April 16, 2020
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/22-2

2:30 p.m., March 25, 2019

2. Sweden—2019 Article IV Consultation

Documents: SM/19/56 and Correction 1; and Supplement 1; and Supplement 2

Staff: Beaumont, EUR; Kaufman, SPR

Length: 1 hour, 6 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE)
	F. Sylla (AF)
	C. Moreno (AG), Temporary
N. Ray (AP)	
	P. Fachada (BR)
Z. Jin (CC)	
	P. Moreno (CE)
L. Levonian (CO)	
	C. Just (EC)
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
M. Kaizuka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
	R. Doornbosch (NE)
T. Ostros (NO)	
	L. Palei (RU)
	R. Alkhareif (SA)
J. Agung (ST)	
P. Inderbinen (SZ)	
S. Riach (UK)	
	M. Svenstrup (US), Temporary

G. Bauche, Acting Secretary
S. Maxwell, Summing Up Officer
M. Gislen, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Communications Department: G. Vilkas. European Central Bank: A. Meyler. European Department: C. Beaumont, J. Bricco, R. Jarin, W. Lindquist, F. Misch. Strategy, Policy, and Review Department: M. Kaufman. Executive Director: A. Mozhin (RU). Senior Advisors to Executive Directors: W. Abdelati (MI), M.Gilliot (FF), N. Jost (NE), K. Karjanlahti (NO), T. Nguema-Affane (AF), S. Potapov (RU), T. Sitima-wina (AE), C. Williams (CO). Advisors

to Executive Directors: S. Buetzer (GR), L. Cerami (IT), Z. Huang (CC), G. Kim (AP), M. Mulas (CE), G. Nadali (MD), B. Parkanyi (NE), I. Skrivere (NO), A. Tola (SZ), N. Vaikla (NO), K. Hennings (BR).

2. SWEDEN—2019 ARTICLE IV CONSULTATION

Mr. Ostros and Ms. Karjanlahti submitted the following statement:

On behalf of the Swedish authorities we would like to thank the mission team for the report as well as for the open and constructive policy discussions during the Article IV consultation with Sweden. The authorities broadly agree with the conclusions and recommendations in the staff report.

Recent macroeconomic development and outlook

The Swedish economy has maintained a high level of activity in recent years and growth has been high. In the beginning of 2019 however, both domestic and global indicators have shown signs of a slowdown. Swedish GDP is therefore expected to grow at a slower pace in 2019. Declining dwelling investments and a softening household consumption are expected to contribute to this development. In recent years, the employment rate has increased to historically high levels and unemployment has decreased. Looking ahead, labor market developments are expected to be more subdued as GDP growth slows down. Sweden is a small open economy and is therefore strongly affected by global economic developments. Looking ahead, there are several factors, such as the United Kingdom’s withdrawal from the European Union and the trade tensions between the United States and other countries that can dampen global demand, affecting Swedish exports. The main domestic risks include a further fall in housing prices, although these prices stabilized in 2018 after falling in the second half of 2017.

Fiscal policy

The Government agrees with the IMF’s assessment of the overall fiscal outlook and that Sweden should maintain the practice of allowing full operation of automatic fiscal stabilizers. We also agree with the position that undertaking a small stimulus in the next few years entails little risk of overheating given the low level of inflation, especially with domestic demand expected to slow. The Government shares the view that the fact that demographic changes in the coming decade are relatively rapid and will raise demand for public investment going forward.

The Government notes the IMF’s recommendation to consider a temporary cut in the medium-term surplus target if factors raise the need for public investment beyond past norms. The Government agrees that it should be possible to review the target on account, for instance, of changes in assessments of demography or debt growth. However, to avoid revisions of the target level being made in a way that reduces the credibility of the target, it is important to carry them out in a predictable way. Therefore, once adopted, a surplus target remains in place, but is reviewed every eighth year.

Monetary policy

Swedish monetary policy has been very expansionary during the last couple of years, with a negative policy rate and extensive purchases of government bonds. After a long period with a policy rate of -0.50 percent, the Executive Board of the Riksbank raised the repo rate to -0.25 percent at its December monetary policy meeting and it was held there at the monetary policy meeting in February 2019.

Somewhat reducing the support from monetary policy is now appropriate assuming the good economic developments and improvements in the inflation picture continue, including an inflation rate close to target. In the main scenario, the strong economic activity, rising cost pressures in combination with slightly higher global inflation pressures are providing preconditions for inflation to remain close to target in the coming years.

Nonetheless, in the light of mainly external downside risks, the Riksbank shares the IMF’s view that it is appropriate to closely monitor incoming data to ensure that inflation remains close to target and that inflation expectations are firmly anchored. There is uncertainty about the global economic outlook – in particular relating to the underlying strength of the euro area economy, trade tensions between the United States and other countries, and the United Kingdom’s withdrawal from the European Union. Developments in the Swedish housing market also entail a substantial risk to household consumption, although housing prices have stabilized over the past year.

The cautious approach to monetary policy is reflected in the repo rate path, which indicates only gradual increases in the coming years. Net purchases of government bonds ended in December 2017, but principal payments and coupon payments continue to be reinvested. Monetary policy thus remains expansionary. Future policy will be determined by the economic outlook and inflations prospects.

Financial stability and macroprudential policy

The financial system operates well at present. The banks have high capital adequacy ratios and high profitability. However, the Swedish banking system is large, interconnected, and dependent on market funding, which entails structural vulnerabilities.

The authorities agree that after the recent tightening of macroprudential measures, this is an appropriate time to review the effectiveness of the steps already taken, while remaining well prepared to implement further measures if needed. Housing prices and household indebtedness in Sweden have been rising for a long time, which is a source of concern. However, there has been a marked slowdown in the growth of household debt lately. In December 2018 household mortgage debt growth was 5.6 percent, which is the slowest rate in over four years (while still being higher than growth in GDP and disposable income), and house prices have been falling moderately. The moderation in house price and slowdown in debt growth indicate that risk build-up has eased somewhat, but the high prices and high and rising household debt remain a vulnerability for the general economy and possibly also for financial stability. The implemented amortization requirement, and the further tightening of this requirement targeting households with high debt relative to income, have contributed to reduce the vulnerability. The authorities will continue to monitor the situation carefully, and the FSA will present a report in June 2019 with an evaluation of the measures introduced.

Recently, nonbank providers of mortgage credit have begun to enter the mortgage market but have so far only captured a very small market share. In order to ensure that these new mortgage providers do not threaten the efficiency of macroprudential measures, the FSA recently expanded the scope of the amortization requirement to include these new players. The authorities also carefully monitor risks in the commercial property market where prices have been rising rapidly, valuations are high, and the sector could be sensitive to rising interest rates or a more severe macroeconomic downturn. Risks within the sector are thus elevated. Swedish banks have large exposures to this sector, which makes it important to monitor the adequacy of banks' risk management carefully.

In 2018, a clearing member in Nasdaq Clearing defaulted, which was a reminder of the importance of establishing a regime for the recovery and resolution of central counterparties. However, there was no risk to financial stability in connection with this default, as the losses were absorbed in accordance with the current EU-regulation (EMIR). The event is currently under investigation by the FSA.

The Swedish banking sector is closely interconnected with its neighboring countries and therefore cooperation amongst the authorities within the Nordic-Baltic region is essential to safeguard financial stability and ensure preparedness should a crisis arise. Efficient arrangements between authorities and sound buffers kept by the banks must be ensured and require close engagement and dialogue. The authorities remain committed to continue to deepen the already strong regional cooperation. As an example of these efforts, a regional financial crisis-simulation exercise, prepared by a working group led by the Riksbank, was carried out in January 2019.

The authorities take very seriously recent reports of banks in the Nordic-Baltic region being used for money laundering. The Swedish and Estonian FSAs have initiated a joint investigation into the Swedish banks handling of money laundering in the Baltics, with the participation of the authorities of Latvia and Lithuania. The authorities agree on the need for broader regional cooperation to enhance anti-money laundering efforts. The authorities note that Sweden’s AML/CFT framework has been strengthened in recent years, including through legislation introduced in 2017, and through additional resources being allocated to the FSA for the AML/CFT supervision. At the same time, the authorities recognize that further action may be necessary.

The Riksbank’s e-krona project has raised considerable national and international interest. The consultation responses on the Riksbank’s second e-krona report, indicate a need to involve a wider set of institutions and a broader scope of additional policy measures in further analysis of how to address challenges from changes in payment patterns and payment markets in Sweden. Since this issue is of considerable importance, a broader inquiry into the challenges posed by the changes in the payment landscape is warranted, including the possible role of an e-krona.

Housing and tax issues

The authorities concur with the IMF that there are challenges in the housing market. High construction costs and how to improve the use of existing property are, for example, challenges that need to be addressed and this could be done in different ways. Support for construction of more affordable rental housing is vital which is why the investment grant for rental dwellings and student housing implemented in 2016 will continue as part of the January Agreement between the parties forming the Government (the Social Democrats and the Green Party), the Center Party, and the Liberals.

The on-going housing policy process of making the planning and building permit process smoother, faster, and more predictable will continue as an integral part of the January Agreement. Furthermore, the impact of quality and location of the apartments in the existing stock of rental housing on the rent setting is to be examined and, where it is not sufficient, measures will be proposed in order to make rents better reflect how housing consumers value these utility factors. Moreover, the agreement also states that a liberalization of how rents are set in new construction will be investigated and implemented. Finally, the process of negotiating collective agreements concerning rent will be made more efficient.

The Government has also implemented reforms to improve the functioning of the housing market. The threshold for deferring capital gains taxation has been temporarily removed and will give greater incentives for those with high capital gains to move in the near future. In the January Agreement it is agreed to abolish the interest on deferrals of capital gains taxation on housing to facilitate mobility. The Government is continuously looking at different possibilities to improve the functioning of the housing market.

The design of the tax system is one of many factors that influence the level of household debt. Any potential measures in this area must be seen in a long-term perspective and therefore need to be based on a broad political consensus. Changes must be handled with great care due to the potential negative effects on growth. General changes to the rules on mortgage interest deductibility will affect those who have already borrowed money to buy a house or part of a tenant-owned property. The conditions for households' investment in housing must be predictable as this is one of the largest financial decisions a household can make. Any changes to deductibility should be gradually phased-in.

Labor market

The Swedish labor market is performing well, with the highest employment rate in the EU (82.5 percent among ages 20-64 years as of 2018:3) and falling unemployment (6.2 percent among ages 15-74 as of 2018:4). Despite this, too many people are unemployed and too many people still have trouble finding work, particularly those who have not completed upper secondary school or those who are born outside Europe. At the same time, employers have difficulties finding people with the right skills. Labor shortages are considerable in several parts of the Swedish labor market. The authorities agree with the IMF that it is important to invest in education and training to equip unemployed women and men who lack the relevant education, training, and experience to fill the vacant jobs. Many steps have been taken in that direction already. In 2016, the Government, together with the social partners, put in place fast tracks to shorten the time between arrival to Sweden and entry into the labor market in professions with a shortage. In 2018, an education and training obligation was introduced for newly arrived immigrants considered to need education and training to find work. The social partners' negotiations on new ways to facilitate labor market entry for people with a weak attachment to the labor market are still ongoing and welcomed by the government.

It is the social partners in the manufacturing industry sector that set the national wage benchmark. As a small export-dependent economy, Sweden needs to maintain international competitiveness. The manufacturing industry can best assess the scope for cost increases without affecting competitiveness. This model has worked well for Sweden. The real wages have had an annual real growth of 2 percent for over 20 years, while the employment rate is the highest in the EU. At the same, time labor peace and competitiveness have been maintained. In the 70s and 80s there was no national wage benchmark and the nominal wage increases were absorbed by high inflation which, on average, led to the absence of real wage growth for more than 20 years. To abandon the prevailing, and hitherto successful, wage benchmark could be risky. The Government's view is that any change regarding a wider range of sectors in setting the national benchmark needs to be initiated by the partners themselves. The Government is aware that deviations may be needed in some cases to facilitate relative wage changes but has no plans to change the National Mediations Office's (NMO) mandate. The wage benchmark should not be regarded as an absolute wage roof. If the negotiating partners agree on exceeding the benchmark, the NMO will not interfere.

Mr. Tombini, Mr. Fachada and Mr. Antunes submitted the following statement:

We thank staff for the report and Mr. Ostros and Ms. Karjanlahti for their thorough statement. After several years of robust GDP results, real growth is projected by staff to decelerate to 1.2 percent in the current year. Notwithstanding slower growth rates, the Swedish economy is in a good position to face looming global uncertainties, thanks to strong macroeconomic fundamentals, coupled with reliable fiscal and monetary policy frameworks. Challenges ahead include persistent low core inflation, exchange rate volatility, housing affordability, and the integration of migrant and low skilled workers into the labor market in a context of population aging.

Sweden fiscal position is sound, giving the authorities fiscal space for accommodative policies in case the domestic and global economy deteriorate further. Sweden's gross public debt has consistently fallen over the years to only 40 percent of GDP, remaining in a downward trend. The successful public pension reforms put Sweden in a comfortable fiscal position to deal with the challenges of population aging. Public pension spending as a share of GDP is falling, providing the country room to increase other social expenditures. We commend the authorities for their expert fiscal management and agree with staff's assessment that automatic fiscal stabilizers should be kept in place, considering the downside risks to growth.

Core inflation is still low, notwithstanding negative interest rates. Although headline inflation has come close to target, this development can be largely attributed to increases in energy and food prices. Adjusted measurements show that core inflation remains low, despite the expansionary monetary stance and the persistently negative repo rate. The weakening of the Swedish Krona vis-à-vis other major currencies may produce some inflationary effects. Nevertheless, wage rises remain subdued and labor market reforms leading to higher wages could have more long-lasting effects on prices formation. We understand that the Swedish authorities are reluctant to update the national wage benchmark formation process, based on manufacturing industry negotiations, because of competitiveness concerns. Could staff provide alternative advice on how to encourage higher salary increases without hampering the competitiveness of the Swedish manufacturing sector?

Swedish authorities shall remain vigilant in face of looming global risks. As a small open economy, profoundly integrated into global value chains, a sudden deterioration in the international economic outlook may have significant impacts on Sweden. The growing menace of a no-deal Brexit and the slowdown of growth rates in the Euro area are particularly troubling risks. The Swedish authorities have successfully built sizeable buffers to counteract external shocks. Nevertheless, the contemporary uncertainties leave no room for complacency. Although the risk assessment matrix mentions Brexit as a high risk, the report itself has not fully explored its implications for Sweden. Staff's comments would be welcome.

The successful integration of foreign-born and low skilled workers into the labor force is key to counteract the effects of aging. Sweden is successfully integrating foreign-born workers into its labor market. While employment growth has averaged nearly 2 percent since 2015, among foreign-born workers employment increased by impressive 6.4 percent. At the same time, although the challenge posed by an aging workforce is less pressing in Sweden than in other advanced economies, the growing participation of foreign-born workers in the labor market is critical to keep the old age dependency ratio at sustainable levels. We commend the Swedish authorities for setting the example on successful social integration of migrants, and we encourage ongoing efforts to provide them relevant training.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We thank staff for a well-written report and Mr. Ostros and Ms. Karjanlahti for their helpful buff statement.

Sweden continues to perform relatively well, benefiting from its strong fundamentals, although growth is declining. After registering robust growth in the period 2014-2018, supported by accommodative monetary policy, GDP growth is expected to decline in 2019, as a result of lower domestic demand and exports, before stabilizing around 2 percent over the medium-term. Employment has increased to historical levels, while inflation remains below target.

Sweden continues, however, to face important challenges and risks. These include significant property price and/or construction decline and demographic shifts, in addition to the external risks associated with a no-deal Brexit and a weaker-than-expected global growth, which could disproportionally affect small and open economies like Sweden.

Against this background, we broadly support staff's policy recommendations. We agree that monetary policy should remain accommodative, pending clear indications about inflation and growth prospects. At the same time, the authorities are well advised to use the fiscal space created by their prudent fiscal policy to allow fiscal stabilizers to operate fully in order to lessen the impact of lower growth in 2019.

We welcome the ambitious reform agenda presented by the new government. The emphasis on promoting inclusive growth while maintaining sound fiscal policy is appropriate. We note with satisfaction that some of the planned reforms, in the areas of taxation, labor market, migrant integration and housing, will be included in the forthcoming Spring budget and the budget for 2020. We particularly appreciate the authorities' efforts to strengthen the integration of migrants into the labor market. In this regard, we would appreciate if staff could indicate if there are lessons from the Swedish experience in integrating migrants?

While the financial sector remains solid, we encourage the authorities to remain vigilant to risks. Here, we agree with staff that the authorities should work diligently and cooperate with other jurisdictions to correct any remaining deficiencies in Sweden's AML/CFT framework.

We read with interest Appendix VII on the Riksbank's E-Krona Project. In an environment of declining reliance on cash and increasing private payment systems, we consider that the Riksbank's growing attention to the risks of a cashless payment system is appropriate. We encourage the authorities to give due consideration to staff recommendation for regulatory options to ensure reliable and efficient private payments. We also encourage staff to follow-up on this experience in future Article IV reports.

With these remarks, we wish the authorities further success.

Ms. Riach submitted the following statement:

We thank staff for their informative report in the context of Sweden's Article IV consultation and Mr. Ostros and Ms. Karjanlahti for additional details in their buff statement.

