SPEECH

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The current economic situation

In this presentation I shall begin with an account of the Riksbank's assessment of the economic situation abroad. I shall then discuss our assessment of economic developments in Sweden. These are the assessments we made at the monetary policy meeting on 30 June and published in our Monetary Policy Report on 1 July this year. I will also comment on new information received during the summer, but I will not make any new overall assessment of economic developments. We members of the Executive Board will not do this until the next monetary policy meeting, which will be held on 1 September. Finally, I shall report how the majority of Executive Board members and I personally viewed monetary policy at the end of June.

My presentation of the current economic situation can be briefly summarised in three points:

- The Swedish economy is developing strongly after the deep recession we have experienced. Inflationary pressures are currently low, but inflation is expected to rise as resource utilisation increases.
- At the most recent monetary policy meeting in June the members of the Executive Board decided to raise the repo rate to 0.50 per cent, and assessed that it would thereafter need to continue to rise towards more normal levels. The earlier extensive lending to the banks is being phased out.
- New information supports the Riksbank's view that the global economy and the Swedish economy are recovering. However, there are some signs of weakness in the United States and Asia, while Europe looks slightly stronger than expected. The unease on the financial markets has waned, but the situation is still not normal.

However, I shall begin by discussing international developments.

International developments

In the Riksbank's Monetary Policy Report earlier in the summer we painted a picture of international developments over the coming years that can be briefly summarised as follows: GDP growth will be strong in the world as a whole, but in Europe GDP growth will be modest and the upturn will start from a very low level. Inflation abroad will be relatively low. But these are of course just rough outlines. Behind them lie more detailed analyses and reasoning, which I will now go on to develop.

Recovery in world economy – strong growth in Asia

The recovery in the world economy is continuing. The rate of the recovery varies, of course, from country to country and region to region, but for the world as a whole we were expecting in June an annual GDP growth of just over 4 per cent over the coming three years. (Figure: Global GDP growth)

The IMF's most recent update to the forecasts for the world economy, in July this year, even implies a slightly higher growth rate this year and next year. Since April the IMF has also made an upward adjustment to its forecasts for this year's global GDP growth. However, the IMF is expecting much higher GDP growth in what is known as the BRIC countries – that is, Brazil, Russia, India and China – than in the more developed countries. (Figure: GDP growth in the BRIC countries)

Growth in Asia was also very strong at the beginning of the year. During the first quarter, the Asian growth economies expanded by the equivalent of an annual growth rate of 10 per cent. It is primarily demand from China that has benefitted other countries in the region. However, new statistics for the second quarter imply that China's GDP growth has slowed down, compared with the first quarter, which may imply some slowdown in Asia. GDP in Japan was also lower than expected during the second quarter of this year.

Growth in the USA slowing down

The US economy is also growing at a good rate after the GDP fall in 2009: our latest forecast is that GDP in the United States will increase by 3.2 per cent this year. One reason for this is the strong economic policy stimulation. However, our assessment at the end of June was that growth will slow down somewhat in 2011 and 2012, as the effects of the economic policy stimulation in the United States wane. (Figure: GDP growth in the USA)

Since we published our Monetary Policy Report in July, new statistics have been published, which indicate that US growth is already beginning to slow down. According to the preliminary National Accounts for the second quarter of this year, GDP increased by 0.6 per cent compared with the first quarter, which is marginally less than the 0.7 per cent we were expecting, and less than during the first quarter. Employment in the private sector rose in July, but was still slightly lower than expected. US unemployment remained unchanged at the same time, at 9.5 per cent.

There are also other signs of weakness. The housing market has not yet begun to recover from the deep fall in connection with the financial crisis. The purchasing managers' index for the manufacturing industry in the United States fell from 59.7 in May to 56.2 in June and 55.5 in July. Although an index figure above 50 indicates growth in the sector, these listings are the lowest since December 2009. (Figure: Purchasing managers' index).

Inflation in the United States has fallen in recent months. Measured in terms of the consumer price index, inflation was 1.2 per cent, but when foods and energy are excluded, it was unchanged at 0.9 per cent. The relatively low inflation is linked to the low resource utilisation in the United States, among other things. Wages are also subdued. (Figure: Inflation in the USA).

