

EN

EN

EN



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
SEC(2009) 188 final

Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Article 9 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

On the updated convergence programme of Sweden, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Sweden, submitted on 1 December 2008, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

- (1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");
- (2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)². The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance

¹ OJ L 209, 2.8.1997, p. 1.. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

² Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 23 January 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2010, as follows. "The overall conclusion is that the medium-term budgetary position is sound with high general government surpluses and Sweden is at low risk with regard to the sustainability of public finances. With GDP growth in 2008 possibly turning out lower than foreseen, the risk of pro-cyclical fiscal policy would be very limited. Moreover, the weakening of the structural budgetary position in 2008 goes along with continued structural reforms aimed at encouraging labour force participation and thus increasing growth potential and is not envisaged to spill over into subsequent years".

Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Article 9 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

On the updated convergence programme of Sweden, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies³, and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [10 March 2009] the Council examined the updated convergence programme of Sweden, which covers the period 2008 to 2011.
- (2) After many years of relatively strong economic growth, the Swedish economy decelerated significantly in 2008 as a result of the global slowdown dampening external demand. Domestic demand kept up rather well until the summer, but has since weakened markedly as business and consumer confidence have fallen sharply along with major stock market indices. The slowdown appears to have worsened in the last months of 2008 and unemployment has started to increase. Partly thanks to a generally sound macroeconomic framework, Sweden entered the downturn with public finances in a relatively strong position and has therefore scope for letting automatic stabilisers play fully and taking discretionary stimulus measures without jeopardising long-term fiscal sustainability. As Swedish public finances have historically been relatively sensitive to the cycle and labour market developments, the main challenge in the coming years will be to ensure a return to full employment so that the expected rapid rise in unemployment does not have a permanent negative impact on public finances. Following several interest rate hikes until September 2008 on account of inflation concerns, the Riksbank has eased monetary policy via successive interest rate reductions (from 4.75% to currently 1.00%) and an expansion of its balance sheet. The nominal effective exchange rate of the krona depreciated by around 10% during 2008.
- (3) The programme contains three different scenarios for the macroeconomic and budgetary projections: a "base scenario" and a two "alternative scenarios", the latter two depicting more cautious macroeconomic and budgetary developments. The base

³ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

scenario is considered the reference scenario for assessing budgetary projections, as it is the only fully-developed scenario containing sufficiently detailed projections. The reference scenario, which takes most of the planned stimulus measures for 2009 into account, envisages that real GDP growth will fall from 1.5% in 2008 to 1.3% in 2009, before recovering to an average rate of 3.3% over the rest of the programme period. In view of the rapid deterioration of the macro-economic outlook in past months⁴ this scenario, which was finalised in September, appears to be based on markedly favourable growth assumptions, in particular for the years 2009 and 2010. This is also reflected in markedly favourable projections for unemployment. The composition of growth is more plausible than the overall GDP growth outlook and the programme's projections for inflation appear realistic. Inflation is expected to fall well below the Riksbank's 2%-target in 2009 as a result of lower commodity prices and an widening output gap dampening price pressures from the demand side.

- (4) For 2008, the general government surplus is estimated at 2.3% of GDP in the Commission services' January 2009 interim forecast, against a target of 2.8% of GDP set in the previous update of the convergence programme. Despite a positive base effect (reflecting a stronger outturn in 2007 than anticipated in the previous programme), the worse-than-planned outcome in 2008 is to a large extent explained by revenue from taxes on consumption and capital income falling short of expectations, which more than offset the positive impact from lower-than-anticipated expenditure growth. This is a reflection of the slower growth of consumption and investment and the significant fall in stock market indices in the second half of 2008.
- (5) In the updated programme, the general government surplus in 2009 is foreseen to narrow by 1.7 percentage points to 1.1% of GDP, which compares with a projection of a deficit of 1.3% of GDP in the Commission services' interim forecast. The 2009 target in the programme update includes the fiscal stimulus measures contained in the 2009 Budget Bill amounting to about 1% of GDP, consisting mainly of tax cuts on earned income and a reduction in social contributions. The estimated impact of the automatic stabilisers on the general government balance is a reduction of the surplus by 0.6% of GDP. The fiscal stance is foreseen to turn expansionary in 2009, with the structural balance decreasing by about 1 percentage point of GDP.
- (6) The main goal of the medium-term budgetary strategy in the programme is to achieve a budget surplus of 1% of GDP on average over the business cycle, supported by multi-annual expenditure ceilings for the central government and a balanced budget requirement for local governments. This surplus target corresponds to Sweden's medium-term objective (MTO) of a structural surplus of 1% of GDP. Despite the significant deterioration in the government balance in 2009, the programme foresees to respect the MTO with a good margin throughout the programme period. This is based on a no-policy change assumption for 2010 and 2011. Both the headline and the primary balance are projected in the programme to strengthen as from 2010, with the headline surplus increasing to 1.6% of GDP and 2.5% of GDP in 2010 and 2011, respectively.
- (7) The budgetary outcomes are subject to downside risks. The main risk to the programme's budgetary projections stems from the macro-economic scenario. In recognition of this risk, the programme contains two alternative scenarios, both with

