FOR AGENDA

0450

SM/90/146

CONTAINS CONFIDENTIAL
INFORMATION

July 27, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Sweden - Staff Report for the 1990 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1990 Article IV consultation with Sweden, which is tentatively scheduled for discussion on Monday, September 10, 1990.

Mr. Geadah (ext. 8830) or Mr. Saavalainen (ext. 8825) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

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INTERNATIONAL MONETARY FUND

SWEDEN

Staff Report for the 1990 Article IV Consultation

Prepared by Staff Representatives for the
1990 Article IV Consultation with Sweden

Approved by Massimo Russo and S. Kanesa-Thasan

July 25, 1990

I. Introduction

Article IV Consultation discussions with Sweden were held in Stockholm between May 31 and June 11, 1990. The principal Swedish representatives were the Minister of Finance, Mr. Allan Larsson; the Governor of Sveriges Riksbank, Mr. Bengt Dennis; the Minister for Taxation and Fiscal Affairs, Mr. Erik Åsbrink; the Minister for Public Administration, Mr. Bengt Johansson; as well as representatives from the Ministries of Agriculture, Finance, Foreign Affairs, and Labor, the Riksbank, the National Institute of Economic Research, the National Debt Office and the Center for Business and Policy Studies. The staff team consisted of Messrs. Schmitt, Geadah, Saavalainen and Thiessen (all EUR), with Ms. Greasley as adminstrative assistant (SEC). Mr. Markus Fogelholm, the Executive Director for Sweden, attended as an observer.

Sweden formally accepted the obligations of Article VIII, Sections 2, 3, and 4 from February 15, 1961. A Social Democratic minority government has held office since 1982. A crisis in February 1990 over economic policy led the Government to resign. It returned to office with a new Minister of Finance. General elections are due by September 1991.

The 1989 Article IV Consultation was concluded at EBM/89/107 (8/23/89) on the basis of SM/89/148 (7/26/89). Directors noted an acceleration of wage and price inflation in Sweden, and a renewed deterioration in its balance of payments. While Directors welcomed efforts to increase the efficiency of domestic investments, including the tax reform, they noted that such reforms would be best introduced in an environment of macroeconomic balance. They urged that fiscal policy be tightened to cool the economy until household saving rates returned to more normal levels. Directors commended the stance of monetary policy, as interest rates were kept high to help dampen domestic demand.

II. Economic background

Swedish economic growth has compared well internationally; in fact, for most of the 1980s, the growth of real GDP exceeded that in other European countries (Chart 1). Despite the room created by a drop in the oil price in 1986, and by the consequent improvement in the terms of trade, domestic demand soon ran up against capacity limits, and by the end of the decade overheating had spread across the economy. Throughout the 1980s, unemployment was very low, but inflation was also higher than elsewhere, though not by as much as might have been expected (Chart 1).

Boosted by two substantial devaluations of the krona in 1981 and 1982, expansion was first led by exports and investment, while private consumption was checked by falling real wages (Chart 2). When export growth slowed down, and the recovery in investment paused in 1986, a recovery of consumption maintained growth (Table 1). Consumption was fueled by a recovery of real wages and rising employment, and by rising household wealth. Furthermore, financial market deregulation released a pent-up demand for durable consumer goods, and for credit to finance it.

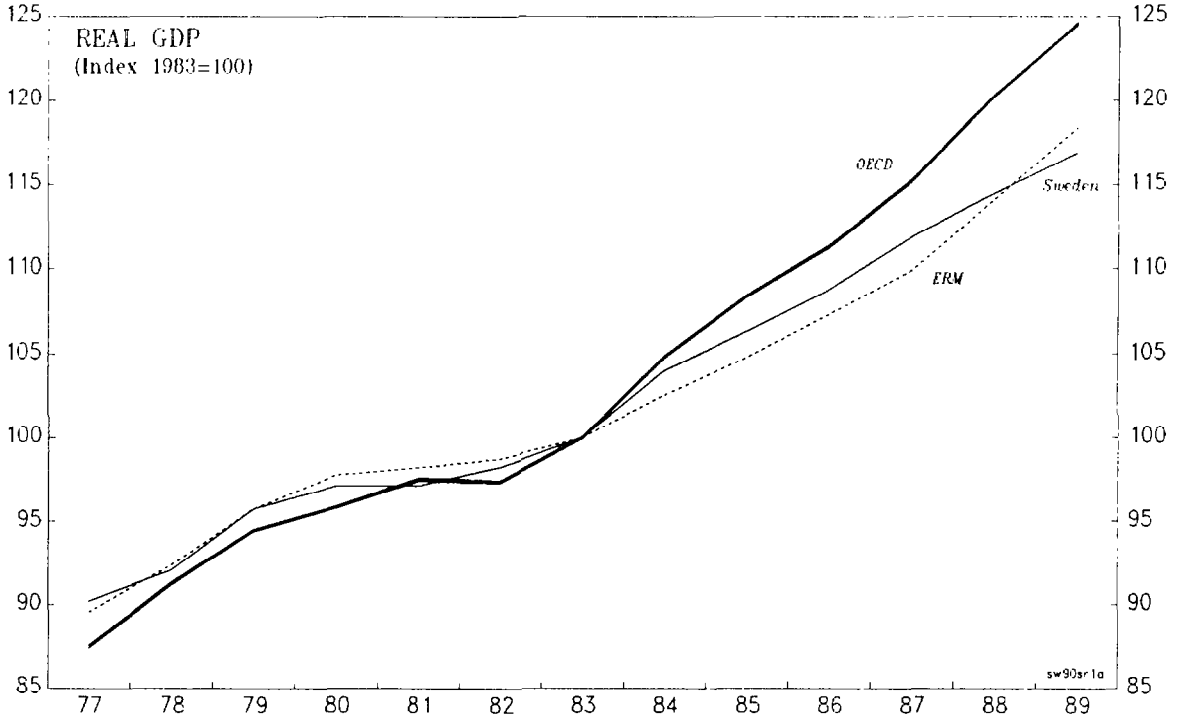
The pause in the growth of investment reflected in part the completion of major projects in the wood-processing industries, but was the consequence mainly of a monetary tightening in 1985, in response to exchange rate pressures resulting from labor unrest. However, as the initial effects of financial deregulation on consumption began to wear off in 1988 and 1989, growth was supported once more by buoyant investment.

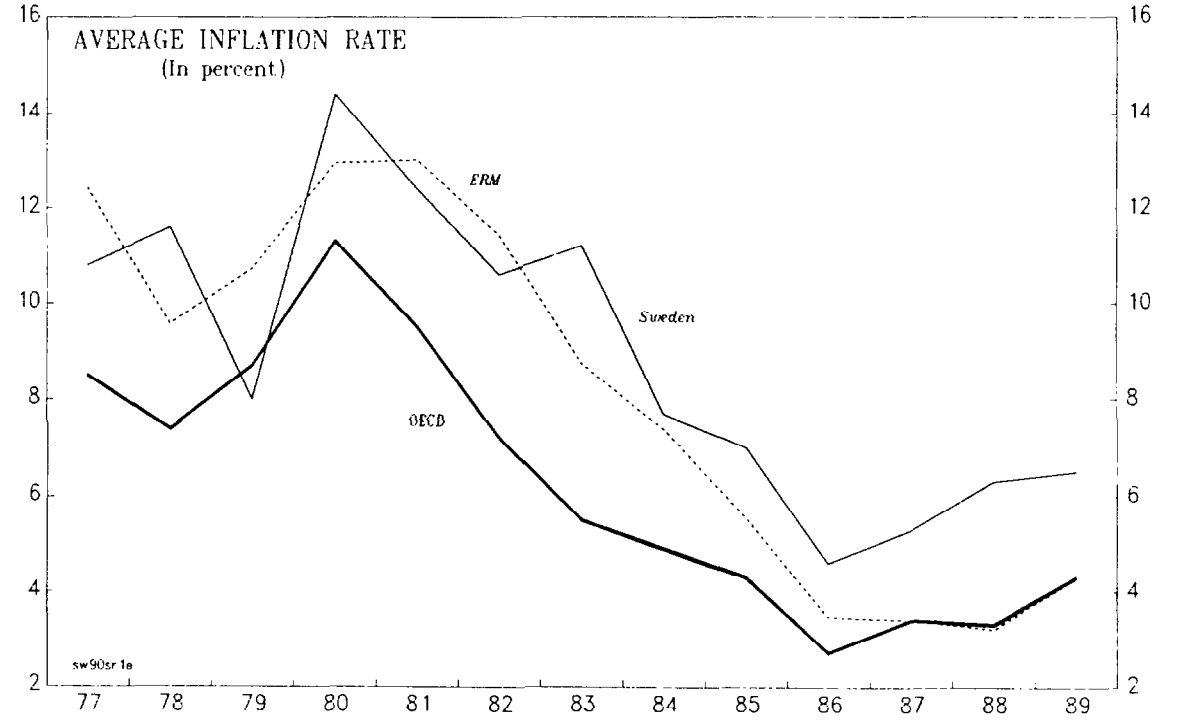
To make room for the recovery of investment and exports, the government budget had swung from a deficit of 7 percent of GDP in 1982, to a surplus of over 4 percent in 1987. Since then the fiscal stance has been more uncertain (Table 2). In 1988 it became expansionary, and moved to restriction in 1989 mainly because of the effects of fiscal drag in response to an acceleration of wage inflation, only to turn expansionary once again, in the face of a rapidly overheating economy, in 1990. After declining from 67 percent to 60 percent between 1982 and 1988, the public expenditure ratio rose once more to 62 percent of GDP in 1990. The tax ratio, for its part, continued rising throughout the period, reaching 56 percent in 1990.

