Ensuring Fiscal and Financial Stability in Europe – Lessons from Sweden

May 18, 2011

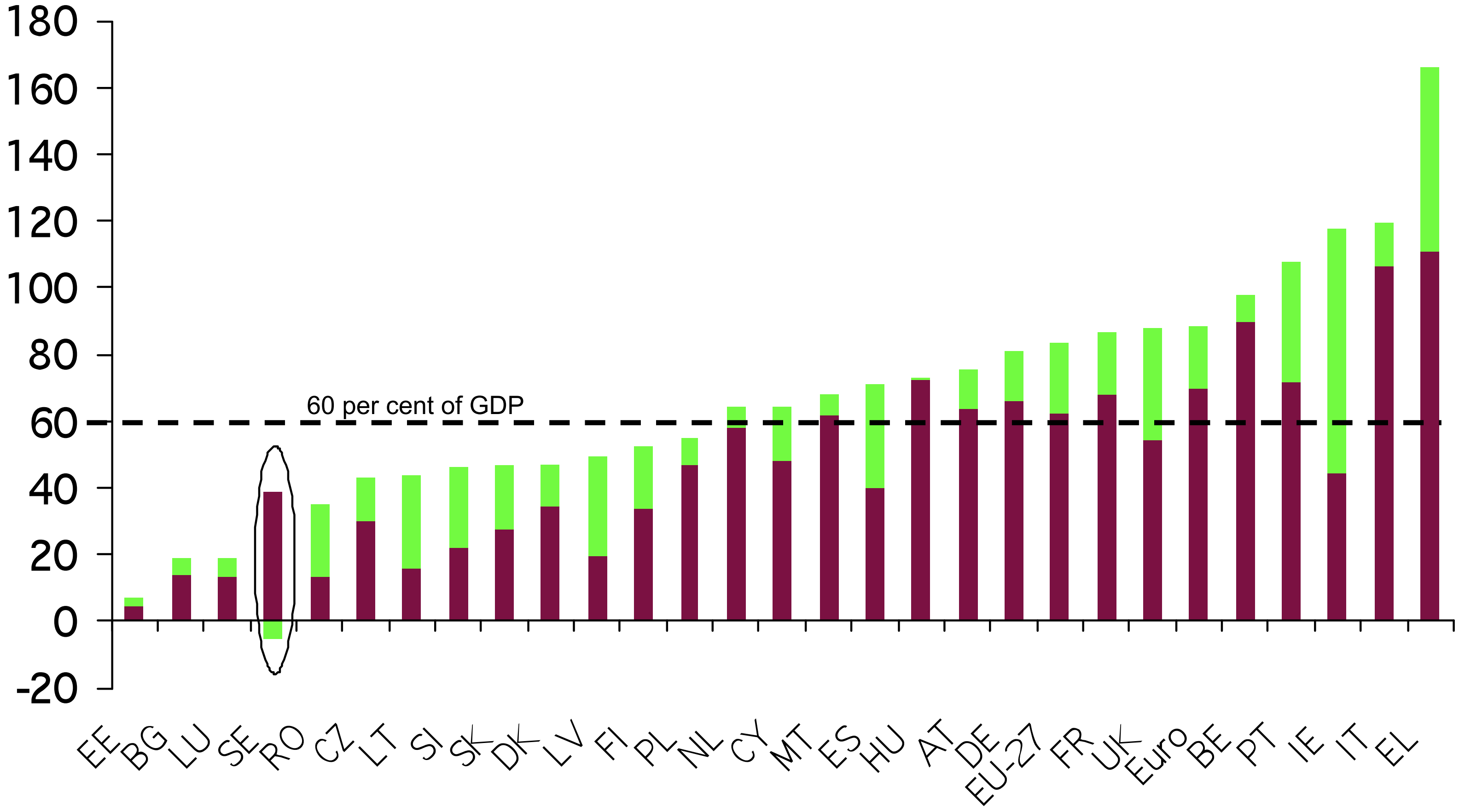
Swedish Minister for Finance Anders Borg

