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SWEDEN – REVIEW OF PROGRESS ON POLICY MEASURES RELEVANT FOR THE CORRECTION OF MACROECONOMIC IMBALANCES

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Executive summary

This is the second specific monitoring report under the macroeconomic imbalance procedure (MIP) for Sweden, reflecting the strengthened and broadened monitoring covering all Member States identified with imbalances[1]. Sweden had been found to have imbalances since the first application of the MIP in 2012. The imbalances relate in particular to continued house price and household debt growth. This report reviews the latest developments and policy initiatives undertaken by the Swedish authorities relevant for the correction of the imbalances identified in the 2017 country report and targeted by the 2017 country-specific recommendation for Sweden. The cut-off date for this report is 7 November 2017.

Economic growth in Sweden is expected to remain strong this year and next, before declining closer to the economy's potential growth rate in 2019. Domestic demand, particularly investment from the buoyant housing sector, has been the main growth engine this year. While investment is set to subside in the coming years, the strengthening of global activity should benefit Sweden's small, open and competitive economy. Overall, real GDP growth is projected to edge down from 3.2% this year to 2.7% in 2018 before easing further to 2.2% in 2019. Inflation has finally picked up, supported by continued accommodative monetary policy and increased economic activity, and is expected to remain broadly stable at 1.7% by the end of 2019. The labour market is forecast to strengthen with unemployment to fall further from 6.8% (as of September 2017) before stabilising at close to 6.3% in 2019. Household debt and housing market developments continued their mutually reinforcing interplay in 2017, albeit at a decelerating pace: nominal house price growth stands at about 6.7% year-on-year as of September (vs 8.6% in 2016) and household debt grew by 6.7% year-on-year as of Q2 2017 (vs about 7% in 2016) to reach 184% of disposable income. Importantly, these somewhat slower growth rates still significantly outpace household income growth.

Some significant policy action is ongoing to address the imbalances associated with household debt and the housing market. The gradual implementation of the 22-point plan for the housing market announced in mid-2016 will likely provide further support for the current strong momentum in residential construction. Some related additional policy measures have been launched as well, notably an initiative to promote foreign competition in the construction sector. The Swedish macroprudential authority is preparing a formal proposal to raise the amortisation rate for new mortgage borrowers with high debt-to-income levels. If approved by the government, this should help contain debt growth in this market segment at the margin. In addition, the Swedish authorities have advanced with legislative work to enhance the macroprudential authority's legal framework, so that it can respond in a more timely manner and using a wider range of potential measures to the risks associated with household debt developments.

However, key policy gaps remain, particularly in relation to tax incentives for (debt-financed) home-ownership and the rental market. There has been no progress on reducing the tax deductibility of mortgage interest, leaving Sweden as one of very few EU countries where uncapped tax relief is granted on the full amount of mortgage interest paid. Similarly, no action has been taken to reform the system of recurrent property taxation, which currently

[1] COM(2016)95 final, 8.3.2016.

includes a relatively low ceiling so that the tax in practice tends to take the form of a fairly modest fixed fee that does not scale up with property values. Finally, Sweden's tightly regulated rental market could benefit from reforms to encourage more supply of rental housing and more efficient usage of the existing stock. Mobility in the owner-occupier market could also be improved by measures to enhance allocative efficiency, in particular by revising the design of the capital gains tax on housing transactions.

In conclusion, against a background of continued house price and household debt growth, the Swedish authorities have gradually proceeded with the policy agenda to address these imbalances – albeit with uneven progress. Policy action has so far mainly focused on macroprudential aspects, including the proposal to strengthen amortisation requirements for high-debt-to-income borrowers and ongoing legislative work towards a more robust overall macroprudential framework. In addition, a number of measures to reduce construction costs and lead times and to improve the overall efficiency of the housing market are gradually getting implemented, further supporting the strong rise in new housing supply in recent years. However, the continued growth of house prices and mortgage debt underscores that further measures are needed. In particular, there remains significant scope for reforming the generous tax treatment of home-ownership and mortgage debt and for comprehensive rental market reforms.

Table 1: Key findings on the implementation of policy reforms[2]

On track	Wait-and-see	Action wanted
• Reform packages to increase developable land availability, reduce construction costs and shorten planning process lead times (part of "22-point plan") • Enhanced legal mandate for macroprudential authority	• Proposal to strengthen mortgage amortisation requirement for high-debt-to-income borrowers • Initiative to promote foreign competition in the construction sector	• Mortgage interest tax deductibility reform • Increased recurrent property taxation • Comprehensive rental market reforms • Revising the design of the capital gains tax on housing transactions

[2] The table classifies reforms under review on the basis of their respective adoption and implementation process, uncertainty and their level of detail. “On track” are measures for which the legislative or implementation process has been completed or is progressing well according to the foreseen timeline, and which are expected to be sufficiently effective. “Wait and see” are measures for which the legislative process is on-going, but is still in a relatively early phase, or measures for which there is still uncertainty on the complete implementation and effectiveness. “Action wanted” are measures for which limited or no action has been taken, or measures that have been announced but which are not sufficiently detailed yet to be assessed.

