account, and the question of adjusting domestic policies had, therefore, not arisen. The staff representatives, however, noted that greater caution in allowing domestic interest rates to decline would have reduced downward pressure in the exchange market.

5. Trade, industrial subsidies, and foreign aid policies

The Swedish authorities hold firmly to the view that agreed rules for competition offer the best prospect for the promotion of world trade, and they support increasing the effectiveness of the work of institutions such as GATT and the extension of free trading principles to areas such as services. They have observed the emergence in recent years of protectionist tendencies with concern and have consistently sought to combat such tendencies.

The Swedish trading system has remained highly open and liberal except for trade in agricultural products, footwear, and textiles. Agriculture is protected principally through the use of import levies with the objective of ensuring adequate food supplies at times of emergency; quantitative restrictions are few and minor. Imports of textiles are subject to quotas chiefly under bilateral restraints negotiated under Multifibre Agreements, which number 16 (excluding arrangements with state-trading countries). Despite quotas on textile imports, penetration into the Swedish market has continued to increase and, at present, only 17 percent of domestic demand is met by local production--a ratio far lower than in other industrial countries. As agreements expire, they will be renegotiated with a view to making them more effective in the future.

The Swedish GSP (Generalized System of Preferences) was instituted in 1972 and has been liberalized in several stages. Virtually all products covered are duty-free: 87 percent of imports from LDCs under MFN or on a GSP basis are free of duty. The scope for further broadening the coverage is considered to be limited given the sensitive nature of items such as textiles.

Since the mid-1970s, the authorities have employed industrial support measures on a significant scale in order to cushion the impact upon certain sectors of industry of the international recession and increased competition from abroad (Table 2). The major sectors that have received support have been shipbuilding, iron and steel and iron-ore mining, and forestry; the major part of support has been characterized as being of a "temporary nature". Support has taken the form of grants, loans, equity and capital contributions; in addition, export credit and credit guarantees have been subsidized. In the two most recent fiscal years, outlays on industrial support measures have shown sharp increases principally on account of the need to write off accumulated losses in the shipyards and in certain public enterprises.

The authorities have reaffirmed their determination to reduce industrial support expenditures since industrial profitability had recovered and as the October 1982 devaluation paved the way for a further significant rise. The Government has decided to take a restrictive stance in the 1983/84 budget, and has thus far allocated only SKr 1.9 billion for industrial support expenditures (equivalent to 1 percent of value added in mining and manufacturing in 1983), compared to SKr 12.1 billion in 1982/83 (or 8 percent of value added in mining and manufacturing in 1982). Expenditures for 1983/84 have been budgeted on the basis of decisions that had been made until June 1983 to support specific enterprises, though additional support may be found necessary, especially if the economic recovery proved to be weaker than at present projected. The authorities are determined to support their restrictive stance by a series of steps that have been taken or are contemplated. These include a rationalization of and a reduction in support of the shipbuilding sector, selective measures of support for the textile and clothing industries, and an increase in minimum interest rates charged by the Ship Credits Guarantee Board to purchasers of Swedish ships. In addition, the authorities have raised minimum interest rates for the financing of export credits by 1/2 percentage point and, in international negotiations on Consensus on Export Credits, have proposed that subsidies be abolished for exports to industrial countries and be reduced for exports to other countries.

While the trade effects of industrial and export support measures are difficult to establish with precision, it is noteworthy that support measures have, to an increasing degree, been conditional upon capacity reductions. Thus capacity in the shipyards has fallen by 40 percent between 1975 and 1981 and in the raw steel smelting sector by 20 percent over the same period. Exports from the iron and steel industry have increased in value reflecting a structural shift toward increased processing but the share of this industry in total Swedish exports has decreased by 2 percentage points to 5 percent between 1975 and 1982.

Swedish official development assistance (ODA) has remained above the UN target amounting to 0.83 percent of GNP in 1981, 1.01 percent in 1982; it is projected to run at 0.85-0.9 percent over the next few years. The overall grant element of ODA has been close to 100 percent. The share of contributions in multilateral form at 30 percent is relatively high. The main principles of Sweden's development aid remain unchanged: priority is given to low income countries, and to agricultural and rural development sectors, but recently the proportion of tied aid has been increasing, partly owing to the growing practice of using the aid budget to subsidize export credits.

V. Staff Appraisal

For several years the Swedish economy has been in marked disequilibrium as evidenced by large deficits on the external current account and in the central government budget. By 1982 domestic savings in relation to GDP had fallen by almost 10 percentage points compared with the mid-1970s--much more than investment--and the rate of inflation has remained high throughout. These imbalances emerged in the mid-1970s when excessive wage pressures resulted in poor external competitiveness and low industrial profitability, leading to a loss of market shares for tradable goods and weak private investment. Domestic activity has been supported by a rapid expansion of public spending financed by borrowing. In the process a shrinking of the sector exposed to foreign competition has occurred, while the share of resources claimed by the public sector has increased sharply.

The Government's economic strategy seeks to correct these imbalances. The objective is to expand the exposed sector while restraining domestic demand, and to achieve this restructuring at a low level of unemployment. As a first step, the authorities improved external competitiveness and business profitability through a large devaluation in October 1982, with the hope of protecting the competitive gains through wage restraint. Wage settlements so far in 1983 have in fact been moderate, and the expected strong rise in productivity implies that the sizable gain in competitiveness flowing from last year's devaluation may well be maintained during 1983. This improvement in competitiveness has already helped a strong recovery of exports and is putting a brake on imports; the external current account deficit may well turn out to be close to 2 percent of GDP compared to 3 3/4 percent in 1982. The recovery in industrial profitability also appears to have led to an upward revision in investment plans, though investment may still decline in 1983.

The Swedish authorities are alive to the need to support the devaluation with domestic measures to bring about the desired restructuring of the economy. Their emphasis has now shifted to fighting inflation. The inflation target of 4 percent that has been adopted for 1984 is ambitious and commendable. It needs, of course, to be backed with adequate financial restraint: Sweden's own experience clearly indicates that it would be extremely difficult to avoid persistently high inflation if the budget deficit is not expeditiously reduced from its present level, as it would otherwise hold down domestic savings and in all likelihood result in excessive domestic liquidity creation.

