SPEECH

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The economic situation and inflation

Let me begin by thanking you for your invitation to Malmö.

My intention today is to give a broad picture of how I view the economic situation abroad and in Sweden. By way of conclusion I will also say a few words about the inflation outlook and monetary policy.

Continued strong international growth

During the spring there were a number of signs that international economic activity had slackened. The assessment that we made in connection with the June Inflation Report was that it probably was a temporary slowdown in activity. The information flow during the summer and at the beginning of the autumn essentially suggests that this was a correct assessment. Both macro data and measurements of business expectations in a number of countries indicate that international economic activity has gained new impetus.

A continued strong economic performance in the United States and continued rapid economic expansion in China and the rest of Asia are currently the engine driving global growth. The Japanese economy also seems more robust that it has done for a long time.

The performance in the euro area, however, remains worrisome, particularly in the major economies. Recently, though, there have been some signs that growth is about to pick up there as well. These signs include a recovery in manufacturing activity.

All in all, it appears that GDP growth abroad will continue to be high this year, albeit somewhat lower than last year. In coming years, too, the prospects for continued high global growth are bright. The fast productivity growth in Asia seems able to continue and thereby give added fuel to world trade. A number of countries are conducting expansionary economic policy, which also will contribute to a rise in resource utilisation.

This is essentially the same assessment of international economic activity that we made in June. We may need to take account of the fact that the effects of the hurricanes in the Mexican Gulf will dampen growth in the United States somewhat in the near term. When the rebuilding process gets going, however, it should contribute to somewhat higher growth. It is of course difficult to estimate the economic effects of such a catastrophe, but most indications are nevertheless that the effects on the US economy will not last that long.

Uncertainty surrounding the oil price and its effects

One factor that has not developed in line with our assessment in June is the oil price. In June, we estimated that the oil price would have fallen back to under 50 dollars per barrel in August. Instead, it rose to new record highs during the summer. It is true that it has dropped somewhat recently but it is still above our previous forecast. Even the expected future oil prices, the forward rates, have risen.

How the high oil price will affect the world economy and price levels at different stages of production is hard to judge. The effects that can be expected to arise will depend, among other things, on whether the high price first and foremost reflects rising demand or whether it is due to supply shocks. The upturn in the oil price in recent years has been accompanied by an increase in oil production, which indicates that the price increase was mainly due to high demand. Mounting demand from countries with rapidly increasing industrial production, such as China and India, has probably played a part. At the same time, it is evident that there have been supply shocks. The conflict in Iraq and the recent storms in the Gulf of Mexico and the southern United States are just a few examples.

What is worth observing is that the rise in the oil price, of almost 40 dollars per barrel, since 2002 does not appear to have dampened global growth to any appreciable extent. This can probably be explained in some measure by the fact that the upswing thus partly seems to be a result of the sharp expansion in Asia and by the fact that economic policy has become more expansionary. That the industrialised countries in particular are not as dependent on oil as before should also have contributed to the effects so far being less than in previous oil crises. However, it is also conceivable that the full impact of the supply shocks has not yet become evident on growth and inflation. To sum up, the oil price and its effects on growth and inflation are a significant source of uncertainty that we are grappling with in our assessment of growth prospects and the inflation outlook.

Low long-term interest rates

In the financial markets recent developments have been characterised by a continuation of low long-term interest rates and a stable krona. The low bond yields are somewhat puzzling. Even though corporate earnings have continued to increase in line with the continued strengthening of international economic activity, investment in many countries has not picked up to the same extent. While the willingness to invest has been relatively low in industrialised nations, regarded from a cyclical perspective, saving has also been high in certain oil-producing countries and in several Asian economies. The combination of a restrained willingness to invest and a high saving rate could, in other words, have contributed to the low bond yields.

In addition, however, interest rates around the world in recent years may have been depressed by more transitory factors such as temporarily low risk premiums, effects of changed rules for pension saving and Asian countries' build-up of their foreign exchange reserves. A fast rise in bond yields cannot be ruled out when these conditions normalise. That in turn could have repercussions for the real economy, partly through the effect on housing prices, household wealth and consumption.

