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■ Monetary policy and the economy

Deputy Governor Irma Rosenberg spoke at Handelsbanken's lunch meeting in Västerås on Friday.

"In the Inflation Report published in early December, the Riksbank painted a relatively bright picture of economic developments in Sweden and abroad. We observed that growth in the world economy was at a high rate and could be expected to remain good over the coming years. We calculated that economic activity in Sweden would continue to strengthen. The information received since December indicates that economic developments have been slightly stronger than expected, both in Sweden and globally," began Ms Rosenberg.

"In the United States, developments appear compatible with the picture painted in December. While retail trade statistics up to the end of November indicate that US household consumption was slightly weaker than expected during the fourth quarter, consumer confidence has rapidly strengthened following the downswing earlier in the autumn. The purchasing managers index for December fell, but this was from a high level, and other economic indicators point to the stable developments continuing. With regard to the euro area, statistics for the third quarter confirmed that GDP growth had increased. It is a positive sign that a larger group of countries are now contributing to improvements in economic activity in the euro area. Both domestic demand and exports showed a good rate of increase. Available indicators, primarily from various business tendency surveys, point towards developments remaining good during the fourth quarter. The economic signals from Asia have also been largely positive. All in all, international growth prospects thus appear slightly stronger now than they did in December. With regard to prices, we can see that the oil price appears to be increasing slightly faster than was previously anticipated. However, consumer prices in the United States fell heavily in November. Inflation has also been slightly dampened in the euro area," continued Ms Rosenberg.

"The assessment of the Swedish economy in the December Inflation Report was that it would continue to develop favourably: growth was expected to be good and the labour market situation was expected to improve, with a clear rebound during 2006. The expansionary economic policy was expected to contribute to increasing both public sector and household consumption this year. At the same time, a weak krona, together with strong growth in Swedish export markets was



■ estimated to lead to good growth in exports. As a result of good growth conditions in the Swedish economy and a large surplus on the current account, the exchange rate was expected to gradually strengthen. However, we envisaged a risk that it might take longer than had been assumed before these fundamentals made an impact on the krona rate, which could give stronger inflationary impulses partly via import prices and partly via stronger growth in exports. This meant that our December analysis also contained an upside risk for inflation," said Ms Rosenberg.

"Since December, the krona has strengthened roughly in line with the forecast. This is probably partly connected to the expectations of the future repo rate having risen slightly since our December meeting. The new statistics that are available indicate that there may be reason for some upward revision in the growth forecast for the Swedish economy. The National Accounts for the third quarter of 2005 show that strong domestic demand and high growth in exports pushed up GDP growth as had been expected. The increase in consumption growth that began during the second quarter of last year continued during the third quarter, and retail trade statistics up to the end of November indicate continued good growth in household consumption. According to the most recent business tendency survey, Swedish companies are optimistic about the near future. It is mainly the construction industry and trade that are experiencing good growth. Construction activity is strengthening increasingly and orders have increased in recent months. The manufacturing industry, too, is still experiencing strong growth in export orders. The National Institute of Economic Research's (NIER) consumer survey shows optimism both with regard to economic growth in Sweden and with regard to private finances," Ms Rosenberg pointed out.

"New information on the labour market also indicates relatively positive developments. Employment and the number of persons in the labour force have increased roughly as we expected in December, according to the Labour Force Survey. The number of new vacancies has continued to increase and the number of redundancy notices has declined. The most recent NIER quarterly business tendency survey also indicates continued positive hiring plans in the construction sector and parts of the private services sector. According to the National Accounts for the third quarter, however, employment growth measured as the number of hours worked was weaker than expected and productivity growth in industry was therefore much stronger than had been estimated. This indicates that, despite high growth, future cost pressure will be held back," continued Ms Rosenberg.

"Inflation in the Swedish economy has been low since the end of 2003. According to the most recent data, for December 2005, annual inflation in terms of the CPI and UND1X stood at 0.9 per cent and 1.2 per cent, respectively. It is primarily the rapid increase in productivity that has dampened inflation. However, imported inflation has been surprisingly low for a long period of time. It has been held back by strong competitive pressure and the earlier krona appreciation. Our assessment in the December Inflation Report was that inflation would rise gradually and approach the target level as capacity utilisation and domestic and international cost pressures increased. However, inflation was expected to be below 2 per cent for the larger part of the forecast period," said Ms Rosenberg.

"It is important to bear in mind the fact that the assessment of inflation in December was based on the assumption of a gradual increase in the repo rate in line with expectations in the financial markets, as reflected in implied forward



■ rates. As I mentioned earlier, these expectations have risen slightly since the December Report. The fact that GDP growth in Sweden is expected to be stronger could justify a higher inflation rate in future. However, at the same time, productivity has once again risen more than expected, which contributes to subduing domestic cost pressures. Moreover, the krona has strengthened in line with our forecast and it is difficult to assess how this affects price trends. All in all, I therefore do not consider there to be reason at present to make any significant revision to our view of future inflation prospects; inflation can be expected to rise gradually towards the target of 2 per cent when capacity utilisation increases in the wake of the strong growth rate," said Ms Rosenberg.

"Given the strong growth in demand, we can expect a relatively modest upturn in inflation. This is something we have pointed out earlier. But as I have already pointed out, it requires that the repo rate is gradually increased. I therefore believe that there is reason, given the information we have today, to now take the first step towards normalising the level of the repo rate and thereby making monetary policy less expansionary. It would also entail a slight reduction in the stimulation effect on the housing market," said Ms Rosenberg.

"Let me conclude by reminding you that what we Executive Board members had slightly differing opinions on at the previous monetary policy meeting in December was exactly when the interest rate should be increased. At the same time, we were essentially agreed that it needs to be increased, which most other forecasters also seem to agree with and which the financial markets seem to have assumed. Next week the Executive Board will meet again to decide on monetary policy. Then we shall see which considerations are made and how my colleagues reason," concluded Ms Rosenberg.