Agenda

- **Ensuring fiscal stability**
- Ensuring financial stability

Europe’s debt problem

General government consolidated gross debt 2008 and 2012, per cent of GDP



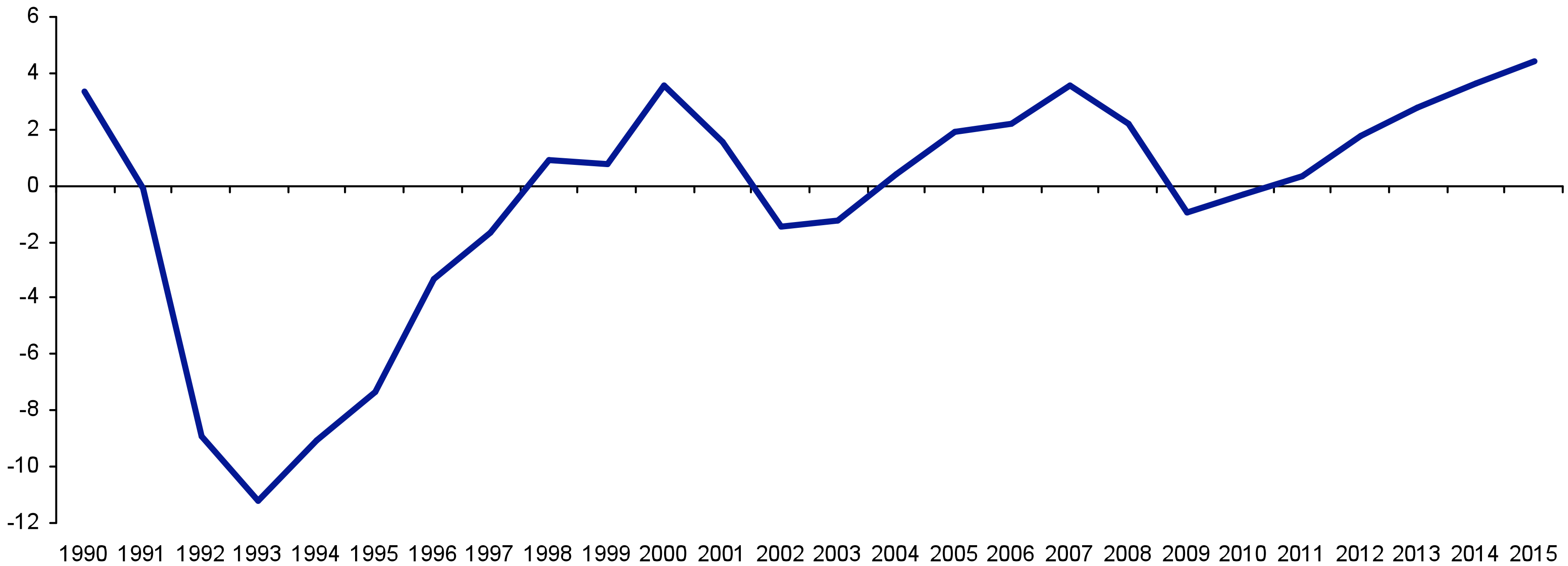
Source: European Commission, Spring forecast, May 2011

Ensuring fiscal stability – lessons from Sweden

- **Sound public finances reflect**
  - A robust fiscal policy framework
  - A strong Ministry of Finance
  - Structural reforms