The large deficits on the US current account and federal budget are another element that has long been one of the key risk factors in the international outlook. The question is not so much whether this situation is sustainable or not. There are many reasons to expect that the deficits will shrink in the period ahead. A weaker dollar and higher US interest rates are likely to be natural features of such a development. The concern revolves mainly around how big the changes in interest rates and exchange rates might have to be and how quickly they might come about.

Domestic demand to take over in Sweden

Like abroad, the Swedish economy showed signs of a slowdown around the turn of the year following a high growth rate last year. As regards the Swedish economy, too, our assessment in June – that it was a question of a temporary slowdown – seems to have been correct. Economic growth seems to have increased over the course of the year. Revised statistics have also shown that developments at the beginning of the year were not quite as weak as was first indicated. During the second quarter GDP growth picked up as we forecast in June. One question, of course, is whether we, with the benefit of hindsight, overdid it when we cut the repo rate in June. I don't think so. Even though the start of the year did not turn out quite as weak as it seemed in June when we lowered the repo rate, it still appears that economic growth and resource utilisation this year will be markedly lower than we expected at the beginning of the year.

In the period ahead we expect that the cyclical upswing to a greater extent will be associated with increasing domestic demand. There are currently a number of signs that such a change is on the way. During the second quarter this year, growth in household consumption seems to have picked up and it appears that consumption continued to grow strongly in the third quarter as well. Moreover, the upturn in investment that began last year has also continued during the first half of 2005.

Export growth, however, was somewhat weaker than expected during the first half of the year owing to the dip in international economic activity. However, monthly data for goods exports and the NIER's business tendency data for new export orders point to a slight pick-up recently.

The high productivity growth in recent years indicates continued good growth in the Swedish economy in the coming years. It has meant that companies have been able to increase their production with their existing work forces. This in turn has improved the cost situation for companies and held back price increases in the economy. The low inflation rate has made it possible to conduct an expansionary monetary policy for a comparatively long period. At the same time, the high productivity and relatively good corporate profitability can be expected to be reflected in favourable wage growth in the period ahead. Altogether, this means that the prospects for good for firm growth in domestic demand and employment over the coming years.

Compared with the assessment in June, we today have somewhat more expansionary monetary policy. The budget bill that was presented in September also suggests that fiscal policy, particularly in 2006, will be slightly more expansionary that we anticipated then. That indicates that we might have to revise up our growth forecasts for the Swedish economy somewhat in the years ahead.

All in all, this means that growth appears able to remain firm in the coming years. Gradually, however, growth should slacken somewhat, which is in line with a normal cyclical pattern with a normalisation of growth in investment and productivity. Less expansionary economic policy is also expected to contribute to somewhat lower growth in 2007 and 2008.

Capacity pressures to rise gradually

As regards developments in the labour market, the assessment of the current tendencies has been made more difficult by the change in methods in the labour force survey. With this reservation, it can nevertheless be said that there are signs that the situation in the labour market is improving. According to the National Accounts the number of hours worked began to rise in the second quarter this year. However, we have not yet been able to see any marked increase in employment since average working hours have risen. When there is an upturn in the economy existing staff are initially used more intensively, and only at a later stage do firms add to their workforces.

Labour market indicators, however, are pointing to a gradual pick-up in employment. For instance, the number of redundancy notices is dropping and the number of new job vacancies is increasing. Relatively strong growth in domestic demand in the period ahead, in combination with the fact that it should become increasingly difficult for companies to boost output without also adding to their workforces, means that we foresee a rise in the demand for labour in the coming years. The Government's recently announced labour market policy programmes for next year can be expected to entail that total employment will increase considerably more than regular employment. But there should also be a rise in the number of regular jobs, among other things in construction, the public sector and the private services sector.

It is, as always, difficult to assess how total capacity pressures in the economy will develop in coming years, and thereby what inflation impulses we may expect from wage formation and companies' price-setting behaviour. Cost pressures have recently been low, which is partly due to the relatively high productivity growth. However, the reasons behind this are not entirely clear, which makes the assessment of future productivity growth more difficult. It does appear likely that the high level of productivity growth has to some extent been cyclical and a result of the composition of growth. It is reasonable to believe that productivity will increase at a slower rate in future as growth is expected to be linked to a greater extent to strong domestic demand and increased production in the private services sector.

