OECD Economic Surveys
SWEDEN

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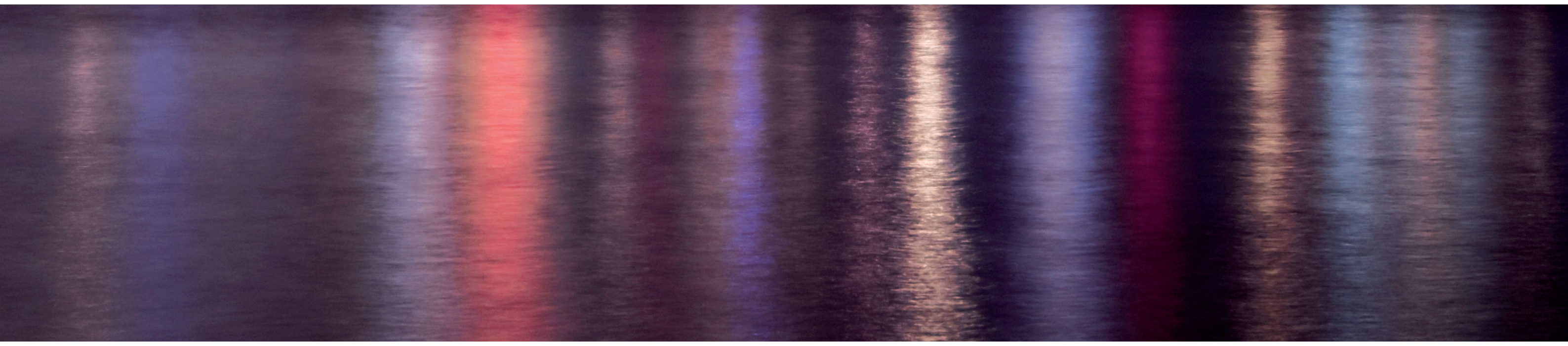
OVERVIEW



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Summary

Sweden has weathered the recent global financial and economic crisis well thanks to strong economic institutions and fundamentals, not least a sound fiscal position. The main challenge going forward is to strengthen institutions and fundamentals even further so as to keep enhancing resilience and sustainable long-term growth. The crisis has revealed that on the whole the monetary and financial framework is sound. Continuing labour market and education system reform is key to avoid entrenched long-term unemployment and to bring workers with weak attachment to the labour market back into employment. Sweden is contributing to global welfare through its ambitious actions to mitigate greenhouse gas emissions, but these targets could be achieved at lower cost.

- ***Maintaining a strong fiscal position.*** In the face of the crisis, Sweden's healthy public finances proved a major asset. Sweden is in a better shape than most other OECD countries to face fiscal pressures coming from population ageing. Going forward, maintaining a sound fiscal framework, encouraging greater labour force participation and further increasing the efficiency of public spending would help cope with future negative shocks and various fiscal pressures.

- ***Further improving monetary and financial policy frameworks.*** Aggressive interest rates cuts, unconventional policy measures and exceptional government support to the financial system all helped contain the depth and length of the recession. As the expansion unfolds, the monetary policy stance needs to continue to tighten and support to the financial system needs to be scaled back. To strengthen the monetary policy framework even further, the central bank could improve communication. Some features of the financial system's institutional framework need to be reviewed to clarify the allocation of responsibilities and ensure that regulations and toolkits are well designed and assigned.

- ***Limiting long-term unemployment and raising overall hours worked.*** Past reforms and measures taken during the crisis have limited the fall in employment and exits from the labour market. But, as in the last deep crisis Sweden faced, there is a risk of a permanent increase in unemployment. Reducing the duality of employment protection legislation would foster the inclusion of groups at the margin of the labour market and improving the wage bargaining framework would ease labour market adjustments. The efficiency of active labour market policies could be raised by increasing the use of training, targeting it towards those who need it the most, and improving cooperation between institutions. Further reforms of the social benefit and tax systems are needed to provide the right incentives for increasing hours worked.

- ***Enhancing the cost-effectiveness of climate change policies.*** Sweden has developed an ambitious policy framework to limit greenhouse gas emissions and has achieved impressive results. Reducing them further could be very expensive, making it important to do so at the lowest possible cost. The carbon price should be made even more central and more uniform across sectors. A larger share of greenhouse gas emission reductions should be achieved in sectors covered by the EU emission trading scheme as well as outside Sweden. The overlap between targets and policies ought to be limited. Improving the assessment of Sweden's climate change policies would help in making progress in these directions.