Overheating surfaced in 1987. The volume of gross fixed investment increased 25 percent between 1986 and 1989, and the investment ratio rose from 17.5 percent in 1986 to 21.3 percent in 1989, the highest level since 1974. The investment boom in 1987-89 came in response to the high rates of capacity utilization already observed, and to a rising differential between the rate of return and interest rates (Chart 3). In fact, from late 1985 to early 1988, Swedish interest rates declined more than those abroad. The trade surplus accordingly began to shrink, and the inflation differential with OECD countries widened again after having declined for several years (Chart 1).

CHART 1
SWEDEN

REAL GDP AND INFLATION 1/

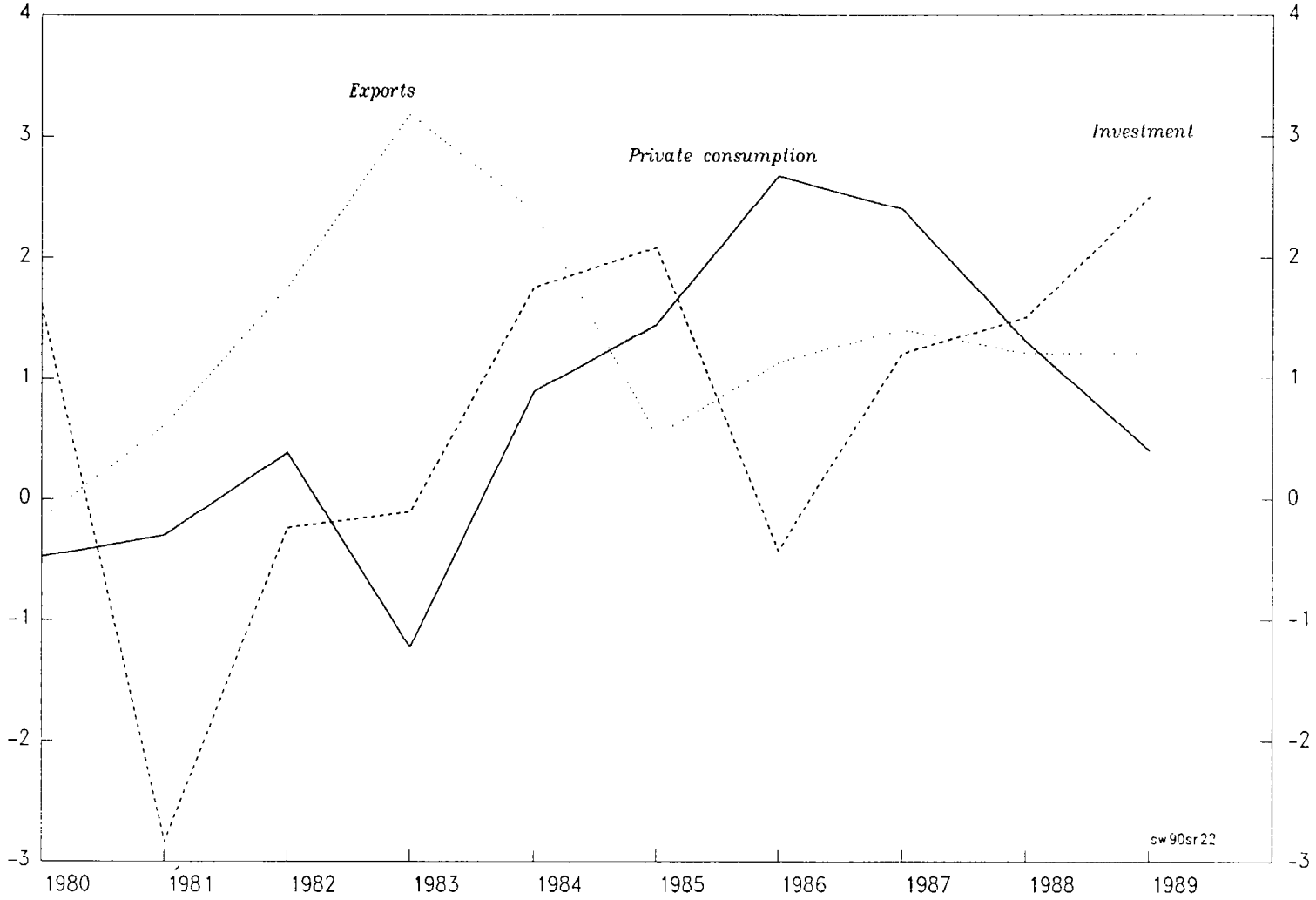




Source: OECD, Economic Outlook No. 47.
1/ Aggregates were computed on 1987 GDP weights expressed in 1987 dollars.

CHART 2
SWEDEN

CONTRIBUTIONS TO REAL GDP GROWTH
(Change in percent of previous year's GDP)

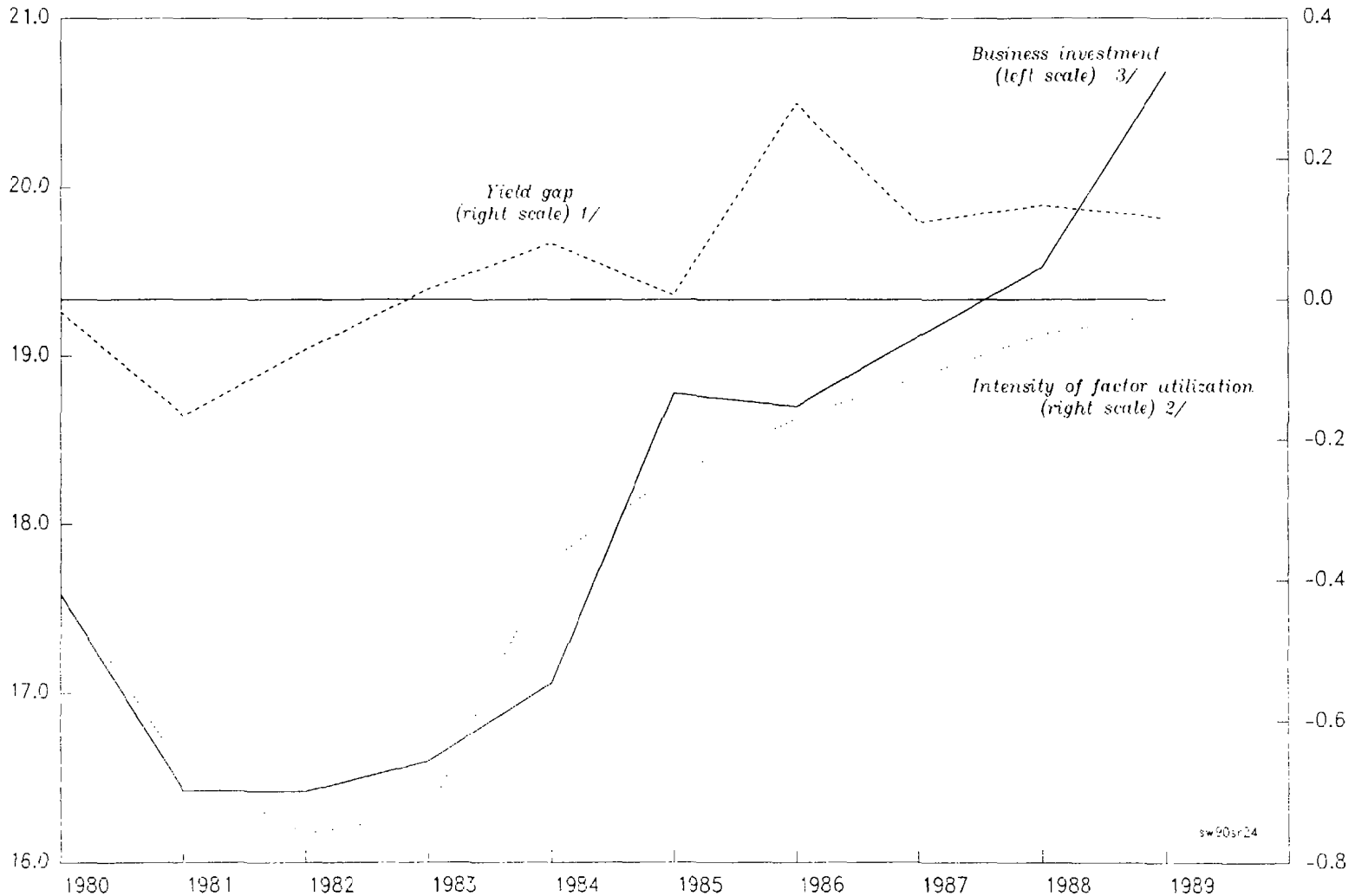


Source: Konjunkturinstitutet.

CHART 3
SWEDEN

BUSINESS INVESTMENT, FACTOR UTILIZATION AND YIELD GAP

(Scale units explained in footnotes)



Source: OECD Economic Outlook Database.

1/ Rate of return in the business sector divided by nominal long-term interest rate. Deviation from one

2/ Composite index of actual vs. desired use of labor and capital. Deviation from one multiplied by ten. For example between 1982 and 1989 the utilization rate index rose from 0.924 to 0.998.

3/ In percent of business sector's GDP.

Table 1. Sweden: GDP and Demand Components

(Volume changes in percent)

	1985	1986	1987	1988	1989	1990 1/
Private consumption	2.8	5.2	4.6	2.5	0.7	1.1
Public consumption	2.4	1.5	1.3	1.0	1.9	1.5
Gross fixed investment	7.3	0.3	7.6	6.4	9.5	3.0
Change in inventories 2/	0.9	-0.5	-0.2	0.3	0.6	-0.1
Total domestic demand	4.4	2.8	4.0	3.2	3.4	1.7
Exports of goods and services	1.5	3.2	3.9	3.3	3.4	2.1
Imports of goods and services	7.8	4.7	7.2	5.8	6.8	4.1
Foreign balance 2/	-2.0	-0.5	-1.1	-0.9	-1.3	-0.8
Gross domestic product	2.2	2.3	2.9	2.3	2.1	0.8

Sources: Ministry of Finance, Reviderad Finansplan, April 1990; data provided by the Swedish authorities; and staff calculations.

