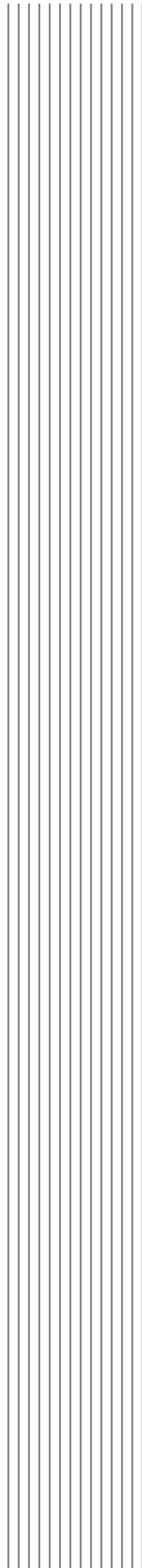


Sweden's Economy



Sweden's Economy

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Sweden's Economy

Foreword

This appendix to the Government Budget Bill for 1999 contains an assessment of economic developments both internationally and in Sweden up to the end of the year 2001.

The assessment is based on material from Statistics Sweden, OECD, IMF and the forecast published by the National Institute of Economic Research on August 25. The Ministry of Finance is, however, solely responsible for the assessment presented here.

The estimates for the years 1999 to 2001 have been made with the aid of the National Institute of Economic Research's models, KOSMOS and FIMO, and are contingent upon a number of assumptions being fulfilled.

Mats Dillén, Assistant Under-Secretary at the Ministry of Finance, is responsible for this appendix. The estimates contained in the appendix are based on information received up until October 6, 1998.

1 Introduction

1.1 Summary

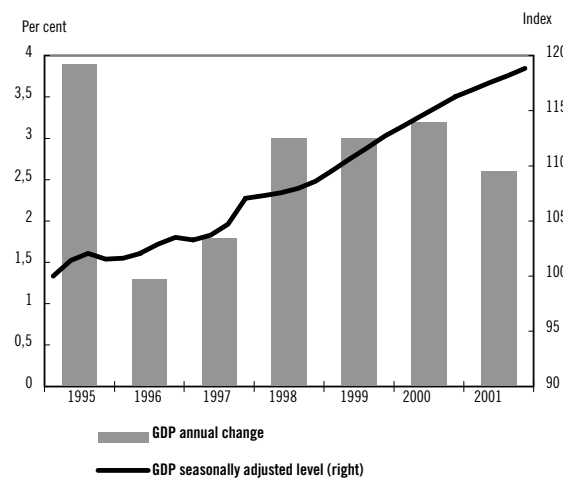
The Swedish gross domestic product (GDP) is expected to grow by approximately 3 per cent in both 1998 and 1999. The Asian crisis has deepened and growth in the global economy has been revised downward compared with the assessment made in the 1998 Government Spring Bill. For Sweden, this has resulted in a slightly weaker growth in foreign trade, although this is counteracted by stronger domestic demand. The situation in the labour market has improved further and a good growth in employment is forecast for the coming years, which will pave the way for falling unemployment.

According to the preliminary National Accounts, the gross domestic product (GDP) in

Sweden was approximately 3 per cent higher during the first half of 1998 than in the same period last year. Foreign trade provided a negative contribution to growth, while gross fixed capital formation and private consumption developed strongly. An expansion in local government consumption and a built-up of stocks also contributed to a high growth rate.

Provided that wage increases are limited to approximately 3 per cent per annum and that the global economy does not markedly deteriorate, the Swedish economy is estimated to be able to grow by around 3 per cent per annum in the years 2000 and 2001 (see Diagram 1.1). Wage formation is assumed to function well and provides, together with low interest rates and the low degree of employment, important explanations as to why the Swedish economy is expected to grow rapidly over a longer period of time without prices and wages accelerating. Growth will be largely driven by strong domestic demand. Foreign trade is foreseen to provide less of a contribution to growth compared with 1996 and 1997. The changed composition in growth, compared with recent years, is favourable for employment and will speed up the decrease in registered unemployment.

Diagram 1.1 GDP Growth



Sources: Statistics Sweden and Ministry of Finance.

The deepened recession in Japan and in large parts of the rest of Asia, the turbulent development in Russia and a slowdown in economic activity the United States are expected to lead to global economic growth falling from just over 4 per cent in 1997 to just over 2 per cent in 1998. The fall in output in the crisis-affected countries in Asia is anticipated to be considerably greater than was assumed in the Government Spring Bill. The recovery in Japan is being hampered by problems in the financial system and pessimism over the future among households and firms. An expansive fiscal policy, together with measures to consolidate the financial sector, are expected to contribute to some recovery in the Japanese economy next year.

Growth in the EU region, as in Sweden, is being driven by relatively strong domestic demand. Low interest rates, brighter prospects on the labour market and a less restrictive fiscal policy compared with 1996 and 1997 will underpin economic growth. Growth prospects in the Nordic countries are good on the whole, although growth in Norway is expected to slow down after a number of good years.

The weak economic situation in Japan and South East Asia has led to a clear downward pressure on prices and profits internationally. One important reason for this is that the decline in demand from the crisis-affected countries has resulted in a significant fall in prices in price-sensitive raw materials, for instance, oil. Next year, a cautious export-driven recovery is expected in the Asian region. The ensuing increasing international competition will subdue general price pressures over the coming years. Expectations of continued international pressures on prices and a less restrictive monetary policy have led to a fall in long-term interest rates in both the EU region and the United States to historically low levels. Despite a higher interest-rate spread visavi Germany, the Swedish ten-year bond rate is lying far below the levels forecast in the Government Spring Bill. There are a number of important explanations for the decline in Swedish interest rates, which has occurred since 1995. These are, apart from lower international interest rates, a markedly increased confidence in a sound development of general government finances and the fact that inflationary expectations have fallen. The Swedish krona has weakened during the autumn, although there are no convincing fundamental reasons for this.

Despite the somewhat divided international economic picture, Swedish exports of goods and services are expected to be able to grow by approximately 6 per cent per annum in 1998 and 1999. At the same time, imports are expected to grow relatively strongly. Foreign trade is therefore expected to provide a negative contribution to growth this year, which is partly due to the low exports to Asia, but also to a very strong rise in imports of services.

The conditions for a long period of high growth in private consumption are better now than they have been for many years. Positive developments in the labour market, low interest rates, a strong wealth position in the household sector, good growth in income and a pent-up need to replace worn-out capital goods are some of the most important factors in favour of a strong growth in private consumption. Another expression of the willingness of households to consume is the fact that the expectations regarding their private economy and the labour market situation are optimistic.

GDP growth in 1998 and, to a slightly lesser extent, in the following years will also be underpinned by a good growth in investment. The substantial expansion expected in the services sector and a high level of capacity utilisation within the manufacturing industry mean that there is a strong need to expand capacity in the business sector. However, there is a clear element of uncertainty for investment in parts of the manufacturing industry dependent on exports. If the negative effects of the Asian crisis on the world economy become more lasting than is forecast, some of the investment by the export industry may be postponed.

The situation in the labour market has developed better than foreseen in the Government Spring Bill. Figures for employment have been revised upward for this year and those for unemployment have been revised downward. Employment had risen by approximately 60,000 people in August, compared with August last year. The most important indicators suggest that a relatively strong growth in employment can be expected during the remainder of 1998 and next year, which in turn will generate a continued fall in registered unemployment. The decline in registered unemployment that was noted in 1997 was largely due to increased participation in the education and training initiative and, consequently, to a decreasing labour supply. During the forecast period the labour supply is expected

to rise as employment increases. By the end of the year 2000, registered unemployment is expected to amount to 4 per cent.

General government finances will show a surplus every year of the forecast period. This means that the indebtedness of the general government sector will fall, while the margin of safety against a slowing down of the economy will increase. General government sector gross debt as a percentage of GDP, defined according to the Maastricht criteria, will fall from 76.6 per cent in 1997 to 55.8 per cent in the year 2001.

There is considerable uncertainty in the forecast in several areas:

- The possibility that the Asian crisis becomes more widespread and prolonged than assumed in the forecast cannot be ruled out. Therefore, Chapter 12 describes an alternative scenario that illustrates the effects on the Swedish economy of less favourable global developments.

- Wages are estimated to rise by an average of 3.1 per cent per annum during the forecast period, and are comprised of the average centrally-agreed wage increases calculated at 2.6 per cent per annum and a wage drift of 0.5 per cent per annum. The assumed wage drift is in line with the assessments made by some of the parties and mediators as part of the wage agreement negotiations last spring. Wage increases of this magnitude would mean that inflationary pressure remains low, and create the right conditions for an expansive monetary policy and good competitiveness for the manufacturing industry. All in all, this promotes a strong growth in employment. However, the possibility that the wage drift may exceed 0.5 per cent per annum cannot be ruled out.

- Developments last year and so far this year have shown that the education and training initiative has largely attracted people who would otherwise have been registered unemployed. The forecast is based on the assumption that the training and education initiative will continue to attract this category of people and that individuals who have completed an educational and training programme will have a greater opportunity to find work afterwards. Another element of uncertainty in terms of the supply of jobs is to what extent individuals currently outside the labour force will enter it when the employment situation, and thus the likelihood of obtaining a job, improves. If the number of those entering into the labour force becomes higher than esti-

mated in the forecast, it will prove more difficult to attain the governments unemployment goal.

1.2 Developments within Different Areas

International Developments

Economic growth in the world has been subdued this year as a result of the deeper recession in Japan and South East Asia. Global price pressures have fallen, which has contributed to lower interest rates and a stimulation of domestic demand in Europe and North America. Uncertainty concerning the development of the global economy has increased in recent months. In particular, the uncertainty with assessments concerning the depth, length and spillover effects of the Japanese recession is considerable. It has not yet been possible to detect any clear turning point in the Japanese economy. However, the forecast assumes stabilisation at the end of 1998 and some recovery during the course of next year. This presupposes that the stimulation measures proposed by the government, which correspond to 5.5 per cent of GDP divided between 1998 and 1999, are fully implemented and that measures taken with the aim of improving the situation in the financial sector are successful and have a positive effect on confidence.

The recession in the crisis-affected countries in South East Asia i.e. Thailand, Malaysia, Indonesia, the Philippines and South Korea, has deepened in 1998 and spread to other countries in the region. A cautious recovery, driven by exports, is foreseen next year. However, it is very difficult to assess the situation, both with regard to domestic and external conditions for an expansion. At the domestic level, this mainly concerns whether the countries have achieved a sufficiently high degree of stability for firms and households to dare to invest and consume and whether the financial system will function sufficiently well to support a recovery. External threats to a more favourable course of growth include that there is no recovery in Japan and that there is a Chinese currency devaluation. In other words, it is clear that the problems in Japan, South East Asia and China are interdependent and that Japan plays a key role in future developments in the region.

Economic developments in the United States are characterised by low inflation, good eco-

conomic growth and low unemployment. Growth has been borne up this year by a strong domestic demand, while the Asian crisis and the strengthening of the dollar have made their marks in the form of a growing deficit in the balance of trade. GDP growth is now expected to slow down compared to the rapid growth rate of 1996 and 1997 and to approach the underlying growth trend next year. Even though the American economy is not so dependent on foreign trade, a deeper Asian crisis, particularly if it spreads to Latin America, could have noticeable effects. Another threat is if global price pressures, which follow in the footsteps of the Asian crisis, lead to a downward revision in profit expectations for firms in the United States. This type of development could affect both investment and stock exchanges and, in the long term, also have a negative effect on economic growth.

Table 1.1 Assumptions for the Forecast

Annual percentage change

	1996	1997	1998	1999	2000	2001
GDP OECD ¹	2.7	2.8	2.1	2.2	2.4	2.3
CPI OECD ¹	2.2	2.0	1.5	1.8	2.0	2.0
Hourly wages, costs	6.0	4.5	3.3	2.9	3.2	3.0
SEK/USD ²	6.7	7.7	7.9	7.7	7.5	7.5
TCW-index ²	116.0	120.5	121.7	120.4	118.5	118.0
German long-term rate ³	6.2	5.7	4.7	4.6	4.9	5.1
Swedish long-term rate ³	8.1	6.6	5.1	5.0	5.2	5.3
Swedish short-term rate ⁴	5.8	4.3	4.4	4.3	4.3	4.3

¹ Annual percentage change, OECD-16.² Annual average.³ 10-year government bond, annual average.⁴ 6-month treasury bill, annual average.

Sources: OECD, Statistics Sweden and Ministry of Finance.

As a counterweight to the slowing down of the United States economy and the weak developments in Asia, economic activity in the EU region is expected to remain strong. The low level of interest rates and a less restrictive fiscal policy will stimulate both investment and private consumption and could lead to an increase in general government consumption. The EU countries are presently in slightly different phases of the economic cycle. Germany, France and Italy are in a relatively early phase of economic upturn. These three countries account for almost 60 per cent of

the total value of output in the EU and, therefore, have a very large impact on economic growth in the EU region as a whole. A number of EU countries are further ahead in the economic cycle, including Spain and the Netherlands. The United Kingdom and Denmark appear poised to enter a slowdown phase. In Finland, growth is expected to remain high, but fall to 3.4 per cent next year. In Norway, falling oil prices and signs of overly high wage rises have weakened the exchange rate and forced a tightening of monetary policy.

Table 1.2 Selected Statistics

	1996	1997	1998	1999	2000	2001
CPI, Dec - Dec	0.1	1.9	0.1	1.1	2.0	2.0
NPI, Dec - Dec	-1.0	-0.9	-0.5	0.6	-	-
Disposable income ¹	-0.7	-1.7	2.7	3.3	1.5	1.8
Savings ratio(level)	4.4	0.8	0.8	1.2	0.3	0.1
Industrial production ¹	2.1	5.4	4.6	4.5	4.0	2.9
Relative unit labour costs ¹	14.5	-5.3	-1.7	-0.4	-	-
Employment ²	-0.6	-1.0	1.3	1.5	1.8	1.1
Registered unemployment ³	8.1	8.0	6.6	5.7	4.4	4.0
Labour market programmes ³	4.5	4.3	3.9	3.9	3.8	3.5
Trade balance ⁴	125	139	144	147	160	170
Current account balance ⁵	2.6	2.8	2.3	2.1	2.2	2.4
General government financial balance ⁵	-2.1	-1.1	2.1	1.1	2.3	3.3

¹ Annual percentage change.² Number of people. Annual percentage change.³ Per cent of labour force.⁴ SEK, billion.⁵ Per cent of GDP.

Sources: Statistics Sweden and Ministry of Finance.

Interest Rates, Wages and Inflation

Swedish long-term interest rates, together with those in the EU region and the United States, have continued to fall over the spring and summer. The Swedish 10-year interest rate is estimated to be just below 5 per cent towards the end of the year, and then show a modest rise during the following years in line with stronger domestic demand in Europe. Parallel with the very low and falling long-term interest rates, the interest-rate spread with German bond rates has widened. The reason for the relatively large decline in German interest rates is thought to be that the turbulence in autumn on the financial markets has resulted in portfolio transfers from

markets perceived as uncertain to more secure markets. The forecast assumes that the German long-term interest rates will rise towards 5 per cent during the course of 1999 and 2000 and that the Swedish long-term interest-rate spread will approach 20 points during the same period. It is also assumed in the forecast that the prime rate will remain unchanged in the USA, while a slight rise is expected in Germany in 1998 and in the European monetary union in 1999. The krona has fluctuated considerably so far this year and periodically been at levels which are incompatible with the fundamental picture of the Swedish economy – the current account balance shows stable surpluses and inflation is expected to remain very low. The forecast is therefore based on the assumption that the krona will gradually strengthen, to lie at a TCW index of 118 towards the end of the year 2000. The final level is the same as in the Government Spring Bill, but it will take a longer time before this final level is reached.

One important part of the positive picture of the Swedish economy is that the outcome of the 1998 wage agreement negotiations was lower than many had feared it would be. Given the points of departure mentioned above, wages are expected to rise by just over 3 per cent per annum during the entire forecast period. To make this possible, wage drift should not exceed 0.5 per cent, which is considerably lower than the historical level of wage drift. An increased mutual understanding of the importance of low nominal wage rises among the parties in the labour market, agreements that allow more decentralised wage setting, greater flexibility with regard to the disposition of working hours and low inflationary expectations are some important reasons behind a likely reduction in the wage drift. There is, however, a risk that wage drift could be higher due to, among things, if a shortage of labour arises during the forecast period.

Inflationary pressures in the Swedish economy have been low over the last 2-3 years and will probably remain so during the remainder of 1998 and 1999. With wage rises assumed to amount to approximately 3 per cent per annum, good growth in productivity, an appreciating krona, low global market prices and low inflationary expectations, which are just below 2 per cent even in the long term, it is difficult to envisage an especially strong threat of inflation. In the light of this, the Riksbank's prime rate, the repo-rate, is expected to remain unchanged up to the

end of 2001. Factors which can disturb the picture of low inflationary pressures are higher wage rises, a weaker krona and that the growth in domestic demand becomes so strong that retailing and wholesaling can increase their margins considerably. However, there would have to be very large departures in relation to what is judged to be the most likely development in this forecast for the threats leading to inflation increasing to 2 per cent in 1999. Nor is it likely that inflation, measured as an annual average, will reach 2 per cent in the year 2000, even though the uncertainty is greater in this time perspective. After that it is assumed that inflation will coincide with the Riksbank's inflation targets, ultimately through monetary policy and subsequently growth being adapted to achieve the target.

Demand and Output

Export growth is expected to decline from almost 13 per cent last year to just below 6 per cent this year. During the first six months of this year, Sweden's exports to Asia (excluding the Middle East) fell by approximately 25 per cent compared with the first half of 1997. Asia accounts for around 8 per cent of Sweden's total exports, which means that the direct effect of the Asian crisis on Swedish export volumes during the first half of the year can be estimated at approximately -2 per cent. However, total exports have been buoyed up by good growth in exports to Europe for the corresponding period (+11 per cent). Approximately 75 per cent of Swedish exports go to Europe. Therefore, the European economy has great importance for Swedish exports. Given some recovery in the Asian region, Swedish exports are also expected to be able to grow by approximately 6 per cent next year.

According to the National Accounts, imports of goods rose by 12.4 per cent during the first half of this year, compared with the first half of 1997. Total imports are expected to rise by almost 9 per cent this year and just over 7 per cent next year. One important element in the growth in imports is that the import of services has been growing at a very rapid rate since 1997. A partial explanation for this is that foreign travel by Swedes has increased considerably. The direct import of cars (classified as an import of services), trade over the Internet and a growing import of technical consulting services have probably contributed to the rapid growth in imported services. The high rate of increase for imports of services means that the services balance as a total

Table 1.3 Demand and Output

	SEK billion 1997	Annual percentage change						
		1995	1996	1997	1998	1999	2000	2001
Private consumption	923	0.8	1.3	2.0	2.7	2.9	2.5	2.0
General government consumption	449	-0.9	-0.2	-2.1	1.9	0.8	0.6	0.8
Central government	134	-2.1	-0.6	-5.0	2.5	0.5	0.5	0.5
Local government	315	-0.4	0.0	-0.7	1.7	0.9	0.6	1.0
Gross fixed capital formation	238	12.4	3.7	-4.8	9.8	8.0	6.8	5.9
Business sector excl. housing	183	27.7	4.7	-0.1	10.7	7.1	4.8	3.2
Housing	24	-23.5	13.1	-25.7	6.2	23.5	25.0	25.0
Authorities	31	-5.7	-8.0	-9.4	7.6	1.4	2.2	1.4
Change in stocks	7	0.5	-1.1	0.7	0.1	0.0	0.0	0.0
Exports	761	12.9	6.1	12.8	5.9	5.8	6.6	5.5
Imports	639	10.2	3.7	11.7	8.8	7.1	6.3	5.8
GDP	1739	3.9	1.3	1.8	3.0	3.0	3.2	2.6

Sources: Statistics Sweden and Ministry of Finance.

will provide a negative contribution to growth this year and next year of 0.4 percentage points and 0.2 percentage points, respectively.

Most of the necessary conditions exist for a continued relatively strong rise in private consumption – a pent-up need to acquire capital goods, a strong household economy and optimism for the future. The need to replace old capital goods has already made its mark in the growth of infrequently purchased goods retailing. Sales of furniture, radio and television equipment have increased by between 10 and 20 per cent during the first seven months of the year, compared with the corresponding period in 1997. Household disposable incomes are expected to rise by just over 2.7 per cent this year and 3.3 per cent next year. The low inflation rate means that developments in real wages will be good, despite the historically low nominal wage increases. Household incomes will be further strengthened by an increasing number of people obtaining work. At the same time, the household wealth situation, despite the downturn on the stock exchange this autumn, is better than it has been for a long time. Private consumption is expected to increase by almost 3 per cent in both 1998 and 1999. The rise in consumption is then expected to diminish somewhat in the years 2000 and 2001.

Over the next few years an extensive expansion of capacity in the business sector and some recovery in residential investment is expected.

The low level of interest rates, a relatively high level of profitability within the business sector and the strong economic position in the household sector will create favourable conditions for a continued expansion in investment. Statistics Sweden's Investment Survey and the National Institute of Economic Research's latest Quarterly Business Tendency Survey both show that there is a strong willingness to invest by the manufacturing industry. With regard to the rest of the business sector, a rapid increase in investment has already been noted in those industries which have a strong connection to household demand. The National Institute of Economic Research's Services Survey indicates a clear improvement in the economic situation for architects and technical consultants, which usually precedes increased investment. There are also good indications of a rapid growth in residential construction during the entire forecast period. Some of the adaptation of the housing stock towards a new, long-term equilibrium level has taken place earlier in the 1990s. Following seven years of more or less a continual decline in residential construction, the starting level is very low. Rising prices for family dwellings in growth regions have increased the profitability of new construction, which means that residential investment is expected to rise again. Despite very high growth figures during the forecast period, residential construction is expected to remain

lower than the long-term normal level in the year 2001.

Overall, gross fixed capital formation will increase by almost 10 per cent in 1998 and by 8 per cent in 1999, and then increase at a slower rate in the years 2000 and 2001. As shown in Table 1.4, gross fixed capital formation will account for approximately 40 per cent of GDP growth up to the end of 2001. However, this item is a component of demand and output which is difficult to assess. The increase in investment in the rest of the business sector and the upturn in residential construction reflect the favourable situation in the domestic part of the Swedish economy which appears to be relatively robust. A stronger growth in investment than forecast cannot be ruled out. With regard to the export-oriented part of the manufacturing industry, however, there is a high sensitivity towards a decline in global growth, which could result in a turnaround in investment within the sector.

Local government consumption increased during the first half of this year, according to the National Accounts. According to the Labour Force Surveys, the number of those employed in the local government sector has increased by approximately 25,000 so far this year, when adjusted for seasonal variations. The growth in employment is expected to diminish during the second half of the year, and will provide a growth in consumption of around 1.7 per cent this year. This can be compared with the period between 1992 and 1997 when consumption declined by a total of 4.5 per cent.

Municipalities and county councils are expected to meet the requirements for achieving a positive financial balance i.e. that their income must not exceed expenditure, with effect from the year 2000. The proposed increase in general grants from central government provides scope for an increase in local government consumption. The overall increase amounts to SEK 22 billion in the year 2001. With regard to the balance requirement and increased central government grants, consumption is estimated to increase by an average of 0.8 per cent per annum and employment rise by 30,000 people for the years 1999 to 2001 inclusive.

Central government consumption has declined three years in a row and last year fell by 5 per cent. During the first half of this year, there was a significant recovery when consumption rose by 4.6 per cent compared with the corresponding period in 1997. This year, central gov-

ernment consumption is expected to rise by 2.5 per cent. An increase of 0.5 per cent per annum is estimated for the coming years.

Table 1.4 Contribution to GDP Growth

	1996	1997	1998	1999	2000	2001
Private consumption	0.7	1.0	1.4	1.5	1.3	1.0
General government consumption	0.0	-0.5	0.5	0.2	0.1	0.2
Gross fixed capital formation	0.6	-0.8	1.5	1.3	1.2	1.0
Change in stocks	-1.1	0.7	0.1	0.0	0.0	0.0
Net foreign trade	1.2	1.3	-0.5	0.0	0.6	0.3
GDP	1.3	1.8	3.0	3.0	3.2	2.6

Sources: Statistics Sweden and Ministry of Finance.

Composition of Growth

The situation of domestic demand taking over as the driving force behind economic growth will mean that the course of growth is more sustainable and balanced. During 1996 and 1997, net exports accounted for a large part of growth (see Table 1.4). The long-term norm is for an increase in exports to largely balance an increase in imports and that the contribution to growth from foreign trade to lie close to zero. The reduction in exports to Asia, together with the growth in domestic demand, mean that foreign trade will provide a negative contribution to growth this year. Over the next three years, foreign trade is expected to provide a slightly positive contribution.

The surplus on the current account will lie at just over 2 per cent of GDP per annum up to the end of 2001, despite the shift towards domestic demand. This will contribute to a desirable amortisation of Swedish foreign debt. Similarly large financial surpluses will be achieved in the general government sector, which will reduce the vulnerability towards future downturns in the economy. The financial savings of firms lie close to zero, which means that this sector provides its own funding for the investments in the forecast. Household financial savings are slightly positive, despite increased investment in housing. The composition of growth and the development of savings in the various sectors describe a well-balanced economic development, on the whole.