The sustained strong performance of the Swedish economy in recent years is set to slow in 2019, after which it is forecast to gradually return to its medium-term potential. We share staff's view of a somewhat softer growth outlook than in the recent past, which is subject to downside risks; automatic stabilizers should be allowed to operate fully, and monetary policy should be data-driven. Given sizable fiscal buffers and muted wage developments there is room for increased public investment and updating the wage formation mechanism. Continued structural reform should target weaknesses in the economy, such as increasing the employability of migrant and low-skilled workers and revamping the residential rental market to improve labor mobility.

Macroeconomic developments

Growth could slow before returning to potential. Economic activity had been robust in recent years, supported by domestic demand, including strong residential investment. Staff attribute this favorable economic performance to the accommodative monetary policy stance. However, we note that sustained job creation and the positive current account balance are evidence of a more diversified growth composition. We welcome the growth rebound in Q4 2018, particularly in export growth, which allows for optimism with regards to this year's growth performance. Despite the expected slowdown in 2019, growth will remain robust and return to its potential in the medium-term.

Fiscal policies

Prudent fiscal policies have enabled Sweden to build substantial fiscal buffers. A positive structural balance, consistent budget surpluses in the past and the low debt-to-GDP ratio have provided sufficient buffers to allow the full operation of automatic stabilizers even in the event of a significant slowdown of the economy. We share staff's assessment that demographic changes on both ends of the age spectrum will create demand for public investment over the medium-term. While fiscal space is available to increase overall spending, we note Sweden already has one of the highest expenditure ratios in the EU.

Monetary and financial market policies

The continuation of a data-dependent approach to monetary policy is appropriate. In this respect, we note that inflation's convergence to the target is conditional on the price and wage developments of Sweden's major trading partners, which could constrain the Riksbank's policy space.

Risks related to the housing market must continue to be monitored and we would encourage the authorities to continue with their efforts to revamp the residential rental market. In light of the substantial increase in house prices in Sweden, especially in larger cities, we welcome the tightening of macro-prudential measures that seem to have improved lending standards and may have contributed to the recent cooling down in housing market. While household indebtedness on an aggregate level is only slightly above the median of comparator OECD countries, we share staff's concern regarding the vulnerability of lower income households both in terms of their high exposure to variable rates and their access to rental properties. We believe macro-prudential measures are a crucial element of the toolkit, but they do not substitute for the need for comprehensive structural reform in the housing market, and thus agree with staff that reform efforts are needed; such as a gradual reduction in fiscal incentives for credit-financed home ownership as well as a cushioned transition to a better functioning housing rental system.

Any remaining deficiencies in Sweden's anti-money laundering framework should be addressed. We welcome the strengthening of Sweden's AML/CFT framework in recent years, and given the presence of Swedish banks in the Nordics/Baltics, we regard a broader regional cooperation in supervision as crucial to effectively enhancing anti-money laundering efforts.

Structural policies

Raising the employment levels of (non-EU) migrants and the low-skilled remains the largest challenge linked to the labor market. In aggregate, Sweden has the highest employment rate among the European countries; however, large asymmetries exist across labor market groups. In particular, the unemployment rates of low-skilled and foreign workers are high and have significantly increased over recent years. We acknowledge the authorities' past efforts in swiftly integrating migrants into the labor force and welcome their reform plans in this area (such as the Entry Agreements) that should further support their employability. At the same time, high entry wages and a compressed wage structure also act as a barrier-to-entry for those further away from the labor market. In this context, like staff, we also welcome education and upskilling initiatives. Finally, we agree that wage formation should be more responsive to Swedish macroeconomic conditions and broadening the sector base could be one option.

Mr. Doornbosch and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Ostros and Ms. Karjanlahti for their informative buff statement. Sweden's sound, forward-looking policies have contributed to the buildup of economic and fiscal resilience and will likely allow the authorities to adequately adjust to the somewhat more challenging economic circumstances, including lower growth prospects. We associate ourselves with the statement of Ms. Riach and would like to add a few remarks for emphasis.

The available fiscal room for maneuver, including the projected declining debt levels, will help the authorities manage downside risks, including those stemming from an ageing population. Given the open nature of the country's economy, weaker than expected global and European growth could pose challenges from an external risk perspective. Therefore, a prudent fiscal stance remains appropriate. We agree with staff that, if circumstances demand, increasing government spending could be appropriate, for instance to further support public investment. At the same time, we agree with Mr. Ostros and Ms. Karjanlahti that such an approach would need to be taken in a way that does not pose a risk to the credibility of national fiscal rules.

Despite optimistic employment data, we encourage the authorities to continue reforming the labor market to address skill shortages and continue investing in education and training, also in view of helping to adjust the economy to digitalization. From the staff report, we understand that structural reforms remain vital in the housing sector. We understand the political sensitivities in this context but encourage the authorities to continue their efforts.

We agree with staff that the risks to the financial sector should be further monitored, including with regards to the housing sector. We welcome the sound data from banks, including capital adequacy ratios and profitability, as well as the expansion of the FI's macroprudential mandate in line with FSAP recommendations. We welcome the authorities' increased focus on AML/CFT risks but agree with staff that further steps might be necessary going forward, including regarding cooperation with other stakeholders in the region.

Ms. Levonian, Ms. McKiernan and Mr. Williams submitted the following statement:

We thank staff for their comprehensive report and Mr. Ostros and Ms. Karjanlahti for their insightful buff statement. The Swedish economy appears to be entering a new phase of slowdown triggered by moderating domestic demand following years of robust growth. However, sizeable fiscal buffers, from sound macroeconomic and fiscal policies, afford the authorities useful policy space to stimulate economic activity and accelerate reforms, particularly in the areas of residential housing and labor market, without compromising the central bank's inflation mandate. We broadly concur with staff's assessments and recommendations and offer the following remarks for emphasis.

We welcome the concurrence between the authorities and staff for the full operation of automatic stabilizers to cushion the slowing growth. However, we wonder whether a cut in the medium-term fiscal surplus as suggested by staff is warranted. We see merit in the authorities' stance that frequent adjustments to the target may compromise fiscal credibility. Moreover, the authorities could pursue the option of reorienting the budget toward greater public investment without shifting the overall expenditure frontier. We welcome staff's comments on the trade-off between cutting the fiscal surplus and realigning the budget to scale up public investment.

Sweden has made good progress on the labor market front, but gains remain uneven between domestic and foreign-born workers. While Sweden has the highest employment rate in the EU - as stated in the buff - unemployment rates among low-skilled and foreign workers remain disproportionately high. Against this backdrop, we urge the authorities to continue to expand education and skills-training opportunities for these workers. Easing employment constraints, such as through state provision of benefits to supplement the salaries of migrants, as well as longer work trial periods, will also help with untangling this challenge. Further, we encourage the authorities to reexamine the current wage setting benchmark model, which in practice acts as a ceiling on wage rates and limits sector-wide wage flexibility.

While noting that the banking system remains highly profitable and capitalized, we stress the need for continued vigilance to mitigate vulnerabilities. In this context, the authorities should remain focused on safeguarding the integrity of the AML/CFT regime, including through regional cooperation. High household indebtedness and connected structural weaknesses in the housing market continue to pose notable risks to macrofinancial stability. In this regard, the recent macroprudential measures represent a good step towards curbing indebtedness and containing risks. We also encourage the authorities to ensure implementation of the tighter amortization requirements that were recently introduced for new mortgages. Relatedly, we agree with staff that further efforts aimed at streamlining rent control, reforming the tax system, and reducing housing construction costs are key to addressing legacy weaknesses within the housing market and moderating household indebtedness.

Mr. Just and Mr. Stradal submitted the following statement:

We thank staff for their informative report, and Mr. Ostros and Ms. Karjanlahti for their helpful buff statement. Sweden's robust economic growth is expected to slow down along with many other European peers. The Swedish economy is well-prepared to face the headwinds given the strong track record of sound macroeconomic policies, robust policy frameworks, and buffers. Longer-term challenges such as the housing market affordability and persistently slow wage growth will require more comprehensive efforts. We associate ourselves with Ms. Riach's statement and add the following comments.

Continued monetary accommodation is warranted. The persistence of low core inflation despite a very long period of low or negative interest rates and the more recent tightening of the labor markets is in line with similarly puzzling developments in a number of advanced economies. We acknowledge the conflicting impacts on the inflation path of relatively robust domestic demand and exchange rate depreciation on one hand, and downside external risks and the inflation persistence on the other hand. However, we would have preferred more nuanced monetary policy advice. We notice that staff uses the mantra of data dependency with increasing frequency. Leaving aside the fact that economic data are subject to significant measurement error and subsequent revisions, the data do not speak for themselves. The art of monetary policy is to interpret the backward-looking data in order to create a forward-looking economic story that informs the appropriate adjustments of the available levers. We would prefer if staff engaged more with the authorities in discussing the internal consistency and plausibility of the story and, if needed, offered an alternative one.

We concur with staff that Sweden has strong fiscal buffers that should be used to cushion the slowdown. Moderate fiscal stimulus is advisable if growth declines below its potential in the context of entrenched low inflation expectations. We note a disagreement between staff and the authorities on whether the activation of the automatic stabilizers is sufficient in this respect, or whether a temporary revision of the medium-term surplus target may be needed. We side with the importance of maintaining the credibility of fiscal rules by sticking to the timeline of revisions, especially when a moderate slowdown, rather than a severe recession, is expected.

Structural reforms should prioritize improving housing affordability and wage formation processes with a focus on more flexibility. High construction costs reflecting complex building regulation, as well as limited competition in the sector, severely restrict the supply, putting an upward pressure on house prices. In addition, strict rent controls similarly affect the rental housing prices. In combination with the tax incentives, it results in a heavy household debt load, increased inequality, and diminished labor mobility. The rent controls should be phased out in a timely manner, while protecting the most vulnerable by well-targeted allowances. With regards to the labor market reforms, we concur with staff that wage negotiations should be better differentiated to strengthen the link between wages and productivity.

We welcome strengthening of the macroprudential framework in accordance with the 2016 Financial Sector Assessment Program recommendations and concur with staff that its effectiveness should be monitored. We welcome the authorities' commitment to further strengthen their AML/CFT frameworks in reaction to the recent high-profile cases of money laundering in the Nordic-Baltic countries. Cross-border cooperation is essential and the joint investigation by the Swedish and Estonian Financial Supervisory Authorities with the participation of the Latvian and Lithuanian authorities is a positive signal. The AML/CFT aspect of the e-krona project should also be thoroughly explored.

Mr. Geadah and Ms. Abdelati submitted the following statement:

We would like to thank Mr. Ostros and Ms. Karjanlahti for their buff statement and staff for their report and topical analysis in the Appendices. We note the broad agreement between staff and the authorities on the performance of the economy and desirable policies. We limit ourselves to a few points for emphasis.

We broadly share the staff's view of the appropriateness of current policies in the face of a slowdown in growth in 2019, with favorable employment indicators and low inflation. As staff note, there does not seem to be significant wage pressures. We agree that a data-dependent approach to monetary policy should continue, deferring further monetary tightening pending signs that the inflation outlook is more firmly and durably consistent with meeting the 2 percent target.

Sweden's healthy fiscal position offers substantial fiscal space. We welcome the growth-friendly tax reforms planned by the authorities and the planned modest stimulus this year. Further reducing the fiscal surplus in line with the medium-term target would release further resources which could facilitate labor and housing market reforms.

Sweden is taking commendable steps to support the employment of migrants and low skilled workers and to help integrate migrants. We strongly welcome the measures to improve education and training. With respect to the reform of public employment services and expanding use of private services, we agree with the need to carefully monitor that such services continue to be delivered to those that need them, including those who are born outside Sweden. We would welcome staff views in the future on how the measures taken by Sweden compare with support provided by other countries, and to what extent they can be replicated elsewhere.

Sweden enjoys a broadly strong financial system and a robust banking system. We encourage the authorities to continue to monitor challenges facing the banking system from financial innovation. Commercial real estate is an area where bank and nonbank financing is playing a growing role, as highlighted in Appendix VIII and should continue to be carefully watched. Despite well-targeted macro-prudential measures, macro-fiscal risks related to the property market remain elevated. Recent measures, including the tightening of amortization requirements, help to contain household debt vulnerabilities.

Sweden is at the forefront of exploring the use of a central bank digital currency (CBDC). We welcome staff's Appendix on the e-Krona Project which highlights the impetus as the population moves away from using cash, and how to address the issues that may arise. We note that first-mover advantages of existing payment systems will be an important factor, as well as the extent to which the government uses e-Krona. We would welcome presentations on this topic, including during the Spring and Annual Meetings for interested country officials. A blog or article in Finance and Development would also be welcome.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for their clear report and Mr. Ostros and Mr. Karjanlahti for their informative buff statement. We associate ourselves with Mrs. Riach's statement and largely share staff's appraisal of the Swedish economy and their key recommendations.

Despite the recent growth slowdown and prevailing downside risks, the short to medium term outlook for the Swedish economy remains positive, supported by favorable labor market conditions, large fiscal buffers, and a strong external position. The real estate sector remains an area of concern and some labor market reforms may be helpful to strengthen monetary policy transmission and support inclusive growth.

We concur that a data-dependent approach to the monetary approach remains appropriate, given that inflation is still subdued notwithstanding strong labor market performance and the recent depreciation of the krona. We welcome staff's analysis of the E-krona project and look forward to an update on future developments in the next consultation. We support the cautionary approach of the Riksbank and its deep analysis, also based on a wide-ranging consultation process, to better understand the needs and implications of the possible issuance of a central bank digital currency.

We agree with staff and the authorities that fiscal policy should support economic resilience by allowing the full operation of automatic stabilizers and using the resources released through the reduced surplus target to increase infrastructure and demographic-related investments. Staff also recommend further reducing the fiscal target before the next formal review, which may undermine the credibility of the fiscal framework, as noted in the buff. Alternatively, how would staff assess the scope for changing the composition of expenditure within the existing fiscal target?

We welcome the tightening of amortization requirements for new mortgages with high loan-to-value ratios and their recently expanded scope to include nonbank providers. As housing prices and household indebtedness remain high, we encourage the authorities to closely monitor the effectiveness of the macroprudential measures. Given the prevalence of variable-rate mortgages, additional measures based on debt service to income ratios may be considered before interest rates start to rise. We appreciated the insightful analysis of the commercial real estate market in Appendix III, which highlights some factors, such as stretched valuations and increasing exposure to non-bank and wholesale funding, which raise financial stability concerns and require close monitoring. Have staff discussed with the authorities any specific measures to address emerging financial stability risks in the commercial real estate sector?

Macroprudential measures should be accompanied by a comprehensive structural reform of the housing market with the aim to support labor mobility, house affordability, construction activity, and reduce inequalities. To this end, we support staff’s recommendations to gradually phase out rental controls, review the tax treatment of property, related capital gains and mortgage interest payments, simplify the rules and procedures for construction, and expand the supply of affordable housing.

Labor market reforms should aim at improving outcomes across the entire labor force and strengthen wage responsiveness to domestic economic conditions. We welcome the social partners’ plan for “entry agreements”, which will allow migrants and long-term unemployed to combine work and training at reduced costs to employers. However, we concur with the need to step up efforts to improve migrant integration and to review the collective bargaining system in order to allow greater flexibility of employment protection and wages. Broadening the range of reference sectors for setting the wage norm and facilitating greater wage differentiation across sectors, for example by appropriately amending the mandate of the National Mediation Office, as staff suggest, not only would support employment prospects for foreign born and low-skilled workers, but could also make wages more responsive to changes in employment, and thus help in strengthening monetary policy transmission.

Mr. Lopetegui and Ms. Moreno submitted the following statement:

We thank staff for the report and Mr. Ostros and Ms. Karjanlahti for their helpful statement.

Sweden is a small open economy very exposed to global dynamics, but also well prepared to face them. In the current juncture it is experiencing a slower pace of growth while inflation remains near target since mid-2017. Monetary policy is still accommodative and fiscal policy has plenty of room to maneuver, owing to buffers and automatic stabilizers. Domestic risks are mainly associated to an eventual sudden drop in housing prices, but also to the integration of migrant and low-skilled workers into the labor market in a context of population aging. The financial sector is sound, well capitalized and profitable despite structural vulnerabilities, like its high dependence on market funding.

We would like to commend the Swedish authorities for the fiscal management that has resulted in fiscal health, strong buffers, and sound policy implementations. In fact, Sweden is part of the select group of economies that has fiscal space to face a less benign economic outlook. We agree with staff recommendations of letting the automatic stabilizers work resulting in a small fiscal stimulus, particularly given that downside risks to growth have increased.

Wage dynamics remain subdued, even as labor market has become tighter in recent years. As explained by staff, wages tend to follow those of Germany and do not reflect structural changes in the Swedish economy. This has to do with the social partners in the manufacturing sector setting the national wage benchmark. Mr. Ostros and Ms. Karjanlahti argue that being a small export-dependent economy, Sweden needs to maintain international competitiveness. In addition, they explain that it has been a successful benchmarking model and abandoning it might be risky. Could staff elaborate on these risks? Do these risks also relate to allowing variation across sectors to be increased?

Unemployment has been reduced to 6.4 percent, but certain groups, mostly unskilled and migrants, are struggling to find jobs. We are encouraged that the authorities agree with staff's appraisal and will renew their efforts to invest in education and training, as well as in facilitating labor market entry.

After being at very high levels during 2017, house prices fell and are only recently starting to rebound. This behavior has been associated with some slowing in the household credit market. Nevertheless, staff identifies several sources of concern in the housing market, calling it "dysfunctional" and requiring reforms to rent control, taxes and construction regulations. At the same time, although with medium relative likelihood, a scenario of significant price and/or construction decline is expected to have a high impact if realized. We therefore encourage the authorities to monitor this sector closely, implementing macroprudential policies if necessary, over and above other recommendations made by staff. We understand some reforms could take longer (like designing the tax system) but as Mr. Ostros and Ms. Karjanlahti highlight, they can be handled with care not to negatively affect growth.

