Review of the Swedish Convergence Programme

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1 Summary

The fifth review of the Convergence Programme for economic policy presented by the Government in June 1995 is submitted in this appendix.

The review shows that the Swedish economy is experiencing a pronounced upturn and that, in addition to strong exports, growth is increasingly being driven by domestic demand. Strengthened confidence among households in future economic developments and pent-up demand for consumer durables are expected to result in the continued decline of the savings ratio. In this way, private consumption can grow, though household incomes stagnates this year, i.a. due to adopted budgetary cuts. GDP, held back by the very low level of construction, is expected to grow by 2.3 per cent. There are signs that the decline in employment in previous years has now been reversed. The inflation rate is rising slightly compared with the very low numbers calculated during 1996, but it is well in line with the inflation target of 2 per cent. After some unrest at the beginning of 1997, interest and exchange rates have stabilised.

The upturn in the economy can be expected to strengthen further during 1998. It is primarily increased investment activity that is helping to push up growth to more than 3 per cent.

The general government´s financial balance has continued to strengthen after the very considerable improvement that took place in 1996. Government expenditure is declining in real terms by about half a per cent, while incomes are growing, even if at a slightly slower rate than GDP. The deficit is estimated to amount to 1.9 per cent of GDP this year. Measured according to the accounting principles in effect within the EU – the European System of Accounts (ESA) – the deficit is equivalent to 1.6 per cent of GDP. The consolidated gross debt is falling in relation to GDP for the third year in a row.

The improvement in the general government financial balance have been stronger than what was estimated in the Convergence Programme. The Consolidation Programme, with measures to strengthen the budget totalling SEK 126 billion, which was passed in 1995, should, according to current estimates, result in a surplus in 1998. Therefore, there is scope within the budget target framework for 1998 for those measures aimed at reducing unemployment that were proposed in the Spring Budget Bill and the additional measures proposed in the Budget Bill for 1998.

Allowing for these measures, general government revenue and expenditure are expected to balance in 1998. However, as a consequence of certain organisational changes with respect to the real estate holdings of the National Insurance Pension Fund, a surplus will be incurred. Together with the sale of state owned assets, this will result in a reduction in the debt ratio by more than 3 percentage points.

According to the medium-term scenario up to and including the year 2000, general government finances will continue to improve after 1998, assuming annual growth of just under 3 per cent. The budget policy target established for the years 1999 and 2000 are 0.5 per cent and 1.5 per cent of GDP respectively and is to be used for the repayment of the net debt. The surplus expected will exceed these targets and will allow some scope for transfers from the public to the private sector. The Riksdag has endorsed the Government's objective of a surplus in the general government financial balance after the year 2000 equivalent to 2 per cent of GDP over a business cycle.

TABLE 1.1 KEY INDICATORS FOR 1995, 1996 AND 1997

	1995		1996		1997	
	CONVERGENCE PROGRAMME	REVIEW SEPTEMBER 1997	CONVERGENCE PROGRAMME	REVIEW SEPTEMBER 1997	CONVERGENCE PROGRAMME	REVIEW SEPTEMBER 1997
GDP growth	2.5	3.6	2.9	1.1	2.6	2.3
Change in the CPI	2.9	2.8	2.7	0.8	2.7	1.1
Unemployment, level	7.0	7.7	6.1	8.1	5.8	8.4
5-year government bond rates	10.6	9.9	10.0	7.3	9.0	5.8
ECU index, level	129.0	126.1	125.0	115.1	121.0	117.5
Current account balance[1]	2.6	2.1	4.0	2.4	4.0	3.1
General government financial balance[1]	-9.0	-7.9	-5.2	-2.5	-3.5	-1.9
under the ESA definition[1]		-7.1		-3.7		-1.6
General government gross debt[1]	84.3	78.2	84.8	77.8	84.0	77.1

[1]Per cent of GDP

Sources: Statistics Sweden and Ministry of Finance

2 The Swedish Convergence Programme

The Government presented a Convergence Programme for economic policy in June 1995. The programme's objective, inter alia, is that Sweden should meet the convergence criteria for participation in the Economic and Monetary Union (EMU). It was stated in the programme that a final position on Swedish participation in EMU will be made in the light of future developments and in accordance with the provisions of the Treaty. According to the programme, the convergence criteria will be met irrespective of whether or not Sweden joins the EMU.

The convergence criteria include the requirement that the inflation rate and interest rates should not deviate too much from those in Member States with the lowest inflation rates. Furthermore a stable exchange rate is required. The general government finances must not, if no special circumstances have occurred, show a deficit larger than the equivalent of 3 per cent of GDP. The general government gross debt should not exceed 60 per cent of GDP, or, if it does, it should decline at a satisfactory rate. To participate in the monetary union from the planned start in 1999, these criteria must be met during 1997.

In addition Sweden's Convergence Programme has as an objective for the general government finances the stabilisation of the central government debt measured as a proportion of GDP by 1996 at the latest and the balancing of general government finances in 1998.

The Convergence Programme states that the Government shall conduct semi-annual reviews of the programme. These reviews have been conducted on the following occasions:

- November 1995, in the Government's bill, *A Policy for Work, Welfare and Growth* (Government Bill 1995/96:25, appendix 2).
- April 1996, in the Spring Budget Bill (Government Bill 1995/96:150, appendix 2).
- September 1996, in the 1997 Budget Bill (Government Bill 1996/97:1, appendix 3).
- April 1997, in the Spring Budget Bill (Government Bill 1996/97:150, appendix 2) .

In this appendix to the 1998 Budget Bill, (Government Bill 1997/98:1), the fifth review of Sweden's Convergence Programme is presented.

The Convergence Programme was based on the forecast for economic development in the Revised National Budget of April 1995. The Convergence Programme also included a Consolidation Programme with measures to strengthen the general government finances by a total of SEK 118 billion between the years 1994 and 1998, an improvement equivalent to 7.5 per cent of GDP.

At the time of the April 1996 review, the measures planned to strengthen the budget were judged to be insufficient to achieve the stated objectives for the general government finances. As a result, the Spring Budget Bill of the same year proposed more mesures that implied a sustained improvement in general government finances by a further SEK 8 billion in 1998. The Consolidation Programme thus contains measures that, up to and including 1998, would strengthen the general government finances by SEK 126 billion, the equivalent of 8 per cent of GDP.

The measures in the Consolidation Programme are phased in time according to the schedule in Table 2.1.

