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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 fourth 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 has had imbalances since the first application of the MIP in 2012. The imbalances relate particularly to high house prices combined with continued 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 2019 country report and targeted by the relevant 2019 country-specific recommendation for Sweden. The cut-off date for this report is 31 October 2019.

After years of solid growth, the Swedish economy is losing momentum. Investment, a main growth driver over the past years, has turned into a drag on economic growth while private consumption is slowing. By contrast, net trade is forecast to support growth. Gross fixed capital formation is set to turn positive only in 2021 whereas private consumption will move to modest growth from next year. Overall, economic growth is set to slow to 1.1% in 2019, stabilise in 2020 and pick up modestly to 1.4% in 2021.The labour market has been atypically synchronised with the business cycle, showing practically no lag. The unemployment rate has increased from 6.3% in 2018 to 7.1% in September 2019 and is set to stabilise just above 7% in 2020 and 2021. Inflation is expected to retreat to 1.7% this year and reach close to 1.5% in both 2020 and 2021 with muted wage growth and the slowing economy reducing price pressures.

Household debt declined slightly as a share of disposable income in the past year but remained at elevated levels, recording 186% in the second quarter of 2019. Compared to GDP, household debt stood at 88%. Following the introduction of stricter amortisation for new residential mortgages in 2018, credit growth to households has slowed down somewhat. In nominal terms, it increased 5.1% year-on-year in the first nine months of 2019 after 6.1% in 2018. Nominal house prices increased moderately after the price decrease in the second half of 2017. In September 2019 the year-on-year increase in nominal house prices was 2.7%, leaving them 2.5% below their peak of August 2017. [2] Real house prices increased by 1.4% over the same period. Indicators continue to point to an overvaluation of house prices, with the gap between prices and fundamentally justified values among the highest in the EU.

Limited policy steps have been taken to address the imbalances associated with household debt and the housing market. For the rental market, the illegal sale of rental contracts has been put under penal law and fines have increased. To improve mobility and a better use of the existing housing stock, the government marginally changed the capital gains tax. A deferral of the capital gains tax liability on housing transactions remains possible when changing houses, while the maximum deferrable amount increased to SEK 3 million. To partially address the continued shortage of housing supply, the government has reinstated investment support for building rental apartments (including for students) as part of the 2020 budget bill. It should enter into force on 1 January 2020 with SEK 2.1 billion, which should gradually increase to SEK 3 billion. Concerning macro-prudential policy, the countercyclical capital buffer requirement for systemic banks has been raised from 2.0 to 2.5% effective as of

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

[2] According to the HOX index of Valueguard Sweden

19 September 2019. As of 31 December 2018, the Swedish authorities have also changed the requirements for a floor for macro-prudential risk weights for residential property. Since this is a technical change leaving the nominal amount of capital requirements broadly unchanged, it is not expected to have an impact on lending.

Important policy gaps remain, particularly in relation to tax incentives for (debt-financed) home-ownership and the rental market. Sweden is one of the very few EU countries with tax relief on the full amount of mortgage interest paid and there has been no progress towards reducing this tax deductibility. In addition, no action has been taken to reform the system of recurrent property taxation, which currently includes a relatively low ceiling so that the tax in practice tends to be a rather modest fixed fee that does not increase with property values. At the same time, the capital gains tax, which negatively affects housing mobility in the owner-occupied housing market segment, has been broadly left untouched. Sweden's rental market remains tightly regulated and dissuades increased supply of rental housing and a more efficient usage of the existing stock.

In January 2019, the new government laid out its broad policy agenda (so-called "January Agreement"), including for the housing market. The January Agreement focuses on the rental market, aims to foster new construction, and higher mobility. While it proposes free rent setting for new builds and a framework for revision of rents following renovations, legislative proposals are outstanding. It also announces a broad tax reform, but no details are known about the direction and to what extent mortgage interest deduction, property tax or capital gains tax will be covered.

