REGERINGSKANSLIET

Ministry of Finance

# Updated Swedish Convergence Programme

*November 2000*

## I Introduction

Sweden presented its convergence programme in December 1998 in accordance with Regulation (EC) 1466/47 of the European Council. The Council evaluated and approved the programme in the spring of 1999. Under the Council's regulation an update of the convergence programme is to be submitted annually. The first update was submitted in November 1999 and approved early in 2000. The present update has been prepared in conjunction with the Budget Bill for 2001 introduced in the Riksdag on September 20, 2000. The Budget Bill is based on an agreement among the Social Democratic Government, the Left Party and the Green Party.

This update of the convergence programme is based on the assessment of the Swedish economy reported in the Budget Bill for 2001. According to this assessment, there has been a substantial improvement in the outlook for 2000 and 2001 compared with the forecast in the 1998 convergence programme. There is also a marked improvement in comparison with the 1999 update of the programme. The direction of economic policy and the budget policy objectives laid out in the 1998 convergence programme remain firm. This means that public finances should show a surplus of 2 per cent of GDP on average over a business cycle and that established expenditure ceilings should not be exceeded.

## II Economic Policy Premises

The aim of the economic policy is to support and extend the favourable economic developments of recent years. In this way the conditions for lower unemployment and higher employment are being created. The objective of reducing open unemployment in 2000 to 4 per cent of the labour force has practically been reached. The goal now is to increase the percentage of employed persons between the ages of 20 and 64 to 80 per cent by 2004.

Keeping firm control over public finances is fundamental to a development with good growth, high employment and low inflation. It is Sweden's experience that medium-term targets for general government net lending and expenditure ceilings provide important support to budget policy. Under the Stability and Growth Pact, Member States are to aim at medium-term budgetary positions that are close to balance or in surplus. The Riksdag has endorsed the Government's medium-term goal of a surplus in general government net lending of 2 per cent of GDP on average over the business cycle. This goal remains unchanged. Thus a solid foundation is being laid in preparation for the challenges that will ensue from the big increase to come in the percentage of older people in the population. The surplus will also provide a safety margin for the public finances so that it will be possible to confront the next recession with fiscal policy to counteract it.

Targets based on the long-term goal are being established for every single year. The Government proposes in the Budget Bill a target for the general government finances for the coming year. The goal is based on the assessment of economic conditions and other relevant factors that can be made at that time. Accordingly the Government is proposing in the 2001 Budget Bill to raise the surplus target in general government finances for 2001 from 2.0 to 2.5 per cent of GDP in order to reduce the risk of an overheated economy. Even after this increase, it is estimated that the surplus in the general government finances will exceed this newly established target and will amount to 3.5 per cent of GDP, given the estimates of economic growth that now can be made. The surplus above the target, which among other things is the result of windfall income is to be viewed as a safety margin and will not be used for reforms.

One important factor in achieving the fiscal policy goals has been the stricter budgetary process that has been in effect since 1997. It provides for three-year nominal expenditure ceilings established by the Riksdag for the central government, including the expenditure on old-age pensions. The fixed expenditure ceilings decline as a percentage of GDP until 2002 and level off in 2003. Beginning in 2000, a balanced budget requirement applies to municipal and county governments.

The legislation on the status of the Riksbank, which came into force in 1999, stipulates that the objective of monetary policy is to maintain price stability. The Riksbank has specified an inflation target of 2 per cent, plus or minus one percentage point, measured against the consumer price index. The Riksbank has made clear when there may be reasons for deviating from this rule. This may happen if the CPI is affected by temporary factors that are not expected to have a permanent impact on inflation or if a larger deviation has occurred and a rapid return to the objective would be associated with substantial real economic costs. In such situations, the Riksbank will explain in advance how large a deviation from the inflation target may be warranted over one to two years. This means that in monetary policy arrangements, the Riksbank normally disregards the effects of changes in indirect taxes, subsidies and home mortgage rates on inflation. At present the index UND1X measures the underlying inflation. The legislation also provides for an executive board that decides independently on all monetary policy matters. When it comes to exchange rate policy, it is the Government that decides on the exchange rate system, while the Riksbank is responsible for its practical application, for example, which central rate will apply in a fixed exchange rate system. Sweden's experience with its present monetary policy regime with an inflation target and a flexible exchange rate has been positive. Linking the krona to ERM2 is not under consideration at present.

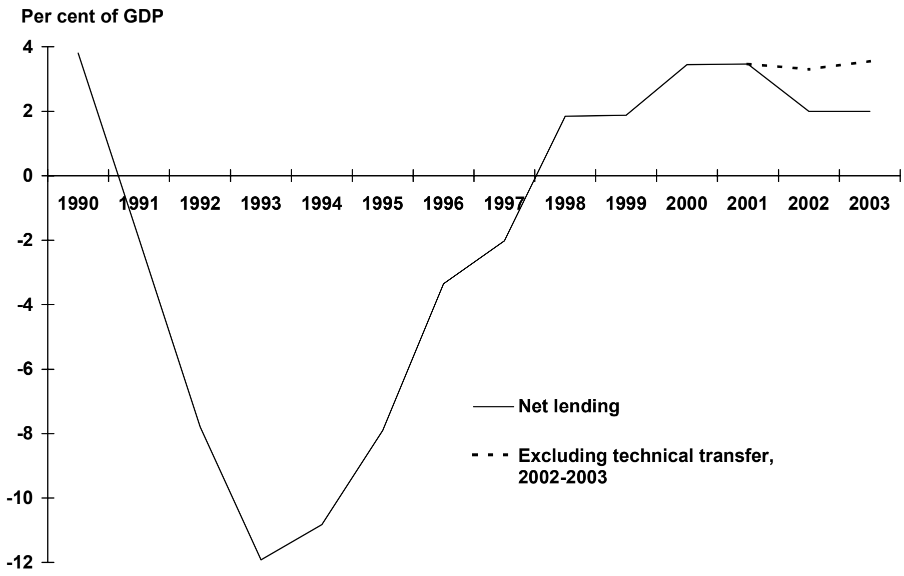
## III Economic Policy

The deep recession at the beginning of the 1990s resulted in substantial deficits in general government finances (see diagram 1). In 1994 the deficit in the general government sector amounted to 11 per cent of GDP and the general government debt was growing rapidly. The sharp increase in unemployment led to significant increases in general government expenditure, (see diagram 2). From 1995 to 1998 the aim of fiscal policy was to eliminate the deficit in general government finances. By means of an extensive consolidation programme, general government finances improved and there was a surplus of about 2 per cent in 1998 and 1999. The structural surplus was even higher since resource utilisation these years was still lower than the potential level.

