REGERINGSKANSLIET

Ministry of Finance

Sweden´s Convergence Programme 1998-2001

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I Introduction

Sound public finances are a prerequisite for sustainable economic growth and high employment. The Stability and Growth Pact agreed by the European Council aims at guaranteeing sustained budget discipline in the third stage of EMU. The Pact strengthens surveillance of budgetary positions of all the Member States. As part of this surveillance, Member States are to submit a stability or convergence programme in accordance with Council Regulation (EG) 1466/97. To conform to the May 1, 1998 declaration by finance ministers, these programmes must be presented before the end of 1998. The convergence programmes apply to those countries not adopting the single currency. The Council has approved special guidelines for the form and content of the stability and convergence programmes.

This Convergence Programme is based on the projection of economic growth and the direction of economic policy presented in the 1999 Budget Bill, which was presented to the Riksdag in October 1998. However in the light of subsequent information, mainly concerning international developments, the projection has been revised in important respects. The Social Democrats, the Center Party and the Green Party support the Convergence Programme. The Convergence Programme does not imply any position or commitment in connection with the single currency.

II Economic Policy Premises

Since the presentation of the previous Convergence Programme in June 1995, the Swedish economy has regained its strength and the basis for high and sustainable growth has been established. A very far-reaching consolidation programme has reversed the deficit in the general government finances – more than 10 per cent of GDP in 1994 – and in 1998 there is now a surplus of nearly 2.5 per cent of GDP, measured according to accounting principles for the Swedish National Accounts. (Measured according to accounting principles for the European System of Accounts (ESA), the 1998 budget surplus is estimated to amount to 1.5 per cent of GDP.) The consolidated gross debt as a share of GDP is declining rapidly. Inflation and inflationary expectations have been reduced to a sustainably low level. All in all, these actions have created the conditions for a decline in interest rates.

The economic policy is directed at maintaining stable macroeconomic conditions in order to lay the foundation for further healthy economic growth. In this way the conditions for increased employment and reduced unemployment are created. One goal is to increase employment in that part of the population aged 20 to 64 to 80 per cent by 2004.

Keeping firm control over the development of public finances is one of the main features of this policy. Swedish experience indicates that medium-term targets for the general government fiscal balance and the debt play a major role in this context. The medium-term target is a budget surplus corresponding to an average of 2 per cent of GDP over the business cycle. Thereby, a comfortable margin can be established in order to be able to avoid an excessive deficit during a future downturn. An important factor in achieving this goal is the stricter budget process that has been in effect since 1997, which includes a provision for a ceiling on public expenditure established by the Riksdag. According to the Stability and Growth Pact, the Member States will aim at the medium-term objective of budgetary positions of close to balance or in surplus.

Sveriges Riksbank formulates monetary policy independently. This policy is based on a price stability objective, which is defined as an increase in the consumer price index of 2 per cent a year, with a tolerance interval of plus or minus one percentage point.

With the aim of strengthening the credibility of the price stability objective, five parties in the Riksdag reached an agreement during the previous parliamentary term on increased independence for the Riksbank. In autumn 1998 the Riksdag has passed resolutions on the constitutional amendments implied in the agreement. The legal changes mean that the price stability objective is prescribed by law and include the introduction of a prohibition against giving instructions to the Riksbank and a provision making it more difficult to oblige members of the Riksbank's Executive Board to retire. The changes effected are in line with the terms laid down in the Maastricht Treaty.

The Riksdag has decided that Sweden should not introduce the euro when the third stage of EMU begins. However Sweden is keeping the door open for a later entry into EMU. Sweden will also continue to fulfil the economic conditions for full membership in EMU in order to preserve its freedom of action. To increase knowledge and stimulate a broad debate on a Swedish participation in the third stage of EMU, a broad and impartial information and educational programme is under way. A decision on participation in EMU will be submitted to the Swedish people for consideration in a general election or referendum.

III Fiscal Policy

The public sector fiscal balance expressed as a percentage of GDP has strengthened by 12.5 percentage points since 1994. The greater part of this improvement – over 8 percentage points, of which reduced interest expenditure accounts for not quite 1 percentage point – has occurred on the expenditure side.

