EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, November 2016

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

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Executive summary

This is the first specific monitoring report under the macroeconomic imbalance procedure (MIP) for Sweden, reflecting the strengthenening and broadening of the 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 2016 country report and targeted by the 2016 country-specific recommendation for Sweden. The cut-off date for this report is 7 November 2016.

After a strong performance this year and last year, the pace of real GDP growth is expected to decrease towards the economy's potential rate. Following broad-based real GDP growth of 4.1% in 2015, Sweden's economy is forecast to lose steam in 2016. While domestic demand, in particular housing investment, is set to be robust, net exports are expected to lower real GDP growth to 3.4% in 2016 due to subdued growth of some of Sweden's major trading partners. Going forward, economic growth is forecast to ease to 2.4% in 2017 and 2.1% in 2018, driven by domestic demand and broadly neutral net exports. Inflation is gradually picking up from a subdued level, supported by continued accommodative monetary policy. The labour market is forecast to strengthen with unemployment projected to fall further from 6.7% (as of September 2016) before stabilising at 6.4% in 2017 and 2018. However, the integration of economically and socially vulnerable groups (low-skilled and non-EU born people) remains an ongoing challenge. Household debt and housing market developments continued their mutually reinforcing interplay in 2015, with house price growth accelerating to 12% and household debt growing by 7.4% to reach 175.9% of disposable income.

A few significant policy steps have been taken to address the imbalances associated with household debt and the housing market. A new mortgage amortisation requirement came into force in the summer, requiring most new mortgages to be paid down by a minimum of 1% per annum. The Swedish authorities have advanced plans 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 going forward. In addition, a reform of the capital gains tax deferral rules for housing transactions has recently been adopted, with a view to improving housing market liquidity and owner-occupier mobility. Finally, after cross-party talks ended without a comprehensive agreement in June 2016, the Swedish authorities put forward a 22-point plan including a broader range of housing market reforms. If well implemented, over time this should help improve the overall efficiency of the sector.

However, key policy gaps remain, particularly in relation to tax incentives for (debt-financed) home-ownership and the rental market. There has been no concrete 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 includes a relatively low ceiling so that the tax in practice tends to take the form of

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

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.

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 been focused on macroprudential aspects, including implementation of the new amortisation requirement and steps towards a more robust overall macroprudential framework. In addition, a number of initiatives have been launched aimed at improving residential investment and the overall efficiency of the housing market, including an important revision of the capital gains tax deferral rules. However, the persistent growth of house prices and mortgage debt suggests 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
• Enhanced legal mandate for macroprudential authority • Revised approach for property capital gains taxation to facilitate more housing transactions • Formal amortisation requirement	• Reform packages to increase developable land availability, reduce construction costs and shorten planning process lead times (part of "22-point plan") • Some specific rental market measures (mainly on "presumptive rents", student housing and subletting) (part of "22-point plan")	• Mortgage interest tax deductibility reform • Increased recurrent property taxation • Comprehensive rental market reforms

[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 26 November 2015, the European Commission presented, in the context of the macroeconomic imbalance procedure (MIP), its fifth 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 26 February 2016[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 macroeconomic imbalances". In particular, the Commission emphasised that Sweden has recorded high and increasing household debt associated with high and growing house prices, posing risks of a disorderly correction with implications for the real economy and the banking sector. The Commission noted that policy measures have been taken in the macroprudential domain but that it was unclear whether those would prove sufficient, and that policy gaps remain in the areas of housing-related taxation, mortgage amortisation and the overall functioning of housing supply and the rental market. In April 2016, 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 12 July 2016[8]. This recommendation addresses the continued rise in household debt, the legal framework for the macroprudential authority and inefficiencies in the housing market. This CSR was considered to be MIP relevant.

Moreover, with the streamlining of MIP categories in 2016, it was also decided that from now on all countries identified with imbalances under the MIP would be covered by specific monitoring. For this purpose, a specific monitoring mission to Sweden was conducted on 6-7 October 2016.

