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The Swedish Macroeconomic Policy Framework

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Abstract

The paper describes the monetary and fiscal policy frameworks in Sweden and analyses how they were established as well as current challenges. Sweden provides a good example of how deep economic crisis, in interaction with independent thinking by academics and other experts as well as policy influences from abroad, can lead to fundamental reforms of policy frameworks. It remains to be seen whether it will be possible in Sweden to adapt the monetary and fiscal frameworks to changed circumstances, while still preserving the benefits they have delivered.

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Sweden's macroeconomic policy framework has recently come to been seen as a role model for other countries. The decade before the international economic crisis erupted in 2007/08 was characterised by low and stable inflation (Figure 1) as well as small fluctuations in economic activity. There were fiscal surpluses (Figure 2) and government debt (Figure 3) was reduced substantially to levels far below the Maastricht benchmark of 60 per cent of GDP. Sweden also weathered the international crisis well. Public finances remained in good shape. The rise in unemployment (Figure 4) was limited.

The recent Swedish performance stands in stark contrast to earlier developments. In the 1970s and 1980s, Sweden was trapped in a devaluation cycle, which culminated in a deep financial crisis when a real estate price bubble burst in the early 1990s. The crisis involved large fiscal deficits (Figure 2) and huge rises in unemployment (Figure 4).

In the aftermath of the 1990s crisis, a new macroeconomic policy framework was established. In the monetary policy area, it involved the adoption of *inflation targeting* and the granting of more *independence* to the central bank. In the fiscal policy area, it meant a *stricter framework*, imposing more discipline, and *pension reform*.

Section 1 discusses the monetary policy framework and Section 2 the fiscal policy framework. Both sections consist of three parts: (a) a review of the current framework; (b) an analysis of how the framework was established; and (c) a discussion of future challenges. Section 3 draws some general conclusions on how crisis experiences can trigger reforms and the roles played by academic research and international influences.

1 The monetary policy framework

1.1 The current framework

According to the Constitution, the central bank (the *Riksbank*) is in charge of monetary policy. The bank's activities are regulated in the *Riksbank* Act. It stipulates that the Riksbank's objective is "to maintain price stability", but does not define this concept explicitly. The bank itself has adopted an *inflation target* of an annual 2 per cent increase in the CPI. The Act does not specify any output or employment objectives. However, the Government Bill proposing the currently existing monetary policy framework pointed out that the *Riksbank*, as a member of the European Central Bank System (ECBS) is, without prejudice to the price stability objective, obliged to support the EU's general economic policies which seek among other things to achieve "balanced economic growth" and "full employment (*Proposition 1997/98:40*). The minutes from the meetings of the bank's Executive Board (see below) also show that the bank sees it as an objective to stabilise output and employment around their equilibrium (sustainable) levels. This policy is often referred to as *flexible inflation targeting*. According to established theory, such a policy does not involve any conflict in the long term between the price stability and output (employment) targets, as the equilibrium output and employment levels are defined as the ones consistent with stable inflation.

The *Riksbank* has a high degree of independence from the political system. First, the bank has *institutional* independence. The government is prohibited from giving instructions to the bank, and the bank is not allowed to take instructions from the government.[1] Second, the *Riksbank's Executive Board*, which takes all policy decisions, has *personal* independence from the political system. i.e. the government and Parliament. The six members are appointed by the bank's *General Council),* which is elected by Parliament. The Council's members are affiliated to political parties, but only some are MPs (currently both the Chair and the Vice Chair are not) and some are politicians who are no longer active. The idea is to have the appointment procedure to the Executive Board at arm's length from day-to-day politics. Board members are appointed for five or six years. They cannot be MPs, ministers or employees in the government offices or at the national level of the political parties. They should be persons with a broad experience of society and economics. The General Council can retire a member of the Executive Board if the member "no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct", but the decision can be appealed.[2] Third, the *Riksbank* has considerable *economic autonomy*. Parliament decides – on a proposal from the bank's General Council – how much of the annual profit that should be paid to the government budget.

It is a challenge how to hold an independent central bank accountable for its policy without interfering with its independence. The *Riksbank* Act does not require the Executive Board to

[1] As it is the government that decides on the exchange rate system, it could in principle peg the Swedish krona to the currency of another country (or set of countries) with high inflation, which could make it impossible for the central bank to achieve its inflation target. This may seem as an inconsistency. It has, however, been argued that since the *Riksbank* is responsible for the implementation of the exchange rate regime, it can always adjust the exchange rate parity in a way that is consistent with its price stability target (*Proposition 1997/98:40*).

[2] The Governor can appeal to the European Court of Justice and the other Board members to the Swedish Supreme Court.

publish minutes from its meetings, but the Board itself has chosen to do so. The law, however, requires the bank to deliver an account of its policy to Parliament twice a year. There are also regularly open hearings with the Governor and other members of the Executive Board in Parliament's Committee on Finance. It publishes an annual evaluation of the bank's performance. The committee also commissions evaluations of the bank's performance by leading foreign monetary policy experts.

1.2 The establishment of the monetary framework

The current monetary policy framework is very different from the one in the 1970s and 1980s. Sweden then tried to maintain a fixed exchange rate, first vis-à-vis the D-mark and later vis-à-vis a trade-weighted basket of currencies. The exchange rate peg was supposed to anchor domestic inflation to that abroad. This did not happen, however, as the fixed exchange rate policy had low credibility. High inflation expectations repeatedly triggered high wage increases, eroding Sweden's international competitiveness and causing unemployment in mainly the tradables (manufacturing) sector. The wage increases were from time to time (1976, 1977, 1981 and 1982) accommodated through currency devaluations, which fed inflation expectations further, thus triggering new rounds of high wage increases and keeping the inflation-devaluation cycle alive.[3]

An important role in the economic policy debate in the 1980s was played by the Economic Policy Group at the Center for Business and Policy Studies (*SNS Konjunkturråd)*, a group of independent academic economists. The Group argued that the government should declare the fixed exchange rate as the overriding objective of macroeconomic policy with full employment being only a subordinate goal.[4] The intention was to make it clear to the parties in the labour market that high wage increases would cause unemployment rises and profit falls that would not be accommodated through new devaluations. An explicit commitment to such an *exchange rate norm* would impose a high reputation cost on the government of abandoning it. This would make the commitment credible and induce the labour market organisations to negotiate wage increases compatible with the fixed exchange rate. Hence the threat of high unemployment would never have to be realised.