A strong fiscal performance since the deep recesseion of the early 1990s

Swedish net lending, % of GDP

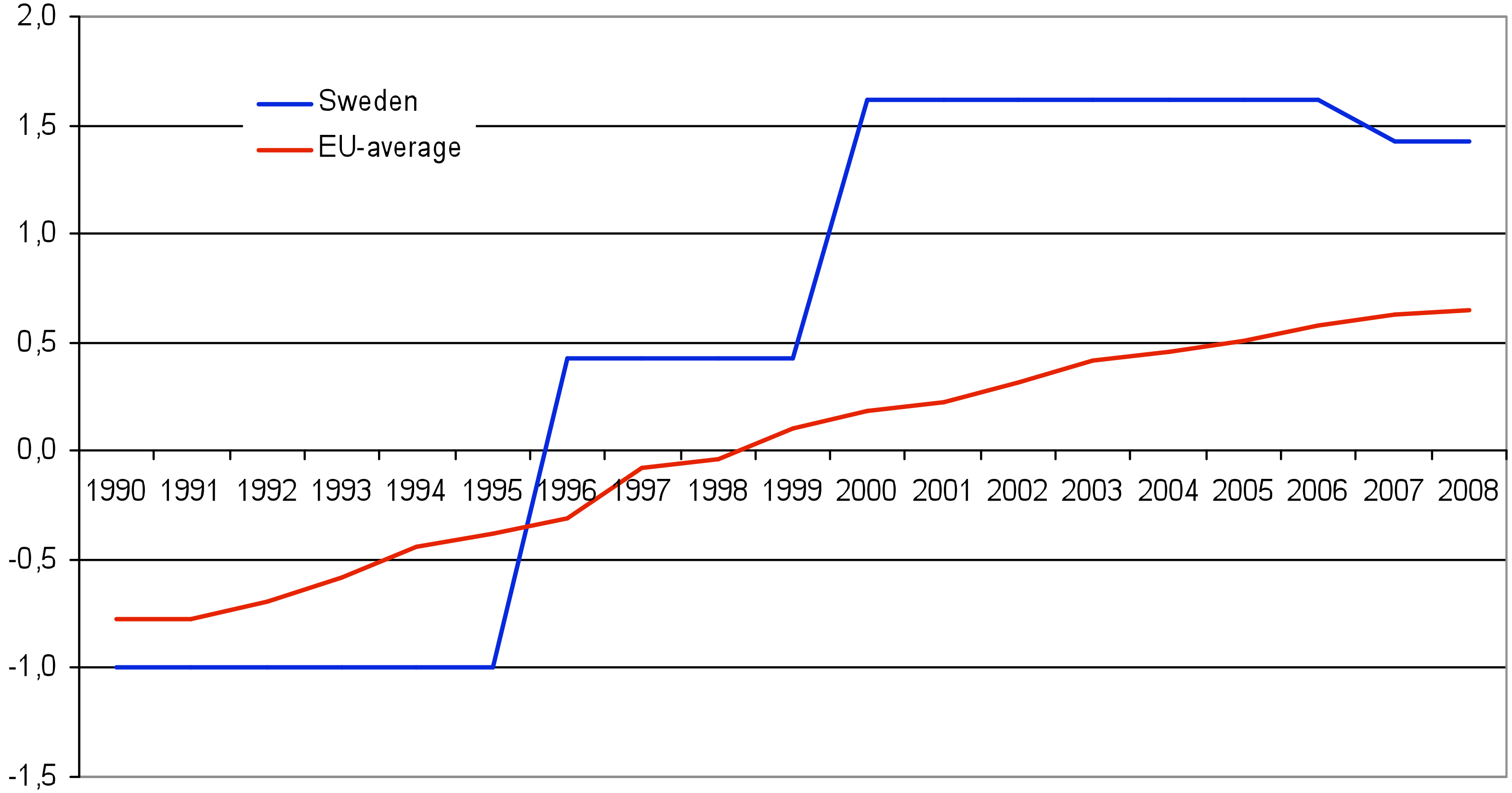


The importance of fiscal policy frameworks

- Fiscal policy institutions bring stability and credibility to the fiscal policy-making process
- Countries with stronger fiscal institutions tend to achieve better fiscal outcomes, in terms of lower deficit and debt
- Households and firms will adjust consumption and investment if they lose confidence in fiscal policy

Sweden’s fiscal policy framework has gone from among the worst to among the best

Fiscal rule index 1990-2008



Source: European Commission.

