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CONTACT Press Service, 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

■ Persson: The current economic situation

Deputy Governor Kristina Persson held a speech on Wednesday on the current situation in the world economy, the Swedish economy and monetary policy at a meeting organised by Byggmaterialdistributörerna (Swedish building materials distributors).

"The world economy has developed very strongly in recent years with an average annual growth rate of 5 per cent. The United States and parts of Asia, China in particular, had acted as growth engines for the world economy. Developments in the euro area have been subdued in recent years, but even there the recovery now appears to be underway. This has contributed to strong growth in exports and GDP in Sweden and now household consumption is also growing at a more rapid rate. One important factor behind this development is probably that the labour market has gradually improved over the past year. Profits and investment are also showing strong growth. Residential construction in particular has really accelerated," began Ms Persson.

"Globalisation has been an important driving force behind this broad-based and strong economic upturn. Over the past 15-20 years there have been large and far-reaching changes in the world economy that have opened up the way for a greater trade exchange and led to national economies becoming increasingly integrated. The greater economic openness in China, India and eastern Europe towards the rest of the world has created new markets and also increased competition," continued Ms Persson.

"At the same time as growth in demand in the world economy has been strong, pressures on consumer prices have been held in check. There has been a global decline in inflation since the beginning of the 1990s. In the industrialised nations the rate of price increase has averaged around 2 per cent in recent years. The main explanations are that monetary policy is now aimed at low inflation and that an increasing number of countries are participating in world trade, which has contributed to greater competition and to increased production in low-cost countries. Globalisation has thus contributed to holding back wages and prices in the industries exposed to global competition, while it has become possible to import products from low-cost countries to a greater extent. The stiffer



■ competition has also pushed companies in the old industrial nations to increase productivity, which also holds back inflation," said Ms Persson.

"In recent years, inflation in Sweden has been surprisingly low and significantly below the Riksbank's target of 2 per cent. During 2004-2005 inflation (measured as UND1X) averaged 0.8 per cent. This year there has been a gradual increase in inflation, but it still remains below the target. However, this development can hardly be due to low demand as GDP growth has actually been stronger than expected. Inflationary pressures have been held back by supply factors, particularly high productivity growth and weak growth in import prices," observed Ms Persson.

"Despite the strong growth in recent years, the labour market has remained weak, but in 2005 employment began to pick up again, after two years of falling employment figures. In recent months there has been a clear upturn in the number of persons employed. At the same time, more people are finding their way into the labour market as job prospects improve, which means that unemployment is falling at a relatively slow rate. The improved prospects in the labour market are also noted in the National Institute of Economic Research's latest business tendency survey, which indicates that the construction industry and parts of the private service industries have positive employment plans for the third quarter of this year," said Ms Persson.

"At the most recent monetary policy meeting on 29 August the Executive Board of the Riksbank decided that the repo rate would be raised by 0.25 percentage points. This decision was partly based on strong GDP growth so far this year, particularly in Sweden, but also abroad. The picture of strong demand is also supported by continued high lending to households and rapid increases in house prices. GDP growth appears likely to be higher this year and next year than we had forecast in June. Productivity has developed much more strongly than expected, which has a subduing effect on unit labour costs. However, the upturn in productivity growth was probably largely due to temporary factors. As economic activity continues to improve, the labour market will strengthen and productivity growth will slow down. This will lead to a gradual increase in inflation," continued Ms Persson.

"The Riksbank pointed out in connection with the decision that it is reasonable to assume that the repo rate will need to be raised further, approximately in line with market expectations, to ensure that inflation is in line with the target a couple of years ahead. I agree with this assessment," said Ms Persson.

"This requires that economic activity develops roughly as we foresee it, namely that the world economy reaches a cyclical peak this year and that this is followed by a slow adjustment to a slightly lower growth rate. However, we cannot rule out the possibility that the global economy will slow down more suddenly. Factors that could trigger this type of scenario are the ongoing slowdown in the US housing market, which together with a high oil price and higher interest rates could lead to a more severe slowdown in household consumption, and thereby growth. At the same time, the higher inflation means that the Federal Reserve does not have the same opportunities as before to stimulate the economy through interest rate cuts. A further risk factor is that the rapid growth in China risks leading to setbacks further ahead," concluded Ms Persson.