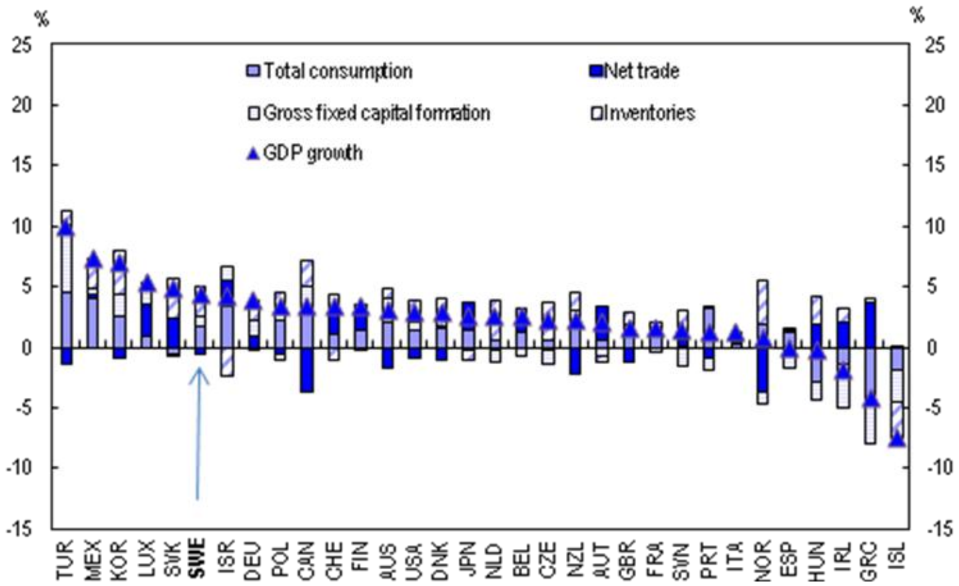
Assessment and recommendations

Strengthening the fundamentals further

Sweden endured a deep contraction during the recent global economic and financial crisis but the recession was short and the economy has bounced back strongly. A key reason why Sweden performed well in the face of this major external shock was that it learned the right lessons from the severe banking crisis it experienced in the early 1990s. This earlier banking crisis triggered far-reaching reforms to restore fiscal sustainability, to put in place a robust monetary policy framework and to improve labour market and social policies. As a result, Sweden entered the latest crisis with strong economic institutions and fundamentals. Moreover, Sweden addressed the crisis through structural reforms, such as the increase in the earned-income tax credit, with positive effects both on the demand side of the economy in the short term and on the supply side in the longer term. Going forward, the challenge is for Sweden to strengthen these fundamentals even further to enable the country to enjoy robust economic growth.

Figure 1. Swedish growth has recovered strongly

Contributions to GDP four-quarter-ended growth to Q2 2010



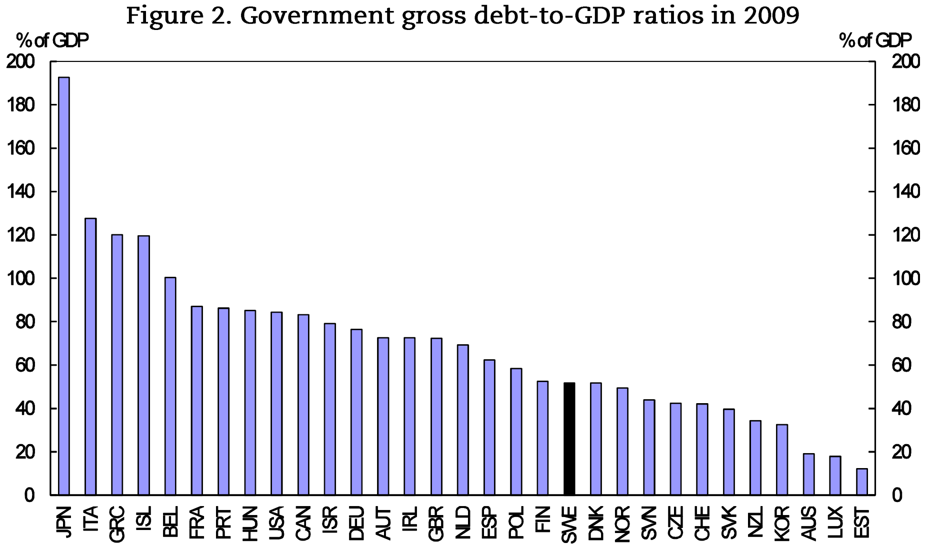
Note: The figure shows OECD countries (except Chile and Estonia) where data on components are available. The contribution of inventories is calculated as a residual.

Source: OECD Analytical database.