Four cornerstones of the Swedish framework

1. A surplus target for total government sector
2. An expenditure ceiling for central government
3. A balance requirement on local governments
4. A stringent budget process controlled by a strong Ministry of Finance

A stringent budget process with a strong Ministry of Finance

- A strong Ministry of Finance has a central role
- Clear budget principles
- An improved, stringent budget process
- A strict top-down process in parliament
- An established, transparent time-line of activities

The budget process has been dramatically improved

- **Before mid-1990s, a bottom-up process**
  - Driven by demand
  - High expectations for new spending reforms
  - Ministry of Finance involved too late in the process
  - Private and public demand grew more than economic growth allowed
- **After the mid-1990s, a strict top-down process**
  - Begins with restrictions, not driven by demand
  - Entire draft budget governed by expenditure ceiling, surplus target and available room for reforms
  - Medium-term context separates discussions of budget’s total size from issues of needs and desirable expenditures

Budget process timeline

•Government's overall political priorities for next year

• Macroeconomic forecasts t+3
•Base-line assessment for expenditure and revenues t+3

• The Spring Fiscal Policy Bill with a Supplementary budget
• Annual performance dialogue with agencies
• National Board of

• Parliamentary approval of the Budget Bill in two steps
• Annual letter of instruction to agencies

December • January • February• March • April • May • June• July• August • September • October • November • December

•Cabinet meeting: fiscal targets, political priorities, preliminary expenditure frames t+3
• Annual Report and Budget requests from agencies t+3

• Parliament approval of the Spring Fiscal Policy Bill
• Allocation of appropriations within expenditure areas
• Cabinet meeting
• Final allocation

• The Budget Bill with a Supplementary budget

Rules are important but will not work without political commitment

- **Near consensus in the Swedish parliament on the importance of the fiscal framework**
- **No major deviations from fiscal framework**
  - Has created a “positive path dependence” where deviations from the framework are politically costly
  - External evaluation from fiscal council and others to increase costs of deviations
- **National ownership over the construction of fiscal framework is a pre-condition for success**

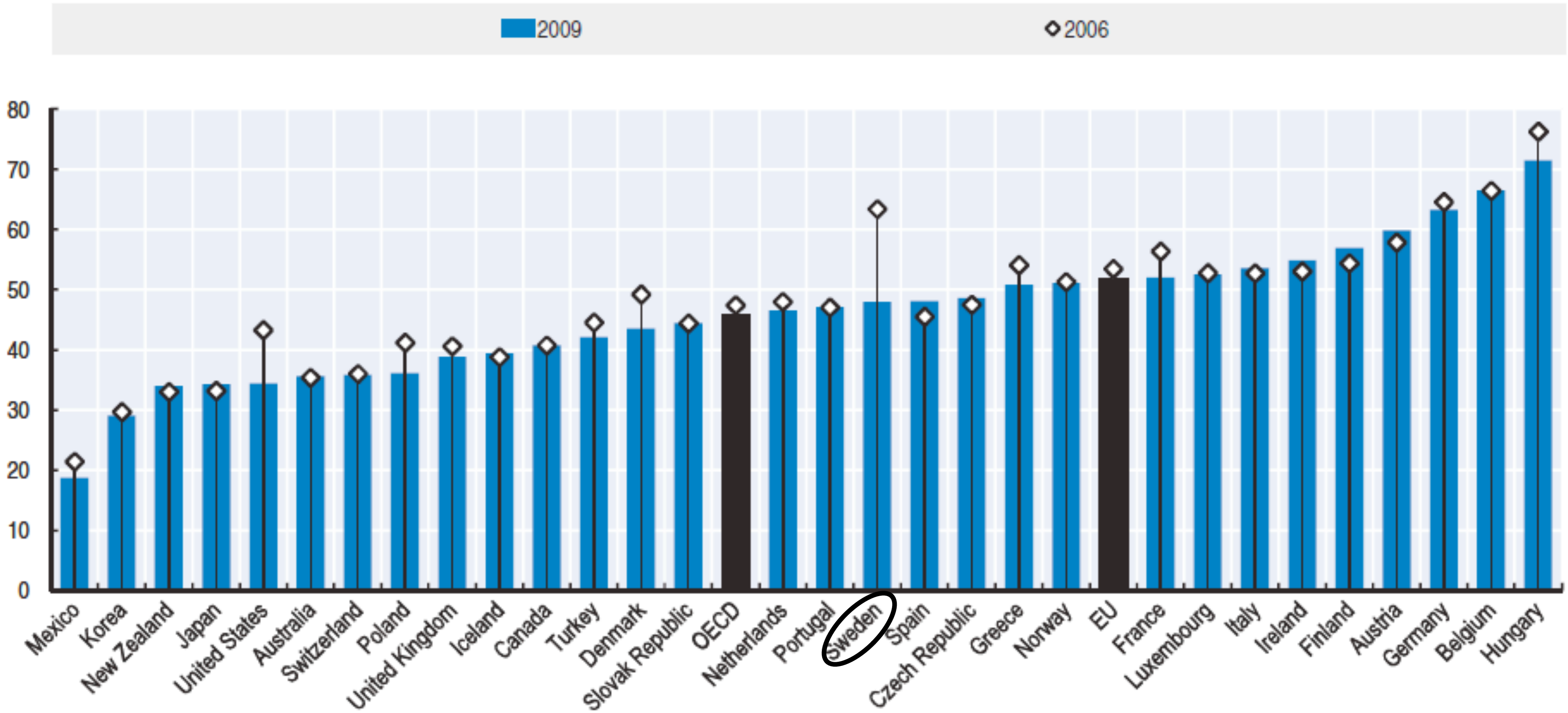
Sructural reforms to improve functioning of labour market

