

## 2015 Article IV Consultation with Sweden Concluding Statement of the IMF Mission

*Sweden's economy is performing well. But housing prices and household debt are elevated and rising and unemployment is high among some groups. Reforms to address the structural problems in housing and labor markets are important to help sustain growth and stability. Monetary, fiscal, and prudential policies should aim to return inflation to target, contain unemployment, and protect resilience and stability, but they cannot substitute for structural reforms. The urgency of such reforms is heightened by rising migration inflows, which provide a valuable opportunity to secure Sweden's social model for the long term.*

### ***Economic Outlook, Challenges, and Priorities***

- 1. Growth is set to remain strong in the near term yet external risks appear to have risen.** Benefitting from supportive policies bolstering domestic demand, growth of about 3 percent is expected to continue into 2016. Exports are also expected to pick up, yet risks remain to trading partner demand, including the euro area, emerging markets, and Nordic neighbors. Core measures of inflation have increased since spring 2014 and rising resource utilization is expected to progressively raise inflation in coming years.
- 2. Strong migration inflows are an opportunity to secure Sweden's social model.** Sweden's humanitarian migration policy has allowed a significant rise in migrant inflows in 2014-15 and inflows appear likely to remain relatively high for some years. Ensuring that migrants are integrated into the labor force more rapidly is key to avoid higher unemployment in the medium term and to maximize their contributions to growth over the longer term.
- 3. However, structural problems in labor and housing markets are major road blocks to fulfilling Sweden's economic potential and they are also causing rising domestic risks.** Despite solid overall employment growth, the low skilled and foreign born are a rising portion of the unemployed. Housing prices are rising fast from elevated levels, resulting in households taking on higher debt burdens and making the economy more vulnerable to shocks. The lack of affordable housing in the major cities also undermines labor mobility, further dragging on Sweden's potential.
- 4. Economic policies must work together to address these challenges.** Macroeconomic policies should continue supporting domestic demand to bring inflation back to target and contain unemployment. Fiscal, macroprudential, and housing policies should aid a rebalancing of housing supply and demand to moderate the rise in housing prices and debt. Labor market and integration policies should help the low skilled and migrants find work.

## **Monetary Policy**

### **5. Inflation has picked up but remains below the 2 percent target.**

CPIF inflation excluding energy has risen to 1.4 percent in August 2015, up from 0.75 percent in 2014. And inflation expectations are more strongly anchored following the Riksbank's signal in February of its determination to raise inflation, with the shift to a negative repo rate and quantitative easing (QE).

**6. It is important to return inflation to target.** This would allow a rebuilding of space for monetary policy to cushion external or domestic shocks. It would also protect the credibility of the inflation target as the benchmark for inflation expectations, which facilitates macroeconomic stability, including through steady functioning of the wage formation process. Allowing low inflation to persist would also pose greater risks of deflation, and would require lower, not higher, interest rates to maintain full employment.

**7. The firmly stimulatory monetary stance should continue until core inflation is durably close to target.** Monetary conditions are highly stimulatory when taking into account the downward shift in the yield curve and exchange rate movements. These stimulatory conditions support inflation reaching the target within the next two years. Maintaining such conditions will likely require an extension of QE into 2016, depending on the inflation outlook.

**8. The Riksbank should remain ready to do more.** There are some uncertainties around the timing of a rise in inflation. Appropriately, the Riksbank maintains a high level of preparedness to make monetary policy even more expansionary if this becomes necessary. With other instruments still available, and given Sweden's strong external position, intervention in the foreign exchange market should be a last resort.

## **Fiscal Policy**

**9. The fiscal stance in 2016 is broadly appropriate.** Fiscal policy is expected to be neutral over 2015-16, with annual variations mostly reflecting fluctuations in capital gains revenues. Such a stance is appropriate considering the need to avoid impeding monetary policy efforts to raise inflation and to help integrate large migrant inflows.

**10. This is the time to start phasing out mortgage interest deductibility to help rebalance the housing market.** The low level of recurrent property taxes means Sweden's fiscal environment strongly favors debt-financed home ownership over renting, with higher income households benefitting disproportionately. A number of European countries have or are in the process of phasing out mortgage interest deductibility. Low interest rates and robust housing demand make this an ideal time to phase out deductibility in

a fiscally neutral manner, thereby moderating house prices and household debt over time with limited effects on economic activity. Increasing the threshold for carrying forward capital gains taxes would alleviate “lock in” effects, facilitating more efficient use of existing dwellings.

**11. The fiscal balance should be raised over the medium term.**

Sweden’s fiscal framework has enabled a reduction in public debt to a modest level. From this strong position, Sweden should allow full operation of automatic fiscal stabilizers over the cycle and be ready to support the economy in case of adverse developments. The current net lending target of a 1 percent of GDP surplus over the cycle has served the country well, but a balance target (excluding variations in the pension balance) could also safeguard Sweden’s fiscal buffers.