A sound fiscal position proved to be a major asset in the face of the crisis

One of Sweden's main strengths going into the crisis was its sound fiscal position, with a relatively low gross government debt and a sizeable structural budget surplus. This allowed the automatic stabilisers to work and provided room to inject fiscal stimulus, without storing up long-term fiscal problems. Going forward, fiscal pressures coming from a rising share of the elderly in the population are expected to be less strong than in most other OECD countries, partly thanks to the pension system reform undertaken in the late 1990s. Even so, Sweden is likely to face significant fiscal pressures related to health and long-term care. The government has explained that its long-standing target of a 1% of GDP budget surplus over the cycle is not meant to finance future permanent spending increases stemming from ageing. Insofar as rising life expectancy enhances well-being, such pre-funding would not be justified from an intergenerational equity perspective. However, as illustrated over the past two years, there is a need to keep room for fiscal manoeuvre in the event of future negative shocks, and in that respect the surplus target provides an adequate safety margin. The government's proposal to increase the age until which individuals have the right to remain in employment from 67 to 69 would contribute to raising the labour market exit age, thereby reinforcing fiscal sustainability. It would in fact be desirable to go further and *more formally link the various retirement age parameters to life expectancy.*

Figure 2. Government gross debt-to-GDP ratios in 2009

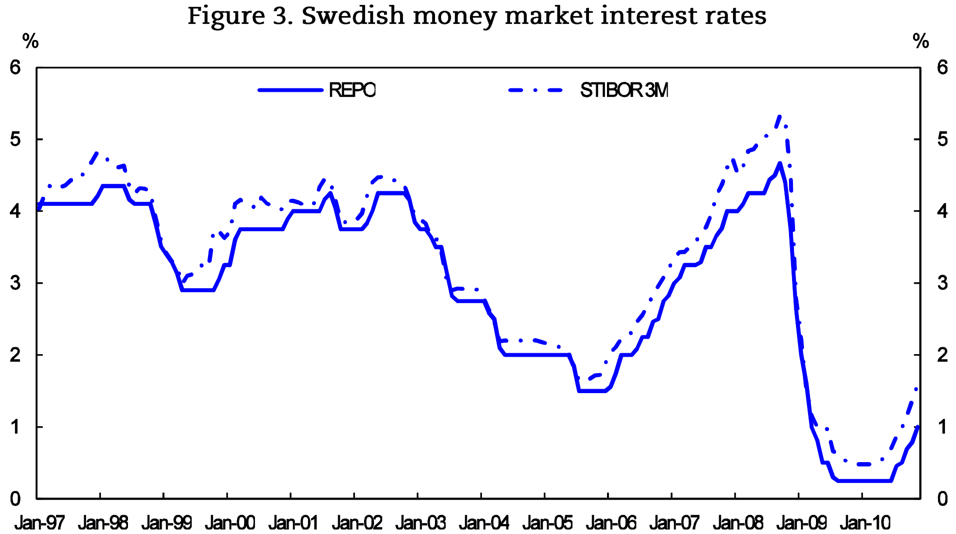


Source: OECD Economic Outlook 88 database.

Monetary policy helped mitigate the downturn but stimulus needs to be withdrawn as the expansion unfolds

On the monetary side, aggressive interest rate cuts and a broad range of unconventional monetary policy measures helped mitigate the downturn. The Swedish economy has now been recovering for some time and the central bank (Riksbank) has unwound a number of the exceptional measures and started to raise the repo rate in steps. This is appropriate and this process *ought to continue gradually as the economic recovery is sustained and financial stress lessens. However, risks remain, particularly external ones, which could influence the speed at which stimulus should be withdrawn.*

Figure 3. Swedish money market interest rates



Note: STIBOR 3M is the 3-month unsecured interbank rate (the Stockholm Interbank Offered Rate).

Source: Reuters and Riksbank.

Monetary policymaking is very transparent but the crisis has highlighted some credibility and communication challenges

The Swedish monetary policy framework is remarkably transparent and has served the country well both in good and in bad times, including as interest rates neared the zero bound. However, the Riksbank did face some credibility challenges during the crisis. In particular, in the course of 2009, larger-than-usual differences arose between market expectations of the future path of the repo rate and the Riksbank's projections, with market expectations significantly higher. Another and more long-standing issue is that the Riksbank's inflation target is defined in terms of the overall consumer price index (CPI), which in Sweden includes mortgage payments, and hence is directly affected by changes in interest rates. While the Riksbank also uses another indicator that holds interest rates constant, the CPI target can at times complicate policy communication, raising the question of the merits of redefining the target in terms of a measure of inflation not directly affected by interest rates. Finally, recent debate in the Executive Board and the appointment of a commission of inquiry point to *the need for the Riksbank to further analyse how asset price and credit developments should influence policy.*

Government support to the financial sector was helpful but now needs to be scaled back

During the crisis, the Swedish financial sector has coped well on the whole. Financial stress was substantial though more limited than in some other countries. In addition to the general funding problem, financial institutions faced a specific one coming from their activities in the Baltics. Government programmes to support lending and the financial sector have helped, either by directly providing funding or acting as a safety net. As conditions normalise, *government support through instruments such as the guarantee programme and the capital injection programme, need to be unwound. The activities of Svensk Exportkredit should be reviewed to examine whether some of them are inappropriate and should be exited completely.*