The fiscal adjustment required to achieve the official objectives may indeed be substantial over the next few years. Sweden's gross medium- and long-term external debt, at about 32 percent of GDP at the end of 1982, has risen to a level that calls for a significant improvement in the external current account. It is the official aim to eliminate the current account deficit over the next few years. The authorities also hope to achieve this improvement against the background of rising domestic investment. If both these objectives are to be met, domestic savings would have to rise by a substantially greater amount than the sought-for improvement in the external current account. While personal savings should contribute, and the income tax reform should help in this respect, most of the improvement would have to come from the government sector, where at present dissaving is large. The incipient recovery in private investment points to the urgency of fiscal restraint. Failure to initiate the required fiscal adjustment would weaken private investment as a result of higher real interest rates, or the external position would suffer as a consequence of higher domestic inflation, or some combination of the two would occur.

In view of these considerations the staff regards a determined effort, sustained over the medium term, at reversing recent trends in budgetary developments to be imperative. The entrenchment of public deficits and the consequent growth of the interest payments burden of the budget have added to the task of eventual correction. The staff welcomes the start in the process of fiscal correction that the authorities intend to make with the budget for 1983/84, when noninterest central government expenditures are estimated to fall significantly in real terms. However, the decisions to raise certain social transfers and outlays on labor market measures have exacerbated the problem of fiscal adjustment, though outlays on industrial subsidies are planned to fall sharply in 1983/84.

Although the specific measures of retrenchment have not yet been fully spelled out, the authorities have stated their determination to adhere to the budget estimates. A realization of the modification planned for the indexation of transfer payments will be crucial in this respect. The staff considers it imperative that, as a minimum, the budgetary estimates be attained and prompt and decisive action be taken in the event of expenditure ceilings being threatened as it is vital not to experience a repetition of the sizable overshooting of expenditures and deficits seen in recent years. Achievement of the budget targets would lay the necessary foundations for a sustained medium-term correction in the public sector accounts. In the view of the staff it is important that the momentum of the reduction in the budget deficit be accelerated from 1984/85. The staff agrees that the restraint has to be concentrated on the expenditure side, in particular on transfers.

Monetary policy in recent years has been subordinated to the role of financing the large government deficit. During the first half of 1982, domestic liquidity was allowed to expand excessively, thus generating severe pressures on the external position. Despite increases in domestic interest rates, the tendency toward capital outflows intensified as speculative pressures built up. After the devaluation last October, domestic interest rates were allowed to decline, and while they remained above those abroad in nominal terms, real interest rates are below those in some other countries. Since mid-1982, the budget deficit has been financed to a greater extent outside the banks through the sale of special Treasury bills mainly to the business sector. While this has dampened the growth of domestic bank credit and broad money, the budget still has been financed in a fairly liquid form. The monetary financing of widening budget deficits in recent years has resulted in an increasingly liquid economy. Thus, adoption of a firmer monetary policy stance appears important to the staff. This would require greater interest rate flexibility, not only in order to ensure that a large part of the budget deficit will be financed outside the banking system, but also to help protect the balance of payments. The staff notes in this connection that greater caution in allowing domestic interest rates to decline in early 1983 would have reduced pressures in the exchange market.

Continued wage restraint is clearly crucial for the success of the economic strategy. While wage agreements so far in 1983 have been encouraging, the latest settlement for the white collar workers may have a demonstration effect that could spill over into 1984. It is, therefore, important to press down on inflationary expectations, and the plans for loosening the link between increases in transfer payments and in price should help in this respect. More generally, the policy of avoiding direct involvement in private sector negotiations in the view of the staff, makes it even more necessary to follow restrained financial policies as a means of making the inflation target credible. An early announcement on budgetary objectives for 1984/85 and the specific measures contemplated to achieve them could dampen expectations and increase public understanding that structural adjustment in the Swedish economy has only just begun.

The gains in competitiveness flowing from the two devaluations in 1981 and 1982 should provide more than ample room for Sweden to benefit from the international recovery now under way. Therefore, the staff strongly supports the authorities' intentions of substantially reducing industrial subsidies, and urges that these intentions be fully adhered to. The staff notes that the Swedish authorities intend to allow upward pressure on the exchange rate to be reflected in a movement of the rate within flexible margins rather than in a relaxation of domestic financial policies. Should the pressure be judged to be fundamental, they would adjust the benchmark. However, should there be downward pressure on the exchange rate, the authorities would first defend the rate through increased intervention, and then follow through with appropriate adjustments of financial policies. The staff believes such an exchange rate policy, if supported by the reduction of industrial subsidies and the adoption of a firm financial policy stance, to be appropriate.

The staff notes with satisfaction that Sweden has continued to maintain a relatively open trading system and has a commendable record on development assistance.

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

Table 1. Sweden: Balance of Payments, 1978-83

(In billions of Swedish kronor)

	1979	1980	1981	1982 Est.	1983 Proj. 1/
Exports, f.o.b.	117.3	129.7	143.2	166.6	198.5
Imports, c.i.f.	122.3	141.1	145.4	173.7	199.5
Trade balance	-5.1	-11.4	-2.1	-7.1	-1.0
Services, net 2/	-0.1	-1.7	-6.7	-10.1	-11.6
Of which:					
Investment income, net	(-3.1)	(-6.1)	(-11.0)	(-15.9)	(-18.6)
Transfers, net	-4.7	-5.4	-5.4	-5.6	-6.2
Current account balance	-9.9	-18.5	-14.2	-22.8	-18.8
(In percent of GDP)	(-2.2)	(-3.5)	(-2.5)	(-3.7)	(-2.7)
Direct investment, net	-2.1	-1.6	-3.4	-4.0	...
Other private capital, net	0.9	4.7	14.4	9.1	...
Net errors and omissions	-1.0	-6.1	-1.4	1.9	...
Capital account balance (excluding central government and Riksbank, net)	-2.2	-2.9	9.6	7.0	...
Overall balance 3/	-12.1	-21.4	-4.6	-15.8	...
Central government and Riksbank borrowing, net	9.3	21.1	5.5	16.1	...
Allocation of SDRs	0.3	0.3	0.3	--	--
Official monetary movements (increase -)	2.6	--	-1.1	-0.3	...
Valuation adjustment (increase -)	0.6	--	-4.1	-4.4	...
Change in official reserves (increase -)	3.2	--	-5.3	-4.7	...
Memorandum items:					
Real exchange rate (fourth quarter; relative unit labor costs, 1975 = 100)	96.2	94.1	89.7	71.6	...
Export volume 4/	9.0	-0.5	-3.5	5.5	7.5
Market shares 4/	-1.5	-5.0	-4.5	1.5	4.5
Current account (in billions of SDRs)	-1.8	-3.4	-2.4	-3.3	-2.3 5/
Capital account (in billions of SDRs)	-0.4	-0.5	1.6	1.0	...

Sou. Sveriges Riksbank, Quarterly Review, various issues; data provided by the Swedish authorities, and staff calculations and estimates.