Table 1.5 Financial Balance

Per cent of GDP

	1996	1997	1998	1999	2000	2001
Gross balance	17.3	16.9	17.3	17.8	18.4	19.1
Real balance	14.6	14.1	15.0	15.7	16.2	16.7
Fixed capital	14.8	13.7	14.5	15.2	15.8	16.2
Change in stocks	-0.2	0.4	0.5	0.5	0.4	0.4
Financial balance	2.7	2.8	2.3	2.1	2.2	2.4
General government	-2.1	-1.1	2.1	1.1	2.3	3.3
Household	3.4	1.4	1.3	1.4	0.7	0.5
Business sector	1.4	2.6	-1.1	-0.4	-0.8	-1.4

Sources: Statistics Sweden and Ministry of Finance.

The Labour Market

Developments in the labour market have been very positive so far this year. Employment is now growing strongly in the business sector and the local government sector. The most important indicators, such as the number of new job vacancies registered, imply that employment will continue to grow at a rapid rate during the remainder of 1998 and 1999. Given that the global economy does not weaken and that wage rises can be limited to 3 per cent per annum, the total increase in employment is estimated to be around 226,000 people between 1997 and 2001 (see Diagram 1.2).

Diagram 1.2 Employment

Thousand people



Sources: Statistics Sweden and Ministry of Finance.

The average number of hours worked is expected to fall over the next few years. Sick leave has increased slightly and a reduction in working hours was included in several of the wage agreements. The rise in productivity is expected to be lower than in recent years. The fact that growth will be driven to a greater degree by domestic demand and not by export growth and the fact that low

wage rises will lower the pressure for rationalisation should contribute to a slightly lower growth in productivity.

As a result of the improved labour market situation, the supply of labour will increase. However, the increase in the supply of labour will be counteracted to some extent by the continued increase in the number of places within the education and training initiative as well as extra university and college places. The strong growth in employment and a limited entry into the labour force will mean that registered unemployment continues to fall. Given the assumption on which this estimate is based – good global economic growth, low wage rises and that the training and education initiative has the intended effect – registered unemployment could fall to 4 per cent by the end of the year 2000.

General Government Sector Finances

From 1994 to 1998, the general government sector financial balance has been turned around from a deficit of 10.3 per cent of GDP to a surplus of 1.3 per cent of GDP, excluding the effect of the AP-fund's property holdings being transferred into an incorporated company. The improvement between 1994 and 1998 is largely due to the extensive consolidation programme. The surplus, measured as a percentage of GDP, will then rise to 1.1 per cent in the year 1999, 2.3 per cent in 2000 and 3.3 per cent in 2001.

The financial surplus means that general government sector debts can be amortised. The consolidated gross debt will decline from 76.6 per cent of GDP in 1997 to 55.8 per cent of GDP in the year 2001, while the central government debt will fall from 82.4 per cent of GDP in 1997 to 54.1 per cent of GDP in the year 2001. However, the decline in the central government debt can to some extent be attributed to the effects of the recently agreed pension reform. It has been assumed in the calculations that there will be a transfer of funds from the AP-fund in the year 2001 of SEK 235 billion, which will mainly be used to amortise central government debt.

The financial balance for 1998 and 1999 has been revised upward by SEK 9 billion and SEK 5 billion respectively, compared with the Government Spring Bill. This is due to higher tax revenue and lower interest expenditure. The Government Spring Bill contained a technical assumption for the purposes of estimation that the financial surplus in excess of the budget goal for the years 2000 and 2001 would be transferred

to the household sector. The estimates presented here are instead based on the whole of the surplus being used to amortise general government debt. If this new assumption and the measures proposed since the Government Spring Bill are taken into account, the underlying balance in the general government sector can also be revised upward for the years 2000 and 2001.

The estimates for fiscal policy measures, which are accounted for in Chapter 11, indicate that fiscal policy is weakly expansive this year and next year and weakly contractive in the years 2000 and 2001. The continued strengthening of general government finances is instead mainly due to positive economic growth and lower interest expenditure.

1.3 Alternative Scenario

With the aim of illustrating the uncertainty in the international picture and the risks connected to this with regard to the growth of the Swedish economy, an alternative scenario is presented in Chapter 12. The alternative scenario is considered to be less probable than the estimates above, which is hereinafter referred to as the base alternative.

The base alternative assumes a cautious recovery in Japan, driven by exports, during 1999. The alternative scenario is based on the Japanese recession being more prolonged and a recovery not taking place before the year 2000, at the same time as general uncertainty will increase through continued turbulence in the financial markets. This will lead to negative repercussions on the rest of the world, primarily next year. Those countries most affected by a deterioration in export conditions and a generally increased uncertainty are the Asian countries already affected by the crisis as well as other growth economies, for instance, in Latin America. The deepened crisis will put pressure on global market prices, which will lead to poorer profits for firms with extensive international trade. The crisis will spread to North America and Europe, partly through direct trade effects and partly through weaker developments on stock exchanges and a general increased uncertainty. This will lead to a poorer development particularly in investment and private consumption. The alternative scenario assumes that monetary policy will become more expansive than in the base alternative, but that

this will not be sufficient to overcome the fall in demand in the short term. The weaker economic growth internationally will lead to a lower global market growth for Swedish exports than in the base alternative.

The Swedish economy will react in a similar way to Europe and North America. Investment in the Swedish export industry is expected to be particularly sensitive to a worsening in the global economy. Lower international growth and the increased uncertainty will spread to households and subdue consumption and residential investment. GDP growth is estimated in the alternative scenario to amount to 2.8 per cent in 1998 and 1.8 per cent in 1999. The lower growth rate, compared with the base alternative, means that employment will not develop as well in the alternative scenario, particularly in 1999, and that registered unemployment will be at a higher level.

During the years 2000 and 2001, growth will be 3.1 per cent and 3.2 per cent respectively, which taken together is slightly higher than in the base alternative. This is due to the global economy having recovered and investment in the manufacturing industry will increase rapidly. In addition, monetary policy is assumed in the alternative scenario to be more expansive in 1999 than in the base alternative, which will have a delayed impact on growth. However, registered unemployment will exceed 4 per cent by the end of the year 2000.

General government finances will not develop as favourably in the alternative scenario as in the base alternative. Lower tax revenue and higher general government expenditure, for instance, in the form of unemployment benefits and social welfare, will lead to a worsened financial balance in the general government sector. The goal of a general government financial balance amounting to 0.5 per cent of GDP in 1999 will be achieved by a slight margin. On the other hand, the general government financial balance in the year 2000 will be lower than the target level of 2 per cent of GDP.

2 International Developments

The growth of the world economy has been moderated over the past year, primarily as a result of the deeper recession in Japan and certain Asian countries. At the same time, global price pressures have declined, which has led to lower interest rates and stimulation in domestic demand in Europe and North America.

Global economic growth is expected to fall from 4.1 per cent in 1997 to 2.2 per cent this year, while in the OECD region it is expected to diminish by just over a half percentage point to 2.1 per cent. At the end of this year and during 1999, a cautious recovery is anticipated in the Asian countries and in the global economy as a whole. However, important prerequisites for this are that confidence in the Japanese economy, including its economic policy, strengthens and that the Asian countries continue to implement the IMF programmes, including a reform of the financial sector.

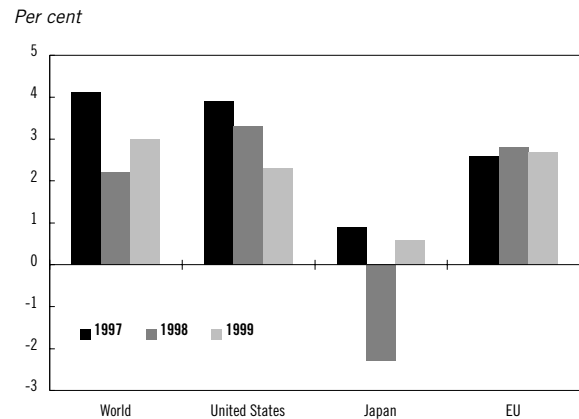
Economic developments in the United States are expected to remain favourable, although some weakness is foreseen in the light of an increasing trade deficit and a slowing down in domestic demand. The EU economy is expected to remain stable and will receive a boost from a less restrictive fiscal policy and favourable monetary conditions i.e. the total effect of interest rate and exchange rate developments on demand.

The Asian crisis has contributed to increased uncertainty on the financial markets of most emerging markets. In Russia, financial turbulence has increased as a result of the deeper recession in Asia and falling oil prices, which has accentuated domestic economic and political problems. Developments in Russia may have some negative consequences in Central and Eastern Europe, but these are expected to be partly counteracted by the continuing buoyant economy in the EU. In Latin America, economic policy has become more constrained in order to try to avoid increased turbulence on the financial markets, which could contribute to a lower domestic demand.

Export market growth is expected to diminish from 10 per cent in 1997 to approximately 6 per cent this year and next year. The recovery in the Asian region will contribute to a rise in exports to 7½ per cent in the year 2000. A reduction in demand among Sweden's most important trad-

ing partners will thereafter lead to a slightly lower export market growth in the year 2001.

Diagram 2.1 GDP Growth



Sources: IMF and Ministry of Finance.

The uncertainty in the assessment of international developments has increased markedly and there is primarily a risk that developments will be worse than forecast.

2.1 Developments in Japan and the rest of Asia

2.1.1 Japan

The long-term economic crisis in Japan has worsened and the country is now in a recession. GDP declined during the final quarter last year and during the first two quarters of this year. This development is serious, bearing in mind the significance of Japan for the world economy.

The economic crisis is linked to the extensive structural problems in the financial sector, primarily caused by considerable regulation and limited insight. A lack of measures to solve the crisis has contributed to increased uncertainty for both the Japanese and global economic growth. Problems in the financial sector have also resulted in a credit squeeze in Japan that is, above all, affecting small and medium-sized firms.

The crisis in the financial system, together with increased unemployment and the Asian crisis, have continued to undermine confidence among firms and households. This has contributed to a reduction in domestic demand. At the same time, the weak economic situation in Asia has led to a less favourable development in Japanese exports.

The government has announced extensive fiscal policy stimulation measures for the budget years 1998 and 1999, in order to mitigate the economic crisis, and it has also allocated funds to consolidate the financial sector. Monetary policy is expected to remain expansive and the prime rate has been assumed to remain unchanged in 1998 and 1999. The overnight call rate was recently lowered to 0.25 per cent, while the discount rate remained unchanged at 0.5 per cent. This measure was taken in the light of deflationary expectations in the economy. However, the scope for monetary policy measures is limited.

GDP is foreseen as stabilising over the next six months, given that the fiscal policy stimulation measures are implemented in full and contribute to a strong increase in public investment.

However, domestic demand is expected to remain weak both this year and next year. Private consumption will be restrained by the pessimism of households regarding the future and by rising unemployment. It is therefore expected that tax relief will increase savings. A weak development in private investment is foreseen in the light of the low confidence among firms, continued credit restraint and problems of surplus capacity.

As the effects of the Asian crisis level off, a slightly better growth in exports is foreseen next year.

Despite the massive stimulation measures during the second half of 1998, GDP is expected to decline by 2.3 per cent in 1998. Next year, GDP growth of 0.6 per cent is expected, primarily due to extensive public investment and a slightly better development in exports. Thereafter, it is expected that GDP will increase by 1.5 per cent in the year 2000 and 2.0 per cent in the year 2001.

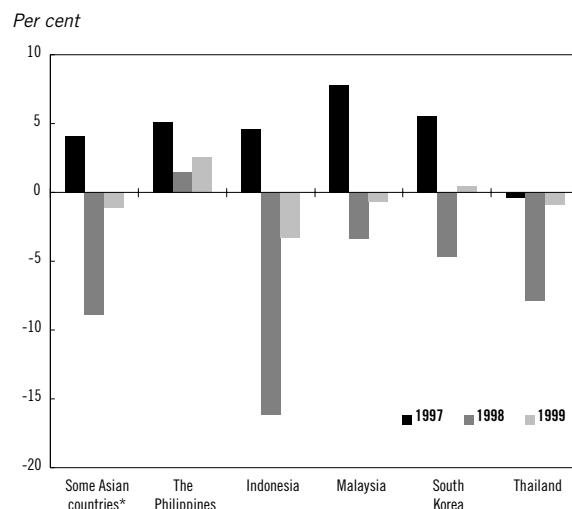
This assessment is associated with considerable uncertainty. If the planned public investment is not implemented in full and confidence among firms and households does not strengthen, the recovery in the private sector will be delayed. The solution to the problems in the financial sector may take some time, which would in many ways have a moderating effect on GDP growth. In addition, the negative influence of the Asian crisis on Japanese exports may be greater than forecast.

2.1.2 Rest of Asia

The financial crisis in Asia of last summer has developed into a deep recession. Weak demand in the countries directly affected by the crisis i.e. Thailand, Indonesia, Malaysia, the Philippines and South Korea, has affected other countries in the region, partly through reduced trade and confidence. A restrictive economic policy has led to a stabilisation in prices, interest rates and currencies, but domestic demand has fallen heavily. Unease on the financial markets, together with high interest rates and a reduction in lending, has had major effects on the real economy. The decrease in output has led to a severe decline in imports in large parts of the region. As a result of, among other things, a tightening of credit and high prices of imported input goods, exports have also developed relatively weakly.

GDP in most countries in the region is expected to fall this year. However, a cautious recovery, driven by exports, is expected to begin at the end of the year and continue in 1999. Increased foreign exchange reserves are expected to result in confidence in the affected countries beginning to return, which could in turn contribute to an increased inflow of capital and lower interest rates. A slightly less restrictive economic policy should also stimulate domestic demand. However, without an improvement in the economic situation in Japan, with increased demand and a stronger yen, the recovery in the region will be severely hampered. A further condition for an export-driven recovery is that the situation in the financial sector in the region improves.

Diagram 2.2 GDP Growth



* These are the Philippines, Indonesia, Malaysia, South Korea and Thailand.
Sources: IMF and Ministry of Finance.

GDP growth in Thailand, Indonesia, Malaysia, the Philippines and South Korea collectively is expected to fall from 4.1 per cent in 1997 to -8.9 per cent in 1998 and -1.1 per cent in 1999. A significant recovery is foreseen for the years 2000 and 2001. In China, growth is expected to be subdued this year and then increase next year. Similar to the prospects for Japan, the assessment of developments in the rest of Asia is marked by considerable uncertainty. For instance, prospects could deteriorate considerably if China, with the aim of strengthening its competitiveness, devalued its currency.

2.2 Developments in the United States

The economic situation in the United States was characterised at the beginning of 1998 by a continued strong increase in domestic demand, low unemployment and inflation, falling bond rates and sound general government finances. GDP growth was strong during the first quarter, but slowed down during the second quarter as a result of negative contributions from stocks and net exports. Private consumption has been stimulated by favourable developments in disposable incomes, a stable and high level of growth in employment and a rise in share prices. Investments have continued to grow at a fast rate, partly in the light of high profit margins for firms. The appreciation of the dollar in effective terms and the lower demand in Asian countries have contributed to a large increase in the deficit on the current account.

Inflation remains low and amounted to an annual rate of 1.6 per cent in August. Several factors have contributed to the fact that there has not been a rise in the rate of price increases, despite unemployment falling below the level considered compatible with low inflation. These factors are the strengthening of the dollar, a modest growth in overall labour costs and the moderating effect of the Asian crisis, for instance, on energy and raw materials prices. A turnaround in this development could lead to rising inflationary pressures.

During the second half of 1998, net exports are expected to provide a negative contribution to GDP growth, while domestic demand continues to grow relatively strongly. However, in 1999 investment is expected to grow more slowly in the light of rising labour costs, falling

profit margins and the fact that the decline in the inflow of orders for the export sector will spread to the domestic sector. The growth in private consumption is also expected to decline. The very low savings ratio and the high degree of share holdings among American households have probably increased the sensitivity of consumption towards changes in confidence, especially in connection with a possible deepening of the global crisis and a weaker development in domestic share prices. Unemployment, which continued to fall slightly this year and stood at 4.6 per cent in September, is expected to rise to almost 5 per cent in 1998 and 1999. GDP growth is forecast at 3.3 per cent in 1998, and then to decline to 2.3 per cent in 1999. In the medium-term perspective i.e. the years 2000-2001, GDP growth is expected to correspond to the estimated potential growth of around 2.3 per cent.

Given the uncertainty prevailing with regard to the United States economy, it is difficult to assess the monetary policy situation. The strong dollar, the Asian crisis and the uncertain situation in Latin America may lead to a very weak growth in exports, with negative effects on profits, share prices and household confidence. On the other hand, a broad decline in domestic demand cannot yet be discerned in the statistics and it is uncertain how extensive a potential slowdown will be. As a result of the risks from external developments on domestic demand and continuing subdued price developments, the Federal Reserve recently lowered its prime rate by 0.25 percentage points to 5.25 per cent. Taking into consideration the risks mentioned of a weaker economic growth being balanced by risks that the labour market situation will be tightened further and that the dollar will depreciate, the prime rate is expected to remain at 5.25 per cent during 1998 and 1999. International developments may, however, lead to a more expansive monetary policy in the United States than forecast.

2.3 Developments in the EU and Euro area

The EU economy, as a whole, has continued to strengthen this year, as a result of increased domestic demand stimulated by favourable monetary conditions and a less restrictive fiscal

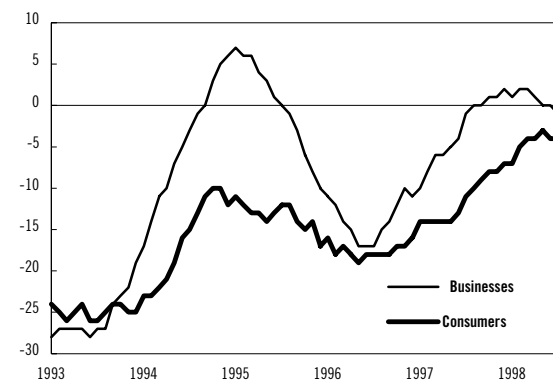
policy. However, the decline in demand from Asia as a whole has meant that the contribution from net exports to GDP growth has decreased. Developments in Asia have also had a dampening effect on European price developments, which has led to lower interest rates. Inflation in the EU is still subdued and amounted to 1.3 per cent as an annual rate in August. Since August last year, long-term interest rates have fallen from almost 6 per cent to around 4 per cent.

The EU countries are currently experiencing different stages of the economic cycle. One group of countries, including Germany, France and Italy, is in a relatively early stage of the phase of an economic upswing while Spain, Portugal, the Netherlands, Finland and Ireland are further ahead in the economic cycle. A slowing down of the economy can be discerned in the United Kingdom and Denmark.

At the turn of the year, the euro will be introduced and the monetary policy of eleven countries will be governed by the European Central Bank. In recent years, the differences in inflation rates and interest rates between the countries have diminished considerably and general government finances have improved considerably. Given this development, among other things, the conditions are deemed good for a smooth transition to the EMU, although the process is not expected to remain unaffected by the recent turbulence on the financial markets. The assessment is that the European prime rate will lie at 3.40 per cent before rising slightly in 1999 as the business cycle continues to be strong. This could mean a lower prime rate for a number of countries further ahead in the economic cycle.

Diagram 2.3 Business and Consumer Confidence in EU

Net balance



Source: European Commission.

The prospects of a continued recovery in the EU as a whole are good. Domestic demand is expected to strengthen in the light of continuing favourable monetary conditions, a slightly improved labour market situation and a less restrictive fiscal policy. In some countries, such as France, Spain and Austria, fiscal policy is considered to be mildly expansive in 1999.

Growth in private consumption is expected to increase in the light of favourable developments in real wages, some reduction in unemployment and an increased confidence in the future among households.

Although the optimism of firms may fall slightly as a result of increased uncertainty in the global economy, the level is still high when seen over a longer period of time. The rate of increase in total labour costs is expected to be moderate, which will contribute to good profit margins. Investment by firms is thus expected to continue to develop relatively strongly.

Table 2.1 GDP Growth, Inflation and Unemployment

Annual percentage change

	1997	1998	1999	2000	2001
<i>GDP</i>					
OECD ¹	2.8	2.1	2.2	2.4	2.3
United States	3.9	3.3	2.3	2.5	2.2
Japan	0.9	-2.3	0.6	1.5	2.3
EU	2.6	2.8	2.7	2.7	2.4
Germany	2.2	2.6	2.7	3.0	2.3
France	2.4	2.9	2.8	2.5	2.5
Italy	1.5	2.1	2.7	3.0	2.3
United Kingdom	3.3	2.0	1.6	2.0	2.3
Nordic countries	3.4	3.4	2.8	2.7	2.2
Denmark	3.4	2.6	2.3	2.2	2.2
Finland	5.9	5.1	3.4	3.1	2.7
Norway	3.5	3.4	2.5	1.7	2.0
<i>Consumer prices</i>					
OECD	2.0	1.5	1.8	2.0	2.0
EU	2.0	1.8	1.9	2.0	2.0
Nordic countries	1.6	1.7	2.2	2.0	2.0
<i>Unemployment as a percentage of labour force</i>					
OECD	6.7	6.5	6.5	6.4	6.3
EU	11.3	10.9	10.6	10.3	10.1
Nordic countries	8.3	7.1	6.4	5.9	5.7
<i>World market growth for Swedish exports</i>					
	10.0	5.9	6.2	7.5	6.5

¹ The OECD-area refers here to 16 countries: USA, Japan, Germany, France, Italy, United Kingdom, Canada, Belgium, Denmark, Finland, the Netherlands, Norway, Spain, Switzerland, Sweden and Austria.

Sources: OECD, National Institute of Economic Research and Ministry of Finance.

The subdued growth in the global economy is expected to lead to a lower export market growth for the EU. The contribution from net exports is anticipated to be slightly negative this year and next year, which is also in line with the assumption of an appreciation of the euro in effective terms during this period.

Altogether, a GDP growth of 2.8 per cent this year and 2.7 per cent in 1999 is forecast for the EU. A GDP growth of 2.9 per cent is expected for both years in the euro area. The poorer development for the EU as a whole is mainly explained by a slowdown in the United Kingdom, where restrictive economic policy is expected to subdue domestic demand, while exports are expected to develop weakly. In the medium-term perspective, GDP growth is expected to be around 2½ per cent i.e. slightly above the estimated potential growth. Relatively good economic growth will contribute to unemployment in the EU continuing to fall at a slow rate. However, the high starting level means that unemployment will continue to be a major problem over the next few years. Inflation is expected to be around 2 per cent.

2.4 Developments in the Nordic countries and Baltic Sea region, including Russia

The favourable economic developments in the Nordic countries are expected to continue, although some weakening in their economies is expected in 1999 as a result of a more restrictive economic policy.

In Denmark, strong domestic demand, stimulated by increased employment and rising real wages, has contributed to a high level of economic growth in recent years. However, there are signs of some slowing down in private consumption this year and domestic demand is expected to fall as a result of a more restrictive fiscal policy. GDP growth is expected to decline to 2.6 per cent this year and 2.3 per cent in 1999.

Rapid economic growth in Finland is continuing. Exports are developing very positively, especially within the telecommunications industry. Employment is rising and this, together with low interest rates, is stimulating a high level of domestic demand. The economic crisis in Russia is considered to have some negative effects on the growth of exports. GDP growth is estimated

to fall slightly to 5.1 per cent this year and 3.4 per cent next year.

The economy remained strong during the first half of the year in Norway. Private consumption has been stimulated by a good growth in employment and increased real wages. As a result of currency turbulence, triggered by, among other things, falling oil prices and problems with wage formation, monetary policy has tightened considerably. This will have a moderating effect on private consumption and on investment. GDP growth is expected to amount to 3.4 per cent this year, to then fall to 2.5 per cent in 1999.

The cautious recovery in GDP growth which took place in Russia last year continued at the beginning of this year. Inflation fell significantly during the first six months, while the exchange rate showed a relatively stable development. The financial crisis, which became evident with a severe weakening of the currency in August, is a setback for the economic policy aimed at stability. The main reasons behind the crisis are the weak fiscal policy and, in particular, the incapacity to strengthen the revenue side of the budget, as well as falling oil prices on the global market, which have led to a rapid decline in the current account. A reduced global confidence in growth economies, as a result of the deeper recession in Asia, has had a negative effect on Russia. The Russian central bank has been forced to abandon the fluctuation band for the rouble, which has led to significant depreciation of the currency and rapidly rising inflation. In addition, the crisis has seriously undermined the entire financial sector, as large sections of the banking and payments systems have ceased to function. There is considerable uncertainty over the continued reform strategy and, in particular, how the problems of funding the budget deficit and refinancing the central government debt shall be solved. Financial instability and reduced confidence in economic policy will have a dampening effect on GDP, which is expected to fall by around 4 per cent this year. No significant recovery is expected in 1999.

Rapid economic growth in the Baltic States and Poland in 1997 continued at the beginning of this year, as a result of strong domestic demand, particularly with regard to investment. The stability-oriented economic policy has contributed to a continued fall in inflation. The prospects for economic growth this year and next year are relatively good. However, the crisis in Russia is expected to have some negative

effects, especially for Latvia and Lithuania, which have extensive trade with Russia. This could increase the problems with the deficit on the current account in these countries. Domestic demand is expected to slow down somewhat and a GDP growth of just over 4 per cent is foreseen for all of the Baltic States and almost 6 per cent in Poland this year.

2.5 Risks concerning International Developments

The uncertainty in the assessment of the international economy has increased significantly as a result of the Asian crisis and, to some extent, of developments in Russia and the growth economies in Latin America. There is primarily a risk that developments will be worse than those described above. Although individual risks are probably not sufficiently serious to result in a steep decline in the global economy, if a number of these risks occurred concurrently it may create chain reactions that tangibly worsen and spread the crisis.

There is first of all a risk of a more prolonged Japanese recession and of the fragility of the financial system further eroding confidence in the economic policy pursued, despite the measures announced in the financial sector and for fiscal policy.