TABLE 2.1 TIMETABLE FOR FISCAL CONSOLIDATION MEASURES

EFFECT AS A PER CENT OF GDP

	CONSOLIDATION PROGRAMME	MEASURES IN SPRING BUDGET BILL 1996	TOTAL EFFECT
1995	3.5		3.5
1996	2.0		5.5
1997	1.0	0.4	6.9
1998	1.0	0.1	8.0

Source: Ministry of Finance

The stated scope of the measures refers to direct or immediate effects in the form of revenue enhancement or expenditure reduction, estimated net, taking into account, inter alia, that reduced transfers to households will lead to lower tax revenue. However, indirect effects of interest rate developments and unemployment have not been included.

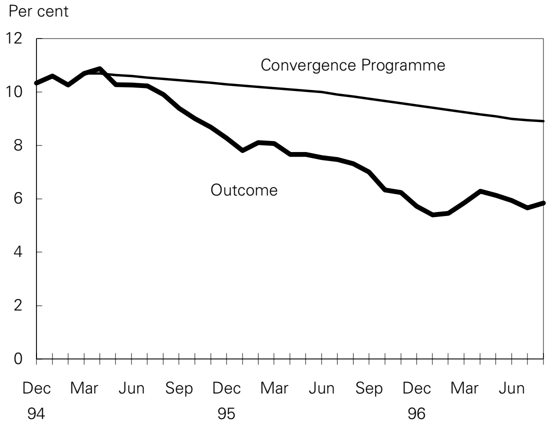
The measures are distributed about equally between revenue enhancement and expenditure reduction. In 1995, the Riksdag passed a decision in principle on the entire Consolidation Programme and the areas in which savings could be made were stipulated. Thereafter specific savings and revenue enhancement measures have been decided by the Riksdag.

3 Developments in the Economy

3.1 Sweden´s economy 1995-1997

When the Convergence Programme was presented in June 1995, the financial markets both in Sweden and abroad were characterised by unrest. Interest rates rose more in Sweden than in other countries and the krona weakened. During the second half of 1995, the situation stabilised and interest rates fell. Confidence in Sweden's economy was strengthened, which was reflected in shrinking interest rate differentials relative to other countries and a strengthening of the krona. The inflation rate was markedly reduced over the year.

Diagram 3.1
Interest rates on 5-year government bonds



Sources: The Riksbank and the Ministry of Finance

Towards the end of 1995 the economic activity in Europe slowed down, which dampened demand in Sweden. Production was partly maintained by building up large inventories. GDP growth was a healthy 3.6 per cent. However, the slowdown became more evident towards the end of the year and the increase in employment that had begun at the beginning of 1994 was halted.

Demand and production continued to develop weakly during the first half of 1996. Interest rates in Sweden kept on falling, interest rate differentials relative to other countries declined further and the krona strengthened. Towards the end of the year, interest rate differentials relative to those in Germany had been reduced to about 1 percentage point. This, together with a downturn in the economy and a reduced propensity for inflation contributed to a gradual decline in the inflation rate during the year. There was even a fall in prices, which however can mainly be attributed to temporary factors. Nominal hourly wages rose by 6 per cent, which pushed up real hourly wages sharply. The average hourly wage increase in 1996 rose, owing to the timing of the wage adjustment under the wage agreements. Average hourly wage increases during the years 1994 to 1996 amounted to 3.9 per cent.

The international economic downturn in 1996 resulted in weakened growth in demand on export markets compared with the previous year. However the Swedish export industry succeeded in maintaining sales volume despite reduced competitiveness owing to a strong krona and substantial hourly wage increases. A low level of imports meant that growth in foreign trade was only slightly weaker than in 1995. Private investment declined at the same time as public investment fell sharply. Despite large wage increases, households' disposable incomes remained largely unchanged compared with 1995, which is explained by higher taxes and reduced transfers. However, a reduction in the savings ratio made room for increased private consumption.

The growth in production in the business sector was primarily restrained by a reversal of the inventory cycle, with the growth in demand largely being met by a reduction in the inventories that had been built up the previous year. According to the preliminary outcome for 1996, GDP increased by 1.1 per cent. The inventory reversal reduced growth by 1 percentage point.

The low growth rate led to a decline of about 30,000 in the number of employed during 1996. However, an increase in the average hours worked, owing in part to lower absenteeism due to illness, meant that the fall in hours worked was more limited. Registered unemployment, after having declined for a few years, began to rise again and amounted to 8.1 per cent on average.

In 1997 the Swedish economy now appears to be recovering broadly after a somewhat mixed picture at the beginning of the year. The inflow of orders to Swedish industries has grown quite substantially and confidence about the future has risen both among households and firms. There are even signs that the situation on the labour market, which normally lags behind the business cycle, is beginning to experience an improvement. According to labour market analyses, unemployment – seasonally adjusted – is beginning to fall, while employment is rising.

Both short- and long-term interest rates, measured as an annual average, are expected to be at a lower level than in 1996.

International economic activity appears to be developing relatively favourably and this is helping along Swedish exports. In addition Swedish companies are gaining market shares and this further strengthens exports. However since imports are also rising rather quickly, the foreign trade contribution to GDP growth remains largely unchanged from the previous year. The current account balance continues to strengthen, primarily as a result of continued improvement in the trade balance, and in 1997 is expected to reach about 3 per cent of GDP.

Domestic demand will probably provide an increasingly important contribution to growth. This is particularly so for private consumption, which