1/ Official projections, spring 1983.
2/ Including correction item for underreporting of services.
3/ Broadly equivalent to the currency flow in Swedish terminology.
4/ Exports of manufactures to OECD, excluding ships.
5/ Converted at SDR 1 = SKr 8.096.

Table 2. Sweden: Central Government Budget 1/

(In billions of Swedish kronor)

	1977/78	1978/79	1979/80	1980/81	1981/82	1982/83			1983/84
						Approved budget 2/	Amended budget 3/	Projected outturn	Approved Estimates
Taxes on incomes and capital gains	29.3	30.5	33.5	34.1	36.3	33.8	36.1	36.6	39.5
Social security contributions	22.8	22.3	24.7	33.9	31.3	36.2	35.5	35.8	46.9
Value-added tax	26.6	29.1	31.7	37.3	40.7	43.5	45.5	45.8	49.1
Other tax revenues	20.1	22.3	25.1	29.5	32.1	37.5	37.9	38.5	40.0
Nontax revenues	13.3	15.5	17.5	20.5	26.7	28.5	28.9	31.5	32.6
Total revenues	112.1	119.7	132.5	155.3	167.1	179.5	183.9	188.2	208.1
Total expenditure	137.3	158.3	185.5	215.3	235.1	255.3	275.7	280.0	298.0
Of which: interest payments	...	...	12.3	23.8	27.7	38.0	45.6	47.2	55.4
Budget balance	-25.2	-38.6	-50.0	-60.0	-68.0	-75.8	-91.8	-91.8	-89.9
(in percent of GDP)	-6.5	-8.9	-10.2	-10.9	-11.4	-11.6	-14.0	-14.0	-12.5
Memorandum item									
Selective industrial support expenditure	3.7	7.2	6.8	5.0	8.4	...	...	12.1	1.9 4/
Above, at 1983/84 prices	6.2	11.3	9.8	6.5	10.0	...	...	13.5	1.9 4/

Sources: Ministry of Finance; and data supplied by the Swedish authorities.

1/ The fiscal year begins on July 1.
2/ Adopted in June 1982 by previous government.
3/ Includes amendments made in December 1982 by current government.
4/ According to decisions taken thus far.

Sweden. Table 3. Illustrative Medium-Term Debt Projections 1/

	1982	1983	1984	1985	1986	1987	1988
Current account (in percent of GDP)	-3.7	-2.7	-1.3	-1.2	-1.2	-1.1	-1.1
Gross total debt (in percent of GDP)	39.1	47.0	46.8	47.0	47.0	47.0	46.9
Net total debt (in percent of GDP)	21.9	23.7	23.6	23.6	23.6	23.6	23.6
Debt service, gross, as a percent of exports of goods and nonfactor services 2/	18.4	18.1	17.1	16.5	22.7	22.1	21.9
Debt service, net as a percent of exports of goods and nonfactor services 3/	13.8	11.9	11.2	11.5	17.3	16.9	16.7

Source: Staff estimates.

1/ The figures correspond to moderate demand management in Sweden, case B (see note below). Developments under cases A and C are illustrated in Chart 6.

2/ Interest payments on total debt plus amortization of medium- and long-term debt.

3/ Interest payments on total debt net of interest receipts on total assets (including official reserves) plus amortization on medium- and long-term debt net of amortization received on medium- and long-term assets.

Note: The illustrative medium-term debt projections have been based on the assumptions contained in the latest WEO paper for 1983 and 1984, and have further assumed that other industrial countries grow at an annual rate of 3 percent and experience an increase in the GDP deflator of 5.5 percent in 1985-88. The trade projections for Sweden take explicit account of the competitive efforts remaining from the 1981 and 1982 devaluations. For 1983 and 1984, the latest official and staff projections are used implying growth in Sweden's domestic demand of 0.1 percent and 3 percent, respectively. Demand management in Sweden for 1985-88 is postulated to follow one of three variants, (A) domestic demand is held back to increase by 1 percentage point less than in other industrial countries, i.e., by 2 percent; (B) domestic demand is assumed to grow at the same rate as in other industrial countries, i.e., 3 percent; or (C) domestic demand is permitted to rise by 1 percentage point faster, i.e., 4 percent. The relative competitive position of the economy is assumed unchanged from its current position. Interest rates are assumed to gradually decline from their current levels to be positive in real terms by 2 percent on short-term debt and by 4 percent on long-term debt after 1984.

Fund Relations with Sweden

Date of membership:	August 31, 1951
Status:	Article VIII, as from February 15, 1961
Present quota:	SDR 675 million.
Proposed quota:	SDR 1,064.3 million.
Fund holdings of Swedish kronor:	At June 30, 1983, SDR 531.634 million or 78.76 percent of quota. Sweden has never made use of Fund resources.
SFF subsidy account:	Sweden has made a total donation of SDR 2.2 million to the supplementary financing facility subsidy account.
SDR position:	Holdings amounted to SDR 239.06 million or 96.98 percent of net cumulative allocations of SDR 246.5 million at June 30, 1983.
Gold distribution:	Four distributions totaling 278,144.648 fine ounces.
Exchange rate system:	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 totalling 16 per cent 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.
Last Article IV consultation:	November 3-10, 1982 (EBS/82/222, 12/3/82) when a Special Consultation under Article IV was conducted. This was concluded by the Executive Board on December 22, 1982 (EBM/82/165). The Board held a preliminary discussion on October 13, 1982 (EBS/82/187, 10/9/82, and Sup. 1, 10/11/82) on Sweden's devaluation of the krona by 15.9 percent on 8 October 1982. The

previous Article IV consultation occurred during August 24-September 4, 1981. The staff report (SM/81/201, 10/27/81) was discussed by the Board on November 18, 1981 (EBM/81/173).

