Sweden: Staff Concluding Statement of the 2023 Article IV Mission 1/

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1. **Stockholm, Sweden – January 27, 2023:** Sweden experienced a strong post-pandemic recovery, but continued global headwinds, higher inflation, and interest rates started to put breaks on consumption and business confidence in the second half of 2022. A mild recession is likely, with growth projected at around -0.3 percent in 2023. Headline inflation (HICP) is expected to moderate to about 6.5 percent in 2023, supported by prudent policy actions and responsible wage negotiations. Strong employment so far is a positive sign and should partly attenuate the burdens placed on households from higher debt servicing and inflation. Public debt will continue decreasing to around 30 percent of GDP by the end of the year. The weakening of the housing and commercial real estate (CRE) market highlights the long-standing vulnerabilities in these sectors, such as their high exposure to variable interest rates, high leverage, and excessive rent control that render the housing market dysfunctional. The short-term outlook remains uncertain, especially regarding inflation, which calls for tight monetary policy while a contractionary fiscal stance can provide additional support in containing price pressures. Growth would benefit from increasing spending on infrastructure, education, training, and green investments over the medium-term as well as from improving the structure of revenue by increasing the extremely low property taxes to allow for a reduction in the high labor taxes. These actions would further raise productivity and employment.

Fiscal Policy

The slightly contractionary fiscal stance in 2023 will appropriately support monetary policy's efforts to reduce inflation. Given the high uncertainty, the fiscal stance should adapt to developments, including by allowing the automatic stabilizers to fully operate. If the recession deepens and inflation subsides, then discretionary spending should be adjusted. However, it would be important that any such adjustments concentrate on bringing improvements to the structure of revenue and expenditure to promote the green transition, increase incentives to work, and support inclusiveness.

energy support measures were swift, and small compared to other European countries. However, they could have been more targeted to the vulnerable segments of the population. While the retroactive electricity compensation, rather than price repression, will help support conservation, such compensation should ideally be linked to household income. Moreover, broad-based fuel tax cuts over the next three years impede carbon reduction efforts and increase the risk of Sweden not meeting its 2030 climate goals. As fuel prices decline, it would be advisable to phase out these cuts.

Under the new 2023 budget, the increased support for regions and municipalities, including in the health sector, is welcome. However, additional support will be necessary, while ensuring the quality and efficiency of the regional fiscal expenditure, given the worsening demographics and the experience during the pandemic, as well as the need to improve education and training. Furthermore, permanently higher unemployment benefits are not conducive to increasing employment and hours worked and should be replaced by more efficient income-based transfers.

As inflation subsides, public investments should be increased to support inclusive growth and the green transition. Given the available fiscal space and favorable debt dynamics, a small deviation from the surplus target over the medium-term would allow for additional growth-enhancing infrastructure and social spending. The next fiscal framework review—set to begin in 2024—should consider lowering the surplus target to allow for increasing efficient spending. Furthermore, to make the taxation mix more equitable and growth friendly, high labor taxes should be lowered and substituted by increasing property taxes from their extremely low level, while ensuring adequate social protection. This, and a reduction in mortgage interest deductibility, would help make the housing market more dynamic and reduce household borrowing. The pension reform that links retirement age to life-expectancy is welcome.

Monetary and Financial Sector Policies

The policy actions to reign in record high inflation are well justified. More forceful monetary policy will be needed to tackle inflation in the short run. The early indications from wage negotiations are positive and should reduce the risk of a wage-price spiral. Considering an exceptionally high level of uncertainty, continuous review of the pace and magnitude of monetary tightening is appropriate. The potential costs of entrenched inflation due to under-tightening outweigh those of over-tightening. The Riksbank should therefore continue to closely monitor developments and consider to slightly tighten the announced interest rate path in order to increase the probability of comfortably achieving its desired inflation path. Reliance on forward guidance should be reduced especially in view of high uncertainty, while preserving clear communication to maintain the anchoring of medium-term inflation expectations. The ongoing tapering of the asset purchase program will contribute to the required overall tightening, and its path should be revisited as needed in line with market and inflation conditions.

The IMF Financial Sector Assessment Program (FSAP) confirmed banks' strong capital and liquidity positions that would help cushion severe macroeconomic shocks. However, as pockets of vulnerabilities exist in the face of higher interest rates, it is recommended that the frequency and intrusiveness of inspections be increased, for which more resources need to be made available to Finansinspektionen. Close attention needs to be given to residential and commercial real estate developments, which requires improving the collection of balance sheet data. Therefore, the government inquiry into household balance sheet data collection is welcome. Access to this data is essential to help inform financial stability and monetary policies. Higher bank capital requirements and/or buffers for banks exposures to CRE risks should be considered. Amortization requirements are an important macroprudential tool to contain risk to household debt and could be raised as needed. The crisis management framework would benefit from greater clarity. In addition, while good progress has been made in anti-money laundering efforts, further developing supervisory risk assessment tools would help deepen the understanding of cross-border risks.

Structural Policies

Structural reforms are essential to improve inclusive growth and social outcomes. Education enhancements should particularly focus on science, engineering, and vocational training to address the skills gap. More reforms are also needed to address housing market distortions by gradually easing rent controls, while providing social protection in a more efficient way, including through expanding the housing allowance to cushion the transition. Addressing supply impediments, including by simplifying building codes and permits, is also essential. There is also a need to implement reforms that raise incentives to work to further increase labor market participation. The recent enhancements in the employment protection framework are commendable. It is important to monitor its implementation, to introduce improvements as needed to reduce any emerging uncertainty or high cost. In addition, it is important to increase efficiency for programs and regional services to better integrate the less educated and the foreign-born. A timely upgrade of the South-North electricity connections would contribute to stable and secure energy for households and business. To achieve Sweden's ambitious climate goals, its carbon pricing should be complemented with increased investments in energy supply and transmission including in renewables and green infrastructure. All the above will help boost Sweden's inclusive and green growth over the medium-term.

1/ An IMF mission, led by Khaled Sakr conducted meetings in Stockholm during January 18-27, 2023. The mission worked closely with the FSAP team led by Tommaso Mancini Griffoli. The mission met with Minister of Finance Elisabeth Svantesson and State Secretaries Johanna Lybeck Lilja and Johan Almenberg; Governor and First Deputy Governor of the Central Bank of Sweden Erik Thedéen and Anna Breman; other senior officials; parliamentarians; and representatives of labor unions, business community, banking sector, and academics. The mission would like to thank the Swedish authorities for the close collaboration and candid discussions.