New financial regulations should be carefully designed

Following Basel and EU deliberations, the Financial Supervisory Authority (FSA) has proposed some liquidity and capital regulations which should come into effect in late 2010 and further reforms will occur in coming years. The relatively favourable capital position of the banks should facilitate proceeding with these changes. The Swedish authorities have also tried to develop other regulations for the financial system, notably an 85% ceiling for the loan-to-value ratio for new housing loans, with a view to protecting consumers and have established a stability fund to support the financial system during crises. When designing further new financial regulations, *attention will need to be paid to their effects on efficiency, stability, competition within and across national borders and consumer protection.*

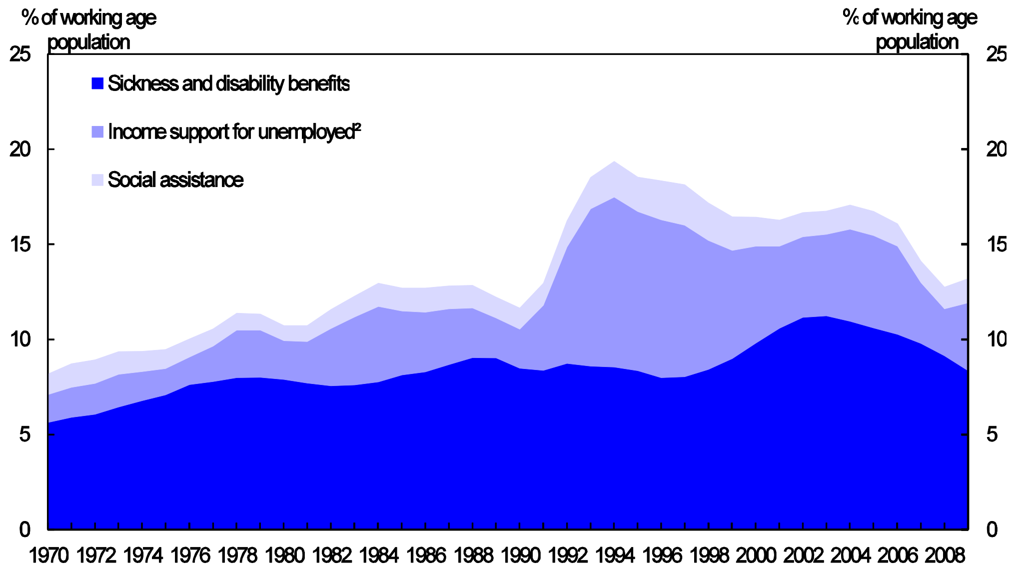
The financial system's institutional framework needs to be improved

Both the Riksbank and the FSA are involved in financial supervision. Furthermore, the National Debt Office (NDO) can provide various types of support. Having several institutions involved can create problems if they have different views. While relations between the Riksbank, the NDO and the FSA are good, the delineation of responsibilities is not always clear. There are some gaps in the toolkits needed to properly supervise and influence financial institutions and *the resolution framework for banks needs to be evaluated. The responsibilities and relationship between the various institutions involved in supervision need to be reviewed and clarified.* If the FSA remains the supervisor, *its toolkit may need to be strengthened so that it can more easily respond to problems.* Another option, if the Riksbank continues to have financial stability responsibilities, would be *to give it more effective instruments to influence banks' behaviour.* There are also some other gaps in the existing framework. In particular, the FSA has only restricted supervision powers over deposit companies that take small deposits. *This anomaly needs to be addressed.* Cross-border banking issues have gained prominence during the recent financial turmoil and the Nordic and Baltic authorities recently reached agreement on a preliminary framework for cooperation and burden sharing between agencies in a crisis. *Financial supervision coordination and cooperation across borders ought to be further nurtured, with more specific and more binding agreements between relevant authorities.*

The labour market has turned around but it is important to avoid lasting long-term unemployment

After the onset of the crisis, unemployment rose markedly, though much less than expected and less than during the early 1990s. It has started to edge down in the course of the recovery, as hiring has picked up. Participation held up much better during the recession than in a number of other OECD countries. The reforms carried out over the past few years are expected to continue to lift labour market participation, from comparatively high levels. Labour market policies are key to preventing entrenched unemployment and to helping workers with weak attachment to the labour market find a job.

Figure 4. Share of the working-age population receiving various types of income support[1]



1. The number of recipients (calculated as full-year equivalents) as a percentage of the working-age population.
2. Includes recipients of unemployment benefits and support for unemployed in active labour market programmes.

Source: Swedish Ministry of Finance; OECD.