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

[3] http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf
[4] http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_sweden_en.pdf
[5] http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_comm_en.pdf
[6] http://ec.europa.eu/europe2020/pdf/csr2016/nrp2016_sweden_en.pdf
[7] http://ec.europa.eu/europe2020/pdf/csr2016/csr2016_sweden_en.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 perform well while exhibiting a gradual deceleration recently. Domestic demand remains robust this year, with the strong investment growth seen in 2015 projected to continue in 2016 at a rate close to 7%. In particular, housing investment is set to continue growing at double-digit rates but also R&D, machinery and equipment investment albeit at a lesser rate. Public consumption growth is expected to peak at 3.8% due to spending related to the large influx of migrants in 2015 as well as welfare expenditures. However, the significant drop (by a fifth) of the influx of migrants in 2016 along with the reduction in the payments from the central to local governments to accommodate asylum seekers as of mid-2017 is expected to result in lower government consumption growth in 2017 and 2018. In parallel, continued employment growth and increasing wages on the back of a tighter labour market are expected to support disposable income and ultimately private consumption over the forecast horizon. After a slowdown in 2016, exports are forecast to pick up again by 3.4% in 2017 and 3.8% in 2018, as demand in Sweden's main export markets is set to rise. In parallel, import growth is expected to slow in line with domestic demand. Thus, net exports are set to make a small, positive contribution to growth in 2018, while the current account surplus relative to GDP is expected to remain broadly stable. Overall, real GDP growth is expected to decline to 3.4% in 2016, 2.4% in 2017 and 2.1% in 2018. Inflation is gradually approaching 2% with the slight pick-up seen in the first half of 2016 expected to continue due to higher oil prices, rising cost pressures due to high capacity utilisation rates and tighter labour market conditions. This ongoing recovery of inflation is supported by continued accommodative monetary policy, with the Riksbank now anticipating that the repo rate will remain negative until at least 2018.

The labour market continues to strengthen with unemployment declining to 6.7% in September 2016 (from 7.4% as of end-2015), and the current employment rate is one of the highest among EU countries. The ongoing challenge for the Swedish labour market is to integrate the growing number of people belonging to some economically and socially vulnerable groups (low-skilled and non-EU born people) whose unemployment rate remains elevated. Due to the gradual expansion of the labour force (notably the integration of refugees from the high 2015 influx) and reported labour shortage and skills mismatch, unemployment is set to stabilise at 6.4% in 2017 and 2018.

Developments as regards imbalances

In March 2016, the Commission concluded that Sweden was experiencing macroeconomic imbalances related to high and increasing household debt associated with continued rapid house prices growth. The following text provides an update of the situation with regard to the imbalances.

<u>Housing sector</u>
Sweden's real house price growth accelerated further in 2015 to 12% year-on-year (13.1% in nominal terms), reinforcing concerns about a possible overheating. In 2016, price inflation cooled somewhat compared to 2015, but remained high at 7.6% year-on-year as of September

2016[10]. Prices of Stockholm flats, which until 2015 had experienced the steepest increase, underperformed somewhat relative to the national average in 2016, rising by 3.1% year-on-year as of September.

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 48 600 in 2015 (up 25% from 2014) and projected to grow further to about 57 000 in 2016 and over 60 000 in 2017. However, this remains well below new construction needs, estimated at about 75 000 per annum for the period of 2015-2020 by the National Board of Housing, Building and Planning (*Boverket*). In addition, housing demand is underpinned by favourable tax treatment of home ownership and mortgage debt, low interest rates, benign credit conditions and particular features of the Swedish mortgage market (notably long mortgage maturities and relatively low amortisation rates).

Indicators point to an increasing overvaluation of house prices compared to fundamentals (estimated at about 35% as of end-2015 by the European Commission), implying risks of a correction. A disorderly deleveraging process from this high level would have adverse implications for household consumption, growth and employment (and, in a severe scenario, for the financial sector).

Household debt

Swedish household debt continued to grow in 2015, increasing by 7.4% in nominal terms on the year, significantly outpacing GDP growth in a context of very loose monetary conditions, in particular record negative short-term interest rates, and persistent rapid house price growth. As a result, household debt stood at 175.9% of disposable income and 87.8% of GDP as of end-2015 – among the highest levels in the EU. Household debt has continued to grow in 2016 (to 178% of disposable income as of June) and is projected by the Riksbank to reach 190% of disposable income by 2019. Notably, the distribution of debt among households is becoming increasingly uneven and the fraction of new borrowers with very high debt-to-income (DTI) ratios is steadily growing, with 17% of them having a DTI above 600% in 2015 (up from 15% in 2014 and 10% in 2011).

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 2016 country-specific recommendation (CSR). This recommendation called for reform of fiscal incentives for (debt-financed) home-ownership, an enhanced legal mandate for the macroprudential authority, and measures to foster housing investment and improve the efficiency of the housing market.

Sweden proceeded with the implementation of a long-awaited mortgage amortisation requirement: since June 2016, most new mortgages must be amortised by a minimum of 2% until the loan-to-value ratio (LTV) drops below 70%, and by 1% per annum until the LTV drops below 50%. While this represents an important step forward, it still leaves Swedish

[10] Based NASDAQ OMX Valueguard-KTH Housing Index.

amortisation requirements significantly softer than in other EU countries, where full repayment of the loan over time is the norm for owner-occupier mortgages. The new measure appears to have had little discernible impact in terms of curbing house price and indebtedness growth: while there has been a brief pause in house price inflation over the summer months (particularly in Stockholm), prices picked up swiftly in autumn. As noted above, year-on-year price growth stood at 7.6% as of September 2016.

