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■ Heikensten: Low inflation, but outlook remains largely the same

Riksbank Governor Lars Heikensten spoke at a meeting in Sala today about the current state of the economy and monetary policy.

"At the beginning of December last year the Riksbank published its most recent report regarding the future prospects for the Swedish economy and the international economy. Our assessment then was that global GDP growth had reached a peak. However, growth was expected to remain robust and international resource utilisation was thus expected to increase. This outlook remains largely unchanged. It is possible that there is reason to be slightly less optimistic with regard to the euro area, as new data gives a rather mixed picture of economic activity there. In comparison, economic activity in the United States appears to remain strong. The natural disaster in the Indian Ocean is a major tragedy that has brought suffering to many people. From this perspective, the macroeconomic effects of the catastrophe are relatively unimportant. Nevertheless, in a speech like this, there is reason to observe that the effects in macroeconomic terms are estimated to be relatively small in most of the afflicted countries," began Mr Heikensten.

"Long-term interest rates in Sweden, the euro area and the United States remain very low in historical terms. The krona has weakened slightly against both the euro and the dollar recently. However, developments in the financial markets are largely in line with the assessment in the previous Inflation Report and my view of future financial conditions therefore remains essentially the same as it was in December," said Mr Heikensten.

"GDP growth in Sweden was rapid last year. The Riksbank's assessment in December was that growth would slow down somewhat this year and next year, but resource utilisation was nevertheless expected to continue to rise. So far, growth has been supported by strong export activity, although it has been assumed that domestic demand will make an increasing contribution. All in all, I do not consider that the new data gives reason for any major change in the views



on future economic activity. Developments in the labour market have in general been in line with the assessment made in December. Demand for labour remains low, but an increased strengthening in economic activity is expected to lead to an increase in employment and a fall in unemployment," said Mr Heikensten.

"In December, CPI and UN1X inflation stood at 0.4 per cent and 0.8 per cent, respectively. This was lower than assumed in our December assessment and resulted from inflation being lower than expected. The Riksbank had earlier assumed that inflation would be well below the target level in 2005. The assumption was that inflation would not increase and be in line with the target until the end of the present forecast period, due to continuing robust demand and higher resource utilisation. The question now is whether there is reason to change the inflation forecast a couple of years ahead as a result of the new information received since December. My first tentative assessment so far is that there is not, although the short-term forecasts may need some slight adjustment," observed Mr Heikensten.

"However, I do see reason to try to nuance the discussion of economic developments and their consequences for monetary policy. Let me point out that the monetary policy system has never been as mechanical as it sometimes appears to be perceived. Last year offers some good examples of considerations that are worth taking up. The separate minutes of the Executive Board meetings show, for instance, that households' rapidly-growing debt burden and house prices have come under discussion. In my opinion, potential risks in this area may sometimes be worth including in the considerations when making interest-rate decisions. Another issue that may need consideration, and which was often discussed at the end of the 1990s, is how to deal with the fact that the current low inflation rate is largely due to weak growth in prices on imported goods. Attempts to fully counteract this by pushing up domestic prices may entail long-term risks, as if the international price picture changes one might find that an excessively high domestic price pressure had been established. It may also be worth mentioning that several of the inflation assessments made last year could in principle have motivated even lower interest rates, as the forecasts implied that inflation would be below the target level during almost the whole of the coming two-year period. The fact that I did not advocate further or larger interest rate cuts was not merely due to the expectation that inflation would be in line with the target two years ahead; it was also due to the strong growth in demand. The Riksbank has explained on previous occasions that it is reasonable to take some account of developments in the real economy, both because these say something about inflation in the longer term and because a stable real economic development is important in itself. This is evident, for instance, in the clarification the Executive Board published in 1999," Mr Heikensten pointed out.

"At next week's monetary policy meeting we shall begin by establishing a new assessment of inflation. This will as usual be decisive when making our decision on the repo rate. Questions of the type I have mentioned may also play some role in the discussion," concluded Mr Heikensten.