Structural measures in the labour market to increase employment and limit long-term unemployment

- **Increased labour supply**
  - Work-first principle
  - Tax cuts on labour income
- **Well-functioning educational system**
  - Apprenticeships
  - Reformed upper secondary school
  - Measures to increase teacher quality
- **Better functioning labour market**
  - More efficient Public Employment Service
  - Active labour market policies
- **Increase demand for weaker groups**
  - Minor adjustments in employment protection
  - Lower VAT in the service sector

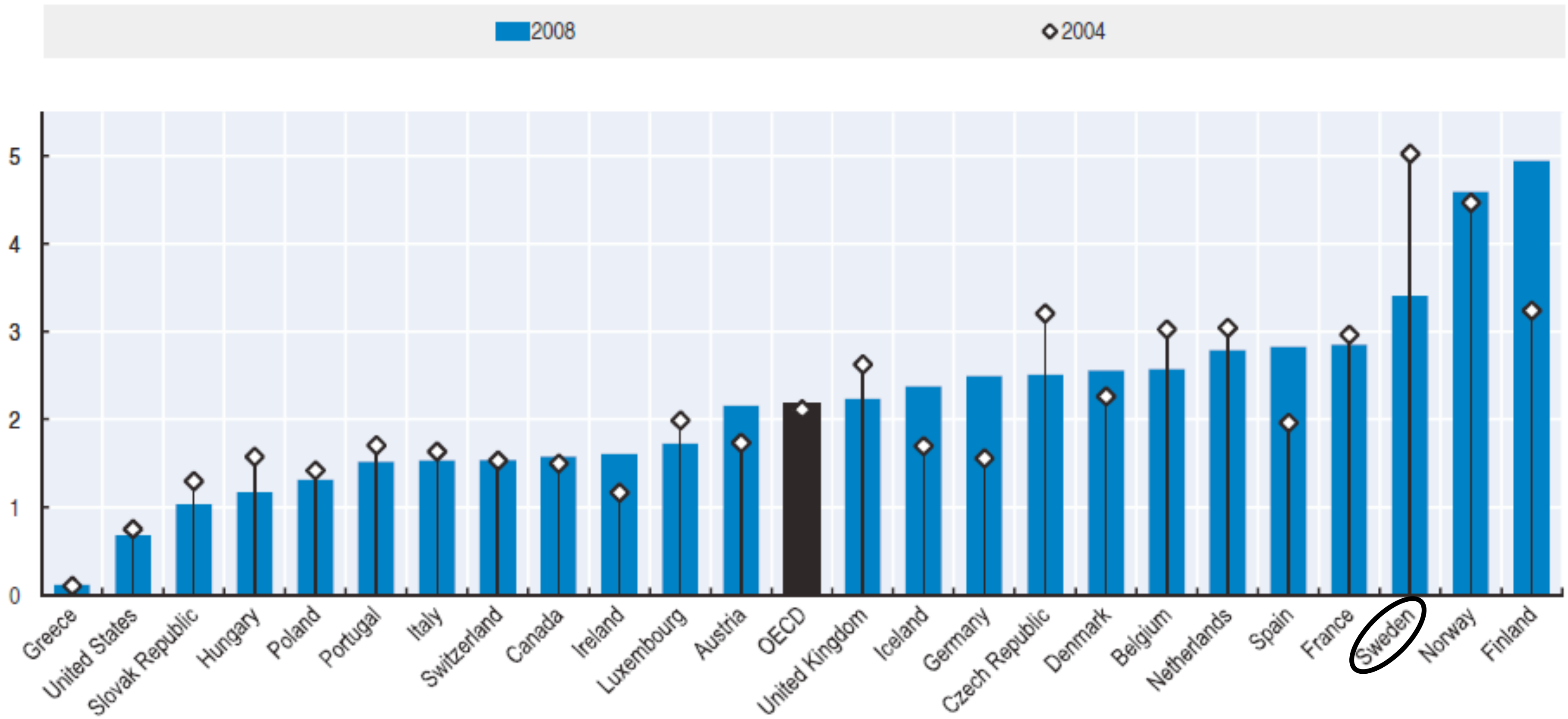
Reduced marginal tax wedge on labour

Marginal tax wedge on labour, as percentage of total labour compensation, at 100% of average worker earnings, single person without children. OECD Going for Growth 2011.