Job-search incentives could be improved even further

Reforms since the 1990s, and in particular the successive increases in the in-work tax credit in recent years, have substantially reduced the unemployment and inactivity traps. However, the average effective tax rate for low-income earners remains high compared to other OECD countries. In particular, mean-tested housing benefits that mainly help single parents and students continue to hamper job-search incentives for these groups. *A cut in housing benefits could be combined with an increase in family benefits for groups at risk of poverty.* Furthermore, as unemployment rose during the crisis, an increasing share of the unemployed ceased to be covered by unemployment insurance and had to rely on social assistance benefits that are withdrawn one-for-one against earned income. *Making contributions to the unemployment insurance mandatory*, as proposed by the government, would help to address this problem. However, as acknowledged by the authorities, *further reforms of the social transfer system are also needed.*

While Sweden follows a mutual obligation approach where the unemployed must fulfil availability criteria in order to receive unemployment benefits, *the implementation of sanctions when job-search requirements are not fulfilled needs to be stricter*. This could be facilitated *by adopting more gradual sanctions.* More fundamentally, the institutional framework where Public Employment Service branches monitor the fulfilment of requirements for receiving benefits but union-managed unemployment insurance agencies, funded largely by government grants, pay out the benefits, does not give the latter sufficient incentives to apply sanctions. To avoid these incentive problems, *the job-placement service and the administration of unemployment benefits should be much better coordinated.*

Active labour market policies need to focus on helping workers find regular jobs

Sweden is among the OECD countries with the highest public expenditure on active labour market policies (ALMPs). It also stands out by the large share of subsidised employment programmes and the small share of training, two features that became even more pronounced during the crisis. The low use of training programmes over the past two years should be seen in the light of the decision to scale up participation in the education system, notably in vocational programmes. There is a risk, however, that some unemployed would enrol in general education even if they would need more specific training. *The ALMP mix will have to shift gradually from work experience placements in the public sector towards training and job-search help.* Furthermore, as subsidised jobs have potentially large displacement effects, they should benefit those who have the lowest probability of finding a standard job. *The targeting of ALMP could be improved by further developing the use of profiling to identify individuals at risk of becoming long-term unemployed.*

The consequences of using education as a counter-cyclical policy instrument need to be monitored

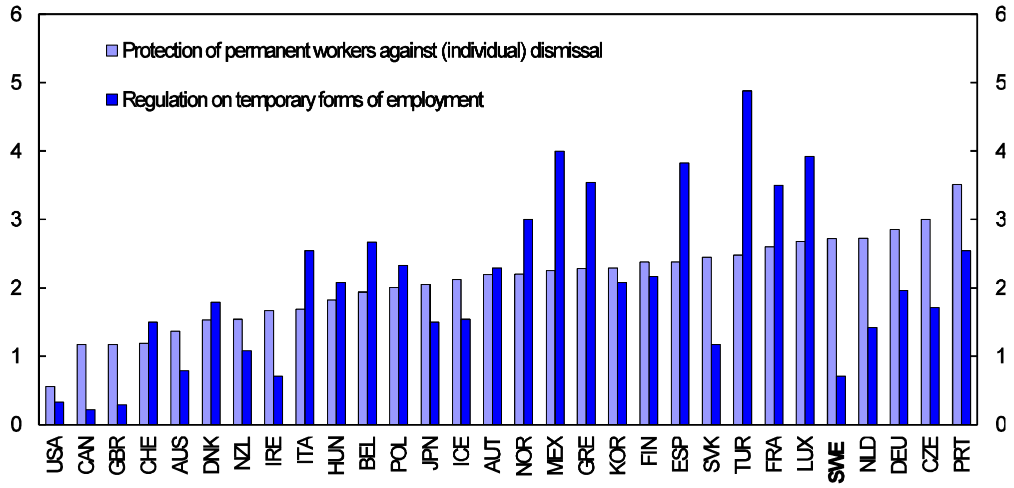
The government's strategy to enrol some of the unemployed in education is a way to take advantage of the crisis by raising human capital. However, enlarging access to the education system runs the risk of lowering its quality if resources are not increased. *The impact of using regular education programmes on both the unemployed workers' employability and the quality of the education system should be assessed.* To encourage education providers to offer appropriate programmes and students to choose the ones that will improve their employability the most, *one approach would be to move gradually towards a system of tuition fees for tertiary education, including for tertiary vocational education, while extending the existing government loans available for students in order to finance tuition costs. Repayment of these loans could be made contingent on future income provided marginal income taxes are reduced.*

Strict employment protection legislation hurts workers at the margin of the labour market

The Swedish labour market model relies to a large extent on social partners' involvement through collective agreements. This allows accommodation to macroeconomic shocks and sectoral idiosyncrasies and changes, while providing workers with adequate security. Against this backdrop, temporary jobs provide flexibility to the labour market but strict employment protection legislation (EPL) for permanent employment may impede low-productivity workers' access to employment. Furthermore, this dual EPL, with high protection for workers with permanent contracts but low protection for workers with temporary contracts, can hinder the accumulation of human capital as firms have less incentive to provide on-the-job training to temporary workers. *Procedures for individual and collective dismissals of workers on permanent contracts need to be eased. Legislation could be considered to facilitate severance payments in lieu of the notice period.*

Figure 5. Employment protection legislation duality

2008[1]



1. OECD indicator for strictness of employment protection legislation. Index scale is 0 to 6, from least to most restrictive.