Table 1 Public Finances
Per cent of GDP

	1994	1995	1996	1997	1998
Total Revenue	59.7	59.6	63.7	62.8	64.1
Taxes	49.8	49.9	54.1	54.2	55.6
Other revenue	9.9	9.7	9.6	8.6	8.5
Total Expenditure	70.0	67.3	65.8	63.9	61.7
Transfers	33.0	31.5	30.3	29.0	28.5
Consumption and investment	30.2	28.7	28.3	28.3	27.4
Interest payments	6.8	7.1	7.2	6.6	5.9
Fiscal balance	-10.3	-7.8	-2.1	-1.1	2.4
Central government	-11.7	-8.9	-3.2	-1.3	1.0
Retirement pension plan	1.6	1.2	1.0	0.6	1.3
Local governments	-0.2	-0.1	0.2	-0.4	0.0
Fiscal balance according to ESA	..	..	-3.5	-0.8	1.5
Consolidated gross debt	79.3	78.0	77.2	76.6	74.2
Net debt	21.9	23.6	20.3	21.7	19.4
GDP, SEK billions	1 531	1 650	1 688	1 739	1 808

Sources: Statistics Sweden and Ministry of Finance.

Only a small part of the improvement in the fiscal balance can be explained by cyclical or other temporary factors. The underlying or structural savings reckoned between 1994 and 1998 have been strengthened by the equivalent of almost 10 per cent of GDP. This improvement is chiefly due to the impact of the consolidation programme. Under this Programme, measures corresponding to 8 per cent of GDP were implemented during these years.

Table 2 Change in the Public Sector Fiscal Balance
Per cent of GDP

	1995	1996	1997	1998
Total change	2.6	5.7	1.0	3.5
Revenue from capital and interest expenditure	-0.4	-0.4	0.0	0.6
Cyclical effects	-0.2	0.5	0.0	0.9
Timing of tax revenue	0.2	1.2	-1.2	1.2
Central government property purchases and sales	0.2	0.4	-0.8	1.1
Change in structural balance	2.8	3.9	3.0	-0.4

Source: Ministry of Finance.

There are several reasons why Sweden should also have a budget surplus in the public sector in the years to come:

- The net debt should be reduced in order to strengthen confidence in the Swedish economy over the long term and to reduce the public sector's sensitivity to interest rate fluctuations.
- For reasons of equity, Sweden must reduce the debt and the concomitant interest payments being handed down to future generations.
- The public sector's net fiscal position needs to be strengthened before the increase in claims on the public sector expected as a result of the increase in the percentage of older people in the population.
- The public finances have a proportionately high degree of sensitivity to economic fluctuations. If there is a surplus during a normal business cycle, enough room will be created so the automatic stabilisers can be allowed to work in the event of a downturn in the business cycle.

Against this background the Riksdag decided in 1997 on a medium-term target for the public finances: the budget surplus in the public sector should amount to an average of 2 per cent of GDP seen over the business cycle. The goal will be achieved gradually so that the surplus will amount to 0.5 per cent of GDP in 1999 and to 1.5 per cent of GDP in 2000. The goals for these years are valid with growth as calculated in the 1997 Spring Budget Bill. If, for cyclical reasons, growth were to deviate substantially from these calculations, an equivalent variance from the stated goals would be tolerated. With the aim of strengthening confidence in the Swedish economy, the Riksdag decided in autumn 1998 to raise the target for 2000 to a public sector budget surplus of 2.0 per cent of GDP. With a surplus of this size, the public sector's fiscal position will be strengthened substantially.

As the medium-term goal refers to the public sector fiscal balance seen over the business cycle, the actual budget surplus could fall below 2 per cent of

GDP in a phase of the business cycle with relatively high idle capacity in the economy, but conversely exceed 2 per cent of GDP in the peak phase of the business cycle. Thus the level that the budget surplus will reach in an individual year is dependent on the phase of the business cycle, which provides scope for the automatic stabilisers to work. In this way it is possible to refrain from a pro-cyclical fiscal policy. A medium-term goal of a public sector budget surplus equivalent to 2 per cent of GDP should also be compatible to some extent with conducting an active fiscal policy, with the aim of moderating swings in the business cycle without risking excessive deficits during down-turns.

