Office Memorandum

To: Members of the Executive Board August 26, 2014

From: The Secretary

Subject: **Sweden—Statement by the European Central Bank Representative**

Attached for the **information** of Executive Directors is a statement by the European Central Bank representative for the Executive Board discussion on Sweden, to be held on Thursday, August 28, 2014.

Att: (1)

Other Distribution:
Department Heads

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August 26, 2014

Statement by the ECB Representative on Sweden

(Preliminary)

Executive Board Meeting

August 28, 2014

We thank staff for the set of comprehensive reports and Ms. Meyersson for her informative Buff statement. We associate ourselves with the views expressed by Mr. Snel in his gray and would like to make a few additional points.

Regarding the **macro economic outlook**, we agree with staff's assessment that real GDP growth in Sweden will gradually accelerate going forward, mainly driven by domestic demand. However, we are slightly less optimistic for 2014. While private consumption remains robust, recent data revisions suggest that investment momentum is less dynamic than previously thought. We also broadly agree with staff projection that, starting from currently low levels, inflation will gradually converge to 2% over the medium term. The lagged impact of the past appreciation of the krona will gradually dissipate and upward price pressures from domestic sources should also increase somewhat on account of strengthening output growth. We concur with staff that financial instability derived from growing mortgage lending and high household indebtedness are the key downside risks to the economic outlook for Sweden, although geopolitical risks are also non-negligible.

We share staff's assessment that the **public finances** are in a sound position thanks to a strong domestic fiscal framework. By adhering to the current consolidation path, the Swedish authorities will meet the requirements of the fiscal rules of the European governance framework with a clear safety margin and bring the debt level on a firm downward trajectory. We further support staff's positive view on the appropriateness of this consolidation strategy. Despite the relatively low debt public debt level, a further improvement in the budgetary position is advisable given that gradual negative demographic developments will increasingly pose a challenge to public finances, due to a shrinking workforce and ageing population.

On risks to **financial stability**, we broadly share the views expressed by staff with regard to the main risks and vulnerabilities identified in the Swedish banking sector. These risks mainly relate to the overvaluation of property prices and high household indebtedness. While direct credit losses for Swedish banks from a decline in property prices should be manageable due to high regulatory capitalisation levels, indirect financial stability effects could be significant. However, we believe that risks from lending by Swedish banks to non-financial corporations and, in particular, commercial property companies might warrant further attention. Commercial property companies are the single largest industry to which Swedish banks are exposed, with around 20% of banks' total lending going to property companies. Although commercial property prices in Sweden have been broadly stable in recent years, demand appears to have been sustained mainly for modern centrally-located buildings, whereas demand for other types of "non-prime" commercial property could entail an increasing credit risk for Swedish banks.

It is important that all coordinated measures affecting credit demand, such as the introduction of a debt service-to-income limit, a lower binding loan-to-value (LTV) cap, the introduction of mandatory amortisation requirements and gradually phasing-out the tax deductibility of mortgage interest rates, are carefully assessed in conjunction with each other.

Finally, we concur with the staff assessment that targeted **labour market reforms** could help reduce unemployment, which has been rather persistent at around 8% despite robust growth in employment. Targeted measures tackling labour market duality and the limited degree of wage flexibility at the firm level could prove particularly effective in this context.