Source: OECD, Employment Protection Database.

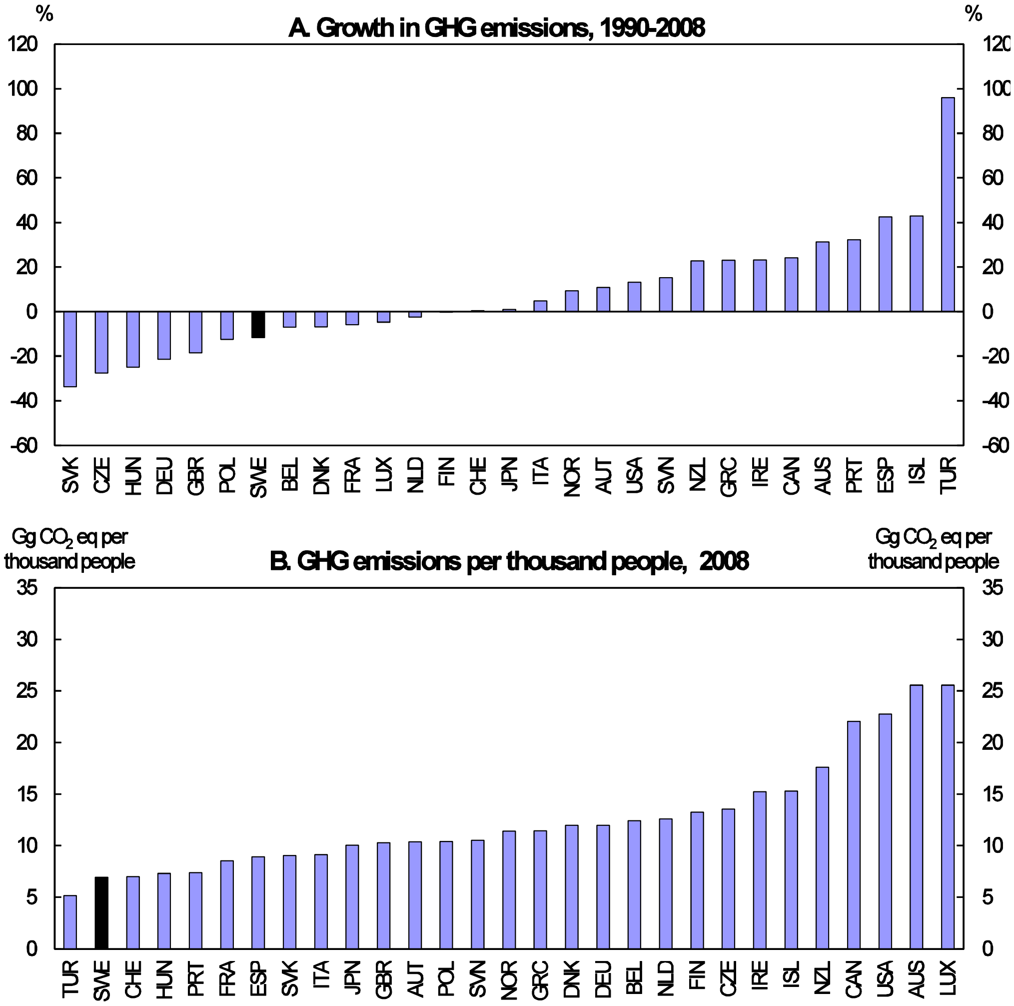
High minimum wages may impede labour market adjustments

While there is no legal minimum wage in Sweden, almost all workers are covered by a minimum wage set in industry-level collective agreements. Combined with high social contributions, this leads to a relatively high labour cost at the lower end of the wage spectrum. This in turn lowers the probability for low-productivity workers to find a job, thereby increasing the risk of long-term unemployment and the associated erosion of human capital. Several measures have lowered the labour cost for weak groups but at a high cost. Continuing with policies to reduce the replacement ratio would lower the reservation wage and thereby should help lower minimum wages. However, as labour unions are unlikely to fully take into account the adverse effects of high minimum wages, *it might be desirable to promote the use of transparent opt-out clauses. An independent commission could play a role and advise on the effects of minimum wages on employment.*

Sweden has adopted very ambitious greenhouse gas emission targets

Sweden has adopted very ambitious targets to lower greenhouse gas (GHG) emissions. The country has developed an extensive and generally sound policy framework to limit such emissions and is one of the OECD countries that has reduced them the most, to what is now a very low level per capita. However, as Sweden has already made enormous progress, the cost of reducing emissions further could be very high, lending urgency to the need to improve the cost-effectiveness of its climate change policies.