As general government finances have improved, it has been possible to ease fiscal policy somewhat. Certain expenditure increases have been possible in priority areas. Since the beginning of 1999, it has been possible to carry out tax reductions aimed particularly at income taxes on low- and middle-income earners. Implementation of this tax relief has been possible at the same time that the Government has achieved, and even exceeded, its goal of a general government surplus of 2 per cent.

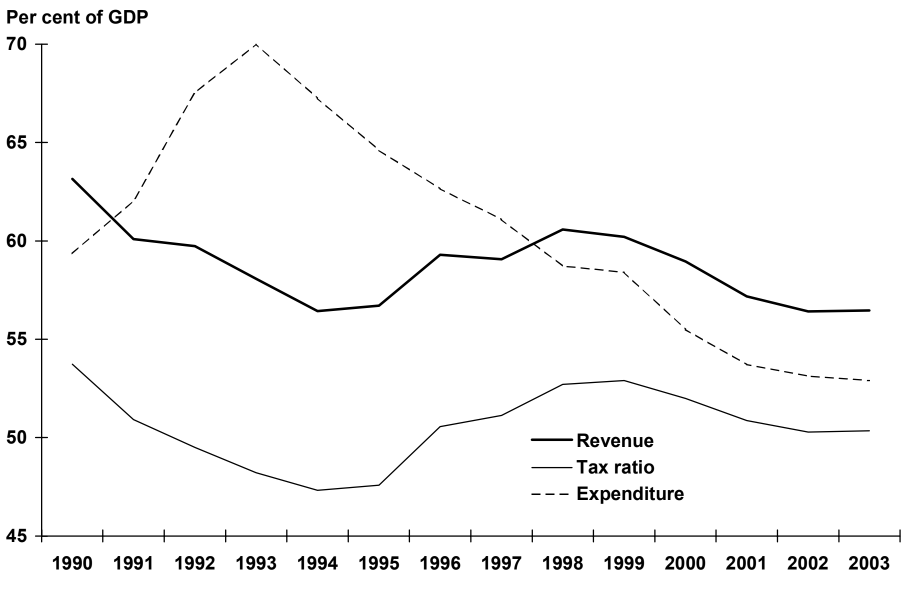
The 2001 Budget Bill proposes lowering income taxes for households further, with the same aim as the reduction in 2000. Moreover a green tax swap is being proposed, whereby energy taxes would be increased and the tax on labour would be lowered by an equivalent amount. To avoid a higher tax levy as a consequence of ending the freeze on assessed values, a lowering of the property tax rate and the wealth tax is being proposed. The tax changes proposed in the Budget Bill and those decided earlier will lead to a tax reduction of more than SEK 22 billion or 1 per cent of GDP in 2001 (see table 1). The tax reductions proposed in the 2001 Budget Bill come to about SEK 16 billion.

**Diagram1: General Government Net Lending, Including and Excluding the Technical Transfer**




Note: The general government surplus in excess of the budget policy goal of 2 per cent of GDP will be transferred under a technical assumption to the household sector.

**Diagram 2: General Government Revenue, Expenditure and Tax Ratio**




In 1999 the Government presented a plan for reforming the income tax for households. The reform has two parts. The first part consists of compensation for social insurance contributions to the old-age pension system. The second part provides for a rise in the lower threshold in the tax rate schedule so that only 15 per cent of taxpayers will pay central government taxes. In 2001 half of these two reforms will have been carried out. After that the Government's intention is to continue according to this plan. However, additional tax reductions have to take into consideration economic conditions, the outcome of future wage negotiations and sufficiently large budget surpluses, given the established goal. In addition a green tax swap is being planned for the period up to 2010 that is designed to be budget neutral. Reduced income taxes and payroll taxes will be substituted for higher energy taxes.

**Table 1: Tax Changes in 2001**

SEK billions

| | 2001 |
|---|---|
| Household income taxes | –14.6 |
| Corporate income taxes | –3.1 |
| Payroll taxes | –1.8 |
| Property and wealth taxes | –3.0 |
| Energy taxes | 3.3 |
| Other | –3.1 |
| Total tax changes[1] | –22.3 |

[1] Aggregate impact, accrual accounting.

There are also proposals for some increases on the expenditure side in the Spring Budget Bill for 2000 and in the 2001 Budget Bill. Together with earlier decisions, the reforms taking effect in 2001 will amount to nearly SEK 13 billion (see table 2).

**Table 2: Major Expenditure Reforms in 2001**

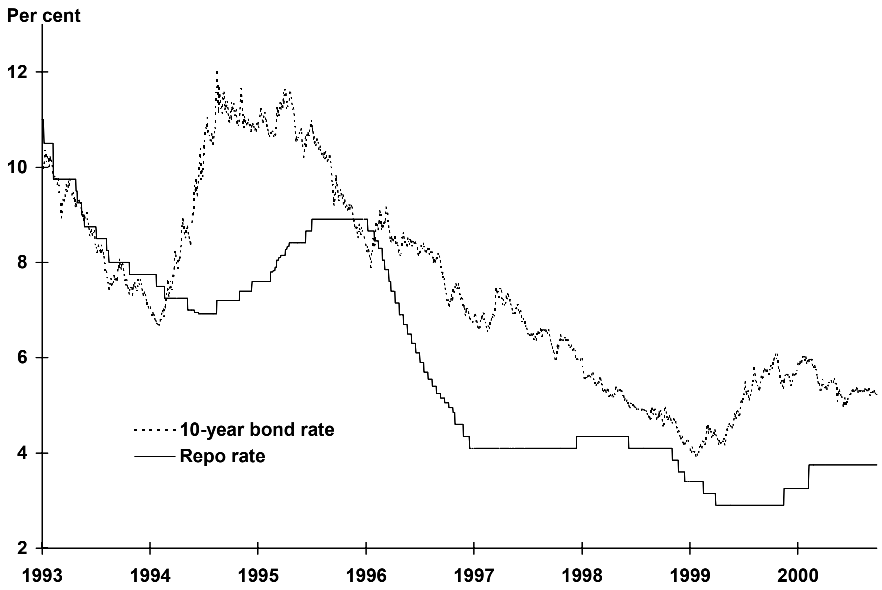
SEK billions

| | | 2001 |
|---|---|---|
| UO 2 | The Government Offices | 0.2 |
| UO 4 | Justice | 0.8 |
| UO 6/15 | Pension rights, mandatory defence service/ studies | 0.9 |
| UO 7 | Increased development assistance | 0.2 |
| UO 9 | Compensation to assist persons 65 or older | 0.3 |
| UO 9 | Dental care | 0.1 |
| UO 11 | Assistance to lowest income retirees | 1.1 |
| UO 12/15 | Increased child's allowance | 2.4 |
| UO 15/16 | Knowledge and skills | 1.4 |
| UO 16 | Education | 0.5 |
| UO 18 | Investment grants for student housing | 0.3 |
| UO 19 | Defence reorientation | 0.2 |
| UO 20 | Environmental programmes | 0.4 |
| UO 25 | Health care, schools and social services | 4.0 |
| Total expenditure reforms | | 12.8 |

The Riksbank gradually lowered the repo rate between January and December 1996 by a total of about 4.8 percentage points to 4.1 per cent. In principle the repo rate then remained unchanged until November 1998 when a new series of reductions were introduced. Between April and November 1999 the repo rate was held constant at 2.9 per cent.