The US central bank, the Federal Reserve, noted at its most recent monetary policy meeting on 10 August that the recovery has slowed down and that inflation has fallen in recent months. The Federal Reserve's assessment was therefore that the recovery will be slightly weaker during the coming period than was previously anticipated. At the same time, the Federal Reserve repeated that it would hold its policy rate low for a longer period of time. They also notified that – unlike the ECB and the Riksbank – they will be holding the size of their balance sheet unchanged by reinvesting the funds the central bank receives when its holdings of securities mature in long-term government bonds. The Federal Reserve is thus postponing the start of its normalisation of monetary policy, compared with earlier indications. (Figure: Central banks' balance sheets).

Weak but rising growth in Europe

According to the Riksbank's forecast in June, GDP growth in the world as a whole will be strong. However, growth in our own region will be modest. The Riksbank's assessment was that GDP growth in the euro area will be 0.8 per cent this year, but that it will increase in 2011 and 2012. (Figure: GDP growth in the euro area).

The factor behind the upturn in the euro area is exports. Exports benefit from the strong growth in Asia and from the fact that the euro has weakened in relation to other currencies. But at the same time, the public finances problems in several European countries have led to a number of fiscal tightening packages, which will subdue domestic demand in the coming period. I shall return to this later.

Since our Monetary Policy Report was published, Eurostat has reported a flash estimate for GDP growth in the euro area for the second quarter of this year. This showed an increase in GDP growth of 1.0 per cent, compared with the first quarter, which was much more than the 0.3 per cent we were expecting, and much stronger than during the first quarter. The average level of GDP growth in the euro area was high thanks to very high growth in Germany. Moreover, the purchasing managers' index for the manufacturing industry in the euro area rose to 56.7 per cent in July. The economic recovery is also continuing in our Nordic neighbouring countries.

Inflation in the euro area was 1.7 per cent in July, measured in terms of the EU-harmonised consumer price index, the HICP, which may be considered a relatively high inflation rate given the low resource utilisation in the EU. But if one disregards energy and unprocessed foods, inflation was only 1.0 per cent in July, which is largely the same inflation rate as earlier in the year. (Figure: Inflation in the euro area).

Continued recovery in the world economy

To summarise the international economic situation one can say that the new information published during the summer largely supports the picture painted by the Riksbank of a continuing recovery in the world economy. But there are some signs of weakness in the United States and Asia, while Europe looks slightly stronger than expected.

Large deterioration in public finances in many countries

There were concerns at the monetary policy meeting in June over the possible consequences of the public finance problems in several countries. During the spring these problems had led to increased risk premiums in the financial markets and caused difficulties for many banks. In a worst case scenario, this could lead to a much weaker development abroad, which would also affect Sweden. I said at the monetary policy meeting that in this case we must be prepared to reconsider the direction for our monetary policy. Given this, I shall now specifically discuss public finance problems and developments in the financial markets.

Deficits in public finances and national debts have increased rapidly in many countries during the economic crisis. (Figure: Public finances in the OECD area).

Developments have been dramatic for some countries, and especially so for Greece. The poorer public finances have pushed up government bond rates and are making it difficult or almost impossible to fund the large deficits. Many other countries are also experiencing serious problems. To improve their public finances these countries are now implementing strict budget tightening, which is necessary to attain a stable long-term development in public finances. But at the same time, the budget constraints will in the short term subdue GDP growth, particularly in the euro area. (Figure: Interest rate differential against Germany).

Concerns over losses in the banking sector

The problems have also affected the banking sector. Banks normally include government securities among their assets, which means that they risk suffering losses if the countries to which they are exposed have problems managing their debt. As the public finances problems became increasingly acute in several areas during the spring, the market focused more on the exposures of the European banks to the countries with the greatest problems. The uncertainty over which banks risked making losses pushed up risk premiums on interbank loans. This was reflected in the basis spread, that is, the difference between the interbank rate and the expected policy rate. During the latter part of April and May the basis spread in the euro market and the United States rose. (Figure: Basis spread).

One measure of how the financial markets assess banks' credit ratings is the premiums paid for what are known as CDS – credit default swaps.[1] High premiums here entail a high credit risk. During the spring the CDS premiums for the European banks rose, particularly in Greece and Portugal, but also in Spain and Italy. An increased credit risk means that it becomes more difficult and more expensive for the banks concerned to fund themselves on the credit markets, which can hold back lending. This also dampens the real economies in the countries concerned. (Figure: CDS premiums for the banks).

