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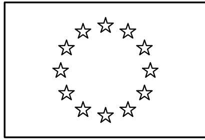

EUROPEAN COMMISSION

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Recommendation for a

COUNCIL OPINION

on the updated convergence programme of Sweden, 2009-2012

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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 sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], 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.

In accordance with the Regulation, the Council delivered an opinion on the first convergence programme of Sweden on 8 February 1998 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

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 29 January 2010, 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 conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy";

(3) 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).

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[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/sgp/index_en.htm.

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

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed 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 called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States 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.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions. The Council agreed on the following principles of the fiscal exit strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) taking country-specific circumstances into account, timely withdrawal of fiscal stimulus was needed; provided that the Commission forecasts continued to indicate that the recovery was strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest; (iii) in view of the challenges, the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) important flanking policies to the fiscal exit would include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability; in addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The Council

[2] Communication from the Commission to the European Council of 26 November 2008.

agreed that these elements should be reflected in the stability and convergence programmes, to be transmitted by Member States to the Commission by the end of January 2010.

2.3. The assessment in the Council Opinion on the previous update

In its opinion of 10 March 2009, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2011, as follows. The Council considers "that the medium-term budgetary position is sound. Large surpluses in good times 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 this assessment, the Council invited Sweden "to implement the planned fiscal policy, including stimulus measures, in 2009, in line with the EERP and within the framework of the SGP, and subsequently ensure returning to the MTO".

Recommendation for a

COUNCIL OPINION

on the updated convergence programme of Sweden, 2009-2012

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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 policies[3], 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 [22 April 2010] the Council examined the updated convergence programme of Sweden, which covers the period 2009 to 2012.

(2) After being severely hit by the recession at the end of 2008, the Swedish economy has subsequently stabilised with low but positive GDP growth. Somewhat uncharacteristically at this stage of the cycle, the Swedish economy has been mainly driven by consumer demand while industrial production, investment activity and exports have merely bottomed out after previous deep falls. Household spending has been helped by supportive fiscal and monetary policies and a stabilisation of the situation in the financial markets. An improving labour market outlook, rising stock market indices and a resumption of the previous upward trend in house prices have also contributed to strengthening consumer confidence. As the economy slipped into recession, the Swedish currency weakened by almost 30% on a trade-weighted basis in less than a year, but has since recovered about three quarters of its lost value. Its recent appreciation should contribute to dampen inflationary pressures, already subdued by significant slack in the economy. The recession and the fiscal policy response it triggered have swung the public sector balance from a surplus of 2.5% of GDP in 2008 to a deficit of more than 1½% in 2009. In order to ensure a sustainable development of public finances, a key challenge will be to avoid that a potentially rather job-anaemic recovery leads to lasting negative effects on long-term unemployment and a permanent loss of labour supply. Ensuring that active labour market policies remain of high quality even as they expand in scope will be important in this regard. Another challenge for policy makers will be to carefully calibrate the withdrawal of the various

[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/sgp/index_en.htm.

stimulus measures so as to neither nip the recovery in the bud nor contribute to the build-up of potentially destabilising household-sector imbalances.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Sweden it is important to undertake reforms in the areas of competition and labour market participation.

(4) The macroeconomic scenario, which is based on the 2010 Budget Bill presented to Parliament in September 2009, envisages that real GDP growth will pick up from -5.2% in 2009 to 0.6% in 2010 and to average 3.5% over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on cautious growth assumptions in 2010 and markedly favourable ones thereafter, given that the projected growth rates are substantially higher than the estimated medium term growth potential. Against this background, the programme's projections for inflation appear somewhat on the low side, though this may reflect the expected strengthening of the Swedish currency.

(5) The programme estimates the general government deficit in 2009 to be 2.2% of GDP. The significant deterioration from a surplus of 2.5% of GDP in 2008 reflects the impact of the crisis through the effect of both automatic stabilisers and discretionary stimulus measures of about 1½% of GDP which the government adopted in line with the European Economic Recovery Plan (EERP). The deterioration was mainly due to falling tax revenue, as both the number of hours worked and average tax rates decreased, consumption fell and corporate profits and capital gains diminished. According to the programme, fiscal policy is planned to remain supportive in 2010. In view of Sweden's relatively favourable budgetary situation the continued fiscal expansion in 2010 is appropriate and in keeping with the EERP. No structural consolidation is foreseen in the outer years of the programme.

