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■ Stimulatory economic policy bolstering growth

First Deputy Governor Eva Srejber gave a speech on Tuesday at Öhman Fondkommission in Stockholm on the subject of inflation targeting and asset prices.

"Allow me to begin by noting that inflation has been stabilised at very low levels in the industrial nations since the mid-1990s. Many factors have contributed to this, including the fact that price stability has been made the explicit objective of monetary policy in many countries," began Ms Srejber.

"A monetary policy focused on keeping inflation on target in the near or medium term is no guarantee, however, against an excessive rise in borrowing and asset prices. Sharply increasing asset prices is not a problem that in itself warrants corrective action. The crucial aspect is whether there is reason to consider asset prices to be too high in the light of fundamentals and whether the bubble has given rise to excess demand in the real economy, misallocations of investments and overly high debt levels," said Ms Srejber.

"In a market economy the prices of financial assets, goods and services serve as a conveyer of information. They provide signals regarding how resources should be allocated in the economy. This means that fluctuations in asset prices are beneficial as long as they reflect realistic changes in players' expectations regarding developments in economic fundamentals. History shows, however, that investors can become over-optimistic about the future," said Ms Srejber.

"We know from experience that a strong credit expansion and sharply rising asset prices have often preceded large falls in resource utilisation and inflation. If a credit expansion and asset price increases are deemed to pose a considerable risk of a substantial drop in demand and lower inflation beyond the normal forecast horizon, we can take this into account in our conduct of monetary policy within the scope of our flexible inflation targeting policy. In such a case this may motivate a more restrictive monetary stance than required to keep inflation on target within the normal forecast horizon. The Riksbank's other objective, financial stability, does not have to be threatened either in order to justify such a monetary policy. It is sufficient that economic growth and inflation in the longer run risk being dampened considerably," said Ms Srejber.

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"A look back at the developments in recent years shows that inflation was low before the equity price bubble burst at the end of the 1990s, mainly owing to changes on the economy's supply side; deregulation, lower import prices and surprisingly fast productivity growth. The economic upswing was derailed when the bubble burst. After a price crash of this kind, households and firms decide to save more and consume and invest less with a view to consolidating their balance sheets. For that reason it has been necessary to have unusually low interest rates to avoid overly low inflation. That in turn has contributed to rising asset prices in other markets, such as the housing market, and to increased household debt just as we have seen in Sweden in recent years," said Ms Srejber.

"The current assessment is that the rapid increase in Sweden of both house prices and household debt since the mid-1990s has not contributed to a build-up of any large imbalances, but of course one can feel some concerns. Households have continued to borrow at a firm rate, and debt as a proportion of disposable income is almost as high as in the early 1990s. Interest costs as a proportion of disposable income is low, however, because interest rates are low. Our analysis indicates that the Swedish household sector in general currently has margins to cope with rising lending rates and a temporary loss of income. We therefore envisage no problem for financial stability, that is, the stability of the banking system, due to households' borrowing. That does not rule out the possibility of individual households running into financial difficulties once interest rates rise. Higher interest rates reduce households' scope for consumption and, coupled with the effects of individual households' financial difficulties, this could begin a process whereby the increase in house prices would be dampened. That could make households want to reduce their debt burden and increase their precautionary saving, which in turn could further subdue consumption demand more generally and thereby subsequently inflationary pressures as well. So there are risks involved if lenders and borrowers in their loan decisions take for granted that the currently low interest rates are going to continue for a long time," said Ms Srejber.

"The decision at the last monetary policy meeting to leave the repo rate unchanged was based on assessments that were close to the economic outlook presented in the most recent Inflation Report in March. At that time, global GDP was predicted to continue to grow firmly, albeit at a slower rate. Despite a gradual pick-up in resource utilisation, international price pressures were expected to be modest in the period ahead. The Swedish economy, too, was forecast to enter a somewhat slower growth phase, but with a higher growth rate than we deem to be sustainable in the long term. Consequently, the slack in resource utilisation in the Swedish economy was anticipated to diminish, giving rise to a pick-up in domestic inflation. All in all, this gave us reason to expect a continued low inflation rate during a large part of the coming two-year period, gradually rising to meet the target a couple of years ahead," noted Ms Srejber.

"This outlook for inflation and growth remains broadly unchanged. Although it seems that growth in the euro area could turn out somewhat weaker in the period ahead, the evidence from other parts of the world, e.g. the United States, suggests that the softening in growth has been temporary. The fundamental factors for continued firm growth, such as strong corporate balance sheets and healthy earnings as well as expansionary economic policy, are still in place. Price pressures remain modest, but producer prices are rising and in some areas are beginning to spill over to consumer prices. Of the industrial nations, this is occurring mainly in the United States. The risks of growth turning out considerably lower are the same as before," said Ms Srejber.

"The outlook for Sweden also remains broadly unchanged, even though some indicators point to marginally weaker growth than anticipated. Swedish exports of goods and industrial production appear to be increasing less than forecast, while components of domestic demand are performing strongly. Employment in the first quarter turned out slightly weaker than estimated, though, which has fuelled uncertainty over the strength of the Swedish cyclical upswing and price developments. Inflation to date has developed roughly as expected in the Inflation Report. However, expansionary fiscal policy, firm growth in real incomes, low interest rates in Sweden – where short- and long-term rates have fallen lately – a weaker krona, rising house prices and increased lending suggest, in my opinion, that economic growth in the period ahead will continue to develop roughly according to the outlook in the latest Inflation Report," said Ms Srejber.

"It is important, though, to monitor whether the recent tendencies towards a slackening in growth are temporary or more persistent, and how they in turn affect domestic price pressures. It is still too early, I think, to completely reconsider the economic outlook. There has been unusually much discussion of monetary policy recently. Many resolute opinions of what the next step should be are being put forward. In the light of the scant data that have been received and the stimulatory economic policy, I feel considerably more open-minded than some commentators and market players regarding the monetary policy deliberations to be made in a month," concluded Ms Srejber.