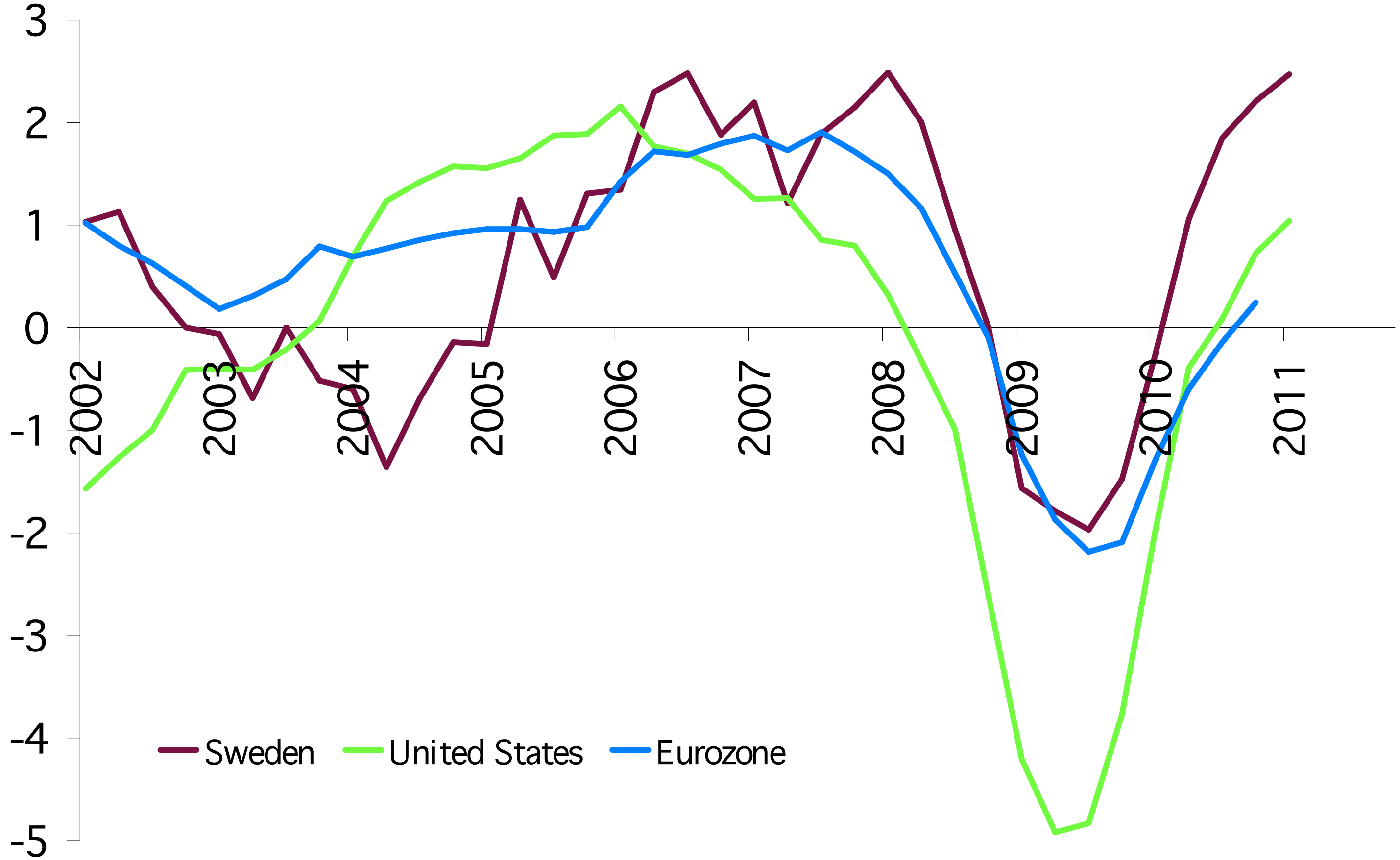
Swedish reforms to disability and sick benefits have paid off

Number of weeks lost due to sick leave. OECD Going for Growth 2011.



Relatively strong labour market in part due to labour market reforms

Percentage change compared with same quarter of previous year.
Sources: Statistics Sweden, U. S. Bureau of Labor Statistics, Eurostat.