We are encouraged by the authorities' commitment to enhance broader regional cooperation in anti-money laundering efforts. Building on recent progress on AML/CFT regulation and supervision, we also take positive note of the authorities' readiness to consider further actions if necessary.

With these comments, we wish Sweden and its people the best in their future endeavors.

Mr. Merk and Mr. Buetzer submitted the following statement:

We thank staff for their insightful report and Mr. Ostros and Ms. Karjanlahti for their helpful buff. We associate ourselves with Ms. Riach's statement and would like to add the following comments.

Supported by prudent macroeconomic policies, the Swedish economy has posted strong economic growth over the past years. Solid government finances have led to a decreasing public debt ratio and unemployment is trending downwards. Medium-term growth prospects – while being subject to increased downside risks – still appear favorable, despite an expected slowdown this year. At the same time, unemployment rates of the foreign-born and low-skilled remain at a high level and still elevated housing prices and household indebtedness continue to pose risks to financial stability. Against this backdrop, tackling structural rigidities in the labor and housing markets as well as closely monitoring vulnerabilities of the financial sector remain the key challenges ahead.

As regards labor market policies, we take positive note of the social partners' plan for entry agreements which will help to support employment of the low-skilled and migrants. In this context, we support staff's recommendation to further strengthen the integration of immigrants into the labor market by enhancing education and training. On the wage formation process, we see some merits in staff's reasoning arguing in favor of broadening the range of sectors setting the wage norm, while recognizing that the current system has served Sweden's small open economy well in the past two decades.

We also take positive note that the "January agreement" contains promising steps to tackle long-standing structural weaknesses in the Swedish housing market. Still, we concur with staff that more comprehensive reforms are required and welcome staff's specific recommendations in this regard. In particular, we concur with staff that rent controls are detrimental to the proper functioning of the housing market and low-income households should rather be protected by greater access to housing allowances. Expanding the supply of available housing, inter alia by raising the amount of land available for construction, is also of great importance in order to address underlying structural factors behind the high levels of house prices.

While it is encouraging that the Swedish banking sector is well capitalized and highly profitable, we second staff in its call to reinforce AML/CFT frameworks and intensify regional cooperation. The well-targeted tightening of macroprudential measures such as a stricter amortization requirement seems to have been effective in containing vulnerabilities by lowering the share of new mortgage loans with high LTI ratios. This notwithstanding, and also with view to stretched valuations in the commercial real estate market, the authorities are well-advised to remain vigilant and stand ready to launch further measures if needed.

We commend the authorities for their prudent fiscal policies which have helped to maintain Sweden's reputation for responsible fiscal management and which allow for automatic stabilizers to operate freely, not least in light of downside risks to growth in 2019. We take note that according to the latest forecast by the Swedish National Financial Management Authority (ESV) the public debt ratio is expected to fall below 30 percent of GDP in 2021. At the same time, the authorities expect high public investment needs in coming years resulting inter alia from demographic shifts. Given the moderate and declining level of public debt, we agree with staff that there is some room for an increase in high-quality public investment. In this context, we note staff's proposal to consider a temporary cut in the medium-term surplus target if public investment cannot be financed within the current fiscal framework. However, allowing for a temporary cut in the (recently updated) medium-term surplus target might entail a risk of jeopardizing the hard-won credibility of the fiscal framework. Furthermore, the medium-term surplus target is subject to regular reviews conducted at an eight-year interval that could take into account factors such as public investment needs, without prejudice to the transparency of the fiscal rule and the goals of macroeconomic stability and fiscal sustainability.

Given still below-target inflation and significant uncertainties around the inflation outlook, we concur that the current accommodative monetary policy stance appears appropriate for the time being. However, the Riksbank should be prepared to tighten once upward pressures on prices intensify. This would also help alleviate financial stability related concerns associated with the current low interest rate environment.

Regarding the assessment of Sweden' external position, we are somewhat surprised that staff gives greater weight to estimates from the EBA REER models "(…) as factors not captured by the EBA model may also be driving Swedish savings-investment balances". Most of these factors, that have been mentioned in the context of last year's external balance assessment, have been addressed by the recent refinements to the EBA methodology. This is reflected amongst others in a change of the contribution of demographic factors to the EBA norm from -1.7 to -0.4 percent. As also shown in Figure 8 and Appendix II the share of prime savers – which is now incorporated as an explanatory variable in the EBA model – is a statistically robust driver of trends in Sweden's current account. Having said this – and also taking into account the relatively small EBA CA gap –, we would not expect the model to yield a particularly bad fit for Sweden. Furthermore, we note that according to staff the fact that the estimated EBA norm for Sweden has been below the actual CA balance for the past two decades suggests that the model is not able to capture certain factors that drive its current account and encourage staff to also look at cross-country comparisons to ensure an even-handed application of EBA.

Mr. Jin and Mr. Huang submitted the following statement:

We thank staff for the insightful report and Mr. Ostros and Ms. Karjanlahti for their informative buff statement. The Swedish economy has experienced a robust growth with strong employment gains in recent years. Looking forward, growth is expected to moderate, and risks are tilted to the downside. It is important for the authorities to maintain macro-financial stability and boost growth potential. We broadly agree with staff's appraisal and would like to limit ourselves to the following comments.

A data dependent approach to monetary policy is appropriate but consideration beyond inflation may be needed. Despite a rate hike in late 2018, the monetary policy remains accommodative. The policy rate stays in the negative regime and the central bank will reinvest its government bond purchase. In the meantime, we noted a broad-scope rise in asset prices. Both residential and commercial properties prices increased substantially, and equity prices stand at a historic high. We encourage the Riksbank to keep a vigilant eye on the asset prices.

The housing price dropped recently but challenges remain. The household leverage is not far above the peer countries, but the interest rate risks are high. With almost three-quarters of mortgages having variable rates, the household is vulnerable to future potential financial condition tightening. The new non-bank entrant into the mortgage markets is another source of concern. The banking sector is subject to comprehensive and systematic supervision from minimum capital requirements to recent macroprudential measures. Ensuring that new entrants face the same supervisory requirements as banks face is important not only for financial stability, but also for a level playing field. Recent expansion of the scope of macroprudential measures to include these new market players is a right step. We agree with staff and the authorities that it is an appropriate time to review the effectiveness of the macroprudential measures already taken. Considering the rising commercial property prices, we are wondering whether this reflects the leakages of the macroprudential measures in residential property prices. Staff’s comments are welcome.

A flexible labor market could help to boost potential growth. We commend the authorities for recent labor market reforms to increase employment of the low-skilled and migrants, including training and public employment services. The labor participation rate of migrants is above the average of peer countries. We noted that the industrial sector set a benchmark wage increase that guides other sectors. Given the fact that the industrial sector currently hires only 11 percent of the workforce, we see merit in staff’s suggestion to update wage formation and increase wage variation across sectors. This could help to align wages with productivities in the sector level, facilitate the labor mobility across sectors, and increase the labor market flexibility.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Kaizuka and Mr. Naruse submitted the following statement:

We thank staff for their detailed reports and Mr. Ostros and Ms. Karjanlahti for their informative statement. It is encouraging that the Swedish economy has maintained a high level of activity in recent years and growth has been high. But Sweden's growth is expected to slow in 2019, with lower domestic demand and weaker export growth. The authorities also continue their efforts to address challenges, such as household debt vulnerability, demographic shifts, and the low level of inflation. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Monetary Policy

We agree with the staff's view that a data-dependent approach to monetary policy should continue. We note that the Riksbank raised the policy rate to -0.25 percent in December 2018. We also take note of the staff's expectation that inflation is expected to rise gradually toward the 2 percent target based on an assumption that Swedish wage will rise over time. At the same time, we also see uncertainty around the timing of durably reaching the inflation target because inflation might be influenced by the euro area economy, trade tensions, and the UK's withdrawal from the EU. Therefore, we concur with the staff's view that it is appropriate to closely monitor data to ensure that inflation remains close to target and that inflation expectations are firmly anchored.

Labor Market Policy

We encourage the authorities to continue the labor market reforms, especially the ones for enhancing employment of migrants and the low-skilled. We positively note Sweden's highest employment rate in the EU and falling unemployment. However, we are concerned that the unemployment rate of the foreign born and low-skilled remains high. Therefore, we support the staff's call for enhanced education and training to support their employment. In this light, we welcome the fact that the budget for 2018 boosted resources for education. On wage, we note that Swedish wage rises have become closely linked to those in Germany, which contributes to low inflation in Sweden. In this regard, we see merit in the staff's appraisal that wage should be linked to domestic economic trends such as inflation expectations and productivity. Staff show one possible approach to achieve this in the staff's report. That is, the National Institute for Economic Research continues to provide information to the social partners who set a national wage benchmark. Could staff elaborate more how this approach could make Sweden's wage reflect domestic economic trends more adequately?

Housing Policy

We recognize the importance of the reforms to improve housing affordability. We support the authorities' on-going initiative of making the planning and building permit process smoother, faster, and more predictable. Also, we see merit in the staff's call for reducing the cost of construction and enhancing productivity in the construction sector. Furthermore, on rent controls, we note that people pay much higher rents (65 percent higher on average) on subletted or newly constructed apartments. We think that the authorities' intention in their statement to investigate and implement a liberalization of how rents are set would help reduce high rents.

Fiscal Policy

We believe that fiscal policy could help address higher public investment needs from demographic changes. Related to a reduction on the medium-term fiscal surplus target from 1 percent of GDP to 0.33 percent, we take note of the staff's assessment that undertaking a small stimulus in the next few years entails little risk of overheating given the low level of inflation, especially with domestic demand expected to slow. Given that demographic changes in the coming decade are relatively rapid in Sweden, we believe that this lower medium-term surplus target could release resources to address higher demand for public investment from demographic shifts, such as needs for additional health care facilities. Also, we note that staff recommend considering a temporary cut in the medium-term surplus target if demographic or other factors require public investment above past norms. On the other hand, the authorities think that to avoid revisions of the target level being made in a way that reduces the credibility of the target, it is important to carry them out in a predictable way (by the eight-yearly reviews). How do staff think that a temporary cut in the medium-term surplus target might reduce the credibility of the target?

Financial Sector Policy

We encourage the authorities to continue monitoring financial sector risks closely. It is encouraging that capital positions of the major Swedish banks are healthy, and that Swedish bank profitability remains strong and exceeds European averages. In this regard, we would appreciate it if staff could elaborate why the bank's profit remains strong despite negative interest rates in recent years. In addition, we take note of the staff's assessment that although the housing market has cooled mildly, household debt remains a macroeconomic vulnerability. We also note that prices have been rising in the commercial property market. In this regard, we encourage the authorities to closely monitor the household situation and banks' risk management. We note that the authorities have adopted macroprudential measures, such as increasing the countercyclical capital buffer. If necessary, we believe that the authorities could consider implementing further fine-tuning measures.

Mr. Mozhin, Mr. Palei and Mr. Potapov submitted the following statement:

We thank staff for the insightful report and Mr. Ostros and Ms. Karjanlahti for their informative buff statement. The growth rate of the Swedish economy is expected to decline due to weaker exports and lower housing investments. Strong fiscal fundamentals and sizeable automatic stabilizers provide some cushion against external shocks and slowing external demand. The recent formation of the new government can help mitigate policy uncertainty. Despite many years of relatively strong growth, the monetary authorities continue to struggle in bringing inflation to the desired target (Appendix 1). Moreover, the authorities in Sweden are grappling with proper evaluation of risks stemming from household debt and assets valuation. The effectiveness of the macroprudential tools remains to be tested. We note that the authorities broadly agree with staff on the analysis of current developments and long-term challenges, as well as on policy recommendations.

Public finances in Sweden remain strong. The new fiscal framework that includes an updated fiscal surplus target of 0.33 percent of GDP and the public debt limit will maintain strong fiscal buffers, while facilitating structural reforms. A modest fiscal stimulus is also warranted against the background of lower growth rates. We note that staff advocate a more proactive fiscal policy with a temporary cut in the medium-term fiscal target. According to staff, such an approach is needed to address population growth in the age cohorts of 10-19 years and 80 plus years. In this context, we welcome the authorities' plans to closely monitor public investment needs. The sustainability of public finances is underpinned by relatively modest prospects of the increase in the old age dependency ratio. At the same time, with the growth slowdown in Europe and escalating trade tensions, do staff see even greater role of fiscal policy in demand management in Sweden in the short run?

For a long period of time monetary policy has been aiming to support economic activity and return inflation to its target. The 2010 experience with a premature attempt at monetary policy normalization was an important lesson for the central banks in many advanced economies, not just for Sweden. After the first hike in the repo rate in December last year to negative 0.25 percent the Riksbank is facing renewed and significant uncertainty about the growth and inflation outlook. The current situation suggests the need for additional postponement of monetary policy normalization. Do staff see any broader lessons from the Swedish experience on challenges for monetary policy normalization in advanced economies after the GFC? What are the main factors holding inflation well below the target for such an extended period?

On the issue of the wage formation system, we note the authorities' views that it has served well in maintaining competitiveness of the economy. However, it can also be one of the key barriers to increasing inflation. From this point of view, we agree with staff that broadening the range of sectors that set the benchmark for wage increases and widening the scope for wage variations could benefit the process by better capturing trends in labor productivity and medium-term inflation expectations.

We welcome the authorities' attention to the e-krona project and call on staff to monitor the developments in this area. While the current focus in this work is primarily on promoting a safe and efficient payment system, we would appreciate additional comments on a possible role of the e-krona in moving the effective lower bound as a constraint on central bank policy rate setting.

The challenge of estimating deviations from equilibrium housing prices is evident in Sweden. While the authorities see substantial vulnerabilities in the Swedish housing market and high household debt levels, some observers offer very strong counterarguments and point to unnecessary welfare losses stemming from active macroprudential measures[1]. Given that many policymakers pay close attention to similar issues, as it is suggested in the GFSR, we believe that the developments and ongoing debates in Sweden are likely to inform broader international community and experts. We note that, according to the authorities and staff, given the high proportion of variable rate mortgages, private consumption may be sensitive to eventual interest rate rises. The recent moderation in housing prices and in the growth of household debt may address some of these concerns. In any case, we

[1] Housing Prices, Household Debt, Macroeconomic Risk: Problems of Macroprudential Policy by Lars E.O. Svensson, 2018.

welcome the authorities' efforts to evaluate the effectiveness of macroprudential measures and the scope for the amortization requirements.

The "January Agreement" between the parties forming the government includes steps to improve the housing affordability in Sweden. At the same time, staff call for more fundamental reforms to lower barriers to labor mobility and to contain inequality. We encourage the authorities to consider staff's recommendations presented in paragraph 25 of the report. We believe that designing a more comprehensive households' protection system could be among the first steps in this area, since phasing out the rent controls and an increase in the ceiling of the property tax may substantially increase the share of housing and rental expenditures in disposable income. Could staff elaborate on the factors behind the sizable increase in the cost of construction over the recent years, besides the weaknesses in the planning process mentioned in the report?

Supported by recent reforms, employment and labor force participation rates have increased, while unemployment dropped. Building on the success of past policies, further efforts are needed to promote employment of harder-to-employ individuals, including recently arrived immigrants. At the same time, survey indicators continue to point to rising labor shortages. This accentuates the need for reforms to facilitate entry to the labor market, as well as to provide education and training to meet the market's needs. Could staff elaborate on the best practices in using private providers for job placements?

Finally, recent events in the Nordic-Baltic region involving Swedbank highlighted serious weaknesses in the implementation of the AML/CFT rules and call for urgent measures to strengthen governance frameworks and regional cooperation in the highly integrated financial sector. We note that the 2018 Eurozone FSAP highlighted the need for a common EU-wide AML/CFT supervision framework and enhanced exchange of information between the prudential supervisors and the AML/CFT supervisors. In this context, could staff elaborate on the key deficiencies in the Sweden's AML/CFT framework, on how they should be addressed, and on how to ensure consistency of reforms in Sweden's and the euro area AML/CFT frameworks?

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its informative report and Mr. Ostros and Ms. Karjanlahti for their candid and comprehensive buff statement. We mostly share the staff's appraisal and associate ourselves to Mr. Riach's statement. We would also like to add some comments for emphasis.

After years of robust growth, Sweden growth is set to slow notably in 2019. Amid weaker Eurozone prospects and soft housing investment, growth is expected to decelerate in 2019 by more than 1 p.p. according to staff's projections (from 2.3 percent in 2018 to 1.2 percent in 2019). Nevertheless, economic growth in quarter-on-quarter terms was likely solid in Q4, although this could be in part due to a favorable base of comparison after temporary factors saw the economy contract in Q3. Staff's comments are welcome. Over the longer run, potential growth is expected to remain below pre-crisis levels in light of continued modest productivity growth, in line with global developments.

Risks remain skewed to the downside, particularly from the housing market. As highlighted by staff, downside risks to growth have increased. Particularly, we are concerned on a weaker-than-expected global growth considering that Sweden is a small open economy. Investment and demand for exports could fall further in response to a more pronounced slowdown among major trading partners. The main macroeconomic and financial risk stems from the evolution of the housing market. While house prices declined in late 2017 and have since been broadly stable, a renewed decline could affect consumer confidence and further reduce household consumption to the extent that households would deleverage. As noted by staff in the annex, commercial property risks could be emerging as prices have been rising rapidly and valuations appear stretched by historical standards.