A delayed recovery in the Japanese economy could create increased instability in the Asian financial markets, which in turn risks making the implementation of economic and political reforms in Asia more difficult. The recovery in Asia could also be hampered by a continuing weak development in Japanese import demand. A deeper and broader recession in Asia could force a devaluation of the Chinese currency. Such a development would put further pressure on the Hong Kong dollar and other currencies in growth economies.

Continued and increased difficulties for the Russian economy could both increase unease on the global financial markets and contribute to a worsening of the situation in other growth economies. There is also a risk that emerging markets, which have large external and domestic imbalances, could be tangibly affected by the Asian crisis. These countries would suffer reduced capital inflows and higher interest rates

in that more secure investments would be sought on the financial markets.

The turbulence on the financial markets is contributing to increased uncertainty. A continued decline in stock prices could lead to a decline in confidence among households and firms, which would have an effect on domestic demand in North America and, to some extent, in Europe.

The United States is expected to absorb the major part of the expected surplus on the current account in the Asian countries. It is therefore important that the United States economy does not slow down to an extent where a recovery in the Asian region is made more difficult. An increased deficit on the United States current account and a larger surplus on the Japanese one could create uncertainty about exchange-rate movements and how these imbalances can be adjusted in the long term.

Finally, there is a risk that countries whose balance of trade has been influenced by the Asian crisis will resort to protectionist measures, competitive devaluation, or postpone necessary structural reforms.

The alternative scenario presented in Chapter 12 analyses the effects of a weaker global growth as a result of certain of these risks being realised i.e. a delayed recovery in Asia, a spread of the crisis to Latin America and continued turbulence on the financial markets.

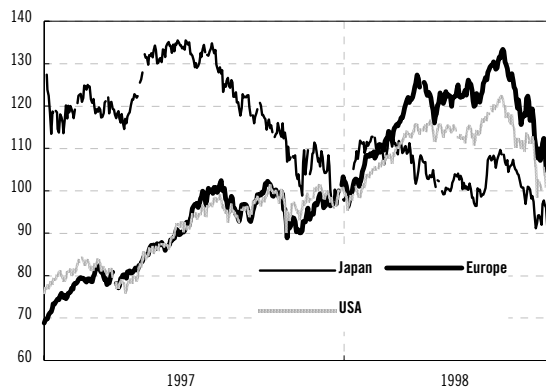
3 Financial Markets

3.1 Developments in the Rest of the World

So far this year, the financial markets have come to be increasingly influenced by weak economic developments in Asia and Russia. In Japan, the gradual downward adjustment of growth expectations and the political inability to handle the problems in the banking sector, which have been known for several years, have created uncertainty and contributed to a weakening of the yen during the first half of the year. However, at the beginning of the autumn the yen strengthened and in mid-September the yen/US dollar exchange rate was the same as at the beginning of this year. The Tokyo Stock Exchange has developed weakly. In Russia, the heavy depreciation in the rouble in August, the restructuring of government securities stock and the fall of approximately 90 per cent on the Moscow stock exchange up until the end of September have led to major losses for foreign investors.

Diagram 3.1 Stock Exchange Growth

Index 1997-12-31 = 100



Source: EcoWin.

The Asian crisis appears to have affected the financial markets in two stages. The first stage involved developments in Asia leading to lower inflationary expectations in Europe and the United States, which in turn contributed to lower bond rates, particularly in Europe. During this period, the dollar strengthened not only against the yen, but also to some extent against the European currencies. The lower bond rates contributed to a continued rise on stock exchanges in the spring, both in Europe and the United States. With regard to Europe, the expectations of a continued economic upswing probably played a role here, while the upturn in

the United States was supported by an inflow of capital in connection with the crisis in Asia. The rise on the New York Stock Exchange during the first half of the year took place despite the fact that there has long been great uncertainty about the valuation of the stock exchange. This uncertainty was based on whether reasonable assessments of future interest-rate developments and the rate of increase for the growth in profit of firms could justify the high levels reached by share prices at the end of 1997.

Diagram 3.2 Dollar in German mark and yen



Source: EcoWin.

The second stage in the reaction to developments in Asia and particularly in Russia, which began during the summer, has been characterised by portfolio transfers from assets perceived as more uncertain to assets considered as involving less risk. This has led to falling share prices and an increased difference in interest rates both between government bonds of different countries and between, for instance, government bonds and mortgage bonds. The increased demand for secure assets has particularly favoured government bonds from the United States and Germany and thus contributed to a decline in bond rates in these countries.

Consequently, the bond rate decline of recent years has, all in all, continued in Europe and the United States. The dollar remains strong, although it has weakened slightly during early autumn as a result of increased expectations of a lower prime rate in the United States. Further, the rise on US stock exchanges of recent years has now been broken.

On May 1, the heads of state and heads of government of the EU decided that 11 of the EU Member States would take part in a monetary union with effect from January 1, 1999. In connection with this, the EU's finance ministers

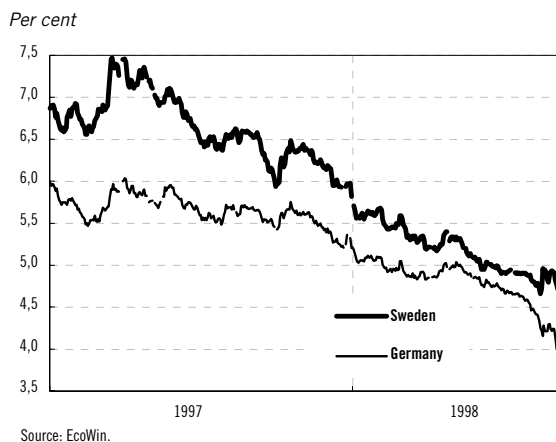
decided to announce that the central rates within the ERM would constitute the bilateral conversion rates which will apply between the currencies of the participating Member States with effect from the commencement of the monetary union. The decision on the conversion rates means that speculation regarding changes in the central rates in the ERM leading up to the formation of the monetary union is avoided. This means that the decision has provided stability for the exchange rate system.

The convergence between the bond rates of the Member States, which will participate in the monetary union, continued during the spring, but in recent months the spread in bond rates has increased once again. For instance, the spread in the 10-year rate between Finland and Germany was around 0.5 percentage points in September, which can be compared with approximately 0.1 percentage point in May.

3.2 Developments in Sweden

Developments in Swedish bond rates have largely been similar to that in other EU countries for the first half of this year. During the spring, bond rates continued to fall, while the interest-rate spread with Germany declined. However, at the end of the summer, the decline in interest rates had come to a standstill at the same time as the interest-rate spread between Swedish and German government bonds had increased considerably.

Diagram 3.3 Bond Rates in Sweden and Germany



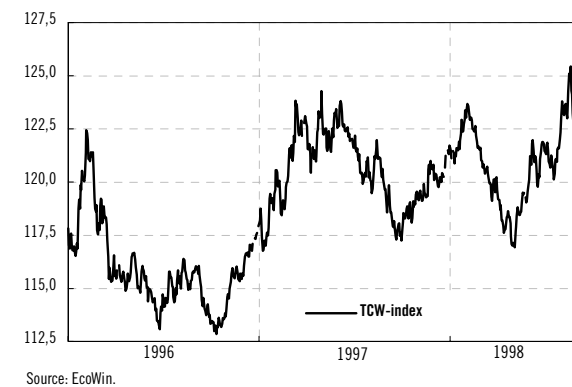
Prices on the Stockholm Stock Exchange have developed in line with other European stock exchanges. During the spring, the rise of recent years continued, but in the summer, prices began

a downward turn. From the beginning of the year up until the end of September, share prices on the Stockholm Stock Exchange had fallen by approximately 2 per cent. The poorest growth has been shown by shares in the forest industry and in 'other industry', where share prices have fallen by around 15 per cent. Shares in service companies and trading companies, on the other hand, have developed positively, with a rise in prices of around 40 per cent.

In autumn 1997, expectations of a less expansive monetary policy began to increase. These expectations were supported by statements from the Riksbank and the inflation report published in December 1997 contained an assessment that inflation would on average amount to around 2 per cent in 1998 and approximately 2.5 per cent in 1999, given an unchanged repo-rate. This meant that inflation would on average exceed the Riksbank's inflation target of 2 per cent in 1999, but it would still lie within the tolerance interval of +/- 1 percentage point. In the light of the expected improvement in the economy, the Riksbank believed in December that there was good reason to change the course of monetary policy during the winter to become less expansive. Shortly after this, the repo-rate was raised by 0.25 percentage points, to 4.35 per cent.

Diagram 3.4 The Krona Exchange Rate

TCW-index, 1992-11-18 = 100



However, during the spring the Riksbank came to make a considerable downward revision in its picture of inflation for coming years. The inflation report published in June contained the assessment that inflation would on average be 0.5 per cent during 1998 and 0.9 per cent in 1999, given an unchanged repo-rate. The main reasons for this altered inflation picture were weaker developments than expected in Asia, together with falling prices for raw materials and certain non-recurring effects on inflation as a result of tax

changes. Consequent to the change in the picture of inflation, the Riksbank lowered its repo-rate once again by 0.25 percentage points to 4.1 per cent at the beginning of June.

Since 1997, the krona has fluctuated without any noticeable general trend. When measured in terms of the TCW index, the krona has been within the interval of 117 to 123 since the beginning of 1997, with the odd exception, and has maintained an average of approximately 120. However, since the beginning of autumn, the krona has been above 123. As shown in Diagram 3.4, the fluctuations have been fairly rapid. The exchange rate has moved from the strongest end of the interval to the weakest in just a few months. In connection with a weakening of the krona a number of possible explanations have been put forward, for instance that Swedish investors have increased the proportion of foreign securities in their portfolios or that foreign investors have sold Swedish shares as part of an international movement towards more secure assets. The change to a more expansive monetary policy at the beginning of summer and falling prices for raw materials have also been claimed by some analysts to be reasons for the weakening of the krona during summer. However, it appears very difficult to present any reliable explanations for the short-term fluctuations in the krona.

Table 3.1 Balance of Payments

Flows, SEK billion

	1997	1998 to July
Current account balance	47.7	21.8
Capital transfers	-0.3	4.7
Financial balance	-33.7	10.8
Direct investment ¹	-9.2	-1.4
Portfolio investment ¹	-140.1	-91.7
Interest-bearing securities ¹	-33.5	-68.8
Swedish ¹	21.3	10.4
Foreign	-54.8	-79.2
Shares	-106.6	-22.9
Swedish	-13.0	29.2
Foreign	-93.7	-52.1
Financial derivatives	13.4	6.8
Other capital ¹	52.1	119.8
Changes in foreign exchange reserves	50.0	-22.8
Residual item	-13.7	-37.3

¹Limited comparability over time as the definition was changed in October 1997.

Source: Riksbank.

Table 3.1 shows the balance of payments in detail for different financial items. The balance of payments always totals zero. This means that the items in the table - current account balance, capital transfers, financial balance and the residual item - total zero. In recent years, Sweden has had a surplus on the current account, which has been countered by a negative financial balance. However, so far in 1998 the financial balance has been positive and only the residual item has been negative. The table also shows that trade in interest-bearing securities has so far in 1998 provided a negative currency flow which is approximately three times larger than the positive balance on the current account. This reflects the acquisition of foreign securities by Swedish investors. Foreign investors have made net purchases of Swedish interest-bearing securities during the year. The trade in shares has also involved a currency outflow so far this year. This is due to Swedish purchases of foreign shares, amounting to SEK 52.1 billion, which exceeds purchases of Swedish shares by foreign investors for SEK 29.2 billion. The statistics for the financial part of the balance of payments are difficult to interpret. This can largely be attributed to the large item 'other capital' which has provided an inflow of capital of SEK 119.8 billion so far this year. This is mainly comprised of trade credits and bank loans from abroad, which are probably connected to Swedish investments abroad. The government decided in October that the central government debt in foreign currency would be amortised by SEK 25 billion. This amortisation will contribute to a currency outflow in the financial balance and comprises part of the outflow of SEK 79.2 billion that can be attributed to the item of interest-bearing securities in foreign currency. During the first seven months of the year, the Riksbank has increased its foreign-exchange reserves through the net purchase of foreign assets corresponding to SEK 22.8 billion, which has also led to a currency outflow. Altogether the table shows that Swedish purchases of foreign assets, together with central government transactions, involve a large currency outflow in comparison with the surplus on the current account.

3.3 Assumptions regarding Interest-rate and Exchange-rate Developments

The assumptions regarding the development of interest rates and exchange rates are made on the basis of the picture of international economic developments described in the previous chapter and the picture of the Swedish economy presented in the following sections. Based on the picture of the European economy, a moderate rise in both short-term and long-term interest rates is expected within the monetary union over the next few years.

The Swedish inflation rate is expected to remain low over the coming years. This means that it is assumed that there is no need for a more restrictive monetary policy. However, Swedish bond rates are mainly expected to follow the European interest-rate rise. In addition, it is assumed that the krona will strengthen slightly compared with the average this year. This is based on both the expected low inflation rate and an expected surplus on the current account.

Table 3.2 Interest and Exchange Rate Assumptions

Final entry for each year

	1997	1998	1999	2000	2001
Repo-rate	4.35	4.1	4.1	4.1	4.1
Interest rate, 6 mth	4.7	4.3	4.3	4.3	4.3
Interest rate, 5 yr	5.6	4.6	4.8	5.0	5.0
Interest rate, 10 yr	6.0	4.9	5.1	5.3	5.3
Diff. Swe-Germany, 10 yr	0.6	0.5	0.3	0.2	0.2
Euro DEM, 6 mth	3.75	3.7	4.1	4.3	4.3
TCW -index	121	122	119	118	118
SEK/USD	7.9	7.80	7.55	7.50	7.50
SEK/German mark	4.41	4.50	4.35	4.30	4.30

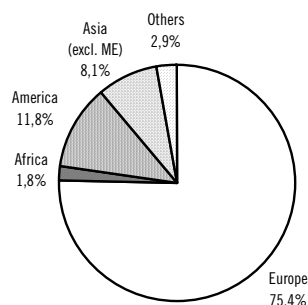
Sources: Ministry of Finance and Riksbank.

4 Foreign Trade

4.1 Trade in Goods

As a result of the favourable global economy and the advantageous product concentration in the export industry (including the telecommunication products industry), 1997 was a very good year for total Swedish exports, which rose by almost 13 per cent. This year exports have continued to increase, but at a slower rate. According to Statistics Sweden's National Accounts figures for the first half of 1998, exports of goods increased by 7.6 per cent compared with the same period last year. The economic setback in Asia has had a considerable influence on Sweden's trade flows this year. For instance, according to foreign trade statistics, the value of Sweden's exports to Asia (excluding the Middle East) have fallen by approximately 25 per cent during the first half of the year, compared with the same period for the previous year. Exports to the Asian region currently account for approximately 8 per cent of total exports of goods, compared with 11 per cent last year. However, the decline in exports to Asia has been more than compensated for by the increases to Europe (+12 per cent) and America (+7 per cent). Europe receives around 3/4 of total Swedish exports of goods and is thereby the most important market. The primary reason for the increase this year of exports can be mainly attributed to favourable economic developments in the EU and Norway.

Diagram 4.1 Swedish Exports to Selected Regions



Source: Foreign Trade Statistics.

More than one half of Sweden's total export value stems from the group, engineering products. Other important export products are forest products, minerals and chemicals. The most important engineering products are machinery, electrical goods and motor vehicles.

These goods have also accounted for the largest rise in exports during the first half of this year. Within the other categories, exports of paper, iron and steel, as well as pharmaceuticals, have developed well.

Uncertainty over the economic situation in Russia, together with the crisis in Asia, makes it difficult to assess developments in international markets and their effects on Swedish exports. Although direct trade with Russia, for instance, only comprises approximately 1 per cent of Sweden's total exports of goods, other countries in Eastern Europe and the Baltic region can be affected by the situation in Russia. Approximately 4 per cent of Swedish exports go to the rapidly growing markets in the Baltic States and Eastern Europe (excluding Russia). The direct effects of the situation in Russia should in any case be limited with regard to continued economic developments in the rest of Europe and thus with regard to Swedish exports.

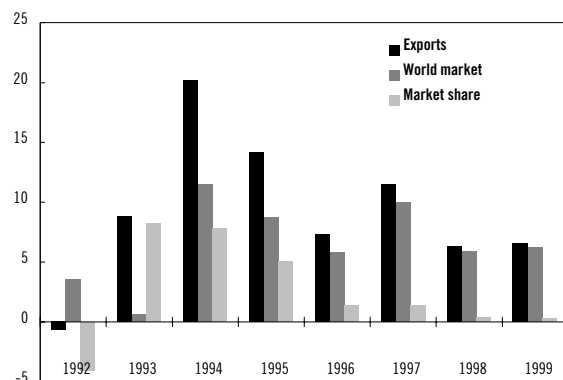
As mentioned earlier, the recession in Asia has led to a heavy decline in Swedish exports to the region. During the first six months of this year, the value of exports to Japan declined by approximately 40 per cent, compared with the same period last year. Exports to China during the same period increased strongly, but this has not been sufficient to compensate for the total reduction to the region. Exports to some of the smaller markets in Asia, such as the Philippines, Indonesia, Malaysia, South Korea and Thailand fell by 40 per cent or more compared with the previous year. However, exports to Hong Kong, the third largest individual market after Japan and China, increased by more than 10 per cent. Export opportunities to Asia over the next few years are highly dependent on developments in Japan and China. The international assessment (see Chapter 2) assumes that economic developments in the region will stabilise and that some recovery will occur next year, driven by exports. However, there is still great uncertainty concerning this scenario.

Another factor contributing to the picture of international uncertainty is economic developments in countries that are large exporters of raw materials. One effect of the crisis in Asia has been that prices for raw materials have fallen markedly during the first half of the year. This means that some economies in South America, Oceania and Africa have seen their export income decline, with ensuing falls on the stock exchange and

foreign exchange turbulence. The "spread" effects of this development to OECD countries may affect parts of the Swedish export industry with its traditionally large element of engineering products if investments in the manufacturing industry show a general decline.

Diagram 4.2 Export Growth, World Market Growth and Market Share Growth for Processed Goods

Percentage change



Sources: OECD and Ministry of Finance.

Developments in international markets give a divided picture. The most important market area, Europe, is expected to continue its good economic development. The economic situation in the United States is also anticipated to remain stable, whereby the market growth for the OECD 14 is expected to increase by around 8 per cent in 1998 and by approximately 6.5 per cent in 1999. In the light of relatively strong European market growth, exports of goods are still expected to rise by almost 6 per cent in both 1998 and 1999.

Price movements during the same period of time are expected to remain moderate as a result of stiffening international competition, which limits opportunities for Swedish firms to raise prices. An expected appreciation of the krona

will also contribute to keeping down export prices. Relative price increases (calculated in a common currency) between Sweden and abroad are not expected to lead to Swedish companies increasing their market shares by any marked extent.

Imports of goods increased by 12.4 per cent during the first half of 1998, according to the National Accounts figures. Statistics divided by country for the first six months of the year show an increase in imports from Asia (excluding the Middle East) of 12 per cent in value. Imports from China increased considerably, while the countries worst hit by the economic recession in the region have not yet increased their exports to Sweden to any great extent. It is probable that imports from Asia will increase further when the effects of the major changes in exchange rates make an impact in the form of lower import prices. However, this development is not expected to affect Swedish manufacturers initially, but rather importers from other countries. More than 80 per cent of the total imports of goods to Sweden come from Europe, with Germany as the largest individual exporter. Engineering products account for approximately half of the imports of goods. As for exports, the most important products in terms of value are machinery, electrical goods and motor vehicles.

It is expected that total imports of goods will increase during the forecast period in line with the expected increase in demand from consumers and stronger investment activity. The high import content in export goods will also begin to contribute to the high rate of increase of imports. Imports of goods are thus expected to increase by almost 8 per cent in 1998 and by approximately 7 per cent in 1999.

Table 4.1 Exports and Imports of Goods and Services

	SEK, billion			Percentage change in volume			Percentage change in price				
	1997	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
Exports of goods	633.2	11.3	5.7	5.8	7.2	5.8	-0.2	-0.8	0.3	0.7	1.1
Processed goods	544.0	11.3	6.3	6.5	7.8	6.2	-0.9	-0.5	0.0	0.7	1.1
Exports of services	125.0	14.4	7.0	6.0	3.5	3.5	6.0	0.7	0.3	1.0	1.6
Total exports	758.2	11.8	5.9	5.8	6.6	5.5	0.8	-0.6	0.3	0.7	1.1
Imports of goods	497.8	10.7	7.8	6.9	6.7	6.0	0.6	-2.5	0.3	0.7	1.1
Processed goods	400.8	12.0	8.3	8.2	7.2	6.3	0.0	-0.8	-0.5	0.7	1.1
Imports of services	136.1	18.1	13.4	8.0	4.6	4.6	6.3	1.8	0.8	1.8	2.0
Total imports	633.9	12.0	8.8	7.1	6.3	5.7	1.9	-1.4	0.4	0.9	1.2

Note: Exports and imports in the table are reported in accordance with foreign trade statistics.
Sources: Statistics Sweden and Ministry of Finance.

Altogether, trade in goods is expected to provide a slightly negative contribution to growth this year. In the medium-term perspective, exports of goods are expected to increase by around 6.5 per cent in the year 2000 and by approximately 5.5 per cent in the year 2001, as a result of international economic growth.

4.2 Services Balance

The balance of services showed a severe deficit in 1997, due to the rapid increase in imports of services. According to the National Accounts figures, imports of services rose by approximately 18 per cent in 1997. During the first half of this year, the same item increased by 13.4 per cent compared with the same period last year. The services that have shown the largest growth are 'travel' and the item 'other services'. The travel item includes expenditure by private persons in connection with travel abroad as well as direct imports of cars, which have increased in recent years. The group 'other services' includes services which are mainly in demand by the business sector, such as, computing/IT services, building services, financial services, etc. Exports of services increased by 14.4 per cent in 1997. During the first half of 1998, exports of services increased by only 1.2 per cent compared with the same period for the previous year. The contribution to GDP growth from the balance of services was -0.2 percentage points in 1997 and for 1998 and 1999 it is expected to be -0.4 and -0.2 percentage points, respectively. The driving force behind this development is a continued increase in imports of services in parallel with an increase in domestic demand, particularly through increasing private consumption. An increase in private consumption is expected, for instance, to lead to increased tourism abroad in coming years.

4.3 Current Account Balance

The forecast for the current account balance has been revised downward considerably compared with the assessment in the Government Spring Bill. One reason for this is the significant deterioration in the balance of services which occurred in 1997 and which is expected to continue during

the period of the forecast. Another reason is a change in the assessment of export and import price movements. Despite the downward revisions, the current account balance is expected to continue to show a large surplus over the next few years. The surplus in the balance of trade compensates amply for the deficit in the balance of services and in net investment income.

The net investment income item is expected to improve during the period of the forecast, i.e. the deficit is expected to decline slightly. One reason for this is that the diversification of Swedish savings in foreign shares in recent years should have a positive effect on net share dividends. Net interest is also expected to continue to improve in 1998 and 1999, primarily as a result of a reduction in the borrowing requirement and thus lower interest payments. On the other hand, regular transfers, covering for instance some of Sweden's aid to developing countries and its contribution to the EU, are expected to increase during the period of the forecast.

The current account balance and, thus, Sweden's total financial balance, are expected to amount to just over 2 per cent of GDP in the years 2000 and 2001. Contributing to the high level of balance is the fact that general government finances should show an average surplus of 2 per cent over the period of the economic cycle.

Table 4.2 Current Account Balance

<i>SEK billion</i>					
	1997	1998	1999	2000	2001
Exports of goods	667.2	667.2	707.8		
Imports of goods	498.2	523.5	561.2		
Trade balance	138.6	143.7	146.6	160.3	170.1
Shipping	5.3	7.4	7.0		
Travel	-24.9	-34.0	-37.8		
Other services	0.9	-5.4	-7.9		
Services balance	-18.7	-32.0	-38.7		
Wages	-1.7	-1.7	-1.7		
Investment income	-45.6	-40.4	-37.3		
net interest	-62.1	-63.2	-60.1		
direct investment	22.6	26.0	25.0		
portfolio shares	-6.1	-3.2	-2.2		
Other transfers	-25.0	-28.0	-29.0		
Current account balance	47.7	41.6	39.9	44.4	49.4
Capital transfers	-0.3	0	0		
Financial balance, per cent of GDP	2.7	2.3	2.1	2.2	2.4

Note: The current account balance is according to Riksbank definition.
Sources: Riksbank and Ministry of Finance.

5 Business Sector Output

Business sector activity is expected to further strengthen during 1998 and 1999. Total output is estimated to grow by slightly more than 3.5 per cent per annum compared with 3 per cent for 1997. The export-driven upturn of last year has spread to more areas within the business sector during the first half of this year. A turnaround in construction activity occurred during the first half of this year and the recovery is expected to strengthen during the forecast period. Continued low interest rates and an improved financial situation for households are anticipated to result in an upturn in housing output while, at the same time, expansion within the business sector will lead to an increase in construction of commercial premises.

On the other hand, industrial activity will weaken somewhat during coming years. Lower global market growth will result in export firms entering a slower phase of expansion. Differences between growth rates in various industries are, however, large. The base industry is expected to be affected the most by the lower growth rate in the world economy, while the telecommunications industry will experience continued strong growth. The private services sector is expected to grow somewhat more rapidly during 1998 and 1999 than during the last few years. An increasingly larger share of the anticipated growth in output in the services sector will be derived from industries targeting households and from industries dependent on developments with investments, such as, the retailing of goods, hotels and restaurants, and consulting firms.