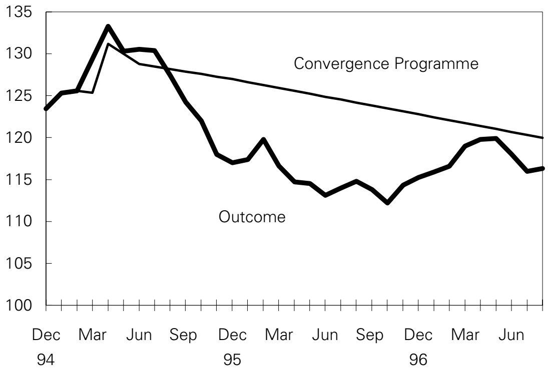
TABLE 3.1 DEMAND AND OUTPUT

	SEK BILLION 1996	PERCENTAGE CHANGE IN VOLUME 1995	1996	1997	1998	1999	2000	1994-2000[2]	DIIFFERENCE 1994-2000[3]
Private consumption	885.3	0.8	1.5	2.3	2.5	2.0	1.9	1.8	0.3
Public consumption	434.2	-1.0	-1.7	-1.1	0.5	-0.4	0.8	-0.4	0.1
General government	132.2	-3.3	-3.7	0.5	0.5	0.5	0.5	-0.9	-0.4
Local government	302.1	0.0	-0.9	-1.7	0.6	0.4	1.0	-0.1	0.4
Gross fixed investment	249.6	10.9	4.7	0.4	5.8	8.0	6.7	6.0	-1.1
Business sector, excl. housing	183.6	25.1	5.9	5.0	5.4	8.1	5.8	9.0	-0.1
Residential	30.3	-28.0	14.7	-21.2	12.8	15.0	15.0	-0.5	-4.9
Authorities	35.6	-0.5	-7.4	-3.5	3.2	2.7	5.3	-0.1	-2.1
Change in stocks[1]	-3.2	0.5	-1.0	0.2	0.1	0.0	0.0	0.0	0.0
Exports	670.4	12.6	5.6	9.6	7.2	5.2	5.1	7.5	0.8
Imports	558.2	10.3	3.5	8.5	7.0	5.1	5.0	6.5	-0.1
GDP	1 678.1	3.6	1.1	2.3	3.1	2.9	2.8	2.6	0.3

[1]Change as a percentage of preceding year´s GDP
[2]Average for the six-year period 1994-2000
[3]Difference in percentage points from the Convergence Programme
Sources: Statistics Sweden and Ministry of Finance.

is expected to increase by 2.3 per cent. However, public sector consumption is expected to continue to restrain growth in 1997. Local government consumption is expected to decline while central government consumption is increasing somewhat. Investment is expected to increase only marginally. It is primarily residential investment that is holding down the level of total investment. Adjustments to inventories now appear to be complete, so that increased demand must more and more be met by expanding production. GDP is expected to grow by 2.3 per cent this year.

Diagram 3.2
ECU index
Index 1991=100



Sources: The Riksbank and the Ministry of Finance

Rapid improvements in productivity are reducing the impact on wage costs increases, which continue to be higher than increases in competitor countries. Wage increases are expected to be nearly 5 percentage points, which is about 1.5 percentage points higher than competitor countries. The inflation rate is increasing a little, after the exceptionally low rates in 1996, but is still in line with the Riksbank's objective of 2 per cent. In the course of 1997 consumer prices are expected to rise slightly more than 2 per cent. Increases in certain excise taxes are contributing to this increase.

The increased economic activity is anticipated to benefit the labour market. Employment is expected to rise for some time to come, which will lead to a gradual decline in unemployment. Because of the high level of unemployment during the first half of 1997, average annual unemployment is expected to be 8.4 per cent, which exceeds the 1996 average. The sum of the number of registered unemployed and the number of participants in labour market programmes is expected to amount to nearly 13 per cent of the labour force.

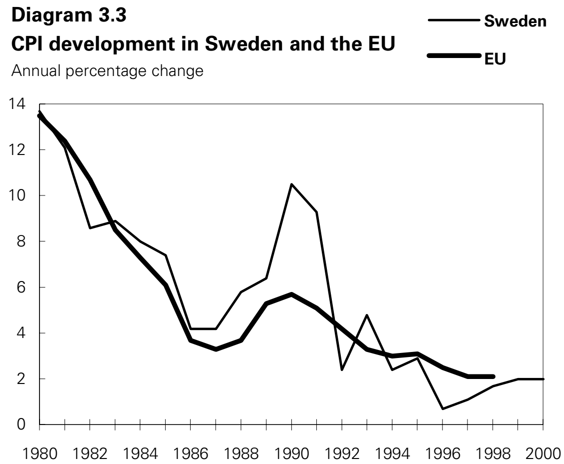
3.2 The Outlook for 1998–2000

In the forecast for 1998 the rate of growth is expected to rise, and GDP is estimated to increase by about 3.1 percent. Even if growth in OECD countries is predicted to be somewhat lower in 1998, compared with 1997, the growth in world markets next year is expected to give a significant boost to Swedish exports. The Swedish export industry is also expected to gain further market shares in 1998. The past year's upturn in investments in industry should have led to expanded production capacity, which should make possible a higher volume of production without bottlenecks becoming a widespread problem. The surplus in the current account is expected to continue to strengthen and is calculated to reach almost 4 per cent of GDP in 1998.

The level of interest rates in Sweden is anticipated to follow the upward trend in international interest rates. As a result, short-term interest rates over the course of next year are expected to rise by one-quarter of a percentage point. The interest rate differential for long-term rates relative to Germany is forecast to remain about 1 percentage point.

With respect to wage developments, the outlook for 1998 is unclear. New agreements are to be negotiated. However, inflationary expectations are lower now than they were when the previous agreements were concluded and the labour market is still weak. Swedish wage increases are therefore anticipated to be adjusted downwards to 3.5 per cent, which corresponds to developments in the most important competitor countries.

Diagram 3.3
CPI development in Sweden and the EU
Annual percentage change



Sources: OECD, Statistics Sweden and Ministry of FInance

Consumer prices are expected to increase by 1.5 percent in the course of 1998, even when taking into consideration the stronger demand from domestic markets, which will probably lead to some increase in the profit margins in the business sector. The smaller increases in wage costs and weaker growth in import prices as a result of some strengthening of the krona explain the lower consumer price increases compared with 1997. In addition indirect taxes will be raised less in 1998 than this year.

Growth will increasingly be driven by private consumption. However, one persistent restraining factor is the fairly weak growth in households' real disposable income. Consequently, the household savings ratio will need to continue to decline in order for consumption to pick up. Against a background of a marked strengthening in the financial position of households during the past year and their pent-up demand for consumer durables, private consumption is expected to grow by 2.5 percent during 1998.

Public sector consumption is expected to increase somewhat next year. However this increase will largely reflect temporary factors, such as labour market programmes.

There are good prospects for strengthened investment activity during 1998. Profits in the business sector will rise and capacity utilisation is expected to increase. Housing prices are expected to rise and the housing shortage will be all the more evident in communities that are expanding. Gross investments are forecast to rise by about 6 per cent.

The economic recovery should result in employment continuing to increase next year. The volume of labour market programmes is increasing somewhat. In addition, a significant expansion in the number of places in educational institutions will curtail supply of labour. Under these conditions registered unemployment may decline. Measured as an annual average, registered unemployment in 1998 is expected to amount to 7.4 per cent.