Further reforms are needed to address the imbalances between supply and demand in the housing market. We commend authorities for the reforms put in place to improve the functioning of housing and we welcome that the "January agreement" includes measures to tackle this challenge. We encourage authorities to step up this process by adopting new measures; in particular, we consider that removing mortgage interest deductibility and increasing property taxes would help ease demand and discourage high leverage. Also, we see a need to stimulate residential construction where shortages are most pressing, notably by removing structural obstacles to construction, and to improve the efficiency of the housing market, including by introducing more flexibility in setting rental prices and revising the design of the capital gains tax.

The banking sector is solid, but it could be vulnerable in the event of a potential abrupt fall in real estate prices. Banks remain profitable and have high regulatory capital adequacy ratios. However, banks' high level of lending to the real estate market remains a key risk and households remain vulnerable to an adjustment in the housing market and an increase in interest rates. To address those challenges, we welcome the enhanced legal framework for the macroprudential authority and the enhanced amortization requirement as they have contributed to strengthen the banking sector's resilience. These measures are also important since Swedish banking groups are of systemic importance for all countries in the Nordic-Baltic financial market. Therefore, as noted in the buff's statement, cooperation amongst the authorities within the Nordic-Baltic region is essential to safeguard financial stability and ensure preparedness should a crisis arise.

We agree with staff's view on fiscal policy. Sweden faces low fiscal sustainability risks in the medium to long term. Strong economic growth, primary budget surpluses and prudent fiscal management have brought about a decline in the general government gross debt in recent years. Given Sweden's strong fiscal buffers, we share staff's view that automatic fiscal stabilizers should operate fully to cushion lower growth in 2019 and we consider appropriate to reduce the cyclically-adjusted surplus to the new medium-term fiscal target by 2020 to facilitate reforms. Further, considering the need to raise public investment in coming years—due to demographic shifts that require more schools, healthcare, and housing facilities—we agree with staff that a temporary cut in the medium-term surplus target could be contemplated.

Notwithstanding the measures adopted, the integration of low-skilled workers and migrants into the labor market needs to be enhanced. Sweden is a top performer in the EU for high employment and low long-term unemployment rates. However, as noted by staff, the unemployment rate of the foreign born and low-skilled remains very high. This challenge is likely to remain in the coming years because of number and composition of the arrival of asylum seekers in late 2015. Could staff elaborate on this high unemployment rates considering the evolution of the labor force? We commend authorities for the efforts already made to improve employability, especially we welcome the introduction programme (etableringsprogrammet). To enhance their employability, we consider that traineeship opportunities should also be included and the link between active participation and receiving allowances should be strengthened. Besides, we believe that helping migrants start businesses could be further explored.

Finally, we would like to commend authorities for their successful climate policy. Sweden is fully on course to meet its EU 2020 and 2030 emission targets and has set national targets that go well beyond these. Sweden aims to achieve net zero emissions of GHG by 2045 and have negative emissions thereafter. This long-term objective will require significant additional efforts to reduce emissions in all main sectors of the economy.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their very clear and well prioritized report and Mr. Ostros and Ms. Karjanlahti for their detailed buff statement. We commend the authorities for the remarkable performances of the Swedish economy. Growth is projected to slowdown in 2019 reflecting a decline in both domestic demand in relation to a deteriorated housing market sentiment and in fixed investment, but also weaker trading partners growth prospects. The hike in exports and investment in 2020 should however spur growth. As pointed by staff the existing substantial fiscal space would allow automatic stabilizers to play fully, while accommodating the arising public investment needs caused by demographic shifts and to tackle insufficient connectivity between main urban centers. We also thank staff for their detailed recommendations on how to update the wage formation mechanisms, that builds on past analytical work in a context of low inflation and persistent current account surplus. We associate ourselves with Ms. Riach's statement and wish to make the following comments for emphasis.

Outlook and risks

We broadly share staff's assessment of the macroeconomic outlook which, despite a slowdown in 2019, remains positive. After strong performance over the recent years, growth is projected to slow moderately in 2019 in line with the deceleration of investment and net exports. However, macroeconomic fundamentals remain solid with unemployment expected to remain around the current low levels. The current account surplus declined slightly over the recent years and remains moderately stronger than the level consistent with medium-term fundamentals. Structural fiscal surplus and public debt are projected respectively at 0,4 percent and 37 percent of GDP this year, suggesting substantial fiscal space which could be used to support growth-enhancing structural reforms in a context of rising downside risks. As pointed out by staff, there is no sign of overheating pressure since core inflation remains subdued despite strong labor market performance overall.

Labor market

In the context of very solid performance of the Swedish labor market, we support staff's recommendations to further enhance the integration of foreign born and low-skilled workers and revise the benchmark for wage rises. We salute actions undertaken by social partners to enable the migrants and the low-skilled to combine work and training at reduced cost to employers. This will certainly improve their level of employability and job matching. Employment protection arrangements should also consider facilitating labor market entry of these categories of the workforce. Though labor market is tightening, wage rises remain subdued, as well as core inflation making Sweden a good example of the widespread inflation puzzle in this regard and recalling that he Philips coefficient might have diminished. in this regard we thank staff for putting forward concrete proposals on how to update the wage formation to make wage more responsive to the macroeconomic conditions of Sweden. The recommendation to include more sectors in forming the national wage norm is, in that context, particularly appropriate as it would contribute to better align average wage rises with productivity growth while supporting domestic demand.

Housing market reform and macroprudential framework

Despite a decline in the second half of 2017, housing price levels remain high and, along with households' indebtedness, the main macroeconomic vulnerability of Sweden. We thank staff for their interesting analysis of the housing sector that highlights the increase in vulnerabilities related to real terms house prices continued surge, among the highest of the OECD's countries, since the mid-1990s. This evolution has been reflected in the sustained rise in the price-to-income ratio, now 30 percent above its 20-year average. Given the high share of floating-rate loans, this rise has contributed to exacerbate risks of households' unsustainable indebtedness, financial instability and intergenerational and regional inequality.

While we fully support the tightening macroprudential framework and the enhancing of data collection on households, we also encourage the authorities to achieve the implementation of the January Agreement. This includes the liberalization of the rental market to increase the rental supply, a broad-base increase in the ceiling on the property tax although we agree that a target increase to the main centers could enhance mobility. In the same line, reforming taxation on real estate transactions' capital gains and and a phasing-out of mortgage interest deductibility, which stands for an incentive for households to invest in many Nordic countries, would contribute to rebalance housing demand and prices. Finally, strengthening competition in the construction sector could induce substantial reduction in construction costs. We thank staff for the attention paid to the distributional impact of the proposed measures and welcome their recommendation to protect the poorest households.

Financial system

Swedish banks are strong, well-capitalized and continue to perform well. Nevertheless, challenges related to new entrants on the mortgage market, financial innovation and AML/CFT frameworks warrant enhanced supervision. New nonbank entities on specific compartments of the market such as mortgages and commercial real estate are playing a greater role. Although nonbanks' activity remain limited on the mortgage market regarding total credit and that credit risk is transferred to end-investors, these entities remain a source of risk as they currently do not meet the same macroprudential and consumer protection requirements. We thus agree with staff they should be carefully monitored. Given the expansion of credit from nonbank entities, we are wondering if there were a causal link between this development and the higher level of macroprudential requirements on borrowers. Does staff have an opinion on this aspect? The recent developments occurred in the context of Danske Bank money laundering case and allegations of money laundering against Swedbank namely mentioned in the report, warrant strong actions from the supervisory authorities to address remaining deficiencies in Sweden's AML/CFT and enhance closer cooperation within the Nordic-Baltic region. we encourage Finansinspektionen to continue to strengthen its operational capacity and to allow more resources to AML/CFT supervision. We would also be interested in staff's comments on the impact of Nordea's relocation on the prudential and AML/CFT supervision framework as Sweden is likely to remain one of its main markets in terms of operations including branches.

Mr. Trabinski and Mr. Tola submitted the following statement:

We thank staff for the well-written report and Mr. Ostros and Ms. Karjanlahti for their insightful buff statement.

The economic outlook for Sweden has moderated and is subject to increased downside risks. Real GDP growth is expected to cool to 1.2 percent in 2019, reflecting weaker consumption, lower exports, and a fall in housing investment. This is below the potential medium-term growth of 2 percent.

Furthermore, weaker global growth, trade-related disputes and uncertainty around Brexit, pose immediate challenges to the economic prospects.

We share staff's view on the continuation of a data-dependent monetary policy stance. Inflation expectations have increased and the Riksbank expects that the CPIF index will almost reach the target of 2 percent in 2019. However, staff projects a more gradual increase in inflation. The differences in the projections reflect the significant uncertainties around the inflation outlook and call for a data-dependent approach to monetary policy. In this context, we agree that deferring further rate increases until the second half of 2019 is appropriate.

Labor market reforms should facilitate increased wage differentiation across sectors and address the high unemployment rate of low-skilled workers and migrants. Staff notes that the tightening of labour markets in recent years has not been fully reflected in wage rises. This in turn has contributed to lower inflation and low interest rates. We share staff's view that the wage formation should better reflect structural changes in the Swedish economy, in order to strengthen the links between wages and other domestic economic trends such as inflation expectations and productivity. Labor market reforms aimed at improving job opportunities for low-skilled workers and migrants should be complemented by comprehensive housing market reforms aimed at facilitating labor mobility.

We welcome the authorities' plans to maintain a prudent fiscal policy stance. Even in the context of the modified fiscal framework, public debt is projected to decline to below 30 percent by 2024. This indicates that allowing automatic fiscal stabilizers to operate fully is consistent with maintaining a prudent approach to fiscal policy. We agree with the authorities that any adjustment to the medium-term surplus target should only be made at the eight-yearly reviews, and after taking into consideration the expected financing needs arising from long-term factors, such as aging.

Sweden's housing market continues to suffer from structural weaknesses that need to be addressed in a comprehensive manner. We welcome the authorities' planned steps in the "January agreement" towards improving the housing situation. At the same time, considering the size of the structural issues, we agree with staff that a more comprehensive reform package would be needed. Further liberalization of rent controls, greater access to housing allowances, and increased rental supply would help improve the functionality of the housing market. Moreover, a broad-based increase in the ceiling on the property tax, accompanied by measures that improve mobility and reduce housing demand, would help rebalance the housing market.

The authorities should stand ready to adjust their macroprudential stance to tackle risks from financial innovation and the entry of nonbank entities into the mortgage market. New technologies are facilitating the access of nonbank entities in the mortgage market. It is important that these entities are subject to similar macroprudential and consumer protection requirements as banks. As staff also flag potential risks to the banking sector stemming from financial innovation, we would like to know how staff assesses the capacity of Swedish banks to invest in IT systems to face these risks?

Ms. Mannathoko and Mr. Sitima-wina submitted the following statement:

We thank staff for a well written report and Mr. Ostros and Ms. Karjanlahti for their informative buff statement. We are in broad agreement with staff's appraisal and recommendations and confine our comments to a few points on fiscal policy, monetary policy, the housing and labor markets, and the AML/CFT framework.

Counter-cyclical fiscal policy will help to counter lower growth

Given the risk of a global downturn and lower domestic growth projections, we believe a counter-cyclical fiscal stance is warranted. Though the fiscal surplus has already declined below 1 percent of GDP in 2018, given the sharp decline in GDP growth projected for 2019, we agree with staff that it is prudent to free some fiscal resources, reducing the fiscal surplus in line with a new 0.33 percent of GDP target for 2020. The freed resources can then go towards providing some stimulus; helping to address higher public investment needs associated with the demographic shift. We also note the importance of enabling the full operation of automatic fiscal stabilizers as the need arises.

Monetary policy should be informed by emerging developments

Authorities need to guard against a policy stance that makes a deteriorating situation worse. Given the uncertainty around the global outlook, alongside slowing domestic growth in a low-inflation context, we agree with staff that a cautious approach to tightening the past expansionary stance is needed. The sharp increase in the policy rate in February may prove adequate to maintain price stability allowing authorities to defer further tightening. We therefore encourage the authorities to proceed carefully, with monetary policy continuing to be informed by emerging developments as reflected in the data.

The interplay between the housing market and slower growth matters

It is important to avoid a future downturn in the housing market that coincides with the slowdown of the economy; as global experience suggests that this would likely result in a more severe economic downturn. Thus, addressing vulnerabilities in the housing market is crucial and reforms proposed to address this are welcome. With respect to linkages to the financial sector, we are pleased to note that the profitability of Swedish banks remains strong, with low non-performing loans and high capital adequacy ratios. However, while the current macroprudential stance is appropriate following the adoption of stricter mortgage amortization requirements, we nevertheless encourage the authorities to continue monitoring risks closely. We wish to highlight staff's recommendation that authorities continue to review the adequacy of banks' risk management and the financial health of commercial property borrowers, given stretched commercial property valuations.

The labor market and demographic shifts

We commend the Swedish authorities on measures underway to equip unemployed labor with the relevant skills needed to fill vacant jobs. We believe that this embracing of diversity in the labor force will serve Sweden well in the long-run, strengthening the value and contribution of the full labor force to Sweden's growth and improving social cohesion. We also support the authorities' stance in allowing the manufacturing industry to continue to set the national wage benchmark. The link that manufacturing provides with the external economy is critical in influencing the evolution of the labor market. It engenders capabilities in labor that are pertinent for global trade and produce the type of structural transformation that will bring the unemployed out of poverty over time. Low-skill services do not do this.

Improving the AML/CFT framework

Given recent developments with Swedbank, we encourage the authorities to strengthen their anti-money laundering and counter-terrorist financing (AML/CFT) framework with a view to addressing existing loopholes and reducing the system's vulnerability to leakages.

With these remarks, we wish the Swedish authorities continued success.

Mr. Raghani and Mr. Diakite submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Ostros and Ms. Karjanlahti for their insightful buff statement. Following recent episodes of solid growth supported by strong domestic demand and exports, Sweden's growth momentum is expected to soften in 2018 -19 amid weakening private consumption, housing investment and exports. Yet, economic fundamentals remain strong with inflation subdued, public debt declining, and an external position that remains healthy. However, the increasing downside risks to the outlook, notably stemming from falling housing investments, global growth slowdown, and demographic changes should be contained through macroeconomic and structural policies to strengthen economic resilience and foster inclusive growth. We broadly concur with staff's policy recommendations and would like to offer the following comments:

We commend the authorities for the sound fiscal policy supported by the full workings of automatic stabilizers. As a result of the prudent policy stance, Sweden enjoys surpluses, low public debt and adequate fiscal space to be used to counter the impact of shocks should the downside risks to growth materialize. The authorities are encouraged to continue allowing countercyclical stabilizers to operate fully. They should stand ready to use part of the surplus over the medium term to address the pressures of higher public investment needs created notably by demographic changes brought about by population ageing and immigration.

In the context of softening growth momentum, monetary policy should remain accommodative as long as inflation remains below the authorities' target. Care should be given to safeguarding financial stability in light of digital financial developments. With the inflation outlook not presenting immediate concern, and given the uncertainties noted by staff regarding euro area growth and wages in Germany, we find appropriate the authorities' prudent approach to make further rate increases contingent on data about developments in the economic outlook and inflation prospects. Good communication about any shift in policy stance should also help anchor expectations. We note with interest the leadership role played by Riksbank in creating a central bank digital currency, the "e-krona" and the evolution of Sweden towards a cashless society, as described in Appendix VII. The transition towards digital payments carries significant benefits but also brings important challenges to the financial system in terms of effectiveness of monetary policy, and equitable access to financial services. We therefore support the authorities' plan to analyze in-depth the implications for financial stability of the changes in payment patterns and the issuance of the e-krona.

In the housing sector, the high housing prices and rents remain potential sources of vulnerability both for macroeconomic and financial sector stability, as well as intergenerational equity. We encourage the authorities to continue addressing the structural constraints in the housing sector through a multipronged policy approach as recommended by staff. These measures must adequately combine macroprudential measures to address risks to the financial sector, and tax and supply-side measures to buttress residential investment growth. With respect to the high DTI indicator, could staff indicate the breakdown between high-income and low-income groups and how this affects risks in the financial sector?

The authorities are encouraged to pursue their efforts to ensure macro financial stability. In this regard, we welcome the implementation of related FSAP recommendations, notably the stricter amortization requirement and the increase in the countercyclical capital buffer. Notwithstanding recent measures, we also urge the authorities to continue to strengthen their AML/CFT framework and seek close cooperation with countries in the region.

It will be important to continue enhancing flexibility and inclusiveness in the labor market. We welcome the increased resources for education in the 2018 budget aimed at upgrading the training of low-skilled and migrants to reduce their high unemployment rate. The authorities' integration framework is noteworthy in Europe and should continue to seek further integration of immigrants and workers with low education levels as indicated by Mr. Ostros and Ms. Karjanlahti in their buff statement. In this regard, the social partners' plan aimed at facilitating the entry of migrants in the labor force by reducing employer's social contributions is commendable.

With these comments, we wish the Swedish authorities success in their endeavors.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

Sweden's strong growth is set to moderate in 2019, dragged down by weaker domestic demand, housing starts, and exports. In this context, we agree with staff's policy recommendations to raise growth back to potential, including reducing the fiscal surplus target to support growth-enhancing reforms and pursuing housing market reform. Going forward, we urge the authorities to stand ready to use available fiscal space and monetary policy to support the economy if downside risks materialize. Sustaining a solid growth rate will also require the authorities to continue their progress on key social issues, such as the integration of refugees and low-skilled workers.

In the context of softening near-term growth and substantial downside risks, it will be critical for the authorities to get the policy mix right. We welcome the authorities' intention to allow automatic fiscal stabilizers to operate fully, leading to a mildly expansionary fiscal stance in 2019. We agree with staff's recommended transition to a new medium-term target by 2020 to release resources for growth-enhancing structural reforms, although it would have been helpful to hear what specific reforms staff would recommend the new government should prioritize.