1. Introduction

On 16 November 2016, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its sixth Alert Mechanism Report[3] to underpin the selection of Member States requiring an in-depth investigation into the existence and extent of macroeconomic imbalances. The subsequent in-depth review in the country report – published on 22 February 2017[4] – examined the nature, origin and severity of macroeconomic imbalances and risks in Sweden. In the accompanying Communication[5], the Commission concluded that "Sweden is experiencing imbalances". In particular, the Commission emphasised that Sweden has recorded persistent house price growth from already overvalued levels coupled with a continued rise in household debt, posing risks of a disorderly correction. The Commission noted that policy measures have been taken to rein in mortgage debt growth and raise housing construction, but that policy steps implemented so far have not been sufficient to address overheating in the housing sector, and that policy gaps remain in the areas of housing-related taxation, the macroprudential framework, and in addressing bottlenecks for new housing supply as well as barriers to efficient usage of the existing housing stock. In April 2017, Sweden submitted its national reform programme (NRP)[6], outlining the policy measures to improve its economic performance and to unwind imbalances. On the basis of an assessment of these plans, the Commission proposed one country-specific recommendation (CSR)[7], which was adopted by the Council on 11 July 2017[8]. This recommendation addresses the continued rise in household debt and inefficiencies in the housing market. This CSR was considered to be MIP relevant.

The second specific monitoring mission to Sweden was conducted on 5-6 October 2017.

The present report assesses the latest key policy initiatives[9] undertaken by the Swedish authorities.

[3] https://ec.europa.eu/info/sites/info/files/2017-european-semester-alert-mechanism-report_en_0.pdf
[4] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-sweden-en.pdf
[5] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-reports-comm-en.pdf
[6] https://ec.europa.eu/info/sites/info/files/2017-european-semester-national-reform-programme-sweden-en_1.pdf
[7] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations_-_sweden.pdf
[8] http://eur-lex.europa.eu/legal-content/SV/TXT/PDF/?uri=CELEX:32016H0818(13)&from=EN
[9] Details on the policy measures taken can be found in the overview table in the Annex.

2. Outlook and recent developments on imbalances

Recent economic developments and outlook

The Swedish economy continues to thrive, growing at around 3%. Domestic demand remains robust in 2017, driven by investment which is projected to grow at a rate close to 8%. In particular, housing investment is set to continue growing at double-digit rates but also machinery and equipment investment gathered strong pace. Investment is then forecast to cool down to around 3% by 2019. Net exports are expected to contribute positively to GDP growth until 2019 and the current account surplus relative to GDP is forecast to edge up to 5.1%. Overall, real GDP growth is expected to be 3.2% in 2017, 2.7% in 2018 and 2.2% in 2019. Headline inflation is set to remain below 2% until 2019 despite continued accommodative monetary policy (a negative repo rate projected by the Riksbank to stay at the current level until mid-2018, before rising gradually and slowly) as well as increasing cost pressures due to high capacity utilisation and a tight labour market.

The labour market continues to strengthen with the employment rate at 81.2% in 2016, the highest among EU countries. Unemployment continues to decline and the favourable economic conditions are likely to support this trend in the coming years. Unemployment is set to stabilise at close to 6.3% in 2018-2019 due to rising labour shortages and limited demand for low-skilled workers.

Developments as regards imbalances

In February 2017, the Commission concluded that Sweden was experiencing imbalances related to persistent house price growth from already overvalued levels coupled with a continued rise in household debt. The following text provides an update of the situation with regard to the main variables related to the imbalances.

Housing sector

Sweden's real house price growth slowed from 12% y-o-y in 2015 to 7.6 % in 2016 (8.6% in nominal terms), as a combination of steep price rises in recent years and the introduction of a formal amortisation requirement in July 2016 appeared to weigh on price growth in some markets (notably Stockholm). In 2017, price inflation cooled somewhat further on average, driven mainly by weakness in the tenant-owned apartment market. Prices of Stockholm apartments in particular continued their underperformance relative to the national average, and are essentially flat year-to-date (YTD) as of September[10]. Single-family homes, on the other hand, which until 2015 had lagged the apartment market, have seen continued price growth at roughly the same rate as in 2016, and are up around 8 % YTD. Overall, house price rises across market segments average about 5.7% YTD, so in spite of the recent deceleration, house prices have continued to outpace income growth.