1/ Official forecast as of April 1990.
2/ Change, in percent of previous year's GDP.

Table 2. Sweden: Public Sector Accounts

(In percent of GDP)

	1985	1986	1987	1988	1989	1990 1/
			(National account definitions)			
Tax ratio	51.0	51.7	54.6	54.5	56.5	56.4
Expenditure	65.0	63.3	61.1	59.9	60.8	61.6
Financial balance	-3.8	-1.3	4.2	3.4	5.0	3.9
Central government	-5.8	-2.6	1.8	1.3	3.1	1.8
Local government	-0.5	-0.6	-0.3	-0.9	-0.8	1.5
Social security	2.5	2.5	2.6	2.6	2.7	3.6
Change in the fiscal stance, primary balance 2/	...	3.7	3.6	-2.0	1.6	-0.1
			(Budget definitions)			
Memorandum items:						
Central government budget balance 3/	-5.2	-1.6	-0.4	1.6	1.1	--
Underlying budget balance 3/	-4.7	-1.4	-0.7	0.1	0.3	-0.1

Sources: Ministry of Finance, Reviderad Finansplan, April 1990; and Konjunkturinstitutet, Analysunderlag, March 1990.

1/ Revised National Budget.
2/ Acccording to OECD Economic Outlook, various issues. A negative sign denotes an expansionary effect. For 1991 the effect is calculated to be -0.4 percent of GDP.
3/ Fiscal year basis.

Although the growth of the capital stock increased to an annual rate of 3-3 1/2 percent, capacity utilisation reached record levels in 1989. In manufacturing, average capacity utilization intensified from 80 percent in 1982 to 90 percent in 1989. Similarly, after a trendwise decline to 1982, the labor supply once more increased rapidly thereafter. Nevertheless, labor markets were exceedingly tight. Hours worked in manufacturing grew at an annual rate of 1.2 percent in 1987-89, while unemployment rates fell to levels that produced accelerating wage inflation (Table 3). Productivity growth in manufacturing slowed down from 4.3 percent in 1983-85 to 1.4 percent since then, while consumer price inflation accelerated to 7 percent by early 1990, or to 10 percent including the once-over effect of tax reform.

The gains in competitiveness in 1981 and 1982 began to erode as early as 1983, but were not wholly lost until the end of the decade. By early 1990 the real effective exchange rate had appreciated above its level in the pre-devaluation third quarter of 1981. Until 1988, the loss of competitiveness was the result, not of lagging productivity growth, but of steady increases in relative labor cost (Chart 4). Part of this deterioration was eased by a depreciation in the nominal effective exchange rate between 1985 and 1988, as the U.S. dollar weakened within the basket to which the krona was pegged. More recently, a sharp retardation in productivity growth in Sweden has also contributed to the loss of competitiveness.

Since 1982, monetary policy has been directed primarily to stabilizing the exchange rate within narrow limits. The scope for affecting domestic demand has accordingly been limited. What scope remained, was fully utilized in an effort to dampen excess demand in 1988 and 1989. Relatively high domestic interest rates attracted large capital inflows, however, which pushed the value of the krona to the strong end of its band and boosted the monetary aggregates (Table 4). There was then a sharp speculative outflow at the turn of the year, which peaked during the February government crisis, and raised the six-month interest rate differential to more than 6 percentage points, before it fell back to a more normal 4 percent, where it has remained since.

Excess demand and declining competitiveness caused the external current balance to deteriorate, and foreign borrowing increased (Table 5). To be sure, the measurement of the Swedish external current account exaggerates the problem, because it does not account for profits earned and reinvested abroad. Swedish companies have in recent years invested heavily, particularly in the European Community countries,

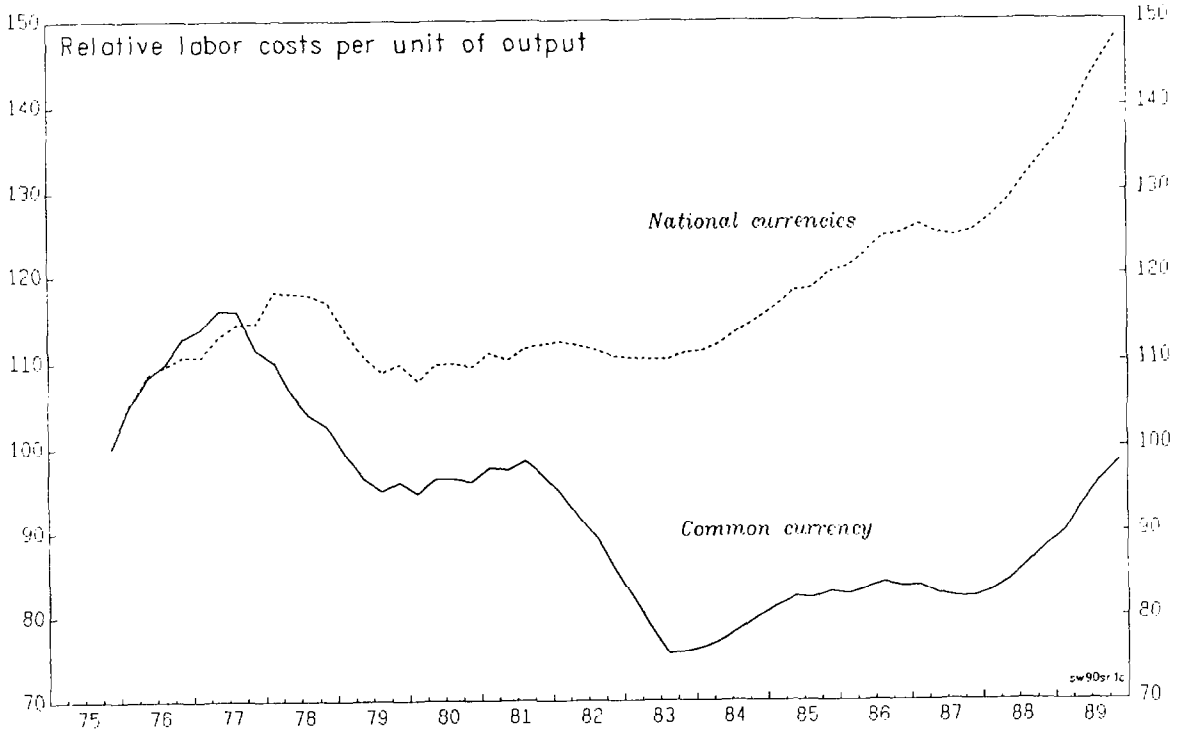
Table 3. Sweden: Wages, Prices, and Employment

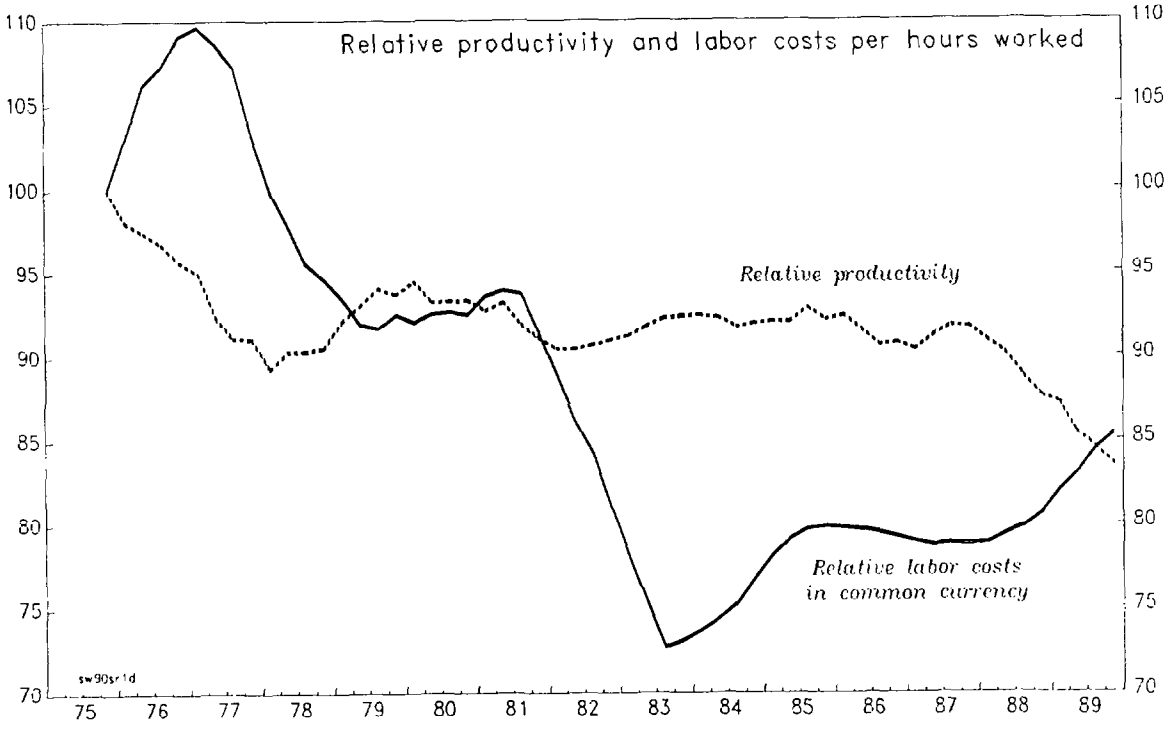
	1985	1986	1987	1988	1989	1990 1/
		(Annual percentage changes)				
Aggregate hourly earnings						
Nominal	7.5	8.6	6.4	6.5	9.4	8.5
Contractual increase	4.2	6.1	3.6	4.2	6.4	5.6
Wage drift	3.3	2.5	2.8	2.3	3.0	2.9
Real 2/	0.1	4.2	2.1	0.7	2.8	-1.4
Hourly wage costs in industry	7.7	7.4	7.0	8.4	10.8	8.5
Hourly earnings	7.5	7.4	6.4	8.4	9.9	7.5
Negotiated	3.8	3.9	--	3.4	4.6	...
Wage drift	3.7	3.5	--	5.0	5.3	...
Social security contribution	0.2	--	--	--	0.6	0.9
Real output per man hour						
Business sector	0.7	1.1	1.7	1.9	1.6	0.5
Manufacturing	1.2	1.5	1.1	1.4	1.7	1.1
Unit labor costs in industry	6.4	5.8	5.8	6.9	8.9	7.3
Consumer prices						
December-December	5.8	3.2	4.9	6.1	6.7	9.8
Year-on-year	7.4	4.2	4.2	5.8	6.4	10.0
		(In percent of labor force)				
Unemployment rate	2.4	2.2	1.9	1.6	1.4	1.6
Unemployed plus persons in labor market schemes as percent of labor force	6.4	6.0	5.5	5.1	4.6	...
Vacancies	0.8	0.9	1.3	1.2	1.1	...
Labor force participation rate	82.6	83.0	83.4	84.0	84.5	...
Men	86.0	85.9	85.7	86.2	86.8	...
Women	79.2	80.0	81.1	81.8	82.2	...