Regarding monetary policy, we agree with the Riksbank's cautious and data-driven approach given the slowdown in economic activity, low underlying inflation, and sluggish wage growth. We note that the Risk Assessment Matrix prescribes "additional monetary support" in the context of a downside shock from weaker-than-expected global growth. Do staff see scope for (and potential effectiveness in) further monetary easing given that rates are still in negative territory and the recent conclusion of the QE program?

The Riksbank's e-krona project sought to address the striking decline in the use of cash in Sweden. We welcome the authorities' cautious testing of this initiative and their plan to involve a wider set of institutions and a broader scope of additional policy measures in further analysis of how to address the challenge of declining cash. We urge the authorities to continue to assess the full potential economic implications of a national digital currency since the real-world impacts remain highly uncertain. This includes the potential effects on fiscal and monetary policy, financial system integrity, feasibility and operational challenges, and overall costs and benefits.

We welcome the new coalition government's intention, as part of the "January Agreement," to begin to address supply challenges and inefficiencies in the housing sector. We agree with staff that more comprehensive housing sector reforms are needed to address inequality and promote labor market mobility, and financial sector vulnerabilities arising from high housing prices. Relatedly, high debt levels of Swedish households and commercial property firms could exacerbate an economic downturn, particularly in the case of an interest rate shock given that most mortgages are variable interest rate. Recent macroprudential measures have helped reduce housing-related financial risks, but close monitoring is necessary, informed by better collection of household-level balance sheet data.

Finally, in light of the recent money laundering allegations surrounding Swedbank's Baltic operations, we found staff's coverage of AML/CFT issues to be insufficient. Mr. Ostros and Ms. Karjanlahti's buff Statement helpfully conveys the authorities' commitment to a sound AML/CFT framework and recognizes that "further action may be necessary." Could staff provide more specific guidance on what deficiencies in the AML/CFT framework should be addressed and how regional cooperation should be enhanced beyond the joint investigation underway?

Mr. Agung, Mr. Ray, Ms. Park and Ms. Rauqeuqe submitted the following joint statement:

We thank staff for their comprehensive report and Mr. Ostros and Ms. Karjanlahti for their helpful buff statement. Sound macroeconomic policies and frameworks have served Sweden well, yielding adequate policy space for the authorities to push ahead with structural reforms in the housing and labor market fronts. As we share the thrust of staff's assessment, the following comments are made for emphasis.

The authorities' prudent fiscal management is commendable. Sweden's low public debt level and ample fiscal buffers has allowed effective operation of automatic stabilizers when needed. We note that staff recommend moving the medium-term surplus target a year after to 2020, in order to support higher public investments in light of looming demographic headwinds. Nevertheless, we share the authorities' concern that unpredictable revisions to the target may jeopardize its credibility. We note the medium-term fiscal targets are reviewed on an eight-yearly basis and invite staff's comments on whether this timeline provides sufficient agility to medium term fiscal policy.

While financial system indicators are sound, housing vulnerabilities need to be closely monitored. The banking system remains well-capitalized and profitable. As recent developments have demonstrated the exposure of Nordic-Baltic banks to money laundering risks, the authorities' commitment to strengthen their AML/CFT framework further to increasing resources for AML/CFT supervision, are welcome steps. On housing, while there has been some moderation in prices, further reforms are needed to strengthen housing affordability and reduce inequality. We note positively that tighter macro-prudential policy could partly account for the recent cooling of the housing market and stronger lending standards. These measures will take time to durably put a dent on household indebtedness and we encourage the authorities to continue to closely monitor the strength of household balance sheets. Gradually phasing out rent controls and simplifying construction rules and procedures could also improve the flexibility of the supply side response and improve housing affordability, which is central to increased labor mobility.

Strong employment outcomes can be further bolstered by measures to better integrate migrant and low-skilled workers. The authorities' efforts in integrating foreign born workers into its labor market and the 'entry agreements' that should further enhance these workers' employability, are commendable. In moving ahead, the wage setting mechanism could also benefit from broadening the range of reference sectors to include services, and therefore be more reflective of and responsive to economy-wide macroeconomic conditions.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written report and Mr. Ostros and Ms. Karjanlahti for their helpful buff Statement.

Sound economic policies and strong fundamentals have helped Sweden experience robust growth in recent years. In 2019, growth is expected to continue, albeit at a slower pace; inflation is close to target; and unemployment has dropped to a post-crisis low. Fiscal and external positions remain in surplus; and solid government finances have placed public debt on a firm downward trajectory, creating substantial fiscal space. We commend the authorities for their skillful economic management and, given increased downside risks to growth, see merit in maintaining accommodative macroeconomic policies, strengthening the financial sector, and advancing housing and labor market reforms. We concur with the thrust of staff appraisal.

Consistent with converging to the lower medium-term surplus target, fiscal policy should remain mildly expansionary, given ample fiscal buffers and slowing growth. Continued full operation of the relatively strong automatic fiscal stabilizers remains appropriate. We note plans to raise environmental taxes to finance income and payroll tax cuts and simplify taxation and regulations for micro-enterprises. While staff argues for a temporary cut in the surplus target to address higher public investment needs from demographic shifts in the coming decade, the authorities see no likely adjustment in the target before 2024. Could staff elaborate on its recommended size, composition, and duration of additional fiscal stimulus measures?

Expectations for gradual rise in inflation on the one hand, and significant uncertainty around the timing of durably reaching the inflation target on the other, argue for a continued cautious and data-dependent approach to monetary policy. We endorse Riksbank's decision to defer further rate increases until the 2nd half of 2019, making them conditional on growth and inflation developments. The e-krona project, scheduled to be tested in 2020, has already attracted considerable national and international attention in an environment of declining use of cash. We welcome ongoing work to evaluate risks and specify technical details of a cashless payment system, and agree on the need to explore regulatory options to ensure reliable and efficient private payments.

The large and interconnected financial system is robust, with banks' capital positions comfortably above the regulatory minima, good liquidity buffers, strong profitability, and high asset quality. While elevated house prices and high and rising household debt could be a cause for concern, the households' sizable buffers help limit the impact of shocks on debt service to banks. However, vulnerabilities remain from certain households with high debt-to-income ratios, large stock of variable-rate mortgages, stretched commercial property valuations, and potential spillovers from financing difficulties among smaller property developers. We take positive note of the recent tightening of macroprudential measures, and find merit in continued close monitoring of macrofinancial risks, including by enhanced data collection on household balance sheets, assessing the health of commercial property borrowers, and reviewing the adequacy of banks' risk management. We also welcome strong regional supervisory cooperation to safeguard financial stability and enhance crisis preparedness.

Comprehensive labor and housing market reforms are required to enhance labor mobility, support employment of the low-skilled and migrants, and bolster growth potential. We welcome plans to strengthen the integration of migrants and the long-term unemployed, including by enhanced education and training and supplementing salaries by a state benefit for up to two years, and see merit in further reforms of employment protection in collective agreements and public employment services. Could staff elaborate on extending trial periods to facilitate labor market entry by the low-skilled and migrants? Wage formation could be updated to broaden the range of sectors that set the benchmark for wage rises beyond the industrial sector but needs to be initiated by the social partners themselves, as indicated by Mr. Ostros and Ms. Karjanlahti. We also encourage the authorities to liberalize rent controls, while expanding access to housing allowance to protect households in the transition, reform property taxes, and simplify the construction regulation to help boost the supply of affordable housing.

We wish the authorities continued success in their endeavors.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their report and Mr. Ostros and Ms. Karjanlahti for their buff statement. We associate ourselves with the statement by Ms. Riach.

The Swedish economy has performed well in recent years, aided by a sound macroeconomic policy mix and supported by domestic demand including strong residential investment, but faces challenges both from external and domestic factors. As Staff highlight GDP data up to the 3rd quarter of 2018 showed signs of slowing external and domestic demand. However, more recent early data for the fourth quarter show a rebound, particularly in export growth. If confirmed, this positive outcome would imply a strong positive carry over for 2019 and suggest upside risks to Staff's forecasts for 2019. Thereafter, we broadly share Staff's expectation that growth rates will be around potential, although risks are primarily to the downside stemming from external and domestic sources. External risks relate to ongoing trade uncertainties, slowing global growth and a disorderly exit of the United Kingdom from the European Union. Domestically, housing market issues remain a key challenge.

Prudent fiscal policies have enabled Sweden to build substantial fiscal buffers. Given the positive structural balance, consistent budget surpluses in the past and the low debt-to-GDP ratio, Sweden has built up sufficient safety margins relative to SGP requirements to allow the full operation of automatic stabilisers even in the case of a significant slowdown of the economy. Besides reducing the surplus target, as Staff suggest, there seems to be scope to change the composition of spending to address public investment needs. Among others, it should be taken into considerations that frequent changes to the fiscal targets could affect the credibility of the fiscal framework, as it was last modified only in 2016. Higher public investment needs could be addressed by shifts in the budget without increasing the expenditure ratio further.

While Sweden has a largely well-functioning labor market, we agree with Staff that reforms should be aimed at specific groups, such as migrants and the low skilled. In aggregate, Sweden has one of the highest employment rates among the European countries. There are, however, large asymmetries across labour market groups. In particular, the unemployment rates of low-skilled and foreign workers have been high and have significantly increased over recent years. The authorities have implemented in 2018 some measures related to education or active labour market policies to improve the labour market integration of these vulnerable groups. While it will most likely take several years before their full impact is materialised, further measures in many different areas are likely still required to further streamline integration. Against this background, the policy measures of the new government, related to the labour market such as easing employment protection legislation to support employment for unskilled, youth or immigrant workers go in the right direction. However, we share the Staff view that wage formation could be more responsive to Swedish macroeconomic conditions and on the scope for increased wage differentiation across sector.

Housing market factors remain a key vulnerability. It is encouraging that tighter macro-prudential policy seems to be having an impact on lending standards and may have contributed to some moderation in housing prices since 2017. However, future developments of the housing market in Sweden are highly uncertain and structural weaknesses remain. Macro-prudential measures are an essential part of the toolbox and should be used proactively. However, they do not substitute the need for comprehensive structural reforms in the housing market and we agree with Staff that reform efforts are needed, such as a gradual reduction in fiscal incentives for credit-financed home ownership in order to curb mortgage demand as well as to the housing rental system. Moreover, it should be remembered that given the tighter amortization requirements apply only to new housing loans, it will take time for the vulnerabilities related to the level of household indebtedness to substantially decrease at the aggregate level.

We follow with interest the Riksbank's E-krona project and welcome Staff's analysis in Annex VII. Banknote dynamics differ between Sweden and the euro area in aggregate. The fall of the stock of banknotes in the Swedish economy is striking and raises important questions about the role of central bank liabilities in the economy. In contrast, the demand for euro banknotes continues to grow and cash remains a popular means of payment. Nonetheless, the Swedish example shows that changes in payment technologies and payment behaviour can be rapid. Therefore, the Swedish experience could provide a useful precedent from which important lessons can be learned. For the time being, the technologies which could potentially be used to issue a central bank digital currency, such as distributed ledgers, have not yet been thoroughly tested and may still require substantial further development before they could be used in a central bank context. We encourage Staff to continue to closely follow these potentially transformative developments.

The Acting Chair (Mr. Furusawa) noted that the Swedish economy had performed well in recent years, but growth was expected to soften in the near term. Directors' gray statements noted the need for fiscal and monetary policy to counter the slowing growth and weak inflation. Directors also underscored the importance of housing and labor market reforms, vigilance to any buildup of financial risks, strengthening the AML/CFT framework, and regional supervisory cooperation.

Ms. Riach made the following statement:

We thank the staff for the informative report and Mr. Ostros and Ms. Karjanlahti for their helpful buff statement. The sustained strong performance of the Swedish economy in recent years is set to slow in 2019, after which it is forecast to gradually return to its medium-term potential. We share the staff's view of a somewhat softer growth outlook than in the recent past.

Prudent fiscal policies have enabled Sweden to build substantial fiscal buffers. In the event of a significant slowdown, automatic stabilizers should be allowed to work fully. We share the staff's assessment that demographic changes on both ends of the age spectrum will create demand for public investment over the medium term. While fiscal space is available to increase overall spending, we note Sweden already has one of the highest expenditure ratios in the EU.

The continuation of a data-dependent approach to monetary policy is appropriate. In this respect, we note that inflation's convergence to the target is conditional on the price and wage developments of Sweden's major trading partners. In light of the substantial increase in house prices in Sweden, especially in larger cities, we welcome the tightening of macroprudential measures that seem to have improved lending standards and may have contributed to the recent cooling in the housing market. While household indebtedness on an aggregate level is only slightly above the median of comparator OECD countries, we share the staff's concern regarding the vulnerability of lower income households, both in terms of their high exposure to variable rates and their access to rental properties.

In aggregate, Sweden has the highest employment rate among the European countries. However, large asymmetries exist across labor market groups. In particular, the unemployment rates of low-skilled and foreign workers are high and have significantly increased over recent years. We acknowledge the authorities' past efforts to help integrate migrants into the labor force and welcome the commitment to further reform. We agree that wage formation should be more responsive to Swedish macroeconomic conditions, and broadening the sector base could be one option.

Finally, we welcome the strengthening of Sweden's Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework, and given the presence of Swedish banks in the Nordic-Baltics, we regard broader regional cooperation and supervision as crucial to effectively enhancing AML efforts.

Ms. Mannathoko made the following statement:

I thank the staff for the report and Mr. Ostros and Ms. Karjanlahti for their buff statement. We have issued a gray statement and are in general agreement with the staff appraisal, so I will just have a few brief comments.

Given the risk of the global downturn and lower domestic growth projections, we highlight that the authorities need to guard against any policy stance that would make a deteriorating situation worse. In our gray statement, we did support the countercyclical policy stance recommended by the staff, in particular freeing up fiscal space within the 2020 fiscal target while allowing full operation of automatic stabilizers, as well as ensuring a data-dependent approach to monetary policy.

In the financial sector, we also would urge the monitoring of risks, including commercial property borrowing. It is important to avoid a future downturn in the economy coinciding with a future downturn in the housing market. We also recommend reviewing the effectiveness of macroprudential measures, strengthening AML/CFT, especially given recent developments with the Swedbank, and enhancing regional supervisory regulation.

Finally, we commend the authorities for the efforts that have been underway to improve employment of low-skilled and migrant workers, including the work on enhancing educational opportunities. We believe that this will create a path that will bear fruit for Sweden in the future.

Mr. Just made the following statement:

We would like to expand on our requests for more nuanced policy advice on monetary policy and make further comments on the money-laundering. First, the staff’s assessment that relies on data dependence is somewhat ambiguous. The way the recommendation is written could suggest that the Riksbank is debating whether to move away from a monetary policy strategy that is based on data.

Second, and more generally, the formulation used in the report on Sweden is not exclusive to Sweden but appears in many other reports. When central bank communication moved to forward guidance, support by the Fund for this policy was certainly useful. However, any recommendation which is used in staff reports continuously across countries risks sounding ritualistic and generic over time. Adapting banks’ business models comes to mind, and so does data-dependent monetary policy. In the latter case, our concern is that outside observers could perceive a data-dependent monetary policy as the monetary policy strategy in and of itself, which it is not. A monetary policy strategy must find a way to combine incoming data and the model of the economy with judgments to formulate and then communicate a path for the policy rate that is most consistent with the policy objectives of the central bank. Data is crucial for the strategy, but is not the strategy.

We also believe that the discussions in staff reports on monetary policy should become richer and should include other topics central banks are grappling with, such as the outside balance sheets and the risk of fiscal dominance and moral hazard, the natural rates or behavior and structural effects of unconventional monetary policy on price discovery, and risk-taking by market participants.

We welcome the authorities’ commitment to strengthen the AML/CFT framework, which is critical to minimize any reputational damage that could arise from Swedbank. As we have emphasized during the AML/CFT review discussions, the effectiveness of the framework is imperative. While Sweden, like other European countries, has the required legal and regulatory framework in place, there are weaknesses in implementation. As in other European countries, supervisors need to be more intrusive and look at actual AML practice in financial institutions. Often AML execution and prosecution by financial intelligence units have significant weaknesses—which is maybe also due to the lack of cross-border information sharing and prosecution—while most supervisory cooperation and even who is responsible for supervision in the host country is also challenged.

In addition, private sector digital payment systems are increasing in importance, which increases the challenge and complexity of identity verification, especially in the context of single markets. We see this policy challenge on par with the operational resilience of payment systems to cyber risks. Both should feature also prominently in Sweden’s e-krona debates.

Mr. Moreno made the following statement:

I will ask a few questions to the staff for clarification. First, on fiscal policy, we support the staff appraisal in the sense of making full use of stabilizers and also in the margin of the surplus. But the authorities should also consider reviewing the composition of spending to increase investment. In the case of Sweden, we have the same problems as in other countries where the national fiscal rule is more restrictive than the Stability and Growth Pact (SGP) and it is often used by the authorities as an argument not to use the fiscal space that they have. This is something that will be useful for the staff to look at it in Article IV reports in the euro area.

The second point I wanted to make is on the housing market. It is the main risk of the country. The authorities are well aware of it and were also calling for the implementation of the January agreement. We share the staff’s view that there is a need for a more comprehensive approach, and I would particularly welcome the comments made by the staff on the need to run the rental market and to review property taxing. What I found most interesting, from which we can draw a lesson for other countries, is the implementation of the macroprudential tools in the housing market. I understand that the authorities want to review the impact of it, but I know there are some graphs. This is a situation that other countries can learn from, and it is also something interesting to extract in a cross-country analysis.