Sweden - Basic Data 1/

Area and population

Total area	486,661 square kilometers
Total population	8.32 million

Composition of GDP (in 1981, at current prices)	In billions of kronor	In percent of GDP
Private consumption	296.8	52.1
Public consumption	169.0	29.7
Total investment (including inventory investment)	105.6	18.5
Exports of goods and services	173.4	30.5
Imports of goods and services	-175.5	-30.8
Gross domestic product	569.2	100.0
(In SDRs per capita)	11,615	

	1979	1980	1981	1982 Est.	1983 Proj. 2/
	Annual percentage changes				
National accounts (at constant prices)					
GDP	4.3	1.9	-0.7	-0.1	1.8
Domestic demand	3.6	1.4	-0.7	0.1	0.1
Private consumption	2.7	0.2	-0.6	1.3	-1.5
Public consumption	4.3	2.3	2.0	1.2	1.4
Gross fixed investment	5.7	3.4	-4.5	-2.5	-0.6
Imports of goods and nonfactor services	12.9	1.1	-4.3	4.9	1.8
Exports of goods and nonfactor services	7.2	-1.6	1.3	3.8	6.6
Employment and prices					
Unemployment rate (in percent of labor force)	2.1	2.0	2.5	3.1	3.5
Total employment	0.7	0.1	-0.6	0.2	0.3
Mining and manufacturing employment	-1.1	-1.2	-3.8	-3.7	-2.0
Other private employment	0.2	-0.8	-0.4	1.1	0.4
Public service employment	3.5	2.9	1.7	1.7	1.5
GDP deflator (yearly average)	7.4	11.8	9.9	9.1	...
Consumer prices (yearly average)	7.2	13.7	12.1	8.6	9.5
Unit labor costs (manufacturing, fourth quarter)	6.6	10.1	12.0	0.3	...
Labor productivity	4.4	1.7	0.4	0.2	2.1
Labor productivity (mining and manufacturing	6.8	1.5	0.1	2.6	5.6

1/ Sources: Data provided by the Swedish authorities; and staff calculations and estimates.
2/ Official projections.

Basic Data (continued)

	1979	1980	1981	1982 Est.	1983 Proj. 1/
External sector					
Export volume 2/	9.0	-0.5	-3.5	5.5	7.5
Market growth 2/	10.5	4.5	1.0	4.0	3.0
Market share 2/	-1.5	-5.0	-4.5	1.5	4.5
Effective exchange rate (fourth quarter)					
Nominal (MERM)	3.6	-0.6	-12.0	-14.7	...
Real (unit labor costs)	2.5	-2.1	-4.7	-20.2	...
Monetary sector					
Broad money	11.3	12.3	14.3	7.8	...
Contributions from: 3/					
Central Government	10.9	14.1	15.2	8.4	...
Bank lending	7.7	7.6	2.6	6.3	...
Private sector external balance	-5.1	-7.9	-1.3	-4.4	...
		(In per cent of GDP)			
Public sector					
Financial balances					
Central government	-7.0	-7.1	-8.6	-10.1	-10.0
Local authorities	0.5	--	0.2	0.1	-0.6
Social security	3.5	3.2	3.3	3.0	2.6
Overall public sector	-2.7	-3.9	-5.3	-7.1	-8.0
Net lending financed by budget	-2.9	-2.7	-2.1	-2.2	-2.4
Central government budget deficit	-9.0	-10.1	-11.7	-13.4	-13.2
Overall public sector deficit	-5.6	-6.5	-7.5	-9.3	-10.4
External sector					
Trade balance	-1.1	-2.2	-0.4	-1.1	-0.1
Current balance	-2.2	-3.5	-2.5	-3.7	-2.7
Overall balance	-2.6	-4.1	-0.8	-2.5	...
		(In billions of SDRs)			
Exports, f.o.b.	21.2	23.6	24.0	24.0	24.5
Imports, c.i.f.	22.1	25.6	24.4	25.0	-24.6
Trade balance	-0.9	-2.1	-0.4	-1.0	-0.1
Services and transfers, net	-0.9	-1.3	-2.0	-2.3	-2.2
Current balance	-1.8	-3.4	-2.4	-3.3	-2.3
Capital account (excluding central government and Riksbank)	-0.4	-0.5	1.6	1.0	...
Overall balance	-2.2	-3.9	-0.8	-2.3	...

1/ Official projections.
2/ Manufactured exports excluding ships to OECD countries.
3/ Change during year relative to money supply at beginning of year.

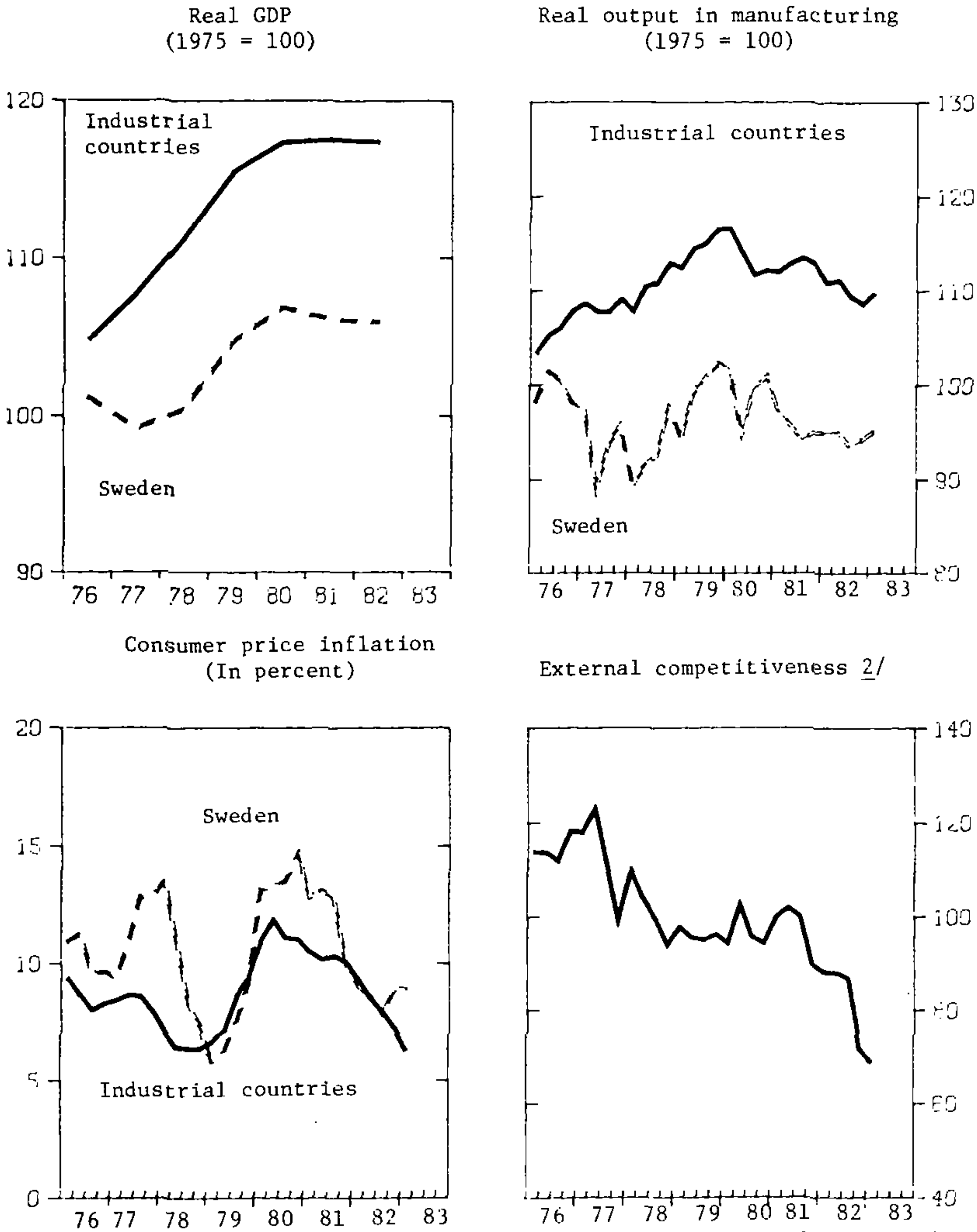
Basic Data (continued)