Sources: Ministry of Finance, Reviderad Finansplan, April 1990; Statistics Sweden, Allman Manadsstatistik, 1990; Konjunkturinstitutet, Analysunderlag, March 1990; data received from the Swedish authorities; and staff estimates.

1/ Official forecast as of April 1990.
2/ Deflated by the private consumption deflator.

CHART 4
SWEDEN
COMPETITIVENESS
(4 quarter moving average, Index 1975 IV = 100)





Sources: IMF, Research Department and staff calculations.

Table 4. Sweden: Monetary Developments

	1985	1986	1987	1988	1989	1990 Q1
		(Annual percentage changes)				
Money supply (M_3)	0.6	10.9	4.0	5.3	9.7	9.2
Contribution from: 1/						
Domestic contribution	--	9.0	2.1	2.1	5.6	2.7
Central Government	-1.0	-0.2	-3.4	-5.8	0.2	-1.7
Commercial banks	5.7	13.0	3.7	9.5	8.2	6.4
Riksbank 2/	-4.7	-3.8	1.8	-1.6	-2.4	-2.0
External contribution 3/	0.6	1.9	1.9	3.2	4.1	6.5
		(In percent; last month of period)				
Treasury discount notes (3-month)	13.4	8.8	9.1	10.4	12.3	14.6
Government bond yield 4/	12.2	10.5	11.4	11.1	12.9	14.3
Eurocurrency deposit rate (3-month) 5/	6.4	5.5	5.7	7.3	8.2	8.4

Sources: Sveriges Riksbank, Annual Report and Quarterly Review; and data supplied by the Swedish authorities.

1/ Changes as percent of money supply at the beginning of the 12-month period.
2/ Excluding lending to the Central Government and net foreign assets.
3/ The so-called currency flow which excludes proceeds of central government foreign borrowing.
4/ For 1985, bonds with ten years to maturity. For 1986 onward, bonds with five years to maturity.
5/ Average of Eurodollar and deutsche mark deposit rates.

Table 5. Sweden: Balance of Payments

(In billions of Swedish kronor)

	1985	1986	1987	1988	1989	1990
Exports, f.o.b.	260.5	265.1	281.4	305.0	332.1	349.7
Imports, c.i.f.	244.7	232.6	257.4	280.7	315.1	336.7
Trade balance 1/	14.5	30.8	22.5	23.4	15.8	12.0
Nonfactor services, net	0.4	-4.4	-4.1	-7.7	-10.0	-10.2
Factor services and transfers, net	-29.5	-25.9	-25.2	-28.7	-39.2	-52.5
Current balance	-14.5	0.6	-7.0	-13.1	-33.4	-50.7
(in percent of GDP)	(-1.7)	(0.1)	(-0.7)	(-1.2)	(-2.7)	(-3.7)
Capital flows, net 2/	17.1	7.8	15.9	29.2	55.2	...
External currency flow	2.6	8.3	9.2	16.1	21.8	...
Memorandum item:						
Reserves (in billions of SDRs) 3/	5.5	5.6	6.0	6.5	7.5	...
(in weeks of merchandise imports)	(10)	(10)	(10)	(10)	(11)	...

Sources: Ministry of Finance, Reviderad Finansplan, April 1990; data provided by the Swedish authorities; IMF, International Financial Statistics; and staff calculations.

1/ Including correction items.
2/ Excluding Government and Riksbank.
3/ End of period.

but reinvested income has not been recorded in the current account. Adjusting for these incomes improves the position of the external current account, but does not affect the trend.

The deterioration in the real trade balance was masked, on the other hand, by the sharp improvement in the terms of trade in 1986, despite a loss of about 12 percent in export market shares between 1985 and 1989. The services account deteriorated rapidly both in 1988 and 1989, mainly reflecting increased travel expenditures abroad. Net interest payments abroad rose to 2.3 percent of GDP in 1989 as the ratio of net external debt to GDP increased to 30.7 percent in 1989. Appropriations for official development assistance have been maintained at 1 percent of GDP since 1975. Gross official reserves stood at SDR 7.5 billion at the end of 1989, equivalent to 11 weeks of imports of goods and services.

III. The Policy Discussions

The year 1990 had opened to strikes in support of exaggerated pay claims, against a background of accelerating price inflation. Despite intensifying demand pressure that took the unemployment rate below 1 1/2 percent, the growth of GDP held steady at just over 2 percent through 1989, but the deficit on external current account widened to just under 3 percent of GDP, with the prospect of reaching nearly 4 percent the following year. Unable to gain support for a significant tightening of fiscal policy, the Government proposed a pay, price, rent, and dividend freeze for a period of two years, accompanied by a ban on strikes, and when that too failed in Parliament in February 1990, it resigned. Soon after, a reshuffled government returned to office, and a new package was agreed in April, which raised the VAT rate 1 1/2 points to 25 percent for a limited period, froze local taxes, delayed the move to a statutory six weeks' holiday, postponed an expansion of parental leave, and pledged to put up child allowances only by installments. The revised budget for 1990/1991 was nevertheless still expected to have an expansionary effect on the economy (Table 2).

The authorities acknowledged that the expansion of demand, which led to the overheating in the economy, and to its adverse consequences for wage and price inflation, had largely been investment-led. The contribution to growth of consumption had diminished steadily in the four years to 1989, from 3 percent to about 1 percent, while that of investment had risen from zero to 2 1/2 percent over the same period. The excess pressure of demand showed up as a negative contribution to growth by the external sector, which dropped from minus 1/2 percent in 1986 to minus 1 1/3 percent in 1989. Fixed investment in the business sector had begun to expand rapidly after the major devaluations of 1981/82 restored profit margins and competitiveness and, with only a short pause in 1986, reached in 1989 its highest level in relation to GDP in 15 years. Now, however, on the basis of rising interest rates, increased wage costs, subdued demand and attractive investment

alternatives in the European Community, the authorities expected a marked slowing down of domestic investment in 1990, followed by a sharp fall in 1991, unless the rise in wage costs could be curbed, and then held to a rate significantly below what past relationships would suggest.

It was strongly impressed upon the mission that there was no intention of responding to these prospects with a fresh devaluation of the krona. Once more to accommodate excessive wage increases with an exchange rate adjustment would irretrievably damage the credibility of the Government's anti-inflationary commitment. Price stability was not only valued for its own sake, but also as a condition for closer participation with the European Community in open markets for goods, services, labor and capital. Partner countries would look unfavorably on devaluations aimed at keeping Swedish unemployment much below Community levels. Participation in wider markets would of course yield economies of scale, access to advanced technology, and scope for greater welfare. Unemployment would at the same time have to rise before wage increases could be expected to subside to European norms. The relative efficiency of labor markets would probably keep the required unemployment rather lower in Sweden than in the rest of Europe, but how much lower, looked very difficult to say in advance.

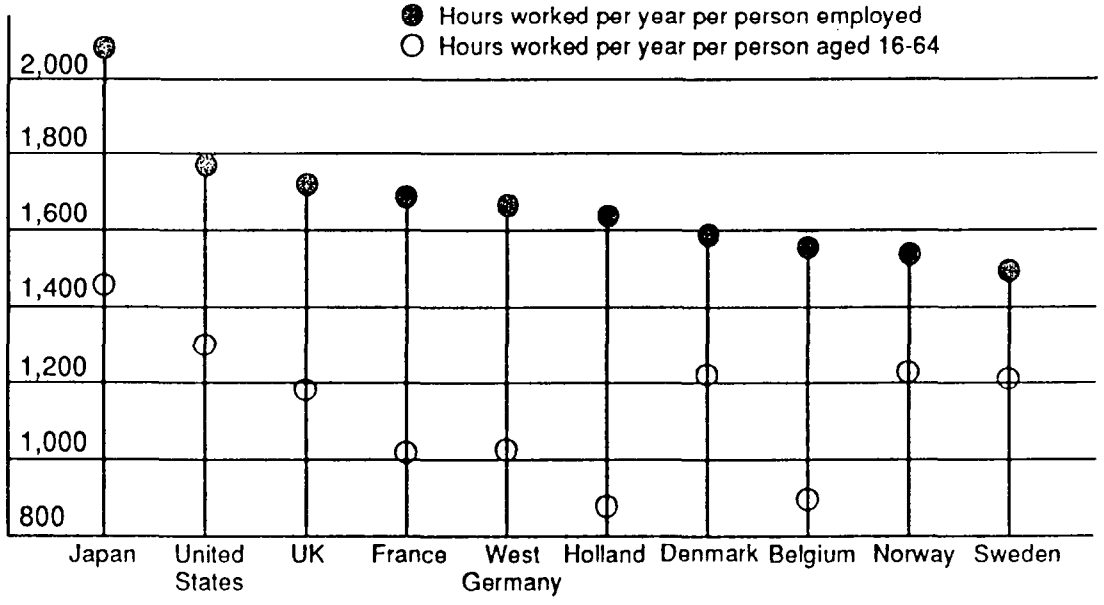
The mission concurred with the Swedish authorities on the need for holding firm on the exchange rate, stressing only that to secure the credibility of their commitment, the authorities would have to be seen to allow unemployment to rise in defense of it. There was for this purpose no alternative to demand restraint. Structural reforms could not substitute for demand restraint in easing the overheating in the economy. They would have to be justified on their own terms as advancing allocative efficiency. The scope for that had been demonstrated in a number of areas, starting with the market for labor.