This persistent price growth is partly the result of a structural undersupply of houses. New construction has picked up strongly in recent years (albeit from low levels), with housing starts reaching 60 800 in 2016 (up 26% from 2015) and projected to grow further to about 75 000 in 2017. However, this still remains somewhat below near-term needs, estimated at about 81 000 per annum for the period of 2017-2020[11], and it is unclear if the recent surge in new development is focused on the regions and market segments where shortages are most acute. On the demand side, the housing market is underpinned by favourable tax treatment of home ownership and mortgage debt, low interest rates, a robust economy, population growth, benign credit conditions and particular features of the Swedish mortgage market (notably long mortgage maturities and still relatively low amortisation rates).

Indicators point to an increasing overvaluation of house prices, with the gap between prices and fundamentally justified values among the highest in the EU[12]. This implies risks of a significant correction, possibly triggering a disorderly deleveraging process with adverse implications for household consumption, growth and employment (and, in a severe scenario, for the financial sector).

Household debt

Swedish household debt continued its growth trend, increasing by 6.7% year-on-year (y-o-y) as of August 2017, significantly outpacing nominal GDP growth in a context of continued accommodative credit conditions and persistent house price growth. As a result, household debt stood at 184% of disposable income and 86% of GDP as of Q2-2017 – among the highest levels in the EU. Notably, there have been some positive developments at the margin, likely driven in part by the introduction of the new amortisation requirement in 2016. In particular, average debt-to-income ratios for new mortgage borrowers dropped somewhat in 2016 (to 402% from 406% in 2015) after years of steep increases, and there also was a slight fall in borrowing at debt-to-income levels over 600 %. However, overall, there has been no meaningful impact on household debt trend growth so far.

[10] Based NASDAQ OMX Valueguard-KTH Housing Index.
[11] Based on estimates by the National Board of Housing, Building and Planning (*Boverket*).
[12] Price-to-income and price-to-rent ratios in Sweden are about 45-60% above their long-term average (as of end-2016), and model-based estimates suggest prices are close to 10% above fundamentally justified levels.

3. Progress with policy implementation: addressing the rise in household debt and house prices

This section describes policy measures taken to address the continued rise in household debt and house prices, against the background of the 2017 country-specific recommendation (CSR). This recommendation called for reform of fiscal incentives for (debt-financed) home-ownership, policy steps to constrain lending at excessive debt-to-income levels, and measures to foster housing investment and improve the efficiency of the housing market.

The Swedish authorities have advanced legislative work to enhance the legal mandate for the macroprudential authority. The revised mandate should ensure that the Financial Supervisory Authority (*Finansinspektionen*, FSA) can introduce potential macroprudential measures that may be required in a timely manner and with a wider scope than is currently the case. Under the new mandate, the FSA will be able to propose a wide range of measures targeting bank lending to households or companies in order to tackle financial imbalances of any kind. Proposals will remain subject to a public consultation process and government consent, but without any need for parliamentary approval (beyond the initial adoption of the legislative framework for the new FSA mandate itself). This should help prevent the long delays that accompanied the introduction of earlier macroprudential measures, notably the new amortisation requirement in 2016. The legislative framework for the new mandate is expected to be adopted by parliament in December 2017 and to fully come into force by February 2018.

In May 2017, the macroprudential authority announced a proposal to raise the amortisation rate for new mortgage borrowers with high debt-to-income (DTI) levels. Specifically, the proposal would require households obtaining a mortgage with an overall debt level over 450% of gross income to amortise by an additional 1 percentage point per annum. Combined with the existing amortisation rule introduced in 2016, this would bring the overall amortisation rate to 3% per annum until the loan-to-value ratio (LTV) drops below 70%, and 2% per annum until the LTV drops below 50%. While this would help contain lending at excessive DTI levels, the initial impact would likely remain muted: the FSA has estimated that the new measure would affect only about 14% of new mortgages issued, and it would only raise the debt service cost (in cash flow terms) for high-DTI borrowing, as opposed to imposing an actual DTI limit. Following a consultation process, the FSA intends to submit the new measure for government approval in mid-November. If accepted, the measure should come in force as of March 2018.

The authorities are gradually implementing the 22-point plan for the housing market announced in mid-2016[13]. The plan contains a range of measures aimed at increasing land available for development, reducing construction costs, shortening planning process lead times and addressing a number of specific inefficiencies in the rental market. Significant parts of the plan have been largely implemented over the course of 2017, particularly with regard to reducing costs and lead times for new construction (see Annex 1 for details). Some new initiatives (not included in the original 22-point plan, but similar in purpose) have been launched as well, notably an effort to promote foreign competition in the construction sector. Other key reforms under the plan, including a comprehensive review of building and

[13] Available at: http://www.regeringen.se/globalassets/regeringen/dokument/finansdepartementet/pdf/2016/pm/sammanfattning-av-regeringens-forslag-22-steg-for-fler-bostader

planning regulations and measures to make more developable land available, involve significant preparatory inquiry work and stakeholder consultation processes. It will thus take some further time before these proposals are finalised and there is some uncertainty on the form they will ultimately be implemented in[14]. Nevertheless, overall, the 22-point plan and similar new initiatives will likely provide further support for the strong ongoing construction upswing.