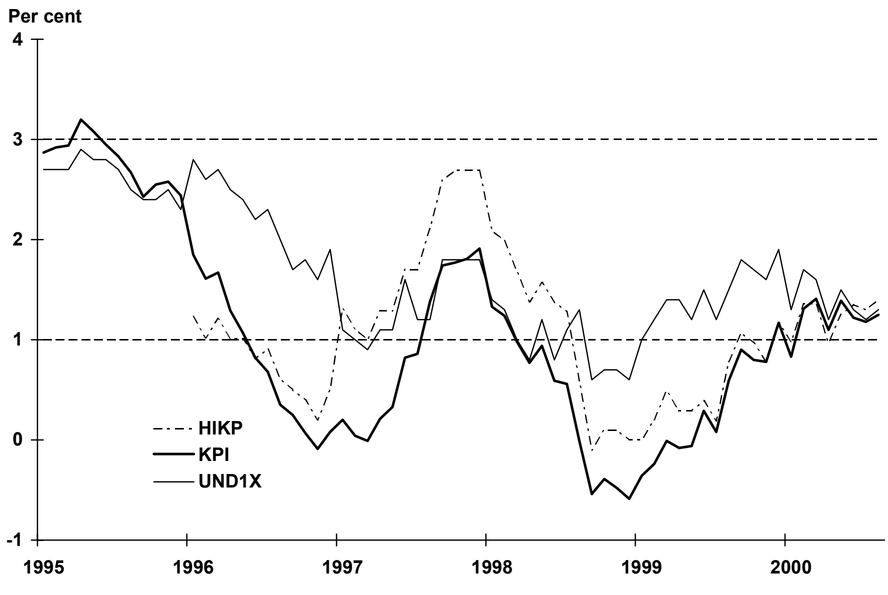
There was then a two-step rise. Since March 2000 the repo rate has stood at 3.75 per cent.

**Diagram 3: Interest Rate Developments in Sweden**




In 1998 inflation measured by the CPI was –0.6 per cent. In 1999 it increased to 1.2 per cent, while underlying inflation as measured by the Riksbank rose from 0.6 per cent to 1.9 per cent. In September 2000 inflation, according to both the CPI and UND1X, amounted to 1.3 per cent. Half of this inflation rate was due to higher prices for gasoline and diesel fuel. Sweden has one of the lowest inflation rates in the EU, which means that the inflation criterion under Article 121 of the Treaty on European Union has been met with a wide margin.

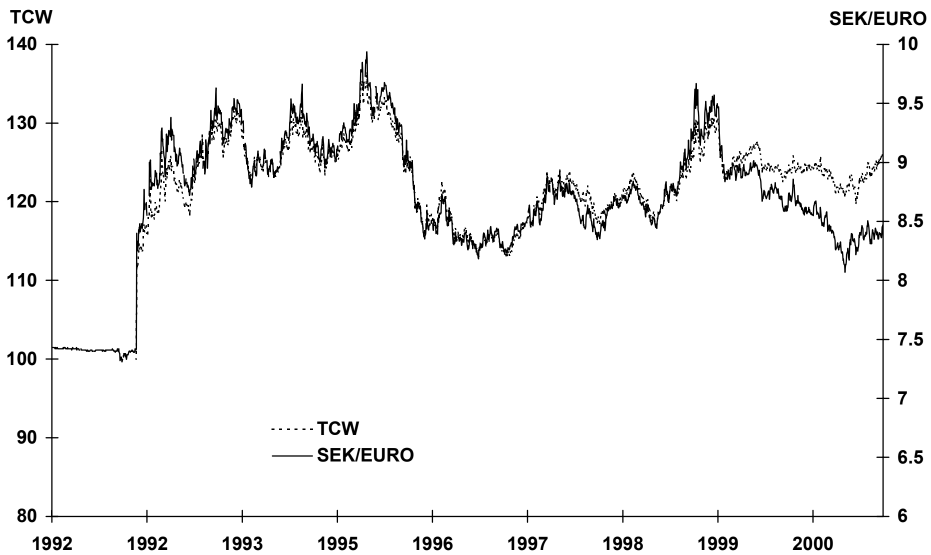
**Diagram 4: Inflation and the Riksbank's Tolerance Interval**



With the rise in interest rates internationally, Swedish bond rates have risen somewhat less than rates in Germany. Interest rate differentials with Germany, which five years ago were more than 4 percentage points, have almost disappeared. Consolidation of general government finances and confidence in price stability have laid the basis for this development. During the third quarter of 2000, long-term interest rates were on average about 5 basis points above the German rates.

Sweden has had a floating exchange rate since 1992. Accordingly the exchange rate is not a monetary policy objective. With an explicit inflation target and a flexible exchange rate, the krona's rate of exchange is decided in the short term by international capital flows and in the long term by economic fundamentals. Sweden has had good experience with its present policy, which is aimed at price stability in combination with a flexible exchange rate. A credible and sustainable policy with this aim creates the conditions necessary for a currency that is stable over the long term. In 1999 and the first quarter of 2000, the krona strengthened against the euro, in part because the economic situation developed more positively in Sweden than in the euro area. Subsequently the krona has weakened somewhat. Its strengthening against the euro has been offset by a weakening against the dollar. The krona has been relatively stable against a trade-weighted average of currencies, TCW, since the beginning of 1999.

**Diagram 5: The Krona Compared With the Euro and a Trade-Weighted Index, TCW**



## IV Economic Developments

The stable general government finances and credibility in the inflation target are laying the foundation for the Swedish economy to continue to develop favourably. Employment is rising and unemployment is falling at the same time that inflationary pressure is moderate. Favourable international economic conditions are contributing to the robust growth of Swedish exports.