Table 5.1 Business Sector Output

Percentage change in volume

	1996	1997	1998	1999	2000	2001
Agriculture, fisheries and forestry	-3.0	4.6	0.0	0.5		
Manufacturing and mining	2.1	5.4	4.6	4.5	4.0	2.9
Electricity, gas, thermal and hydropower	0.2	1.8	0.5	-1.0		
Construction	0.8	-5.4	4.9	6.1		
Business sector services	2.6	2.9	3.5	3.6		
Total business sector	2.1	3.0	3.7	3.8	3.6	2.8

Sources: Statistics Sweden and Ministry of Finance.

In a medium-term perspective, that is, between 1999 and 2001, a larger share of growth in output in the business sector is expected to become

more focused on the domestic market. This will result in continued expansion in the construction sector, while the rate of increase for manufacturing and mining output will be lower than for the next two years, due to a decline in the contribution of net exports to economic growth.

5.1 Manufacturing and Mining

Industrial activity was strong for most of last year, with a marked increase in output during the second half of 1997. A strong contributing factor to this favourable development was continued prosperity within the electrical engineering and telecommunication products industries. These industries accounted for almost one-half of the total growth in manufacturing and mining output. During the first half of this year, industrial activity has slowed, mainly due to developments in the Asian region. As a result of the recession in Asia, market growth for Swedish export goods will be considerably lower both this year and next year compared with 1997, which will have a moderating effect on the output of export goods. The Swedish export industry is somewhat more exposed to the Asian region than EU manufacturing as a whole, but the crisis-affected countries in Asia constitute a comparatively small market.

Countries in Western Europe comprise the most important market for the Swedish export industry and strong investment activity within EU will compensate, to some extent, for the weak growth in Asia. The expansion of capital stocks in Europe is favourable for Swedish manufacturing, since it is largely specialised in the production of investment goods. However, there is a significant risk that the upturn in investment within EU will cease next year if the Asian crisis results in more widespread effects than has been assumed in the forecast.

The strong growth in domestic consumption and investment is also expected to result in a more rapid increase in output in domestic manufacturing than has been the case for the last few years. Overall, manufacturing output is estimated to increase by approximately 4.5 per cent both this year and in 1999. Consequently, the growth rate measured as an annual average is lower than for 1997. However, growth in output for the next 12 months will be considerably slower than last year, reflecting somewhat weaker industrial activity.

The increase in output up until and including 1999 is expected to be greatest in the investment goods industry, but growth in other industries targeting the domestic market will also increase. On the other hand, growth in production in the intermediate goods industry (the forest industry, among others) will be considerably lower than last year. The Asian crisis has significantly reduced the demand for intermediate goods and prices have fallen. According to the latest Business Tendency Survey for August from the National Institute of Economic Research, marked increases in stocks have arisen within the forest industry. This is expected to lead to production restrictions during the autumn.

Table 5.2 Selected Industrial Statistics

Percentage change

	1996	1997	1998	1999
Industrial production	2.1	5.4	4.6	4.5
Hourly wage costs	7.6	4.7	3.4	2.9
Productivity	2.4	6.5	4.0	3.5
Unit labour costs, (ULC)	5.1	-1.7	-0.6	-0.6
ULC, 14 OECD countries	1.0	-0.6	0.9	1.1
ULC, 14 OECD countries in SEK	-8.2	3.5	0.8	-0.3
Relative ULC, SEK	14.5	-5.3	-1.7	-0.4
Profit margin, change	-2.2	0.1	1.3	0.1
Gross operating surplus ¹	34.2	35.0	37.8	38.3

¹Gross operating surplus refers to the share of value added at factor prices. Sources: OECD, National Institute of Economic Research and Ministry of Finance.

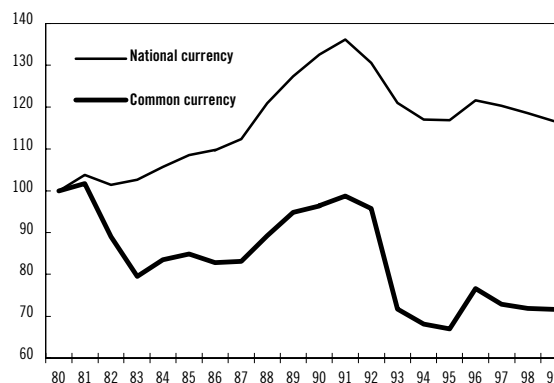
Industrial capacity utilisation rose to the high figure of 90.1 per cent during the second quarter of this year, but is expected to fall somewhat towards the end of 1999. The high investment level within manufacturing will result in capital stocks increasing by about 9 per cent between the end of 1997 and the end of 1999. At the same time, output within manufacturing is foreseen to increase by approximately 7 per cent. The fall in capacity utilisation in combination with a moderate increase in employment should ensure that the risk of bottlenecks causing inflationary pressures within manufacturing during the period up until the end of next year, is small or non-existent.

During the year immediately following the depreciation of the Swedish krona in the autumn of 1992, wages in Sweden increased more rapidly than in the rest of the world. In spite of this, the favourable competitive situation was largely retained due to the significant increase in productivity during this period. It is probable that the recession resulted in an increase in the potential

for rationalisation for a number of years and this, in turn, led to the high growth in productivity (see Chapter 6).

Diagram 5.1 Manufacturing and Mining's Labour Costs per Produced Unit in Sweden Compared with 14 OECD Countries

Index 1980 = 100



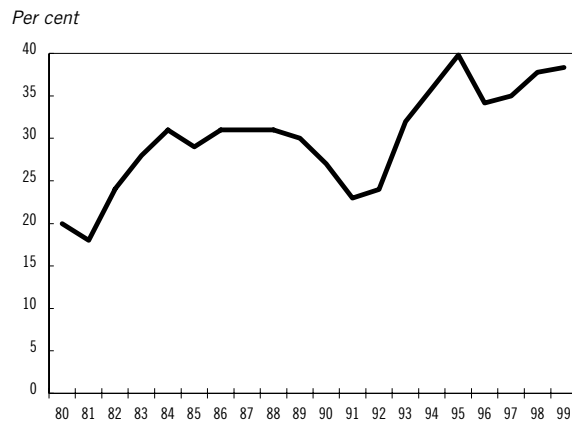
Sources: OECD, Statistics Sweden and Ministry of Finance.

The competitive situation for Swedish manufacturing will improve somewhat up until 1999 from an already favourable starting-point. Wages are expected to increase in line with wages in the rest of the world while, at the same time, Swedish growth in productivity will be slightly higher. As a consequence, relative unit labour costs in manufacturing, measured in a common currency, are estimated to decrease somewhat between 1997 and 1999. With the wage agreements reached in the spring, wages will probably develop up until the year 2000 in line with wages in countries that are Sweden's most important competitors. This will be a contributing factor to a decline in the previous very high productivity growth rate.

International price increases have been lower than was anticipated in the Government Spring Bill. Until now, the immediate effects of the Asian crisis have been falling prices in raw materials which has meant low or even falling prices for intermediate goods in both Sweden and the rest of the world. Apart from this, the Asian crisis is expected to result in price competitiveness gradually increasing for manufactured goods when industrial firms in the Asian region try to gain market share. In addition, wages and productivity will develop favourably, from a cost perspective, within the OECD countries during coming years which will limit total price increases for manufacturing products both this year and next. In all, prices in the world market will rise by slightly less than 1 per cent per annum, which

will also have a moderating effect on the price of Swedish manufacturing goods.

Diagram 5.2 Manufacturing and Mining's Share of Gross Operating Surplus



In Sweden, low import prices, limited wage increases and continued favourable growth in productivity are expected to result in variable costs per produced unit remaining more or less the same between 1997 and 1999. At the same time, the relatively weak Swedish krona is expected to allow export firms to increase their profit margins to a limited extent. The forecast assumes that firms experiencing tighter conditions in the domestic market will improve their profitability somewhat during the coming years when domestic demand picks up. For manufacturing and mining as a whole, product prices weighted together are estimated to rise by slightly less than 1 per cent per annum. This will result in profitability, measured as gross operating surplus as a percentage of added value, rising to 38.3 per cent in 1999, which is a high level in comparison with other OECD countries. The expected small rise in prices within manufacturing will contribute to consumer prices increasing at a very slow rate for some time to come.

5.2 Construction

Construction activity has gradually strengthened this year after having experienced weak growth in 1997. The turnaround this year is mainly the result of increased construction investment in the business sector together with an increase in civil works construction (for example, the Öresund Bridge). As from next year, residential invest-

ment is expected to take over as the driving force behind construction activity. In all, production is estimated to increase by 5 per cent this year and by 6 per cent next year.

Table 5.3 Construction

	SEK, billion		Annual percentage change		
	1997	1996	1997	1998	1999
Construction investment	101.7	1.9	-13.1	8.3	10.4
Business sector	56.5	0.9	-5.2	9.3	8.3
Authorities	21.3	-7.8	-16.2	7.9	1.3
Housing	23.8	13.1	-25.7	6.2	23.5
Repairs and maintenance	85.2	1.1	3.9	0.7	0.0
Total	186.9	1.6	-6.6	5.0	6.1

Sources: Statistics Sweden and Ministry of Finance.

During recent years, general economic growth has rapidly improved the conditions for construction activity. Total GDP growth in the economy is expected to be good during the years leading up to the turn of the century while, at the same time, interest rates will remain at present low levels. The construction industry can therefore be expected to expand heavily during coming years and grow in line with, or more rapidly than, the overall economy.

Residential construction has been low since the beginning of the 1990s. This, together with the reduction of housing subsidies and the extremely high real rates of interest, has resulted in an adjustment of housing stocks to new equilibrium levels. The adjustment process is now likely to be more or less completed, which is expected to mean that favourable household incomes together with improvements in the labour market situation will lead to a gradual increase in the demand for housing. Most indicators point to an improvement in residential construction. In growth regions, the price relationship between newly constructed housing and housing in the second-hand market is such that construction is proving profitable. The order situation for construction consultants and architects has also improved, and the latest Business Tendency Survey for the construction industry from August, indicates increased residential construction from now on. As a result of lengthy lead times in the construction process, a more marked upturn in residential construction will probably not be noticeable until next year.

The significant increase in output within the business sector is expected to result in an expan-

sion in capacity in coming years. Construction of new commercial premises has been very low during recent years. Investment has mainly been in the renovation of and extensions to existing properties. However, the relatively marked increase in consumption together with developments in employment should result in a gradual increase in new construction of, above all, commercial and office premises. The vacancy ratio, that is the number of vacant premises in relation to supply, has fallen to levels that justify new construction in expanding areas, at the same time as profitability can be significantly improved. A number of government investment programmes will also contribute to the increase in output in the construction sector during coming years. For instance, approximately SEK 1.5 billion per annum has been earmarked for a conversion programme for the energy sector. For the period 1998 to 2001, a total of SEK 6.8 billion has been allocated for a programme for ecological sustainability. This year, civil works construction will be further supported by the building of the city ringroads and the Öresund Bridge.

6 The Labour Market

Towards the end of last year, employment began to rise. So far this year, the number of people employed has increased by around 60,000, when adjusted for seasonal variations, and now lies at approximately the same level as at the beginning of 1996. The supply of labour, which fell heavily in autumn 1997, has also risen since the start of the year, although not as rapidly as employment. Altogether, the rise in employment and the growth in the supply of labour mean that the figures for registered unemployment will fall from 8.0 per cent in 1997 to 6.6 per cent this year. The prognosis for coming years is for favourable economic development in both Sweden and the rest of Europe, which should lead to a continued rise in employment. At the same time the supply of labour will be held back as the number of education and training places increases even further. This will result in registered unemployment falling to 4.0 per cent by the end of the year 2000. The conditions necessary for good economic growth and a strong growth in employment are a continuing good global economy and the labour market and wage formation functioning properly. To bring registered unemployment down to 4.0 per cent also requires that the education and training initiative be aimed at persons who would otherwise have been registered as unemployed as well as all the extra education and training places being made available.

Table 6.1 Labour Market

Annual percentage change

	1997	1998	1999	2000	2001
GDP, producer prices	2.0	3.1	3.1	3.0	2.4
Productivity	2.9	2.0	1.9	1.4	1.4
Number of hours worked	-1.1	1.1	1.2	1.5	1.0
Average hours worked	-0.1	-0.2	-0.3	-0.2	-0.1
Number of employed	-1.0	1.3	1.5	1.8	1.1
Labour force	-1.1	-0.2	0.5	0.4	0.6
Registered unemployment ¹	8.0	6.6	5.7	4.4	4.0
Labour market programmes ¹	4.3	3.9	3.9	3.8	3.5

¹ Percentage of labour force.

Sources: Statistics Sweden, the National Labour Market Board and Ministry of Finance.

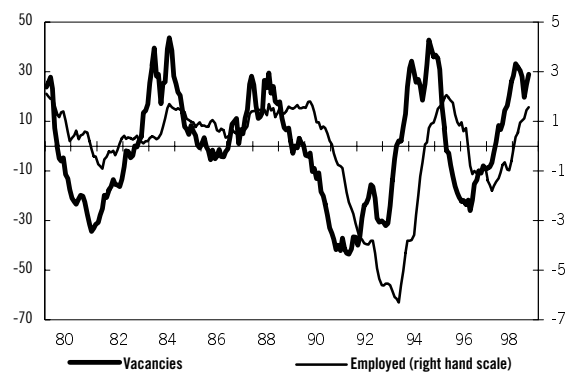
Employment

During the next few years, employment is expected to rise at a relatively rapid rate as a result of a strong upturn in output. This year, the num-

ber of people employed is expected to rise by 52,000 and next year it is expected to rise by 59,000 persons, measured as an annual average. One factor, which supports the assumption of a rise in employment, is that the number of job vacancies has increased gradually since the middle of 1997. From an historical point of view, this has been a good indicator of the development of employment. Diagram 6.1 shows that the development of employment has followed the development of the number of job vacancies accompanied by a slight lag.

Diagram 6.1 Number of Newly-Reported Vacancies and Number of Employed

Annual percentage change



Sources: The National Labour Market Board and Statistics Sweden.

The National Labour Market Board's latest survey of 9,000 work places also shows that optimism with regard to the next few years has increased considerably both within the business sector and the general government sector. For the first time during the 1990s, all the Swedish counties are positive in their assessment of future employment prospects, according to the National Labour Market Board.

Employment in the business sector has increased by approximately 35,000 people so far this year, when the figures are seasonally adjusted. It is mainly the private services sector that has been behind this rise. However, manufacturing and the construction sector have also noted some upturn. Employment in agriculture and forestry, however, is continuing to fall.

The demand for private services is expected to continue to be strong as a result of private consumption rising and investment activity increasing. It is therefore expected that this sector will also show the largest rise in employment next year. Manufacturing output is expected to grow at roughly the same rate next year as this year. To meet this rise in production, it is estimated that

employment within manufacturing needs to rise by 17,000 people between 1997 and 1999. Activity in the construction sector has risen weakly this year. Next year, a more marked increase in residential construction is expected, which will lead to a rise in employment of 8,000 people, measured as an annual average. Altogether, the number of people employed in the business sector is expected to increase by approximately 86,000 between 1997 and 1999.

Employment within municipal authorities has increased by approximately 25,000 people, when seasonally adjusted, since the beginning of this year. The rise in employment is probably an effect of the fact that central government grants to the local government have been raised and by the need of recruitment for teachers increasing in connection with the expansion in the number of education and training places. Employment is also expected to rise slightly within municipalities and county councils in 1999. However, the scope for an increase in employment is limited, as both municipalities and county councils are bound to achieve a balanced budget with effect from the year 2000 (see Chapter 11). Employment within central government authorities is expected to decline slightly. Overall, employment within the general government sector is expected to rise by 24,000 people between 1997 and 1999.

Table 6.2 Employment in Different Sectors

Thousands	1997	1998	1999	2000	2001
<i>Private sector</i>	2695	2732	2781	2842	2874
Agriculture and forestry	109	102	98		
Manufacturing and mining	800	806	817		
Construction	218	220	228		
Private services	1569	1604	1638		
<i>Public authorities</i>	1223	1238	1247	1258	1270
Central government	189	188	188		
Local government	1034	1050	1060		
Total	3922	3973	4032	4104	4148
Total labour force	4264	4255	4276	4294	4321

Sources: Statistics Sweden and Ministry of Finance.

Given continued positive developments in the global economy, GDP is expected to rise by approximately 3 per cent per annum in the years 2000 and 2001 i.e. at almost the same rate of increase as in the years 1998 and 1999. The neces-

sary conditions for such a relatively strong rise in GDP is that the labour market and, in particular, wage formation function well so that the available resources in the labour market can be mobilised, without wage rises pushing up inflation. In the light of the good growth in the economy, it is estimated that employment could increase by a further 116,000 people or so between 1999 and 2001. Similar to the situation in the years 1998 and 1999, the largest rise in employment will take place within the private sector.

Diagram 6.2 Number of Employed and People in Labour Force



Sources: Statistics Sweden and Ministry of Finance.

Average Hours Worked

The number of hours worked is expected to develop slightly more weakly than the number of those employed during the forecast period. This is due to the fact that the average number of hours worked is expected to fall slightly, partly as a result that sick leave, which has fallen considerably thus far in the 1990s, is likely to rise slightly as the labour market situation gradually strengthens. So far this year, a slight rise in the amount of sick leave has been noted. Another factor, which may contribute to a reduction in the average number of hours worked, is that several central wage agreements signed this year include a reduction in working hours. Some agreements also contain an increased opportunity for a more flexible distribution of working hours, which may lead to less overtime.

Productivity

During the period 1998-2001, productivity is expected to increase at a slower rate than would be suggested historically with a GDP growth rate of 3 per cent per annum. The increase in productivity is also expected to be lower than the average so far during the 1990s. The rapid increase in productivity during the economic recession at

the beginning of the 1990s was probably temporary and most likely caused by a number of interdependent factors. One partial explanation may be that the very weak economy created pressures for rationalisation. This meant that firms with relatively low productivity potential could not cope with the competition and were pushed out of the market and that it was primarily people with relatively high competence and work capacity who managed to obtain and retain jobs. Rapid progress in information technology and deregulation in certain industries have probably also contributed to a high growth in productivity. It is difficult to determine whether the rapid increase in recent years indicates a trend towards higher productivity growth, but the assessment is that the rationalisation potential is lower today than it was at the beginning of the 1990s. In addition, the profit levels of manufacturing firms are high, seen from both an historical and an international perspective, which reduces rationalisation pressures. If the wage increases are limited to approximately 3 per cent for the next few years, this will contribute to lower rationalisation pressure. The driving forces behind the rise in output are also assumed to switch from export to domestic demand, which tends to moderate increases in productivity.

Labour Market and Education & Training Policy Measures

In recent years, several different types of new measures have been introduced. The number of education and training places in both adult education and at universities and colleges has increased. As part of labour market policy, such things as, temporary severance pay, resource work, the IT initiative and increased municipality involvement to activate young people have been introduced. Temporary severance pay means that unemployed people between the ages of 60 and 64 in autumn 1997 were given the opportunity to receive unemployment benefits without needing to put themselves at the disposal of the labour market for the years remaining until their retirement. According to the National Labour Market Board, approximately 18,500 people received this type of measure. Resource work means that employers in the general government sector are given the opportunity to take on a person who has been long-term unemployed, to carry out quality improvement work for a limited period of time for a remuneration equivalent to unemployment benefits. The greatest number of peo-

ple involved in this measure was just over 5,000 in spring 1998. The IT initiative is an agreement between the government, the Federation of Swedish Industries and representatives of IT-firms to introduce training within the framework of labour market policy programmes. This training is expected to comprise 10,000 people from December 1, 1997 to the end of 1999 and is aimed at counteracting the lack of competent and professionally qualified personnel in the IT field. Despite the introduction of several new measures in recent years, the average number of people in labour market policy measures has declined by approximately 20,000 between 1997 and 1998. The main cause of this is that the number of places in work experience schemes and work place introduction programmes has declined compared with last year. The estimated volume of measures in 1998 has been revised downward compared with the Government Spring Bill, from 179,000 to 165,000. This volume is assumed to remain the same in 1999 and 2000, to then decline to 150,000 in 2001.

Table 6.3 Labour Market Programmes

Thousand people

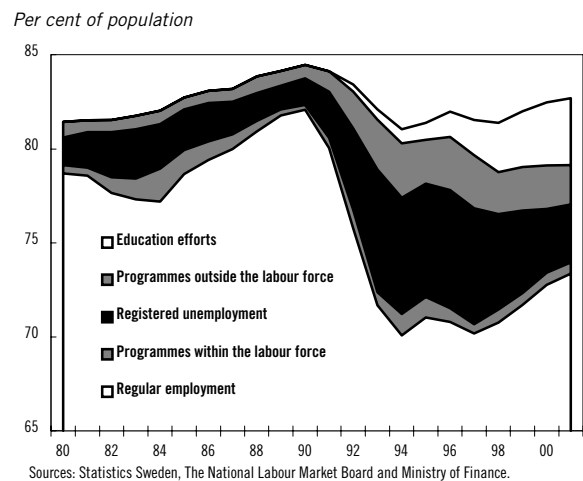
	1996	1997	1998	1999	2000	2001
<i>Within the labour force</i>	41	32	38	40	36	33
Temporary employment	8	7				
Recruitment subsidy	12	4				
Trainee temporary replacement scheme	10	4				
Start-up grants	10	12				
Public temporary workers	0	5				
<i>Outside the labour force</i>	155	152	127	125	129	117
Labour market training	46	37				
Work experience scheme	52	53				
Local government programmes for young people	13	14				
Computer centres	12	14				
Workplace introduction	32	34				
Total	196	185	165	165	165	150

Note.: For the years 1998-2001, local government responsibility for young people under 25 years of age are included within labour market programmes. For 1997 and 1998, people within resource work and the IT-initiative are also included. People within recruitment subsidy, trainee temporary replacement and temporary employment programmes are placed together under the individual employment support programme. Sources: The National Labour Market Board and Ministry of Finance.

The Labour Force

The supply of labour fell heavily in autumn 1997, mainly as a result of the number of places in adult education and universities and colleges being increased and of the introduction of temporary severance pay. Since the beginning of the year, more people have sought their way into the labour market as employment has increased. This development is expected to continue over the next few years. However, the rise will be limited by the further expansion in the number of education and training places. On the other hand, temporary severance pay granted in autumn 1997 will contribute to a higher net addition to the supply of labour over the coming five years than if this measure had not been introduced. The reason for this is that the number of people who will retire at the age of 65 is becoming fewer i.e. people leaving the labour market as a result of retirement will become less than it would otherwise have been. This year, the supply of labour will also be affected by the number of people in labour market programmes who are not counted as part of the work force declining compared with last year. Overall, the supply of labour is expected to rise by approximately 40,000 people during the course of 1998. When measured as an annual average, however, the labour force is reduced by just over 10,000 people as a result of the heavy fall last autumn. Between 1998 and 2001, the supply of labour will increase by a further 65,000 people or so, while almost 50,000 people are expected to become part of the available labour force. This means that the labour force participation rate i.e. the labour force as a percentage of the population, will rise from 76.8 per cent in 1997 to 77.0 per cent in the year 2001. This is still approximately 7 percentage points lower than in the year 1990, when the labour force participation rate lay at a record high level. If one adds to this the increase which has occurred in the number of study places and the number of labour market policy programmes outside the labour force since the year 1990, a broader measure of the supply of labour is obtained. This extended measure fell from just over 84 per cent of the population between 16 and 64 years of age in 1990 to a lowest point of 81 per cent in 1994, after which it is expected to rise to almost 83 per cent in the year 2001.

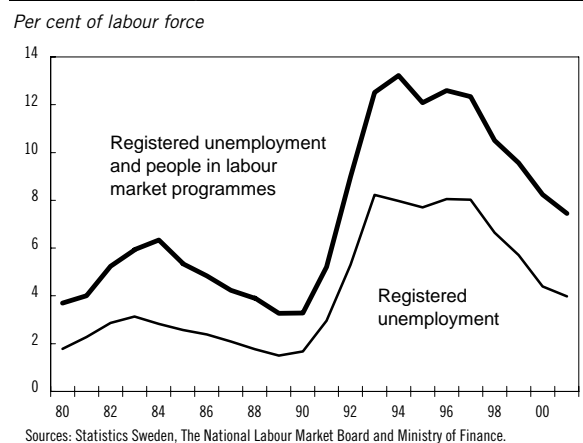
Diagram 6.3 Population in Age Group 16 – 64 Distributed by Group



Registered Unemployment

Since the summer of 1997, registered unemployment has fallen by just over 1.5 percentage points to approximately 6.5 per cent, when seasonally adjusted. During the next few years, the rapid rise in employment, combined with relatively modest growth in the supply of labour, is expected to lead to registered unemployment falling to 4.0 per cent by the end of the year 2000. The labour market policy measures will then comprise approximately 3.5 per cent of the labour force.

Diagram 6.4 Registered Unemployment and People in Labour Market Programmes



Risks in the Forecast

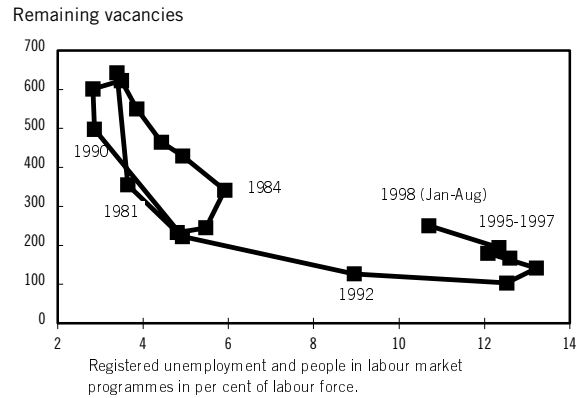
A prerequisite for being able to reduce unemployment to 4.0 per cent is that the education and training initiatives will continue to be aimed at people who would otherwise be registered unemployed and that the number of education and training places increases as planned. During autumn 1997, there were no major difficulties in

filling these new places. This may be more difficult in the future, as a result of, for instance, a shortage of teachers or problems recruiting people with the right educational and training needs. The prospect of filling the number of education and training places up to next summer increased in that the right to obtain a study grant for adult education was extended from 1 to 2 years for those who began their courses in autumn 1997.