[3] See, for example, Jonung (1999) and *Finans- och penningpolitiskt bokslut för 1990-talet* (2001).

[4] The thinking of the SNS group was developed in SNS (1985, 1986, 1987). Similar thoughts had earlier been advanced by e.g. Calmfors et al. (1976), Myhrman (1977), Jonung (1978), Lindbeck (1978) and Calmfors (1979). See also Calmfors (1996) for a survey of the debate.

In the 1980s, the *Riksbank* was still very dependent on the government. Policy decisions were taken by the bank's General Council comprised of politicians. Monetary policy objectives were not explicitly defined. The strong incentives for politicians to maintain low unemployment under all circumstances therefore undermined the credibility of the fixed exhange rate. For this reason, the SNS Economic Policy Group advocated more independence for the *Riksbank*. The Group was strongly influenced by the then recent research on the *time inconsistency problem* of monetary policy, which emphasised how politicians interested in both low unemployment and low inflation had *ex post* incentives to renege on *ex ante* announcements of low inflation policy in order to improve employment outcomes. Such policies would, however, in the long term only result in high inflation without any long-run impact on unemployment, as the public would learn about the behaviour of policy makers and thus anticipate it.[5]

The SNS Group's recommendations first met with strong political resistance. However, during the second half of the 1980s it became increasingly evident that fundamental changes were needed to bring down inflation. The economy was strongly overheated, the boom being fueled by fast credit growth in the wake of credit market deregulations. In this situation, the ideas of the SNS Group gained increased acceptance. After a failed government attempt in 1990 to legislate against high wage and price increases, the Social Democratic government in 1991 announced that the main economic-policy objective "over the coming years must be to permanently reduce inflation" and that "this task is superior to other ambitions and requirements".[6] The exchange rate peg was then also shifted from a trade-weighted currency basket to the ecu (a weighted average of EU currencies). The SNS Group had an even greater influence on the thinking of the Liberal-Conservative government which came to power in the autumn of 1991. In the spring of 1992, it declared that "the fixed exchange rate is a crucial and definitive norm for economic policy".[7]

The attempt to establish an exchange rate norm was not backed by any major institutional changes. When the norm was introduced, the inflation that it was designed to prevent had already occurred and eroded Sweden's competitiveness. The boom came to an abrupt end in 1990/91 when the property price bubble burst – in much the same way as occurred in, for example, the US, the UK, Ireland and Spain during the recent economic crisis which started in

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[5] The seminal contribution was Kydland and Prescott (1977). See also Barro and Gordon (1983a,b),

[6] *Proposition* 1990:91*:*100, bil.1, p. 4.

[7] *Proposition* 1991/92:150, bil 1, p. 1

2007/2008 – and Sweden entered a deep recession. This triggered expectations of a new devaluation, so the *Riksbank* had to defend the krona through big interest rate hikes which deepened the downturn. This created an impossible situation and in November 1992 the fixed exchange rate was abandoned. This was amidst a period of general European exchange rate turbulence. Pegging the exchange rate again did not seem a credible option in this situation.

At the same time, there was widespread agreement that an anchor was needed to keep inflation under control. There was a strong case for trying to capitalise on the investment in reputation for inflation fighting that had been made during the defence of the fixed exchange rate. Therefore, in January 1993 the *Riksbank* decided to adopt an annual *inflation target* of 2 per cent. The decision was inspired by the monetary policy regimes that had earlier been introduced in Canada and New Zealand.

The *Riksbank's* formal status was analysed by a Government Commission, initially appointed by the Social Democratic government in 1990, but which received new terms of reference and a new composition in 1991 by the Liberal-Conservative government that had just taken office. The Commission proposed more independence for the bank in its final report in early 1993 (*Riksbanksutredningen* 1993). The importance of more autonomy for the *Riksbank* was also underlined by the *Lindbeck Commission*, another Government Commission, appointed by the Liberal-Conservative government, consisting of academics and given the remit to propose both policies and institutional reforms to take Sweden out of the economic crisis (*Lindbeck Commission* 1994).[8]

The proposals on a more independent *Riksbank* were not adopted when they were made. The idea was opposed by the Social Democrats, who came to power again in 1994. The main reasons were a worry that monetary policy would be decided by experts, not sharing the political objectives of the government, and a fear of insufficient co-ordination with fiscal policy (Bergkvist and Gradin 1993).

However, in 1997 the Social Democratic government changed its position and initiated a five-party agreement on more independence for the *Riksbank*, which in some respects went even further than the proposals by the earlier Government Commission. There were two main reasons for why this happened. The first has to do with the Swedish entry into the EU in 1995

[8] The Commission was named after its chair, professor Assar Lindbeck. The Swedish version of the report was published in 1993.

(which interestingly cannot just be seen as an exogenous political event changing preconditions for both economic institutions and policies, since the then Social Democratic government's decision to apply for EU membership in 1990 was partly motivated by expectations that this would contribute to macroeconomic stability; Carlsson 2003). As a member of the EU, Sweden was obliged to strengthen the independence of its central bank. The second reason is related to the Swedish decision in 1997 to stay outside the EU's monetary union. This course of action was recommended in 1996 by the *Calmfors Commission,* another Government Commission, consisting of academics, which had been given the remit to analyse the pros and cons of Swedish membership in the monetary union.[9] The Commission regarded central bank reform, strengthening the *Riksbank's* independence, as "a necessary prerequisite for stable macroeconomic developments if Sweden does not participate in the monetary union".[10]

To sum up, the current monetary policy framework in Sweden is the outcome of a long process. Its establishment was a response to an earlier malfunctioning system, which motivated a number of academic proposals on reforms, to a large extent inspired by international resarch developments in the monetary policy area. The ideas gained increased acceptance in Sweden around 1990 when the failure of the earlier monetary regime became even more apparent than before. The final transition to the current regime was triggered by two developments: Swedish EU membership, which imposed requirements to do central bank reform, and the Swedish decision to stay outside the monetary union, which made it clear that credibility for low–inflation policy had to be built at home.

