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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 third 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 in particular 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 2018 country report and targeted by the 2018 country-specific recommendation for Sweden. The cut-off date for this report is 8 November 2018.

Economic growth in Sweden is expected to remain solid this year, before subsiding to slightly below 2%. Domestic demand, notably household consumption, has continued to be the main growth engine in 2018, while the external environment has provided only limited support. In the coming years, domestic demand growth is set to wane due to falling residential investment and slowing real disposable income growth. Overall, real GDP growth is projected to slow from 2.4% this year to 1.8% in 2019 and 2020. Inflation has picked up in 2018 to 2.1% and is expected to retreat to 1.6% by 2020 as temporary factors fade away and wage growth remains muted. Unemployment is likely to fall to 6.3% this year and projected to stabilise just above 6% over 2019 and 2020. Household indebtedness has continued to grow in 2018, but at a decelerating pace: household debt rose by 6.1% year-on-year as of Q2 2018 (7% in 2017 and 8% in 2016) to reach 186% of disposable income. This somewhat slower rate still significantly outpaces income growth. Meanwhile, following a 9% decline in the autumn of 2017, house prices appear to have broadly stabilised in 2018 – albeit at a level that remains high compared to fundamentals.

Some further policy steps have been taken to address the imbalances associated with household debt and the housing market. The continued gradual implementation of the "22-point plan" for the housing market will likely provide some support for new residential construction amidst a slowdown triggered by the recent housing market weakness. Some related additional policy measures have been completed as well, notably an initiative to promote competition in the construction sector by setting up a web portal with English-language guidance for foreign developers. The Swedish macroprudential authority has introduced a higher minimum amortisation rate for new mortgage borrowers with high debt-to-income levels, which over time can help contain debt growth in this market segment. The countercyclical capital buffer rate for banks will also rise to 2.5% from September 2019, further strengthening financial sector resilience. In addition, the Swedish authorities have put into place an enhanced legal framework for the macroprudential authority, so that it can now respond faster and using a wider toolbox 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 toward 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

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

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.

In conclusion, against a background of continued household debt growth coupled with elevated house prices, 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 enhancing the overall macroprudential framework, strengthening mortgage amortisation requirements and further raising the countercyclical capital buffer rate for banks (as well as, in prior years, imposing loan-to-value limits and risk weight floors for mortgages). In addition, a number of measures to reduce construction costs and time lags and to improve the overall efficiency of the housing market are gradually being implemented. However, continued high house price levels 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 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 (part of "22-point plan") • Initiative to promote foreign competition in the construction sector • Enhanced legal mandate for macroprudential authority • Strengthened mortgage amortisation requirement for high-debt-to-income borrowers • Further increase in countercyclical capital buffer requirement		• Mortgage interest tax deductibility reform • Increased recurrent property taxation • Comprehensive reforms of the rental housing market • 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 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 22 November 2017, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its seventh 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 7 March 2018[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 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 rein in mortgage debt growth and raise housing construction, 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 2018, 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 13 July 2018[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 third specific monitoring mission to Sweden was conducted on 11-12 October 2018.

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

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[3] https://ec.europa.eu/info/sites/info/files/economy-finance/com-2017-771-en.pdf
[4] https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-sweden-en.pdf
[5] https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-communication_en.pdf
[6] https://ec.europa.eu/info/sites/info/files/2018-european-semester-national-reform-programme-sweden-en.pdf
[7] https://ec.europa.eu/info/sites/info/files/file_import/2018-european-semester-country-specific-recommendation-commission-recommendation-sweden-en.pdf
[8] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2018:320:FULL&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 perform well growing at around 2%. Domestic demand, notably private consumption, has been solid in 2018 driven by strong labour market activity. As residential investment is set to decrease, total gross fixed capital formation is expected to slow from 6.1% in 2017 to just 2% in 2019 and 2020. Net exports are not projected to contribute to growth. The current account surplus relative to GDP is forecast to decline to close to 3% in 2019 and 2020 (from 3.3% in 2017 and 4.3% in 2016). Overall, real GDP growth is expected to be 2.4% in 2018 and 1.8% in 2019 and 2020. Headline inflation is set to increase to around 2% this year and next, as a result of the Swedish krona's depreciation in 2018 and the rise in oil and unprocessed food prices, before receding to 1.6% in 2020 as temporary factors should fade away and wage pressures remain muted.