All in all, declining productivity growth and higher wage increases as the labour market improves ought to lead to a gradual rise in companies' production costs. However, the cost increases look to be moderate, and we expect that cost pressures will remain relatively low over the coming years.

It should be emphasised that it is difficult to determine exactly how far productivity growth will slow down and thereby how much companies' costs may increase in future. It is likely that the rate of increase in productivity has risen as a result of the large-scale investment in information technology made by companies at the end of the 1990s and due to the effects of globalisation on competition and output. However, it is fully possible that we will have reason to revise up our forecast for productivity growth even more in coming years. It is just as conceivable that productivity growth will prove to be weaker than estimated.

Gradually rising inflation

Inflation has remained low since the end of 2003. Both increases in prices of consumer goods that are mainly imported – imported inflation – and increases in prices of domestically-produced goods – domestic inflation – have remained low for some time.

There have probably been several different factors contributing to the low inflation in recent years, including rapid productivity growth, relatively low capacity pressures and a stronger krona. Imported inflation also appears to have been held down by import substation, i.e. a shift from imports from countries with relatively high prices to countries with relatively low prices. Clothing prices, for instance, have shown unusually weak growth and over the past two years they have actually fallen. The EU's new regulations for clothing and textile imports have contributed to keeping down the rate of increase for clothing prices. Furthermore, stiffer competition in the food industry has led to food prices falling.

Inflation has recently been slightly higher than we had calculated on in the June Inflation Report. This is primarily due to the unexpectedly high price of oil. However, the domestic inflation rate was slightly lower during the summer than we assumed in our earlier assessment.

As before, our assessment is that inflation will rise in the near future. Increased cost pressures and rising capacity pressures should contribute to an increase in domestic inflation. At the same time, the factors that have dampened inflation over the past year – rapid productivity growth and increased competition – will continue to hold back price rises. We are therefore assuming that domestic inflation will rise at a slow rate over the forecast period.

Regarding the forecast for imported inflation, our assessment is that the effect of the price-dampening factors will decline somewhat. Although it can of course be assumed that the substitution for cheaper goods in imports will continue, rising global capacity pressures are expected to lead to higher international price pressures. Nor do we expect the krona exchange rate to continue to have the same price-dampening effect as it has had in recent years.

The fact that cost pressures and capacity pressures will rise in Sweden is also judged to affect consumer prices of imported products since these are processed and distributed before being sold on in the Swedish market. All in all, therefore, there is reason, in my opinion, to believe that imported inflation excluding oil will rise gradually over the coming year. However, I believe that it may remain relatively low.

Future monetary policy

The assessment is thus that inflation will rise over the coming years, but at a relatively moderate rate. Compared with the assessment we made in June, it now appears that inflation may turn out somewhat higher. In the short term, this is primarily due to the higher oil price. In the longer term, it is the higher growth rate that indicates a slightly higher inflation rate than we had forecast in June. However, this is partly counteracted by the fact that the underlying productivity growth in the economy may need some upward revision.

In the forecast of inflation that we will be presenting in the Inflation Report to be published next week, we will no longer be basing our forecast on the assumption of an unchanged repo rate. The point of departure instead is the policy rate expected by the market in the period ahead, as reflected in implied forward interest rates. With this point of departure - and taking into account the different risks that we envisage - it is reasonable to believe that inflation one to two years ahead will approach our inflation target of two per cent.

When the Executive Board convenes to discuss monetary policy on Wednesday next week, future inflation prospects will of course will the decisive factor for our decision. It is likely that we also will have a discussion regarding how we should view the continued rise in house prices. Personally, I do not think that there is any immediate hurry to raise the repo rate, something that the Executive Board also communicated in August. But it is clear nonetheless that this is the next natural step if the current outlook remains unchanged. When it may become appropriate to modify the currently very expansionary monetary policy depends, of course, as usual primarily on economic developments in the period ahead and on the assessment of future inflation.