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CONTACT Tomas Lundberg, Press Officer, tel. +46-8-787 02 15

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

■ Incoming data important

Governor Lars Heikensten today spoke at a meeting in Tylösand organised by regional local authorities about the current economic situation and monetary policy.

"Let me begin with the assessment of business tendencies and inflation trends made in the Riksbank's March Inflation Report. We observed then that the recovery in the Swedish economy that began in 2003 had continued last year. Strong international demand for Swedish exports was an important motor here. Global GDP growth was assumed to have peaked in 2004, but to continue at a good rate over the coming years. Even growth in the euro area, which had remained surprisingly weak, was expected to increase moderately in coming years," began Mr Heikensten.

"The economic upswing was expected to continue and gradually spread to the domestic segments of the economy. Corporate investment, construction and household consumption were expected to account for the majority of the increase in demand during 2005. Although employment had been surprisingly weak last year, continued good GDP growth indicated that employment would nevertheless rebound in the coming years. Despite gradually rising resource utilisation, we anticipated that inflation would remain low, at least over the coming year. However, in the long term inflation was expected to rise as the economic upswing continued and resource utilisation became tighter with the result that companies' costs increased," observed Mr Heikensten.

"When we made a follow-up in April of our assessments in the March Inflation Report, we pointed out that the prospects for economic activity had become rather more uncertain, due to weaker growth statistics from the euro area. At the same time, the picture was mixed with regard to whether or not the slackening in growth in the United States was temporary. In addition, there were signs in Sweden that goods exports and industrial production had increased less than expected and that the labour market had not yet shown a clear rebound. Given these factors, we stressed that we intended to closely monitor whether the slackening tendencies seen in economic activity were temporary or more persistent," said Mr Heikensten.

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"The Riksbank chose to hold the repo rate unchanged at 2 per cent, both when the Inflation Report was published and at the most recent monetary policy meeting in April. The decisions were not entirely easy, although the Executive Board was unanimous on both counts. Although our assessment was that inflation would be in line with the target at the end of the two-year forecast period, we estimated that it would be lower than the 2-per cent target until then, partly due to the effects of various types of supply factor. At the same time, we were assuming – as indeed were most other analysts – that growth would be higher over the coming years than the economy could sustain in the long term without inflation accelerating. The question was therefore whether it would be worthwhile further fuelling demand, particularly as we were already a good way into the cyclical upswing. An additional factor here is the high growth in household borrowing, combined with rising house prices. Although none of these arguments in itself would be sufficient to refrain from cutting the interest rate, when combined they called for some caution, in our opinion," continued Mr Heikensten.

"There may perhaps be reason in this context to elaborate on the discussion held regarding the rapid credit boom and house price trends. The Riksbank is not concerned about house prices in themselves. Nor are we worried about the banking system as a whole, although debt levels have increased and some 1980s elements are visible. Here I am thinking about the tabloid headings and the increasingly escalating campaigns to persuade households to borrow more. However, something we cannot disregard is what might happen in terms of general demand and employment if conditions should change and households want to reduce their indebtedness. There is a risk that this would force an abrupt adjustment in demand. The fact that this is not merely theoretical speculation is made clear by developments in the Netherlands in recent years, as well as the unease in, for instance, the United States, the United Kingdom and Australia," said Mr Heikensten.

"When inflation is as low as it has been in Sweden recently, it is easy to forget how the relationship between economic activity and inflation usually looks. Developments in the United States and more recently even in the United Kingdom can serve as a reminder that the usual relationship still seems to apply. Over the past year, the US inflation rate has risen gradually and it would appear that this can be largely explained by traditional factors; companies' labour costs have increased more rapidly as productivity growth has slackened and resource utilisation has increased," said Mr Heikensten.

"How should we then regard economic developments and inflation over the coming years? The world economy is continuing to grow at a relatively stable rate and most analysts are expecting this will continue, although there are of course risks, particularly due to the saving imbalances that have been built up. A fundamental driving force behind this upswing is economic policy, which has provided stimulation in many areas. Companies' balance sheets are now generally strong, after a few years of low interest rates, while profits are good. There are also many factors in Sweden that indicate good growth. Both fiscal and monetary policy are expansionary and will probably remain so for some time. Nominal wage increases of around 3.5 per cent and the present low inflation rate lead to good development in real wages. All in all, this means that households can expect good income growth. Companies are also in a positive situation, with strong balance sheets and good profit levels. The currently low exchange rate provides further support for demand. The risks of a weaker development in Sweden are probably mainly linked to the continued weak labour market," continued Mr Heikensten.

"Compared with the assessment we made in March, there is reason for slightly less optimism with regard to international developments. This is mainly related to the fact that developments in the euro area appear to be slightly weaker than we assumed in the Inflation Report. With regard to Sweden, the assessment is that growth will continue to be relatively good. The expected shift towards domestic demand now appears to be under way. However, newly-received labour market data show slightly weaker growth than expected, although there are signs of stabilisation. It is not possible to rule out the risk that the large changes occurring now and the concern over continued weak employment growth will hold back household consumption propensity more than we had calculated. Together with the slightly weaker international picture, this would appear to motivate more subdued output growth in Sweden, particularly during the current year, than we assumed in the Inflation Report," continued Mr Heikensten.

"Let me round off with a couple of reflections on the present decision-making situation for monetary policy. As usual, the Riksbank's Executive Board has to evaluate the information we have received and try to make the best possible assessment. On the whole it seems to me, as I mentioned earlier, that the statistics received so far indicate that economic activity may be slightly weaker than we anticipated in March. In addition, I believe that the uncertainty over economic activity in Sweden and abroad has increased somewhat. However, there has been no drastic change."

"I personally have emphasised, on several occasions this spring, the importance of not fastening in one particular position. It is important that all doors are kept open. I am now carefully monitoring the information we receive and acquainting myself with the discussions pursued. I am not yet ready to take a firm line ahead of the next monetary policy meeting," concluded Mr Heikensten.