

## Lars Heikensten: The current economic situation

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, at a seminar organised by the SNS Center for Business and Policy Studies, Stockholm, 16 November 2005.

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"The Riksbank's most recent assessment of inflation prospects was published in Inflation Report 2005:3 on 20 October. There we painted a bright picture of economic developments in both Sweden and abroad. International growth was expected to remain good. In the United States, the strong growth was expected to slacken somewhat, mainly due to tighter monetary policy. This was expected to be counteracted to some extent by higher growth in the euro area. At the same time, it was considered probable that the strong growth in Asia would continue. As before, the growth figures in China were expected to be high, while the situation in Japan for the first time in more than a decade appeared to be relatively stable with rising growth. All in all, the global growth rate was expected to be between 3.5 and 4 per cent, which is slightly lower than last year, but still entails good opportunities for Swedish exports," said Mr Heikensten.

"The information received since the Inflation Report was published largely confirms this assessment. Despite hurricanes and a high oil price, US households and companies have continued to increase their consumption and investment at a stable rate. Elsewhere in the world, too, we have seen a number of positive economic signals. For instance, the purchasing managers index for the manufacturing sector rose in both the euro area and Japan in October. Recent statistics thus indicate that international economic activity remains strong and that developments are largely in line with the assessment made in the Inflation Report. This also means that there may be less reason for concern over international developments than has sometimes been the case in recent years," continued Mr Heikensten.

"With regard to the Swedish economy, we observed in October that economic activity had accelerated again after the slowdown at the beginning of the year. Exports were expected to show strong growth. The investment upturn that began last year was expected to continue, but gradually enter a calmer phase. Private consumption was also expected to rise more rapidly given, for example, a good growth in real wages, expansionary fiscal policy and a gradual increase in employment. All in all, we foresaw a fairly good growth rate and a normal economic cycle, where domestic demand would become more of a driving force. Given this background, we were assuming there would be a turnaround for the better in the labour market," said Mr Heikensten.

"New data also largely confirm the earlier picture with regard to economic activity in Sweden. The most recent business tendency survey paints a bright picture of the situation in most sectors included in the survey, and foreign trade statistics indicate stronger growth in exports. In line with developments elsewhere in the world, the Swedish purchasing managers index for October also showed a positive development. The expected upturn in private consumption is confirmed by new information, in this case turnover in the retail trade sector. The picture of a gradual, cautious strengthening of the labour market is also supported by incoming data regarding, for instance, new job vacancies, redundancies and companies' recruitment plans. Employment appears if anything slightly stronger than was expected," said Mr Heikensten.

"Inflation in the Swedish economy has been low since the end of 2003. According to the most recent data, for October, annual inflation in terms of the CPI and UND1X stood at 0.5 per cent and 0.8 per cent, respectively. The low domestic inflation rate is largely due to a surprisingly rapid increase in productivity. At the same time, imported inflation has been kept down by strong global competitive pressure, spare resources in the global economy and a previously relatively strong krona. Our assessment in the Inflation Report was that inflation would increase in future, but at a fairly moderate rate. At the beginning of the forecast period the oil price in particular was expected to push up the rate of price increase. After that, rising capacity utilisation in Sweden and abroad, together with diminishing effects of a number of price-dampening factors, was expected to lead to inflation rising. Against that background, our assessment was that UND1X inflation would rise from the current low levels and be close to the target a couple of years ahead," observed Mr Heikensten.

"Experiences show that the situation in the financial markets is often slightly uneasy during phases when interest rates are adjusting upwards. This has also been the case over the past year. There appears to have been unusually clear focus on differences in short-term rates between different

countries, which has had repercussions for the krona. Let me therefore underline that it is not at all strange that Swedish short-term rates have been lower than those in many other countries. For various different reasons, some of which I have mentioned earlier, inflation has been much lower in Sweden than in other countries. Compared with the United States and the euro area, the difference is between 0.5 and 1 percentage point on average for the past three years, depending on which inflation measure is used. In 2004, the difference was as much as 2 percentage points. When one looks ahead, which is important in this context, according to Consensus Forecast, forecasters are expecting higher inflation in the euro area and the United States than in Sweden," continued Mr Heikensten.

"It is clear that the krona has developed more weakly since the spring than the Riksbank expected. As you know, we do not have a target for the exchange rate. However, it is an important factor when we assess future inflation. In this context it is not the present exchange rate that is decisive, but how we see it developing in a slightly longer-term perspective. There is no reason to depart from the basic assessment we made earlier; there are still strong reasons in favour of a stronger krona. It is not merely that Swedish macro data in general has developed well over a number of years compared with, for instance, the euro area; most forecasts indicate that this development will continue. Sweden is also one of the countries that has had the highest trade surplus as a percentage of GDP over a number of years, which is one indication among many that the value of the krona has been relatively low. However, even if we should not – as I see it – change our basic assessment that the krona will strengthen, its value at present is rather different. There is therefore reason to take into consideration a risk scenario for inflation linked to a weaker exchange rate. Just as the Riksbank emphasised during 2003 and 2004 that the strong krona was one reason behind the low inflation rate, there is reason to point out that the weakening of the krona this year, particularly if it persists, could result in higher inflation," said Mr Heikensten.

"All in all, I do not at present see any reason to change my view of inflation now to any great extent, compared with the October assessment. However, in my opinion, the changes that have occurred would appear to indicate slightly stronger economic growth and perhaps also the risk of a slightly more rapid rate of price increase, mainly connected with international inflation and a weak krona. Given the information we have now, the financial markets' expectations of a repo rate increase some time next year appear reasonable. As I see it, this conclusion is supported by the strong growth in the real economy and the increased risks that follow on from a continued rise in house prices," continued Mr Heikensten.

"Let me conclude with a few more general reflections. It is quite natural given the current situation with extremely low interest rates and stimulation from monetary policy that the time for a repo rate increase is approaching. There have been increases in the repo rate on a number of previous occasions since inflation targeting was introduced, without any dramatic consequences. This is essentially a natural consequence of the strong economic growth and something that could contribute to safeguarding continued stable development in the Swedish economy during coming years," concluded Mr Heikensten.