**Table 3: Demand and Output[1]**

Annual Percentage Change in Volume

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Household consumption expenditure[2] | 4.1 | 4.7 | 3.4 | 2.1 | 2.1 |
| General government consumption expenditure[2] | 1.8 | –1.4 | 0.9 | 1.0 | 0.9 |
| Gross fixed capital formation | 8.1 | 5.1 | 6.8 | 2.5 | 2.8 |
| Changes in stocks[3] | –0.5 | 0.2 | –0.1 | 0.0 | 0.0 |
| Exports | 5.2 | 9.8 | 7.7 | 5.9 | 5.7 |
| Imports | 5.0 | 8.8 | 7.5 | 6.0 | 5.9 |
| **GDP** | **3.8** | **3.9** | **3.5** | **2.1** | **2.1** |

[1] Forecasts have been made for 2000–2001; the figures for 2002–2003 are estimated using the assumptions found in Table B1, which include economic growth in line with the trend.
[2] Beginning in the year 2000, the transfer of the Church of Sweden from the public sector to the household sector has affected consumption expenditure estimates. Without this change, the estimates would be 3.7 per cent and 0.6 per cent respectively.
[3] Per cent of GDP.

With high demand, expanding employment and an industry-led increase in productivity growth as contributing factors, GDP is expected to rise by about 4 per cent in 2000 and 3.5 per cent in 2001. Underlying inflation is low even though the increases in oil prices in 2000 have raised consumer prices slightly. Households' real disposable income is estimated to go up by 3.5 per cent in 2000 and over 4 per cent in 2001. The favourable growth in income is partly the result of the expected upswing in employment, the income tax reductions that have been implemented this year and that have been proposed for next year and the low inflation, which is strengthening the growth in real wages. The sharp improvement in households' wealth position is further increasing their propensity to consume. Private consumption is expected to increase about 3.5 per cent a year in 2000 and 2001. General government consumption is expected to rise 0.6 per cent in 2000 and 0.9 per cent in 2001. Gross investment is expected to increase about 5 per cent in 2000 and about 7 per cent in 2001. Investment in commercial property and in the telecommunications sector are estimated to grow especially vigorously. Residential investment is also expected to increase but it is more difficult to assess, owing in part to supply restrictions. It is anticipated that net exports will contribute 1.0 and 0.2 percentage points to GDP growth in 2000 and 2001 respectively.

The growth in employment in the first half of 2000 has been quite positive and has surpassed earlier expectations. In 2000 the increase in employment is estimated at 2 per cent and at 1.3 per cent in 2001 – a total increase of 134,000 persons. This means that the regular employment ratio for persons between the ages of 20 and 64, which according to the Government's goal should reach 80 per cent in 2004, is estimated to rise from 75.9 per cent in 1999 to 77.7 per cent in 2001. Open unemployment is expected to fall to 3.8 per cent in 2001. The relatively rapid increase in employment means that the resources available in the economy will decline in the in the years to come. Thus there is an increased risk of wage increases greater than what is compatible with balanced economic development. On the other hand productivity growth may be better than expected. To sum up inflation is expected to rise, but to be moderate in the period 2000–2001 and to remain below the inflation target.

In the forecast by the Ministry of Finance, the repo rate is expected to rise by half a percentage point to 4.25 per cent in the autumn of 2000 and an additional half percentage point in 2001. In the medium term, the repo rate is expected to come to 4.5 per cent.

No forecast of economic conditions has been made for 2002 and 2003. GDP is expected to follow the long-term growth trend in the economy, which is 2 per cent. The labour supply will expand owing to decreases in some training programmes and cyclically dependent labour market policy programmes. This expansion is expected to lead to a growth rate slightly above the long-term trend. Therefore it is expected that employment may rise somewhat more quickly than the increase in the working age population in 2002 and 2003 without resulting in inflationary wage increases. The employment ratio is expected to increase to 78.0 per cent in 2003.

**Table 4: Key Indicators[1]**

Per cent, unless otherwise stated

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| CPI, Dec-Dec | 1.2 | 1.1 | 1.7 | 2.0 | 2.0 |
| HICP, Dec-Dec | 1.2 | 0.9 | 1.3 | – | – |
| UND1X, Dec-Dec | 1.9 | 1.0 | 1.3 | – | – |
| Hourly wage increase | 3.4 | 3.5 | 3.5 | 3.5 | 3.5 |
| Number of employed | 2.2 | 2.0 | 1.3 | 0.5 | 0.5 |
| Open unemployment[2] | 5.6 | 4.6 | 3.8 | 3.9 | 4.0 |
| Labour market policy programmes[2] | 3.1 | 2.6 | 2.6 | 2.3 | 2.0 |
| Current account[3] | 2.5 | 2.6 | 3.6 | 4.0 | 4.2 |
| Disposable income[4] | 3.3 | 3.4 | 4.2 | 4.9 | 2.3 |
| Saving ratio (level)[5] | 2.1 | 2.2 | 2.9 | 5.6 | 5.7 |

[1] See also Table B1 for the assumptions on which the forecasts are based.
[2] Per cent of the labour force.
[3] Per cent of GDP.
[4]Real change. The inclusion of the Church of Sweden in the household sector beginning in 2000 affects the estimated increase for 2000. The calculations presented here exclude this effect. When this institutional reclassification is included, growth in disposable income is 4.4 per cent. The growth figures for 2002 and 2003 reported here include the effects of the assumed technical transfer to households of the general government surplus in excess of the target level of 2 per cent of GDP. The saving ratio includes savings in contractual pensions.
[5] Per cent of disposable income.

The healthy growth in GDP and the rapid increase in employment in recent years have thus far been combined with low inflation and low inflationary expectations. It is possible that the labour market and wage formation are functioning better than expected. If so, this would mean that potential output would be higher than that assumed in the calculations. This will become apparent in the upcoming wage negotiations. Moreover it is expected that potential GDP growth may also be higher than estimated. The Riksbank assumes a potential output growth of 2.0–2.5 per cent. However, there is considerable uncertainty about the extent to which there will be available resources in the economy in 2002 and 2003.

## V General Government Finances

In 1999 general government net lending came to 1.9 per cent of GDP, which was 2.6 percentage points above the EU average of –0.7. In 2000 net lending is estimated at 3.4 per cent of GDP. With the proposed tax reductions in the Budget Bill and other measures taken into account, the surplus in 2001 is expected to be 3.5 per cent. In 2000 and 2001 general government revenue and expenditure will both continue to fall as a percentage of GDP (see diagram 2). Estimates of net lending for 2002 and 2003 are 3.3 and 3.6 per cent of GDP respectively.

The estimated savings will thus surpass the budget goal of a surplus of 2 per cent of GDP in 2002 by SEK 30 billion and in 2003 by SEK 37 billion. In the estimates, a technical assumption is made that for these two years there will be a transfer to the household sector of that part of the surplus in excess of the target. Accordingly central government interest expenditure, central government debt and the financial position of the general government in 2002 and 2003 are estimated using the assumption that net lending will be in line with the budget objective of 2 per cent of GDP.