In addition to the short-term forecast, which extends to the end of 1998, estimates for economic and financial developments have been made for the years 1999 and 2000. Over the medium term it is very difficult to predict cyclical fluctuations. The forecast for economic activity, which is reported in this review, is instead developed around the assumption that resources available at the end of 1998 can be put to use without causing inflationary pressures in the economy.

In the forecast it is further assumed, in the absence of political decisions, that the number of persons in labour market programmes will diminish somewhat during the period. Another important assumption is that the strong emphasis on increased basic training for the unemployed and other proposed measures aimed at reducing unemployment will have the intended results. Moreover an assumption is made about a transfer from the public sector to households, as is reported in section 4.2. Inflation is assumed to be in line with the Riksbank's objective of 2 per cent.

Diagram 3.4
Registred unemployment
Per cent of labour force

Sources: Statistics Sweden and Ministry of Finance

Furthermore the forecast is based on the assumption that the wage formation process will be improved. The room for economic growth will then be relatively large. GDP is estimated to grow by 2.9 per cent in 1999 and 2.8 per cent in the year 2000 and unemployment will be reduced to 4.5 per cent in the year 2000.

Economic development in the OECD area is expected to be relatively strong over the medium term. Actual growth is anticipated to exceed the potential and is estimated to amount to 2.5 per cent a year during the years 1999-2000. Conditions are considered to be favourable for continued strong growth in the rest of the world too. Inflation in the OECD area is expected to be about 2.3 per cent during the period. In the EU it could be somewhat lower.

Continued low inflation and improved government finances means that confidence in Sweden's economy should remain high. The differential relative to Germany's five-year government bonds is assumed in the forecast to remain at 1 percentage point during the period and the krona will appreciate somewhat during 1999.

Wages are forecast to rise by 3.5 per cent a year, which is compatible with inflation of 2 per cent. With wage formation functioning well, competitiveness will continue to be strong during the entire period. Both exports and imports are estimated to increase by about 5 per cent per year, an increase which means that foreign trade will make a positive contribution to growth of about 0.5 percentage points a year. The current account surplus will then amount to about 4 per cent of GDP, which may be warranted, given the demographic structure and weak residential investment in the 1990s, which is expected to continue through the end of the decade.

Private consumption is estimated to increase by about 2 per cent a year. The savings ratio for households is forecast to rise during the years 1999 and 2000 and at the end of the period be on a level that is somewhat higher than the average for the past 20 years. This should be seen against a background where households are expected over the short term to draw down the savings ratio more than what is desirable over the long term owing to more purchases of consumer durables and that, it is anticipated that transfers from the public sector will increase.

Public sector consumption is estimated to increase weakly in the medium-term scenario. The local governments are presumed to meet the requirement to balance their budgets which comes into force in the year 2000 and according to which the local governments are not allowed to plan their activities in a way that creates a deficit. With the additional annual central government grants of SEK 4 billion in each of the years 1999 and 2000, which were announced in the Budget Bill it is estimated that local government consumption could increase by a total of about 2 percent. According to current plans the labour market programme with so called resource persons will cease at the beginning of 1999, a measure that will restrain the increase in local government consumption between 1998 and 1999.

The low interest rates in relation to earlier years combined with relatively high profit levels constitute good conditions for expanding investments, which is a condition for avoiding costly bottlenecks. Residential construction is also expected to rise after the very low number of starts earlier. Nonetheless, for the year 2000, new production is still estimated, from an historical perspective, to remain at relatively low levels.

Employment is forecast to rise by a total of 120,000 persons between the years 1996 and 2000. Increased education is expected to have a strong impact on the labour force, which is estimated to shrink by 36,000 persons during the same period.

The positive scenario which is described above is, however, dependent on wages not increasing by more than 3.5 per cent, despite the fact that unemployment is expected to fall rapidly. Improving the manner in which wage formation functions is therefore a fundamental condition.

3.3 Comparison with the Convergence Programme

In total GDP growth in 1995 and 1996 has been less than 1 per cent weaker than the estimate in the Convergence Programme, 2.3 per cent a year instead of 2.7 per cent. Growth in 1995 was stronger than what was expected when the Convergence Programme was presented, but that was countered by the unforeseen slowdown in 1996. Growth during 1997 has been about the level predicted in the Convergence Programme.

Despite the fact that the international slowdown during the preceding year was not predicted in the Convergence Programme, exports during the past three years have grown in line with the forecast. The propensity to import has risen, however, so that the contribution to growth by foreign trade has been less than expected.

The financial position of Swedish households has grown more favourably than the forecast made two years ago. The net of taxes and transfers has, inter alia, made a less negative contribution to disposable income than forecast. Concurrently, the savings ratio has decreased to the extent forecast, with the result that private consumption has increased more than expected.

In contrast public consumption has declined more than expected. This decline is entirely explained by the significant decrease in central government consumption, which is difficult to forecast. Local gov-

TABLE 3.2 KEY ECONOMIC INDICATORS

	1994	1995	1996	1997	1998	1999	2000	1994-2000[1]	DIFFERENCE 1994-2000[2]
Annual percentage change									
Hourly wage cost	2.4	3.3	6.1	4.8	3.5	3.5	3.5	4.1	-0.2
CPI, annual average	2.4	2.8	0.8	1.1	1.7	2.0	2.0	1.7	-1.1
Household real disposable income	1.4	-0.4	-0.1	0.0	1.8	2.6	3.6	1.2	0.4
Industrial production	14.0	9.8	2.1	6.0	5.5	3.6	3.3	5.0	0.5
									DIFFERENCE YEAR 2000[2]
Level in per cent									
Household net savings ratio	8.0	6.9	5.4	3.2	2.6	3.1	4.7		0.4
Registered unemplyment, share of labour force	8.0	7.7	8.1	8.4	7.4	6.0	4.5		-1.1
Labour market programmes, share of labour force	5.3	4.4	4.5	4.3	4.7	4.5	4.4		0.6
Current account balance, per cent of GDP	0.4	2.1	2.4	3.1	3.8	3.9	4.0		0.8
Swedish 5-year bond rates	9.0	9.9	7.3	5.8	6.1	6.3	6.3		-1.7
German 5-year bond rates	6.2	6.0	5.0	4.6	5.1	5.3	5.3		-1.5
ECU index (1991=100), level	123.8	126.1	115.1	117.5	115.5	114.5	114.0		0.0

[1]Average for a six-year period, 1994-2000
[2]Difference from the Convergence Programme
Sources: Statistics Sweden, The Riksbank, N.I.E.R., Labour Market Board and the Ministry of Finance

ernment consumption however, fell less than anticipated.