Although the conditions for high economic growth and a rapid increase in employment are good, there is a risk that employment will develop more weakly than assumed in the forecast. The global economy may weaken if the crises in Asia and Russia become more extensive and prolonged than assumed in the forecast. The consequences for Swedish growth and employment of this type of development are dealt with more closely in Chapter 12. Another risk is that wage rises could increase by more than 3 per cent per annum (see Chapter 7). This problem may arise if firms, despite high unemployment, cannot recruit sufficient competent labour or if matching problems arise in the labour market as a result of a lack of mobility in terms of geography, profession or industry. This could lead to a higher wage drift and poorer growth in employment than assumed in the forecast. There are presently already signs that there is a shortage of certain types of labour. According to the National Labour Market Board, the county labour boards are pointing out that there are growing shortages in a number of professional groups. The National Institute of Economic Research's surveys for manufacturing and for the services sector indicate that there is primarily a shortage of technicians and industry-specific specialists in certain sectors, particularly the computer industry and consulting. The number of new vacancies registered is also tending to remain in place to a greater extent than before, which may mean that the employers are finding it difficult to find the right people to employ. The matching problems in the labour market can be illustrated by a Beveridge curve, which shows the total of registered unemployed and people within labour market policy programmes in relation to the number of remaining job vacancies (see diagram 6.5). The listing for 1998 shows that the number of remaining vacancies has increased, at the same time as the total number of unemployed and people within labour market programmes have declined. The curve also shows that the number of remaining job vacancies is higher than before at a

given level for the total of people within programmes and unemployed. This indicates that it is more difficult to fill the vacancies now than it was before i.e. matching problems seem to have increased.

Diagram 6.5 The Beveridge Curve



Sources: Statistics Sweden and the National Labour Market Board.

7 Wages

Centralised wage agreements for the years 1998-2000 have now been finalised for virtually the whole of the labour market. The majority of agreements run for 3 years. In many of the agreements, however, the final year of the agreement may be cancelled. For the economy as a whole, it is estimated that the agreements will result in wage increases on average of 2.6 per cent per annum, which is approximately one percentage point lower than the agreed wage increases that the previous wage agreement gave rise to. In some agreements, the parties or independent arbitrators have also reported estimates of wage drift for the next few years. The assessments vary between 0 and 0.8 per cent per annum, with a weighted average of 0.5 per annum. The forecast presented here is dependent on the increase in wages being in accordance with these estimates i.e. that wage drift for the whole labour market is limited to an average of 0.5 per cent per annum. Total wage increases are estimated in this context to be slightly more than 3 per cent on average per annum for the years 1998-2001.

Table 7.1 Hourly Wages

Annual percentage change

	1996	1997	1998	1999	2000	2001
Manufacturing and mining	7.4	4.5				
Agreement	3.7	3.1	2.9	1.5	2.4	
Wage drift	3.6	1.4				
Construction sector	3.4	3.8				
Agreement ¹	2.6	3.8	3.1	1.9	–	
Wage drift	0.8	0.0				
Private services	5.6	4.4				
Agreement	4.5	3.6	3.1	2.7	2.5	
Wage drift	1.1	0.8				
Central government authorities	7.4	4.3				
Agreement	5.0	3.5	1.9	2.5	2.5	
Wage drift	2.4	0.8				
Local government authorities	5.8	4.8				
Agreement	5.3	4.7	2.3	2.7	3.5	
Wage drift	0.5	0.1				
Total	6.0	4.5	3.3	2.9	3.2	3.0
Agreement	4.4	3.8	2.8	2.4	2.7	
Wage drift	1.7	0.7	0.5	0.5	0.5	

¹The agreement for construction workers, which is the largest group within the construction sector, runs only until the 31 September 1999. No agreement is therefore included in the table for this sector in the year 2000. Sources: Statistics Sweden and Ministry of Finance.

The Agreements

Since the last round of wage negotiations in 1995, negotiation arrangements in some agreements have changed, and this has probably affected the wage negotiations this year. In connection with the Government Spring Bill for 1996, the government requested the parties in the labour market to submit their views on future wage formation and to jointly formulate the changes to the negotiating system and wage formation necessary to ensure that wage formation functions more efficiently. The background was that the 1995 wage negotiations resulted in comparatively high wage increases. The proposed actions, which the various parties submitted, differed significantly from each other. It emerged, however, that there was a broad area of consensus among parties in the labour market regarding the importance of wage formation in combating unemployment. The most concrete change took place within manufacturing and mining, where the parties signed an agreement, which included, among other things, new negotiating arrangements.

Another change from the previous wage negotiation round is that employers were seen to place greater weight on the co-ordination of wage negotiations. Employers in the private sector advocated that agreements within the manufacturing industry exposed to competition, where the negotiations were run on the basis of the new and more structured negotiating arrangements, should be concluded before other agreements. From the viewpoint of the employees, the unions affiliated to the Swedish Trade Union Confederation were all united around a co-ordinated wage claim, which was valued in total at 3.7 per cent, including wage drift.

The wage negotiations this year resulted in agreements which are estimated to lead to wage increases on average of 2.8 per cent this year, 2.4 per cent in 1999 and 2.7 per cent in the year 2000 for the economy as a whole. The somewhat lower figure for wage increases in 1999 than in the other years is due to the fact that some of the three-year agreements are divided into two periods i.e. revisions to the agreements will take place on two occasions only, at the beginning of 1998 and at the end of 1999. This means that wage increases measured as an annual average will be low in 1999.

In several of the agreements concluded this year, the previously introduced trend towards more freedom for wage determination at the local level has further strengthened. In some of the

agreements there are no centrally determined wage increases. In a number of other agreements, a general wage increase is laid down which will only apply in the event that the parties do not reach agreement at the local level. This makes it difficult to determine what the final wage increases resulting from the agreements will be. It also makes it more difficult to distinguish between agreed wage increases and wage drift.

For the majority of local government employees, only the minimum threshold for wage increases has been laid down. This means that there is considerable uncertainty over the size of final wage increases.

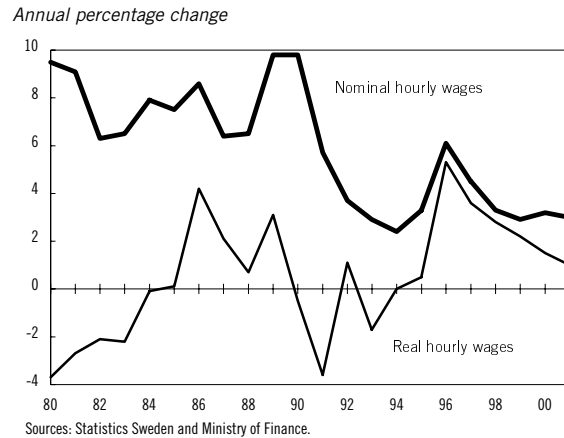
One element common to many agreements is that, within the framework of the total agreed wage increases, a certain amount of flexibility in wages has been allowed for cutting working hours. In some agreements, reductions in working hours can be taken as increased time off, pension or increased wages. Flexibility in accommodating working hours has also increased in some agreements.

Wage drift

Since 1980, wage drift has amounted on average to just over 2 per cent per annum. The greatest wage drift has been recorded within manufacturing and mining. Since the mid-1990s, wage drift has been somewhat lower than the historical average, at just over 1 per cent per annum. This must still be regarded as relatively high wage drift, given the weak labour market situation and the relatively high wage rises agreed in the 1995 round of wage negotiations. In addition, inflation has been very low over recent years, significantly lower than inflationary expectations at the time of the wage negotiations in 1995. This should have contributed to low wage drift, since increases in real wages were considerably higher than the parties contemplated when the agreements were signed.

There are several factors that suggest that wage drift in the next few years can be limited to 0.5 per cent per annum. Price pressures in the economy are expected to continue to be low (see Chapter 8), and this can be expected to moderate wage drift. Real wages will, with the nominal wage increases assumed in the forecast, rise on average by 2.2 per cent per annum. This is considerably more than the average increase in real wages between 1970 and 1997.

Diagram 7.1 Hourly Wage Growth in Total Economy



Since individual wage determination will take place to a greater extent than before at the local level, employers will have greater opportunity to distribute wages directly with reference to individual performance and the recruitment situation. That means that there is less of a need than before to adjust the relative wage position among their employees via wage drift. In some agreements there are also elements of greater flexibility in accommodating working hours, and this may lead to reduced overtime costs.

Other factors which point towards low wage drift are that as from 1999, it is not anticipated that there will be any more rises in employee contributions and income tax, and that greater attention will be paid to wages than was the case in the last round of wage negotiations. The co-operation agreement within the manufacturing industry, the Swedish Trade Union Confederation's common wage claim, and the estimates of wage drift made by the parties or the arbitrators in some agreements, are likely to place greater pressure than before on the parties to hold wage drift down. That the views on future wage formation contained in the submissions from the different parties show a broad consensus on the importance of wage formation in combating unemployment, probably contributed to ensuring that the agreements for the years 1998-2000 will be lower than for the preceding three-year period. It may also be expected to contribute to limiting wage drift, so that total wage increases will not lead to deterioration in Sweden's competitiveness and to retarded growth in the economy. Firms have limited scope to pass increased costs on to consumers, when monetary policy is aimed at achieving the inflation target. International price competition, which will probably become sharper in the near future as a consequence

of the effects of the Asian crisis on the world economy, will also make it more difficult to raise prices. In the light of this, high wage increases will principally create pressure on firms to rationalise their operations, which has a moderating effect on growth in employment. If firms are unable to increase productivity at the same rate as the rise in real wages, their profit margins will fall. This will also act as a brake on growth in the economy, and will impair growth in employment. Increased awareness of these relationships is likely to contribute to low wage drift.

Even though there are a number of factors which point to low wage drift in the future, there is still a risk that wage drift will be higher than is assumed in the forecast. As demand for labour increases, there may be a shortage of workers in certain industries, and this can increase wage pressures. If wage drift will be high in certain industries or for some professional groups, there is a risk that wage drift will also be driven up in other industries as well. Historically, there has been substantial linkage between wage increases in different industries and sectors, despite the fact that conditions, such as the profit situation or developments in employment, have varied.

As mentioned above, some agreement structures make it difficult to determine the size of wage increases. The fact that the majority of local government employees have only been given a minimum threshold for the agreement may involve substantial wage increases over and above this threshold, which would be recorded as high wage drift within this sector. Only the Swedish Municipal Workers' Union has laid down definitive agreed wage increases. The agreement gives a wage rise approximately 1 percentage point higher per annum than the increases defined as the minimum threshold in the other agreements. This involves a risk that wage increases in other areas will exceed the minimum threshold by 1 percentage point. This applies in particular to members of the Swedish Association of Health Professionals, who have been promised for the years 1998 and 1999 0.5 percentage points more than the other county council employees, under an agreement signed in 1995.

International Comparisons

So far during the 1990s, wages in Sweden have risen by a few tenths of a percentage point per annum more than the average in the rest of Europe. The substantial increases in costs have been offset by a weaker currency and a more

rapid growth in productivity in Sweden. In the next few years, productivity is expected to grow at about the same rate as in the rest of Europe. At the same time it is assumed that the Swedish krona will strengthen. In this context it is important that wages in Sweden do not increase more rapidly than in most countries important to Sweden in terms of competition. This will avoid any deterioration in competitiveness for Swedish export industries. If firms cannot compensate for possible higher cost increases through rationalising their operations or reducing their profit margins, they will be forced to increase export prices. This would lead to reduced demand for Swedish goods, which would curb growth and employment. The wage increases assumed in the forecast are generally in line with developments in the rest of Europe.

Table 7.2 Compensation per Employee in the Business Sector According to OECD¹

<i>Annual percentage change</i>				
	1996	1997	1998	1999
Germany	2.4	2.2	1.8	1.9
France	2.8	3.3	2.3	2.4
Italy	4.3	4.4	3.2	2.8
Great Britain	3.3	4.9	5.4	4.8
Austria	2.0	2.0	2.2	2.7
Belgium	1.0	2.7	2.5	2.6
Denmark	3.6	4.0	4.3	4.7
Finland	2.9	1.7	3.4	2.8
Greece	10.9	9.5	6.7	5.5
Ireland	3.5	4.9	6.0	5.9
the Netherlands	2.1	2.5	2.7	3.6
Portugal	5.5	6.0	4.1	4.0
Spain	3.6	3.1	3.0	3.5
Sweden ¹	6.2	3.6	4.1	4.0
EU	3.3	3.5	3.1	3.1

¹OECD's forecast. See footnote 1.

Sources: OECD Economic Outlook, June 1998.

¹The OECD's estimate of compensation per employee include social insurance fees such as sickness insurance, while other employer contributions, which are pure payroll taxes, are not included. In Sweden, a change between social insurance fees and payroll taxes occurred in 1997, which held back labour costs by 1.1 percentage points according to the OECD estimate, notwithstanding that the change does not affect total employer contributions. Because labour costs are measured per employee and not per hour, the estimate is also affected by changes in average hours worked.

8 Inflation

Inflationary pressures in the Swedish economy are currently very low. This is illustrated, for instance, by the fact that the consumer price index (CPI) was unchanged between August 1997 and August this year. Conditions are favourable for low price increases in the future. Moderate wage increases, good productivity growth, modest international price rises, as well as low inflationary expectations among households and firms, are contributing to holding down consumer prices in Sweden. The development of the CPI this year is largely governed by temporary effects, such as, falling interest rates and certain changes in taxes and subsidies. Inflation is expected to remain around zero for the rest of 1998. Next year, inflation is expected to increase by about 1 per cent during the course of the year.

Wages are expected to increase moderately for the years 2000 and 2001 as well, while productivity growth will weaken to some extent. It is assumed that the Riksbank will achieve its inflation target, which will make inflation about 2 per cent for the year 2001. Since consumer prices are expected to rise by about 1 per cent during the course of 1999, the annual average for the year 2000 is estimated at 1.7 per cent.

Housing Costs

An important explanation for the low growth in prices this year is the reduction in housing costs. The housing item constitutes one-third of the total CPI, and is, therefore, highly significant for the inflation rate measured. During the first half of the year, the limit for the tax reduction for repairs and extensions to housing was raised and property taxes were reduced. This resulted in lower housing costs for households as these are measured in the CPI. With lower interest rates, the interest expenditure for homeowners continued to fall. Mortgages which successively are maturing are normally renewed at a lower interest rate. In August this year, this cost reduction contributed to a fall in inflation of 0.7 percentage points. For the rest of 1998 and for 1999, it is expected that lower interest rates will hold down inflation. The fall in interest expenditure for homeowners is, however, expected to be significantly slower next year, which is an important explanation for the fact that prices are expected to increase rather faster during 1999 than during 1998.

In addition to the above-mentioned factors, the low housing costs so far this year are explained by the modest increase in rents for rental apartments. From December 1997 up to and including August this year, rents increased by only 0.7 per cent. Since the majority of tenancy agreements are signed during the first half of the year, this indicates that increases in rent will be barely 1 per cent this year, which is low in historical terms. In recent years, rents have increased by approximately 3-4 per cent per annum, and this has raised the CPI to a significant extent. Low interest rates and the temporary reduction in property taxes for multidwelling apartment buildings next year, among other things, indicate that rents will increase moderately over the next few years as well.

Wages and Producer Prices

Wage costs are highly significant for the development of prices and employment. During the years 1995-1997, wages rose on average within the business sector by almost 5 per cent, and in general government authorities by over 4 per cent per annum. Agreements concluded so far during 1998 indicate a significant downturn in the rate of wage increases. If this does not occur, there is an imminent risk of prices increasing rather more rapidly, and, through a tightening in monetary policy, employment increasing more slowly than has been assumed in this forecast. Consequently, wage formation appears as a risk in the forecast.

Table 8.1 Consumer Prices

	Annual percentage change				
	1997	1998	1999	2000	2001
CPI, year-on-year	0.9	0.5	0.7	1.7	2.0
CPI, Dec-Dec	1.9	0.1	1.1	2.0	2.0
Base amount (thousand)	36.3	36.4	36.4	36.7	37.3
HICP ¹ , year-on-year	1.8	1.2	1.1	-	-
HICP ¹ , Dec-Dec	2.7	0.5	1.5	-	-
NPI, year-on-year	-1.2	-1.4	0.7	-	-
NPI, Dec-Dec	-0.9	-0.5	0.6	-	-
CPI, OECD ² , year-on-year	2.0	1.5	1.8	2.0	2.0

¹ Harmonised index for consumer prices within EU.

² OECD refers to 16 countries, see chapter 2.

Sources: Statistics Sweden and Ministry of Finance.

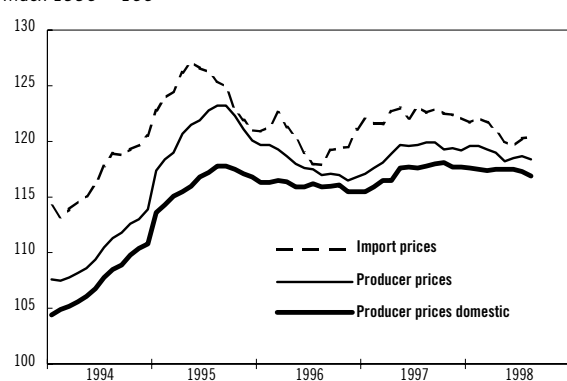
Excessive wage increases can create inflationary pressures, among other things, through increased production costs in manufacturing industry. During the period 1995-1997, productivity in manufacturing grew by almost 5 per cent per an-

num. The extensive improvements in efficiency largely balanced the wage increases, and this has contributed to keeping producer and domestic market prices relatively stable in the past few years (see Diagram 8.1). For example, manufacturing prices for the domestic market have been virtually unchanged from mid-1995 to August this year. Estimated investment for the manufacturing industry is high both for this year and next, which points to continued high growth in productivity. The expansion of productive capacity is likely to assist in avoiding inflationary bottlenecks over the next few years, despite expectations of a continued rise in industrial production.

Since an ever-increasing proportion of manufacturing intermediate goods is imported, developments in international prices and movements in the exchange rate have a major effect on production costs for manufacturing. The comparatively weak increase in producer prices in more recent years is partially explained by the strengthening of the Swedish krona during 1995 and 1996. The advantageous growth in productivity and the low wage increases in OECD countries, together with the Asian crisis, have held down world market prices. The Asian crisis has led to fierce international competition, which is forcing down prices, as indicated by, for example, the National Institute of Economic Research's Business Tendency Survey from August this year. The Survey shows that Swedish manufacturing firms expect a continued sharp fall in sales prices on export markets.

Diagram 8.1 Producer and Import Prices

Index 1990 = 100



Source: Statistics Sweden.

Over and above their effects on production costs, import prices are also important for Swedish consumer prices through the fact that a signifi-

cant part of household consumption is made up of goods produced abroad. Low international price increases and the assumed strengthening of the krona will cause import prices to decrease this year, which will contribute to lower Swedish consumer prices. Next year, global raw materials prices are expected to rise, and this will provide a modest boost to inflation in Sweden.

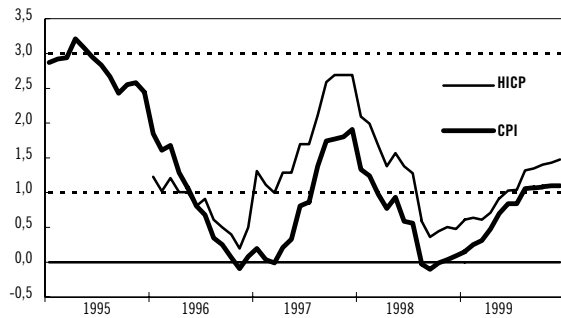
Inflationary Expectations and Household Demand

The low and falling inflation rate over the past few years has led to a substantial fall in inflationary expectations. Statistics Sweden's Survey shows that household inflationary expectations for one year ahead have been at or below the Riksbank's inflation target for some time. The business sector also expects price increases to be modest in the future. Both the National Institute of Economic Research's Business Tendency Surveys and Prospera and Aragon's research into the commodity and money markets show that inflationary expectations over a 2 to 5 year horizon are well within the Riksbank's tolerance interval for inflation. The fall in long-term nominal interest rates from 1995 can also be interpreted as indicating that market expectations of future inflation have become lower. The increase in interest rates, which took place in August this year, can probably not be interpreted as increasing inflationary expectations. The somewhat higher interest rates are explained rather by the fact that the risk premium has increased on, for example, Swedish bonds as a result of the global uncertainty in the financial markets. Treasury bills futures with settlement in six months i.e. expected future short-term interest rates as of today, are still low, which indicates that the market does not expect a tightening of monetary policy in the next few months. Taken together, the falling inflationary expectations of households and the business sector show that the Riksbank's price stability targets have gained public confidence. This has reduced inflationary tendencies in the Swedish economy.

A factor, which will probably contribute to somewhat higher consumer prices in the next few years, is an increase in private consumption. In this forecast, it is assumed that the expansion of household demand, in combination with modest cost increases, will create scope for producers and sellers to raise profit margins over the next few years.

Diagram 8.2 Consumer Price Development According to CPI and HICP

Annual percentage change



Note: The broken lines in the diagram show the Riksbank's tolerance band for CPI.
Sources: Statistics Sweden and Ministry of Finance.

Changes in Taxes and Subsidies

About 1 percentage point of the 1.9 per cent increase in the CPI during the course of last year can be explained by changes in indirect taxes and subsidies, including higher tobacco duties.

This year, in contrast, tax changes are expected to reduce the CPI by approximately 0.6 percentage points, which is an important explanation as to why the rise in the CPI during the course of the year is expected to be as low as 0.1 per cent. In January this year, the duty on alcohol was raised, which, together with the change in electricity tax, raised the CPI to some extent. During the first half of this year, as mentioned above, the reduction in property taxes, along with the raised limits for tax reductions for repairs and extensions to housing, helped reduce the CPI. This was followed by a cut in tobacco duty. Next year, it is expected that changes to taxes and subsidies will cause the CPI to rise by approximately 0.1 percentage point during the course of the year. Support for heavily indebted apartment buildings constructed during the late 1980s and the reduction in property taxes on family dwellings and hydro-electric power stations are expected to help reduce the CPI to some extent. On the other hand, when the tax reduction for repairs to housing ceases and when waste taxes are introduced next year, there will be a rise in the CPI.

Overall, a major part of the differences between the CPI increases during 1997, 1998 and 1999 is explained by changes in taxes and subsidies. These changes, as well as interest expenditure for homeowners only has a temporary effect on inflation. After adjustment for these temporary factors and disregarding the increase around the end of 1997 and beginning of 1998, inflation is considered to be relatively stable at between 1 and 1.5 per cent for the period 1997-1999.

HICP

Inflation in Sweden, according to the EU's harmonised index for consumer prices, HICP, has fallen from 2.7 per cent in December 1997 to 0.6 per cent in August this year, which is below the average for the EU countries. The HICP contains approximately 80 per cent of the basket of goods in the CPI. The most important difference between the two measures is that interest costs for homeowners are not included in the HICP. As interest expenditure is falling at an ever-slower rate, the difference between the two measures is decreasing. In December next year, it is estimated that the HICP's 12-monthly figures will be 1.5 per cent i.e. slightly higher than the CPI.

9 Household Sector and Private Consumption

During the next few years, a recovery in household real incomes will occur. Consumption will increase somewhat faster than incomes, thus resulting in low savings.

9.1 Household Incomes

Growth in household real incomes has developed weakly in recent years. After the substantial increases at the beginning of the 1990s, mainly as a result of the fact that the tax reform of 1990-91 was underfunded, total incomes for the household sector have fallen. However, income developments in recent years have been divided. Real wage incomes before tax have grown, while tax increases and reduced compensation levels in the transfer systems have pulled down household incomes.

This year, household real disposable incomes are expected to increase by 2.7 per cent, a somewhat stronger increase than estimated in the Government Spring Bill. Behind this relatively marked upturn lies a continued increase in real wages before tax together with rising employment.

Transfers from the general government sector will also provide a positive contribution to the development of incomes this year, despite a fall in unemployment. Pensions will increase considerably as a result of low inflation while, at the same time, the extra housing benefit for pensioners has been raised. Sickness insurance payments will increase significantly this year for several reasons. Compensation levels for sick pay and parental benefits were raised at the beginning of this year from 75 to 80 per cent, and the number of sick days has increased. In addition, sickness insurance payments will increase as a result of the

Table 9.1 Household Disposable Incomes, Consumption and Savings

	SEK, billion, current prices	Percentage change, 1991 prices				
	1997	1997	1998	1999	2000	2001
Wage bill incl. sick pay	756.6	3.3	4.0	3.4	3.0	2.1
General government transfers	387.9	-0.3	2.5	-0.5	-0.6	0.3
Pensions	216.2	0.1	1.1	1.3	0.7	1.2
Health insurance etc.	34.3	-6.9	10.9	3.7	1.1	1.5
Unemployment benefits etc.	55.3	2.0	-8.6	-12.5	-14.4	-10.3
Other transfers	82.2	-0.1	10.0	0.1	2.3	1.8
Net interest and dividends	-13.5					
Net other income	204.9	-6.1	1.7	2.0	3.7	1.6
Direct taxes and charges	405.7	7.1	6.2	-0.4	3.3	1.4
Disposable income	930.2	-1.7	2.7	3.3	1.5	1.8
Private consumption	922.9	2.0	2.7	2.9	2.5	2.0
<i>Savings ratio, as a percentage of disposable incomes</i>						
Net savings ratio		0.8	0.8	1.2	0.3	0.1
Financial balance		2.6	2.5	2.6	1.4	0.9
<i>Percentage contribution to the development of real incomes</i>						
Wage bill incl. sick pay		2.7	3.3	2.9	2.5	1.8
General government transfers		-0.1	1.1	-0.2	-0.2	0.1
Net interest and dividends		-0.1	0.8	0.1	0.0	0.2
Net other income		-1.3	0.3	0.4	0.7	0.3
Direct taxes and charges		-2.9	-2.8	0.2	-1.5	-0.6

Note: Wage bill, income transfers, net interest and taxes are deflated by the consumer price index (CPI). Disposable income is deflated by the implicit price index for private consumption (IPI).