The labour market continues to strengthen with the employment rate at 81.8% in 2017, the highest among EU countries. Economic growth is expected to lower unemployment to 6.3% in 2018. Shortages of skilled labour and skill mismatches are set to prevent the unemployment rate from falling much further in 2019 and 2020.

Developments as regards imbalances

In March 2018, 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.

<u>Housing sector</u>

After two decades of largely uninterrupted price growth, the housing market experienced a notable slowdown in 2017, culminating in nominal price falls of about 9% on average in the autumn. Combined with price rises earlier in the year, this resulted in a decline in real house price growth over the course of 2017 as a whole to 4.5% (vs 7.6% in 2016 and 12% in 2015). This recent housing market weakness appears to have been triggered mainly by a degree of oversupply in specific market segments (particularly newly built high-end apartments in Stockholm); in addition, the introduction of a formal amortisation requirement in 2016 likely also played some role. Over the course of 2018, prices have remained broadly stable so far. However, even after the late-2017 declines, real house prices remain up by about 200% over the past 25 years, significantly outpacing income growth as well as house price rises in other EU countries.

This elevated house price level is partly the result of a structural undersupply of dwellings. After experiencing a protracted post-crisis 'double dip', new construction has seen a notable upswing in recent years, with annual housing starts more than tripling from their 2012 nadir to about 64 000 in 2017. However, this remains well below near-term needs, estimated at about 90 000 per annum for the period of 2018-2020[10], and it is unclear if the recent surge in new development was focused on the market segments where shortages are most acute.

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

Moreover, leading indicators point to a significant near-term fall in new housing investment in the wake of the recent housing market weakness: in H1 2018, housing starts fell by about 10% versus the year before across Sweden as a whole, and by over 30% in Stockholm. On the demand side, the housing market is underpinned by favourable tax treatment of home ownership and mortgage debt, still low interest rates accompanied by highly favourable credit conditions (resulting in a continued build-up of household debt, as discussed below), population growth, and particular features of the Swedish mortgage market (notably long mortgage maturities and still relatively low amortisation rates).

Indicators continue to point to a large overvaluation of house prices, with the gap between prices and fundamentally justified values among the highest in the EU[11].

Household debt

Swedish household debt continued to rise, increasing by 5.9% year-on-year as of September 2018. While this represents a further gradual slowdown from the peak growth rate of about 7.8% in mid-2016, it remains well above nominal income growth. As a result, household debt stood at 186% of disposable income and 88% of GDP as of Q2-2018 – among the highest levels in the EU. Rising household debt is driven primarily by mortgage debt growth, in turn linked to high house prices, but consumption borrowing has been rising rapidly as well in recent years (albeit from low levels). Notably, the distribution of debt among households is becoming increasingly uneven, with the fraction of new mortgage borrowers with debt-to-disposable-income ratios above 600% growing to 17.2% in 2017 (vs 16.4% in 2016, and about 12% in 2013).

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 2018 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 enhanced the legal mandate for the macroprudential authority. The revised mandate, in force since February 2018, is designed to ensure that the Financial Supervisory Authority (*Finansinspektionen*, FSA) can introduce potential macroprudential policy steps that may be required promptly and with a sufficiently far-reaching scope. The FSA is now equipped to propose a wide range of measures targeting lending to households or companies so as to tackle financial imbalances of broadly any kind. Proposals remain subject to a public consultation process and government consent, but there is no longer any need for specific parliamentary approval. The new framework has already been put to some use: for instance, it has allowed the FSA to respond swiftly to the recent emergence of a new type of non-bank mortgage providers by adjusting existing regulations to fully cover these firms from 2019

[11] Price-to-income and price-to-rent ratios in Sweden are about 45-65% above their long-term average (as of end-2017); model-based estimates suggest prices are a more modest 11% above fundamentally justified levels (but this partly reflects exceptionally low interest rates).

onwards. Overall, based on such early practical experience with the new mandate, it appears to operate broadly as intended.