Figure 6. GHG emissions in Annex I countries, trend and level



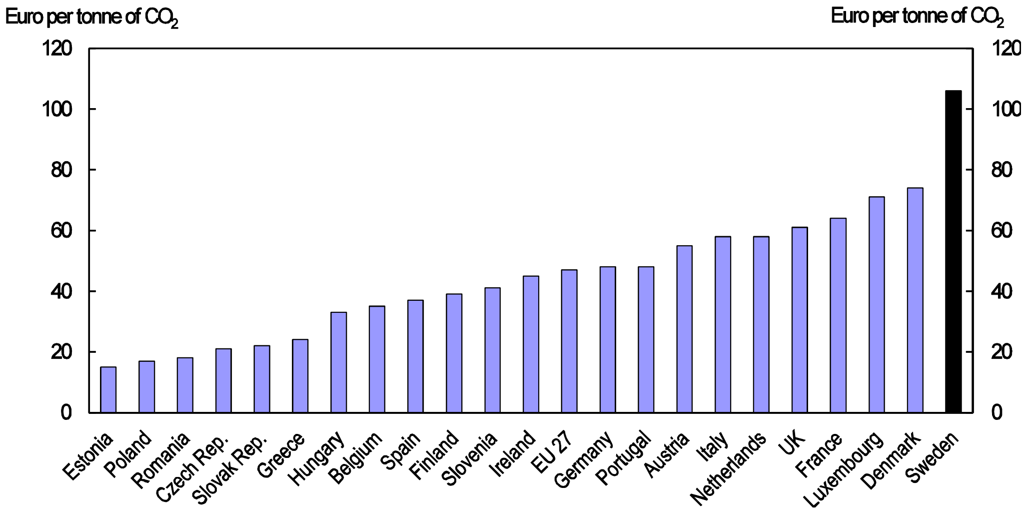
Source: UNFCCC.

The carbon price could be made even more central and more uniform

Market-based instruments are widely used, with a CO_2 tax, an energy tax and the participation in the EU emission trading system (ETS). However, the CO_2 and energy taxes include a large number of exemptions. These exemptions generate heterogeneity in carbon prices, which forces emission reductions onto sectors where abatement costs are not necessarily the lowest. *Continue to gradually phase out exemptions from the carbon tax in line with Parliament's 2009 decision.* This would allow the general level of the tax to be lowered while achieving the same amount of GHG emission reductions. Having an energy tax that taxes CO_2 in addition to the carbon tax makes the price signal on carbon less clear to firms and households. *The interactions between the CO_2 tax and the energy tax could be limited by reforming the two. As far as possible, the carbon dioxide externality should be addressed through the CO_2 tax. The energy tax and perhaps other taxes could be used to address other externalities.* Furthermore, as the production and imports of biofuels generate GHG emissions, though not only in Sweden, *biofuels should be taxed over and above VAT.* This can be done, as is planned, by assessing tax exemptions against environmental sustainability criteria. Moreover, *an energy tax should be applied to biofuels.*

Non-market based instruments are also widely used, with some of them helpfully complementing the framework while others overlap with price instruments, forcing GHG abatement in sectors with relatively high marginal abatement costs. *The use of other instruments that implicitly generate a carbon price needs to be limited to situations where there is a distinct market failure or some other clear objective.* As an electricity certificate system is in place, *other forms of support to renewables in the electricity sector could in many cases be removed. In particular, programmes to finance "green investments" at the local level that have delivered limited GHG emission reductions should be phased out.*

Figure 7. Implicit tax rates on CO_2 in OECD countries, 2006



1. Implicit CO_2 tax rates presented in Panel A are computed by dividing the sum of the revenues from the taxes on fossil fuel and on electricity (generated from fossil fuel) by CO_2 emissions. In the case of Sweden, it includes revenues from the CO_2 tax and the energy tax.

Source: ADEME (2009).

The share of GHG emission reductions achieved in sectors covered by the EU ETS and outside Sweden should be raised

Up to now, Sweden has mainly reduced its GHG emissions in sectors that are not covered by the EU ETS, partly because targets are set for these sectors, even though abatement costs are likely to be high. Extending the base of the CO_2 tax would allow lowering its general level, thereby narrowing the gap *vis-à-vis* the EU carbon price and giving more incentives to reduce emissions in sectors covered by the EU ETS. Moreover, in future negotiations on the allocation of permits within the EU ETS, *Sweden could take a larger share of the effort by negotiating lower permit allocations conditional on a downward adjustment of the EU quota.* In parallel, *it needs to continue to work towards a reform of the existing flexible mechanism, including an improvement in monitoring capacities.*