Owing to the financial surplus and sales of certain state held shares, the consolidated gross debt in 2000 is estimated to be less than the reference value of 60 per cent of GDP stipulated in the Stability and Growth Pact and to fall to about 48 per cent of GDP in 2003. The net debt is expected to turn into a positive financial position in 2001. The net debt is expected to decline by about 19 per cent of GDP between 1999 and 2003.

**Table 5: General Government Finances[1]**

Per cent of GDP

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| *Revenue* | 60.6 | 60.2 | 58.9 | 57.2 | 56.4 | 56.5 |
| Taxes and charges | 52.7 | 52.9 | 52.0 | 50.9 | 50.3 | 50.3 |
| Capital income | 4.4 | 3.6 | 3.3 | 2.7 | 2.6 | 2.6 |
| Other revenue | 3.5 | 3.8 | 3.7 | 3.6 | 3.6 | 3.5 |
| *Expenditure* | 58.7 | 58.4 | 55.5 | 53.7 | 53.1 | 52.9 |
| Transfers | 24.1 | 23.5 | 22.5 | 21.8 | 21.3 | 21.4 |
| Consumption | 26.7 | 27.0 | 26.3 | 25.9 | 26.0 | 25.9 |
| Investment, etc. | 1.7 | 2.5 | 2.5 | 2.5 | 2.6 | 2.6 |
| Interest expenditures | 6.2 | 5.3 | 4.2 | 3.5 | 3.3 | 3.0 |
| *Net lending before technical transfer* | 1.9 | 1.9 | 3.4 | 3.5 | 3.3 | 3.6 |
| Primary net lending before technical transfer | 3.7 | 3.7 | 4.3 | 4.3 | 4.0 | 4.0 |
| Technical transfer | – | – | – | – | 1.3 | 1.6 |
| *Net lending after technical transfer* | 1.9 | 1.9 | 3.4 | 3.5 | 2.0 | 2.0 |
| Primary net lending after technical transfer | 3.7 | 3.7 | 4.3 | 4.3 | 2.7 | 2.4 |
| Consolidated gross debt[2] | 72.4 | 65.6 | 58.9 | 53.2 | 50.2 | 48.2 |
| Net debt[2] | 15.8 | 11.4 | 0.5 | –3.7 | –5.9 | –8.0 |

[1] In Table B3 there is a more detailed breakdown of the items in this table.
[2] The technical transfer is included in the consolidated gross debt and the net debt calculations for 2002 and 2003 shown here. Excluding the technical transfer, the consolidated gross debt in 2002 would be 48.9 per cent and the net debt would be –7.2 per cent. In 2003 the respective percentages would be 47.3 and –8.8.

The forecasts reported in previous sections indicate that in 2000 general government net lending will go up 1.5 per cent of GDP to about 3.5 per cent of GDP. In 2001 forecasts also indicate that the surplus will amount to 3.5 per cent of GDP. If the technical transfer is not taken into account, the surplus will stay at this level in 2002 and 2003.

The general government finances are estimated to have a contractionary effect on the economy this year and to be almost neutral in the following year, given measures that have been agreed and decided. With economic growth surpassing the long-term trend, general government finances will strengthen in the absence of policy changes, owing to automatic stabilisers. They would dampen demand in the private sector.

Table 6 shows an indicator of the discretionary fiscal policy, that is, that part of the change in the general government surplus that is contingent on political decisions. After adjusting the surplus for the cycle, the accrual of tax revenue, etc., the remaining item provides a rough indicator of the discretionary fiscal policy stance. The indicator includes the impact of those measures that will take effect during the years shown in the table. Also included are the effects of volume factors in the transfer system that are not directly dependent on active decisions.

**Table 6: Fiscal Stance**

Per cent of GDP

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| **Change in net lending before technical transfer** | **0.0** | **1.5** | **0.0** | **–0.2** | **0.3** |
| *Of which* | | | | | |
| Economic growth including tax base shifts | 1.6 | 1.4 | 0.7 | –0.2 | 0.0 |
| Accrual of tax revenue | –0.9 | 0.4 | 0.6 | –0.6 | –0.2 |
| Net property purchases and net capital transfers | –0.9 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net income from capital and net interest expenditure | 0.0 | 0.9 | 0.1 | 0.1 | 0.3 |
| **Adjusted net lending before technical transfer[1]** | **0.2** | **–1.1** | **–1.3** | **0.5** | **0.2** |
| **Technical transfer** | **–** | **–** | **–** | **–1.3** | **–0.3** |
| **Adjusted net lending after technical transfer[1]** | **0.2** | **–1.1** | **–1.3** | **–0.8** | **–0.1** |

[1] Adjusted net lending indicates the fiscal policy stance. A negative number means that the stance is expansionary; a positive number means that the stance is contractionary.

The discretionary fiscal policy has an expansionary stance in 2000 and 2001 according to the indicator in Table 6. This stance needs to be seen in the following context: it is estimated that there are available resources in the economy and that the production gap – that is, the difference between actual and potential production – is expected to close only at the end of 2001. Consequently the upward revision of GDP made in the forecast is judged to be the result of a permanent recovery. In addition it can reasonably be assumed that some part of household income will be used for a gradual increase in the saving ratio. Inflation and inflationary expectations also continue to be low. In light of this and the size of the automatic stabilisers, the fiscal policy measures are not expected to lead to an overheating of the economy. The fiscal policy in 2002 and 2003 is expected to be contractionary under the assumption that there will be no transfer to households. If in 2002 the entire surplus in excess of 2 per cent of GDP were expected to be transferred to households, then the fiscal policy would be expansionary. The estimates for 2002 and 2003 are very uncertain and no political decision has been taken as to how the excess surplus will be used.

The phasing in of the reformed old-age pension system will affect the distribution of net lending between the central government and the old-age pension system. In 2003 when the phasing in has been completed, the estimates for central government net lending show a deficit of about 1 per cent of GDP after the anticipated transfer to households. The surplus in the general government sector will instead come from the old-age pension system, which will have net lending estimated at between 2.5 and 3 per cent of GDP this year. As a result of the statutory balanced budget requirement for the local government sector beginning in 2000, net lending for the sector as a whole is expected to be positive. In 2000 and 2001 the surplus is reckoned to be especially large owing to temporarily high tax revenues.

