BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

May 19, 1980

TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached are two memoranda relating to a request by the Swedish Riksbank for an increase in the swap line, one prepared by the Manager for Foreign Operations dated May 16, 1980, and the other by the Board's Division of International Finance dated today.

It is contemplated that this subject will be discussed at tomorrow's meeting of the Committee under Agenda item 2.

Attachments

CONFIDENTIAL--F.R.

May 16, 1980

To	Federal Open Market Committee	Subject: Request for Increase in Swap Arrangement by Swedish Riksbank.
From	Scott E. Pardee	

In Basle last week, Governor Wohlin of the Swedish Riksbank asked if the Federal Reserve might consider increasing the swap line by $200 million to $500 million. Chairman Volcker has suggested that I present the question to the FOMC at the May 20 meeting.

By official forecasts, Sweden is expected to have a current account deficit of $3 1/2-4 billion this year. Private forecasters, and those of the Federal Reserve staff, believe that the deficit could run somewhat higher, perhaps to as much as $5 billion. Private capital movements are more difficult to forecast. Sweden experienced some outflows of funds earlier this year, when interest rates rose sharply in the U.S. and in the Euro-market. For internal reasons the Riksbank was unable to match the rise in short rates (the discount rate is currently 10 percent), but has made sure that domestic rates have held firm now that interest rates in the U.S. and the Euro-markets have receded. In addition, the Riksbank is quietly allowing interest rates on private long-term borrowings to rise. These relative interest rate movements should help neutralize private capital flows.

On balance, therefore, the Swedish authorities expect a financing problem on the order of $4 billion, which they plan to cover largely through official borrowings abroad. Of this, some $2.25 billion has already been arranged, and additional loans are in the early stage of discussion. There was some concern that the recent general strike would have a chilling effect on investor interest, but the latest round of loan negotiations in Germany and Switzerland occurred during the strike and went smoothly. Moreover, although the roughly 11 percent wage increase which emerged from the strike is admittedly expensive, the Swedes do not believe that the settlement will seriously hamper their financing effort, and some of our private market contacts in New York feel the same.

In requesting an increase in the swap arrangement with the Federal Reserve, Governor Wohlin's concern is that the Riksbank needs more backstop in the form of short-term bridge financing. The Riksbank uses an intervention approach based on a currency basket and finances its intervention out of the proceeds of the official borrowings. In light of the current economic and political uncertainties, the krona is vulnerable to sudden bursts of selling pressure, and the Riksbank may be obliged to sell dollars in the market at a faster pace than they are raised through financing. Presently, in addition to some $2.9 billion of currency reserves, the Riksbank has undrawn credit lines with commercial banks of some $500 million and another international facility of $200 million. The increase in the Federal Reserve line would give them an added cushion. Sweden also has a $220 million reserve position in the IMF and $280 million of SDRs.

Governor Wohlin said that the Riksbank has no immediate need to draw on the Federal Reserve. (The swap line between the Federal Reserve and the Riksbank has never been drawn upon by either party.) Nevertheless, he did not wish to rule out the possibility that they may come in for a drawing at some point. They would prefer that any drawings to be under the usual three-months' terms embodied in the agreement, but he expected actual use of the line to be for much shorter term than that since the drawings would serve as a bridge until new international loans could be arranged, perhaps in the matter of weeks.

Currently, in addition to keeping domestic short-term interest rates firm and allowing long-term interest rates to rise, the Riksbank is pressing for a reduction in the fiscal deficit both for this year and next. Governor Wohlin has gained a commitment from the government to reduce planned expenditures next year, but is still pressing for further trimming of this year's budget.

Details of the Riksbank's request to increase the swap arrangement, and of Sweden's situation generally, are still being discussed between us and officials of the Riksbank. Should the FOMC vote to approve the increase, Riksbank officials recognize that we would have to release the action in the policy record but they would want to have as little publicity as possible.

SEP/msb

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 19, 1980

To George B. Henry

Subject: Sweden's Economic Position

From Jerry Caprio

CONFIDENTIAL (FR)
CLASS II - FOMC

I. Summary

The Swedish economy faces several adjustment problems over the next few years. Although economic activity is likely to expand in 1980 at about a 3 percent rate, the inflationary spurt that began in the second half of 1979 shows little sign of abatement. Sweden has just experienced its most serious labor dispute in 70 years, and the outcome -- an average 11 percent increase in labor costs -- will hinder efforts to reduce the inflation rate and to improve Swedish competitiveness in international markets. Also, the current account in 1980 will widen sharply from the deficit of $2.6 billion recorded in 1979.

There are presently a number of imbalances in the economy, which have arisen in the wake of government attempts to prevent a rise in unemployment. Expenditures on various labor market schemes -- such as wage subsidies and retraining -- have tripled in the past three years, while aid for ailing industries has more than quadrupled during the same period. The public sector has grown substantially, with expenditures currently running at about 65 percent of GDP and with taxes not far behind. The government is committed to reducing the size and influence of the public sector on the economy. In view of the recent wage settlement, it is likely that achievement of this objective will conflict with its full employment policy.