Investments have developed considerably weaker than expected with respect to the business sector, residential construction, and investments by public authorities.

The most significant difference in a comparison of the outcome with the forecast in the Convergence Programme concerns employment. Instead of the estimated increase in employment of 170,000 persons during the years 1995 and 1996 the increase was only 36,000 persons in these years. Total unemployment is now estimated to be 2.3 percentage points above the forecast in the Convergence Programme. At the same time the volume of labour market programmes did not reach the planned level and consequently the level of registered unemployment is about 2.6 percentage points higher.

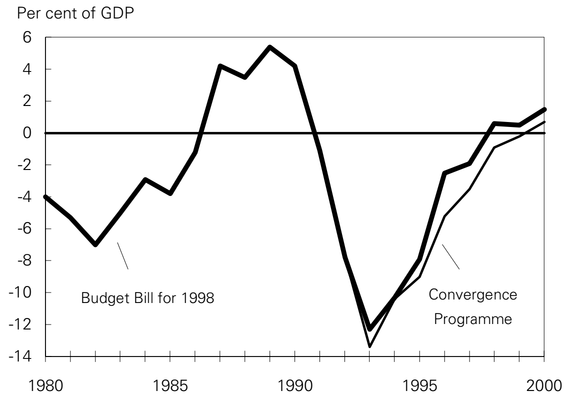
Because of the very modest price increases last year, the inflation rate was much lower than was anticipated in the Convergence Programme. The price level, as measured by the consumer price index, is expected to be 4.8 per cent higher this year than the 1994 level, while it was expected to rise by 8.5 percent according to the Convergence Programme. The low inflation has contributed to considerably greater than expected reductions in the interest rate level, as well as in interest rate differentials vis-à-vis the rest of the world. According to the Convergence Programme the interest rate differential vis-à-vis Germany, measured as an annual average, was expected to be 1.7 percentage points in 1997, but it now amounts to just over 1 percentage points. At the same time the krona has strengthened more than was foreseen in the Convergence Programme.

4 General Government Finances

4.1 Development during 1995-1997

The general government financial balance has improved substantially since 1994. This improvement was especially pronounced in 1996 when, in one year, the deficit in the financial balance shrank by nearly SEK 90 billion or 5.5 percentage points of GDP, down to SEK 42 billion, which was equivalent to 2.5 per cent of GDP. For 1997 the deficit in the general government financial balance is expected to decline further and is estimated to amount to 1.9 per cent of GDP, or SEK 33 billion.

Diagram 4.1
General government financial balance



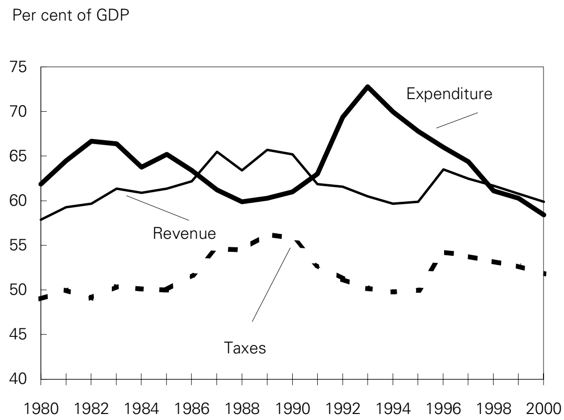
Sources: Statistics Sweden, NIER and Ministry of Finance

Since 1994 the deficit in the general government financial balance has declined by 8.4 percentage points of GDP in three years. Of this reduction, 2.8 percentage points can be attributed to the fact that revenue has grown faster than GDP, while 5.6 percentage points are explained by the fall in expenditure as a share of GDP.

Somewhat less than half of the Consolidation Programme consists of tax increases. The tax ratio rose sharply between 1995 and 1996. However this was largely due to temporary factors that led to extraordinarily high tax payments during 1996, whereas the opposite had been true in 1995. A change in the collection of value-added tax and the timing of the payment of the corporate tax together with one-time payments of a special payroll tax were contributing factors. Higher assessed values for housing led to increased revenue from the property tax. In addition the total wage bill, which is the most important tax base, grew considerably more rapidly than nominal GDP. The increase in taxes and charges – for example increased social security fees, which are a part of the Consolidation Programme – contributed by only 0.5 percentage points to the rise in the tax ratio in 1996. When the temporarily high tax revenue from 1996 drop off in 1997, the tax ratio will fall by 0.5 percentage points, despite certain future increases in taxes and charges. Seen over the three-year period between 1994 and 1997, the tax ratio has risen by 4 percentage points. Other revenues of the general government sector, such as the yield on the National Pension Insurance Fund, have become less important as a consequence of the fall in interest rates.

Measured in real terms, expenditure has shrunk by 2 per cent since 1994 and the expenditure ratio consequently has been reduced by 5.6 percentage points. More than half of this decrease is accounted for by reduced transfers to households, which are estimated to be of about the same magnitude in nominal terms as they were three years ago. Interest rate expenditure in relation to GDP has declined, due to the stabilisation of the debt ratio and falling interest rate levels. General government consumption has decreased by 3.8 per cent in real terms since 1994. A rise in relative prices for general government consumption limited the decrease in relation to GDP measured in current prices, so that the expenditure ratio for consumption decreased by 1.6 percentage points from 27.2 percent to 25.6 percent.

DIAGRAM 4.2
General government revenue and expenditure



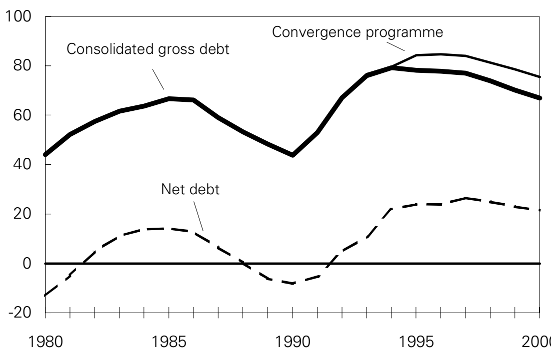
Sources: Statistics Sweden, NIER and Ministry of Finance

The accounting principles for the Swedish National Accounts differ in certain respects from those that apply within the EU for measuring Member States' budget deficits. The differences come about mainly because certain taxes and interest expenditures have to be allocated in time in another way according to the rules for the European System of Accounts (ESA). For 1996 reallocation of tax revenues primarely contributes to the downward adjustment of the general government financial balance from -2.5 per cent to -3.7 per cent of GDP. For 1997 an adjustment primarely of interest expenditures leads to a financial balance measured according to ESA of -1.6 per cent of GDP, an upward adjustment by 0.3 percentage points compared with the Swedish National Accounts.