[1] Somewhat simplified, one can say that a CDS is a contract where the buyer pays the seller a premium for the seller to take on the credit risk linked to an underlying asset, such as a bond. The premium then becomes a measure of the credit risk.

Reduced concern, but still not normal

In an attempt to assess the stability of the banking sector the Committee of European Banking Supervisors, CEBS, carried out stress tests on 91 European banks in July this year. The results of these stress tests have now been published. The assessment is that all but 7 banks have sufficient resilience to manage a worse scenario in the period 2010-2011. The CEBS has here assumed a weaker economic growth, higher interest rates and poorer stock market than in the European Commission's forecasts, as well as losses linked to the banks' holdings of European government bonds. The four major Swedish banks included in the survey managed all of the stress tests with a good margin.[2]

The results of the stress tests have generally been well-received by the market. However, it should also be pointed out that there has been some criticism, which has concerned the CEBS' assumptions not being sufficiently tough. Nevertheless, interest rate differentials towards Germany declined after the CEBS reported its results, as did the basis spreads and the CDS premiums for banks in the four countries concerned, although they have risen again in August and the levels remain higher than they were in the spring. However, during the summer the countries affected have managed relatively well in issuing government bonds, and the banks' interim reports have been positive. The European Central Bank has been able to reduce both its purchases of government bonds and its lending to the banks.

The general picture is, to summarise, that the unease in the financial markets has been subdued during the summer, at the same time as the situation is still not normal.

From this international perspective I shall now move on to a national one, and take a look at economic developments in Sweden.

Economic developments in Sweden

At the beginning of this presentation I summarised the picture of developments in Sweden painted in the Riksbank's Monetary Policy Report. The Swedish economy is developing strongly following the severe downturn. GDP was expected to grow relatively quickly over the coming years, and the labour market was expected to improve. Inflationary pressures are currently low, but are expected to increase as resource utilisation rises. I will now describe developments in the Swedish economy in a little more detail, and at the same time discuss new information received during the summer.

Strong GDP growth

The Riksbank's Monetary Policy Report from July forecasts relatively high GDP growth in the coming years: that Swedish GDP will grow by 3.8 per cent this year, and then by on average just over 3 per cent a year in 2011 and 2012. (Figure: GDP growth)

We could also note that the first quarter of the year had been better than expected. It is particularly pleasing that the upturn was on a broad front – all of

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[2] For the banks to manage the stress test their Tier 1 capital ratio, that is, their Tier 1 capital in relation to their risk-weighted liabilities, must not fall below 6 per cent. In the stress test the major Swedish banks' were calculated to have Tier 1 capital ratios of 8.9-10.3 at the end of the test period.

the components of GDP contributed to the upturn. Moreover, the Riksbank also saw good opportunities for a continuing recovery. Domestic demand is being maintained by a continued expansionary economic policy, combined with an optimistic view of the future in both the household and corporate sectors. In addition, growth abroad is expected to rise during the forecast period. This will contribute to an increased demand for Swedish export products, which in turn will benefit business sector investment as resource utilisation rises.

Our picture of a recovery in the Swedish economy is also supported by new statistics published after the Monetary Policy Report. According to Statistics Sweden's first preliminary compilation of the National Accounts for the second quarter of this year, Swedish GDP increased by 1.2 per cent, compared with the first quarter (seasonally-adjusted). This is slightly more than the 0.9 per cent we have assumed in our report, and also slightly more than other forecasters have expected. GDP has thus increased for five quarters in a row and has recovered half of the large fall totalling 8 per cent that took place during the previous five quarters. (Figure: GDP per quarter)

The picture of continued good growth is also supported by the National Institute of Economic Research's Economic Tendency Survey, which was presented at the end of July. Although the indicator fell between June and July this year, the fall was marginal and the indicator still points to the mood among companies and households being much stronger than normal. (Figure: Economic Tendency Survey).

The purchasing managers' index in Sweden rose to 64.2 on the other hand, which can be compared with a figure of 62.4 in the previous month. It was primarily increased orders and production that contributed to the rise. (Figure: Purchasing managers' index).

Moreover, new statistics show that industrial production has continued to increase strongly, and slightly more than market expectations, while the production of services has remained at an almost unchanged level. However, industrial production is still far below the earlier peak levels. (Figure: Industrial and services production).