1.3 Challenges for the monetary policy framework

The current monetary policy framework has been successful in achieving low inflation, in fact too successful as average CPI inflation 1997-2014 was only 1.0 per cent, i.e. 1 percentage point below the 2 per cent target (see Figure 1). This has led to a debate on the *Riksbank's* policy. It has been claimed that the undershooting of the inflation target has caused

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[9] The Commission was named after its chair, professor Lars Calmfors, the author of this chapter. An English version of the Commission's report was published in 1997 (Calmfors Commisssion 1997).

[10] According to the Government Bill on a new *Riksbank Act*, the government shared the view of the five-party working group on the status of the *Riksbank* that "it is of particular importance with high credibility for monetary policy in a situation when Sweden remains outside the monetary union when it starts" (*Proposition 1997/98:40)*. According to the Government Bill proposing that Sweden should stay outside the monetary union, Sweden must *at least* demonstrate its willingness to achieve price stability (and fiscal surpluses) as clearly outside as inside the monetary union *(Proposition 1997/98:25).*

unnecessary unemployment (Svensson 2015). Critics have also argued that the bank has acted asymmetrically in the case of deviations from the inflation target, reacting more to upward than to downward deviations (e.g. Assarsson 2011).

An issue raised by these experiences is whether a *price level target* over a defined period would be superior to the current annual *inflation target*, since the former target would require periods of inflation below the target to be compensated by periods of inflation above it. Another issue is whether the objective of stabilising unemployment around its equilibrium level should be stated explicitly in the *Riksbank Act*. It has also been claimed that a somewhat higher inflation target might be desirable, as this would likely imply higher inflation, and hence a lower real interest rate that would stimulate the economy in a deep recession when the repo rate approaches zero.[11] However, both the politicians and the *Riksbank* have been reluctant to contemplate such changes because of a worry that they could undermine the credibility of low-inflation policies.

In 2009-2013, during the economic crisis, there was considerable disagreement within the *Riksbank's* Excecutive Board. A minority consistently argued for lower interest rates than the ones decided by the majority. The conflict reflected divergent views on how *financial stability* should be promoted. To contain household debt and house prices, the majority set the repo rate higher than the level that would be desirable for reaching the inflation target and stabilising unemployment around its equilibrium level. The minority in the Board questioned the idea that financial stability is in danger and that the repo rate is an effective instrument to achieve it.[12] The *Riksbank* Act stipulates that the bank is "to promote an effective and secure payments system". This was interpreted by the Executive Board's majority as a go-ahead for using interest rate policy to promote financial stability. It is a contentious issue whether this interpretation was consistent with the *Riksbank* Act.[13] The use of interest rate policy to achieve financial stability is problematic for the accountability of the *Riksbank*, as almost any (downward) deviation from the inflation target could be motivated by concerns about future financial crises.

The conflict in the *Riksbank's* Executive Board reflects the increased awareness of the risks of financial instability in the wake of the international financial crisis that erupted in 2007/2008

[11] See, for example, Calmfors (2013c).
[12] See, for example, Svensson (2014).
[13] In the view of the Executive Board's majority financial stability was seen as a prerequisite for the achievement of the inflation target in the long term, since a financial crisis could lead to very low inflation or deflation in the future.

and the lack of knowledge of how to best avoid such crises. However, in 2013 it was decided that the Financial Supervisory Authority (FSA) should be given control control over a number of new financial stability tools (Finansdepartementet 2013). The tools include loan-to-value regulations and risk weights for different types of bank loans as well as liquidity and capital requirements for banks. The establishment of these tools under the FSA's control can be expected to mitigate the conflicts in monetary policy between traditional stabilisation objectives and financial stability objectives. From 2013 the Riksbank began to put mor emphasis on the inflation target and initiated a series of interest rate cuts which resulted in negative repo rates in 2015. However, co-ordination problems between monetary and financial stability policies could arise. The idea is that they should be resolved in the newly established Financial Stability Council, which is composed by the Minister for Financial Markets and the heads of the FSA, the *Riksbank* and the National Debt Office.

2 The fiscal framework

2.1 The current fiscal framework

The fiscal framework consists of several parts:

1. A *top-down* approach when Parliament decides the annual budget. Decisons are taken in two steps. In the first step, Parliament determines total government expenditure and its allocation among 27 expenditure areas. In the same step, changes in tax rates and various fees are decided. These decisions are taken on the basis of a proposal from Parliament's Committee on Finance. In a second step, individual expenditure items within each expenditure area are determined. These decisions, which are based on proposals from other committees in Parliament, cannot change the overall expenditure level in an expenditure area. This process ensures that there is an overall decision on total government expenditure so that it (and the budget balance) is not just the outcome of a large number of uncoordinated individual decisions. Fiscal transparency is promoted by rules on completeness of the budget, which do not allow the use of any extrabudgetary funds, and on gross budgeting, prohibiting the netting out of expenditures against revenues.

2. According to the Budget Act, the government is obliged to propose an annual *ceiling* for *central government expenditure* three years ahead. If there is a risk that the ceiling will be broken, the government has to take action or propose actions to Parliament

such that this is avoided. The ceiling puts a limit to budget slippages on the expenditure side of the budget.

3. The Budget Act also stipulates that the government is to propose a target for general government net lending *(*a *surplus target)* to Parliament. The numerical target is not specified in the Act and can thus be altered by Parliament without any change in the Act itself. But since its inception in 1997 the target has – in effect – been held unchanged at 1 per cent of GDP.[14] The target does not apply to an individual year but "over a business cycle". However, no attempts are made to measure the length of the cycle. Instead adherence to the target is evaluated by a number of indicators: a ten-year backward-looking average of actual net lending, a partly forward-looking average of net lending (actual figures three years back and forecasts for the current and three future years), and the current structural net lending (which is adjusted for both the cycle and one-off measures). There is no requirement that past violations of the target must be compensated for. On the contrary, the government has made it clear that earlier developments are just a guide to judge the likelihood of meeting the target in the future.[15] This is in line with the idea of *tax smoothing*, i.e. that it is optimal – in order to minimise tax distortions – at each point of time to set tax rates so that they, if held constant at current levels also in the future, can be expected to finance anticipated future government expenditure. Then temporary budget shocks are allowed to result in permanent changes in government debt.