(6) In 2010 the updated programme foresees the general government deficit to increase to 3.4% of GDP, partly as a result of an additional stimulus package amounting to about 1% of GDP. The main discretionary measures on the revenue side consist of a fourth step in the so called in-work tax credit scheme, with an estimated impact on the government balance of 0.3% of GDP. A reduction in the taxes on pensions adds a further 0.1% of GDP to the stimulus. On the expenditure side, measures include additional state transfers to the municipalities of about 0.3% of GDP and additional resources to crime control and the judicial system, education and training activities and measures to support the growth of small enterprises amounting to about 0.1% of GDP each. The planned fiscal stance as measured by the change in the structural balance, the cyclically-adjusted balance (recalculated according to the commonly agreed methodology) net of one-off and other temporary measures, is expansionary, with the structural deficit widening by 1.6 percentage points. The difference compared to the size of the fiscal package of 1% of GDP is mainly explained by lower tax elasticities.

(7) The main goal of the budgetary strategy is to bring the general government deficit back below the 3% of GDP reference value (after reaching 3.4% of GDP in 2010) and to keep it on a firm downward trend. The budgetary projections are based on a no-policy change assumption for the period after 2010 and foresee the headline general government deficit to gradually narrow from 3.4% of GDP in 2010 to 2.1% of GDP in 2011 and 1.1% of GDP in 2012. The primary balance is expected to have a similar profile, going from a deficit of 2.2% of GDP in 2010 to a deficit of 0.8% in 2011, before swinging into a surplus of 0.4% of GDP in 2012. This is a fairly significant improvement, in particular since it does not include any consolidation measures and the number of hours worked – an important tax base for income tax – does not rebound strongly in 2011-12. The structural balance calculated according to the commonly agreed methodology, on the other hand, is expected to deteriorate, with the deficit widening from 1.3% of GDP in 2010 to 1.5% of GDP and 2.1% of GDP in 2012. The structural balance may, however, be underestimated, as there are lags in the cyclical evolution of the general government balance that are not fully captured in the cyclical adjustment. The MTO of Sweden is to achieve a surplus of 1% of GDP over the cycle. In view of the new methodology[4]and given the most recent projections and debt level, the MTO more than adequately reflects the objectives of the Pact. However, the updated convergence programme does not envisage achieving the medium-term budgetary objective within the programme period.

(8) The budgetary outcome could turn out better than projected in the programme in 2010 and worse than projected thereafter. The reference scenario in the updated programme dates from the 2010 Budget Bill published in September 2009 and does not take into account the subsequent improvement in the economic outlook for 2009-10.[5] Preliminary fiscal outcomes in 2009 also appear to be better than foreseen, notably with higher-than-expected receipts from VAT. In February 2010, the government estimated that the 2009 deficit amounted to 1.6% of GDP compared with a forecast of 2.2% of GDP in the updated programme. This could spill over into 2010. For the years 2011-12, the reference scenario foresees very strong GDP growth, based on buoyant domestic demand. Stimulus withdrawal, in particular a normalisation of interest rates, could, however, dampen consumer confidence, in particular in view of high household indebtedness. This development could be exacerbated, were the current house price inflation to slow down. While the situation in the financial sector has clearly improved, credit losses in some of the big banks are still running high and lending margins are being squeezed. Given the importance of the banking system to the functioning of the economy, possible government interventions in case of a confidence crisis could also have a negative impact on the budget, although some of the cost of government support to the financial sector could also be recouped in the future. 2010

[4] The country-specific MTOs should take into account three components: i) the debt-stabilising balance for a debt ration equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

[5] However, the programme refers to the government's November 2009 update of the forecast, which reflects part of the improvement in the outlook compared to the reference scenario, and two alternative growth profiles, which portray a worse and a more favourable macroeconomic projection, respectively. None of these projections are detailed enough to be considered as the reference scenario.

being an election year, with parliamentary elections to be held in mid-September, risks stemming from the electoral cycle exist, but are not deemed to be particularly large.