Despite these problems, Sweden continues to be regarded as a good risk on international credit markets, due in part to its low level of foreign debt. Thus, access to foreign borrowing should make it possible for Sweden to move gradually in addressing its economic difficulties.

II. The Swedish Economy in the Mid-1970s

Since World War II, Sweden has been committed to maintaining a low level of unemployment. During the 1974-75 worldwide recession, this commitment -- coupled with the expectation by Swedish authorities of a shorter and weaker recession than occurred -- led to the adoption of stimulative fiscal and monetary policies. The consequent increase in aggregate demand, at a time of a significant slowdown abroad and slow productivity advance at home, led to a sharp decline in Swedish competitiveness. Sweden's membership in the European currency snake exacerbated this trend; the weighted average krona appreciated by over 7 percent between 1974 and 1976. By mid-1977, Sweden's export market shares were about 20 percent lower than in 1974, producing large current-account deficits.[1/] These developments in the external account undoubtedly were exacerbated by the erosion of technological superiority in several key exporting industries, notably shipbuilding.

In August 1977 the government embarked on policies designed to reduce the external imbalance and the rate of inflation. The central features of this program were: a withdrawal of the krona from the snake, a 10 percent devaluation against a basket of the currencies of major trading partners, and a brief price freeze followed by an intense surveillance of prices.[2/]

1/ Until corrected last year, there was a substantial underreporting of service exports, producing a reported current-account deficit of $3.3 billion for 1977. This figure was later corrected to a deficit of $1.8 billion.

2/ This "surveillance" has included several temporary freezes of selected commodities. More recently, the government has used a temporary freeze to facilitate labor negotiations. General price surveillance continues in force to date.

Another ingredient in the turnaround of the Swedish economy in the late 1970s was the very moderate wage settlement of March 1978. At that time Sweden's three major unions agreed to a 3 percent wage increase over the March-December 1978 period and a 2 percent rise during the following ten months. The inflation rate was 10-11 percent at the time of the settlement. An important pre-condition for the settlement was the incorporation of a price trigger clause, according to which negotiations were to be reopened if the CPI rose by more than 7.25 percent during the March-December 1978 period or by more than 5 percent in the first 10 months of 1979.[1/] Additionally, personal income tax rates were reduced. This very low wage settlement was also facilitated by a centralized labor market, slack labor market conditions, especially in traditional industries, a very even distribution of income, and, until recently, excellent labor relations.

III. The Domestic Economy and Inflation: Recent Developments

As 1978 proceeded, the effects of the devaluation and the wage settlement began to show up in activity and prices. Led by foreign demand and government spending, real GDP advanced by 2-1/2 percent in 1978, while inflation was proceeding at a rate of less than 6 percent by the end of the year. However, the labor market remained slack. Although the unemployment rate was 2.2 percent, about another 4 percent of the labor force was engaged in labor support schemes, while public employment and early retirement rose quickly. Moreover, real private consumption had declined slightly in 1977 and 1978.

Thus, the Swedish government decided in 1978 to adopt a more expansionary stance. Net transfers increased sharply in the second half of 1978 and in 1979, leading to the enlarged government deficits shown in Table I for these two years.

1/ This clause was not activated until October 1979.

Also, after three years of inventory decumulation, inventories rose sharply, accounting for 1-1/2 percent of the roughly 4 percent advance of real GDP.

The 1979/80 jump in oil prices contributed to an undoing of Sweden's success in reducing inflation. Although the rise in consumer prices averaged about a 7 percent rate during 1979, compared with 10 percent in the previous year, this yearly average masks a significant acceleration since last July. During the last half of 1979 the average monthly rate of increase was 1 percent. Then, in January of this year, the CPI rose by about 3-1/4 percent, with the energy component of the index accounting for 1-1/2 percentage points of this rise.[1/] In April consumer prices were 13-1/2 percent above their year-earlier level. This sharp run-up of consumer prices complicated the labor negotiations that were just completed (see below).

IV. The External Sector

Sweden's current-account balance moved from surplus to deficit in 1979. The turnaround of the trade account (Table I) was responsible for most of the decline. Although exports rose by 26 percent, imports, led by a 72 percent increase of the oil bill, jumped by almost 40 percent. The Swedish government has predicted a $4 billion current-account deficit in 1980, but this forecast assumes more rapid economic growth outside Sweden and a lower oil price than appears reasonable at this time. The Board Staff views a deficit of about $5 billion as more likely. Private forecasts are in the same neighborhood.

As stated earlier, Sweden withdrew from the snake in 1977. Since that time, the government has pegged the value of the krona to a basket of 15 currencies representing its main trading partners. Since mid-November, the Riksbank has sold

1/ Food and housing price increases accounted for another 1-1/2 percentage points.

about $2.5 billion to maintain this peg. Although the discount rate has been raised in several steps from 6.5 percent to 10 percent since last July, relative interest-rate differentials were cited as an important factor behind the capital outflows that have produced downward pressure on the krona early this year. Swedish intervention has helped to keep the value of the krona in terms of its basket within ± 2 percent of its September 1977 value. Despite the downward pressure at the end of last year and early this year, the krona is still within 1 percent of its target value.