4. There is a *balanced budget requirement for local governments* (municipalities and regions). They must budget for an excess of revenues over expenditures. If this requirement is not met, it must be compensated for within three years. Unlike the surplus target for the entire public sector, the balanced budget requirement for local governments does not apply to net lending, which is calculated without accruing investment expenditure, but to the economic result after such accrual. Also in contrast to the surplus target, the balanced budget requirement for local governments applies annually. Possibilities have, however, been introduced for local governments with strong finances to build up balancing accounts (rainy-day funds) in good times that can be activated in cyclical downturns.

[14] The target was decided in 1997 and fully applied in 2000 after a phasing-in period.
[15] See, for example, *Proposition 2009/10:1*50 and Fiscal Policy Council (2010).

5. The state *pension system* is one with *defined contributions*, which means that benefits are adjusted to fixed contributions. Pensions are indexed to per capita wage growth, but a balancing mechanism, which limits the degree of indexation, is activated if the long-run financial stability of the system is threatened: this occurs if the capitalised value of contributions plus the assets in existing buffer funds fall below the value of pension liabilities. The balancing mechanism is automatic according to a predetermined formula. Hence, no political decisions are required to ensure the long-run sustainability of the pension system (but new political decisions that endanger sustainability can, of course, be taken).[16]

6. Central government budget decisions are based on a procedure where an annual *scope for reforms* is calculated by the Ministry of Finance.[17] The scope for reforms is defined as the total sum of permanent tax reductions and government expenditure increases that can be actively decided by Parliament and that are compatible with the surplus target. The scope for reforms arises because tax revenues grow automatically more or less in line with GDP, whereas government expenditure does not. The reason is that only some expenditures are tied to wages (which grow at about the same rate as nominal GDP), whereas others are indexed to wages only with deductions for productivity increases, are indexed to prices (which grow more slowly than wages) or are fixed in nominal terms. Absent discretionary decisions, government net lending thus tends to improve automatically. The Finance Ministry's calculation of the scope for reform forms the basis for the budget discussions within the government. The calculation has usually also been accepted by the main opposition parties.

7. A *Fiscal Policy Council* evaluates the government's fiscal policy.[18] The Council is to assess whether public finances are sustainable in the long run and whether they are consistent with the surplus target and the expenditure ceiling as well as with the cyclical situation of the economy. The Council consists of six members with either "high scientific competence in economics" or "practical experience of economic-policy work". An annual report is published in May, about one month after the government has presented its Spring Fiscal Policy Bill. The report is formally addressed to the government, but is also the subject of a public hearing in Parliament's

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[16] See, for example, EEAG (2007) for a brief description of the Swedish pension system.
[17] See Fiscal Policy Council (2011).
[18] See Calmfors (2013b).

Committee on Finance. In addition, the public finances are regularly monitored also by the National Institute for Economic Research, the Office for Budget Management and the National Audit Office.

2.2 The establishment of the fiscal framework

The major part of the fiscal framework was established as a as a consequence of the economic crisis of the early 1990s, when very large fiscal deficits emerged (Figure 2).[19] In 1993, the deficit was 12 per cent of GDP. Government debt was increasing fast (Figure 3) and government bond yields were high. The then Liberal-Conservative government made it one of its top political priorities to stop the accumulation of debt in 1993. This objective received an even higher priority when the Social Democrats came to power in 1994 and formulated a fiscal consolidation programme. It contained clearly stated objectives: first (November 1994) that government debt should be stabilised as a share of GDP latest in 1998 and later (April 1995) that a balanced budget (zero general government net lending) should be achieved in 1998, and that government debt as a share of GDP should be stabilised already in 1996. In June 1995, the government set the objective that government net lending was not to exceed 3 per cent of GDP (a convergence criterion for joining the monetary union) in 1997.

In its first Budget Bill in 1995 *(Proposition* 1994:95:100) the Social Democratic government also announced that the fiscal consolidation programme was to be complemented by institutional changes of the budget process. The first changes to be imposed were the central government expenditure ceiling and the top-down budget process in 1996.

The consolidation programme was very successful and the set objectives were achieved (see Figures 2 and 3). The success was to a considerable degree attributed to the formulation of clear and well-publicised objectives. This served as an important inspiration for the formulation of the surplus target, which was decided in 1997. The numerical level chosen – 1 per cent of GDP – was based on the insight that the strains on future public finances arising from an ageing population could be eased through pre-funding (saving in advance) and that fiscal surpluses would increase the scope for countercyclical fiscal policy in downturns.[20] In 2000, the described reforms of the fiscal framework were complemented by the balanced budget requirement on local governments, which was motivated by a desire to avoid that

[19] See, for example, *Finans- och penningpolitiskt bokslut för 1990-talet* (2001) or Fiscal Policy Council (2008).
[20] Ibid. See also *Stabilisation Policy in the Monetary Union* (2002).

fiscal discipline in the public sector would be jeopardised by a lack of discipline in local governments.