(9) Government gross debt is estimated at 42.8% of GDP in 2009, up from 38.0% of GDP the year before. Apart from the increase in the deficit and the decline in GDP growth, a significant stock-flow adjustment reflecting primarily a loan to the central bank contributed to the rise in the debt ratio. The debt ratio is projected to increase by a further 2.4 percentage points over the programme period to 45.2% of GDP in 2012, mainly driven by continued government deficits. The risks to the projected evolution of the debt ratio appear to be broadly balanced, with some positive risks for 2010 and some downside risks thereafter. Gross debt remains well below the reference value and the net financial position is positive.

(10) The long-term budgetary impact of ageing is clearly lower than the EU average and the large assets accumulated by the public pension schemes will help finance part of the increase in pension expenditure. The budgetary position in 2009, as estimated in the programme, contributes to the reduction of gross debt. Ensuring primary surpluses over the medium term and implementing appropriate structural reforms would contribute to limiting the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report[6] as low.Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value, would put the debt ratio on a declining path, reducing it to about 15% of GDP by 2020.

(11) 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. Notably, a Fiscal Council has been set up with the task of evaluating how well the government has implemented its fiscal policy objectives. This Council presented its second annual report in 2009. The government has recently also strengthened the rules regarding the expenditure ceiling and is considering ways to strengthen the status of the surplus target. Remaining weaknesses relate to the risk of the framework not being sufficiently able to prevent pro-cyclical policies in good times, in particular at local government level. This stems from the fact that the balanced-budget requirement does not allow local governments to use surpluses in good times to cover deficits in bad times.

(12) As achieving a high rate of employment is a prerequisite for achieving sustainable public finances, in particular in view of the ageing of the population, the government has taken a number of measures on both the supply and demand side to improve the incentives to work and reduce the cost of hiring, in particular for groups with a relatively low employment rate, such as young people and immigrants. Labour income

[6] In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

taxes have been reduced, in the form of a so called in-work tax credit and a higher threshold for paying state tax. These tax cuts have been coupled with general and targeted reductions in social contributions to lower the cost of hiring. Reforms have also been undertaken with regard to the unemployment and sickness insurance systems, where both the level of benefits and the length of time a person can receive them have been scaled back. While the number of people receiving sickness insurance benefits has already fallen, the effects of the income tax reforms are mainly to be expected in the medium to long term.

(13) Overall, the strategy to maintain supportive fiscal policies also in 2010 can be considered in line with the EERP. The stronger-than-projected outcome in 2009 and the improvement in the macroeconomic outlook for 2010 makes the achievement of the nominal budgetary targets plausible, despite the downside risks to the macroeconomic scenario for 2011-12. Nevertheless, in structural terms no progress towards meeting the MTO is expected even during the 2011-12 period, during which growth assumptions are deemed favourable. Therefore, the budgetary strategy would need to be reinforced by specifying concrete measures in the outer years of the programme period to be in line with the requirements of the Pact.

(14) 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 data[7].

The overall conclusion is that large surpluses in good times allowed fiscal policy to play an active role in the downturn, not only by boosting demand in the short term but also by strengthening the economy's long-term growth potential. The fiscal stance is appropriately continuing to be expansionary in 2010 in line with the EERP. The programme projects the deficit to widen to 3.4% of GDP in 2010, from 2.2% in 2009, due mainly to the additional stimulus measures taking effect in this year. Thereafter, the deficit ratio is projected to gradually narrow to 2.1% of GDP in 2011 and 1.1% in 2012. This improvement is due mainly to assumed strong economic growth, as the programme does not envisage any consolidation efforts in these years. Risks to the planned adjustment seem balanced overall, with upside risks in 2010 compensating downside risks in 2011-12. However, should budgetary outcomes fall short of the projected ones, the government would have to stand ready to adopt timely discretionary consolidation measures.