In conclusion, against the backdrop of elevated household debt and overvalued and moderately rising house prices, the Swedish authorities have only made limited advances to address the imbalances. Some policy action came from the macro-prudential side i.e. the increase in the countercyclical capital buffer and redefining the calculation of risk weights for real estate. In addition, a few steps have been taken to increase the efficiency of the housing market and support new construction. However, significant scope remains for reforming the tax treatment of home-ownership and mortgage debt and the rental market. The January Agreement indicates intentions in that direction, but details are missing at this stage.

Table 1: Key findings on the implementation of policy reforms[3]

On track	Wait-and-see	Action wanted
• Ceiling for deferred capital gains taxes raised from SEK 1.45 million to SEK 3 million (after a four year period without a cap) • Increase in countercyclical capital buffer requirement • Redefined macro-prudential risk weights for real estate • Investment support for construction of rental apartments	• Reforms to improve the working of the housing market and mobility (part of the "January agreement")	• Mortgage interest tax deductibility reform • Increased recurrent property taxation • Revising the design of the capital gains tax on housing transactions • Comprehensive reforms of the rental housing market

[3] The table classifies reforms under review on the basis of their respective adoption and implementation process and their credibility and 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 21 November 2018, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its eighth Alert Mechanism Report[4] 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 27 February 2019[5] – examined the nature, origin and severity of macroeconomic imbalances and risks in Sweden. In the accompanying Communication[6], the Commission concluded that "In Sweden, imbalances persist despite some recent adjustments in house prices and policies". In particular, the Commission emphasised that Sweden is experiencing overvalued house price 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 curb household debt growth and housing demand through macro-prudential measures, but that policy steps implemented so far have not been sufficient to address overvaluation in the housing sector, and that policy gaps remain in relation to tax incentives for home ownership as well as the functioning of housing supply and the rental market. In April 2019, Sweden submitted its national reform programme (NRP)[7], 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 three country-specific recommendations (CSRs)[8], which were adopted by the Council on 9 July 2019[9]. One recommendation, considered to be MIP relevant, addresses the continued rise in household debt and inefficiencies in the housing market.

The fourth specific monitoring mission to Sweden was conducted on 7-9 October 2019.

The present report assesses the latest key policy initiatives[10] undertaken by the Swedish authorities.

[4] https://ec.europa.eu/info/publications/2019-european-semester-alert-mechanism-report_en
[5] https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-country-report-sweden_en.pdf
[6] https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-communication-country-reports_en_0.pdf
[7] https://ec.europa.eu/info/sites/info/files/2019-european-semester-national-reform-programme-sweden_en.pdf
[8] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019DC0527&from=EN
[9] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52019DC0527&from=EN
[10] 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

After years of solid real GDP growth averaging 2.6% from 2013 to 2018, the Swedish economy is losing momentum. Economic growth is set to slow to 1.1% in 2019 on the back of domestic demand growth turning slightly negative. Gross fixed capital formation decelerates the fastest, largely due to a pronounced fall in housing investment. Net exports are forecast to be the sole driver of growth in 2019. Economic growth is set to stabilise in 2020 and pick up only modestly to 1.4% in 2021 as exports are set to weaken and domestic demand is to recover only slowly. Headline inflation is set to decrease from 2.0% in 2018 to 1.7% in 2019, and reach 1.6% in 2021, close to the rate of underlying inflation.

The labour market is weakening but the employment rate continues to be the highest among EU countries. Employment growth decelerated sharply in the first half of 2019, in line with the slowdown in domestic demand. The unemployment rate has increased markedly from 6.3% in 2018 to 7.1% in September 2019[11] and is set to stabilise just above 7% in 2020 and 2021. The unemployment rate of the lower-educated workforce is significantly higher than average.

Developments as regards imbalances

In February 2019, the Commission concluded that Sweden was experiencing imbalances related to overvalued house price levels coupled with a continued rise in household debt. The following text provides an update of the situation by reviewing the main variables related to the imbalances.