The Swedish authorities have advanced plans to enhance the legal mandate for the macroprudential authority, with a view to ensuring that the Financial Supervisory Authority (*Finansinspektionen*) can introduce potential macroprudential measures that may be required in a timely manner and with a wider scope than is currently the case. This should help prevent the long delays that accompanied the introduction of the amortisation requirement mentioned above, which was originally proposed by the FSA in 2014 but ended up becoming the subject of legal challenges and could only be implemented after transfer of the legislative initiative to the government. The Swedish authorities have achieved broad political agreement that the FSA's legal mandate needs strengthening and a specific legislative proposal to do so is currently in the final stages of preparation. Going forward, this more robust legal framework should allow the FSA to respond swiftly to household debt developments, thus contributing to the broader goal of keeping the corresponding macroeconomic and financial risks in check.

In June 2016, after cross-party talks ended without a comprehensive agreement, the Swedish authorities put forward a 22-point plan[11] aimed at reforming various (supply and demand) aspects of the housing market. The plan is centred around proposals judged to benefit from broad support across political parties and key stakeholder organisations. The objective is, broadly, to increase land available for development, to reduce construction costs by streamlining building regulations and reducing planning process lead times and to address a number of specific inefficiencies in the rental market (see Annex 1 for details). Most of the underlying reforms involve broad review and stakeholder consultation processes. Hence it will generally take some time before these proposals are finalised and there is some uncertainty on the form they will ultimately be implemented in. As a result, it is currently difficult to assess their ultimate impact. One key measure included in the overall reform package is the abolishment of the ceiling for deferral of capital gains taxes on property sales, which should help increase housing market liquidity and owner-occupier mobility. This measure has been adopted already, and will enter into force in 2017 (initially on a temporary basis until 2020).

Collectively, this set of initiatives should, over time and if well implemented, make a meaningful contribution to the wider objective of fostering housing investment and improving the overall efficiency of the housing market. However, these reforms are generally incremental in nature and leave untouched some of the key underlying 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 flexibility and allocative efficiency in usage of the existing rental stock. This could help improve access to the rental housing market, which could in turn remove some upwards price pressure from the owner-occupier market.

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

To conclude, although a few significant policy steps have been taken to address the imbalances associated with household debt and the housing market, key policy gaps remain. Areas of progress include the introduction of the new mortgage amortisation requirement, the ongoing initiative to enhance the macroprudential authority's legal framework and the reform of the capital gains tax deferral rules for housing transactions. The broader package of planned housing market reforms announced over the summer should, in due course, also result in some efficiency gains if well implemented. However, there remains scope for adjusting the tax incentives for (debt-financed) home-ownership, for more comprehensive rental market reforms, and potentially for further macroprudential measures aimed at keeping household debt growth in check.

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 in 2017 / 2018: Enhanced legal mandate for macroprudential authority		**June 2016:** a formal amortisation requirement came into force, mandating that new mortgage loans are amortised by 2% per annum until the loan-to-value (LTV) ratio drops below 70%, and by 1% until the LTV is below 50%.	CSR (1) – 2016: Address the rise in household debt … 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 later in 2016/2017 (part of the "22-point plan" set of reforms)**:** – Reform package to increase developable land availability[12] – Reform package to reduce construction costs and shorten planning process lead times[13]	**October 2016:** Ceiling for deferral of capital gains on home sales temporarily abolished (will enter into force in January 2017 and will apply to sales between 21 June 2016 and June 2020) **April 2016:** introduction of financial		CSR (1) – 2016: Foster investment in housing and improve the efficiency of the housing market, including by introducing more flexibility in setting rental prices and by revising the design of the capital gains tax to facilitate more housing transactions.

[12] This package includes a measure to make more state-owned land available for housing construction, a review of the requirements on municipalities to plan for sufficient housing provision, a review of the regulations on traffic noise in residential buildings and a review of regulations for rural development in coastal areas.

– Stakeholder consultation on proposals to enhance the "presumptive rent" system (*presumtionshyressystemet*) for newly constructed rental housing – Inquiry into credit guarantee system for rental housing construction – Review of conditions to develop student housing in areas with shortage – Reform of subletting rules	contribution for municipalities to stimulate housing construction (SEK 1.85 bn in 2016, SEK 1.8 bn in 2017, SEK 1.3 bn from 2018 onwards).		

[13] This package includes a comprehensive review of building regulations, development of a proposal to simplify building-regulations compliance checks for series of identical housing units, a review of the Planning and Building Act, simplification of detailed zoning requirements at the municipal level, a review of the list of permit-free building works, an investigation of possible approaches to reform planning decision appeal rights, and some further measures to streamline the planning process.