If demand was difficult to restrain, perhaps one could do something to increase the <u>supply of labor</u> to the market, to hold wages down. Labor force participation rates at about 85 percent of the working age population are of course already high in Sweden, and could hardly be increased much further. High participation rates were associated with comparatively low hours worked per person employed, though hours worked per person of working age still put Sweden higher than France and West Germany, and lower only to the United States and Japan (Chart 5). Various measures that biased the public's choice between work and leisure were being reviewed, however, including some perhaps generous provisions for sick pay, parental and educational leave, statutory paid holidays, and until this year's tax reform takes effect, very high marginal tax rates on earned income. Apart from the tax reform, the Government proposed making employers responsible for sickness benefits covering the first two weeks of illness. Additional measures were under consideration to facilitate the return to the labor force of people on disability and on old-age pensions, and to speed up the integration of immigrants into the labor market. The mission welcomed most of these

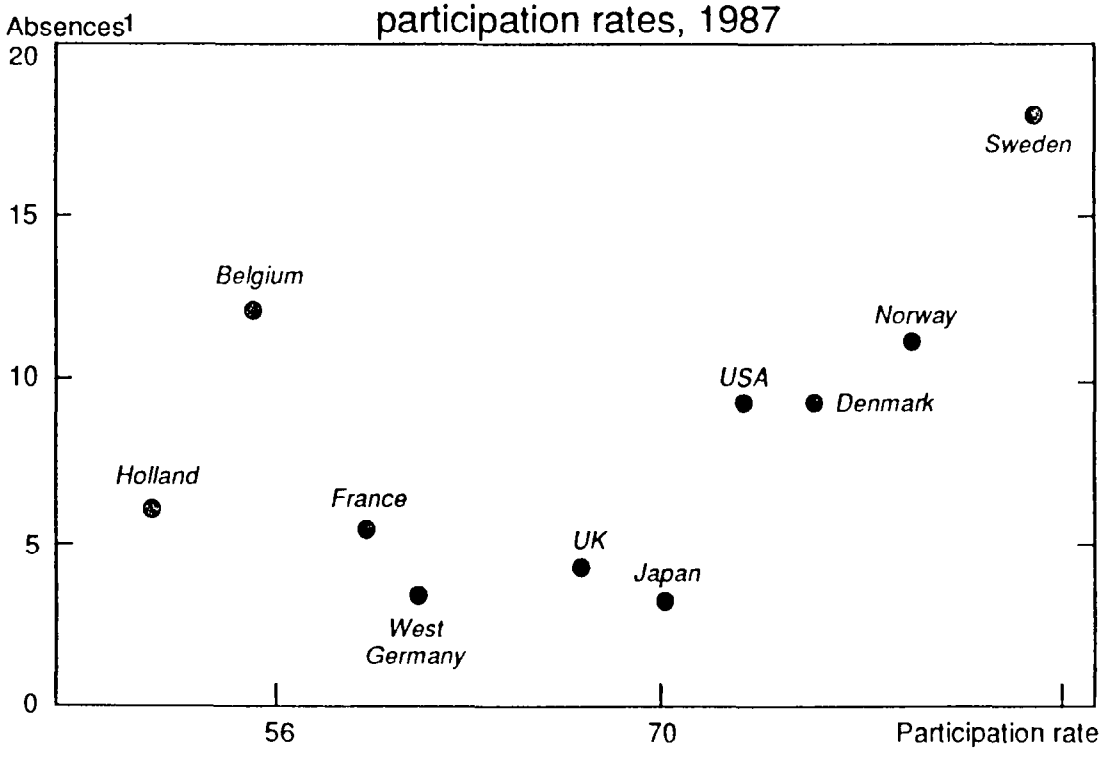
CHART 5

SWEDEN

Comparison of hours worked per year per person employed, and per person aged 16-64, 1987



Relationship between work absences and participation rates, 1987



Source: Statens Offentliga Utrendigar 1989:53, Arbetstidkommitténs betänkande, Bilagedel A, p 264

1 Absences from work as percent of normal working time.

reforms insofar as they strengthened consumer choice, and therefore improved allocative efficiency, but noted also that less flexibility in hours worked would in all likelihood reduce participation rates as well, leaving the net effect on labor supply uncertain.

If the labor supply cannot easily be increased, perhaps the growth in its productivity could be accelerated to ease the overheating in the labor market. It needed first of all to be acknowledged that, until very recently, the increase in labor productivity in Sweden had not been notably slower than abroad (Chart 4). Nevertheless, exceptionally weak productivity growth in the last two years was frequently cited as a major cause of the overheated economic situation. However, the pattern of recent years--very weak productivity gains in conjunction with full capacity utilization--also allowed a contrary explanation. Full capacity utilization delays closures of plants that would otherwise be scrapped; high investment will at the same time require reaching down further along the spectrum of techniques available at the time. It was thus the overheating that may have contributed to a low productivity performance, not the other way around. No appeal need therefore be made to underlying structural weaknesses in the economy. Advances in the available spectrum of techniques could still be accelerated, of course. Whether the rate of technical progress in this sense had been exceptionally low in Sweden deserved to be looked at afresh.

The low level of household saving was also considered as a possible source of overheating in the Swedish economy. To be sure, for growth with external balance the important consideration is total savings by households, firms, and the public sector. This total had consistently increased in relation to GDP since 1982 (Chart 6). A major factor had been the elimination of the public sector financial deficit. Household saving persistently declined over the period, though the decline was initially compensated for by rising enterprise savings. The weakening of household saving in recent years was probably due mainly to credit market deregulation in 1985, which provided households with expanded access to consumer credit, at a time when their wealth was also increasing with the appreciation of real estate values and equity, and when borrowing was still subsidized by allowing interest expenditure to be offset against a very high marginal tax rate. Once the tax reform is fully in place, and households have had time to achieve their preferred net asset positions, household saving could well rebound to more traditional levels. The mission stressed, however, that the adequacy of those levels cannot be judged in terms of their contribution to a cooling of the economy. Any renewed interference to achieve that additional purpose would diminish allocative efficiency, and therefore reduce welfare.

Tax reform was perhaps the most ambitious structural measure to have been successfully implemented by the present Government. 1/ It consists primarily of lower tax rates and broader tax bases, as well as a more uniform taxation of different types of income, investment and consumption. In the process, the direct taxation of labor incomes was reduced, and compensated for by roughly equal increases in taxes on capital income and on consumption, respectively. The primary objective has been a reduction in the economic costs of taxation without reducing total tax revenue. Tax considerations will therefore feature less prominently, now than before, in the distribution of productive resources and in the choice of compensation. Different activities will compete on more equal terms. To be sure, the reform is also expected to stimulate work and saving: Swedes were to be encouraged to work and to save themselves out of the present crisis. But this effect is almost coincidental; rather than demand management, allocative efficiency has been the main objective of the reform. The macroeconomic effects of the tax reform in the 1990s were in fact acknowledged to be extremely difficult to quantify in advance. Whatever they might be, however, allocative efficiency would be enhanced by the reform, and the mission accepted that.

Deregulation had meanwhile led to major structural changes in financial markets as well. A highly regulated financial sector has been transformed into a market system. Domestic markets were effectively decontrolled once credit ceilings were abolished in late 1985, and interest ceilings lifted. Exchange restrictions were also progressively liberalized, and virtually all of them were abolished effective July 1989. With capital movements increasingly unencumbered, it was becoming more and more difficult to maintain substantial interest rate differentials with those abroad, except in times of crises, or to use monetary policy to affect demand conditions at home. This loss of monetary autonomy was nevertheless accepted by the authorities, again on efficiency grounds. To better compete globally, mergers of financial institutions have led to increased concentration at home. The restructuring of portfolios in Sweden and abroad has also produced substantial net outflows of long-term capital. The mission as much as the authorities expected the market to settle down once such initial adjustments are completed.