⁴ The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

less favourable growth assumptions based on the international financial crisis proving deeper and more protracted than assumed in the reference scenario. From the information available, it would seem, however, that even the least favourable of the two alternative scenarios might underestimate the impact on the general government balance of the economic downturn projected in that scenario. This confirms that there is substantial uncertainty as to the degree of sensitivity of the government balance to changes in economic activity at the current juncture. While the uncertainty concerns both the revenue and the expenditure side, it is probably larger on the revenue side, given the recent volatility of some revenue components, notably revenues from capital income taxes. On the expenditure side, there is uncertainty about the impact of recent reforms of the sickness and unemployment insurance systems on government expenditure and about potential consequences for public finances of explicit and implicit guarantees to the financial sector.

- (8) The long-term budgetary impact of ageing is lower than the EU average. The budgetary position in 2008 as estimated in the programme with a high primary surplus contributes to the reduction of gross debt and the large assets accumulated by the public pension schemes will help finance part of the increase in pension expenditure. However, if the 2009 budgetary position as projected by the Commission services' interim forecast was taken as the starting point, a small sustainability gap would arise. Maintaining high primary surpluses over the medium term would contribute to limiting the risks to the sustainability of public finances, which are currently at a low level.
- (9) The Swedish budgetary framework can overall be considered as strong and has contributed to the significant debt reduction observed since its introduction. To increase transparency, the government has in recent years taken a number of steps to refine the framework and is committed to continue reviewing the performance of the framework to address remaining weaknesses. In the context of the recent review, a Fiscal Council was set up with the task of evaluating how well the government has implemented its fiscal policy objectives. This Council presented its first annual report in 2008. Remaining weaknesses relate to the risk of the framework not being sufficiently able to prevent expansionary policies in good times, when the surplus target or balanced budget requirement at the local level are not binding. This may limit the room for manoeuvre in downturns. The government has recently also strengthened the rules regarding the expenditure ceiling and has the explicit ambition of gradually lowering the tax burden on the economy.
- (10) With a view to stabilising the financial sector, the Swedish authorities have adopted a range of measures, including a doubling of the ceiling of the depositors' guarantee (to SEK 500.000 per account), a system of credit guarantees for banks' medium-term borrowing (maximum amount of SEK 1500 billion or almost 50% of GDP) and a scheme to facilitate the recapitalisation of solvent banks (maximum amount of SEK 50 billion or about 1½% of GDP).
- (11) In line with the EERP agreed in December by the European Council, Sweden adopted a number of fiscal stimulus and structural reforms measures. The fiscal stimulus packages for 2009 adopted by Sweden are an adequate response to the economic downturn. While the measures implemented or proposed are timely and reasonably well targeted, they are principally permanent in nature. This is notably the case for the lowering of income taxes and social contributions, which forms part of the government's structural agenda to improve incentive to go from inactivity to

employment. The measures are related to the Lisbon structural reform agenda for Sweden as reviewed by the Commission on 28 January 2009. The measures proposed in the Supplementary Bill, on the contrary, are mostly temporary in nature and were proposed as a direct response to the downturn.

- (12) Based on the fiscal measures contained in the updated programme, the structural balance is expected to decrease by about 1% of GDP, implying an expansionary fiscal stance *y*. Taking into account the additional measures proposed in the Supplementary Bill, the expansionary stance is somewhat more pronounced. This is appropriate given the worsening of the economic outlook that has occurred in recent months. Under a no-policy-change assumption, the updated programme foresees that the structural balance increases only slightly in 2010 and by about ½ percentage point in 2011, implying a mildly restrictive policy stance in that period. Sweden's fiscal position is considered fully in line with the criteria of the Stability and Growth Pact.
- (13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data⁵.