Sources: National Institute of Economic Research, Statistics Sweden and Ministry of Finance.

period in which the employer is responsible for paying sick leave having been reinstated to 14 days, with effect from April 1, 1998, after having been 28 days before. However, this will not affect household incomes since sick pay is reduced by a corresponding degree. The level of compensation for unemployment benefits was raised to 80 per cent as of October 1, 1997. Other transfers will rise in real terms by 10 per cent. This significant rise includes an increase in the number of people receiving various forms of student grants as well as the fact that child benefits and large family allowances were increased at the beginning of the year by a total of SEK 2.9 billion.

This year, direct taxes and charges will rise, partly as a result of an increase of one percentage point in the individual social security fees paid into the pension system. In addition, the raised level of compensation in unemployment benefits will be partially funded through increased individual social security fees. Tax on small businesses has been reduced by treating an increased proportion of profits as capital income. Household tax payments will increase this year due to the fact that supplementary preliminary tax payments were unusually large as a result of capital gains on shares realised in 1997.

It is foreseen that in 1999 there will be a continued growth in employment and real wages. Pensioners will also gain an increase in their real incomes. The base amount will be calculated using total inflation for the previous year instead of only a proportion of inflation, as was the case earlier. In addition, it is proposed that pensions be raised by 2 percentage points, that is from 98 to 100 per cent of the base amount, together with a further increase in extra housing benefits. However, transfers from the general government sector will decline overall as a result of the fall in employment.

The central government income tax will be changed next year through the removal of the temporary additional income tax while, at the same time, the tax levy of 25 per cent will remain effective on income exceeding SEK 389 000 per annum. In addition, a temporary tax reduction for wage earners with income up to SEK 245 000 per annum has been proposed for 1999. The net effect will mean a tax reduction of approximately SEK 6 billion compared with the 1998 rules. Overall, real incomes are estimated to increase by 3.3 per cent next year, which is approximately $\frac{1}{2}$ percentage point more than estimated in the Government Spring Bill.

Favourable economic growth is expected to lead to a continued increase in employment in the years 2000 and 2001, while real wage increases will be subdued due to inflation rising slightly. The effect of increased employment on disposable incomes will be modest as a result of the fact that unemployment benefits will fall parallel to this. It is proposed that child benefits will be increased in two stages by a total of SEK 5 billion. Incomes will be dragged down when the temporary tax reduction ceases. Real disposable incomes are estimated to increase by 1.5 per cent in the year 2000 and 1.8 per cent in 2001.

9.2 Private consumption

During 1997, household total consumption expenditure rose by 2 per cent compared with the year before, measured as an annual average. This is the strongest increase in private consumption during the 1990s. In particular, capital goods retailing contributed to growth in consumption with, for example, cars and parts of infrequent goods purchases. During the first half of 1998, private consumption rose by 2.5 per cent compared with the first half of 1997. This rise in consumption was somewhat stronger than anticipated in the Government Spring Bill. Above all, car and infrequent purchases retailing continued to experience strong sales growth.

The increase in private consumption last year coincided with a decrease in household real disposable incomes. Consequently, the household savings ratio i.e. savings as a percentage of disposable incomes, fell to a level of less than 1 per cent. Household disposable incomes are expected to increase by 2.7 per cent this year and growth in household incomes is expected to strengthen further during 1999. This favourable development in household incomes will allow considerable scope for an increase in private consumption in coming years. In addition, the scope for an increase in private consumption will be strengthened by the comparatively strong position of household wealth. The main reason for the improved wealth situation is that the value of shares and family dwellings has increased during the last few years. The need to allocate savings from disposable incomes has thereby been reduced. In addition, the low levels of interest rates facilitate the financing of certain purchases of capital goods,

which means that sales volumes of capital goods will probably increase.

During the last few months, the situation in the labour market has improved. Employment has increased and unemployment decreased. As a consequence of the improvement in the labour market, the uncertainty of households regarding future labour income has decreased. The improved financial position of Swedish households is reflected to a large degree by household expectations for the future, according to Statistics Sweden's Consumer Survey. The majority of households believe their own financial situation will improve in the future and that future prospects for the Swedish economy are favourable. The majority of households also expect unemployment to fall and inflation to continue to be low.

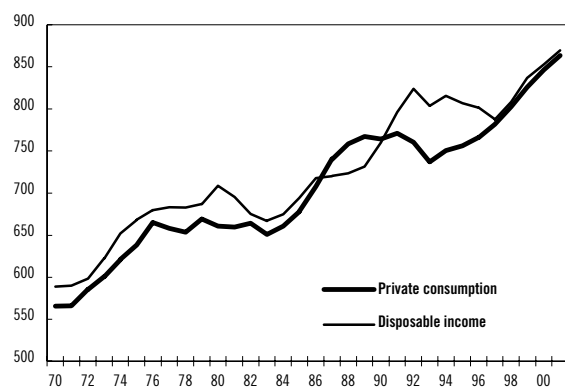
As a result of increasingly optimistic future expectations, Swedish households have reduced their savings. The household savings ratio is low at present and bank lending to households has gradually increased since the second half of 1997. However, the volume of household total bank credit is, despite the upturn, considerably less than at the end of the 1980s. So far during 1998, developments in retail sales indicate that the decline in household savings has created scope for purchases of home electronics and furniture, among other things. Radio and television equipment retailing increased by approximately 20 per cent during the first half of 1998 compared with the first half of 1997, while furniture retailing rose by approximately 10 per cent during the same period. In addition, current statistics regarding total new car registrations indicate a significant increase in car sales.

Overall, household total demand is expected to increase further during coming years, mainly as a result of a rise in disposable incomes, improved labour market conditions and very positive expectations of the future. Total private consumption is now estimated to rise by 2.7 per cent in 1998 and by 2.9 per cent in 1999. Consequently, the assessment made in the Government Spring Bill has been readjusted upward by 0.4 percentage points for each year. Growth in consumption is then expected to decline to 2.5 per cent in the year 2000 and to 2.0 per cent in 2001. The decline in the growth rate for private consumption is mainly the result of the expectation that households, to a large extent, will upgrade and replace worn out capital goods during 1998 and 1999. Expenditure for these items is anticipated to eventually revert to normal long-term levels, which will result in a weaker increase in household total consumption expenditure.

Naturally, there are a number of uncertainties in the assessment of household consumption developments for coming years. This is particularly true of possible effects on household expectations of the future, thereby affecting consumption behaviour, due to various macro-economic events, both domestic and international. It is possible, for example, that the Asian crisis will deepen and that its effects on the Swedish economy will have repercussions on household consumption behaviour. The household wealth position is affected negatively by the global downward readjustment in share prices. However, it is probable that the short-term relationship between household consumption expenditure and prices of shares will be relatively limited. The reason for this is that households generally endeavour to even out their consumption expenditure over time.

Diagram 9.1 Private Consumption and Disposable Income

SEK billion, 1991 prices



Sources: Statistics Sweden and Ministry of Finance.

10 Gross Fixed Capital Formation

Investment activity picked up during the first half of this year. The total volume of investment rose by approximately 10 per cent compared with the corresponding period last year. In all, total gross fixed capital formation is estimated to increase by slightly less than 10 per cent in 1998 and by 8 per cent in 1999.

The strong increase in output within both manufacturing and the private services sector is expected to lead to a rise in investment activity in the business sector. However, within the export-oriented part of the business sector, investment growth will gradually decline while the need for expansion in the domestic market will increase. Conditions for some recovery in residential investment are also good. At the same time as interest rates are low, the economy of households is improving. During this year, general government authorities have contributed to the strong expansion in investment, partly due to the construction of city ringroads, but also because of the upturn in local government authority investment.

Table 10.1 Gross Fixed Capital Formation by Sector

	SEK billion		Annual percentage change			
	1997	1998	1997	1998	1999	2000
Business sector	183.6	-0.1	10.7	7.1	4.8	3.2
Manufacturing and mining	64.1	-6.9	8.0	4.5	4.5	3.0
Other business sector	119.5	3.8	12.1	8.4	5.0	3.3
Housing	23.8	-25.7	6.2	23.5	25.0	25.0
New construction	11.5	-19.2	5.5	32.0		
Renovations	12.3	-32.0	7.1	14.0		
General government	30.5	-9.4	7.6	1.4	2.2	1.4
Total	237.9	-4.8	9.8	8.0	6.8	5.9
Machinery	136.2	2.8	11.1	6.2	4.5	3.2
Building and construction	101.7	-13.2	8.3	10.4	9.7	9.3

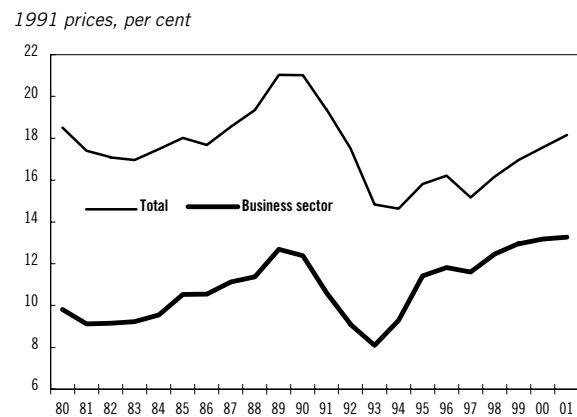
Sources: Statistics Sweden and Ministry of Finance.

During the period between 1999 and 2001, the investment ratio i.e. investment as a proportion of GDP, will approach the levels of the 1970s and 1980s. The low investment ratio in recent years can, in part, be attributed to the need to adjust capital stocks for housing to long-term sustainable levels. The high real interest rate has also

very probably contributed to the low levels of investment. In medium-term calculations, low interest rates and relatively high profitability in the business sector provide good conditions for continued expansion. Relatively high investment activity is also a prerequisite for avoiding costly bottlenecks. In addition, good labour force supply will contribute to the favourable growth environment during coming years. Housing production is expected to gradually normalise due to rising disposable incomes and positive employment growth. However, it is estimated that residential investment will be at a low level in 2001 compared with the 1980s.

10.1 Business Sector Investment

Diagram 10.1 Investment as a Proportion of GDP



Investment in the manufacturing industry has remained at a very high level during recent years, mainly due to the significant increase in exports together with a high level of profitability. Although investment in manufacturing temporarily fell last year, production capacity was further expanded. As a result of the significant rise in output towards the end of 1997, expansion in capacity utilisation increased. This development has continued during the first months of this year despite industrial activity experiencing some weakening. During the second quarter of this year, resource utilisation amounted to a total of 90.1 per cent, a level at which investment needs to increase considerably to avoid bottlenecks in output. Investment will also be stimulated by a further expected increase in profitability this year from an already favourable high starting-point. Although international pressure to keep prices down has increased during the year, productivity

growth has continued to be favourable and wage increases have been limited.

According to Statistics Sweden's Investment Survey from May, manufacturing firms are planning considerable expansion in investment this year. Considering the uncertain economic situation that has arisen as a result of the Asian crisis, it is probable that some of the planned investment will be postponed to next year. However, according to the National Accounts, investment rose by slightly more than 8 per cent during the first half of this year compared with the corresponding period last year. At the same time, the most recent Quarterly Business Tendency Survey from the National Institute of Economic Research indicates that expansion in capacity within manufacturing will also continue at the same significant extent for the second half of the year. Therefore, investment within manufacturing is expected to increase by 8 per cent during 1998, which means that capital stocks will expand by more than 4 per cent. Investment volumes will be very large within the engineering industry, which will be favoured by good investment activity in Europe.

In 1999, investment is estimated to increase by approximately 4 per cent. Resource utilisation is also expected to remain on a high level next year. In combination with high profitability, this will create favourable conditions for continued expansion in capacity. Both private consumption and exports will increase to a significant degree, which should result in considerable investment increases within both the consumer and the investment goods industries.

Investment within the rest of the business sector increased more than expected during the first half of the year. An extremely substantial expansion was reported in sectors that are to a large degree affected by household demand. Within retailing, for example, investment volumes rose by a total of 25 per cent during the first half of the year compared with the corresponding period in 1997. For both 1998 and 1999, investment is estimated to increase heavily within most industries within the rest of the business sector. This development is supported by the results of Statistics Sweden's Investment Survey from May. Considerable growth in output and low interest rates will create favourable conditions for a continued expansion of capacity during the forecast period. Indicators that are available also point to a marked increase in investment activity in the future. Prices for commercial property in the country as a whole have risen by 15 per cent during the last two years. At the same time, vacancies in growth regions have been reduced to such a degree that new production of commercial premises has become profitable again. The National Institute of Economic Research's Business Tendency Survey for the Services Sector from June, reports increased economic activity for architects and technical consulting. An upturn in these industries is usually followed by an increase in investment in real capital with a delay of 6 – 12 months. Some structural changes will also contribute to the expansion of investment in the future. Deregulation within the energy sector will result in increased demand for rationalisation. This, together with the central government energy conversion programme in which an annual allocation of SEK 1.5 billion has been set aside, will result in a strong expansion in the energy sector. This year, it is expected that central government infrastructure projects, such as the construction of the Öresund Bridge and the approach roads to it, and an increase in investment in railways, will contribute to investment growth within the rest of the business sector. Overall, investment is estimated to increase by 12 per cent this year and by approximately 8 per cent in 1999 within the rest of the business sector. Consequently, resource utilisation will increase somewhat up until and including 1999. However, estimations of future investment growth include some uncertainties. During earlier economic upswings, there has been a tendency for a more rapid rate of growth than reported in this forecast.

Table 10.2 Other Business Sector Investment

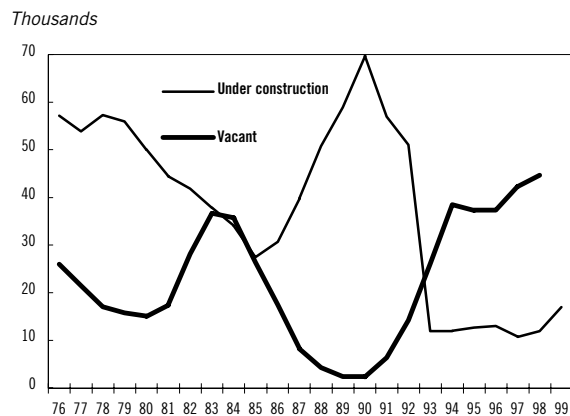
	SEK billion		Annual percentage change		
	1997	1996	1997	1998	1999
Agriculture and forestry	8.9	6.0	7.1	4.4	4.1
Energy and hydropower	14.1	-4.1	3.3	10.4	14.4
Construction	4.6	-2.0	13.4	4.0	11.0
Retailing and wholesaling	17.2	0.4	4.3	20.0	17.0
Financial services	2.5	-15.1	30.5	15.0	11.0
Consulting services	14.1	0.2	6.3	16.0	7.0
Household services	11.2	-3.1	13.5	5.0	5.0
Property	7.7	15.2	2.8	9.0	16.0
Other services	39.2	-1.6	-1.6	12.3	1.8
of which transport and communications	24.4	11.6	-3.2	19.0	-2.0
Total	119.5	0.3	3.8	12.1	8.4

Sources: Statistics Sweden and Ministry of Finance.

10.2 Residential Investment

Construction of new housing rose by 12 per cent during the first half of 1998 compared with the corresponding period in 1997. However, during the first half of last year construction of new housing fell to a record low level. Since the recession in the beginning of the 1990s, construction of new housing has remained on a very low level from an historical point of view. This has resulted in the housing stock being gradually adjusted to a new equilibrium level. The reduction in housing subsidies to a level corresponding 30 per cent of interest rate costs has now been more or less carried out, while the general economic conditions for an increase in demand for housing are rapidly improving. Household disposable incomes are expected to rise drastically after having experienced a long period of stagnation, and employment will pick up. This will result in improved conditions for a marked upturn in housing output.

Diagram 10.2 Number of Apartments – Vacant and under Construction



Note: The number of vacant apartments relate to the 1 March each year. The number of apartments under construction include both multi family and single family dwellings.
Sources: Statistics Sweden and Ministry of Finance.

Construction of new housing has up until now been at a low level due to prices in the second-hand market in general being less than the costs of new production. Because of the overall 8 per cent rise in prices of family dwellings during the last year, differences between prices in the second-hand market and costs for new production have been reduced to approximately 10 per cent. However, regional differences are very large. In most growth areas, new production is already profitable today while, at the same time, the number of vacant apartments is low. In other areas, it will not become profitable to

construct new housing within the foreseeable future, and the vacancy ratio is very high. In June, the Riksdag reached a decision about the housing policy bill, thereby setting aside uncertainty regarding future financing of residential construction, a result that will favour the construction of new housing. Further, the reduction of property taxes from 1.7 per cent to 1.5 per cent of the tax assessment value, as well as the proposed temporary reduction in property taxes for multi-dwelling apartment buildings should lead to an increase in demand for housing. According to the Quarterly Business Tendency Survey from June, published by the National Institute of Economic Research, the construction of new housing during the second half of the year seems to be heading towards a significant recovery. Long project lead times are likely to mean that a marked rise in construction of new housing is not noticed before next year. Overall, the number of apartments under construction is estimated to rise to slightly more than 12 000 this year, and to 17 000 next year. According to the National Board of Housing, Building and Planning, the long-term requirement for new housing amounts to 30 000 – 35 000 per annum.

Renovations of housing have also been at a very low level during the last years, although the temporary stimulation subsidy resulted in a short-lived upturn in renovation volumes during 1996. The low level of profitability in the industry and the weak growth in household incomes has probably led to some necessary renovation work being postponed. However, low interest rates, which are gradually strengthening the financial position of residential property companies in combination with the relatively strong development of household incomes, should result in renovations approaching a more long-term equilibrium level. The number of multi-housing apartments under renovation was, however, still at a low level during the first half of this year. It is probable that this is the result of uncertainties that remained at that time regarding the future system for housing financing. During the same period, renovations of owner-occupied houses rose. During coming years, ecological sustainability subsidies will be available and this, together with interest-rate subsidies for renovations, will stimulate renovation activities.

10.3 Change in stocks

The total effect on GDP growth of changes in stock is expected to remain neutral both this year and next year. However, developments with changes in stocks are difficult to interpret due to the fact that the primary statistics and the National Accounts largely give different results.

During the second half of last year, limited stock building was carried out within manufacturing. At the same time, industrial production rose rapidly and the decline in the stocks ratio, that is, stocks in relation to the volume of production, which started during the second half of 1996, continued. At the beginning of this year, manufacturing output moderated somewhat, and the National Institute of Economic Research's Business Tendency Surveys for Manufacturing from July and August of this year, indicate an increase in dissatisfaction with the size of stocks of finished goods. However, during 1998 demand is expected to pick up, thus limiting the growth of stocks of finished goods. Instead, the forecast upturn in manufacturing output is expected to result in an increase in stocks of intermediate goods and work in progress during the second half of 1998 and during 1999. Forecasts for output and changes in stocks indicate that the fall in the stocks ratio will continue both this year and next year. However, international developments constitute a risk factor in the forecast. From the beginning of the year and up until and including June, growth in orders from export markets dissipated, and if international demand declines further, unwanted stock building may occur in manufacturing with an upturn in the stocks ratio as a result. Such a development could lead to a change towards a more rapid increase in manufacturing stocks this year, to be followed by destocking during 1999.

Last year, stocks within both retailing and wholesaling increased. Stock building in retailing has to do with the upturn in private consumption last year. Household demand is expected to increase in the future, which will lead to somewhat increased stocks for retailing as a whole. The upturn in household demand together with a rise in manufacturing output are expected to also contribute to an increase in stocks within wholesaling next year.

Overall, total stocks this year and next year are estimated to grow by approximately the same extent as during last year. This means that the

contribution to growth in changes in stocks will be close to zero for both years.

Table 10.3 Stock Changes and Contributions

SEK billion, 1991 prices

	1996	1997	1998	1999
Agriculture and forestry	33	-102	-100	-100
Manufacturing and mining	1161	-1831	2900	2800
Electricity, gas, thermal	129	-324	0	0
Retailing and wholesaling	-4747	8996	5900	6200
Total	-3424	6739	8700	8900
Contribution to GDP	-1.1	0.7	0.1	0.0

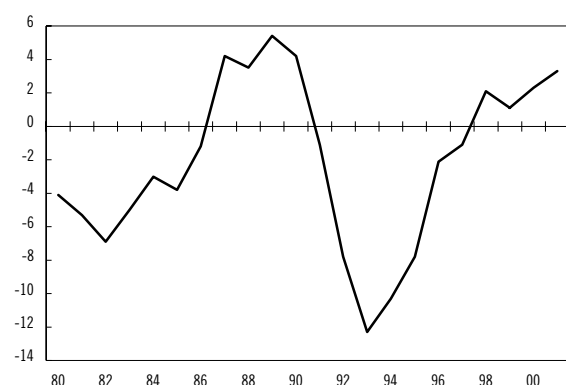
Sources: Statistics Sweden and Ministry of Finance.

11 General Government Sector

General government finances have improved considerably since 1994 and this year, the financial balance in the general government sector is expected to show a surplus, which will then grow during the forecast period. The central government borrowing requirement, which amounted to approximately SEK140 billion as recently as 1995, has been turned into a surplus, which means that the central government debt can begin to be amortised this year.

Diagram 11.1 General Government Financial Balance

Per cent of GDP



Sources: Statistics Sweden and Ministry of Finance.

11.1 Consolidated General Government Sector

Financial Balance

In 1997, the financial balance deficit amounted to approximately SEK19 billion. This meant that the deficit, when measured as a percentage of GDP, was reduced to 1.1 per cent from 10.3 per cent in 1994. For 1998, general government finances are expected to show a surplus of approximately SEK38 billion or 2.1 per cent of GDP. However, 0.8 percentage points of this surplus are due to the National Pension Fund's holding of Swedish properties being transferred to a company. This transfer will be credited to the financial balance as shares, which, as distinct from property, are regarded as a financial asset in the National Accounts. If this accounting type effect is excluded, the surplus amounts to 1.3 per cent of GDP. Dividends from the state-owned property company, Securum, which were paid out this year, are not credited to the financial balance.

A surplus of 1.1 per cent of GDP is estimated for 1999. This surplus will then rise as a percentage of GDP to 2.3 per cent in the year 2000 and to 3.3 per cent in 2001, see table 11.1.

Table 11.1 General Government Finances

SEK billion, current prices

	1997	1998	1999	2000	2001
Revenue	1092.8	1148.1	1163.8	1201.9	1241.4
<i>per cent of GDP</i>	62.8	63.3	61.7	60.7	60.0
Taxes and charges	941.7	992.9	1014.8	1053.5	1096.2
<i>per cent of GDP</i>	54.2	54.8	53.8	53.2	53.0
Capital income	84.6	85.1	77.3	75.8	70.4
Other income	66.4	70.1	71.7	72.6	74.8
Expenditure	1111.9	1110.1	1142.5	1155.5	1172.5
<i>per cent of GDP</i>	63.9	61.3	60.6	58.4	56.7
Transfers to households	506.3	510.5	519.1	514.7	520.8
Consumption and investment	491.7	496.1	529.3	550.2	570.1
Interest expenditure	113.9	103.5	94.2	90.6	81.6
Financial balance	-19.1	38.1	21.3	46.4	68.9
<i>per cent of GDP</i>	-1.1 ¹	2.1 ¹	1.1	2.3	3.3
Financial position					
Net debt	376.8	338.1	310.5	265.4	197.6
<i>per cent of GDP</i>	21.7	18.7	16.5	13.4	9.6
Consolidated gross debt ²	1331.8	1319.2	1321.8	1280.1	1153.1
<i>per cent of GDP</i>	76.6	72.8	70.1	64.7	55.8

¹ According to the EU-rules the financial balance as a proportion of GDP amounted to -0.8 per cent in 1997 and is estimated to be 1.2 per cent in 1998.

² The consolidated gross debt is defined according to EU:s convergence criteria (Maastricht).

Sources: National Institute of Economic research, The Swedish national Debt Office, The Swedish National Audit Office, Statistics Sweden and Ministry of Finance.

The improvement in the financial balance will be achieved through the fact that expenditure as a percentage of GDP (the expenditure ratio) will fall. The expenditure ratio, which began to fall in 1994, is expected to diminish from 63.9 per cent in 1997 to 56.7 per cent in 2001. Of this decline of 7.2 percentage points, lower interest expenditure will account for 2.7 percentage points. Otherwise, the reduction can mainly be attributed to the fact that expenditure on transfers is increasing more slowly than GDP. Expenditure for the general government sector in the form of consumption and investment will fall by only 0.6 percentage points of GDP between 1997 and 2001. Following a temporary increase this year, revenue as a percentage of GDP will also fall. This decrease will be due to both the tax ratio declining and interest income falling. The drop in interest income is largely an effect of the reform of the pension system, which includes a reduction in the assets of the National Pension Fund.