Adjusting the public sector fiscal balance to cyclical behaviour presupposes that expenditure is under control and, as a result thereof, fiscal policy enjoys strong credibility. Keeping expenditure under the established ceilings is a fundamental target. Since the 1997 budget, new and stricter rules for the central government budget process have been put into practice. These rules include a provision whereby the Riksdag, in connection with the Government's Spring Budget Bill, establishes nominal expenditure ceilings for each central government expenditure, excluding interest payments. Such expenditure ceilings have been established for the years 1998-2001 and mean that the expenditure items for which ceilings have been established will not be allowed to rise by more than 6.5 per cent in the coming three-year period. The established expenditure ceilings cannot be exceeded without the Riksdag passing a resolution to that effect.

Expenditure was held under the expenditure ceiling by a wide margin in 1997. In 1998 there appeared to be some risk in the autumn that the ceiling would be exceeded. To avoid such a possibility, measures have been taken to reduce certain expenditure. If the expenditure ceiling for 1999 threatens to be exceeded, measures will be taken to limit central government expenditure.

Beginning in 2000 a balanced budget requirement applies to local and county governments. This requirement means that revenue and expenditure must balance. In practice the expenditure of the local government sector, with a given tax levy, is also limited by this requirement. However, the economic conditions of the various municipal and county governments differ considerably owing to such reasons as demographic changes.

The direction of fiscal policy is not decided by current business conditions alone. The underlying growth and the way in which the labour market functions are also important. Wage formation plays a particularly significant role here. A wage formation process that functions well and a better functioning labour market increase the level of production, which is compatible with the maintenance of low inflation – a situation that is also reflected in stronger public finances. A central government commissioner has recently submitted proposals to the Government for changes in the rules surrounding wage negotiations, including a strengthened mediation function and certain restrictions on the right to take industrial action.

Weak growth associated with structural problems must not result in a weaker fiscal policy. The major effort to promote education is an important component of a strategy for increased growth. Another important factor affecting growth is the design of the tax system. As a result of the favourable developments in the public finances, scope can be found for certain changes in the tax system in the coming years. Therefore the Government has invited representatives of all the parties in the Riksdag to discussions on the future direction of tax policy. A starting-point in this overhaul is that the tax system will be characterised by simplicity and uniformity, with a broad tax base and low tax rates.

IV Forecast for the Coming Years

Economic Outlook

The consolidation of public finances and stable monetary conditions have laid the foundation for favourable growth in production and employment in the next few years. The current international economic slowdown is partially offset by a strong growth in domestic demand. The growth in Sweden's GDP is estimated to amount to 2.2 per cent in 1999 and about 2.5 per cent in the years 2000 and 2001.

In October 1998, in connection with the 1999 Budget Bill, the Government gave its assessment of the economic outlook up to and including 2001. Information received subsequently, especially concerning the international situation, has caused a modest downward revision of the growth forecast for the next two years.

The economic crisis in Asia and elsewhere and unrest in the financial markets has caused considerable uncertainty in assessing international developments. The forecast assumes a stabilisation of the international financial system and a modest recovery in the Japanese economy in 1999, which will then strengthen successively in 2000 and 2001. A growing number of signs point to a downturn in growth in the United States, at the same time that the prospects for growth in the EU have moderated somewhat. In 1999 growth in GDP is estimated to amount to about 1.5 per cent for the OECD area and to 2.25 per cent for the EU area.

Favourable monetary conditions and stronger public finances will form the basis of relatively good growth in Europe during the forecast period. Growth in the countries of the EU is estimated at 2.5 per cent in 2000 and 2001. Growth in the OECD area as a whole is expected to come to just over 2 per cent a year.

Favourable conditions in the Swedish economy should lead to relatively high growth in the next few years. The interest rate on ten-year government bonds has been brought down to its lowest level for several decades and at the same time, the interest rate differential against the euro area has been reduced to about 0.4 percentage points. The inflation rate is low and stable. During 1998 consumer prices have fallen slightly. However temporary factors such as changes in certain taxes and subsidies partly account for this decline. The underlying rate of inflation is estimated to be about 1 per cent. During 1999 the consumer price index is expected to increase by a little more than 1 per cent. The low inflation has made it possible for the Riksbank to lower its instrumental rate on four occasions by a total of 0.75 percentage points. Market interest rates are expected to fall a little more in early 1999, but to begin to rise towards the end of the year in both Sweden and the rest of the world, owing to stronger economic growth.

