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■ The Swedish economy and monetary policy

Deputy Governor Svante Öberg gave a speech at Öhman Fondkommission in Stockholm on Tuesday, on the theme of the Swedish economy and monetary policy.

"On 27 April, I and my colleagues on the Executive Board of the Riksbank decided to hold the policy rate unchanged at 2 per cent, on 11 May the minutes of the Executive Board's monetary policy meeting were published and on 19 May we published a description of the monetary policy framework. These events provide the basis for the speech I will give today," began Mr Öberg.

"At the meeting on 27 April we agreed to hold the policy rate unchanged. This decision was based on the inflation assessments presented in the Riksbank's Inflation Report in February and the new information on economic developments received since then. Underlying inflation was expected to approach 2 per cent, but to be below this figure during the forecast period. The forecast is based on the assumption of gradual increases in the policy rate," said Mr Öberg.

"However, the decision to hold the interest rate unchanged was not self-evident. Some of us expressed the opinion at the meeting that there was reason to consider an increase as early as April. I was one. I would like to take this opportunity to elaborate on my reasoning. This is in the light of the document we published on 19 May regarding the monetary policy framework," continued Mr Öberg.

"The Riksbank conducts what is known as *flexible inflation targeting*. I shall here take up three aspects of flexible inflation targeting: measures of inflation, taking consideration of developments in the real economy and taking into account financial developments," said Mr Öberg.

"Monetary policy is guided by various measures of underlying inflation. There is no single measure of inflation that at each point in time indicates the proper stance of monetary policy. The Riksbank can choose to disregard effects that contribute to inflation deviating temporarily from the target. This occurs on a regular basis with regard to, for instance, indirect taxes and household mortgage



■ interest expenditure, as well as supply shocks that are assessed as temporary. In practice, monetary policy today is mainly based on one measure of underlying inflation, UND1X," observed Mr Öberg.

"The Riksbank also takes into account developments in the real economy when making monetary policy decisions. In the preparatory works for the Sveriges Riksbank Act, it was stated that the Riksbank, without prejudice to the price stability target, should support the goals of general economic policy with a view to maintaining a sustainable level of growth and high rate of employment. If a disruption were to contribute to inflation deviating substantially from target, it is a question of judgement as to how quickly it should be returned to 2 per cent. Normally, monetary policy aims to attain the inflation target within two years. However, in some situations it may be necessary to allow a little longer time than two years for inflation to return to target, in order to avoid causing unnecessary fluctuations in the real economy," continued Mr Öberg.

"My experiences of forecasting work are that there is considerable uncertainty linked to longer-term forecasts. This makes it important to take into account different types of risk when making monetary policy decisions. One risk that I envisage is connected with the strong developments in the real economy – the strong growth and rapid increase in employment. We will probably attain a fairly normal capacity utilisation level in the labour market in the not too distant future, while the central wage agreements for the greater part of the labour market will be renegotiated next year. In the February Inflation Report, underlying domestic inflation was calculated at up to 3 per cent at the end of the forecast period, which reflects an expectation of relatively high domestic cost pressures," said Mr Öberg.

"In my opinion, there can be some risk that the expansionary monetary policy will overly reinforce the economic upswing and allow domestic prices and costs to rise. It could have more long-term consequences for price-setting and wage formation. The policy rate is still below what can be regarded as an average figure over a long period of time. The question is at what pace it should be raised to a more normal level. This will in turn depend on how the economy develops," considered Mr Öberg.

"Our monetary policy decisions also take into account changes in asset prices and other financial variables. At present, there is reason to give particular consideration to the credit expansion and to house price developments. This is primarily a question of avoiding severe fluctuations further ahead. When economic activity eventually begins a downswing, this could result in an abrupt adjustment with falling house prices and weak growth in demand. The risk of this type of development increases if monetary policy is excessively expansionary for too long," continued Mr Öberg.

"There has recently been unease on the stock markets. However, it is too early to draw any more far-reaching conclusions from recent events. As usual, the Riksbank will monitor developments and how these may affect inflation and other macroeconomic developments," concluded Mr Öberg.