The overall conclusion is that the medium-term budgetary position is sound. Large surpluses in good times have created fiscal space to allow fiscal policy to play an active role in the current downturn, not only by boosting demand in the short term but also by strengthening the economy's long-term growth potential. The fiscal stance has appropriately become expansionary in 2009. However, there are short-term risks to the fiscal balance, and there is a need to strengthen the fiscal framework to ensure that the government balance improves once the economy picks up again.

In view of the above assessment, Sweden is invited to:

- (i) implement the measures in line with the EERP as planned;
- (ii) reverse the adverse budgetary impact of the fiscal stimulus measures once the economy recovers.

⁵ In particular, the data on nominal GDP growth and privatisation proceeds are not provided.

Comparison of key macro economic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	CP Dec 2008	2.7	1.5	1.3	3.1	3.5
	COM Jan 2009	2.5	0.5	-1.4	1.2	n.a.
	CP Nov 2007	3.2	3.2	2.5	2.2	n.a.
HICP inflation (%)	CP Dec 2008	2.5	3.6	1.5	n.a.	n.a.
	COM Jan 2009	1.7	3.3	0.7	1.0	n.a.
	CP Nov 2007	1.7	2.7	2.5	2.1	n.a.
Output gap ¹ (% of potential GDP)	CP Dec 2008	1.0	-0.5	-1.6	-1.0	-0.2
	COM Jan 2009 ²	2.5	0.7	-1.9	-2.0	n.a.
	CP Nov 2007	0.6	0.9	0.6	0.0	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	CP Dec 2008	8.4	8.2	8.2	8.3	8.1
	COM Jan 2009	8.3	6.1	6.5	6.6	n.a.
	CP Nov 2007	7.1	7.2	7.4	7.7	n.a.
General government revenue (% of GDP)	CP Dec 2008	56.2	55.4	54.1	53.8	53.3
	COM Jan 2009	56.4	55.1	53.0	52.7	n.a.
	CP Nov 2007	56.300	55.5	54.9	54.6	n.a.
General government expenditure (% of GDP)	CP Dec 2008	52.6	52.5	53.1	52.2	50.8
	COM Jan 2009	52.8	52.8	54.3	54.1	n.a.
	CP Nov 2007	53.3	52.6	51.8	51.1	n.a.
General government balance (% of GDP)	CP Dec 2008	3.6	2.8	1.1	1.6	2.5
	COM Jan 2009	3.6	2.3	-1.3	-1.4	n.a.
	CP Nov 2007	3.0	2.8	3.1	3.6	n.a.
Primary balance (% of GDP)	CP Dec 2008	5.4	4.7	2.6	3.0	3.8
	COM Jan 2009	5.4	4.1	0.2	0.1	n.a.
	CP Nov 2007	4.6	4.4	4.5	4.8	n.a.
Cyclically-adjusted balance ¹ (% of GDP)	CP Dec 2008	3.0	3.1	2.0	2.2	2.6
	COM Jan 2009	2.1	1.9	-0.2	-0.2	n.a.
	CP Nov 2007	2.7	2.3	2.8	3.6	n.a.
Structural balance ³ (% of GDP)	CP Dec 2008	2.2	2.8	1.9	2.1	2.5
	COM Jan 2009	2.1	1.6	-0.3	-0.2	n.a.
	CP Nov 2007	2.3	2.0	2.8	3.6	n.a.
Government gross debt (% of GDP)	CP Dec 2008	40.6	35.5	32.2	28.3	23.8
	COM Jan 2009	40.6	34.8	36.2	36.0	n.a.
	CP Nov 2007	39.7	34.8	29.8	24.5	n.a.

Notes:

¹ Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

² Based on estimated potential growth of 2.6%, 2.3%, 1.3% and 1.2% respectively in the period 2007-2010.

³ Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.3% of GDP in 2008 and 0.1% in 2009-11 all deficit-reducing according to the most recent programme and 0.3 % of GDP in 2008 and 0.1% in 2009; all deficit-reducing in the Commission services' January interim forecast.

Source:

Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.