Finally, on the labor market, I tend to side with the authorities in the sense that it should be social partners who drive the changes in the collective bargaining system. Having said this, I would welcome the staff’s comments on how it is currently articulated/ Is it only the social partners from the industry sector that are involved? How about the other social partners from the services sector? Are they involved in the process, or have they just taken prices from the industry level collective bargaining?

Mr. Merk made the following statement:

We associate ourselves with Ms. Riach's statement and would like to make the following comment.

We commend the authorities for their prudent fiscal policies, which have helped to maintain Sweden's reputation for responsible fiscal management, and which allow for automatic stabilizers to operate freely. At the same time, the authorities expect high public investment needs in coming years resulting from demographic shifts. Given the moderate and declining level of public debt, we agree with the staff that there may be some room for an increase in high-quality public investment. In this context, we note the staff's proposal to consider a temporary cut in the medium-term surplus target if public investment cannot be financed within the current fiscal framework. However, allowing for a temporary cut in the recently updated medium-term surplus target might entail a risk of jeopardizing the hard-won credibility of the fiscal framework as Sweden's Fiscal Council has pointed out as well.

Furthermore, the medium-term surplus target is subject to regular reviews that could take into account factors such as public investment needs without prejudice to the transparency of the fiscal rules and the goals of macroeconomic stability and fiscal stability.

Mr. Kaizuka made the following statement:

We commend the Swedish authorities for the strong economic performances to date, with a declining unemployment rate and the highest employment rate in Europe. However, much attention should be paid to certain domestic risks and vulnerabilities, which include household indebtedness, falling housing prices, and still-high unemployment rate of foreign-born and low-skilled workers.

On the household indebtedness, we notice that the Financial Supervisory Authority (FSA) has implemented the amortization requirement targeting households with high debt, and also recently expanded the scope of requirement to include the newly emerged non-bank players. We encourage the staff to continue communication with the authorities and keep eyes on the implementation and the effectiveness of those measures.

Second, on the labor market, it is crucially important for the authorities to provide education and training to equip the unemployment people, most notably the foreign born. Japan is now gradually making itself open to foreign workers, and thus we would like to learn from the Swedish experience for future policy directions and options.

On wages, we have posed a question to the staff asking how the National Institute for Economic Research could function in order to make Sweden's wages reflect domestic economic trends more adequately. The staff's comments are welcome.

Finally, I am interested in the Swedish government bond market. Sweden will continue to deliver fiscal surpluses, and the central bank holds 40 percent of outstanding government debt. I wonder whether the Swedish government bond market is facing a problem of limited liquidity. In other words, how can it maintain the liquidity in order for the government bonds to play the role of a benchmark for that entire debt market?

Mr. Castets made the following statement:

I thank the staff for the set of clear reports. We thought the report was able to set a clear number of priorities and to focus on them, and this is a good example for the Article IV reviews in that regard. We also would like to thank Mr. Ostros and Ms. Karjanlahti for the insightful buff statement. We associate ourselves with Ms. Riach's statements.

Despite a slowdown in 2019, macroeconomic fundamentals remain solid, including a strong external position, low debt, low unemployment. Sweden is also well-known for addressing income inequality and of poverty, so overall we feel that the fundamentals are solid. We would like to stress two points in our discussion.

The first one is on the labor market. We acknowledge that the indicators point to a solid performance, and we salute the initiatives of social partners to enhance integration of immigrants and low-skilled workers while ensuring higher employability of those segments. We understand that it is a major issue. But though the labor market is tightening, wage rises remain quite subdued, and once again we find this inflation puzzle that is present in other European economies. This emphasizes the change in the relationship between inflation and employment and the fact that the inflation may not materialize even where labor markets' performance is quite strong. The staff came with some concrete recommendations. The discussion has mentioned the wage bargaining mechanism and how to expand beyond the industry that is now setting the benchmark for the world economy, and, in fact, for wage formation to be more responsive to the macroeconomic conditions in Sweden itself. We found that extremely interesting, and we encourage the staff to keep working on it.

Our second point is on the housing market reform. We noted that vulnerabilities have increased in relation to the sustained rise in house prices and the price-to-income ratio, but we also noted that the macroprudential framework has been strengthened recently, along with the implementation of the 2016 Financial Sector Assessment Program (FSAP) recommendations. So in this respect, we support the staff's recommendation to keep enhancing data collection in households to enable the supervisory authorities to closely monitor the effectiveness of these new measures.

Finally, like Mr. Moreno, we commend the Swedish authorities for their leadership in adaptation to climate change and notably on carbon taxation.

Mr. Ray made the following statement:

I wanted to talk about a few issues. One is fiscal policy, and the other is the e-krona. On fiscal policy, I did wonder when the staff would not recommend allowing automatic stabilizers to work in an economy such as Sweden. It struck me as an odd thing to stress. On the medium-term target, we have got some sympathy for the authorities' views that this does seem a little odd to fine-tune a medium-term fiscal target, particularly in a system such as Sweden's where there are eight yearly reviews by the fiscal council. Rather than focusing on the composition of spending within a given envelope, I found that I tended to agree with the authorities, particularly for something like demographic shifts, which may be relatively rapid in Sweden, but they are still relatively slow-moving things.

On the e-krona, I found that an interesting appendix, and Sweden seems to have led the way in this field in a number of respects. I remember when I was a student being taken to see what was then a brand new thing called an automatic teller machine in Stockholm, something that we did not have in our hemisphere or anywhere else in Europe, It was a bit of a first, so now they seem to be leading the way in not having any cash at all, and that is also fascinating. The appendix listed a whole range of potential risks with going cashless, and my understanding is people who think more deeply about monetary policy than I do can see some big positives about not having any cash. I did wonder whether the balance was there. That being said, I would welcome the staff's future work on Sweden to keep focusing on this issue, because it does seem that this is something that a number of countries will follow, and the whole question of e-central bank currencies, the question about how payment systems work without cash in them at all, is an interesting one and something which much of the membership would benefit from. Where we have got path breakers like Sweden, we should be studying what they are doing.

Mr. Inderbinen made the following statement:

We commend the authorities on the favorable outcome of the Swedish economy over the past years. While growth is leveling off, it has led to high levels of employment both historically and in regional comparison. I would like to make three points, one on fiscal policy, one on the external balance, and one on AML.

On fiscal policy, we note the staff's recommendation to reduce the medium-term surplus target if factors point to a need to increase public investment over the medium term, and we also note the preference of the authorities to maintain the review mechanism that they have built into their fiscal framework, and we very much sympathize with this stance. As Mr. Merk, Mr. Ray, Mr. Doornbosch, and Mr. Just have emphasized, it is important to take account of the credibility risks that the approach advised by the staff would entail. More broadly, we would suggest that the staff does take into account fiscal frameworks of countries when formulating advice. This is an important element that should feed into staff advice. It should be compatible with national fiscal frameworks.

On the EBA, we welcome the humility that the staff displays in stating that not all factors are possibly captured in the current account approach, the assessment, and we welcome that they also look at the real exchange rate index and level approaches in making that determination, and we believe this should provide an example of assessments of other countries as well, given that the current account often does not capture all aspects, especially in a highly integrated open economy, such as Sweden's.

Finally, on the AML, we welcome the intention of the authorities to increase regional cooperation on AML, also to apply additional resources toward securing a sound AML/CFT supervisory framework and also the authorities' recognition that further action may be necessary, particularly in the regional context.

Ms. Moreno made the following statement:

I will start by commending the authorities for the macroeconomic conduct that has allowed Sweden to fare external vulnerabilities in a much stronger position than during past events due to the stronger buffers and the implementation of macroprudential policies. As we mentioned in our gray statement and as others have also mentioned, growth has slowed but inflation remains on target. Monetary policy is still accommodative but ready to tighten if data on inflation dynamics were to indicate that.

On the fiscal side, it is one of the few economies with space for small stimulus if automatic stabilizers were able to fully operate. I would like to make three comments. One is on wage dynamics. They remain subdued mostly because of a benchmarking model that isolates wage dynamics with the structural changes in the Swedish economy.

We asked some questions that the staff will address, but Mr. Ostros and Ms. Karjanlahti caution against risks of abandoning this model, so we would like to hear the staff's opinion pm these risks. What could one expect if wage variation across sectors is allowed? Would there be a source of risk in that sense?

A second point is regarding housing prices and the risk of a strong rebound and a consequent downturn. Has the staff applied the new house-price-at-risk methodology that is presented in Chapter 2 of the Global Financial Stability Report (GFSR)?

Regarding AML/CFT, I mentioned that we are encouraged by the authorities' commitment to enhance broader regional cooperation, and we take positive note of their readiness to consider further actions if necessary.

Mr. Jin made the following statement:

The Swedish economy has experienced robust growth with strong employment gains in recent years. Prudent fiscal policy helps to build fiscal buffers against external uncertainty. Recently, a strengthened macroprudential framework ensures the banking system is robust and helps to curb the rise of housing prices. The decreasing unemployment rate of the low-skilled and the migrants reflects the Swedish authorities' continuous efforts in labor market reforms.

Looking ahead, we are glad to know that the new government will continue the momentum of reforms. Given that the housing prices and equity prices remain high, we encourage the authorities to stay vigilant about the high level of asset prices. The central bank's digital currency e-krona project is interesting and creative. We are looking forward to its following progress.

Regarding the labor market, we encourage the authorities to share their experience in enhancing the employment of the low-skilled and migrants, and we suggest the authorities to reduce the wage rigidity and increase the labor market flexibility.

Mr. Alkhareif made the following statement:

Sweden continues to perform relatively well. As mentioned by Mr. Castets, employment has increased to historical levels while inflation remains below target. However, like many countries, Sweden continues to face important challenges. In particular, this relates to the housing market and demographic shifts. Against this background, we welcome the ambitious reform agenda by the authorities and the new government.

The emphasis on promoting inclusive growth while maintaining sound fiscal policies is appropriate. We particularly appreciate the authorities' efforts to strengthen the integration of migrants into the labor market, as mentioned by Directors.

I would like to highlight two points raised by my colleagues. The first is on the e-krona project. We commend the staff's emphasis on this important project. Sweden has taken a lead on this, and many countries are benefitting from the experience of Sweden in this important area, and we encourage the staff to follow up on this experience in future Article IV consultations.

Finally, we encourage the authorities to further strengthen the banking system, including the AML/CFT framework. With these comments, we wish the authorities continued success.

The staff representative from the European Department (Mr. Beaumont), in response to questions and comments from Executive Directors, made the following statement:[2]

> I thank Directors for their questions. We tried to address most of them in writing, but I can elaborate on wages and fiscal policy. Before I do, let me take the questions that arose during the discussion.
>
> On macroprudential evaluation, there is a cross-country project underway in the European Department on this topic, which might be coming up in the Spring regional outlook.
>
> On house prices, we did not take advantage of the new housing-price-at-risk methodology. But let me note what we did, which was a cross-country analysis of house prices in the long run using OECD data, which I believe was a working paper by Nan Geng, which is quite a good basis for assessing deviations in housing prices from fundamentals.
>
> Government bond markets were impacted by the purchases of the Riksbank. There was some decline in turnover, but it was generally seen to be manageable. A factor that helped protect the liquidity of the markets was a repo facility provided by the National Debt Office which helped dealers maintain adequate bond holdings to conduct their trading business.
>
> In terms of the e-krona, we are planning further work in that area, and we are intending to collaborate both with the Riksbank and the Monetary and Capital Markets Department (MCM), so we can take full advantage of the skills of those parties.
>
> On monetary policy, I would contend that maybe it is a drafting problem. Our bold sentence is quite un-nuanced, but the text itself is reasonably clear. We say: although underlying inflation is expected to rise gradually, uncertainties around this outlook have widened. Deferring monetary tightening is appropriate pending clearer signs that the inflation outlook is consistent with durably meeting the inflation target. The inflation outlook takes advantage of all the data available, so it is data-dependent.
>
> Turning to wage formation, this is very much in the hands of Sweden's social partners. The Swedish government does not play any significant role in how wages are formed in Sweden. The system the partners have adopted and maintained since 1997 makes the industrial sector wage rise the benchmark

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

for the other sectors in the country. We suggest refinements to that system, one of which is to broaden the range of sectors that set this national benchmark, and the second is to have more flexibility around the benchmark. Directors’ questions were mostly on the first point, so I will focus on that.

Our motivation for proposing a broader representation of the economy in setting the national wage benchmark is coming from our concerns about low wage inflation, which has remained low despite sustained monetary stimulus and quite tight labor markets. Why is wage inflation so low? Under the current approach, despite Sweden having a floating exchange rate, the industrial sector aligns nominal wage increases in Sweden with nominal wage increases in Germany; and this is motivated by the fact that Sweden’s industrial companies are often competing for contracts in Germany, or they are competing with German firms in other markets. The industrial unions are quite comfortable with this approach because their experience is that has helped protect these well-paying jobs, and they have generally gotten some real wage increase, because even with low nominal wage increases, with inflation being even lower, there is still a real wage increase.

While the stated motivation around this approach is to protect competitiveness, in practice if one compares Swedish wages in euro to German wages in euro, there is significant fluctuation over time, because the krona has a floating exchange rate. So, in practice, there is much less protection for competitiveness than would appear to be the motivation for this approach.

The staff’s proposal would not change the situation, which is quite normal for countries with a floating exchange rate. Our proposal about broadening the range of sectors in setting the national wage benchmark aims to shift the focus of wage formation to the wider economic situation. These other sectors face domestic market conditions and the services export sector will often face quite different market conditions from the industrial sector in the global economy. The reason for broadening is to reduce the focus on one external wage as the most relevant factor, because these other sectors will not find that focus so relevant for their business. In coming to an agreement across a broader range of sectors, it would seem to be natural for them to focus on what is the average wage increase that is sustainable while maintaining high employment and high investment. It would be quite natural for these discussions to focus on trends in inflation, trends in productivity, maybe business profitability. All those factors could be included in the discussion.

Our expectation would be—just to be a bit more quantitative—if one looked at inflation expectations and productivity trends in Sweden, that they would agree on wage increases of 3 percent or maybe a bit more, which is significantly higher than the agreements that have been reaching around 2 percent. If they had higher wage agreements, the growth rates in nominal disposable income and nominal spending would be higher. The growth rates in unit labor costs would be higher; and overall, they would end up with a higher inflation rate. Say inflation rose by three-quarters of a percentage point, or by one percentage point, that would not be a threat to competitiveness in a floating exchange rate regime. What would happen is that over time, the nominal exchange rate would adjust to bring about roughly the same equilibrium real exchange rate; we have a chart in the report which shows that the average real exchange rate is quite stable in the longer term.

What is the role of the National Institute in this process? It already prepares an annual wage formation paper which informs the negotiating parties about all those factors I listed: inflation, productivity, business profitability, compared with profitability in other countries. All the relevant factors are already being provided as inputs to these negotiations. Our expectation would be that that information may have more influence when there is a wider range of sectors discussing wages.

We do not believe that this change to more representative national wage formation is a threat to employment and competitiveness. Rather, it is a proposal to ensure that nominal wage formation is more consistent with Sweden's floating exchange rate and inflation-targeting framework.

Let me note that the proposal is to refine the centralized bargaining approach. We are not proposing a shift to decentralized bargaining, even though decentralized bargaining is much more typical of countries with floating exchange rates and inflation targeting. We are not proposing that because it does not fit Sweden's social model.

In terms of the wage variation across sectors, it is quite exceptional for agreements deviating from the national benchmark to be made in practice. Recently special consensus was reached that nurses assistants and teachers could have significantly higher increases to help mobilize labor to move to those jobs. Considering the demographic changes and significant shifts in demand for labor, there seems to be a need for more flexibility in the system. In terms of what the risks are from having more flexibility, there could be some tensions for sectors to keep adhering to the national benchmark. We expect those tensions could be somewhat reduced if those sectors had a greater role in forming that benchmark than they do currently.

I will now turn to fiscal policy, mostly public investment and the surplus target. In relation to the slowing economy, we see the full operation of the automatic stabilizers as the main role of fiscal policy. It was worth mentioning because they are quite strong in Sweden. There is a chart in the report about that, or at least a hyperlink. Making a timely transition to the new lower medium-term surplus target is also useful, but I would not overplay that because it is only 0.2 percent of GDP. Separately from those short-term macroeconomic considerations, we were thinking about the challenge from demographics; this is not the usual long-term, steady aging challenge, but quite sharp changes in the coming decade. The number of people aged over 80 rises by 50 percent over the next 10 years, and they have quite special needs for elder care. There is also a substantial rise in people of student age.

A frontloading of infrastructure for healthcare and education is needed to serve those population groups. After one completes this process of investing, one can go back to a more normal level. So it is a quite frontloaded and temporary shock to investment needs. Demographics will also imply long-lasting changes in current spending, but it can have frontloaded effects on investment; so it is not a completely smooth process.

We discussed the potential needs arising from this process during the mission. The local authorities had lists of how many hospitals and how many schools they would need, but it was hard to convert that into an easily digested percent of GDP number or number of years. At the same time, Sweden is also considering another lumpy investment, which is to build some new railway lines connecting the main centers, which we were told was maybe a once-in-a-century type investment. The question about these challenges is how to best manage them within Sweden's very well-performing fiscal framework. If one can find other savings, that would be the ideal approach. But if one studies the budget process in Sweden, every year they are starting from a zero nominal baseline, and they have been doing this for a few decades, so there is not significant fat in the system. We do not believe it will be easy to find major savings without some significant tradeoffs in terms of other social goals. This is why we came to the concept of possibly having a temporary reduction in the surplus target as a means to finance this temporary rise in investment without making those types of difficult tradeoffs. Because Sweden is in a very strong fiscal position, it could handle a temporary deviation from its usual fiscal targets.

