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A role model for the conduct of fiscal policy? Experiences from Sweden

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A B S T R A C T

Sweden was hit by a severe macroeconomic crisis in the early 1990s. GDP fell for three consecutive years in 1991–1993, unemployment increased by 9 percentage points, banks had to be nationalized, and public budget deficits exceeded 10 percent of GDP. The recovery was however quick. GDP growth was around four percent in 1994–1995, and budget deficits had been eliminated by 1998. Growth remained high in the subsequent decade, and the government debt ratio was reduced by almost 50 percent of GDP.

This paper describes and analyzes the Swedish crisis and the policy measures implemented in response to the crisis. Policy measures include abandoning the fixed exchange rate, fiscal austerity, a new stricter fiscal framework, and several structural reforms in the 1990s. These policies were appropriate for handling the Swedish crisis, but the Swedish experiences have limited applicability for the current debt crisis, in particular because currency depreciation in combination with strong growth on export markets was a key ingredient in the Swedish recovery. Implementing fiscal austerity would have been more complicated absent this export-led growth. Moreover, the new fiscal framework has most likely contributed to strengthening public finances, but I demonstrate that budget surpluses and high GDP growth only explain around a third of the reduction in the public debt ratio after 1997.

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1. Introduction

The Swedish economy entered a severe macroeconomic and financial crisis in the early 1990s. In several dimensions, the build up and early phases of the Swedish crisis resemble the developments preceding the current European crisis. In 1985–1990, there was rapid credit expansion, quickly rising house prices combined with high real-estate investment, and current account deficits. Growth was high, there was little unemployment, the public debt-to-GDP ratio was low and falling, and monetary policy was constrained by a fixed exchange rate.

In 1990, it was evident that these developments were not sustainable. The fixed exchange rate in combination with high wage and price inflation had eroded competitiveness. External factors became less favorable when the United States and many European economies entered a recession, and when German monetary policy was tightened following the reunification. A Swedish tax reform in 1990–1991 further raised the effective real interest rate faced by households. The business-cycle peaked in late 1989 or early 1990. GDP then fell for three consecutive years, 1991–1993. Failing banks had to be nationalized, unemployment increased from 2 percent in 1990 to 11 percent in 1993, and government gross debt increased by more than 30 percentage points of GDP in these three years. The fixed exchange rate was abandoned in late 1992, resulting in a sharp currency depreciation.

The important policies implemented to address the immediate crisis after the currency was allowed to float consisted of a general guarantee extended to the depositors and creditors of the banks and mortgage institutions, rapid recapitalization of the banking system, relatively tight monetary policy to build credibility for a newly announced inflation target, and efforts to consolidate fiscal policy. These policies turned out successful. The banking system was basically reconstructed and recapitalized by mid 1993. GDP growth resumed quickly and was close to 4 percent already in 1994. The public budget deficit (general government net borrowing) peaked at 13 percent of GDP in 1993 but had been turned to a surplus in 1998. And inflation expectations started falling down towards the inflation target in 1995.

In addition to the policies implemented to address the immediate crisis, a series of structural reforms were implemented in the 1990s to improve the frameworks surrounding monetary and fiscal policy, improve the design of social insurance schemes, and strengthen competition on product markets. Growth remained high in the decade after Sweden had recovered from the crisis, and public finances have strengthened further. For example, public debt fell by more than 50 percentage points relative to GDP from its peak in 1996–2011.

The ambition with this paper is to give an overview of these policies and reforms, and to analyze how they contributed to the Swedish recovery. I focus in particular on aspects of the fiscal consolidation and reforms of the fiscal framework that may be of relevance for the current European crisis.

My main message is that many economies today face substantially deeper problems than the Swedish economy did in the early 1990s. The Swedish recovery was facilitated by the large currency depreciation in combination with strong growth on export markets. Without these developments, the general guarantee extended to banks could have become a much larger burden on public finances (as a similar guarantee did in Ireland recently). Moreover, attempts to consolidate public finances in the early 1990s were not successful in reducing the growing budget deficit. The successful and important consolidation was implemented in 1995 when growth was already high. There are clear indications that this consolidation was contractionary. But the consolidation was still politically and economically acceptable, most likely because the economy had started recovering.

During the ongoing crisis, most economies have not benefitted from substantial currency depreciation or strong external demand. Thus, while fiscal and monetary austerity was appropriate for Sweden in the 1990s, it is not clear that such policy choices would be successful today. Other factors contributing to the deeper problems in many economies today are the initial public debt levels and demographic challenges. While budget deficits were large in the early 1990s and the debt rapidly increasing, the net government debt ratio was never large. It peaked at 27 percent of GDP in 1996, while many countries today have debt ratios around 100 percent of GDP. Many Southern European countries today also face severe demographic challenges with rapidly aging populations, and in some cases also falling total populations. In combination with pension and health care systems that are not well-designed to handle the demographic change, these anticipated developments aggravate market perceptions of fiscal sustainability already today.

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