By pursuing an economic policy which continues to emphasise low inflation and surpluses in the public finances and the current account, confidence in the Swedish economy is strengthening and thus conditions for a stable exchange rate in the long term are improving. Participation in the European exchange rate mechanism, ERM2, can be viewed as a natural step towards possible Swedish participation in EMU.

The Swedish krona has a floating exchange rate. Therefore some fluctuation in the exchange rate is natural. During 1997 and 1998 the exchange rate has fluctuated, but there has not been any definite trend. More recently, the krona has weakened in connection with the unrest in the international financial markets. The weakening of the krona appears to be unwarranted in view of the economic fundamentals showing favourable growth, low inflation, stable current account surplus and increasing budget surpluses in the public sector.

Diagram 1: 10-Year Government Bond Interest, 1994-1998

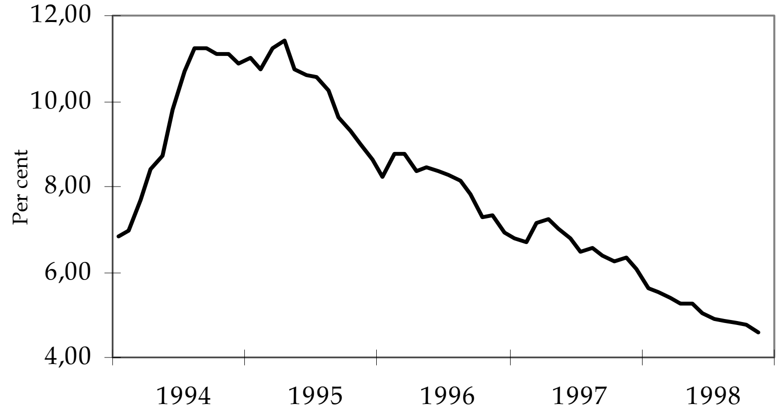


Diagram 2: Inflation, 1994-1998

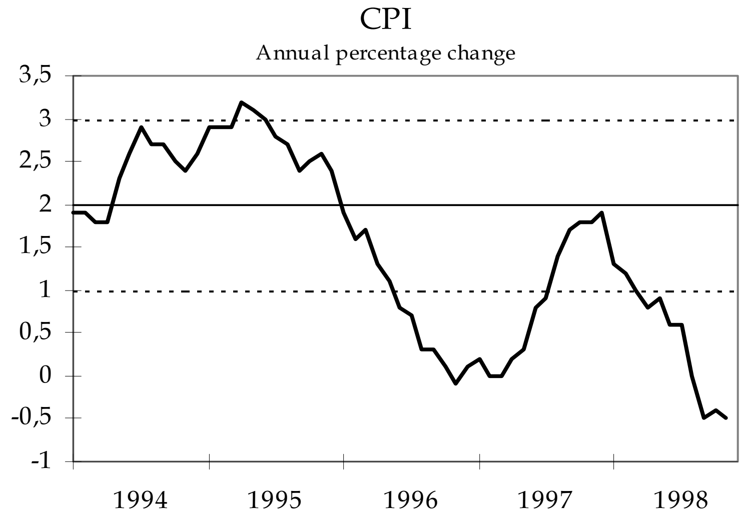
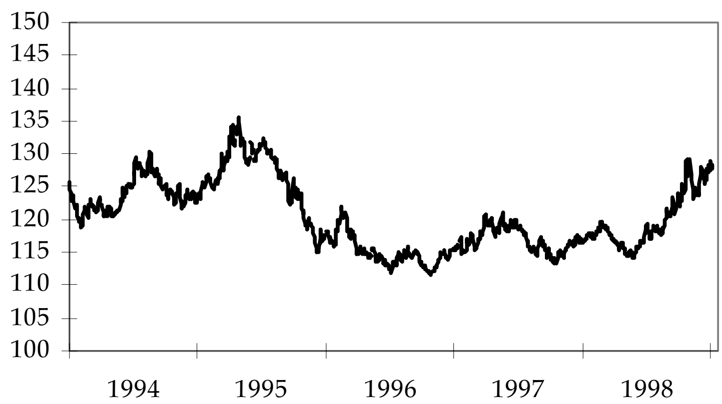


Diagram 3: ECU Index 1994-1998



Export growth has weakened in 1998 compared with the most recent four years, when exports on average grew more than 11 per cent a year. Swedish exports to Asia have declined sharply. However this decline is partially offset by the continuing growth of exports to the European market. An expected downturn in the international industrial outlook in 1999 will lead to further restraints on the growth of Swedish exports, which are largely composed of manufactured goods.