It is welcome that the review of the fiscal framework in 2016 included a process of reviewing those targets every eight years. Our proposal could be taken up in 2024 at the next review, so we are not specifying the exact modalities of reviewing the target. It could be possible to address that in 2024. But if one looks at the local authority investment, it is rising quite rapidly, so maybe that tension between investment needs and fiscal framework will arise before 2024, and it would be unfortunate if the central government felt that to observe the target, it had to squeeze its own investment. In our view, we should keep the door open to earlier reviews if they are warranted by developments.

Setting a suitable bar for advancing a review to be earlier than the normal eight-year schedule would be a way to preserve the credibility of the target, and here we are suggesting that a large temporary investment need could be a trigger for that type of early review. Another way to do this without formally changing the target would be to adopt some escape clauses, which has been discussed in recent Fund papers on fiscal rules, as a way to combine some flexibility with credibility.

Our discussion of potential approaches to deal with higher investment needs is not related to the current macro situation. It is more about how to ensure investments needed for economic and social purposes can be accommodated within the fiscal framework without undermining its credibility. The motivation for that is if we ensure that the framework supports the delivery of needed investment, it is also important for the sustainability and credibility of the framework over time.

Mr. Castets made the following statement:

I thank the staff for the precise and detailed answers on wage formation and on fiscal issues. I did not intend to intervene, but since Directors have raised this issue and staff provided a very comprehensive and convincing answer, I would like to recall that what we have in our policy so far is that when looking at the fiscal space, the staff should take into consideration domestic or regional fiscal rules, but it does not mean that the staff has to refrain from indicating how it sees the suitability and the adequacy of this fiscal rule while taking into consideration the macroeconomic environment of a particular country, and we feel that this is what the staff has done in this report. They came with a detailed, precise case for temporary adaptation where we do not see much risk for the credibility of the Swedish fiscal framework given where public debt is and given the past good performances on that front. Related to that, this Article IV consultation could be a good example for other countries because we feel that the way it looked at the aging issue is much more in-depth than has been done in many other European countries. This issue of how we deal with the investment needs we will face and not having purely a fiscal approach, like calling for more fiscal consolidation in advance but trying to identify where we need to invest or prepare our societies for this huge challenge—I believe this is very well done in this report.

Mr. Doornbosch made the following statement:

I agree. I was also greatly encouraged by the answers provided to the questions, and particularly on the fiscal framework. I thought the way the staff described the tradeoff between the medium-term investment needs and protecting the credibility of the rules by, for example, frontloading the review to be quite convincing. The only thing that I would have a different take on is using escape clauses for this type of very predictable, medium-term investment needs. I would consider escape clauses in fiscal frameworks more for something that comes externally that is hard to predict and not so much for a medium-term investment needs that one can see coming in the long term.

Mr. Merk made the following statement:

On the discussion on the fiscal framework, we do not discuss the situation like that every day. Sweden has a prudent fiscal policy. We commend them for responsible fiscal management. There is a moderate and declining level of public debt, and such a situation does not come for free. My conviction is that a part of that situation is owed to prudence and respect as well as national fiscal rules, and so I have a bit of difficulty supporting advice that calls on the authorities to deviate from those fiscal rules. That should be the prerogative of the Swedish authorities if they would come to such a very difficult decision. I have a bit of a problem with this advice to deviate from the fiscal rules, and I have great respect for the Swedish authorities on that front.

Mr. Moreno made the following statement:

I would like to associate myself with the comments made by Mr. Castets. It is useful that the staff gets into the analysis of the fiscal rules. Just to reiterate the point that I was trying to make, there is some sort of asymmetry.

The fiscal rules cannot be more lax than the Stability and Growth Pact, but they can be more restrictive than the Stability and Growth Pact. We are in the EU, and we are having an issue with a number of national fiscal rules in countries of the European Union that are more restrictive than the Stability and Growth Pact, and this is something that the staff can look at, and the staff's analysis is useful.

Mr. Ostros made the following concluding statement:

Let me start by thanking the whole Article IV mission team, highly qualified and a nice team to work with, led by Mr. Beaumont, for the high-quality interaction with my authorities and for providing valuable analysis and recommendations. I also thank Directors for their gray statements and interventions. It is nice to have a debate on Sweden.

The Swedish economy has performed well in recent years with a strong increase in employment rates reaching historically high levels. GDP is expected to grow at a slower pace in 2019, as many have mentioned. The relatively strong fiscal position and low public debt allows full operation of the automatic fiscal stabilizers. My government agrees with the staff that undertaking a small stimulus in the next few years, considering that domestic demand is projected to slow, entails little risk of overheating.

It is an interesting proposal from the staff to consider a temporary cut in the medium-term surplus target to make room for additional investment, and several Directors agree with that. But like Mr. Agung, Mr. Ray, Ms. Levonian, Mr. Doornbosch, Mr. Merk, Mr. Trabinski, and Mr. Just, I would also like to caution against changing targets in an unpredictable way.

Swedish monetary policy has been very expansionary in recent years with the negative interest rates and extensive purchases of government bonds. The support for monetary policy was somewhat reduced with the increase in the repo rate in December. The Riksbank shares the Fund's view that it is appropriate to closely monitor incoming data to ensure that inflation remains close to the target and inflation expectations are firmly anchored.

A major source of concern is the fact that housing prices and household indebtedness in Sweden have been rising for a long time. However, there has been a marked slowdown in the growth of household debt lately. The implemented amortization requirement and the further tightening of this requirement have contributed to reduce these vulnerabilities. Now is an appropriate time to review the effectiveness of steps already taken.

One of our major structural problems is the Swedish housing market. As described in our buff statement, measures have been taken, and several new measures are planned as part of the government's platform agreed upon in January. The authorities appreciate the staff's advice in this area now and going forward.

I note Directors' references to high capital adequacy ratios and high profitability in the banking sector. However, it is important to point out that the Swedish banking system is large, interconnected, independent from market funding, which entails structural vulnerabilities. The interconnectedness of the banking system with the neighboring countries makes it essential to cooperate closely with the authorities in the Nordic-Baltic region. As an example of these efforts, a regional financial crisis simulation exercise prepared by a working group led by the Riksbank was carried out in January 2019. Thirty-one authorities participated, including relevant European authorities. The Fund was invited to follow the game from the control room at the Riksbank. The simulation included two fictitious large Nordic banks with subsidiaries in the Baltic States and Iceland, as well as significant branches in Norway and Sweden. The simulation tested liquidity provisions, supervisory action, and resolution and provided important insights.

Many Directors referred to the need to enhance ongoing cooperation between authorities in the Nordic-Baltic region on AML issues. My authorities take very seriously reports of banks in our region being used for money laundering. The authorities recognized that further action may be necessary. Although Sweden has the highest employment rate in the EU, we do not lack challenges on the labor market. The fact that we experience considerable labor shortages at the same time when low-skilled people have difficulties in finding jobs is an illustration of the challenge. Education is at the forefront of the efforts. The fast track to enter the labor market for newly arrived refugees has been implemented. The social partners are negotiating further steps to facilitate the entry into new jobs for relatively low-skilled workers.

Finally, on the Swedish wage formation system, wage negotiations in Sweden are completely up to the social partners to decide upon, and it is a system that has delivered real wage increases for 20 consecutive years. It is quite difficult to change it because the partners are quite happy with it. The labor income share of income also remained quite stable during a period when it has decreased in many other parts of the world.

> Let me conclude by thanking Mr. Beaumont once again and his team for excellent leadership on four Article IV consultations. Sometimes it is a bit of a challenge. When Mr. Beaumont suggests to our parliamentarians to increase spending, they look a bit concerned. When he turns to the labor union and says they could ask for higher wage increases, they look a bit troubled. But we are happy for the advice and for the cooperation with Mr. Beaumont and his team.

The Acting Chair (Mr. Furusawa) noted that Sweden is an Article VIII member, and no decision was proposed.

The following summing up was issued:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the sound economic performance in recent years, with strong domestic demand gains driving solid economic growth, rapid job creation, and a narrowing of the current account surplus. Directors noted, however, a softer near-term growth outlook, with downside risks from weaker global growth and domestic demand. Against this background, they encouraged the authorities to strengthen the foundations for inclusive growth, particularly through housing and labor market reforms.
>
> In view of the heightened economic uncertainties, Directors considered that monetary policy should remain cautious and data-dependent to ensure that inflation remains close to target and that inflation expectations are firmly anchored. They agreed that the Riksbank's deferral of further rate increases until the second half of 2019, dependent on the economic outlook and inflation prospects, was appropriate.
>
> In light of Sweden's prudent policies and strong fiscal buffers, Directors welcomed the authorities' intention to allow the automatic fiscal stabilizers to operate fully in 2019. They also supported reducing the cyclically-adjusted surplus to the new medium-term target by 2020, given little risk of overheating from the resulting small stimulus at a time of slowing growth. A number of Directors considered that higher public investment needs arising from demographic shifts or other factors could be addressed by shifts in the budget, while consideration of a temporary cut in the medium-term surplus target would need to be balanced with preserving its credibility.
>
> Directors commended the employment gains in recent years, while noting that unemployment among the foreign-born and low-skilled remains high. They welcomed the social partners' plan for "entry agreements" to

enable migrants and the low-skilled to combine work and training at reduced cost to employers. Directors encouraged the social partners to update wage formation to reflect structural changes in the economy, such as by broadening the range of sectors that set the benchmark for wage rises.

Directors encouraged comprehensive housing market reforms to improve housing affordability, thereby supporting labor market mobility and inclusive growth. In addition to liberalizing rents for newly-built apartments, Directors saw merit in phasing out rent controls, cushioning the adjustment by expanding access to the housing allowance. To promote the efficient use of existing property, Directors favored higher recurrent property taxes, including by phasing out mortgage interest deductibility. They also supported strengthening competition in the construction sector to lower construction costs.

Directors welcomed the adoption of stricter mortgage amortization requirements, while calling for risks to remain under close watch, including by collecting household level balance sheet data. They supported continued review of the adequacy of banks' commercial property risk management and the health of commercial property borrowers. Directors emphasized that the authorities should continue work to correct any remaining deficiencies in Sweden's AML/CFT framework and to strengthen regional cooperation. They welcomed the authorities' exploration of the e-Krona and encouraged assessment of the potential economic implications of the digital currency, along with regulatory options to ensure reliable and efficient private payments.

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

APPROVAL: April 23, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***The risk assessment matrix mentions Brexit as a high risk, the report itself has not fully explored its implications for Sweden. Staff's comments would be welcome.***

- The risk assessment matrix includes weaker-than-expected global growth as a medium-high risk, with a medium impact. An uncoordinated Brexit is mentioned as a potential contributing factor to lower global growth.

- Exports to the UK are about 6 percent of Sweden's total exports and 1.7 percent of GDP. Hence, even a sizable decline in UK growth would have modest direct impact on Sweden.

- The impact of uncoordinated Brexit on Sweden is likely to mostly be via a decline in EU growth. IMF estimates (Euro Area SIP, 2018) are that the long run impact under a hard Brexit scenario would lead to a decline in the level of output in Sweden by 0.8 percent. A milder Brexit scenario (where the U.K. leaves the single market and the customs union, but the U.K. and the EU agree on a broad free trade agreement) would lead to a decline of 0.3 percent over the long term.

2. ***Amid weaker Eurozone prospects and soft housing investment, growth is expected to decelerate in 2019 by more than 1 p.p. according to staff's projections (from 2.3 percent in 2018 to 1.2 percent in 2019). Nevertheless, economic growth in quarter-on-quarter terms was likely solid in Q4, although this could be in part due to a favorable base of comparison after temporary factors saw the economy contract in Q3. Staff's comments are welcome.***

- The projection for 2019 GDP growth takes into account GDP data for 2018Q4.

- While growth in Q4 was strong, at 1.2 percent q/q, it relied on an exceptional 3.1 percent q/q jump in exports, with domestic demand rising only 0.3 percent q/q. The surge in exports may be revised or there may be some reversal in Q1.

Fiscal Policy

3. ***With the growth slowdown in Europe and escalating trade tensions, do staff see even greater role of fiscal policy in demand management in Sweden in the short run?***

- Automatic fiscal stabilizers are relatively strong in Sweden (see Figure 2.2 in the 2015 Spring Fiscal Monitor). Their full operation will help cushion the slowdown in 2019. The transition to the new medium-term surplus target by 2020 would provide a stimulus, although it is quite small.
- But given Sweden's low unemployment and positive output gap in 2018, and a slowdown that is expected to be temporary, staff is not calling for discretionary stimulus. Reducing the structural balance below its medium-term target could be warranted to counter a deeper and more lasting recession.

4. ***We welcome staff's comments on the trade-off between cutting the fiscal surplus and realigning the budget to scale up public investment.***

- Staff will respond orally to this question.

5. ***How would staff assess the scope for changing the composition of expenditure within the existing fiscal target?***

- Staff will respond orally to this question.

6. ***How do staff think that a temporary cut in the medium-term surplus target might reduce the credibility of the target?***

- Staff will respond orally to this question.

7. ***We note the medium-term fiscal targets are reviewed on an eight-yearly basis and invite staff's comments on whether this timeline provides sufficient agility to medium term fiscal policy.***

- Staff will respond orally to this question.

Monetary policy/e-Krona

8. ***Do staff see any broader lessons from the Swedish experience on challenges for monetary policy normalization in advanced economies after the GFC? What are the main factors holding inflation well below the target for such an extended period****?*

- Slow increases in Swedish unit labor costs have been an important factor in the weakness of core inflation. Staff estimates that ULC increases (defined as wage growth minus trend productivity growth) have been below 2 percent since 2012 and are currently around 1¼ percent.

- Accordingly, the report discusses how Swedish wage formation linked to German wage trends contributes to subdued wage rises relative to the tightness of labor markets, prolonging low inflation and low interest rates (Paragraph 20).

- Another important factor behind low inflation has been the persistent weakness of inflation in the euro area. This has direct impacts via imported consumer goods, but also contributes to subdued wage rises in Europe and Germany which drag on wage rises in Sweden, as noted above.

- Sweden's experience is one of spillovers from low inflation in the euro area into domestic inflation, despite its floating exchange rate regime. The result is a delay in monetary normalization relative to its own cyclical developments, entailing potential macrofinancial risks. This is why staff recommends addressing the macrostructural issues in wage formation. Drawing broader lessons would require further work.

9. ***Do staff see scope for (and potential effectiveness in) further monetary easing given that rates are still in negative territory and the recent conclusion of the QE program?***

- The Riksbank has options for further easing if needed. It could further defer rate hikes. There is scope for lowering the policy interest rate further into negative territory. These measures would be effective, especially considering the strong passthrough to mortgage interest rates, which are predominantly floating.

- The QE program could also be renewed. The Riksbank currently holds about 45 percent of the outstanding stock of Swedish government bonds. The adoption of QE had a notable impact on term premia, as discussed in prior staff reports.

- Should the authorities have concerns about the functioning of the government bond market, additional options for QE include purchases of covered bonds or corporate bonds, which would reduce credit spreads and borrowing costs for firms and households.

10. ***While the current focus in this work is primarily on promoting a safe and efficient payment system, we would appreciate additional comments on a possible role of the e-krona in moving the effective lower bound as a constraint on central bank policy rate setting.***

- The Riksbank is still considering whether the e-krona would be interest-bearing, but sees it as a payment instrument, rather than as an instrument for monetary policy.

- However, the Riksbank recognizes that a non-interest-bearing e-krona raises the repo rate's effective lower bound to zero.[3]

- This issue could potentially be addressed by limiting holdings to holdings of e-krona to amounts needed for transaction purposes, but that may also have disadvantages.

11. ***We note that first-mover advantages of existing payment systems will be an important factor, as well as the extent to which the government uses e-Krona. We would welcome presentations on this topic, including during the Spring and Annual Meetings for interested country officials. A blog or article in Finance and Development would also be welcome.***

- There will be several seminars on Central Bank Digital Currencies (CBDC) during the Spring Meetings including by the iLab and MCM. The Sweden team is currently considering expanding its analytical work on the e-krona in collaboration with MCM.

Financial sector and housing market

12. ***We would appreciate it if staff could elaborate why the bank's profit remains strong despite negative interest rates in recent years***.

- This issue was explored in the following paper:

- Rima A. Turk, "Negative Interest Rates: How Big a Challenge for Large Danish and Swedish Banks?," WP/16/198 https://www.imf.org/external/pubs/ft/wp/2016/wp16198.pdf

- Swedish banks have a high reliance on wholesale funding. The cost of wholesale funding declines with the policy rate. So net interest margins are protected even when lending interest rates decline.

13. ***As staff also flag potential risks to the banking sector stemming from financial innovation, we would like to know how staff assesses the capacity of Swedish banks to invest in IT systems to face these risks?***

[3] https://www.riksbank.se/globalassets/media/rapporter/e-krona/2018/the-riksbanks-e-krona-project-report-2.pdf

- Swedish banks are relatively efficient with low cost to revenue ratios. This in part reflects the benefits of sizable investments in IT, suggesting that Swedish banks are quite capable in this respect.

14. ***Given the expansion of credit from nonbank entities, we are wondering if there were a causal link between this development and the higher level of macroprudential requirements on borrowers. Does staff have an opinion on this aspect?***

- Residential mortgages originated by nonbank entities are subject to the same requirements and macroprudential regulation as loans from banks.
- The business model of the nonbanks appears to be more focused on price competitiveness and convenience, as they target relatively low risk borrowers.