Brighter labour market

The recovery in the labour market has also continued. Employment began to rise during the fourth quarter of last year, and unemployment has begun to fall. The forecast in our Monetary Policy Report is that unemployment will fall fairly slowly, and be just over 7.5 per cent in the year 2013. (Figure: Labour and employment and unemployment).

Since the report was published the labour force surveys for June have been published. These show that employment increased slightly more, and that unemployment was lower during the second quarter of this year, than we had forecast.

Inflation close to target of 2 per cent

In our Monetary Policy Report we expect inflation to remain fairly close to the inflation target of 2 per cent during the forecast period. This is because, despite strong GDP growth, resource utilisation will be low, and this will hold back domestic inflationary pressure. Inflationary impulses from abroad will also be weak. But as economic activity recovers and resource utilisation rises, inflationary pressures will increase.

Our assessment was therefore that underlying inflation – measured in terms of the CPIF, the consumer price index with a fixed interest rate – would fall towards 1 per cent this year, and then rise towards 2 per cent at the end of 2012. CPI inflation, on the other hand, had increased during the spring, and we expected it to continue to increase as a result of rising interest rates, until it peaks at almost 3 per cent in 2013. (Figure: Inflation).

Following the monetary policy meeting at the end of June, new inflation figures have been published for June and July. These show that the CPI and the CPIF rose by 1.1 and 1.7 per cent respectively in July, compared with the same month last year. Inflation is so far in line with the assessments in the Monetary Policy Report: in July underlying inflation was only 0.1 of a percentage point lower than the forecast in our Report.

Long-term inflation expectations

It is important to the Riksbank that long-term inflation expectations in society are anchored securely around the inflation target of 2 per cent. This makes our work easier. If most people expect inflation to be 2 per cent, this affects price-setting and wage-formation, so that we can more easily attain the inflation target in the long term (even if short-term fluctuations cause inflation to deviate from the target level). This is the reason why we carefully follow inflation expectations.

According to a survey from Prospera, inflation expectations for the coming five-year period were on average 2.2 per cent in June. This figure represents an average for all respondents. (Figure: Inflation and inflation expectations).

Recovery in the Swedish economy

To summarise, the new information presented during the summer supports the Riksbank's view that the Swedish economy is continuing to recover. GDP growth has so far this year been slightly higher than we had expected, and the labour market has shown slightly stronger development. Inflation has largely been in line with our forecasts. But this does not say very much about the future, of course. And as I mentioned at the beginning, I shall not make any overall assessment of economic developments here today; I shall wait until the Executive Board's next monetary policy meeting at the beginning of September.

I will now go on to describe how the Riksbank, and I personally, viewed monetary policy at the most recent monetary policy meeting at the end of June.

Swedish monetary policy

Following the financial crisis, monetary policy in Sweden has been aimed mainly at moderating the depth of the economic recession that came in the wake of the crisis. The repo rate has been held at an all-time low of 0.25 per cent for a whole year. The Riksbank has also provided the banks with more liquidity than normal, through a number of extraordinary measures. However, for some time now the situation has been such that we could begin to normalise monetary policy, and now in the final part of my presentation I shall describe in more detail our reasoning at the most recent monetary policy meeting.

Normalisation of the repo rate

In July we raised the repo rate from 0.25 to 0.50 per cent. I agreed with the picture of economic developments painted in the most recent Monetary Policy Report and supported both the proposal to raise the repo rate by 0.25 percentage points and the repo rate path described in the Report. But I also pointed out that we must be prepared to reconsider the direction of our monetary policy, if developments abroad turn out to be much weaker than we have expected. (Figure: Repo rate).

Back in April we were expecting to need to raise the repo rate either in July or September. We later had to make a substantial upward revision to the forecast for GDP growth this year, at the same time as the forecasts for inflation and wages remained largely unchanged. This pointed towards raising the repo rate in July rather than waiting until September.

But, despite the fact that the forecast for GDP growth in 2010 had to be revised up substantially, we were nevertheless expecting resource utilisation to remain low for most of the forecast period, and inflationary pressures to be modest. This pointed towards the repo rate needing to be held at a lower rate than normal over the coming period. However, our joint assessment was that we ought to ease up on the accelerator and gradually raise the repo rate towards a more normal level, as resource utilisation increases.