Housing sector

Nominal house prices have shown moderate growth following the price decrease in the second half of 2017. They increased by 2.7% in September 2019 year-on-year[12], leaving them 2.5% below their peak of August 2017. In real terms, the increase was 1.4% year-on-year in September 2019. As regards particular segments of the housing market, a noticeable difference exists between single-family homes and apartments. Apartment prices declined more (-10.4%) than single-family houses from peak (August 2017) to trough (December 2017) and have recovered less with prices in September 2019 standing 5.1% below their peak (single-family houses: -0.8%). From a long-term perspective, real house prices have grown faster than disposable income over the past two-and-a-half decades. Their price increase by about 200% also outpaced house prices in most other EU countries. Despite the 2017 decline in house prices, indicators continue to point to an overvaluation of house prices, with the gap between actual prices and fundamentally justified values among the highest in the EU[13].

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[11] See also the press release of Statistics Sweden from 17 October 2019 on the quality of the labour force survey (https://www.scb.se/en/finding-statistics/statistics-by-subject-area/labour-market/labour-force-surveys/labour-force-surveys-lfs/pong/statistical-news/labour-force-surveys-lfs-september-2019/)

[12] According to the HOX index of Valueguard Sweden

[13] Price-to-income and price-to-rent ratios in Sweden are about 35-60% above their historic average (as of end-2018); model-based estimates suggest prices are a more modest 7% above fundamentally justified levels (but this partly reflects exceptionally low interest rates).

Several factors are at play in propelling house prices in Sweden. For one, there is a mismatch between the housing stock and housing needs. Even when total new construction reached almost 55,000 buildings in 2018, the highest number since 1992, it was below the estimated need of around 65,000 new buildings per year[14]. Building construction, however, decelerated in the first half of 2019. The total number of construction starts declined by 21% on the year and the number of granted permits by some 16%. At the same time, new construction has been mostly confined to outside the metropolitan areas, partly because building constraints are more and more binding inside metropolitan areas. These supply and demand imbalances in the housing market are further aggravated due to the favourable tax treatment of home ownership and mortgage debt, a continued low interest rates environment supporting mortgage debt growth (see below), population growth, and particular features of the Swedish mortgage market (notably long mortgage maturities and still relatively low amortisation rates).

Household debt

Household debt as a share of disposable income has been broadly flat since the end of 2017. In the second quarter of 2019, it was around its historic high at 186% (88% of GDP). In nominal terms, household debt increased by 5.1% year-on-year in the first nine months of 2019 after a 6.1% increase in 2018. The increase is driven primarily by mortgage debt growth, in turn linked to developments in the housing market, but borrowing for consumption has been rising faster than mortgage debt in recent years (albeit from low levels). Following the macro-prudential tightening (stricter amortisation requirements for new loans) in 2018, the distribution of debt has become more concentrated. New loans with debt-to-income ratios above 450% have fallen from 15.0% of the total new loans in 2017 to 8.4% in 2018. At the same time, the share of new loans with debt-to-income ratios between 300% and 450% has jumped from 32.1% in 2017 to 37.8% in 2018.

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

This section describes policy measures taken to address the continued rise in household debt combined with elevated house prices, against the background of the MIP relevant 2019 country-specific recommendation (CSR). This recommendation called for reform of fiscal incentives for (debt-financed) home-ownership and measures to foster housing investment and improve the efficiency of the housing market.

Sweden has raised the ceiling for deferred capital gains taxes from SEK 1.45 million to SEK 3 million. The increase in the ceiling can promote housing market mobility. However, the deferred capital gain is subject to a yearly tax of roughly 0.5%, which in the current low-interest-rate environment makes a deferral less attractive. Moreover, during the period 21 June 2016 – 20 June 2020, there is a temporary exemption from the previous maximum deferrable amount of SEK 1.45 million, so in practice the new rules represent a tightening of the deferral conditions. More generally, a deferral only reduces the immediate cash flow

[14] Based on estimates by the National Board of Housing, Building and Planning (*Boverket*).

impact and not the effective wealth reduction, thus, room for a substantial capital gains tax reform still exists.