As with the reforms of the monetary framework, academic input was important for the reforms of the budget process, but the impact was more indirect. The direct influence came from work in Parliament on reforming the process initiated already before the crisis and from experts in the Ministry of Finance, based on their earlier experiences of budget work. A key role was played by a study, made by a civil servant, which found that the Swedish budget process was very weak in an international comparison and recommended a stricter framework including a top-down budget approach and a government expenditure ceiling (Molander 1992).[21] A main conclusion in the study was that earlier economic crises in Sweden depended to large extent on an inability to contain expenditures in good times (Molander and Holmquist 2013). The study was inspired by an earlier academic analysis of budget processes in EU countries, which found that they had an important effect on fiscal outcomes (von Hagen 1992). The conclusions in the Molander study were endorsed by the Lindbeck Commission (1993), which was important for gaining acceptance for these ideas in the political system. They were first adopted by Parliament in its work on the budget and subsequently by the government in its internal preparation of the budget.[22]

European influences were also important for the introduction of the stricter fiscal framework. The fiscal crisis and the consolidation process in the 1990s coincided in time with the formulation of the EU fiscal rules in the Maastricht Treaty and the stability pact.[23] Paradoxically, it appears that Sweden took these rules much more seriously than the member states joining the monetary union. The government stated that Sweden had to demonstrate its ability to establish a fiscal surplus “at least as clearly” outside as inside the monetary union (*Proposition* 1997/98:25). To establish a sufficient margin to the EU 3-per-cent-of-GDP deficit ceiling in normal times, in order to avoid violations in downturns, was also an explicit deliberation behind the formulation of the surplus target.[24]

[21] The study was commissioned by the Expert Group for Public Economics (ESO), an independent committee attached to the Ministry of Finance, with the remit “to make an independent contribution to expanding and deepening the knowledge data available to future socio-economic and fiscal policy decisions”.
[22] The main ideas were set out in Talmanskonferensen (1994) and Molander et al. (1995).
[23] The Maastricht Treaty was agreed in 1992 and adopted in 1993. The discussions on the stability pact started in 1995 and the pact was finalised in 1997.
[24] See, for example, *Stabilisation Policy in the Monetary Union* (2002), *Utvärdering av överskottsmålet* (2010) and *Proposition 2009/10:150*.

After the fiscal reforms in the 1990s, no further changes were implemented for some time. There were fiscal surpluses and the government debt was gradually reduced (see Figures 2 and 3). However, the Liberal-Conservative government coming to power in 2006 implemented additional reforms. They were not motivated by any acute fiscal problems. Instead, they were responses either to academically based proposals or to a general political desire to further improve the fiscal framework. The latter motive reflected a strong political will in the Liberal-Conservative government to show that it could handle the public finances well (the earlier Liberal-Conservative coalition governments in 1976-1982 and 1991-94 presided over large deteriorations of the fiscal balance). [25]

The first reform was the establishment of the Fiscal Policy Council (FPC) in 2007.[26] In recent years, there has been a strong international trend to set up such national fiscal watchdogs. Here, Sweden was quite early and the Swedish Council has to some extent served as a role model for similar institutions elsewhere. The idea of such independent fiscal monitoring institutions first appeared in the international academic debate in the 1990s as an attempt to find ways of transferring the benefits of independent policy-making in the area of monetary policy to that of fiscal policy. In Sweden, the idea was picked up by a Government Commission with the remit of analysing fiscal policy in the event of membership in the monetary union (*Stabilisation Policy in the Monetary Union* 2002). Based on a background report by Wyplosz (2002), the Commission proposed the establishment of an independent fiscal watchdog.[27]

The proposal was rejected by the Social Democratic government at the time, but was more popular with the Liberal-Conservative opposition. It was endorsed by the then chief economist of the Moderates (the Swedish Tory Party), Anders Borg (Borg 2003). In 2006, he became Minister for Finance in the Liberal-Conservative government and then pushed through the establishment of the FPC. This was done although the parties of the left (Social Democrats, the Greens and the Left Party) opposed it on the grounds that unelected experts would get too much power and that the FPC's analyses were bound to have a Liberal-Conservative bias. However, these parties changed their views gradually and in 2011 entered

[25] See Calmfors (2013a,b)

[26] The author of this chapter was the FPC's first chair in 2007-2011.

[27] See, for example, Calmfors (2003) and Debrun et al. (2009) for surveys of proposals on independent fiscal monitoring institutions. Existing such institutions have been surveyed by the European Commission (2006), Hagemann (2010) and Calmfors and Wren-Lewis (2011). See also OECD (2013) for a list of OECD notes on such institutions in various countries.

an agreement with the government regarding the FPC, extending its remit also to analysis of income distribution issues.

Other recent changes in the fiscal framework were made on the government's own initiative, largely without any major input from more academic thinking. They seem to have reflected a genuine interest by the Finance Minister in 2006-2014(Anders Borg) in fiscal framework issues, an interest which was further stimulated by the sovereign debt crises in the euro area. The Spring Fiscal Policy Bill in 2008 set out clear principles for calculating the annual scope for reforms (see Section 2.1), based on the surplus target and the cyclical situation, as a means of imposing more discipline on the budget process *(Proposition 2007/08:150)*. Before 2011, it was not obligatory for the government to propose an expenditure ceiling (although it had always been done after the possibility was introduced in the Budget Act of 1996) and the surplus target had no formal legal backing. From 2011, the Budget Act makes it obligatory for the government to propose both an expenditure ceiling and a surplus target to Parliament.

To sum up, the establishment of a stricter fiscal framework took place in two steps. The most important reforms were done in the second half of the 1990s as a as a reaction to the fiscal crisis that was triggered in the first half of the 1990s. The proposals on reforms came mainly from experts inside the Ministry of Finance. The formulation of fiscal rules at the EU level provided an important source of inspiration, not least because there was a wide consensus that Sweden should live up to these rules and hence be able to decide itself from "a position of strength" whether or not to join the monetary union. There was a second round of reforms, though less pervasive, from 2007. It was not triggered by any acute fiscal problems in Sweden, but was instead motivated by arguments of principle on how to strengthen the framework further. In this phase, academic reasoning played a direct role for the establishment of a fiscal watchdog.

2.3 Challenges for the fiscal framework

On the whole, the fiscal framework has worked well and delivered fiscal discipline. Figure 2 shows that the surplus target of 1 per cent of GDP has someetimes been exceeded and Figure 3 that government debt has fallen strongly. It is noteworthy that this has occurred without any formal sanction procedures being in place: instead the respect for the fiscal framework seems to have been based on a political consensus never again to get into a fiscal crisis situation requiring harsh consolidation measures as in the 1990s (EEAG 2011; Calmfors 2012, 2013a). However, recently fiscal deficits have arisen (1.4 and 1.9 percent of GDP in 2013 and 2014, respectively; see *Proposition* 2014/15:100) and the Fiscal Policy Council (2015) has concluded that the surplus target has not been meet. This reflects a conflict of goals between the objective of fiscal discipline and the objective of countercyclical fiscal policy. It is unclear how the violation of the fiscal target will be dealt with.