Although external borrowing by the government has increased significantly in the past few years, its net foreign debt position did not become negative until 1977. At the end of September 1979, net foreign debt of the government was about $4 billion (4 percent of GDP), compared with net foreign assets of $315 million (0.5 percent of GDP) at the end of 1976. Over this same interval, gross public foreign liabilities rose by over 600 percent to over 5 percent of GDP. However, compared with many other governments, especially in the Scandinavian group, the ratio of foreign debt to GDP is quite low.

V. Economic Policies and Prospects

In addition to the long-standing goal of high employment, the Swedish authorities have more recently committed themselves to reducing the size of the public sector. During the 1970s, the public sector grew to the point that expenditure is about 65 percent of GDP, though about one half of this total represents transfers. Much of the expenditure increase came in the form of rising outlays on labor market policies, assistance for ailing industries, continued improvement in social benefits, and, in 1979, measures to improve the competitiveness of industry. Revenues have not kept pace with this growth due to some income tax concessions and to the slow growth of the tax base.[1/] Thus, the central government deficit jumped to about 8 percent of GDP in 1979 from near balance in 1976.

Monetary policy in 1978 and 1979 was primarily concerned with the problem of preventing an undue increase in liqudity generated by the large budget deficit. Reserve requirements and cash ratios, two of the main instruments of Swedish monetary policy, were raised from early 1978 to early 1980.[2/] Although interest rates increased in 1979, they remained below foreign rates, inducing a net capital outflow. This outflow, plus a more moderate growth in bank lending to the private non-housing sector, helped slow the growth in broad money to 11 percent in 1979 compared with 17 percent in 1978.

The short-term outlook of the Federal Reserve is for 3 percent real GDP growth in 1980, somewhat lower than the official government forecast. Although the inflation rate will decelerate from the 24 percent annual rate recorded in the first quarter, by the fourth quarter the CPI is still likely to be 10-1/2 to 11 percent above the year earlier level. As stated above, our current-account forecast is also somewhat more pessimistic than the official prediction.

The outlook beyond 1980 depends very much on what the Swedish government does next. The recent labor dispute, when over 25 percent of the labor force was either locked-out or on strike, produced settlements that will raise labor costs in 1980 by about 11 percent over the average for 1979. The Swedish government had hoped for an increase in labor costs of only 7 percent, which would improve further Swedish competitiveness. With increased exports, the authorities could then reduce the growth of expenditures without sacrificing their employment goal.

1/ Some of these tax decreases were granted to encourage the low wage settlement of 1978, while more recent decreases have been to encourage investment.

2/ On April 14, the Riksbank lowered the cash ratio -- the quota that commercial banks must keep with it -- from 8 to 2 percent, the level the ratio was last July. The new liquidity was absorbed by a two- and a ten-year bond issued by the Debt Office.

The recent wage settlement undermines this strategy, and the government now may be forced to accept a trade-off between these two goals.

Table I

Trends in Major Swedish Economic Indicators, 1973-1979[1/]

	1973	1974	1975	1976	1977	1978	1979
1) GDP	3.5	4.1	0.8	1.3	-2.4	2.5	4.1
2) Unemployment	2.5	2.0	1.6	1.6	1.8	2.2	2.1
3) Wholesale Prices	11.0	23.6	7.9	8.3	8.6	6.8	10.6
4) Consumer Prices	6.7	9.9	9.8	10.3	11.4	10.1	7.2
5) Money Stock (M1)	10.1	25.1	8.8	6.8	8.2	15.4	13.5[2/]
5a) Money Stock (M2)	N.A.	9.5	12.1	5.0	9.0	17.2	11.3
6) Exports (FOB) (U.S.$billions)	12.1	15.9	17.4	18.5	18.9	21.7	27.5
7) Imports (CIF) (U.S.$billions)	10.6	16.4	17.9	19.3	19.8	20.5	28.4
8) Trade Balance (U.S.$billions)	1.5	-0.5	-0.4	-0.8	-0.9	1.2	-0.8
9) Current Account Balance (U.S.$billions)	1.2	-0.9	-1.6	-2.4	-1.8	0.1	-2.6
10) Exchange rate (krona/$,period average)	4.36	4.44	4.15	4.36	4.48	4.51	4.29
11) Net Foreign Exchange Reserves (end of period, $ billions)	2.5	1.7	2.9	2.6	3.6	4.3	3.9
12) Budget-deficit as % of GDP	-1.2	-4.3	-4.1	-0.5	-3.5	-6.3	-8.3

1/ Data are expressed as a percentage change over the previous year, except for the unemployment rate and unless otherwise noted.
2/ September over September.

Source: IMF and National Sources.