PRESS RELEASE

DATE: 5 April 2005
NO: 24
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■ The Riksbank influences future inflation, not current inflation

Deputy Governor Villy Bergström spoke today at Landshypotek in Gävle-Dala about the factors guiding the Riksbank's monetary policy.

"Recently we have seen high GDP growth coupled with weak developments in employment and low inflation. Meanwhile, house prices have continued to rise sharply, as has credit growth. So it is not that strange that a debate has arisen over monetary policy. The discussion has seen arguments on both sides; on the one hand there are those that think monetary policy has not been expansionary enough, and has thus held back employment unnecessarily, and on the other there are those that have warned that it has been too expansionary, thereby fuelling asset prices too much. One thing that surprises me, though, is that the criticism levelled at the Riksbank, that the policy rate is not low enough, is often based on current inflation and not on forecasts of future inflation," began Mr Bergström.

"It is therefore important to clarify that the current inflation rate does not serve as a guide for what the policy rate should be today. Current inflation is important, however, in so far as it constitutes the starting point for our forecast of inflation 1-2 years ahead, which does guide our decisions on interest rates," said Mr Bergström.

"When following the debate one can sometimes get the impression that there are exaggerated expectations of what the Riksbank can actually achieve with monetary policy, especially in the short term. Hypothetically, it may perhaps be possible to influence inflation in the coming months but such a scenario would require very large rate adjustments. That would most likely give rise to other, less desirable effects on other parts of the economy, e.g. sharp swings in output. In addition it would result in an even greater impact on inflation 1-2 years ahead since that is the time frame in which a rate adjustment is deemed to have its largest effect. So we would have to think that inflation in that perspective is going to deviate sharply from target," said Mr Bergström.

"That is not the situation today. We do expect inflation to remain low in 2005 and 2006, but it is forecast to be in line with the target towards the end of the forecast horizon – in other words the horizon that guides the Riksbank's monetary policy today. That is because domestic inflation is anticipated to rise in line with the cyclical upswing and a reduction in spare resources. Also, we assume that those factors that have led to falling prices of imported goods in the past year will gradually diminish over the forecast period, even though we expect imported inflation to remain low," explained Mr Bergström.

"Furthermore, the key driving forces behind the currently low inflation, i.e. the rapid productivity growth and the low imported inflation, are factors that monetary policy can do very little about. These are supply factors that in themselves act as a stimulus on growth – a rate of growth that already is high and moreover exceeds what is deemed to be sustainable in the long run. To conduct a more expansionary monetary policy with a view to driving up domestic prices would under these circumstances be risky and could result in a domestic inflation rate that proves difficult to stop were the economy to continue to grow strongly and resource utilisation to pick up. It could further fuel the developments in house prices and the credit expansion, and lead to sharp swings in private demand in the period ahead," said Mr Bergström.

"Other factors that have contributed in some measure to the low inflation are the increased competition in the retail sector, which has resulted in falling food prices, and the abolition of the EU's import quotas on clothing and textiles. Allow me here to clarify that such changes, especially the declining food prices but to some extent also the removal of the import quotas, at least partly entail price level adjustments that are of a temporary nature. It is difficult to determine how long such adjustments will go on, but in the Inflation Report we judged that their long-term effect on the inflation rate would not be as extensive as it is now," said Mr Bergström.

"Our most recent assessment thus points to an inflation rate in line with the target towards the end of the forecast period. Were we to end up in a situation with weaker economic activity and a deterioration in the labour market this assessment may of course have to be reconsidered. Likewise if the economy were to speed up unexpectedly. As always, the future stance of monetary policy will depend on the new information received about economic developments in Sweden and abroad, and on how the Riksbank assesses the inflation outlook," concluded Mr Bergström.