15. ***Considering the rising commercial property prices, we are wondering whether this reflects the leakages of the macroprudential measures in residential property prices. Staff's comments are welcome*.**

- Leakages from macroprudential measures on residential mortgages are very unlikely to contribute to commercial property prices. Reductions in mortgage lending would rather reduce the banks' needs for wholesale funding.

- The rise in CRE prices mostly reflects strong demand for commercial space and rising rents, driven by the overall solid economy. But price gains are also associated with a decline in yields on this property, consistent with a search for yield in a low interest environment, including by foreign investors.

16. ***Have staff discussed with the authorities any specific measures to address emerging financial stability risks in the commercial real estate sector?***

- The diverse nature of commercial real estate (CRE) projects and lending complicates the application of uniform types of macroprudential instruments as in the residential mortgage market.

- As discussed by the ESRB, the macroprudential toolkit to address CRE is still relatively underdeveloped in general, and few macroprudential measures have been implemented in European countries that directly target CRE vulnerabilities.[4]

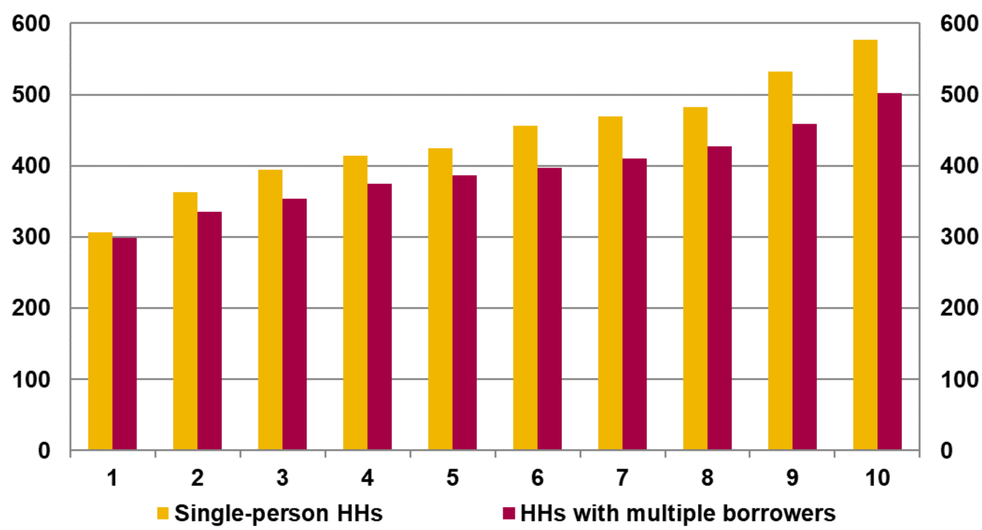
[4] https://www.esrb.europa.eu/news/pr/date/2018/html/esrb.pr181126_1.en.html

- However, the authorities are well aware of risks associated with CRE lending and closely monitor them. To this end, the Swedish FSA is currently working on a report that focuses on the risks associated with CRE, to be released in Q2 of 2019.

17. ***With respect to the high DTI indicator, could staff indicate the breakdown between high-income and low-income groups and how this affects risks in the financial sector?***

- For new loans, the DTI ratio is significantly lower for low-income groups than for high-income groups. This may reflect the concentration of high-income households in the major centers where property prices are especially high. It is consistent with the FSA analysis that households generally have adequate buffers to absorb shocks to their income or expenses without going into arrears. Overall, the distribution of debt is likely to attenuate the financial risks from the high overall DTI level.

Figure 1: Debt-to-income ratio by income decile and household type, new loans



18. ***Could staff elaborate on the factors behind the sizable increase in the cost of construction over the recent years, besides the weaknesses in the planning process mentioned in the report?***

- Investment in buildings rose by 30 percent cumulatively from 2013 to 2018, driven primarily by a 115 percent jump in new construction of dwellings. In these years, there have been broad based increases in construction costs, including materials, labor, plant and equipment, etc.

- Over a longer horizon, as reflected in the figure on page 14 of the staff report, it is not the case that rising costs reflect high demand. Rather, as analyzed by the Swedish

Competition Authority, a lack of competition in the sector partly reflects municipal land acquisition and planning systems that are complex and time consuming, favoring those with local knowledge.[5]

- Sweden also has rigorous building standards, such as in relation to energy efficiency, which likely also increase costs. Municipalities impede standardization of buildings and cost savings from mass production through local variations in standards.

19. ***In this context, could staff elaborate on the key deficiencies in the Sweden’s AML/CFT framework, on how they should be addressed, and on how to ensure consistency of reforms in Sweden’s and the euro area AML/CFT frameworks?***

20. ***Could staff provide more specific guidance on what deficiencies in the AML/CFT framework should be addressed and how regional cooperation should be enhanced beyond the joint investigation underway?***

- Sweden’s AML/CFT framework was assessed by the Financial Action Task Force (FATF) in 2017. It found that “Sweden has a strong regime to tackle the money laundering and terrorist financing risks it faces, but needs to improve its national policy coordination.” See full assessment: http://www.fatf-gafi.org/countries/s-t/sweden/documents/mer-sweden-2017.html
- At Sweden’s request – and based on the information provided in its first follow-up report – the FATF re-rated Sweden on 10 of the 40 Recommendations and moved the country from enhanced to regular follow-up. See: http://www.fatf-gafi.org/countries/s-t/sweden/documents/fur-sweden-2018.html
- The most salient of the remaining technical deficiencies in Sweden’s AML/CFT regime concern: the imposition of targeted financial sanctions related to terrorism (see R.6) and proliferation (see R.7), the employment of risk-based AML/CFT supervision (see R.26), and cash couriers/the cross-border transportation of cash (see R.32).
- The Swedish authorities continue to work to address the technical deficiencies and effectiveness gaps in their AML/CFT framework, including via legislative reforms and enhanced cooperation across countries. The next FATF review of Sweden’s effectiveness in mitigating its ML/TF risks is likely to be conducted in late 2022.
- Staff is engaging with the authorities in the Nordic/Baltic region on macro-critical AML/CFT issues through Article IV’s (e.g. Latvia, Estonia, and Denmark).
- With regard to AML/CFT coordination, the 2018 Euro Area FSAP recommended establishing a European-level institution responsible for aspects of AML/CFT supervision as opposed to the current arrangement with national responsibility.

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[5] http://www.konkurrensverket.se/globalassets/publikationer/rapporter/rapport_2015-5.pdf

- Regarding consistency of reforms with Europe, Sweden coordinates with the EU on AML/CFT, including with respect to the implementation of the relevant AML Directives and potential steps to improve coordination across countries.

21. ***We would also be interested in staff's comments on the impact of Nordea's relocation on the prudential and AML/CFT supervision framework as Sweden is likely to remain one of its main markets in terms of operations including branches.***

- Nordea's relocation of its HQ to Finland implies that the SSM is responsible for supervising the banking group, with the Swedish FSA participating in the supervisory college. This transition has been completed.

- While AML/CFT measures in cross-border financial institutions are supervised by the host country authorities, the home country authorities are responsible for supervising application of group-wide AML policies and procedures. This means that Swedish authorities and the FSA continue to supervise Nordea's AML/CFT in Sweden, while coordinating group-wide AML policies with the Finish authorities.

Structural issues

22. ***On wage, we note that Swedish wage rises have become closely linked to those in Germany, which contributes to low inflation in Sweden. In this regard, we see merit in the staff's appraisal that wage should be linked to domestic economic trends such as inflation expectations and productivity. Staff show one possible approach to achieve this in the staff's report. That is, the National Institute for Economic Research continues to provide information to the social partners who set a national wage benchmark. Could staff elaborate more how this approach could make Sweden's wage reflect domestic economic trends more adequately****?*

- Staff will respond orally to this question.

23. ***Could staff provide alternative advice on how to encourage higher salary increases without hampering the competitiveness of the Swedish manufacturing sector?***

- Staff will respond orally to this question.

24. ***Mr. Ostros and Ms. Karjanlahti argue that being a small export-dependent economy, Sweden needs to maintain international competitiveness. In addition, they explain that it has been a successful benchmarking model and abandoning it might be risky. Could staff elaborate on these risks? Do these risks also relate to allowing variation across sectors to be increased****?*

- Staff will respond orally to this question.

25. ***Could staff elaborate on the best practices in using private providers for job placements?***

- The authorities plan to study the experience of Australia and others in outsourcing services previously provided by the public employment service. The most well know challenge is "cherry picking" in which the private provider allocates less effort to job placement for the more difficult cases, including migrants and the long-term unemployed.

- Further discussion is provided by the following OECD report:[6]

26. ***We particularly appreciate the authorities' efforts to strengthen the integration of migrants into the labor market. In this regard, we would appreciate if staff could indicate if there are lessons from the Swedish experience in integrating migrants?***

- Sweden has a long-standing framework for integrating migrants especially refugees, as discussed in Box 1 below.

- In 2015, the selected issue paper included a more extensive discussion of migrant integration:[7]

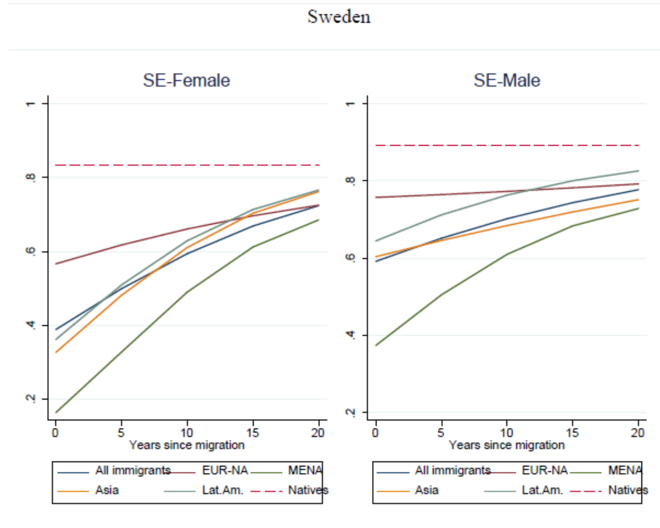
- Further cross-country research on this issue was conducted: Giang Ho, Rima Turk-Ariss, 2018, "The Labor Market Integration of Migrants in Europe: New Evidence from Micro Data," WP/18/232.[8]

[6] https://www.oecd-ilibrary.org/employment/activating-jobseekers_9789264185920-en

[7] https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Sweden-Selected-Issues-43432

[8] https://www.imf.org/en/Publications/WP/Issues/2018/11/01/The-Labor-Market-Integration of-Migrants-in-Europe-New-Evidence-from-Micro-Data-46296

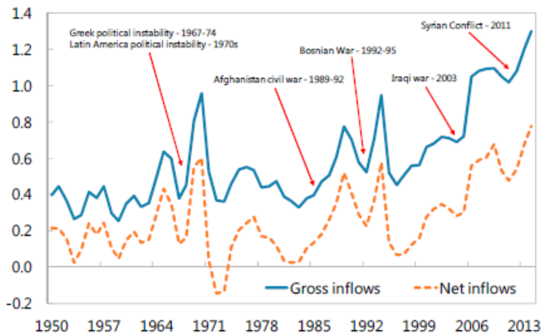
- Integration is found to be a long process, depending on the origin of the migrant, their education level and gender, but also on labor market conditions when they arrive.



Box 1. Migration Flows and the Integration Framework for Asylum Seekers

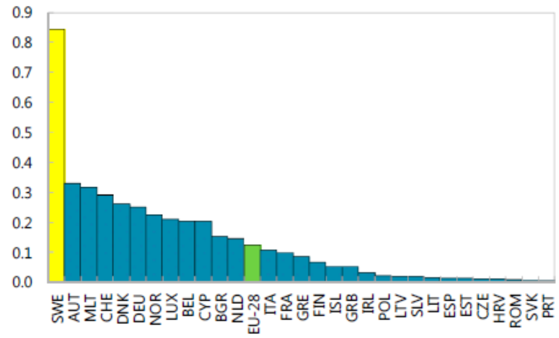
Migration to Sweden has led to an increasingly diverse population. Net immigration to Sweden dates back to the 1930s and gross inflows have been rising over the years, reaching 1.3 percent of the population in 2014, up from ¾ percent in the early 2000s. Over that period, the share of foreign-born persons has risen from 11¾ to 16½ percent of the population. Swedish migration policy has a strong humanitarian dimension, with peaks in migration inflows coinciding with wars and unrest elsewhere. Relative to its population, Sweden receives more asylum seekers than any other EU country.

Migration Flows
(Percent of population)



Sources: Statistics Sweden and Fund staff calculations.

Asylum Seekers, 2014
(Percent of population)



Sources: Eurostat and Fund staff calculations.

The composition of migrants to Sweden is changing. The share of those seeking asylum (and family reunification) is rising; in 2014, asylum seekers comprised about two-thirds of total migrant inflows, up from about one-third in 2010. The majority of asylum seekers in recent years come from Eritrea, Somalia, Afghanistan, Iraq, Iran, Kosovo, Albania, and Serbia, with Syria the largest source since 2012. In 2015, unaccompanied minors—primarily from Afghanistan—are more than 20 percent of total asylum seekers, up from about 8 percent over recent years.

Sweden has a well-developed framework for integrating refugees—the introduction program. Eligibility is restricted to asylum seekers who have received a residence permit as refugees, quota refugees, or other persons in need of protection, aged 20–64 years (or 18–19 years without parents living in Sweden) and their relatives. An introduction interview by the Public Employment Service (PES) assesses their experience, education, and ambitions in order to develop an "introduction plan" which can last up to 24 months. The plan has three main activities that should occupy participants full-time: (i) Swedish language training; (ii) employment preparation, such as the validation of education and professional experience; and (iii) social studies to provide a basic knowledge of Swedish society. Participation in the program is voluntary, but an introduction benefit is conditional on participation. Participants who find work are able to continue to claim the introduction benefit alongside their wages for six months, after which the benefit is reduced in proportion to the time spent working. The PES can assist refugees with an introduction plan in finding accommodation at a location where it considers the chances of obtaining work or education are good.

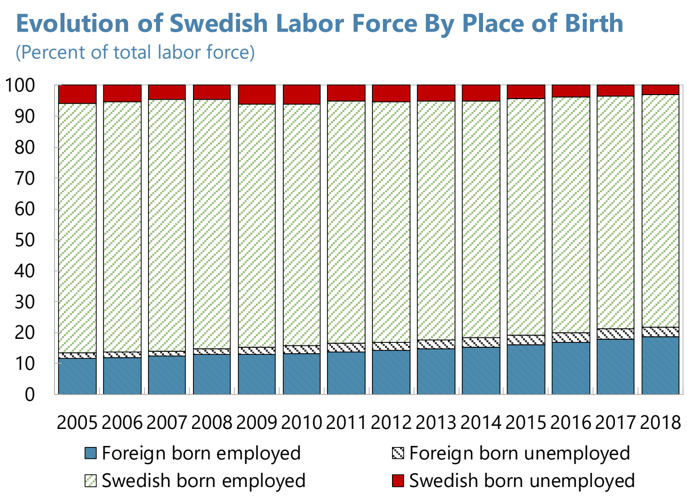
Nonetheless, rising asylum seeker inflows are stretching administrative capacity and leading to policy adjustments. Recent reports are for average daily inflows over 1,500 persons with the number of asylum seekers reaching about 160,000 in 2015 on updated estimates, up from 83,300 in the earlier official forecast. The average processing time for residency permits has doubled from an average of 108 days in 2012 to 220 days during Q1–Q3 2015. The authorities have announced that they would issue temporary residence permits for limited period, allowing for a later review of residency—with exceptions including unaccompanied minors and families with children who would continue to receive permanent residence permits. More recently border controls were established—migrants seeking asylum can enter Sweden only if they register on entry.

27. ***As noted by staff, the unemployment rate of the foreign born and low-skilled remains very high. This challenge is likely to remain in the coming years because of number and composition of the arrival of asylum seekers in late 2015. Could staff elaborate on this high unemployment rates considering the evolution of the labor force?***

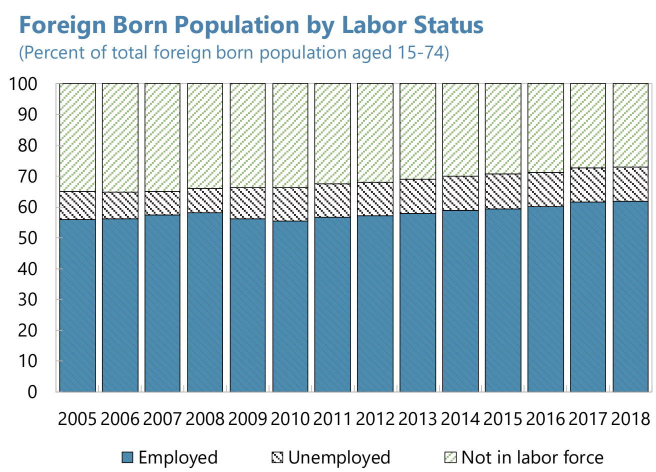
- The share of foreign-born workers in the Swedish labor force has steadily risen, increasing from 13 percent in 2005 to 22 percent in 2018.

- The increase in asylum seekers in recent years has not coincided with an increase in the share of the foreign-born population that is either unemployed or not in the labor force.

- It seems likely that a significant portion of the recent asylum seekers are still in the process of gaining the capacity to enter the labor force. The above research suggests that their integration will take a substantial time overall.



Sources: Statistics Sweden



Sources: Statistics Sweden