I also felt it was reasonable that we in Sweden should begin to raise interest rates sooner than the United States and the euro area. This was because we were forecasting a higher GDP growth and a slightly higher inflation rate in Sweden, particularly in comparison with the euro area, in June. Moreover, our assessment was that fiscal policy in the United States and the euro area would probably need to be tightened much more than in Sweden, which meant that these areas would need to hold their interest rates lower.

Another reason for beginning to raise interest rates was to clearly mark that interest rates will in the long run be much higher than they are now. Otherwise there is a risk that companies and households will base their economic decisions on too-low long-term interest rate expectations, which can lead to unsustainably-high loans and distorted investment decisions. This can in turn entail negative effects on production and employment.

Unrealistic expectations of interest rates

The low interest rate we have had over the past year has probably held back expectations of interest rates in the longer run, too. According to Prospera's surveys, expectations of the repo rate five years ahead have fallen by around one percentage point since we began making large cuts in the repo rate in autumn 2008. (Figure: Repo rate and expected repo rate).

Market expectations in June were well below the interest rate path, and the gap was also unusually large. This implies that monetary policy was in practice much more expansionary than we had intended. (Figure: Monetary policy expectations).

The National Institute of Economic Research's surveys of expectations of variable mortgage rates moreover implied that households were expecting relatively low interest rates in the longer run. In June, households were expecting a variable mortgage rate of 4.3 per cent in five years.

It is important for monetary policy that expectations of the interest rate are in line with the repo rate path. This is because it is market expectations of interest rate developments, and not the Riksbank's own repo rate path, which determine the interest rates offered to households and companies. In addition, households' and companies' own expectations of interest rates govern their actions. Thus, expectations of future interest rates are important for the development of the economy. At the same time, the Riksbank's ability to steer expectations in the longer run is limited in that we only steer the shortest interest rate, the repo rate, while the repo rate path is only a forecast.

During the summer, market expectations of the repo have risen slightly in the short term, but fallen by more than 30 basis points in the longer run. Household expectations of variable mortgage rates, on the other hand, have risen significantly according to the National Institute of Economic Research. They are now largely consistent one and two years ahead with the Riksbank's repo rate path from the most recent monetary policy meeting. However, households were still expecting a relatively low mortgage rate five years ahead.

Normalisation of monetary policy in general

The normalisation of monetary policy includes, in addition to interest rate raises, the phasing out of the support the Riksbank has given to the banks. When the Riksbank decided to lend almost SEK 300 billion at a fixed interest rate last year, it was also decided that the banks would pay back the loans on 30 June, 25 August and 6 October this year. In addition, some variable-rate loans will mature.

Despite the phasing out of the fixed-rate loans being known in advance, it could affect money market rate, pushing them up until the final loans mature. This is when the interbank market will really have to begin functioning as normal. The effective policy rate is also expected to return to being in line with the repo rate instead of the fine-tuning rate, which is 10 basis points lower than the repo rate.

When the first fixed-rate loans totalling SEK 100 billion reached maturity on 30 June, the Riksbank's total lending to the banks declined by SEK 91 billion. At the same time, other loans also matured, while new variable-rate loans with a one-month maturity increased by SEK 20 billion. The whole process was carried out without any disruptions to the markets. The outstanding loans have since declined further and now amount to SEK 222 billion. (Figure: the Riksbank's outstanding loans).

Summary

I have now described the Riksbank's views and my own personal views of economic developments and monetary policy in Sweden as at the most recent monetary policy meeting. The Swedish economy is currently developing strongly, after suffering a deep recession. Inflationary pressures are low, but are expected to rise as resource utilisation increases. Monetary policy is still aimed at supporting the recovery in the economy, but a normalisation has begun. According to the assessment we made in June, the normalisation process will continue gradually through interest rate adjustments and the maturity of fixed-rate loans.

The new information we have received over the summer largely supports the picture of the recovery in the world economy continuing. There are some signs of weakness in the United States and Asia, while Europe looks slightly stronger than expected. The unease on the financial markets has waned, but the situation is still not normal. The new information also points to a continued recovery in the Swedish economy.

However, the Riksbank will not make any new overall assessment of economic developments until the next monetary policy decision, which will be made on 1 September. By then we will have received more information and we will update our forecasts.

Thank you!