### ***Financial Stability***

**12. The stability risks Sweden faces are principally of a macroeconomic nature.**

High house prices and household debt increase the sensitivity of domestic demand and employment to shocks. International experience indicates that household deleveraging and wealth effects can give rise to prolonged recessions. Even if mortgage defaults are limited, significant distressed loans can emerge among firms reliant on the domestic market. It is therefore welcome that the Financial Supervisory Authority (FSA) is undertaking a review of risk weights on banks’ corporate loan books.

**13. Macroprudential policies must protect financial resilience while containing the drag on economic growth.** Although they cannot substitute for reforms to address structural imbalances in the housing market, such policies can help contain risks in the medium-term, especially during a period of exceptionally low interest rates.

**14. The proposed amortization requirements should be implemented.**

Discussions around the proposal in recent years have contributed to a rise in the share of mortgages that are amortizing. It is important to cement and reinforce this change in culture by putting the regulation in place. Its macroeconomic impact is expected to be small. The adequacy of debt amortization progression should be kept under review.

**15. A Debt-to-Income (DTI) limit is also needed to protect household financial resilience.**

A DTI limit would complement the current Loan-to-Value (LTV) limit, especially during a period of exceptionally low interest rates and rapidly rising housing prices. Drawing on international experience, a small share of mortgages could exceed the limit adopted to allow for individual financial circumstances. The share of mortgages with an elevated DTI is already high in Sweden; the limit should be calibrated to avoid a further increase. Few

households would face a constraint on their borrowing at the outset, yet the limit would become more binding over time if house price gains outpace income growth.

16. **The framework for macroprudential policies should enable timely action with suitable checks and balances.** The stop and go process of adopting amortization requirements has generated market uncertainties. There is an urgent need to ensure the FSA has access to a range of macroprudential tools to address risks in a timely and efficient way by strengthening its legal mandate. If targeted macroprudential tools are delayed, banks' capital buffers may need to be further increased.

17. **Regional cooperation on financial stability issues and the resolution framework for large cross-border banks should be enhanced.** In particular, regarding Nordea's planned shift to a branch structure, robust cross-border supervisory cooperation is needed between the Swedish, regional, and European authorities, such as information sharing, depositor protection, and resolution arrangements.

### *Housing Market*

18. **Housing supply is falling behind rising needs.** The slow response of new construction to urban population growth partly reflects municipal land acquisition and planning systems that limit competition. Rent controls have greatly reduced the supply of rental apartments by driving conversion to tenant ownership and deterring new construction. Moreover, lock-in effects from these controls hinder mobility and the efficient utilization of the remaining rental supply. As a result, many young households have to buy rather than rent.

19. **Addressing this self-made problem is important for growth and stability.** More competition through incentives for municipalities to modernize land acquisition and planning procedures, together with "use it or lose it" permits or taxes on undeveloped land, would raise supply. Phasing out rent controls, including by exempting all new construction, while protecting vulnerable households through the housing allowance is also important.

### *Labor Market and Integration Policies*

20. **The Swedish labor market has become increasingly polarized.** Although overall employment is high, unemployment falls heavily on the low skilled and the foreign-born. These gaps in part reflect high entry-level wages and strict employment protection for regular contracts. Rising migration inflows, with the majority being asylum seekers, will add to these challenges.

21. **Sweden's labor market needs further adaptation to the evolving composition of its labor force.** Social partners should explore ways to ensure that entry-level wages are not a hurdle for groups with high unemployment to gain work, for example by introducing special wage scales for those needing on-the-job training or by enhancing flexibility at the firm level. Adequate income could be ensured through social support and tax credits. Partners should also review employment protection for regular contracts so that these exit costs do not deter firms from giving opportunities to new entrants with sufficient skills. Greater emphasis on training that meets employer needs could better assist vulnerable groups gain jobs and early active labor market support should be provided where long-term unemployment risks are high. The effectiveness of public matching services could be increased by expanding contacts with employers and wage subsidies can be made more effective when combined with effective matching.

22. **Faster integration of asylum seekers into the labor market is critical.** Sweden has a well-developed introduction program for asylum seekers; avoiding delays is particularly important given the rising numbers. The government is taking welcome steps to accelerate the integration process such as "fast tracks" and should seek further improvements. Employment programs for youth—which combine work and training—should be expanded to help newly-arrived refugees gain their first job and build needed skills.

*The mission team thanks the Swedish authorities and other counterparts for the excellent discussions and greatly appreciates their kind hospitality.*