A related issue concerns the numerical value of the surplus target. If government net lending is 1 per cent of GDP on average, government net financial wealth will, under plausible assumptions, continue to increase from the current level of around 20 per cent of GDP and ultimately converge to a level somewhere around 65 percent (Fiscal Policy Council 2014).[28] It is not obvious that such a large precautionary buffer is needed in the event of future fiscal crises. The government, consisting of Social Democrats and the Green Party, which took office in 2014, has announced that it wants to change the fiscal target to a balanced budget target (*Proposition* 2014/15:100). A Government Commission with the remit to analyse such a change has been appointed.

Yet another issue concerns the Fiscal Policy Council. Although set up earlier and acting as a role model for many of its counterparts in other countries, the Council has a rather weak formal position compared to arrangements elsewhere. This likely reflects reluctance among politicians to expose themselves to "too much monitoring"; it is obvious that the Minister for Finance in the Liberal-Conservative government 2006-2014 (Anders Borg) was very uncomfortable with the Council's critique of some government policies in the first years of its existence, which led to a stressed relationship, as described in Calmfors and Wren-Lewis (2011) and Calmfors (2013b). An interesting proposal is that the Council's remit could be extended also to monetary policy (Socialdemokraternas forskningskommission 2014). One aim is to strengthen the monitoring of monetary policy. Another motive is a worry that there may not be sufficient co-ordination between the monetary policy decided by the central bank and the government's fiscal policy. Common monitoring of the two policies might help ensure an appropriate policy mix.

In the autumn of 2013 the earlier political consensus on the budget process was challenged by a conflict between the government and the opposition parties on the top-down approach. After the initial overall decision on the budget, including a tax cut for high-income earners, had been taken in Parliament, the tax cut was reversed in a new decision. This was possible since the government is a minority one. The government argued that this was a violation of

[28] The exact level will depend on how the value of the stock held by the government sector develops.

the “spirit” of the top-down approach, whereas the opposition parties instead claimed that the decision was consistent with both the formal and informal rules, as it strengthened the budget (Mattson 2014). The earlier consensus was re-established in an agreement between the government (Social Democrats and Greens) that took office in 2014 and the Liberal-Conservative parties (the so-called December Agreement that year). According to the agreement, Parliament should not later reverse tax or expenditure decisions included in the overall budget decision once that has been taken.[29]

3 Conclusions

Major changes in the monetary and fiscal frameworks in Sweden were undertaken in the 1990s. They were direct responses to severe macroeconomic problems of inflation and large fiscal deficits. The granting of more independence to the *Riksbank* in the late 1990s was to a large extent motivated by the inflation-devaluation cycle characterising the Swedish economy in the 1970s and 1980s, when low credibility for politicians’ commitment to a fixed exchange rate in the case of short-run conflicts with the objective of full employment was a key factor for keeping the cycle alive. The adoption of inflation targeting in 1993 was a response to the forced move to a flexible exchange rate. The aim was to capitalise on the earlier, but failed, investment in the defence of the fixed exchange rate as a means to achieve low inflation. The top-down budget process, the central government expenditure ceiling, the surplus target and the balanced budget requirement on local governments were all reforms seeking to lock in the gains from the fiscal consolidation process in the second half of the 1990s.

EU membership played an important role for establishing the new monetary and fiscal frameworks. EU Treaty obligations required greater central bank independence. The EU fiscal rules did not directly require any changes in the domestic fiscal framework, but served as an important source of inspiration. At the same time, EU membership cannot be seen as a purely exogenous factor, as the decision to seek entry into the EU partly came about as a measure to enhance macroeconomic stability. EU membership was used as a vehicle for change in the economic-policy frameworks. The question of EMU entry towards the end of the 1990s played a particular role. When Sweden decided not to join, the desire to preserve credibility for

[29] The December agreement also stipulated that Parliament should pass the budget of a minority government it it has support from “the largest party constellation” even if there is no majority in favour (Fiscal Policy Council 2015). The motivation was to make it easier for a minority government and avoid a situation like the one that occurred in 2014 when the red-green government could not get its budget through Parliament. The government had instead to govern with the budget proposed by the Liberal-Conservative parties. That budget was approved by Parliament because it was supported also by the populist and anti-immigration Sweden Democrats with which the Liberal-Conservative parties did not want to co-operate.

policies outside the monetary union rather became a motive for more stringent monetary and fiscal frameworks than would have been the case inside.

Academic thinking played a greater direct role for the reforms in the monetary policy than in the fiscal policy area. Explicit commitment to a price stability target and central bank independence in order to increase credibility for low-inflation policy had consistently been advocated by academic policy groups throughout the 1980s. This created a fertile soil for the adoption of the inflation target and the move to central bank independence in the 1990s. The fiscal reforms in the 1990s were instead more directly driven by technocrats inside the Ministry of Finance (who were, however, influenced by the academic thinking in the field) and by a desire in the Parliament to have a better functioning budget process. But a decade later, the establishment of a fiscal watchdog, the Fiscal Policy Council, was the result of direct academic proposals and not any response to existing fiscal problems. Other measures after 2007 to further strengthen the fiscal framework, such as guidelines for computing an annual scope for reforms and a stronger legal status for the government expenditure ceiling and the surplus target, seem to have been taken mainly on the initiative of a Minister for Finance with an unusually great interest for fiscal framework issues. This interest was probably further enhanced by the sovereign debt crises in several EU countries.