The general government financial balance does not, in accordance with a recommendation from the

EU's statistical agency, Eurostat, include dividends from the state owned property company, Securum. This company was established in 1992 and was a part of the state's support for the banks in connection with the crisis in the financial system. The support for the banks debited the financial balance and consequently contributed to the deficit. The dividends from Securum are estimated to amount to SEK 6.3 billion or 0.4 per cent of GDP in 1997. In earlier estimates of general government finances for 1997, these dividends have been included in the financial balance, entailing an improvement compared with the preceding review, which is greater than what the stated figures indicate.

Diagram 4.3
General government consolidated gross debt and net debt
Per cent of GDP



Sources: Statistics Sweden, NIER and the Ministry of Finance

The consolidated gross debt, as defined according to the Maastricht criteria, amounted to 79.3 per cent of GDP at the end of 1994. The debt ratio has since been reduced and is estimated to amount to 77.1 per cent of GDP at the end of 1997. During 1997 exchange rate developments will result in an increase in the value of the part of the debt that is denominated in foreign currencies. However this will be counteracted for to some extent by using the revenue from the sale of state owned assets to reduce the debt.

The net debt of the general government sector, that is, liabilities minus financial assets, is revised sharply downwards for the years 1995 to 1997 compared with the estimate in the preceding review. This is a consequence of including the increase in value of the central government's holdings of stocks and bonds, etc. for 1995 to the accounts. There will also be an increase in the value of the assets of the National Pension Fund for 1996. Net debt will not decline at the same rate over the years as gross debt since general government financial assets will also decline as a share of GDP. Net debt is estimated to amount to 26.5 per cent of GDP at the end of 1997, which is an increase of 4.6 percentage points since 1994. The national debt was stabilised already in 1995 and is estimated to amount to 83.5 per cent of GDP at the end of 1997.

4.2 Outlook for 1998-2000

During 1998 the general government finances are expected to balance, so that revenue and expenditure will be of equal magnitudes, in accordance with the budget policy goals set out in the Convergence Programme. According to the latest reviews, the underlying strengthening has been be stronger than earlier forecasts indicated. Therefore there has been scope – within the framework of the goal of a balanced budget – for the proposals presented in the Spring Budget Bill, such as increasing enrolment in educational institutions and, in the Budget Bill for 1998, inter alia, higher child allowance.

The forecast for financial balance amounts to SEK 10 billion, or more than 0.5 per cent of GDP. However that figure is affected by two technical accounting factors. The first is that the Government, in a bill to the Riksdag, will propose that the National Pension Fund should not be able to own property directly, but only indirectly through property companies. One of the reasons is to achieve competitive neutrality between the Fund and private companies in the property market. In the National Accounts, the necessary transformation of the Fund's property into a separate company will be shown as a negative investment, reducing expenditure and improving the financial balance reported by about SEK 15 billion. The second factor is, as referred to above, that the dividends from Securum are not included in the financial balance. In 1998 it is estimated that these dividends, which constitute real revenue for the state, will amount to SEK 4.7 billion. Adjusted for both these factors, general government finance will balance.

The improvement in general government finances in 1998 compared with 1997 is primarily on the expenditure side. Expenditure exclusive of interest payments will decrease in real terms by 0.2 per cent. The chief contribution to the reduction in expenditure will come from the interest subsidy to housing, which will be almost halved between 1997 and 1998. The decrease in the subsidy is comprised of a combination of lower interest rates, less residential construction and changed rules. In accordance with earlier decisions, the compensation level in the social insurance schemes will be raised, with the result that transfers to households will rise, despite the fact that unemployment is expected to decline. Government investments are expected to recover after declining in 1996 and 1997.

The tax ratio will continue to fall in 1998, despite an increase in the individual social security fee by 1 percentage point. At the same time there will be a switch between the individual health insurance fee and the supplementary pension fee . There will also be a switch between various employers contributions.

The consolidated gross debt at the end of 1998 is estimated at 73.9 per cent of GDP. The decrease in the debt ratio can be explained in part by the sale of state owned assets. During 1997 and 1998 revenue from these sales will amount to almost 2 per cent of GDP.

During the four-year period, 1994-1998, which the measures in the Consolidation Programme cover, the general government financial balance, adjusted for the above technical factors, are expected to strengthen by a total of 10.3 per cent of GDP. This can be compared with the original estimate that the programme's measures have budget strengthening effects equivalent to 8 per cent of GDP. Since average GDP growth during the period has only been somewhat higher than what is assessed to be sustainable over the long term without driving up the inflation rate, the improvement of general government finances owing to changes in the business cycle has been minor. The greatest part of the strengthening is accordingly structural.

While the measures in the Consolidation Programme are divided about equally between increased revenue and reduced expenditure, the strengthening of the general government finances focuses on the expenditure side. Of the increase in the financial balance equal to 10.3 of GDP, a lower expenditure ratio accounts for 8.0 percentage points and increased revenues for 2.3 percentage points. The deviation from the Consolidation Programme can be partly explained by the fact that the measures that led to reductions in taxable transfers contributed to lower tax revenue and hence a lower tax ratio. Moreover other non-tax revenue has decreased, one reason being the lower interest rate levels. Furthermore, the Consolidation Programme did not include the reduction of local government consumption in relation to GDP, which occurred during the period.