Agenda

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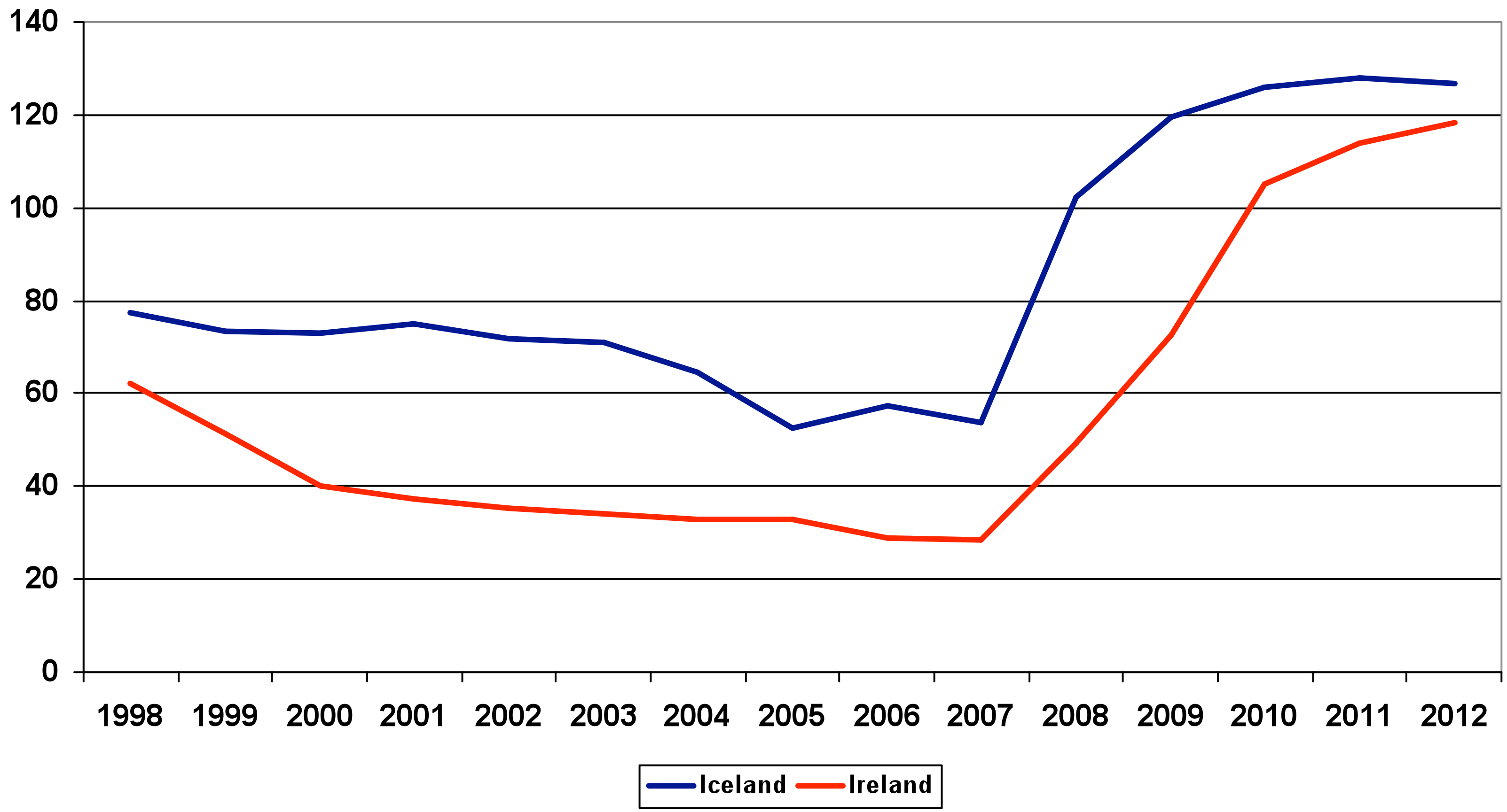
- **Ensuring financial stability**

Important to be able to manage banking crises without great burden on public finances

Public sector gross debt as percentage of GDP. Source: OECD



Crisis prevention

- Higher capital requirements on banks
- Stronger rules for sufficient liquidity ratios
- End to unhealthy compensation schemes
- Better financial supervision
- Improved stress tests

Increased capital requirements should improve financial stability

- **Several advantages of increased capital requirements**
  - Reduces the risks of future financial crises through increased owner responsibility
  - Increases confidence in the bank's financial position and thus reduces the risk of refinancing
  - Dampens household demand for credit and risky behaviour by banks

Managing banks in crisis

- **Transparency**
- **Broad and speedy action to ensure the financial system functions**
  - Government: capital injections, guarantee programmes, possibility of further interventions
  - National Debt Office: improved liquidity
  - The Riksbank; lowered the repo rate, loans with longer maturities and lower collateral requirements than normal
- **Do not take over administration of a bank without taking over ownership**
  - Secures taxpayers' money and share of rise in value
  - Rapid means of reconstructing the bank and restoring confidence
  - Effective means of reducing moral hazard problems
  - Valuation and pricing is key
- **Special administration is a problematic solution**
  - No compensation for taxpayers
  - Government assumes responsibility but owners still have potential upside

Conclusions

- **Europe must make serious reforms to ensure fiscal and financial stability**
- **Lessons from Sweden**
  – Introduce a strong fiscal policy framework
  – Ensure an effective budget procces, where the Ministry of Finance has a central role
  – Implement necessary structural reforms