	1979	1980	1981	1982 Est.	1983 Proj. 1/
	(In billions of SDRs)				
Gross external debt (end-period)	20.1	27.2	34.3	40.9	...
Net external debt	4.3	9.1	13.9	19.6	...
Debt service ratio (gross, relative to exports of goods and services, in percent)	8.8	11.1	15.3	18.4	...

CHART 1

SWEDEN

SWEDEN IN AN INTERNATIONAL CONTEXT 1/



Sources: International Financial Statistics; staff calculations and estimates.

1/ "Industrial countries" series are derived by weighting output or inflation figures for Sweden's 14 main trading partners (trade weights).

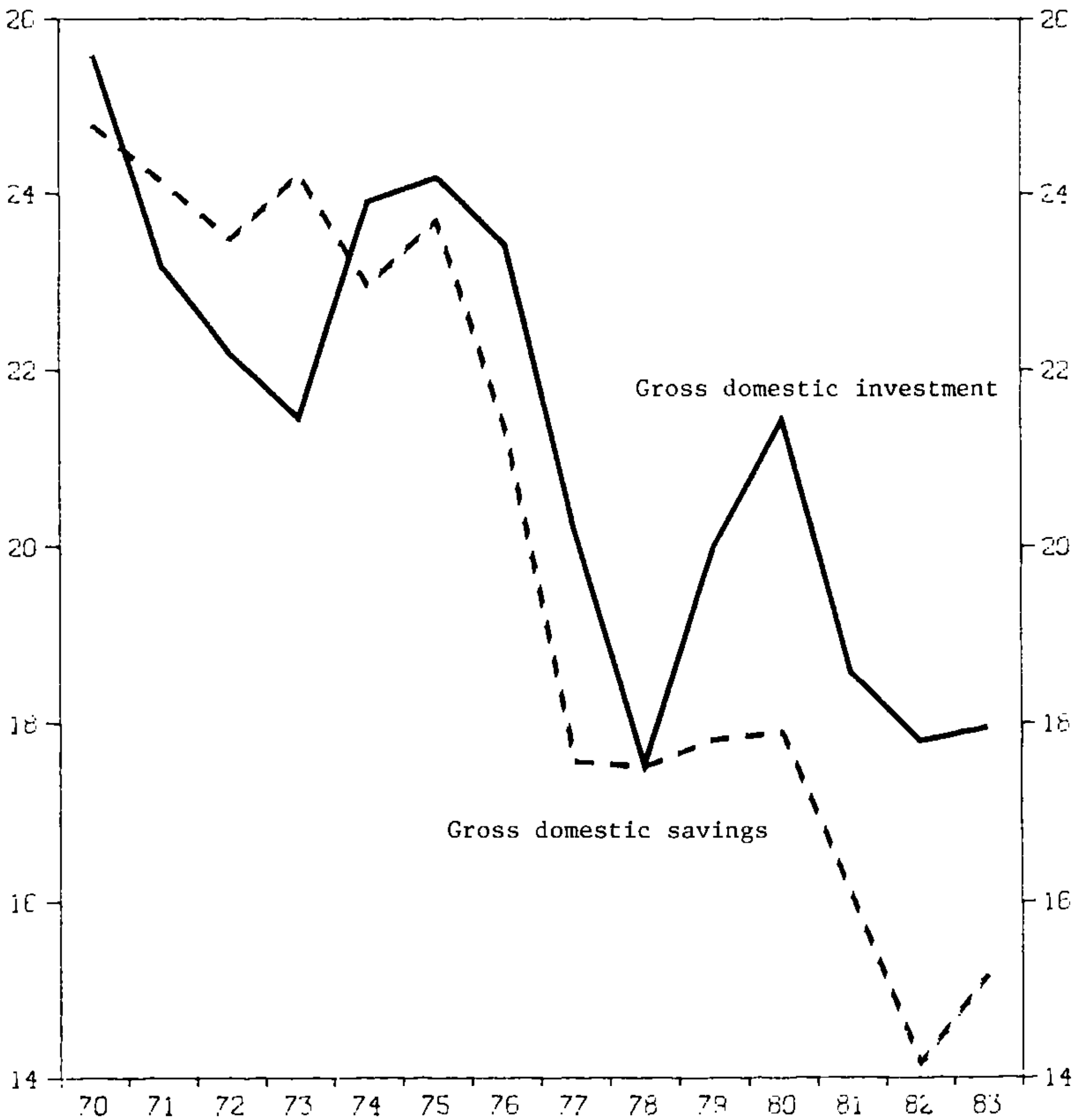
2/ Real exchange rate based on relative change in unit labor costs, with 1975 base.

CHART 2

SWEDEN

SAVINGS AND INVESTMENT

(In per cent of GDP)