In March 2018, a strengthened amortisation rule for new mortgage borrowers with high debt-to-income (DTI) levels came into force. Specifically, it requires households obtaining a mortgage with an overall debt level over 450% of gross income to pay down their debt by an additional 1 percentage point per year. Combined with the existing amortisation rule introduced in 2016, this raises the overall amortisation rate to 3% per year until the loan-to-value ratio (LTV) drops below 70%, and to 2% per year until the LTV drops below 50%. While data are not yet available for a detailed impact analysis, the initial effect of this new regulation appears to be relatively muted. Although there have likely been some changes in borrower behaviour in specific regions and market segments, there seems to be little immediate impact on overall house price and household debt developments. This is broadly in line with ex-ante expectations, as the new measure affects only a limited share (about 14%, based on FSA estimates) of new mortgages issued. Nevertheless, over time, this additional macroprudential policy step can help contain mortgage borrowing at excessive debt-to-income levels.

The macroprudential authority decided to raise the countercyclical capital buffer (CCyB) for banks from 2.0 to 2.5 percent from September 2019. The FSA has first activated the CCyB in 2014, at a rate of 1%, as a broad measure to improve the resilience of the banking system. In subsequent years the CCyB rate was gradually raised to 2% (applicable from March 2017). In September 2018, the FSA decided that the rate will be further increased, to 2.5%, from September 2019[12]. While not specifically targeted at imbalances in relation to household debt and the housing market, this measure will serve to further support overall financial sector robustness in the face of such vulnerabilities.

The authorities have proceeded further with the gradual implementation of the "22-point plan" for the housing market[13]. The plan, originally proposed in June 2016, contains a range of measures aimed at increasing land available for development, reducing construction costs, shortening planning process lead times and addressing several specific inefficiencies in the rental market. Significant parts of the plan have been implemented already, particularly on 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 completed as well, notably an effort to promote foreign competition in the construction sector by setting up an English-language portal on local building regulations. Other key reforms under the plan, including a comprehensive review of building and planning regulations and measures to make more developable land available, involve significant preparatory inquiry work and stakeholder consultation processes. It will thus take some additional time before these proposals are finalised, and it remains uncertain whether they will result in actionable conclusions and in what form these can be ultimately implemented[14]. All in all, the 22-point plan and similar new initiatives will likely provide

[12] 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.

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

[14] This inherent implementation risk is illustrated by the fact that for several measures, the formal inquiry work has been completed as envisaged and a final report issued, yet without any material practical impact for the time being. An inquiry on the special "presumption rent" system for newly built rental housing formally

some ongoing support for new residential construction. This may help cushioning the decline in new building activity resulting from the recent housing market weakness somewhat.

Having said 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 the supply of rental housing as well as a more efficient usage of the existing rental stock, in particular by introducing more flexibility in setting rental prices. The owner-occupier market could also benefit from measures to improve mobility; in particular, revising the design of the capital gains tax on property transactions could help combat lock-in effects and free up underused family dwellings[15].

To conclude, although some policy action has been taken and/or is ongoing to address 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, the completion of the macroprudential authority's enhanced legal framework, and the tightened amortisation requirement for high-DTI borrowers. The upcoming increase in the countercyclical capital buffer for banks is also a positive step. 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.

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concluded in July 2017, but failed to resolve the current lack of clarity about rent levels after expiry of the presumption period. Similarly, a project to compile an inventory of state-owned land that could be suitable for housing construction has been finalised in February 2018, but with no immediate plans to negotiate sale of the land identified or otherwise prepare it for development (although there will be some longer-term follow-up as part of the "sustainable urban areas" plan; see table in Annex 1). Furthermore, the National Board of Housing, Building and Planning (*Boverket*) was asked to develop guidelines for simpler building-regulations compliance checks for series of identical housing units; these were finalised in September 2017, but did not achieve full implementation due to apparent legal and technical obstacles.

[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*
	September 2018 (to come into force from September 2019): increase in countercyclical capital buffer rate from 2.0 to 2.5%.	**February 2018:** Enhanced legal mandate for macroprudential 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 2018 or over the course of 2019: – Comprehensive review of building and planning regulations and detailed municipal zoning requirements[16] – Review of requirements on municipal-lities to plan for sufficient housing[17]		**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	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

[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 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]		**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]	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 (…)

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