The overlap of targets raises the cost of achieving the climate target

In addition to the GHG emission reduction target, Sweden has other targets that interact with the climate target. These include an energy efficiency target, a global renewables target and a renewables target for the transport sector. These targets have been adopted at the EU level, but Sweden tends to endorse targets that are more binding. While some of these targets aim at fulfilling other objectives than reducing GHG emissions, having several targets that impact on GHG emissions generates additional constraints on the economy and hence raises the cost of meeting the climate target. The renewables target may serve to improve Sweden's energy security (though it leads to high imports of biofuels), but it is very costly. Furthermore, it is not obvious that there is a need for specific support to renewables in addition to that induced by the carbon price. *The costs and gains of having developed renewable energy and of expanding its use further need to be assessed. Sweden could consider pursuing a less binding national target, insofar as this target is renegotiated at the EU level. Furthermore, the ambition to move to a fossil-fuels-independent vehicle fleet could lead to very large costs and hence ought to be reconsidered.*

The electricity certificate system aiming at developing renewables in the electricity sector is market-based and therefore encourages investments in the most profitable technologies. However, it entails deadweight losses and is a subsidy to renewable energy, which is already boosted through the EU carbon price. The government should assess the *electricity certificate system and restrict its access to technologies that require support in addition to that provided by the EU ETS carbon price. Some provisions could be introduced to avoid the certificate price reaching levels that generate excessively large costs to consumers.*

The assessment of Sweden's climate change policies could be improved

To raise the cost-effectiveness of the climate policy framework and to share its experience with other countries, Sweden should assess further the impact and costs of its policies. It could do this by developing ex *ante and ex post evaluations by both governmental and independent institutions.* Having a single institution in charge of coordinating the assessment of policies would help. In the absence of a global policy framework to mitigate climate change but with regional initiatives being in place, a key issue for countries like Sweden that want to do more is how to combine national policies with regional ones. *The interactions between Sweden's climate change policies and those decided at an international level need to be further assessed.*

Chapter summaries

Chapter 1. Consolidating the recovery

Sweden is recovering strongly from the recent deep recession, supported by substantial fiscal and monetary policy easing and a pick-up in external demand. A relatively accommodating monetary stance coupled with an improving labour market are expected to help sustain growth. Though Sweden's fiscal position is enviable compared with many other countries, there is scope to further strengthen the fiscal framework. Medium-term fiscal pressures could be reduced by encouraging greater labour force participation and increasing the efficiency of public spending. Closing the income gap vis-à-vis leading OECD economies will require further labour market reforms, further tax reforms to enhance work incentives, and a reduction in the extent of public ownership in market-related activities to boost competition and productivity.

Chapter 2. Monetary policy and the financial system during and after the crisis

In the wake of the global financial and economic crisis, the Swedish central bank aggressively cut interest rates and introduced an array of unconventional policy measures. This helped limit the depth and length of the recession and facilitated a strong recovery. Moreover, the Riksbank has successfully maintained low and stable inflation, and longer-term inflation expectations are well anchored, notwithstanding occasional communication problems. While the financial sector experienced stress, in part due to bank exposures to the Baltic countries, it coped well on the whole. However, there is room to improve financial sector regulation and to revisit the financial supervision framework.

Chapter 3. Limiting long-term unemployment and non-participation

After the onset of the crisis, unemployment in Sweden increased markedly, though much less than expected and than during the early 1990s, even as participation in the labour market held up well. The challenge going forward is to ensure that high unemployment does not become entrenched or leads to withdrawals from the labour force. The government has taken measures to mitigate this risk, particularly in the areas of job-search incentives and enrolment in education. Nevertheless, additional reforms are needed to ensure a sustained job-rich expansion. Such reforms should focus on increasing the flexibility of the labour market and strengthening job-search incentives further.

Chapter 4. Enhancing the cost-effectiveness of climate change mitigation policies in Sweden

Sweden has developed an extensive and sound policy framework to limit greenhouse gas emissions. It is now one of the OECD countries with the lowest greenhouse gas emissions per capita and it has successfully managed to decouple GDP growth from emissions growth. However, as Sweden has already significantly lowered its greenhouse gas emissions, the cost of reducing them further could be very high, making it urgent to improve the cost-effectiveness of Sweden's climate change policies. A strategy to enhance the cost-effectiveness of this policy framework would include: i) reducing differences in carbon prices between sectors and increasing even further the role of market-based instruments; ii) limiting overlap between targets and policies; iii) raising Sweden's participation in greenhouse gas emission reductions abroad; and iv) improving the assessments of the policy framework.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Sweden were reviewed by the Committee on 25 November 2010. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 10 December 2010.

The Secretariat's draft report was prepared for the Committee by Stéphanie Jamet, Luke Willard and Niels-Jakob Harbo Hansen under the supervision of Vincent Koen. Research assistance was provided by Thomas Chalaux.

The previous Survey of Sweden was issued in December 2008.

Further information

For further information regarding this overview, please contact:

Stéphanie Jamet, e-mail: stephanie.jamet@oecd.org; tel.: +33 1 45 24 88 63; or
Luke Willard, e-mail: luke.willard@oecd.org; tel.: +33 1 45 24 87 41.

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