**Table 7: Net Lending and the Central Government Budget Balance**

Per cent of GDP

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| General government | 1.9 | 1.9 | 3.4 | 3.5 | 2.0 | 2.0 |
| Central government | 0.8 | 3.9 | 0.3 | 7.2 | –0.9 | –1.2 |
| Old-age pension system | 1.3 | –1.9 | 2.5 | –4.6 | 2.6 | 2.9 |
| Local government | –0.3 | –0.1 | 0.6 | 0.8 | 0.3 | 0.3 |
| Central government budget balance | 0.5 | 4.2 | 3.7 | 1.0 | 0.1 | –0.8 |
| Central government debt | 76.7 | 69.7 | 61.7 | 53.3 | 50.8 | 49.3 |

Sweden's general government finances are relatively sensitive to cyclical fluctuations. A 1 per cent increase in GDP is estimated to increase net lending in the general government sector by 0.75 per cent of GDP. As a consequence, the automatic stabilisers will be relatively large. However, the sensitivity of the general government finances to interest rate changes is relatively weak and is affected by the considerable interest revenue of the old-age pension system. When long-term interest rates increase by one percentage point, interest expenditure increases about 0.5 per cent and interest revenue increases about 0.25 per cent of GDP. Accordingly the net effect is a worsening of net lending equivalent to 0.25 per cent of GDP.

## VI Structural Policy

Since 1997 open unemployment has fallen from more than 8 per cent to 4 per cent. During the same period, inflation has declined from 2 per cent to 1.3 per cent as of September 2000. Thus, in spite of the good rate of growth and rapid upswing in employment in recent years, the underlying inflationary pressure in the Swedish economy is still low. This indicates that the way in which the markets – including the labour market – are functioning is better than previously expected. There are various explanations for the improvement. The policy of low inflation has gained wide acceptance. The social partners have changed the negotiating process so that the risk of conflicts appears to have diminished. Wage developments also appear to have been adapted more to the specific conditions of individual businesses.

The Government has taken a number of measures aimed at further improving the way in which markets are functioning and making the welfare system more efficient. A new pension system has been introduced that is robust to changes in the long-term rate of growth and demographic changes. In addition there are stronger financial incentives for labour supply. The new system is funded to a limited extent. Appendix A2 contains a long-term scenario that illustrates the demands on general government finances in order to cope with the strains that will result from an increasing percentage of elderly in the population.

Under the plan to reform income taxes for households described in Section III, households will be compensated for their contributions to the old-age pension system. At the same time, the floor of the lowest tax bracket in the schedule for national tax will be raised so that the proportion paying tax to the central government is projected to include only 15 per cent of wage earners. These measures will reduce low- and middle-income earners' marginal taxes. Thus, along with making day care fees less dependent on income, this reduction will act as a labour supply stimulus.

A series of reforms in the 1980s and 1990s has improved the way in which markets function. In the future the Government will also initiate economic reforms to improve competition in various markets. Among other things, the Government intends to strengthen competition in retailing so that consumer prices in Sweden will decline to be more in line with the average level in the EU and to simplify the rules for public procurement. The Government also intends further to promote competition by proposing measures against forming cartels. In addition Sweden is actively working to dismantle remaining obstacles to free movement in the single market. A more detailed description of the Swedish measures to improve the way in which markets function can be found in the national report to the EU on economic reforms in the product and capital markets.

To achieve the targeted employment ratio of 80 per cent in 2004, a number of conditions have to be met. The rate at which wages increase has to be consistent with productivity growth and the Riksbank's inflation target. At the same time, economic policy needs to focus on increasing the labour supply. In 2000 measures have been taken to improve the conditions for wage formation consistent with lasting high employment.

The Government has proposed that central government programmes in the IT area focus on creating an information society open to everyone by supporting accessibility and skills training. A central feature is the broadband initiative. In order to satisfy the demand for skilled labour, university programmes and research will be expanded.

In order to be able to place more of the long-term unemployed in regular jobs, the extended recruitment incentive for persons who have been without work for a long time has been raised and an activity requirement has been introduced as part of unemployment insurance. To increase the supply of labour, vocational labour market training is under way and special IT programmes are being implemented. The Government is also proposing measures to provide better opportunities for permanent jobs for immigrants.

# Appendix

## A1 Comparison With Previous Convergence Programmes

Table A.1 compares this update of the convergence programme with the programmes for 1998 and 1999. Growth in 1999 was markedly stronger than indicated in the 1998 convergence programme, but only marginally higher than expected in the 1999 update of the programme. In the present update the increase in GDP forecast for 2000 has been revised upwards by 1.3 percentage points compared with the 1998 convergence programme and by 0.9 percentage points compared with the 1999 update. The corresponding upward revisions in GDP forecast for 2001 are 1.0 and 1.3 percentage points respectively. For 2000 and 2001 both private consumption and exports have been revised upwards, which shows the breadth of the current upswing in the business cycle. The stronger demand is leading to a higher increase in employment – about 1 percentage point in 2000 and about half a percentage point in 2001 – when compared with the 1998 convergence programme. Compared with the 1999 update of the convergence programme, the employment forecast has also been revised upwards. During the forecast period, long-term interest rates are expected to be about half a percentage point higher than stated in the 1998 convergence programme, but in line with the forecast made in the 1999 update. Net lending in the general government sector is expected to be significantly higher than what was forecast in the programme for 1998 and in the 1999 update. This improvement will result in a lower gross debt than indicated in previous forecasts. By the end of 2000, the gross debt is expected to be lower than the reference value of 60 per cent.

## A2 Long-Term General Government Finances

Economic development is expected to be favourable in the next few years. The number of employed will increase and there will be a financial surplus in the public sector. However, beginning in 2008 the proportion of retired persons in the population will increase markedly at the same time that the percentage of persons of working age will decline. As a result, tax revenues will increase at a slower rate while the cost of transfers and general government consumption in the form of health care and social services will increase. The demographic changes will also lead to a dramatic increase in the percentage of the population over the age of 80 in the years after 2020. Such a development means that public expenditure in the form of health care and social services will increase still more.

Given these circumstances, it is important to consider decisions on tax reductions and increases in expenditure in the next few years from a long-term perspective. A high level of public savings for a number of years ahead will be necessary in order to reduce general government interest payments in the long term.