The inflation target has been instrumental in anchoring inflation expectations at a low level, and the budget surplus target has become generally accepted as a norm for fiscal policy. Both targets were, however, formulated without any underpinning in-depth analysis. It is not clear that they were set optimally. A somewhat higer inflation target would make it easier to achieve negative real interest rates, and thus to stimulate the economy, in recessions. The surplus target has been motivated as a measure to reduce government debt radically, but once this has been achieved, it is not obvious that precautionary considerations motivate such a favourable long-run financial position for the government as is implied by the surplus target. A key issue is whether the political system has the capability to reformulate these targets and still maintain credibility for low inflation and fiscal discipline. This likely requires a broad political consensus, transparent explanations and a clear message that any changes are one-off measures and not the start of a number of successive revisions. The fact that inflation has been held consistently below the inflation target and that fiscal outcomes have been much stronger than in most other countries ought, however, to give policy makers considerable leeway to reformulate the targets without loss of credibility. In the fiscal field, a reformulation of the surplus target, for example to a balanced budget requirement, could be combined with a strengthening of the role of the fiscal watchdog, the Fiscal Policy Council, such that it comes to match the best international practice, which is not now the case.

To conclude, Sweden provides a good example of how deep economic crisis, in interaction with independent thinking by experts and policy influences from other countries, can lead to fundamental reforms of policy frameworks. Academic thinking is a crucial input that must be there as an intellectual basis when the need for reform arises. International considerations are an important vehicle that can be used to push through changes. Although reforms in fundamental economic-policy frameworks are often crude, the design of new institutions tends to be regarded as dogmas that are not to be questioned. It remains to be seen whether it will be possible in Sweden to adapt the monetary and fiscal frameworks to changed circumstances, while still preserving the benefits they have delivered. This requires a continued political consensus which may be more difficult to maintain as the memory of the fiscal crisis in the 1990s fades away. A key issue will be how to secure an appropriate policy mix between the central bank’s monetary policy and the government’s fiscal policy.

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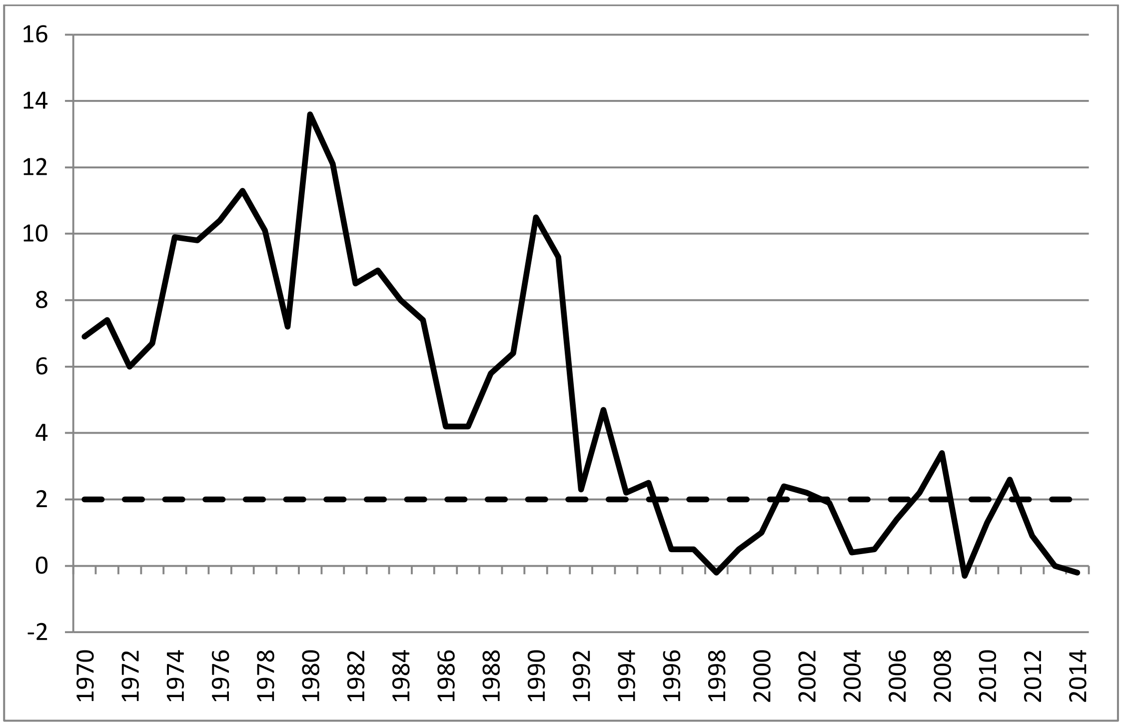
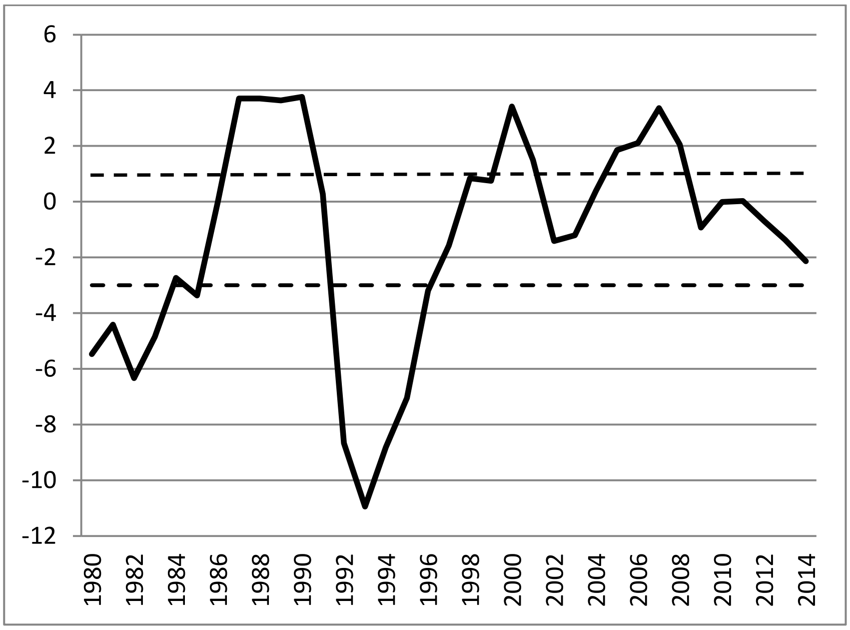
Figure 1 CPI inflation, per cent



Note: The broken line indicates the 2 per cent inflation target.