Domestic demand is expected to be the engine of growth in the Swedish economy in the period covered by the forecast. After several years of very weak growth, the conditions for significant growth in household disposable income now exist. Declining interest rates have helped strengthen the financial position of households appreciably in recent years. Domestic confidence in economic developments in Sweden is intact, despite the international unrest. After several years of weak consumption, there is a pent-up demand for capital and other goods. Favourable developments in the labour market, combined with lower interest rates, will create conditions for a considerable increase in private consumption.

Table 3 Basic Economic Indicators

Percentage change

	1997	1998	1999	2000	2001
Demand and Output					
Private consumption	2.0	2.7	2.5	2.5	2.0
Government consumption	-2.1	1.5	0.9	0.6	0.6
Investment	-4.8	9.0	5.3	7.3	4.9
Change in stocks	0.7	0.4	-0.3	-0.1	0.0
Exports	12.8	5.5	4.4	6.0	4.9
Imports	11.7	8.9	5.0	7.0	4.6
GDP	1.8	2.8	2.2	2.6	2.5
Key Indicators					
Inflation, Dec-Dec	1.9	-0.2	0.5	1.3	2.0
Hourly wage increase	4.5	3.3	2.9	3.2	3.0
Ten-year government bond interest (level)	6.6	5.0	4.4	4.7	5.1
Exchange rate, ECU index	117.2	120.0	120.3	117.5	116.5
Employment	-1.0	1.4	0.9	1.0	1.0
Unemployment level, per cent	8.0	6.6	5.9	5.3	4.7

Source: Ministry of Finance.

After stagnating for two years, investment has also turned around and will continue to grow during the forecast period. In industry, capacity utilisation is high and profit levels are relatively good. However investment by industry will slacken in 1999 as a result of a reduction in exports. But investment is needed to meet growing demand in the domestic market. In addition residential investment is expected to recover, even though the recovery will start from a very low level.

GDP is estimated to grow by 2.8 per cent in 1998 and then slow to 2.2 per cent in 1999. After that growth is expected to be 2.5 per cent a year, given the assumptions previously stated.

Developments in the labour market have been unexpectedly strong during 1998. Job vacancy statistics, etc. indicate that developments will continue to be favourable in the immediate future. However the weakening trend in industry and other areas of the economy will lead to a weaker growth in employment during 1999. After that, employment is expected to grow at an annual rate of about 1 per cent. Open unemployment is estimated to fall from an average of 6.6 per cent in 1998 to 4.7 per cent in 2001.

Public Finances

In 1998 public finances show a budget surplus for the first time in eight years. Given the macroeconomic developments described previously, the surplus is estimated to be about 1 per cent of GDP in 1999. Thereafter, in view of policies that have now been decided, the budget surplus will increase. It will exceed 2 per cent of GDP in 2000 and 3 per cent of GDP in 2001. Measured according to ESA accounting principles, the budget surplus in each of these years is estimated to be about half a percentage point lower.

Owing to agreed tax reductions, among other reasons, tax revenue, which was temporarily high during 1998, will fall as a percentage of GDP during the forecast period. The tax ratio will be reduced by nearly two percentage points between now and 2001. Thus the improvement in the fiscal balance will be attributable to a substantial reduction in expenditure as a percentage of GDP. Measured in real terms, expenditure is estimated to be 2 per cent lower in 2001 than in 1998. Declining interest expenditure will account for one percentage point of this decrease in expenditure. It is chiefly labour market related expenditure that will fall in conjunction with declining unemployment. The underlying or structural surplus will increase by about 1 per cent of GDP between 1998 and 2001. The fiscal policy now mapped out is expected to be slightly expansionary during 1999 and somewhat contractionary during 2000 and 2001.

As a result of the statutory balanced budget requirement for local and county governments, which comes into effect at the beginning of the year 2000, the sector as a whole is expected to show a budget surplus. This surplus has been estimated at almost 0.5 per cent of GDP.