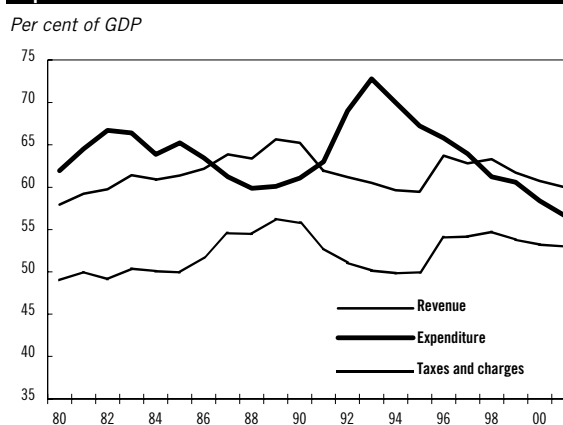
Compared with the assessments in the Government Spring Bill, the forecast for the financial balance has been revised upward for the years 1998 and 1999, which takes into account the tax reductions and increases in expenditure proposed following the Government Spring Bill. The reduction in property taxes, which has already been decided, and the proposals for tax reductions and higher pensions are expected to burden the financial balance by around SEK7.5 billion in 1999. The assessment of general government finances, excluding these measures, has thus changed in an even more positive direction. Tax revenue this year has proved to be considerably higher than previously forecast and the assessment for 1999 has been revised upwards. In addition, interest rates and, consequently, general government interest expenditure are lower than was estimated in the Government Spring Bill. If the lower property taxes and measures now proposed are excluded, the financial balance is revised slightly upwards for the years 2000 and 2001. The Government Spring Bill contained an assumption of a technical nature for estimation purposes, which meant that transfers would be made to the household sector to the extent that the general government sector financial balance exceeded the goal. There is no such assumption made in this forecast. Instead, the forecast is based on the entire estimated surplus forming a loan repayment of the general

government net debt by a corresponding amount.

Financial Position

The financial balance shows the change in financial wealth that occurs through transactions. Consequently, changes in value do not affect the financial balance. The same applies to sales of shares and other financial assets, as they do not change the position of financial wealth.

Diagram 11.2 General Government Revenue and Expenditure



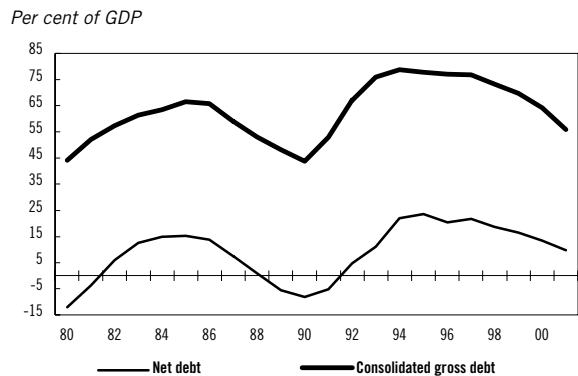
Sources: Statistics Sweden and Ministry of Finance.

The general government debt, on the other hand, is affected by the acquisition and sale of financial assets and changes in the value of the debt in foreign currency. The general government sector consolidated gross debt, defined in accordance with the Maastricht criteria, corresponded to 79.3 per cent of GDP at the end of 1994. The debt ratio has since been reduced and amounted to 76.6 per cent at the end of 1997 and is estimated to fall to 72.8 per cent towards the end of 1998. The financial surplus and continued sale of general government shareholdings will enable the debt to fall and amount to below 60 per cent of GDP by 2001. The consolidated gross debt will also be reduced by a considerable non-recurring transfer of assets from the National Pension Fund to the general government as part of the reform of the old age pension system and this will be used to amortise the central government debt.

The general government sector financial net debt i.e. debt minus all financial assets, is considerably lower than the consolidated gross debt. This is mainly due to the fact that the National Pension Fund has considerable financial assets in addition to government bonds. The net debt will fall as the surplus in the financial balance increases and is estimated that it will be reduced

from 21.7 per cent of GDP at the end of 1997 to 9.6 per cent at the end of 2001.

Diagram 11.3 General Government Consolidated Gross Debt and Net Debt



Note: The consolidated gross debt is defined according to EU's convergence criteria (Maastricht).

Sources: Statistics Sweden and Ministry of Finance.

Taxes and Charges

Taxes and charges as a percentage of GDP (the tax ratio) amounted to approximately 54 per cent in 1996 and 1997. This is a rise of over 4 percentage points from 1995. Only one-third of the substantial rise between 1995 and 1997 can be explained by changes in tax regulations and higher tax values on property. An almost equal percentage of the rise in the tax ratio is due to a recovery in the important tax bases, the wage bill and private consumption, which was held down as a percentage of GDP in 1995 and the immediate preceding years.

Table 11.2 General Government Taxes and Charges

Per cent of GDP

	1997	1998	1999	2000	2001
Taxes and charges	54.2	54.7	53.8	53.2	53.0
Household direct taxes and charges	22.8	23.3	22.5	22.5	22.3
Company direct taxes	2.9	3.5	3.6	3.2	3.2
Pay roll charges	14.4	14.6	14.6	14.6	14.5
Value added tax	7.5	7.2	7.2	7.2	7.3
Other indirect taxes	6.5	6.2	5.9	5.7	5.7

Sources: National Institute of Economic Research, Statistics Sweden and Ministry of Finance.

Household reported net income from capital for taxation purposes i.e. interest income, share dividends and capital gains with deductions for interest expenditure and capital losses, was negative up to 1995. In total, this gave a reduction in tax revenue. Since 1996, capital incomes have provided a positive net figure, which raises the tax ratio. This turnaround in household capital incomes is a consequence of household financial savings being high for several years and of

households realising part of the increase in value that has taken place with shares and property in recent years.

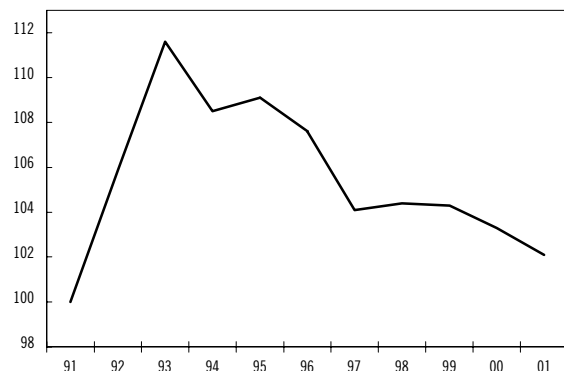
This year, the tax ratio will rise to 54.8 per cent, partly as a result of an increase in the national supplementary pension charge of 1 percentage point and large tax payments on capital gains, etc. last year. The reduction in the property tax from 1.7 to 1.5 per cent this year will not make a full impact on tax revenue until next year. There will also then be a reduction in central government income tax when the "additional income tax" is abolished and only partly compensated for by a tax of 25 per cent on high incomes. In addition, it is proposed that there be a temporary tax reduction for low-income earners in 1999 and a reduction in property taxes on rented apartment blocks. Direct taxes for firms, which will lie at a historically high level in 1998 and 1999, are expected to fall slightly some years thereafter. Revenue from the taxation of capital gains is expected to decline during the forecast period. Overall, the tax ratio is expected to decline from 54.8 per cent in 1998 to 53 per cent in the year 2001, see table 11.2.

Expenditure

As shown in diagram 11.4, there was a large real increase in general government expenditure at the beginning of the 1990s, due, in part, to the support given to the banks. In 1994 expenditure began to fall, despite increased interest expenditure on the central government debt. In 1997, expenditure amounted to around 4 per cent less in real terms than in 1994. Total expenditure in real terms is expected to increase slightly this year and then remain basically unchanged in 1999.

Diagram 11.4 General Government Real Expenditure

Index 1991 = 100



Sources: Statistics Sweden, National Institute of Economic Research and Ministry of Finance.

Interest expenditure will fall heavily as a result of the fall in interest rates and the lower central government debt. Lower interest rates will also lead to lower interest subsidies for housing. On the other hand, transfers to households will rise this year, despite a large fall in unemployment. The compensation levels in social insurance and child benefits have been raised and the employer responsibility period for sick pay has been halved, which increases the payments made by the general government sector. General government consumption and investment will also increase in volume after several years of decreases. In terms of constant prices, general government consumption will grow much more slowly than GDP, but because price increases are higher than GDP, consumption as a percentage of GDP will remain unchanged in 1998 and 1999.

At the beginning of the next century, interest expenditure will continue to decline in line with that the central government debt is reduced. Expenditure for unemployment will further decline. Pensions will show a rising trend as a result of an increased number of pensioners with high Supplementary Pensions Scheme points. Expenditure for sickness insurance is expected to develop on a par with wages, provided the regulations remain unchanged. Other transfers to households will increase through the proposed

increase in child benefits. Interest subsidies for housing will be halved both in the year 2000 and in 2001 to a level of just over SEK 2 billion in 2001. General government consumption is expected to grow relatively slowly. Altogether, expenditure will fall in real terms by 1.3 per cent in 2000 and by 0.9 per cent in 2001, see table 11.3.

Fiscal Policy

In 1994, the general government sector financial balance showed a deficit equivalent to 10.3 per cent of GDP. For 1998, a surplus of 2.1 per cent of GDP is estimated. This means that between 1994 and 1998 the financial balance improves by 12.4 per cent of GDP. Behind this development lie a number of factors, in addition to fiscal policy measures, such as the economic cycle, changes in the level of interest rates, accounting practice of tax revenue and purchases and sales of property. Table 11.4 describes the contribution of these factors to the change in the financial balance. The component that refers to the economic cycle takes into account both GDP growth and the development of the most important tax bases in relation to GDP. The part that affects GDP is measured as 75 per cent of the deviation in GDP growth from an assumed trend development of 2 per cent. This estimate of economic sensitivity

Table 11.3 General Government Expenditure in Current Prices and Change in Volume

	SEK billion, current prices				Percentage change, 1991 prices	
	1997	1997	1998	1999	2000	2001
Total expenditure	1111.6	-3.1	0.3	-0.1	-1.3	-0.9
exclusive interest	997.7	-2.7	1.4	0.9	-0.9	0.1
Transfers to households	387.9	-0.3	2.5	-0.5	-0.6	0.3
Pensions	216.2	0.1	1.1	1.3	0.7	1.2
Health insurance	34.3	-6.9	10.9	3.7	1.1	1.5
Unemployment benefits	55.3	2.0	-8.6	-12.5	-14.4	-10.3
Other	82.2	-0.1	10.0	0.1	2.3	1.8
Other transfers	118.4	-6.6	-6.7	5.9	-8.8	-4.9
<i>of which</i>						
Pharmaceuticals	13.6	-0.3	-4.8	4.2	6.7	-0.4
Interest subsidies	20.8	-25.7	-48.2	-29.7	-46.9	-52.1
Contribution to EU	20.1	19.2	3.7	4.1	-4.6	1.5
Interest expenditure	113.9	-6.5	-9.6	-9.7	-5.4	-11.7
Consumption	449.3	-2.1	1.9	0.8	0.6	0.8
Investments etc.	42.4	-14.6	7.9	2.1	2.5	1.5

Note: The percentage change of investment expenditure is calculated exclusive of net purchase of property.

Note: Deflated by the implicit price index for general government consumption and investment. Other parts deflated by CPI.

Sources: Statistics Sweden, National Institute of Economic Research and Ministry of Finance.

in general government finances is based on simulations in models of general government sector revenue and expenditure. The way that the general government financial balance is affected by the economic cycle is due not only to GDP growth, but also to the composition of this growth. An export-driven growth provides less tax revenue than if the growth is driven by private consumption. Shifts between profits and wages also affect tax revenue as profits are in the short term taxed at a lower rate than wages.

The significance of the development in the tax base becomes clear when the contribution from the economic cycle to the change in the financial balance in Table 11.4 for the years 1995 and 1996 is compared. In 1995, GDP rose by 3.9 per cent, but the wage bill and private consumption developed weakly. In 1996, the rise in GDP was only 1.3 per cent but the wage bill rose considerably, by almost 5 per cent. This resulted in the economic cycle providing a negative contribution in 1995 and a positive contribution in 1996 to the change in the general government sector financial balance, despite the fact that actual growth was above the trend in 1995 but not in 1996.

Table 11.4 Change in Financial Balance

Per cent of GDP

	1995	1996	1997	1998	1999	2000	2001
Total change	2.6	5.7	1.0	3.2	-1.0	1.2	1.1
<i>of which</i>							
Net capital income and net interest expenditure	-0.4	-0.4	0.0	0.7	0.1	0.1	0.3
Economic growth including tax base shifts	-0.2	0.5	0.0	0.6	0.6	0.5	0.2
Timing of tax revenue	0.2	1.2	-1.2	1.2	-0.3	-0.4	0.1
Net purchase of property	0.2	0.4	-0.8	1.2	-0.8	-0.1	0.0
Adjusted primary balance	2.8	3.9	3.0	-0.4	-0.5	1.0	0.5

Source: Ministry of Finance.

The accounting practice of tax revenue has great importance for the financial balance in some years. It is mainly the cash burden of taxes, which is included in the balance. In 1996, the financial balance was raised temporarily by the change in the collection of VAT. In 1998, tax payments from households and firms will increase more than the estimated tax finally determined, which is partly explained by the fact that tax on the high capital gains in 1997 will be collected this year.

The amounts which are registered in the National Accounts as purchases and sales of properties is often a result of financial transactions,

such as sale and lease-back agreements and company incorporations. In 1997, the general government financial balance was dragged down by local government purchases of properties. In 1998, the balance will be improved by the transfer of the National Pension Fund's properties into a company.

After taking into account the contributions from these factors to the change in financial savings, one residual item remains, and this is the adjusted financial balance, which can be interpreted as a rough indicator of the direction of fiscal policy. As shown in Table 11.4, the adjusted financial balance rose by a total of 9.7 per cent of GDP from 1994 to 1997. Fiscal policy was thus strongly constrictive during this period. The tax increases and savings in the consolidation programme amounted to 7 per cent of GDP for these years. The fact that the improvement in the adjusted balance was even greater is partly due to savings among municipalities and county councils, which were not included in the consolidation programme, and to expenditure for interest subsidies on housing being reduced as a result of the decline in interest rates.

This year and next year, the adjusted financial balance will decline by approximately 0.5 per cent of GDP per annum, which indicates a mildly expansive fiscal policy. Naturally, the consolidation programme will also lead to a strengthening of the budget in 1998, but this will be compensated for by other measures, such as increased compensation levels in social insurance, raised child benefits, reduced property taxes and higher central government grants to local governments, which will contribute to an increase in local government consumption. For the year 2000, the adjusted balance will be improved by 1 per cent of GDP and in 2001 by 0.5 per cent of GDP. Consequently, by way of summary, according to this measure, fiscal policy will be mildly expansive in 1998 and 1999 and mildly constrictive in the years 2000 and 2001.

11.2 Central Government

The financial situation for the central government has improved markedly in recent years. The central government financial balance showed a deficit of approximately SEK180 billion in 1994, while this year it is estimated to achieve a surplus of SEK14.6 billion. A corresponding improve-

Table 11.5 Central Government Finance

SEK billion, current prices

	1997	1998	1999	2000	2001
Revenue	618.7	665.4	719.9	741.2	958.4
Taxes and charges	560.7	603.3	615.1	633.3	660.3
Transfer from the pension fund			45.0	45.0	235.0
Other revenue	58.0	62.1	59.8	63.0	63.1
Expenditure	641.3	650.8	704.8	673.0	676.4
Transfers to households	323.7	312.4	309.2	298.6	297.4
Contribution to local government	60.2	81.6	91.2	94.1	96.4
Old age pension charges to the pension fund			15.3	15.2	15.5
Transfer of premium reserve funds			37.0	12.5	18.1
Consumption and investment	151.2	160.5	165.3	169.9	175.5
Interest expenditure	106.3	96.4	86.8	82.7	73.5
Financial balance	-22.6	14.6	15.1	68.3	282.0
Borrowing requirement	6.2	-12.0	-16.0	-63.1	-203.1
Central government debt	1432.1	1404.5	1382.3	1321.8	1119.7
<i>per cent of GDP</i>	<i>82.4</i>	<i>77.5</i>	<i>73.3</i>	<i>66.8</i>	<i>54.1</i>

Sources: National Institute of Economic Research, The Swedish National Debt Office, Statistics Sweden and Ministry of Finance.

ment will also be shown due to the fact that the central government borrowing requirement has been turned around from a borrowing requirement of SEK185 billion in 1994 to an amortisation on the central government debt of SEK12 billion this year. The central government debt was at its highest, as a percentage of GDP, during the years 1994-95, when it amounted to 84 per cent. At the end of this year it is estimated to be equivalent to 77.5 per cent of GDP, see table 11.5 on the next page.

The reform in the old age pension system will involve a tangible burden on central government finances from 1999, while there will be a corresponding improvement in the old age pension system. As discussed in more detail in section 11.3, central government old age pension charges, transfers of premium reserve funds to the premium pension system, etc. will result in a net weakening in central government finances of SEK43 billion in 1999, SEK22 billion in the year 2000 and SEK28 billion in 2001. As compensation for this weakening, funds will be transferred from the National Pension Fund to the central government during the period 1999-2001. This will correspond to SEK45 billion in 1999, SEK45 billion in the year 2000 and SEK235 billion in 2001. This large transfer in 2001 also comprises compensation for the period thereafter. The one-off transfer in 2001 will be partly comprised of mortgage bonds, which will be managed by the Swedish National Debt Office until the bonds

fall due for payment. This means that there will be no effect on the central government borrowing requirement in 2001 to the extent that these bonds fall due for payment after 2001. On the other hand, the central government financial balance will be affected by the transfer of mortgage bonds. It has been assumed in the forecast that the transfer in 2001 will be comprised of mortgage bonds worth SEK63 billion which fall due after 2001. Altogether the central government financial balance will be strengthened during the years 1999, 2000 and 2001 by approximately SEK2, 23 and 207 billion as a result of the reform in the pension system.

In total, including the pension reform, the central government financial balance is expected to amount to SEK15, 68 and 282 billion, respectively for the years 1999, 2000 and 2001. The amortisation of the central government debt will be slightly lower than the financial surplus. It is estimated that the central government debt will decline by SEK285 billion from 1998 to 2001 to a corresponding 54.1 per cent of GDP in 2001. Approximately SEK168 billion of this decline constitutes the effects of the pension reform, equivalent to 8 per cent of GDP.

Apart from the transitional effects, the pension reform is expected to weaken central government finances and to increase the borrowing requirement by SEK50 billion, while the balance in the old age pension system will be strengthened by the same amount. To illustrate the

starting point for central government finances after the full implementation of the reform in 2001, an estimate has also been made of the balance that would have arisen in 2001 if the reform, in its entirety, had been implemented on December 31, 2000. This underlying financial balance is calculated at 0.8 per cent of GDP.

Central government expenditure is estimated, according to National Accounts, to amount to SEK650.8 billion in 1998. Of this expenditure, only consumption and investment comprise a real use of resources and are included in GDP. Central government consumption accounts for approximately 1/5 of general government expenditure and approximately 7.5 % of GDP. Central government consumption varies relatively significantly from year to year and has proved difficult to forecast. The system of saving appropriations allows central government authorities to partly shift the consumption of their budgeted funds from one year to another. In addition, the preliminary results of the National Accounts are uncertain and often undergo major revisions.

Central government consumption in constant prices has declined constantly since 1995 and last year consumption fell by 5 per cent. There was a recovery during the first half of 1998, when consumption rose by 4.6 per cent, compared with the equivalent period in 1997. This strong increase was due to large purchases of goods and services, partly for defence, while central government employment continued to fall. The rate of increase is expected to diminish to 0.5 per cent during the second half of the year, which will lead to a rise for the whole year 1998 of 2.5 per cent. An increase of 0.5 per cent per annum is expected for the coming years of the forecast period.

11.3 National Pension Fund/ Old Age Pension System

In 1998, revenue by way of charges for the National Supplementary Pensions Scheme is estimated to be approximately SEK34 billion less than the pensions paid out. This deficit will be financed by the direct yield from the National Pension Fund in the form of dividends and interest income, which, in total are expected to amount to SEK43.4 billion. This year the Pension Fund's domestic property holdings, which have an estimated value of SEK15 billion, will be

transferred to a company. This transaction will be entered into the National Accounts as a contribution to the Pension Fund's financial balance. After discounting this effect, the Pension Fund's financial balance amounts to SEK8.3 billion. As the Pension Fund system's deficit in revenue has shown a growth trend, the Fund's savings have gradually diminished. At the beginning of the 1990s, the Pension Fund had a balance of SEK46.5 billion.

The old age pension reform decided by the Riksdag means that the National Pension Fund would take on a partly new role with effect from 1999. The National Pension Fund will in future finance income-based old age pensions within the 'distribution section' of the reformed system. The funding responsibility for the supplementary pension, in the form of early retirement and widow/widower's pension, will be transferred to the central government budget. In addition, the reform means that the National Pension Fund's revenue by way of charges will be improved with the introduction of central government old age pension charges on some transfers, etc., which will be paid over the central government budget. The levels of the national supplementary pension charge and the old age pension charge are 6.95 and 6.40 per cent, respectively for this year and are expected to remain at this level during the forecast period. The old age pension reform also means that the charges will be higher.

Alongside the National Pension Fund system, The building up of an asset base will begin in 1999 within the premium pension system. The funds allocated correspond to an earned premium pension right and will be invested with a fund manager chosen by the beneficiary him/herself. As the central government Premium Pension Authority will be the formal owner of the unit trusts, savings in the premium pension system will be included in the National Accounts as part of the general government sector. The general government sector will therefore be divided, as from the year 1999, into the central government sector, the local government sector and the old age pension system, of which the latter will include the National Pension Fund and the Premium Pension Authority. Savings in the 7th National Pension Fund will be included in the Premium Pension Authority.

During 1999, retroactive premium pension funds, totalling SEK37 billion, for the years 1995-1997 will be transferred from the temporary management of the Swedish National Debt Of-

fice to the Premium Pension Authority. The balance in the premium pension system will therefore correspond to a reduced central government balance. Funds corresponding to the premium pension right will not be transferred to the Premium Pension Authority until the second year after the year of income. The transfer in the year 2000 thus refers to the income year 1998. With effect from income year 1999, the earned premium pension right will be raised from 2 per cent to 2.5 per cent of pension-based incomes and amounts. This means that the transfer to the premium pension system will rise with effect from the year 2001 and is then estimated to amount to approximately SEK18 billion.

Table 11.6 National Pension Fund/Old Age Pension System

SEK billion, current prices

	1997	1998	1999	2000	2001
Revenue	133.6	134.4	181.2	157.8	161.7
Contributions	87.5	91.1	105.7	112.5	116.2
Personal contribution	7.8	52.2	58.4	60.4	62.4
Employers contribution	79.7	38.9	32.0	36.9	38.3
Central government contribution			15.3	15.2	15.5
Premium reserve funds			37.0	12.5	18.1
Interest, dividend etc.	46.1	43.4	38.5	32.8	27.5
Expenditure	122.6	126.2	181.4	185.8	381.5
Pensions	121.6	125.1	135.2	139.5	145.2
Transfer to central government			45.0	45.0	235.0
Other expenditure	1.1	1.1	1.1	1.3	1.2
Sale of property		15.0			
Financial balance	11.0	23.3	-0.2	-28.0	-219.8
Pension fund			-38.2	-42.7	-241.0
Premium pension system			38.0	14.7	21.2

Sources: National Institute of Economic Research, The Swedish National Debt Office, Statistics Sweden and Ministry of Finance.

Overall, those parts of the old age pension reform decided on so far will bring about a long-term improvement of the financial balance of the old age pension system. When the level of charges to the old age pension system is finally established, the balance will be further improved by around SEK 30 billion. The underlying balance in 2001 i.e. the balance which would have arisen if the pension reform as a whole had been implemented on December 31, 2000, will therefore amount to SEK48 billion, which corresponds to 2.3 per cent of GDP.

11.4 Local Government

During the first half of this year, employment and consumption of goods and services in municipalities and county councils rose more strongly than had been foreseen in the 1998 Government Spring Bill. The forecast has therefore been revised upward and the volume of consumption² is expected to increase by 1.7 per cent this year. The increase follows on from a development with stagnation or falling consumption since the beginning of the 1990s.

With a higher tax revenue than in the previous estimate, there is scope in this sector for both an economy in balance with effect from the year 2000 and a stronger growth in consumption volumes up to the end of 2001 than was previously estimated.

The local government sector here refers to municipalities, county councils and parishes, excluding local government enterprises.

According to the preliminary result from the National Accounts, local government sector expenditure was equivalent to 24.1 per cent of GDP last year. Consumption comprised 18.1 percentage points of this. Municipalities and county councils accounted for 67.8 per cent and 28.9 per cent, respectively of the total consumption within the sector.

Factors which Affect Developments within the Sector

In accordance with previous decisions by the Riksdag, the level of general grants from the central government to municipalities and county councils this year and last year was raised by a total of SEK12 billion. The government is now proposing a further improvement of SEK4 billion, with effect from next year. In addition to this, the government intends to propose further increases of SEK4 billion and SEK2 billion, respectively for the two following years. In total, these improvements will lead to the level of the general grants from central government amounting to SEK22 billion more with effect from the year 2001.

Central government grants are also affected by financial regulation between the central govern-

² This refers to total consumption, which includes the total of wages, payroll taxes, consumption of goods and services as well as capital wear and tear.

ment and the local government sector. With effect from this year, municipalities and county councils have taken over the principal responsibility for incontinence articles. The county councils have, at the same time, taken over responsibility for pharmaceutical subsidies from the central government.