Source: SCB, Sweden.

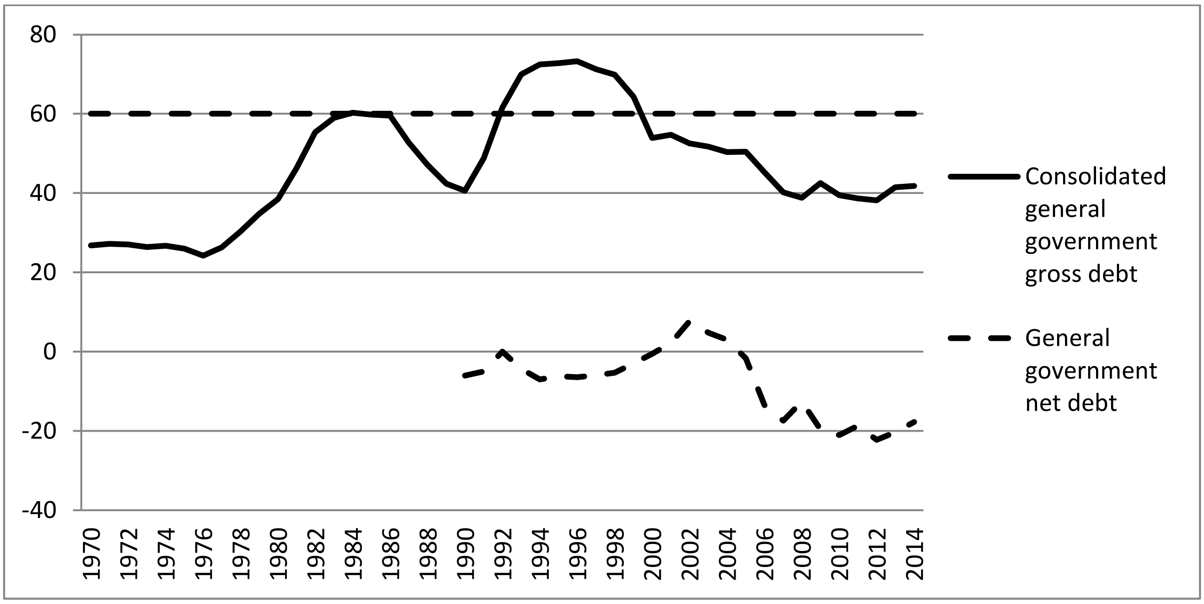
Figure 2 General government net lending, per cent of GDP



Note: General government net lending is the difference between the sector's revenues and expenditure as defined in the national accounts. The broken lines indicate the surplus target of 1 per cent of GDP and the EU deficit ceiling of 3 per cent of GDP respectively.

Source: IMF World Economic Outlook.

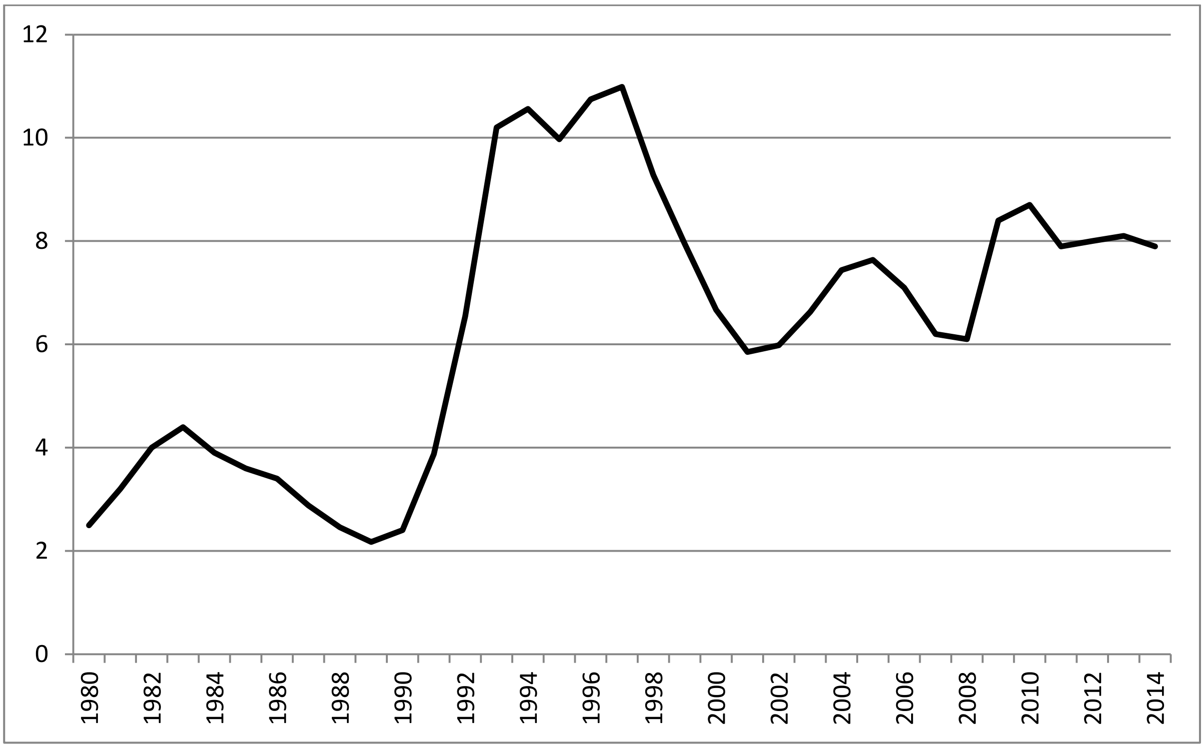
Figure 3 Government debt, per cent of GDP



Note: Consolidated general government gross debt is general government total debt after all internal claims and liabilities in the sector have been netted out. General government net debt is the sector's gross financial debt minus its financial assets (including claims on the private sector). The horizontal broken line indicates the EU debt ceiling of 60 per cent of GDP.

Source: IMF World Economic Outlook.

Figure 4 Unemployment, per cent of the labour force



Source: SCB, Sweden.