TABLE 4.1 GENERAL GOVERNMENT FINANCIAL BALANCE

CURRENT PRICES

	SEK BILLION	PER CENT OF GDP						
	1996	1994	1995	1996	1997	1998	1999	2000
Revenues	1 066	59.7	59.9	63.5	62.5	61.7	60.8	59.9
Taxes and charges	912	49.8	50.0	54.3	53.8	53.2	52.7	51.8
Income capital	87	6.0	5.8	5.2	4.7	4.5	4.3	4.3
Other income	67	3.9	4.0	4.0	3.9	3.9	3.8	3.8
Expenditures	1 108	70.0	67.8	66.0	64.4	61.1	60.3	58.4
Household transfers	388	25.6	24.0	23.1	22.6	22.1	21.3	20.4
Other transfers	125	7.4	7.9	7.5	7.1	6.3	6.2	5.8
Interest expenditures	119	6.8	7.1	7.1	6.8	6.1	5.7	5.2
Consumption and investment	475	30.2	28.8	28.3	27.9	26.6	27.1	26.9
General Government Financial balance[1]	-42	-10.3	-7.9	-2.5	-1.9	0.6	0.5	1.5
Central government	-53	-11.7	-8.8	-3.2	-2.3	-0.5	0.2	1.1
Social insurance	16	1.6	1.2	0.9	0.7	1.3	0.4	0.3
Local government	-5	-0.2	-0.2	-0.3	-0.3	-0.3	-0.1	0.1
Primary balance[2]	-10	-9.5	-6.6	-0.6	0.2	2.2	2.0	2.5
Net debt	402	21.9	24.0	23.9	26.5	24.9	23.0	21.5
Consolidated gross debt[3]	1 306	79.3	78.2	77.8	77.1	73.9	70.2	67.0
Central government debt	1 411	84.1	84.3	84.1	83.5	79.4	75.3	71.8
GDP level, SEK billion		1 531	1 645	1 678	1 747	1 842	1 931	2 025

[1] General financial balance for 1998 amounts to 0 per cent of GDP including dividends from Securum but excluding effects of transferring real estate holdings of National Pension Fund to limited company form.

[2] Financial balance excluding income capital and interest expenditures

[3] According to the definition in the Maastricht criteria.

Sources: Statistics Sweden and the Ministry of Finance

In the 1997 Spring Budget Bill (Government Bill 1996/97:150), the Government defined its goal for general government finances after 1998: the establishment of a long-term surplus of 2 per cent of GDP seen over a business cycle. For the years 1999 and 2000 the transition will be by means of a surplus of 0.5 and 1.5 per cent of GDP respectively, given the economic growth forecast in the Spring Budget Bill. The medium-term scenario in that same bill indicated that, with unchanged rules for taxes and transfers, there would be a surplus in the financial balance, which exceeded these goals by about SEK 15 billion in 1999 and SEK 25 billion in the year 2000.

The assumptions about economic growth in 1999 and 2000 included in the present estimates are largely in agreement with what was anticipated in the Spring Budget Bill and for that reason the budget policy goals remain in place. The underlying strengthening of government finances is somewhat greater. When the measures proposed in the Budget Bill for 1998 and the announced increase in the central government grants to local governments by SEK 4 billion in 1999 and an additional SEK 4 billion in 2000 are taken into account, the surplus in the general government financial balance are estimated to exceed the established goals by almost SEK 3 billion in 1999 and about SEK 20 billion in 2000. In conformity with the Spring Budget Bill, it is assumed that the budget goals are governing, so that these additional surpluses are transferred to the private sector. Consequently the goal established for the general government financial balance will be achieved.

Forecasts of economic growth over the medium term always contain an element of uncertainty. Taking into account that the general government finances are relatively sensitive to variations in the rate of growth, there is a corresponding uncertainty concerning the financial balance in the general government sector. If the rate of growth should turn out to be 1 per cent lower each year in 1999 and 2000, the financial balance would then be estimated to be SEK 25-30 billion less in the year 2000. The goals for general government finances are dependent on the economic activity. If, however, growth is weaker owing to structural causes – for example, poorly functioning wage formation – the goal of a surplus will still stand.

4.3 Comparison with the Convergence Programme

Despite weaker growth than what was predicted in the Convergence Programme, the improvement in general government finances has come about faster than expected. The goal of stabilising central government debt as a proportion of GDP was achieved as early as 1995. It is primarily revenue that is growing more strongly than projected. The tax ratio this year will be nearly 2.5 percentage points higher than what was stated in the Convergence Programme. This compensates in part for the lower revenue in other areas, primarily interest revenue.

But expenditure too, has grown more slowly. If the growth in expenditure had followed the prediction in the Convergence Programme, then expenditure exclusive of interest payments measured in real terms would have been SEK 15 billion higher this year. In addition, interest expenditure is expected to be considerably lower as interest rate levels have fallen more than was predicted in 1995. In total general government expenditure relative to GDP is about 0.5 percentage points below the forecast in the Convergence Programme, despite the lower GDP level.

The gross debt is substantially lower than forecast. The debt ratio at the end of 1997 measured according to the Maastricht requirements is 6.9 percentage points lower than predicted. This is partly an effect of improved financial balance, but it is also due to the stronger exchange rate, with its impact on the part of the debt that is denominated in foreign currency.

TABLE 4.2 GENERAL GOVERNMENT FINANCES, DIFFERENCES FROM THE CONVERGENCE PROGRAMME

PERCENTAGE POINTS OF GDP

	1995	1996	1997	1998	1999	2000
Revenue	-0.7	2.3	1.1	-0.3	-0.9	-1.8
Expenditure	-1.8	-0.4	-0.6	-1.8	-1.6	-2.6
Financial balance	1.2	2.7	1.7	1.5	0.7	0.8
Primary balance[1]	0.6	2.2	1.3	1.0	0.1	-0.2
Net debt	-7.3	-10.5	-9.2	- 9.8	-10,3	-9,7
Consolidated gross debt[2]	-6.1	-7.0	-6.9	-7.4	-8.5	-8.5
Central government debt	-5.9	-7.2	-6.9	-8,2	-9,9	-10.5

[1] Financial balance excluding capital income and interest expenditures.
[2] According to the difinition in the Maastricht criteria.
Source: Ministry of Finance.

In the Convergence Programme the assessment was made that the goal to balance general government finances in 1998 could not be achieved without additional budget strengthening measures. The forecast indicated that there would still be a deficit equivalent to 1 per cent of GDP this year. Such measures were agreed later in the 1996 Spring Budget Bill. However, the underlying improvement in the general government finances has proved to be stronger than estimated, an outcome which has made scope for those measures to counter unemployment that were proposed in the 1997 Spring Budget Bill and again in the Budget Bill for 1998. In comparison with the Convergence Programme, a financial balance in general government finances has been achieved primarily due to lower expenditure. Measured in relation to GDP, it is the lower interest expenditure that explains this difference. Expenditure for transfers and consumption next year are estimated to be equivalent to a larger part of GDP than forecast in the Convergence Programme.