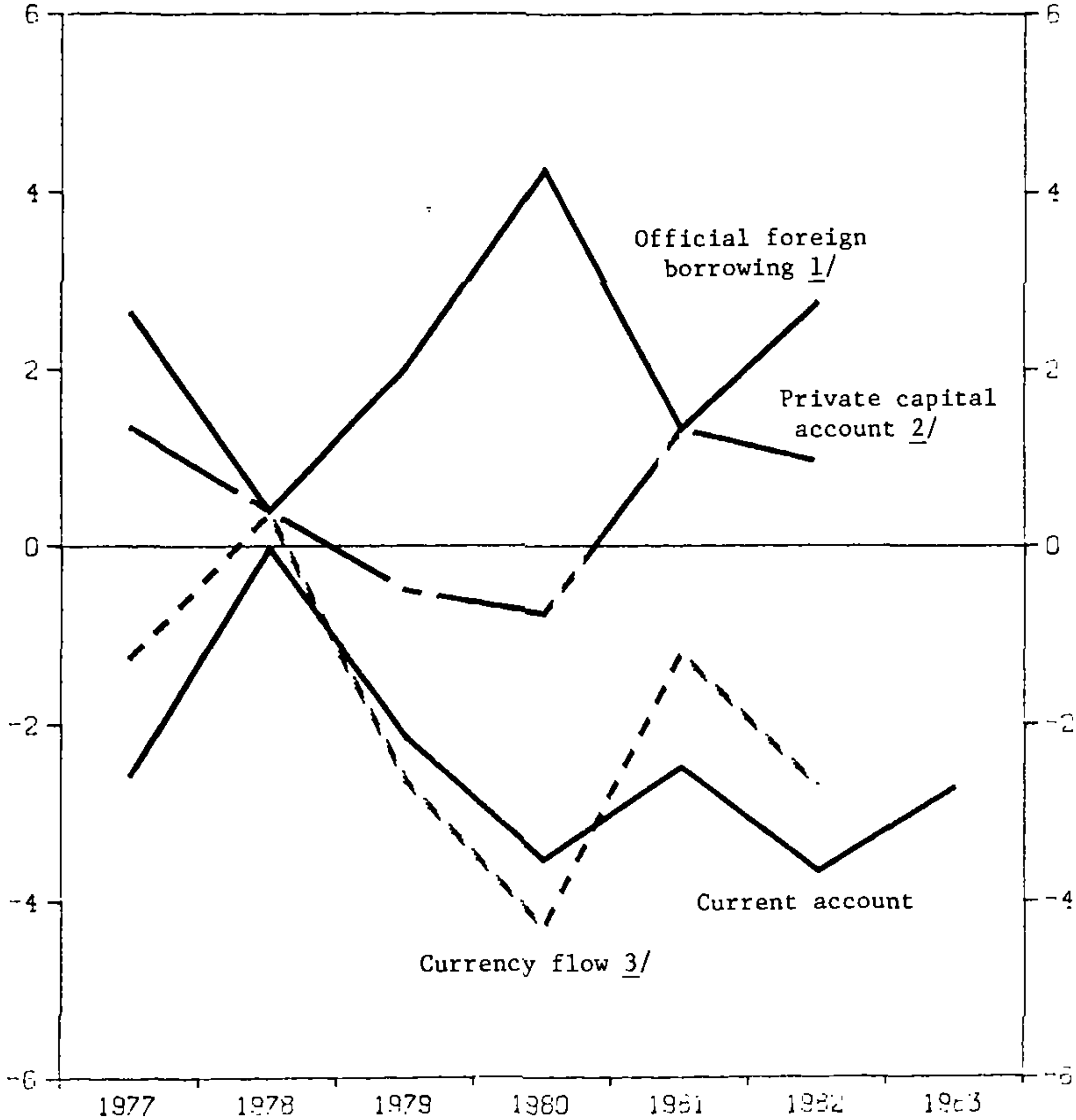
Source: Data provided by the Swedish authorities.

CHART 3

SWEDEN

EXTERNAL ACCOUNTS

(In percent of GDP)



Source: Swedish authorities, staff calculations and estimates.

1/ Central Government, and Riksbank, net.

2/ Excluding official foreign borrowing.

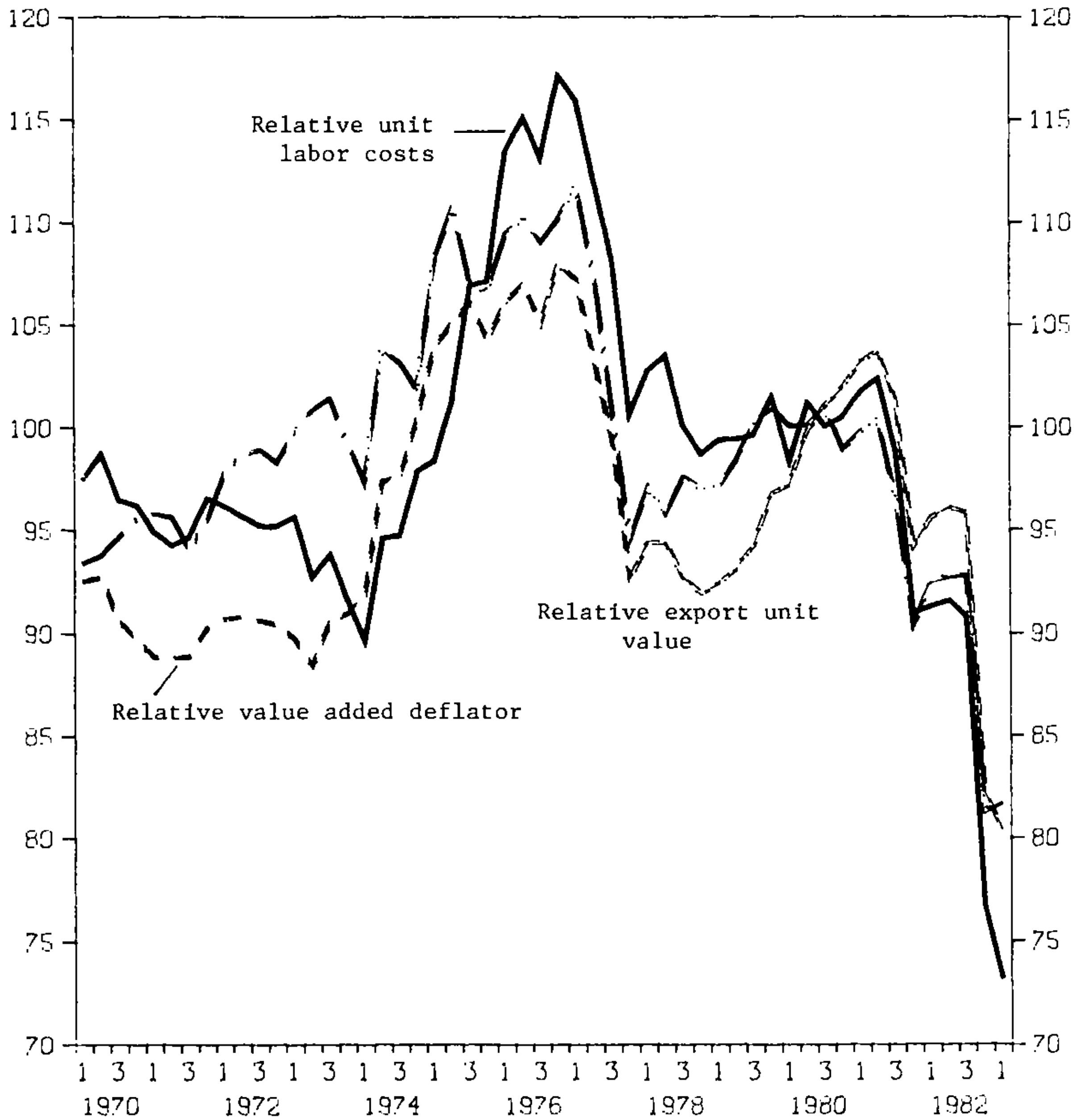
3/ Equal to the sum of the current and private capital accounts.