The Swedish Financial Services Authority (FSA) has tightened macro-prudential policy somewhat further. The supervisor increased the requirement for the countercyclical capital buffer (CCyB) as of 19 September 2019. The FSA had gradually raised the CCyB to 2% (applicable from 14 March 2017) since its introduction in 2014. In September 2018, the FSA decided to further increase the requirement to 2.5%, effective as of 19 September 2019[15]. This measure will serve to support overall financial sector robustness even if not specifically targeted at imbalances related to household debt and the housing market. In addition, the FSA adapted the requirements for macro-prudential risk weights for real estate. This measure entered into force on 31 December 2018 for a period of 2 years. While unlikely to have an impact on lending, it increased the comparability of reported risk-weighted capital ratios for Swedish banks with EU peers.

To reduce the continued shortage of housing supply, the government has reinstated investment support for building rental apartments (including for students) as part of the 2020 budget bill. It should enter into force on 1 January 2020 with SEK 2.1 billion, gradually increasing to SEK 3 billion. Together with an easing of building regulations this may attenuate supply side issues somewhat.

Key policy gaps remain, particularly in relation to tax incentives for (debt-financed) home-ownership and the rental market. There has been no progress toward reducing the tax deductibility of mortgage interest, leaving Sweden as one of very few EU countries where 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 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 a 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.

All in all, regardless of some rather limited policy action, key policy gaps remain to address the imbalances associated with high household debt and the housing market. Overvalued house prices combined with persistent household debt growth underscore that further reforms are needed. In particular, there remains significant scope for reforming the generous tax treatment of home-ownership and mortgage debt and for comprehensive housing market reforms. While the reform agenda of the new government (so-called “January Agreement”) contains elements related to such deeper reforms, such as freer rent setting and a comprehensive tax reform, details are missing at this stage[16].

[15] Increases in the CCyB are required to be preannounced by at least one year, so that banks have sufficient time to adjust to the higher buffer level. In October 2019, the FSA announced an unchanged level of 2.5% for 2020.

[16] The January Agreement is available at: https://www.government.se/speeches/20192/01/statement-of-government-policy-21-january-2019/

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*
		September 2019: increase in countercyclical capital buffer rate from 2.0 to 2.5%. **September 2018:** increase in risk weights for real estate (implemented in December 2018) **February 2018:** Enhanced legal mandate for macro-prudential authority **March 2018:** Strengthened mortgage amortisation requirement for borrowers with debt above 450 % of gross income	CSR (1) – 2016: Ensure that the macro-prudential authority has the legal mandate to implement measures to safeguard financial stability in a timely manner. CSR (1) – 2017: Address risks related to household debt, (…), while constraining lending at excessive debt-to-income levels.
Housing market			
Announced measures	*Adopted measures*	*Implemented measures*	*Sources of commitment*
Expected by late 2019 or over the course of 2020: – Comprehensive review of building and planning regulations and detailed municipal zoning requirements – Review of requirements on municipal-	Raising the maximum deferred capital gains taxation from SEK 1.45 million to SEK 3 million (following a four-year-period without a cap). Investment grant for rental		CSR (1) – 2019: Address risks related to high household debt by gradually reducing the tax deductibility of mortgage interest payments or increasing recurrent property taxes. Stimulate investment in residential construction

lities to plan for sufficient housing – Inquiry into credit guarantee system for rental housing construction	accommodation		where shortages are most pressing, in particular by removing structural obstacles to construction. Improve the efficiency of the housing market, including by introducing more flexibility in rental prices and revising the design of the capital gains tax.
		June 2018: initiative to promote foreign competition in the construction sector by setting up website with English-language guidance for foreign developers, including translations of building regulations **February 2018:** Inventory of state-owned land that could be made available for housing construction[17] **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 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) – 2018: Stimulate residential construction where shortages are most pressing, notably by removing structural obstacles to construction, 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. 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 (…)