Swedish trade policy has been exceptionally liberal with low tariffs and few quantitative restrictions except on trade in textiles and footwear and in agricultural products. The mission welcomed the prospect that restrictions on textiles were soon to come to an end, and that those on agricultural products were to be wound down. A bill to restructure the agricultural control system had already been presented to Parliament. The removal of border protection against low import prices was to be left pending the results of the GATT negotiations

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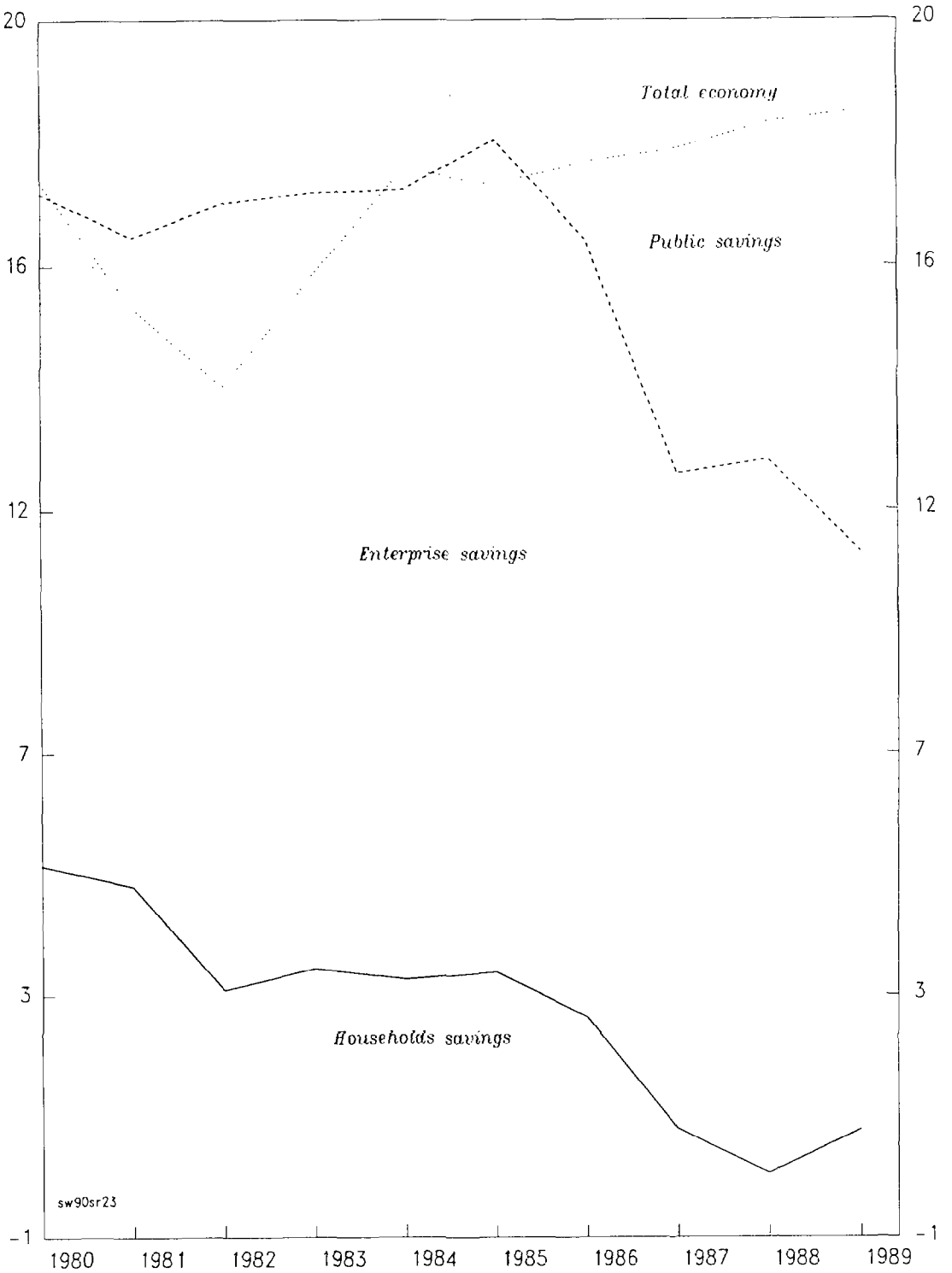
1/ For a more detailed exposition of the tax reform, see the forthcoming Recent Economic Developments report.

CHART 6
SWEDEN
GROSS SAVINGS
(In percent of GDP)



Source: Konjunkturinstitutet.

currently in process. However, internal market controls, which led to surpluses, particularly of grain that had to be exported at a loss, were to be phased out over a five-year period starting in July 1991. The progressive loss of agricultural export subsidies will reduce grain producers' incomes with the decline in prices at which they have to sell their product. This would, however, be offset by income support during the transitional period. As for textiles, all quantitative restrictions were to be removed with the expiration of the Multifiber Arrangement in July 1991, and the domestic support program was to be terminated the following year. The textile industry was deemed to be competitive now, having found its niche in the market. The relative price of both products was expected to fall, and allocative efficiency to be improved thereby. But the rate of inflation of all prices taken together, was of course another matter entirely.

The energy sector was the one area in which structural reform had perhaps not been as successful as in other fields. The low price of electricity had for some time past been a source of comparative advantage for Swedish industry. It was due mainly to a plentiful supply of cheap hydroelectric power, and to low costs for nuclear power. However, Parliament's decision to phase out nuclear power, and to restrict carbon dioxide emissions, placed important restraints on economic growth, especially as Parliament had also limited the further expansion of hydroelectric power. The additional ceilings on the emission of sulphur and nitrogen oxides could also become important. Of course, unilateral Swedish action, particularly on carbon dioxide emissions, was unlikely inasmuch as the problem was international in scope. Insofar as environmental damage is a cost, taking it into account in resource allocation may be said to increase efficiency. It was also granted, however, that the phasing out of nuclear power, and restrictions on the emission of carbon dioxide, sulphur and nitrogen would have to proceed at a pace that does not impose unmanageable strains on the economy. This, the mission thought, needed to be clearly stated. A disorderly process would serve only to force Swedish industry to relocate abroad, with little if any net gain in welfare at home or abroad.

All but the last of these structural reforms had progressed a remarkable distance. The mission did not see, however, how any of them, or even all of them together, could make a significant contribution to the problem of overheating in the economy. Their purpose was to increase welfare by promoting a more efficient allocation of resources. To alter the degree of utilization of those resources, macroeconomic demand management measures would still be required.

A fixed exchange rate could itself provide a pivot around which a stabilization process can take shape in the market. As wages continue to rise in an overheated labor market, profit margins will progressively shrink, to the point where investment would begin to fall back in response. Official forecasts suggested that this point would be reached in Sweden this year. As investment declines, unemployment would rise,

and cost inflation recede. However, the Revised Budget Statement took a jaundiced view of this approach to stabilization, and called for resolute measures to prevent such a development--with its economic stagnation and rapidly rising unemployment. The mission also saw drawbacks in this approach. It bears down most on the traded goods sector, which is least able, with a fixed exchange rate, to pass rising labor costs into prices, and where the profit squeeze is therefore likely to overshoot what is needed on average to cool the economy as a whole. Yet, unless the authorities could mount a vigorous response of fiscal and, where possible, of monetary restraint, this might yet be the only way for them to ride out the inflationary process, rather than surrender to it.

A more widely distributed and timely effect could be obtained by a policy of fiscal restraint in support of the fixed exchange rate. Unfortunately, on present prospects the government budget was still likely to be somewhat expansionary, both in 1990 and 1991. Given the first signs of a cooling down in the economy, the authorities argued, the fiscal stance could still turn out to be appropriate. The mission, for its part, thought it rather early to offset the deflationary effects of exchange rate stability with fiscal expansion. The danger that such offsets could be overdone looked real. There had, for example, been considerable pressure to fill vacancies in local government, particularly in the health services and the police. For the moment, the authorities had responded by placing a ceiling on local government revenues, and thereby, given the limits on their borrowing, on local authority spending as well. Would they be able to keep these restraints in effect once slack begins to develop in the labor market? Yet, without such slack, wage moderation could not be counted on. The loss of competitiveness would continue, enough perhaps to threaten confidence in the currency, and with that, in future relations with the European Community.

With fiscal policy an uncertain quantity, monetary policy remained as the last line of defense against inflation in Sweden. In normal circumstances, monetary policy could make only a limited contribution to demand management, in a small open economy with a fixed exchange rate. In times of crisis, on the other hand, the defense of the exchange rate, which was the designated objective of monetary policy, would require increases in interest rates that, coincidentally, could help to dampen domestic activity as well. How high interest rates must go to achieve the desired result, no one could tell beforehand, the mission thought. At any rate high enough to create the necessary cooling of the economy. Nor could one be sure how much unemployment would need to rise to stabilize costs and prices. That, too, would have to be discovered in practice. Perhaps not impossibly high. The steadfastness of policy would be tested, however, by the willingness of the authorities to persevere until they did know.

IV. Economic Outlook

The rate of economic growth in Sweden was in 1989 considerably lower than among its trading partners. The authorities saw the major reason for this in the rapid rise of labor costs, which had led to further losses of market shares abroad, and to accelerating imports. The labor market is expected to become less overheated in the course of 1990, but the wage level is still rising much faster than in competitor countries, and the growth rate of output, at less than 1 percent, is accordingly expected to continue lagging behind that in the rest of the world. Growth will remain low in 1991 as well. Swedish producers are expected to continue losing market shares, and investment is expected to slacken, if not in fact to decline.

The crucial factor, in the view of the authorities, is wages. The official projections already take into account the effects of the 1990/91 budget, of the tax reform, and of other measures to promote competition. Preliminary figures showed wage increases in 1989 to have averaged about 9 1/2 percent, or almost twice the rate among Sweden's main competitors. For 1990, the authorities hope that those increases can be held to an average of 8 1/2 percent. This figure presupposes that any renegotiations, triggered by the consumer price index in March exceeding the December 1989 level by more than the agreed 4 percent, do not yield further increments in 1990. With unemployment beginning to creep up once more, wage drift is also expected to be moderate.