**Table A.1: General Government Net Lending, Gross Debt and Macro-economic Forecasts Under the Convergence Programmes for 1998–2000**

Percentage change, unless otherwise stated

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| *Net lending*[1] | | | | | | |
| Convergence programme, 1998 | 2.1 | 0.6 | 1.9 | 1.9 | – | – |
| 1999 update of the programme | 2.3 | 1.7 | 2.1 | 2.0 | 2.0 | – |
| 2000 update of the programme | 1.9 | 1.9 | 3.4 | 3.5 | 2.0 | 2.0 |
| *General government gross debt*[1] | | | | | | |
| Convergence programme, 1998 | 71.6 | 68.9 | 64.4 | 57.0 | – | – |
| 1999 update of the programme | 71.7 | 66.1 | 58.8 | 54.1 | 52.0 | – |
| 2000 update of the programme | 72.4 | 65.6 | 58.9 | 53.2 | 50.2 | 48.2 |
| *GDP* | | | | | | |
| Convergence programme, 1998 | 2.8 | 2.2 | 2.6 | 2.5 | – | – |
| 1999 update of the programme | 2.6 | 3.6 | 3.0 | 2.2 | 2.0 | – |
| 2000 update of the programme | 3.0 | 3.8 | 3.9 | 3.5 | 2.1 | 2.1 |
| *Employment* | | | | | | |
| Convergence programme, 1998 | 1.4 | 0.9 | 1.0 | 1.0 | – | – |
| 1999 update of the programme | 1.5 | 2.7 | 1.6 | 0.5 | 0.3 | – |
| 2000 update of the programme | 1.5 | 2.2 | 2.0 | 1.3 | 0.5 | 0.5 |
| *Inflation, CPI Dec-Dec*[2] | | | | | | |
| Convergence programme, 1998 | –0.2 | 0.5 | 1.3 | 2.0 | – | – |
| 1999 update of the programme | –0.6 | 0.9 | 1.3 | 2.0 | 2.0 | – |
| 2000 update of the programme | –0.6 | 1.2 | 1.1 | 1.7 | 2.0 | 2.0 |
| *Inflation, HICP Dec-Dec*[2] | | | | | | |
| 1999 update of the programme | 0.0 | 0.8 | 1.0 | – | – | – |
| 2000 update of the programme | 0.0 | 0.6 | 1.1 | 1.1 | – | – |
| *Ten-year interest rate*[2] | | | | | | |
| Convergence programme, 1998 | 5.0 | 4.4 | 4.7 | 5.1 | – | – |
| 1999 update of the programme | 5.0 | 4.9 | 5.4 | 5.5 | 5.3 | – |
| 2000 update of the programme | 5.0 | 5.0 | 5.4 | 5.4 | 5.3 | 5.2 |
| *Exchange rate*[3] | | | | | | |
| Convergence programme, 1998 | 120.0 | 120.3 | 117.5 | 116.5 | – | – |
| 1999 update of the programme | – | 8.8 | 8.7 | 8.7 | 8.7 | – |
| 2000 update of the programme | – | 8.6 | 8.4 | 8.5 | 8.6 | 8.6 |

[1]The convergence programme has been recalculated using the European System of Accounts (ESA) 95 and for 2001, it has been adjusted for the net lending target. Using ESA 79, net lending and consolidated gross debt in the convergence programme are respectively estimated at 1.5 and. 74.2 for 1998; 0.3.and 71.4 for 1999; 1.6 and 66.7 for 2000; and 1.5 and 58.0 for 2001.

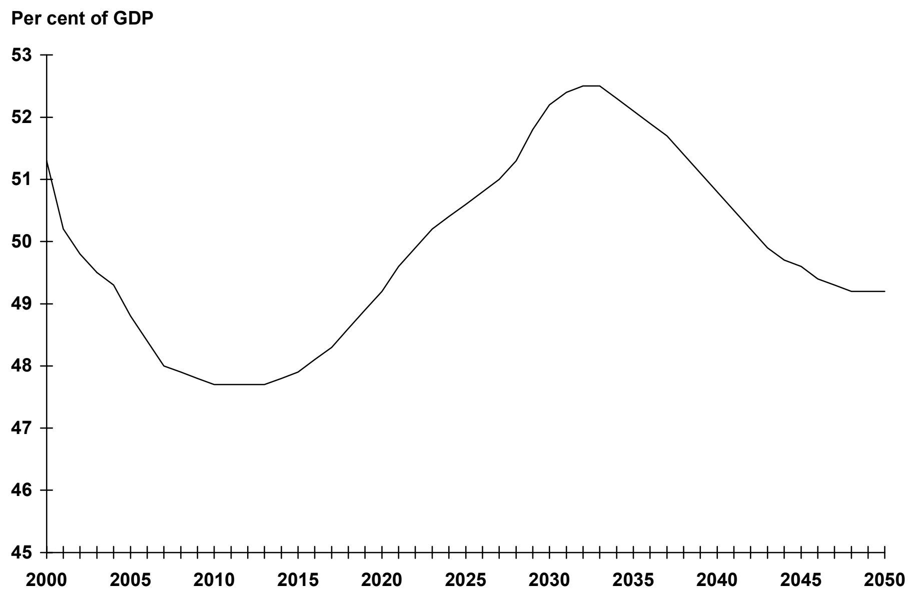
[2] Per cent.

[3] SEK/Euro.

[4] ECU index.

To illustrate the effects of these demographic changes, long-term estimates of the growth in general government finances are reported in this section. Diagram A.1 shows general government expenditure growth in the event that the demographic changes are allowed to fully affect expenditure levels. In addition an increase in the growth of public consumption by half a per cent a year is assumed in order to take into account some increase in standards. For example, this means that health care costs per person in various age groups will increase by half a per cent a year in fixed prices. Under this assumption general government expenditure, excluding interest, will decline as a share of GDP up until about 2010, only to increase sharply after that time.

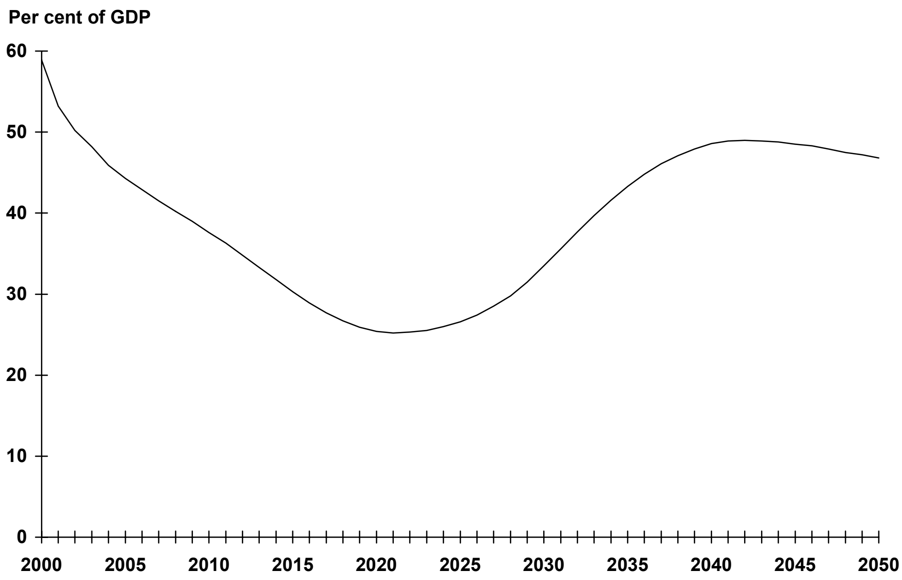
**Diagram A.1: General Government Primary Expenditure**




In this scenario it is assumed that a general government surplus of 2 per cent a year will be maintained over the next 15 years. The surpluses that accumulate will lead to a major reduction in indebtedness and hence in a substantial decrease in the interest expenditure burden. This will make the financing of the current welfare model possible when the strains caused by the demographic changes are also taken into consideration. The estimates also show that a surplus of 2 per cent a year in the general government finances up until 2015 will leave some room for a permanent lowering of the tax ratio or for some increase in general government expenditure in addition to that found in the basic estimates. In this connection the continuing internationalisation of the economy and its significance for the possibilities of maintaining the tax ratio also have to be taken into account.