CHART 4

SWEDEN

REAL EXCHANGE RATES 1/

(1980 = 100)



Source: IMF, International Financial Statistics.

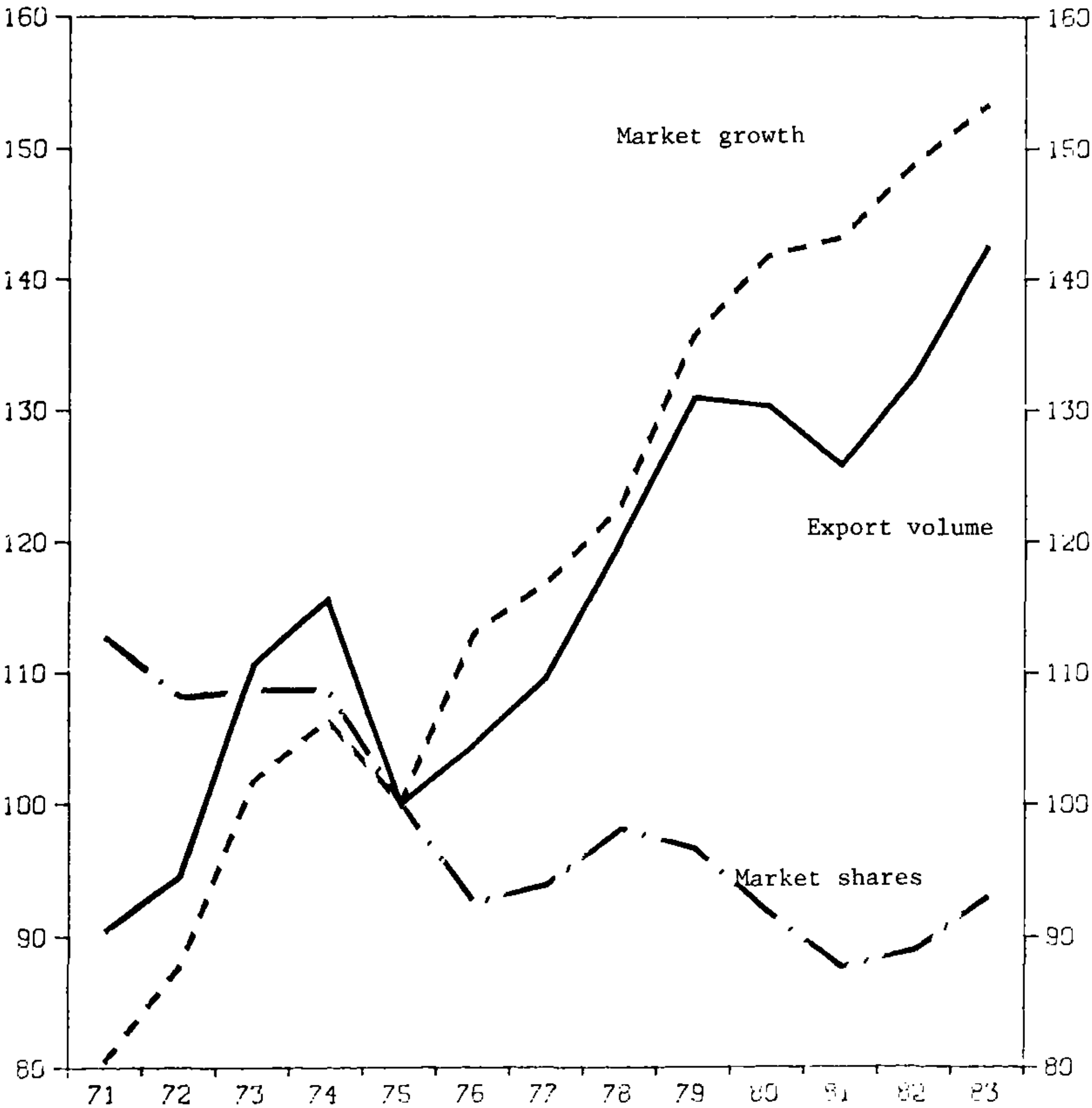
1/ Manufacturing sector.

CHART 5

SWEDEN

EXPORT PERFORMANCE

(1975 = 100)



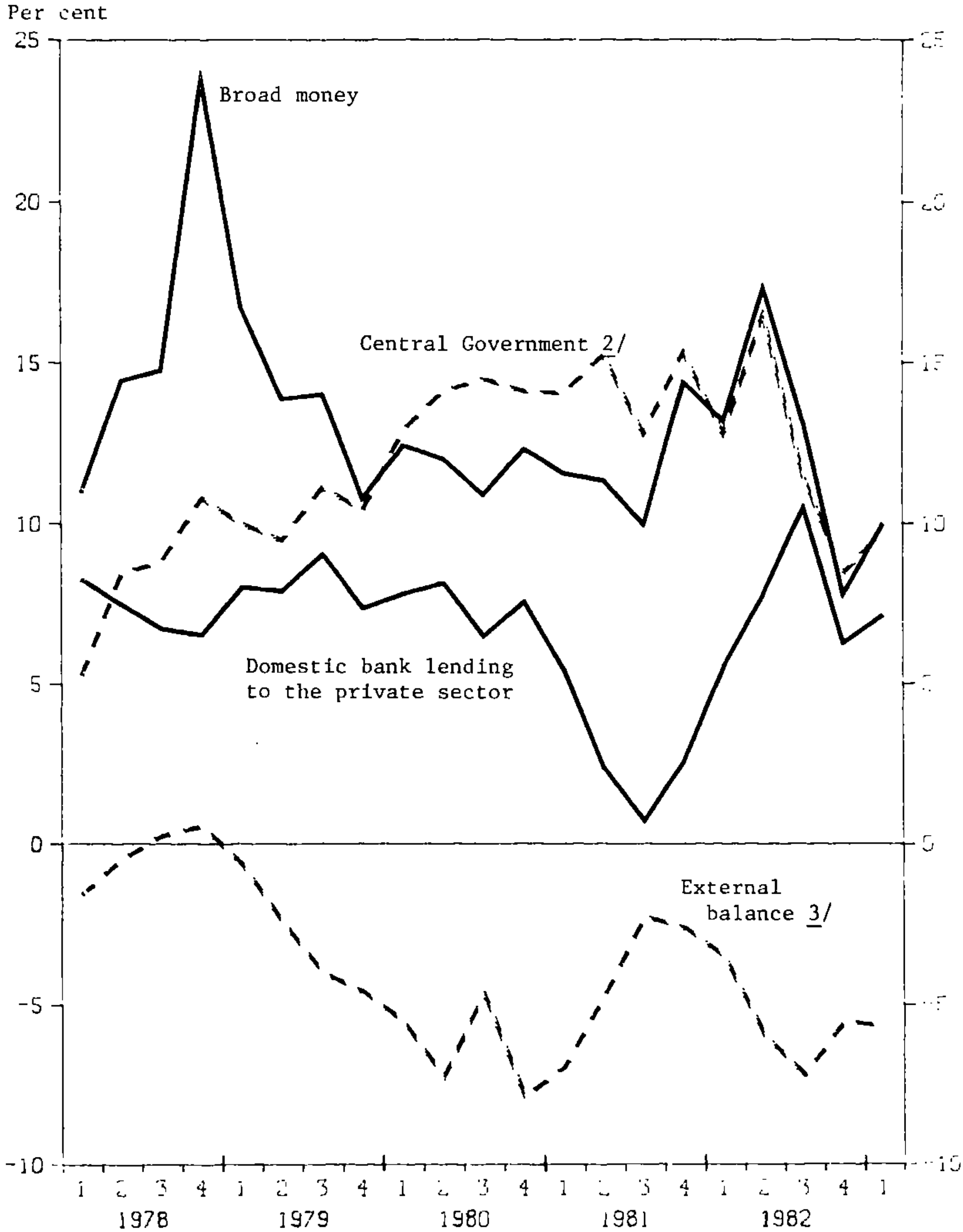
Sources: Swedish authorities and staff calculations.

1/ Manufactures excluding ships to OECD countries.

CHART 6

SWEDEN

CONTRIBUTION TO GROWTH IN BROAD MONEY 1/



Sources: Sveriges Riksbank, Quarterly Review, and Statistical Yearbook.

1/ Increase over 12 months as a percentage of the money stock at the beginning of the period.

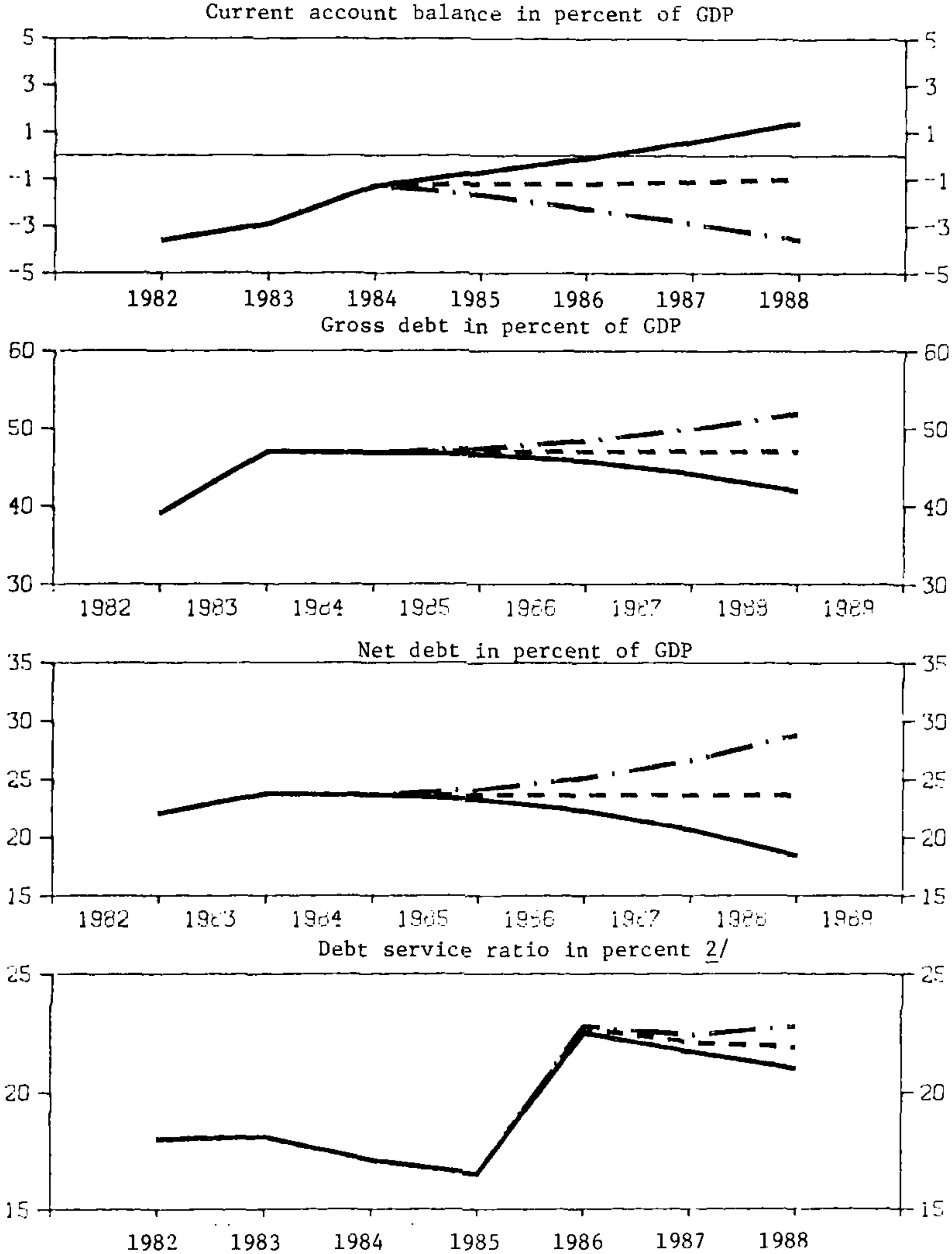
2/ Borrowing abroad and in the domestic banking system.

3/ Excluding foreign borrowing by Central Government.

CHART 7

SWEDEN

ILLUSTRATIVE DEBT PROJECTIONS 1/



1/ Further explanations contained in Table 3.

2/ In percent of exports of goods and nonfactor services.