The authorities declined to make wage forecasts for 1991. Instead they calculated, first, that an improvement in the relative level of Swedish costs, would require that the rate of wage increases be lowered to no more than 3 percent in 1991. They next estimated that a continuation of past behavior patterns would, instead, keep wage increases as high as 8 percent. Should the first alternative be feasible, GDP growth could be held to 1 percent according to official projections, and price inflation be lowered from 7 1/2 percent in 1990 to just under 4 percent in 1991. Otherwise, they feared, GDP growth would fall to 1/2 percent, and inflation remain at 5 1/2 percent. Tax reform would in either case add 3 1/2 points to price inflation.

Turning to the components of demand, the authorities noted that gross fixed investment had risen by nearly 10 percent in 1989. High capacity utilization, and many years with high profitability, had contributed to this exceptional buoyancy. The authorities nevertheless expected the growth of investment to slacken appreciably in 1990, as a result of high interest rates in defence of the krona, weakened profitability, and expectations that costs will continue to develop unfavorably. Indeed, if the rapid rise of wage costs continues, and profits go on declining, they expect investment in 1991 to drop.

The growth of total consumption, on the other hand, was expected to rise marginally to just over 1 percent in 1990. Wages and prices were both climbing rapidly, accompanied by income tax cuts. Rising interest

rates, and successive restrictions of tax allowances for interest expenditures rendered households less eager to borrow. Accordingly their savings ratios were expected to go on rising, also in 1991. The tax reform was projected to increase disposable incomes, however, supporting increases in total consumption that could go as high as 2 1/2 percent in 1991, if wage increases followed the historical trend.

The authorities feared that the contribution to growth from foreign trade would remain negative, despite a weaker increase in imports as domestic activity slackened. If the wage rise was not curbed, the cost crisis would become even more pronounced in 1991. Swedish producers will then lose market shares at an accelerating rate at home as well as abroad. With weak economic growth, unemployment will also climb, according to official calculations, from 1.4 percent in 1989 to 1.6 percent in 1990, and to 2 or 2.3 percent, respectively, in the two alternatives for 1991.

Looking further ahead, the mission calculated the implications for the balance of payments and the net external debt of medium-term projections provided by the authorities for the 1991-95 period (Appendix I). Scenario A is based on the authorities' medium-term model-based projections. In it, wages increase by about 8 percent in 1991, and by sizably lower rates thereafter as the loss of competitiveness, and an increase in unemployment in the initial part of the period, lead to a rapid moderation in wages. The current account deficit rises at about 4 percent of GDP, while the ratio of external debt to GDP increases to 38 percent. Scenario B highlights the effect of wage adjustment on the simulation outcome. Wages are not assumed to adjust promptly as in Scenario A, but to grow at annual rates which decline gradually to 6 percent by 1994-95. As competitiveness does not recover during the period, the current account deficit rises to 6 1/2 percent of GDP in 1995, while the external debt ratio increases to 40 percent of GDP.

V. Staff Appraisal

The discussions took place against the background of strikes early in the year in support of exaggerated pay claims in response to accelerating price inflation. Intensifying demand pressure took the unemployment rate below a mere 1 1/2 percent, but the growth of GDP was holding steady at its capacity rate of just over 2 percent, while the deficit on current account widened, with the prospect of reaching 4 percent in the current year. The expansion of demand, which led to the overheating of the economy, appears to have been largely investment-led. Fixed investment in the business sector had begun to expand rapidly soon after the devaluations of 1981/82 restored profit margins and competitiveness.

Business surveys have now begun to reflect impending trouble. On the basis of increased wage costs, rising interest rates, subdued

demand, and attractive investment alternatives in EC countries, the authorities already projected a slowing down of investment in 1990, followed by a fall in 1991, unless the rise in wage costs can be held to a rate significantly below what past relationships would suggest. Unit labor costs have returned to the level, relative to trading partners, which they held before the 1981/82 devaluation.

The authorities stressed that they have no intention of devaluing the krona again. Once more to accommodate excessive wage increases with an exchange rate adjustment would inevitably damage the credibility of their anti-inflationary commitment. Price stability is valued not only for its own sake, but also as a condition for closer participation with the EC in a single European economic space. EC countries are unlikely to look favorably on devaluation aimed at keeping Swedish unemployment very much below their own levels. Unemployment will therefore have to rise until wage incomes subside to European norms.

The staff remains concerned that the adjustment process could, left to itself, bear down most on the traded goods sector, which is least able, with a fixed exchange rate, to pass rising labor costs into prices, and where the profit squeeze is therefore likely to overshoot what is needed on average to cool the economy as a whole. A more evenly distributed effect could be obtained if the fixed exchange rate were supported by a more vigorous policy of fiscal restraint. Unfortunately, on present prospects, the government budget is likely to be somewhat expansionary still in both 1990 and 1991. New fiscal measures in the fall would certainly be welcome.

With fiscal policy still an uncertain quantity, monetary policy remains as a last defense. In times of crisis, the defense of the exchange rate, which must be the prime objective of monetary policy, will require increases in interest rates which can, coincidentally, help dampen economic activity as well. The credibility of the Swedish commitment to fixed exchange rates will be tested by the authorities' willingness to let interest rates rise to whatever level is required to achieve that purpose.

The Swedish authorities have concentrated much of their energies over the last two years on the implementation of structural reforms, particularly in liberalizing financial markets, in tax reform, and in removing some of the last barriers to trade. The staff welcomes each of these measures in its own right. Their purpose is to increase welfare by promoting a more efficient allocation of resources. To alter the degree of utilization of those resources, however, macroeconomic demand management measures are still required. Structural reforms cannot substitute for demand restraint in easing the overheating of the Swedish economy.

Sweden has an exemplary record of financial assistance to developing countries. ODA allocations are being kept at 1 percent of GDP, and bilateral assistance is directed mainly to the poorest countries.

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

Illustrative Medium-Term Scenario

The staff's baseline scenario attempts to illustrate the macroeconomic implications of current policies under present global assumptions. The assumptions regarding future economic growth in Sweden's major trading partners, exchange and interest rates, price developments for manufactured goods, oil and other primary commodities are generally consistent with the June 1990 World Economic Outlook exercise. 1/ The simulations are run for the 1991-95 period. Total domestic demand, wages and productivity are assumed to grow at the rates projected by the Ministry of Finance's long-term survey.

The results of the scenario are presented in the following chart. Scenario A assumes that the growth in wage costs in Sweden falls from about 8 percent in 1990 to an average of about 4 1/2 percent during 1993-95. With an unchanged nominal effective exchange rate and an annual increase in industrial productivity between 3 and 4 1/2 percent, this would result in a halt in the deterioration in Swedish relative unit labor costs in 1992-93 and an improvement thereafter. Total domestic demand is assumed to grow by about 1/2 percent in each of 1991 and 1992 and at an average annual rate of 2 percent thereafter. The current account deficit rises to 5 percent of GDP in 1991, but stabilizes at about 4 percent of GDP in 1994-95 as improvements in the trade balance are offset by increased interest payments. Net external debt rises to about 38 percent of GDP. Real GDP growth averages about 2 1/2 percent annually during the latter part of the simulation period, only slightly lower than GDP growth abroad.

Scenario B highlights the effect of a slower wage adjustment on the simulation outcome. The annual increase in wage rates is assumed to fall to 6 percent in 1994-95, which would be closer to rates observed in Sweden during the last two decades than those of Scenario A. With unchanged demand and productivity assumptions, competitiveness is not regained during the period. The current account widens throughout the

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1/ Real GDP in Sweden's partner countries is assumed to grow by 2.4 percent in 1990, 2.6 percent in 1991, 2.7 percent in 1992-93 and 2.6 percent thereafter. The price of oil is assumed to rise from US$17.18 in 1990 to US$20.71 in 1995. The U.S. dollar interest rate (LIBOR) is assumed to decline from 8.6 percent in 1990 to 8.0 percent in 1995. As Sweden is assumed to be a price taker in the world market, changes in competitiveness would be transmitted through production costs and profits to affect volumes, but not the terms of trade. In the official medium-term scenarios, Swedish traders are assumed to be able to affect their export prices, resulting in substantial gains in the terms of trade over the simulation period.