As shown in Diagram A.2, the surplus in the general government finances for the period up to 2015 will lead to a considerable reduction in general government indebtedness. Owing to this there will be scope for general government expenditure and debt-ratio to increase. Under these conditions the demographic strains on the economy should be manageable.

**Diagram A.2 Consolidated Gross Debt**




In an alternative scenario, in which the surplus target is not preserved through to 2015, the general government finances will encounter significant problems in the long term. The deficit in about 2020 would exceed the reference values in the Stability and Growth Pact. In addition deficits would mean a steady rise in the debt ratio during the latter part of the period. The limits in the Stability and Growth Pact would be exceeded.

To sum up, the estimates show that the surplus in the general government finances should be maintained for a number of years ahead in order to make possible balanced development in the long term. Developments in general government savings and the debt ratio will be manageable while at the same time it will be possible to preserve the welfare system without sharp tax increases when the percentage of older persons increases. In that way, passing on the costs for retired persons, health care and social services to those who will then be of working age will be limited.

## Statistical Appendix

### Table B.1: Assumptions Used in the Forecast

Annual average, unless otherwise stated

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| World GDP[1] | 2.5 | 3.2 | 4.5 | 4.1 | 3.7 | 3.7 |
| HICP EU | 1.3 | 1.2 | 2.0 | 1.8 | 1.8 | 1.7 |
| Hourly wage costs in Sweden [1] | 3.8 | 3.4 | 3.5 | 3.5 | 3.5 | 3.5 |
| Exchange rate, SEK /US Dollar | 8.0 | 8.3 | 8.9 | 8.4 | 8.0 | 7.6 |
| TCW index | 123.2 | 124.8 | 123.1 | 121.9 | 120.5 | 119.5 |
| German 10-year interest rate | 4.6 | 4.5 | 5.3 | 5.3 | 5.1 | 5.0 |
| Swedish 10-year interest rate | 5.0 | 5.0 | 5.4 | 5.4 | 5.3 | 5.2 |
| Swedish 6-month interest rate | 4.2 | 3.3 | 4.2 | 4.6 | 4.7 | 4.6 |

[1]Annual percentage change.

### Table B.2: Central Government Net Lending and Consolidated Gross Debt

Per cent of GDP

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| Net lending deficit | –1.9 | –1.9 | –3.4 | –3.5 | –2.0 | –2.0 |
| Stock and flow adjustments | 2.3 | –1.8 | –0.2 | 0.9 | 1.0 | 2.0 |
| Increase in financial assets, etc. | 0.8 | –2.2 | –1.1 | –1.5 | 1.7 | 2.7 |
| Consolidation | 0.1 | 0.0 | 2.0 | 3.1 | –0.3 | –0.4 |
| Effect of exchange rate on govt. debt | 1.4 | 0.4 | –1.1 | –0.7 | –0.4 | –0.3 |
| Effect of increase in GDP | –3.1 | –3.0 | –3.0 | –3.1 | –2.1 | –2.0 |
| Change in gross debt | –2.6 | –6.7 | –6.7 | –5.7 | –3.0 | –2.0 |
| Gross debt (level) | 74.2 | 65.6 | 58.9 | 53.2 | 50.2 | 48.2 |

**Table B.3: General Government Finances**

Per cent of GDP

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| Revenue | 60.6 | 60.2 | 58.9 | 57.2 | 56.4 | 56.5 |
| Taxes and charges | 52.7 | 52.9 | 52.0 | 50.9 | 50.3 | 50.3 |
| Direct taxes | 22.6 | 22.4 | 21.4 | 20.8 | 20.2 | 20.4 |
| Taxes on products and production | 15.5 | 17.0 | 15.3 | 14.9 | 14.9 | 14.8 |
| Social insurance contributions | 14.5 | 13.4 | 15.2 | 15.1 | 15.1 | 15.1 |
| Income from capital | 4.4 | 3.6 | 3.3 | 2.7 | 2.6 | 2.6 |
| Other revenue | 3.5 | 3.8 | 3.7 | 3.6 | 3.6 | 3.5 |
| Expenditure | 58.7 | 58.4 | 55.5 | 53.7 | 53.1 | 52.9 |
| Transfers | 24.1 | 23.5 | 22.5 | 21.8 | 21.3 | 21.4 |
| Households | 20.5 | 20.1 | 19.4 | 18.8 | 18.6 | 18.8 |
| Business sector | 2.6 | 2.4 | 1.9 | 1.8 | 1.4 | 1.3 |
| Foreign | 1.1 | 1.1 | 1.2 | 1.2 | 1.3 | 1.3 |
| Consumption | 26.7 | 27.0 | 26.3 | 25.9 | 26.0 | 25.9 |
| Investment, etc. | 1.7 | 2.5 | 2.5 | 2.5 | 2.6 | 2.6 |
| Investment and stocks | 2.7 | 2.7 | 2.6 | 2.6 | 2.6 | 2.6 |
| Purchase less sale of real property | –1.0 | –0.3 | –0.1 | –0.1 | –0.1 | 0.0 |
| Interest | 6.2 | 5.3 | 4.2 | 3.5 | 3.3 | 3.0 |
| Technical transfer assumption | – | – | – | – | 1.3 | 1.6 |
| Net lending | 1.9 | 1.9 | 3.4 | 3.5 | 2.0 | 2.0 |
| Primary net lending | 3.7 | 3.7 | 4.3 | 4.3 | 2.7 | 2.4 |
| Consumption of fixed capital and net capital transfers | 2.4 | 2.2 | 2.3 | 2.2 | 2.2 | 2.2 |
| Capital accumulation | 1.7 | 2.5 | 2.5 | 2.5 | 2.6 | 2.6 |
| Net saving | 1.2 | 2.1 | 3.7 | 3.8 | 2.4 | 2.4 |
| Consolidated gross debt | 72.4 | 65.6 | 58.9 | 53.2 | 50.2 | 48.2 |
| Net debt | 15.8 | 11.4 | 0.5 | –3.7 | –5.9 | –8.0 |