In the Convergence Programme a relatively substantial increase in tax revenue was forecast for 1998. However, later decisions on a change in the collection of the value-added tax and other shifts in the timing of tax payments have resulted in temporarily higher tax revenue in 1996 and 1997. Instead of an increase, the tax ratio will fall next year and then end up about 1 percentage point higher than the forecast in the Convergence Programme. This deviation can be ascribed to subsequent tax increases, adopted after the Convergence Programme was presented, part of wich will be used for financing, inter alia, the educational programme.

That the underlying strengthening in general government finances appears to be stronger than expected is also shown in a comparison of the forecasts for the period after 1998. In the Convergence Programme a growth of 1.7 per cent a year was expected to lead to an improvement of the general government financial balance by 1.6 percentage points of GDP between 1998 and the year 2000. With the current goals for the financial balance, this had not provided scope for any transfers to households. The present forecast, taking into consideration the measures proposed in the Budget Bill for 1998 and the assumed transfers to households, provides for a strengthening of the financial balance by 3.1 per cent of GDP at a growth rate of 2.9 per cent in the same period

TABLE 4.3 CHANGES IN GENERAL GOVERNMENT FINANCIAL BALANCE 1994-1998

	PER CENT OF GDP	CHANGE IN PERCENTAGE-POINTS 1994-1998	
	1996	BUDGET BILL 1998	CONVERGENCE-PROGRAMME
Revenue	63.5	2.0	1.9
Taxes	54.3	3.4	1.8
Capital income	5.2	-1.5	-0.1
Expenditure	66.0	-8.9	-7.6
Household transfers	23.1	-3.5	-4.8
Interest expenditures	7.1	-0.7	-1.1
Consumption and investment	28.3	-3.6	-3.1
Financial balance	-2.5	10.9	9,5
Adjusted		10.3	

[1]General government finance balance for 1998 amounts to 0 per cent of GDP including dividends from Securum but excluding effects of transferring real estate holdings of National Pension Fund to limited company form.
Source: Ministry of Finance.

5 Economic policy

The Swedish economy is characterised by two basic imbalances – the deficit in the general government financial balance and the high unemployment.

As noted earlier in this review, general government finances are now under control. There are good prospects for running a surplus after 1998 and thereby beginning to reduce the net debt.

Developments with respect to unemployment have been more negative. The recovery in employment after the crisis of 1991-93 halted towards the end of 1995 and the number of employed declined. It is only this year that there have been indications of a reversal. The Government has set the goal of reducing open unemployment to 4 per cent by the year 2000. In the medium-term scenario unemployment, calculated on an average annual basis, is estimated to amount to 4.5 per cent in the year 2000.

A prerequisite for attaining the goal of reducing unemployment is that fiscal policy should be formulated so that the budget policy goals will be realised and the rate of inflation and inflationary expectations can be kept at a low level. Otherwise rising interest rates would threaten to restrain the growth that is needed to generate enough employment. With the aim of strengthening confidence in the price stability objective, it is proposed that the Riksbank, by a change in the law, be given a more independent position in relation to the Government and the Riksdag.

Reduced unemployment with continued low inflation places increased demands on properly functioning wage formation. Seen from a long-term perspective, the rate of increase in wages in Sweden has been higher than in competitor countries. In the past few years, a significant increase in productivity has been able to compensate for this. However in the future the rate of increase in wages can hardly exceed that in other countries.

Wage formation, by tradition, is primarily a question for the parties on the labour market. The Government has, however, assigned to a special commissioner the task of looking into – in consultation with the parties' representatives – whether government regulations on wage negotiations, such as the regulations on conflicts in the labour market, conciliation etc., can be changed in a direction that facilitates wage agreements at a lower level.

Against a background of low inflation and reduced inflationary expectations and the parties' realisation of the importance of a wage formation that does not drive inflation, there are assessed to be good possibilities that the increase in wages can come down to a level that makes sustainable low unemployment possible in the future.

Maintaining strong competitive pressure is an important factor in restraining inflationary tendencies. Increased internationalisation in general, and the single market in the EU in particular, have substantially reduced the scope for passively passing inflationary impulses on in the form of increased market prices. In addition the Competition Law has been made more stringent in important respects – for example, by forbidding collusion that reduces competition among firms and abuse of a position of dominance.

The principal way to reduce unemployment over the long term is to increase labour's competence and, by doing so, better match the supply of labour to the demand at the prevailing wage level and wage structure. Therefore, a substantial expansion in the number of places for students in educational institutions is now actively under way. The ambition is an increase in the number of students by 140,000 persons – equivalent to 4.7 per cent of the labour force – between now and the turn of the century. Out of this total, 60,000 places will be in higher education. This effort should be seen against a background of a relative decline in the number of students and an enrolment rate that is lower than in many other countries.

Increased flexibility in the labour market can remove impediments to the expansion of employment. Laws and regulations governing the labour market have been changed with the aim of making it easier for small firms to match their labour force with their production needs. This means, inter alia, increased possibilities for fixed term employment. Increasing employment in small firms has also been supported by certain changes in tax regulations, such as reduced employers' contribution for part of the wage bill.

The rules of unemployment insurance play an important role in how the labour market functions. A decision has recently been taken on the reform of rules for unemployment compensation with the aim of underlining its role as an adjustment mechanism. Inter alia, the conditions for qualifying for the right to compensation have been tightened and the possibilities of drawing compensation for very long periods have been limited.

Maintaining sound general government finances presumes firm control over expenditure. As part of the Consolidation Programme, a series of changes in the principal expenditure systems, which will also have a long-term effect, has been implemented. The risk of expenditure drift in social insurance has been reduced by lowering the levels of compensation. In addition, the conditions for the right to such compensation as health insurance and early retirement have been made more stringent. The effects of these changes are indicated in, inter alia, a lower influx into early retirement. With respect to health insurance, the institution of a period paid by the employer has contributed to a decline in short-term absence owing to illness.

From the budget year 1997, a new system for the central government budget process has been in force. The aim of the changes is to tighten expenditure control. In principle, all appropriations in the budget are so called framework appropriations, which can only be exceeded within certain defined limits. Further more the budget is governed by a three-year nominal expenditure ceiling, both for consolidated expenditure and for 27 different expenditure areas.

An equivalent control over expenditure growth in the local government sector will be achieved through the statutory balanced budget requirement that will take effect beginning in the year 2000. This requirement means that municipalities and county councils cannot plan to have financial deficits.