Table 4 Public Finances
Per cent of GDP

	1998	1999	2000	2001
Total Revenue	64.1	62.3	61.8	61.0
Taxes	55.4	54.5	54.3	53.9
Other revenue	8.5	7.7	7.4	6.9
Total Expenditure	61.6	61.3	59.7	58.0
Transfers	28.5	28.1	26.9	26.0
Consumption and investment	27.4	28.3	28.4	28.1
Interest payments	5.9	4.8	4.4	3.9
Fiscal balance	2.4	1.1	2.2	3.0
Central government	1.0	0.8	3.1	13.5
Retirement pension system	1.3	0.0	-1.5	-10.9
Local governments	0.0	0.3	0.5	0.5
Change in structural fiscal balance	-0.4	-0.4	0.9	0.6
Fiscal balance according to ESA	1.5	0.3	1.6	2.5
Consolidated gross debt	74.2	71.4	66.7	58.0
Net debt	19.4	16.8	14.0	10.6
GDP, level Bill SEK	1 808	1 865	1 938	2 019

Source: Ministry of Finance.

The distribution of the budget surplus between the central government and the national retirement pension system will be affected during the forecast period by the agreed reform of the retirement pension. The result of the reform, when fully implemented, will be to strengthen the revenue of the retirement pension system, while the budget surplus of the central government will be reduced by an equivalent amount. To compensate for this transfer, it has been decided that there will be a transfer of funds from the National Pension Fund to the central government for the amortisation of the central government debt. The size of this transfer has not been established, but pending a final decision, a transfer of SEK 45 billion a year will be made in 1999 and 2000. In the calculations reported in Table 4, a technical assumption has been made that an additional transfer of SEK 235 billion will be made 2001. After the pension reform has been introduced, and excluding the temporary effects, estimates are that the budget surplus in the public sector in 2001 will be distributed in such a way that the central government will have a budget surplus of 0.6 per cent of GDP, the retirement pensions system a surplus equivalent to 1.9 per cent of GDP and the local governments a budget surplus of 0.5 per cent of GDP.

As a consequence of the surplus, the consolidated gross debt of the government will be reduced, beginning in1999. Therefore the debt ratio will decline markedly. The assumed transfer of funds from the National Pension Fund to the central government will help to reduce the consolidated gross debt by more than 3 per cent of GDP.

VI Sensitivity Analysis

Public finances in Sweden have a relatively high sensitivity to cyclical developments and changes in the rate of growth. The fiscal balance in Sweden has historically fluctuated substantially over the business cycle. It is worth pointing out that these swings have been largely a manifestation of a discretionary contracyclical fiscal policy, rather than the automatic functioning of the tax and transfer systems.

A number of sensitivity analyses of the public finances were reported in connection with the 1998 Spring Budget Bill and the 1999 Budget Bill. These analyses considered alternative paths of development for the Swedish economy. The starting-point for these sensitivity analyses is that GDP growth in the next few years will be weaker than estimated; at the same time current tax and expenditure regulations remain unchanged. According to these calculations, the fiscal balance will worsen over a two-year period by the equivalent of 0.5-0.6 per cent of GDP for each percentage point that the real GDP level deviates from a base scenario. The calculations also show that the public finances are affected differently, depending on the factors behind the weaker growth. The shifting composition of GDP and differences in how wage formation is adjusted means that the tax base and public expenditure will be affected in different ways. Generally speaking, a recession generated by weaker international growth will affect the public finances less than a recession that is determined chiefly by domestic factors.

The sensitivity of the public finances to swings in the business cycle has been reduced in the past decade by a series of decisions. A comprehensive tax reform at the beginning of the 1990s reduced the marginal taxes and thereby the scale of the large stabilisers that had previously been built into the taxation of income. The balanced budget requirement applying to local governments restricts the possibility of financing their activities by borrowing in periods of weak revenue growth.

According to the guidelines for the Convergence Programmes, these Programmes will also report sensitivity calculations indicating how the interest rate level affects the public finances. A partial assessment of the impact of interest rates on public sector expenditure shows that a one percentage point increase in the long-term interest rate leads to an increase in interest expenditure in the public sector of about SEK 10 billion, which is equivalent to

0.5 per cent of GDP. However the public sector's interest revenue will also rise by about SEK 5 billion. Therefore the net effect on the public sector fiscal balance is limited to about 0.25 per cent of GDP.