In view of the above assessment and also given the need to ensure sustainable convergence, Sweden is invited to

(i) implement the 2010 fiscal policy as planned in line with the EERP, while ensuring that the planned breach of the 3%-of-GDP reference value would remain contained and temporary;

(ii) ensure that the nominal budgetary adjustment projected in the programme is achieved, if necessary by timely adoption of consolidation measures to ensure that lower-than-expected growth does not derail the envisaged consolidation of government finances in the outer years of the programme, as well as to ensure progress towards the MTO.

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7 In particular, the data on net lending of the private sector, which have the effect of making the assessment objectively more difficult, are not provided.

Sweden is also invited to improve compliance with the data requirements of the code of conduct.

Comparison of key macroeconomic and budgetary projections

		2008	**2009**	**2010**	**2011**	**2012**
Real GDP (% change)	**CP Jan 2010**	**-0.2**	**-5.2**	**0.6**	**3.1**	**3.8**
	COM Nov 2009	-0.2	-4.6	1.4	2.1	n.a.
	CP Dec 2008	*1.5*	*1.3*	*3.1*	*3.5*	*n.a.*
HICP inflation (%)	**CP Jan 2010**	**2.1**	**2.0**	**0.4**	**0.6**	**0.9**
	COM Nov 2009	3.3	1.9	1.7	1.7	n.a.
	CP Dec 2008	*3.6*	*1.5*	*n.a.*	*n.a.*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2010**	**1.7**	**-4.1**	**-3.6**	**-1.3**	**1.5**
	COM Nov 2009[2]	0.9	-4.5	-4.1	-3.3	n.a.
	CP Dec 2008	*-0.5*	*-1.6*	*-1.0*	*-0.2*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Jan 2010**	**7.8**	**7.2**	**7.1**	**7.4**	**7.4**
	COM Nov 2009	8.1	7.6	7.7	8.1	n.a.
	CP Dec 2008	*8.2*	*8.2*	*8.3*	*8.1*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2010**	**55.6**	**54.9**	**54.6**	**54.3**	**53.9**
	COM Nov 2009	55.6	53.8	52.3	52.0	n.a.
	CP Dec 2008	*55.4*	*54.1*	*53.8*	*53.3*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2010**	**53.1**	**57.1**	**58.0**	**56.3**	**54.9**
	COM Nov 2009	53.1	55.9	55.6	54.6	n.a.
	CP Dec 2008	*52.5*	*53.1*	*52.2*	*50.8*	*n.a.*
General government balance (% of GDP)	**CP Jan 2010**	**2.5**	**-2.2**	**-3.4**	**-2.1**	**-1.1**
	COM Nov 2009	2.5	-2.1	-3.3	-2.7	n.a.
	CP Dec 2008	*2.8*	*1.1*	*1.6*	*2.5*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2010**	**4.2**	**-0.9**	**-2.2**	**-0.8**	**0.4**
	COM Nov 2009	4.2	-0.8	-2.1	-1.4	n.a.
	CP Dec 2008	*-4.7*	*-2.6*	*-3.0*	*-3.8*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2010**	**1.5**	**0.2**	**-1.3**	**-1.4**	**-2.0**
	COM Nov 2009	1.9	0.5	-1.0	-0.7	n.a.
	CP Dec 2008	*3.1*	*2.0*	*2.2*	*2.6*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2010**	**1.2**	**0.3**	**-1.3**	**-1.5**	**-2.1**
	COM Nov 2009	1.6	0.3	-1.0	-0.7	n.a.
	CP Dec 2008	*2.8*	*1.9*	*2.1*	*2.5*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2010**	**38.0**	**42.8**	**45.5**	**45.6**	**45.2**
	COM Nov 2009	38.0	42.1	43.6	44.1	n.a.
	CP Dec 2008	*35.5*	*32.2*	*28.3*	*23.8*	*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 2.0%, 0.9%, 0.9% and 1.3% respectively in the period 2008-2011

[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 both 2011and 2012, all deficit-reducing, and 0.1% of GDP in 2009, deficit increasing, according to the most recent programme and 0.3% of GDP in 2008 and 0.2% of GDP in 2009, all deficit-reducing, in the Commission services' autumn 2009 forecast.

Source:

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations