

SUR/08/86

August 5, 2008

**The Acting Chair's Summing Up
Sweden—2008 Article IV Consultation
Executive Board Meeting 08/72
August 1, 2008**

Executive Directors agreed with the thrust of the staff appraisal. They commended Sweden for its strong economic performance with high output and employment growth, moderate inflation, a well-functioning financial system, solid public finances, and a favorable external position. Directors welcomed that successive authorities have addressed demographic challenges, first with pension reform and now with labor supply measures. Although subject to some uncertainty, Sweden's economic prospects are promising, provided that the financial and economic risks are managed carefully. The main challenges ahead are to continue to strengthen the financial system's resilience to adverse shocks and to firmly anchor inflation expectations.

Directors emphasized that the Swedish financial sector is performing well and that its financial indicators appear to be sound. They stressed the increasing importance of financial-real economy linkages, with the financial turbulence showing that markets react to dents in confidence with high speed and increasing costs that can lower growth. This adds a premium to sound bank management, supervision, and regulation. Swedish banks' strategy of diversifying into Baltic neighbors offers opportunities, but also requires tight risk management to minimize contingent claims.

Directors noted that market signals were indicating that banking risks have increased. While rating agencies, the Riksbank, the FSA, and the banks themselves are confident that they are able to cope with adverse events, Directors pointed out that increased interconnectedness in financial systems could accentuate the impact of shocks and spillovers. They encouraged the authorities to complete the draft law on a new banking resolution framework as soon as possible, and recommended that it be applied in a comprehensive manner. Directors welcomed the meaningful progress made by the authorities in addressing the 2002 FSAP recommendations, and agreed that an FSAP Update could help identify the policies and measures needed to bolster further financial sector resilience.

Directors considered that the current position of the krona provides Sweden with strong competitiveness, and noted the staff's assessment that the krona is somewhat below its estimated medium-term equilibrium value. With the krona likely to appreciate gradually over the medium term, the current account surplus should decline toward a level consistent with medium-term fundamentals. A firmer krona would also assist in mitigating foreign price pressures.

Directors welcomed the Riksbank's recent increase in the policy rate, given that inflation has risen well above the upper limit of the target band, and indicators of core inflation and inflation expectations had picked up. As short-term price pressures should not be allowed to seep into second-round effects, Directors stressed that monetary policy should remain as firm as needed to clearly break inflation expectations, and welcomed the upward bias in monetary policy.

Directors commended the authorities for their exemplary fiscal performance, and observed that Sweden now has some fiscal room to respond to a slowdown. Directors considered that the 2009 budget could include some targeted tax cuts and moderate increases in public investment in infrastructure, R&D, and pre-schooling to strengthen further long-run supply conditions. They welcomed the authorities' recognition that cautious policies remain warranted, given the possible drop in revenues as the economy slows. Also, tax measures could turn out more costly than expected over time and long-run aging costs remain uncertain.

Directors saw merit in further pursuing the intertemporal public sector balance sheet, which could be included in the Budget Bills, updated on an annual basis. Such a balance sheet would provide additional transparency to the fiscal position and forward-looking strategy, thereby enriching the public debate and informing policy. Periodic independent updates of the estimates of aging costs could also be useful.

Directors welcomed the authorities' continued efforts to pursue structural reforms to increase employment. Supply reforms in labor taxation should increase transparency in the tax and benefit system and reduce compliance costs. Evaluations of the efficacy of the labor supply measures by the authorities and stakeholders are welcome to make sure that these deliver the intended effect.

Directors praised the authorities for the high level of official development assistance, noting that it has exceeded 1 percent of GDP.

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