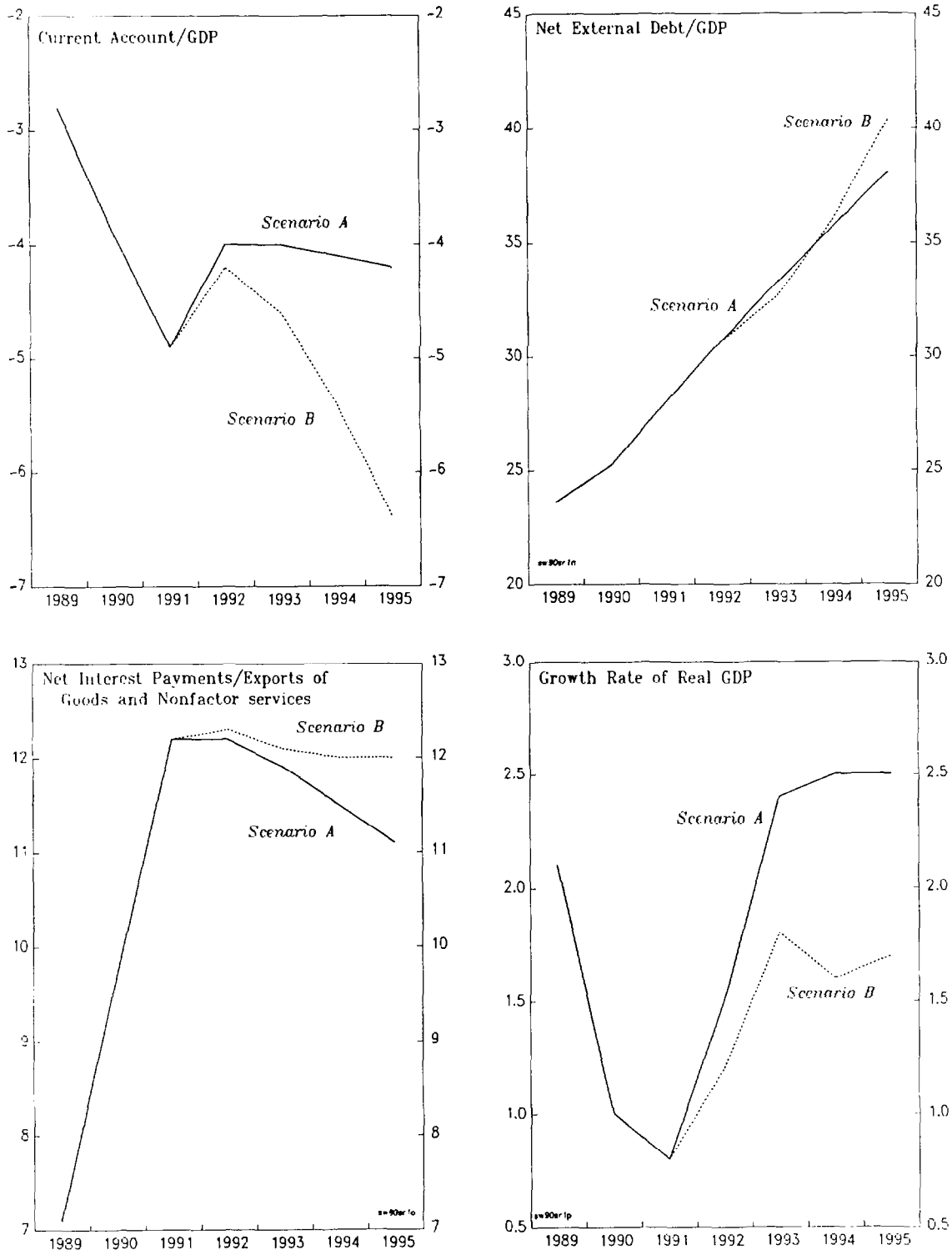
period, to 6 1/2 percent of GDP in 1995, as the trade balance deteriorates and interest payments increase. Net external debt increases to 40 percent of GDP by 1995.

CHART 7

SWEDEN

MEDIUM-TERM SCENARIOS

(In percent)



Source: Staff simulations.

Sweden - Basic Data

Social and demographic indicators

Total area	486,661 square kilometers
Total population (end-1989)	8.53 million
Labor force (1989 average)	4.47 million
GDP per capita (1989)	SDR 14,778

Population characteristics and health (1985):
- Life expectancy at birth
  - Male: 74
  - Female: 80
- Infant mortality (aged under 1, in percent of live births (1985): 0.6
- Population per physician: 387
- Population per hospital bed: 73.2

	1986	1987	1988	1989	1990 Official forecast
National accounts (at constant prices)	(Annual percentage change)				
GDP	2.3	2.9	2.3	2.1	0.8
Total domestic demand	2.8	4.0	3.2	3.4	1.7
Private consumption	5.2	4.6	2.5	0.7	1.1
Public consumption	1.5	1.3	1.0	1.9	1.5
Gross fixed investment	0.3	7.6	6.4	9.5	3.0
Imports of goods and nonfactor services	4.7	7.2	5.8	6.8	4.1
Exports of goods and nonfactor services	3.2	3.9	3.3	3.4	2.1
Selected economic indicators					
Unemployment rate (in percent of labor force)	2.2	1.9	1.6	1.4	1.6
Total employment	0.7	0.8	1.4	1.5	0.7
Unit labor costs in manufacturing	5.8	5.8	6.9	8.9	7.3
GDP deflator (average)	6.9	4.8	6.6	7.4	9.7
Consumer prices (average)	4.2	4.2	5.8	6.5	10.0
Consumer prices (December-December)	3.2	4.9	6.1	6.7	9.8
Broad money (M_3)	10.9	4.0	5.3	9.7	8.1 1/
External sector					
Export volume (merchandise)	2.9	3.7	2.7	2.5	1.6

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

1/ On the 12 months through April 1990.

Sweden - Basic Data (Cont'd)

Selected economic indicators (Cont'd)	1986	1987	1988	1989	1990 Official forecast
Import volume (merchandise)	4.3	7.5	4.8	6.5	3.7
Market share for manufactured exports	-2.5	-0.2	-3.3	-4.9	-3.0
Terms of trade (f.o.b./c.i.f.)	8.5	-0.3	1.3	0.9	0.4 1/
Real effective exchange rate (relative unit labor costs)	1.4	1.3	5.0	8.9	6.0
			(In percent)		
Treasury bill rate (three-month) 2/	9.83	9.39	10.08	11.50	12.97 3/
Government bond yield 2/	10.26	11.44	11.20	11.30	13.60 3/
Public sector			(In percent of GDP)		
Financial balance					
Central Government	-2.6	1.8 4/	1.3	3.1	1.8
Local authorities	-0.6	-0.3	-0.9	-0.8	-1.5
Social security	2.5	2.6	2.6	2.7	3.6
Overall public sector	-1.3	4.2 4/	3.4	5.0	3.9
Balance of payments			(In billions of Swedish kronor)		
Exports, f.o.b.	265.1	281.4	305.0	332.1	349.7
Imports, c.i.f.	232.6	257.4	280.7	315.1	336.7
Trade balance 5/	30.8	22.5	23.4	15.8	12.0
Services and transfers, net	-30.3	-29.4	-36.4	-49.2	-62.7
Current balance	0.6	-7.0	-13.1	-33.4	-50.7
(in percent of GDP)	(--)	(-0.6)	(1.2)	(-2.7)	(-3.7)
Capital account 6/	7.8	15.9	29.2	55.2	...
Overall balance 6/	8.3	9.2	16.1	21.8	...
			(In percent)		
Net external debt (in percent of GDP; end-period)	21.0	20.6	22.9	30.7	...
Net external interest payments relative to exports of goods and nonfactor services	9.5	9.0	9.0	11.6	...

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

1/ National Institute of Economic Research forecast.

2/ Annual average.

3/ Average for May.

4/ Includes revenue from a one-time tax on the capital of life insurance companies equivalent to around 1.6 percent of GDP.

5/ Including correction items.

6/ Excluding Central Government and Riksbank.

Sweden - Statistical Issues

1. Outstanding Statistical Issues

a. Government finance

Data published in IFS cover consolidated central government operations, including extrabudgetary and social security operations, through 1988, as reported for publication in the Government Finance Statistics Yearbook.

Data published in the 1989 Government Finance Statistics Yearbook cover consolidated central government operations, as described above, through 1988, and local and consolidated general government operations through 1987. The presentation includes all tables, and a table describing the derivation of principal central government aggregates from national sources is available. The GFS correspondent has already replied to some parts of the 1990 GFS questionnaire.

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

The table below shows the currentness and coverage of data published in the country page for Sweden in the July 1990 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Sveriges Riksbank, which during the past year have been provided on a regular and timely basis.

Status of IFS Data

		Latest Data in July 1990 IFS
Real sector	- National accounts	Q3 1989
	- Prices: WPI	February 1990
	CPI	March 1990
	- Production	February 1990
	- Employment	February 1990
	- Earnings	Q4 1989
Government finance	- Deficit/Surplus	1988
	- Financing	1988
	- Debt	March 1990
Monetary accounts	- Monetary Authorities	April 1990
	- Deposit Money Banks	August 1989
	- Other Banking Institutions	Q4 1986 1/

1/ Data through the fourth quarter of 1989 have now been reported and will be included in the August 1990 issue of IFS.

Interest rates	- Discount Rate	April 1990
	- Bank Lending/Deposit Rates	December 1989
	- Bond Yields	Q4 1986
External sector	- Merchandise Trade: Values	January 1990 1/
	Prices	February 1990
	- Balance of Payments	Q4 1988
	- International Reserves	April 1990
	- Exchange rates	May 1990

3. Coverage, currentness, and reporting of data in GFS Yearbook

a. Most recent year with data: 1988.

b. Missing tables: none.

1/ Total exports and imports available through March 1990.

Fund Relations with Sweden

(As of June 30, 1990; 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 814.6 million (76.5 percent of quota).

(c) Fund credit: none.

(d) Reserve tranche position: SDR 249.7 million.

(e) Current operational budget: the krona is in the current budget; transfers SDR 41.5 million, receipts SDR 19.4 million.

(f) As a participant in the General Arrangements to Borrow, Sweden is committed to lend the Fund up to SDR 382.5 million.

III. Stand-by or extended arrangements and special facilities

None.

IV. SDR Department

(a) Net cumulative allocation: SDR 246.5 million.

(b) Holdings: SDR 201.0 million or 81.5 percent of the net cumulative allocation.

(c) Current designation plan: Sweden is included in the current designation plan for SDR 3.5 million.

1/ Due to the fact that its holdings of SDR were above acceptance limit.

V. Administered accounts

(a) SFF subsidy account donation: SDR 2.2 million.

(b) ESAF Trust: Subsidy contributions in the form of a grant of SDR 18.4 million in 1988, SDR 18.1 million in 1989, and SKr 150 million per year in the period 1990-91.

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. On June 27, 1985 the authorities announced that the krona would be maintained within margins of 1 1/2 percent on either side of its benchmark value of 132. On July 3, 1990, the exchange rate of the Swedish krona vis-à-vis the U.S. dollar was US$1=SKr 6.005.

IX. Last Article IV consultation

Discussions for the 1989 Article IV consultation were held in Stockholm from May 31 to June 11, 1989. The Staff Report (SM/89/148, 7/26/89 and Cor. 1, 8/16/89) was discussed by the Executive Board on August 23, 1989 (EBM/89/107). It is expected that the next consultation will be held on the standard 12-month cycle.