However, this should not detract from the fact that these reforms are quite narrowly focused and generally incremental in nature. Crucially, they leave untouched some of the key underlying structural issues, particularly the generous tax treatment of home-ownership and mortgage debt. In addition, Sweden's rental housing market could benefit from more comprehensive reforms aimed at improving supply of rental housing as well as more efficient and flexible usage of the existing rental stock. The owner-occupier market could also benefit from measures to improve mobility; in particular, revising the deisgn of the capital gains tax on property transactions could help combat lock-in effects and free up underused family dwellings[15]. As the aggregate supply/demand gap in the housing market is gradually shrinking thanks to the strong rise in construction output, these allocative efficiency issues will become especially prominent.

To conclude, although some significant policy action is ongoing aimed at addressing the imbalances associated with household debt and the housing market, key policy gaps remain. Areas of progress include the continued gradual implementation of the 22-point plan for the housing market and the ongoing effort to enhance the macroprudential authority's legal framework, which is now approaching completion. The macroprudential authority's proposal to tighten amortisation requirements for high-DTI borrowers is also a positive step, albeit with a likely modest initial impact. Overall, there remains scope for adjusting the tax incentives for (debt-financed) home-ownership, for comprehensive rental market reforms, for revising the design of the capital gains tax on housing transactions, and potentially for additional macroprudential measures aimed at containing household debt growth.

[14] This inherent implementation risk is illustrated by the fact that for some measures, formal inquiry work has been completed as envisaged and a final report issued, yet without clear conclusions on key questions: an inquiry on the special "presumption rent" system for newly built rental housing failed to resolve the current lack of clarity about rent levels after expiry of the presumption period.

[15] To help address this issue, the deferral rules for capital gains taxes on property transactions were expanded on a temporary basis from June 2016 as part of the 22-point plan. However, this deferral approach only mitigates the immediate cash flow effect, and fails to tackle the actual wealth reduction represented by the capital gains tax liability.

Annex 1: Overview table of MIP-relevant reforms

MIP objective: addressing the rise in household debt and house prices			
Financial sector			
Private indebtedness			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Expected by March 2018: strengthened mortgage amortisation requirement for borrowers with debt above 450 % of gross income	**December 2017** (expected)**:** Enhanced legal mandate for macroprudential authority (adoption expected by 13 December based on parliamentary timeline, with the measure entering into force in February 2018)		CSR (1) – 2017: Address risks related to household debt, (…), while constraining lending at excessive debt-to-income levels. CSR (1) – 2016: Ensure that the macro-prudential authority has the legal mandate to implement measures to safeguard financial stability in a timely manner.
Housing market			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Expected in 2018: – Comprehensive review of building and planning regulations and detailed municipal zoning requirements[16] – Negotiated solution to make more state-owned land available for housing construction[17]	**July 2017:** initiative to promote foreign competition in the construction sector, including setting up website with translations of building regulations (to be operational by mid-2018) and inquiry on obstacles for foreign construction companies	**March 2017:** – Guidelines for simpler building-regulations compliance checks for series of identical housing units[16] – Wider range of permit-free building works[16] – More limited timeline and scope for	CSR (1) – 2017: Foster investment in housing and improve the efficiency of the housing market, including by introducing more flexibility in setting rental prices and revising the design of the capital gains tax.

[16] Part of the reform package to reduce construction costs and shorten planning process lead times (included in the "22-point plan").
[17] Part of the reform package to make more developable land available (included in the "22-point plan").

– Review of the requirements on municipalities to plan for sufficient housing[17] – Review of regulations for rural development in coastal areas[17] – Inquiry into credit guarantee system for rental housing construction[18] **Expected over the longer run:** – Development of new sustainable urban areas, with a total of about 100,000 homes (specific plans announced in September 2017)[18] – Planned construction of 28 000 new homes (21 000 for student housing and 7 000 regular homes) by state-owned student housing company (*Akademiska Hus*), to be completed by 2026 (announced in August 2017)[18]		appealing planning decisions[16] **May 2017:** – Less stringent requirements for traffic noise levels for residential buildings[17] – Temporary simplifications for specific building permits to facilitate construction of refugee shelters[18]	CSR (1) – 2015: To alleviate the structural under-supply of housing, foster competition in the construction sector, streamline the planning and appeals procedures for construction (…)

[18] Part of the broader "22-point plan" for the housing market.