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■ Some aspects on financial developments

Riksbank Governor Lars Heikensten today spoke in Västervik at a seminar organised by Sparbanksstiftelsen Tjustbygden. Besides touching upon future developments in inflation, Mr Heikensten discussed some financial aspects.

"In this year's first Inflation Report, which was presented a couple of weeks ago, the Riksbank observed that the recovery in the world economy had become increasingly evident over the past half year. The economic upswing has progressed somewhat in Sweden too, with mounting export demand, continued optimism among households and firms, and favourable consumption growth. In the coming years we expected production growth to average just over 2 ½ per cent. The Swedish economy would thereby gradually approach full capacity utilisation. Against this background it is natural for price pressure to increase. Nevertheless we forecast inflation, as measured by UND1X, to be below target in the years ahead. High productivity coupled with a weak labour market and low imported inflation was expected to dampen the rise in prices. This forecast was the reason that we cut the repo rate by 0.5 percentage points. New data regarding both Swedish and international conditions have largely confirmed the picture we presented in the Inflation Report," said Mr Heikensten.

"Interest rates in the bond market are currently very low, especially in the light of the economic developments that we and most other economic agents expect. Low actual and expected inflation, and thereby also low key interest rates, are of course one important explanation. But there are also other factors that have caused interest rates to be unusually depressed. One contributory factor is that Asian central banks have been buying US Treasuries on a large scale in order to prevent an appreciation of their own currencies. The yield spreads between US Treasuries and riskier claims on other countries or firms have also narrowed markedly, stimulated by a favourable supply of liquidity around the world. As the global upswing strengthens and investment picks up, interest rates will return to higher, more normal levels," said Mr Heikensten.



■ "The low levels of interest rates combined with an improved profit outlook have also resulted in a broad rise in equity prices around the world in the past year. To some extent this is still due to cost-cutting, but there are many indications that firms have also increased their sales recently. The equity market's valuation indicates that equities in general are somewhat highly valued compared with the average in the past decade. At the same time it is not unusual for valuations to exceed the historical average at the beginning of an economic upswing. Once again it is mainly the IT and telecom sectors that have been pushing up equity valuations. Prices that rise rapidly can fall just as quickly if the forecasts do not materialise; I think it is good to remember this now that newspaper headlines once again are promising quick killings in the equity market. It is fundamental factors such as growth and the profit outlook that will determine the sustainability of these developments," noted Mr Heikensten.

"The low levels of interest rates have also contributed to a relatively sharp rise in household debt and house prices in many countries. There is a discussion as to whether the situation is sustainable and whether there is a risk of indebtedness becoming too high in the economy. Swedish household debt as a percentage of disposable income is approaching the levels seen at the beginning of the 1990s. But at the same time, due to low interest rates, households' interest costs as a percentage of their income have been more or less halved since then and are now at an historically low level. Nor when we look at households' balance sheets as a whole, i.e. household debt in relation to total wealth (financial assets and property), is the situation dramatic. The share of GDP attributable to consumption has not changed either, which suggests that the rapid build-up of debt has been used to a large extent to finance various assets, mainly housing. We are not concerned at present about the consequences of this situation for the payment system. Nor should it entail any great difficulties for the household sector as a whole. But problems could ensue for individual households once interest rates begin to rise, especially if property prices were to fall at the same time. So it is important that households themselves are vigilant in this regard. It is also something that banks and mortgage institutions have every reason to monitor carefully. Some firms are already carrying out detailed sensitivity assessments and analysing their customers' ability to pay also at higher levels of interest rates. I think this is wise," said Mr Heikensten.

"In all, neither financial developments nor new data regarding the real economy since the last monetary policy meeting have changed the outlook in any significant way. Economic activity is strengthening at the same time as inflationary pressure is judged to increase gradually. Looking a couple of years ahead, inflation is expected after our rate cut to be roughly on target," concluded Mr Heikensten.