Since 1997, there have been special central government grants for labour market policy measures in the form of public temporary employment and resource work.

The government declared in autumn 1996 that the municipalities and county councils would receive compensation if they were forced to pay back some of the advances received in connection with the final calculations for the 1997 preliminary tax payments. This compensation has been treated as a temporary increase in central government grants of SEK2.6 billion in 1999. Next year, revenue received by municipalities and county councils will be further improved by a temporary transfer of central government income tax equivalent to SEK1.3 billion.

The average municipal tax rate is assumed to remain unchanged at the 1998 level during the entire forecast period. The opportunity to raise the tax rate is limited by the law on lowering general grants from the central government in special cases. This law means that any municipality or county council that establishes a higher tax rate next year than that applying in 1996 will have

their general grants from the central government reduced by an amount corresponding to half of the income from the tax increase.

The estimates have not taken into account the coming tax exchange between municipalities and county councils for the new county councils in Västra Götaland and Skåne.

In connection with the crisis settlement by the government in 1992, an agreement was signed for a change in pension regulations for municipalities and county councils. The agreement resulted in reduced pensions with effect from 1993. Following a legal action, the Labour Court recently ruled this agreement null and void. Municipalities and county councils will therefore be forced to pay out retroactive pensions corresponding to approximately SEK1.0 and 0.6 billion. The payments are expected to be made before the end of 1998. However, the retroactive payment will result in tax revenue for the municipalities and county councils increasing by about SEK400 million in the year 2000.

Since the Government Spring Bill was published, several central wage agreements have been signed in the local government sector. Most of these agreements cover several years and give a slightly higher wage increase than was forecast earlier. The wage increase rate in the forecast has therefore been revised upwards.

Table 11.7 Local Government Finances¹

SEK billion

	1997	1998	1999	2000	2001
Revenue	411.3	441.2	462.6	480.8	497.3
Taxes	294.4	300.5	311.2	325.1	337.6
Central government contribution ²	60.2	81.6	91.2	94.1	96.2
Other	56.6	59.1	60.1	61.7	63.5
Expenditure	418.5	441.1	456.1	474.8	490.6
Transfers	78.2	90.7	92.4	94.7	96.2
Consumption	315.1	329.2	341.5	355.5	368.9
% change in volume ³	-0.7	1.7	0.9	0.6	1.0
underlying % ⁴	-1.6	0.3	1.0	1.3	1.0
Investment	25.2	21.2	22.2	24.6	25.6
Financial balance	-7.2	0.2	6.5	6.1	6.7

¹ Revenue and expenditure are reported exclusive of central government equalisation contributions and central government equalisation charges. The equalisation contribution for 1998 is established at SEK 21 billion.

² Reported as from 1998 net after deductions for local government contributions to the value added tax repayment system.

³ Annual percentage change in fixed prices.

⁴ Annual percentage change in volume excluding public temporary employment, resource work, change in cost responsibility for incontinence articles and the education and training initiative.

Both municipalities and county councils are obliged by law to achieve balanced finances with effect from the year 2000. This balance requirement means that the budget in every municipality, county council and municipal association formed before 1998 must be established in such a way that expenditure does not exceed revenue. Expenditure should include the change in the pension liability. However, if expenditure exceeds revenue, the deficit must be covered within two years.

Normally, a positive financial balance is required to achieve the balance requirement. If investment expenditure is greater than the depreciation, however, a negative financial balance can be combined with achieving the requirement. This type of situation is currently more likely to occur among the municipalities than among the county councils. Estimates of financial developments in the local government sector assume that all municipalities, county councils and municipal associations will meet the balance requirement.

Developments up to the end of 2001

Revenue in the local government sector is expected to be higher than forecast in the Government Spring Bill up to the end of the year 2001. As a result of an unexpectedly high preliminary taxation outcome for 1997, a continued high level of employment and higher wage increases, tax revenue is expected to rise. The grants from central government will also increase, partly because of the above mentioned improvement measures.

The National Tax Board has established that the VAT charge for municipalities and county councils for 1999 will be SEK1,970 and SEK965 per capita, respectively. This means that deposits to the VAT tax repayment system will be higher than previous estimates, with effect from next year.

Expenditure within the sector is also expected to be higher than forecast in the Government Spring Bill. However, transfers will decline slightly, partly as a result of a weaker development in prices. Supplementary benefits within the social welfare system, which has increased over a long period of time, is expected to begin to fall with effect from this year. The reduction comes partly from increasingly favourable developments in the labour market. Altogether, this provides greater scope for consumption and a higher level of employment than before. This development is supported by

the result from the National Accounts for the first half of this year. Not only employment, but also consumption of goods and services has increased, which can be partly explained by the fact that the municipalities are buying services in connection with the education and training initiative (Kunskapslyftet), including consultants acting as teachers.

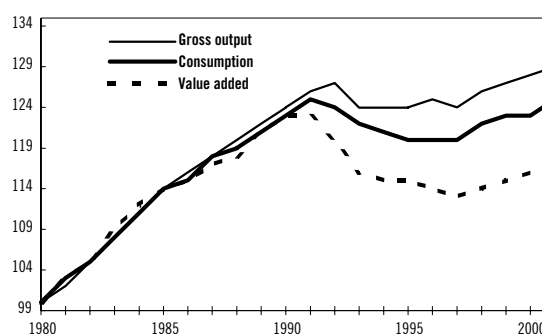
It is estimated that with effect from 1998 there will be scope for an increase in the volume of consumption by an average of 1.0 per cent per annum. This increase means that the number of those employed will increase by an average of just over 11,000 per annum. The scope for an increase in the volume of consumption is approximately the same magnitude in the municipalities and county councils, but is distributed somewhat differently between the years.

In 1998, consumption in constant prices is expected to increase by approximately 0.4 per cent as a result of public temporary employment and resource work and by approximately 0.4 per cent as a result of a change in the responsibility for incontinence articles, as well as 0.5 per cent for the education and training initiative. When adjusted for these changes, the underlying consumption volume is reached. This is expected to increase by 0.3 per cent this year. With effect from next year, however, the underlying consumption rate is expected to grow more rapidly than the actual consumption rate.

The financial balance in the local government sector is expected to be lower this year than was forecast in the Government Spring Bill, which is partly a result of the payment of retroactive pensions. The balance is expected to be slightly higher in coming years than was previously foreseen. The financial balance for both municipalities and county councils is expected to amount to

Diagram 11.5 Local Government Consumption

Index 1980 = 100



Sources: Statistics Sweden and Ministry of Finance.

an average of SEK2.8 billion per annum, with effect from next year. The level of the financial balance is assumed, with effect from the year 2000, to correspond to a positive result for the sector, as a whole, as each municipality, county council and municipal association must as a minimum requirement achieve a balance in their finances.

Value added in the local government sector is calculated as the total of wages, payroll taxes, etc. and capital wear and tear on fixed assets. Value added comprises the contribution by this sector to GDP.

Consumption is a measure of the tax-financed activities of the sector. If sales income and charges are added to consumption, the gross output figure is obtained, which corresponds to local government sector total output and consumption of resources.

As shown in Diagram 11.5, value added, consumption and gross output of the local government sector increased in constant prices up to the beginning of the 1990s. Thereafter, value added declined sharply. This is mainly explained by the fall in employment. Neither consumption nor gross output declined to the same extent as value added. This is due to the fact that the local government sector is buying materials and services to an increased extent and that charge-financed activities and sales income have risen in volume. For the coming years, value added, consumption and gross output are expected to increase again, albeit at a slower rate than before.

12 Alternative Scenario

During winter and spring 1998, there was an unusually broad consensus of opinion among various economic analysts regarding the development of the Swedish economy. However, as the Asian crisis has deepened, prolonged and spread, opinions have begun to diverge. Various assessments have been made with regard to the length and depth of the crisis, the spread effects to the rest of the world and the repercussions on the Swedish economy.

To illustrate the uncertainty over international developments and the possible repercussions for Swedish growth, employment and general government finances, this chapter presents an alternative scenario, which describes developments in the event of a weaker global economy. The comparison is thus made with the "base alternative" presented above. The two scenarios are assumed to begin to diverge at the beginning of October 1998. The alternative scenario is judged to be less probable than the base alternative.

International Developments

The base alternative foresees a cautious, export-driven recovery in the Asian region during 1999. The spillover effects from the Asian crisis on the OECD region outside of Asia are assumed to be moderate. However, there is great uncertainty over this assessment and there is a risk of poorer growth eventuating.

The alternative scenario assumes that the economic recession in Japan will be more prolonged than is assumed in the base alternative. The problems in the financial sector will remain and the stimulation from fiscal policy will partly fail to arrive. This will contribute to a continuing low level of confidence among both households and consumers. The delayed recovery in Japan will mean that the financial markets in the rest of Asia remain unstable and will thus make more difficult the implementation of economic and political reforms in the crisis-affected Asian countries. The alternative scenario assumes that there will not be any recovery in the Asian region until the year 2000.

The deepened Asian crisis in the alternative scenario means negative repercussions on the rest of the world, particularly on emerging markets. Those of these countries that have considerable budget and current account deficits will be especially vulnerable to the effects of the Asian crisis. They will suffer a reduction in capital inflows and

higher interest rates in that the financial markets take refuge in safe investments. In addition, those countries that have strong commercial and financial links to the Asian countries are also more vulnerable. Further, a decline in the demand for raw materials will lead to a further deficit in the current account for countries that export raw materials. The alternative scenario assumes that these countries for instance, in Latin America, will pursue a stricter economic policy to counteract the financial turbulence and this will have negative effects on domestic demand.

Poorer economic growth in Latin America would mean deterioration in the development of exports, particularly in the United States and in some European countries. Weaker export growth would lead, with a slight lag effect, to a poorer development in investment in the export-dependent sectors, and contribute to lower employment.

Apart from the trade effects, Europe and North America would also be directly affected by the turbulence on the financial markets, which is expected to continue and become deeper in the alternative scenario. The deepened crisis would lead to accentuated price pressures and thus pressures on profits, which would lead to lower profit expectations and a weaker development in stock prices than is foreseen in the base alternative. This means that expectations for the future among both households and firms are affected negatively.

North America would be hit relatively hard by a stronger and more prolonged decline in stock prices, primarily because the savings ratio there has already fallen considerably. The United States has been stimulated over a long period of time by a good development in wealth and, together with a lower growth in employment, a fall in stock prices would contribute to a slower rate of increase in private consumption.

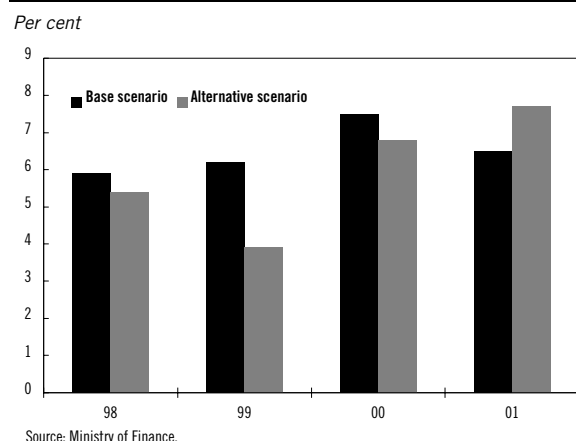
In Europe, where private consumption is considered to be less sensitive to developments in stock prices, the direct effects of a deepened Asian crisis are expected to be somewhat less than in North America. Nevertheless, squeezed company profits and increased uncertainty would lead to a lower growth in employment and investment than in the base alternative, which in the long term would also have a negative effect on private consumption.

The weaker growth in demand, compared with the base alternative, is assumed to lead to an easing in monetary policy, particularly in the United

States and Europe. This would moderate, but could not eliminate in the short term, the negative repercussions on growth and employment.

The alternative scenario therefore assumes that the recovery in Asia will not begin until the year 2000 and that the crisis will have more negative repercussions on the rest of the world, particularly in the years 1999-2000. The difference between the base alternative and the alternative scenario with regard to global GDP growth and therefore export market growth is most significant in the year 1999. The difference in global market growth is estimated at just over 2 percentage points this year.

Diagram 12.1 Export Market Growth in the Alternative Scenario



Sweden's Economy

Weaker international growth in the alternative scenario means poorer market growth for Swedish exports, combined with increased price pressures. Lower import prices and weaker demand will generate lower inflationary pressures, even in Sweden. The Riksbank is therefore expected to pursue a more relaxed monetary policy. The interest-rate spread with other countries is expected to remain the same as in the base alternative. The exchange rate is also assumed to be the same, as monetary policy will be more relaxed in both Sweden and the rest of the world. Unlike the many previous global economic slowdowns, the profit level in the manufacturing industry will be relatively high. There will therefore be scope within a large section of the manufacturing industry for price competition by reducing profit margins. Swedish firms can consequently be expected to lower their prices to retain and win market share. The Swedish export industry will therefore cope much better with an international slowdown today. Despite lower export prices, the growth in exports will be weaker than in the base alternative. The effect on exports for the current year will be slight, as the two alternatives do not diverge until the end of the year. Next year, export growth will be much weaker than in the base alternative.

Table 12.1 Selected Statistics in the Alternative Scenario

Per cent

	1998	1999	2000	2001	Difference compared with base scenario percentage points			
					1998	1999	2000	2001
Market growth for Swedish exports	5.4	3.9	6.8	7.7	-0.5	-2.3	-0.7	1.2
TCW-index ¹	121.7	120.4	118.5	118.0	0	0	0	0
German long-term rate ¹	4.30	4.03	4.39	4.8	-0.05	-0.25	-0.25	0
German short-term rate ¹	3.58	3.38	3.69	4.30	-0.05	-0.50	-0.50	0
Swedish long-term rate ¹	4.76	4.44	4.64	5.00	-0.05	-0.25	-0.25	0
Swedish short-term rate ¹	4.31	3.80	3.80	4.30	-0.05	-0.50	-0.50	0
Hourly wages	3.3	2.9	3.2	3.0	0	0	0	0
CPI ¹	0.5	0.4	1.3	2.0	0	-0.3	-0.4	0
Real disposable income	2.7	3.2	1.6	2.0	0.0	-0.1	0.0	0.1
Savings ratio (level)	0.9	1.8	1.0	0.6	0.1	0.6	0.7	0.5
Industrial production	4.3	2.7	4.1	3.9	-0.3	-1.8	0.1	1.0
Employment	1.1	0.5	1.6	1.6	-0.2	-1.0	-0.1	0.5
Registered unemployment	6.7	6.5	5.3	4.5	0.1	0.8	0.9	0.5

¹ Annual average.

Source: Ministry of Finance.

The adaptation of output to lower demand will take some time, which will lead to an involuntary build up of stocks. The effect on GDP of lower exports will thus be slightly delayed.

Poorer industrial activity, with deteriorating profit prospects and greater uncertainty, will lead to a major turnaround in investment in the export sector. After a period of time, investment in closely related export-dependent sectors will also decline, compared with the base alternative. Greater uncertainty will mean that both firms and households will postpone their investment. Unlike the economic recession at the beginning of the 1990s, investment volumes and capital stocks are relatively balanced at the moment. At the beginning of the 1990s, there were severe imbalances, particularly in the residential sector. Today, residential construction is at a low level, which means that the risk of a major decline in investment in this sector is relatively small.

The slowdown in the economy will also spread to households and dampen consumption. Lower growth, compared with the base alternative, will lead to a weaker growth in employment and in household disposable incomes. However, the impact of this will be counteracted by the fact that transfers, for example, in the form of unemployment benefit, will become higher. The poorer profit prospects for firms will lead to weaker developments on the stock exchange. Swedish households own relatively large volumes of shares and share ownership is relatively well dispersed, which means that household wealth will be affected quite considerably compared with other European countries. Property prices will be affected negatively by a lower growth, even though the impact will be moderated by the more relaxed monetary policy. The alternative scenario thus involves weaker growth in house-

hold incomes and wealth, which together with the generally higher uncertainty will lead to lower consumption. The risk of a more considerable slowing down in the growth of consumption is considered to be relatively slight. Households have consolidated their finances during the 1990s and have a very good wealth position.

Lower exports, investment and private consumption will lead to imports also being lower, which will reduce the impact on GDP. The more relaxed monetary policy with a lower repo-rate will subdue the impact on GDP, but in the short term will not manage to completely counteract the fall in demand that will arise through lower international growth and a generally higher level of uncertainty.

The estimates in the alternative scenario are also based on a number of assumptions of a more technical nature. As in the base alternative, wages are assumed to increase by approximately 3 per cent per annum. To make adjustments for the effects of different international developments, the estimates are based on unchanged regulations. Central government consumption, general government investment and the volume of labour market policy measures are thus assumed to be the same as in the base alternative. Therefore, the effects reported refer to the consequences of weaker international developments, disregarding the changes in regulations to which such weaker developments could give rise.

For local government, it is assumed that the balanced finances requirement must be fulfilled with effect from the year 2000 in both the base alternative and the alternative scenario. This means that local government consumption will be adapted as a result of the lower tax revenue in the alternative scenario.

Table 12.2 Demand and Output in the Alternative Scenario

Percentage change

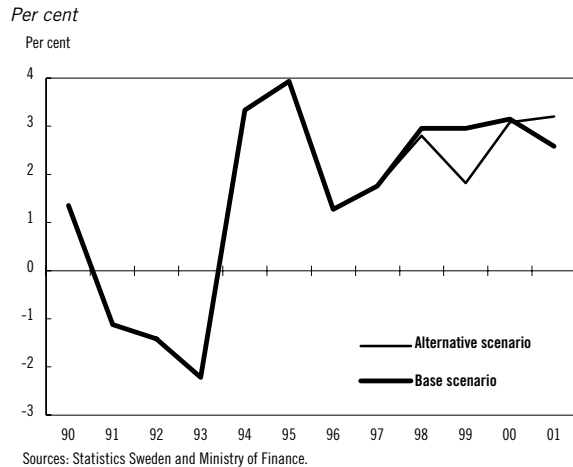
	1998	1999	2000	2001	Difference compared with base scenario percentage points			
					1998	1999	2000	2001
Private consumption	2.6	2.2	2.4	2.4	-0.1	-0.7	-0.1	0.4
General government consumption	1.9	0.4	0.0	1.1	0.0	-0.4	-0.5	0.2
Gross fixed capital formation	9.4	4.2	8.3	7.0	-0.4	-3.8	1.5	1.1
Change in stocks	0.2	-0.1	0.0	0.0	0.1	-0.1	0.0	0.0
Exports	5.4	4.3	6.3	6.4	-0.5	-1.6	-0.3	0.9
Imports	8.6	5.2	6.4	6.4	-0.3	-1.9	0.1	0.6
GDP	2.8	1.8	3.1	3.2	-0.2	-1.2	-0.1	0.6

Source: Ministry of Finance.

Overall, GDP is expected to grow by 2.8 per cent in 1998 and 1.8 per cent in 1999 in the alternative scenario, which is 0.2 and 1.2 percentage points lower, respectively than in the base alternative.

The lower growth rate means a poorer labour market situation than in the base alternative, with weaker growth in employment, particularly next year. Poorer international developments will have a direct impact on employment in the manufacturing industry, but employment in the rest of the business sector will also be affected as a result of weaker domestic demand. The balanced finances requirement in the local government sector will restrict the scope of operations and employment will therefore also develop more weakly in this sector as well. Overall, it is estimated that employment will increase by 0.5 per cent next year, which is 1 percentage point lower than in the base alternative. The weaker growth in employment will lead to fewer people entering the labour market, which will dampen the impact on registered unemployment. Registered unemployment is estimated at 6.5 per cent next year, which is 0.8 percentage points higher than in the base alternative.

Diagram 12.2 GDP Growth in the Alternative Scenario



The slowdown in the global economy is not expected to reduce Swedish GDP in the long term as much as in the short term. In the space of a few years, when the international turbulence has settled, the more relaxed monetary policy has made a greater impact, global growth has recovered and capital stocks prove to be too low following a period of relatively low investment, a recovery can be expected. This means that growth will be higher in the alternative scenario for a couple of years. However, this recovery is not expected to be fully complete within the time

period being considered here, and the level of GDP is assumed to be lower in 2001 than in the base alternative. In the alternative scenario, GDP growth is estimated to be 3.1 per cent in the year 2000 and 3.2 per cent in the year 2001. This means that in the year 2001, GDP will be 0.9 per cent lower than in the base alternative.

As GDP will be lower during all of these years, unemployment will be higher, which means that the unemployment goal will not be achieved by the end of the year 2000.

Diagram 12.3 Registered Unemployment in the Alternative Scenario



General Government Sector Finances

With weaker economic growth, general government finances will develop more poorly than in the base alternative. Historically, the general government financial balance has shown a high sensitivity to changes in the economic cycle. Some of these changes may, however, be attributed to discretionary fiscal policy measures rather than automatic effects on the general government financial balance with given taxation and expenditure regulations.

In the alternative scenario, the most important tax bases will develop more slowly than in the base scenario. The wage bill is expected to be just over 1.5 per cent less in the year 2000 as a result of the weaker growth in employment, and private consumption is assumed to be just over 1 per cent lower. Altogether, tax revenue is estimated at SEK13 billion less in the alternative scenario.

On the expenditure side, it is mainly unemployment benefits and other household transfers that will be affected by the weaker labour market. Higher unemployment and lower employment compared with the base alternative will mean ex-

Table 12.3 General Government Finances in the Alternative Scenario

	1998	1999	2000	2001	Difference compared with the base scenario percentage points			
					1998	1999	2000	2001
Revenue	1147	1154	1186	1228	-1	-10	-16	-13
<i>per cent of GDP</i>	<i>63.4</i>	<i>62.1</i>	<i>61.1</i>	<i>60.2</i>	<i>0.1</i>	<i>0.4</i>	<i>0.4</i>	<i>0.2</i>
Taxes and charges	992	1006	1041	1086	-1	-8	-13	-10
<i>per cent of GDP</i>	<i>54.8</i>	<i>54.2</i>	<i>53.6</i>	<i>53.2</i>	<i>0.0</i>	<i>0.4</i>	<i>0.4</i>	<i>0.2</i>
Capital income	85	76	73	68	0	-2	-3	-2
Other income	70	72	72	74	0	0	0	0
Expenditure	1111	1144	1152	1168	0	1	-4	-4
<i>per cent of GDP</i>	<i>61.3</i>	<i>61.6</i>	<i>59.3</i>	<i>57.2</i>	<i>0.1</i>	<i>1.0</i>	<i>0.9</i>	<i>0.6</i>
Transfers to households	511	524	518	521	1	5	4	1
Consumption and investment	496	527	545	566	0	-2	-6	-5
Interest expenditure	103	93	89	81	0	-1	-2	-1
Financial balance	37	10	34	60	-1	-11	-12	-8
<i>per cent of GDP</i>	<i>2.0</i>	<i>0.5</i>	<i>1.8</i>	<i>3.0</i>	<i>-0.1</i>	<i>-0.6</i>	<i>-0.6</i>	<i>-0.4</i>
Financial position								
Net debt	340	323	290	231	1	13	25	33
<i>per cent of GDP</i>	<i>18.8</i>	<i>17.4</i>	<i>14.9</i>	<i>11.3</i>	<i>0.1</i>	<i>0.9</i>	<i>1.5</i>	<i>1.8</i>
Consolidated gross debt	1321	1334	1305	1186	1	13	25	33
<i>per cent of GDP</i>	<i>73.0</i>	<i>71.8</i>	<i>67.2</i>	<i>58.1</i>	<i>0.2</i>	<i>1.8</i>	<i>2.5</i>	<i>2.4</i>

Source: Ministry of Finance.

penditure of approximately SEK 4 billion more for the central government in 1999 and 2000. No consideration has been given here to the necessity of taking measures so that the central government expenditure ceiling is not exceeded, as the estimates assume given taxation and expenditure regulations.

For the total general government sector, the increase in expenditure for the central government will to some extent be counteracted by the fact that consumption in municipalities and county councils will be lower than in the base alternative. When combined with the requirement to achieve balanced finances, the lower tax revenue in municipalities and county councils will provide less scope for a growth in local government consumption. In the year 2000, consumption in municipalities and county councils is expected to be just over 1 per cent lower than in the base alternative. The balanced finances requirement will thus contribute to reducing the sensitivity of general government finances to changes in the economic cycle.

The general government financial balance is estimated to be SEK11 billion lower in both 1999 and the year 2000, compared with the base alternative, which is equivalent to approximately 0.5

per cent of GDP. The goal for the general government financial balance, corresponding to 0.5 per cent of GDP in the year 1999, will be achieved. However, the general government financial balance will not reach 2 per cent of GDP in the year 2000.

The difference between the alternatives with regard to the general government sector financial balance will correspond to just under half of the difference in GDP in the year 2000. This provides a measure of the degree of sensitivity in general government finances to the economic cycle given the case of the alternative scenario with an analysed disturbance in the form of a slow-down in the international economy and assuming that no fiscal policy measures are taken. Appendix 1 in the 1998 Government Spring Bill analysed two other disturbances that resulted in an economic sensitivity of 57 per cent and 45 per cent, respectively. This shows that general government finances vary in sensitivity to different types of disturbances, which is due to the fact that different disturbances influence the composition of GDP and thus the tax bases and general government expenditure in different ways.

Summary

The Swedish economy is sensitive to what happens in the rest of the world. Weaker global growth will thus have considerable repercussions on Swedish economic growth, employment and general government finances. Such a development makes it more difficult to achieve the goal of halving unemployment by the year 2000. However, general government finances are sufficiently strong in the base alternative for the general government financial balance to show a surplus each year, despite the weaker international growth. Therefore, the slowdown avoids becoming deeper and prolonged by a lack of confidence in the Swedish economy, which could be expressed by, for instance, higher interest rates.