Separate minutes of the Executive Board meeting, No. 20

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DATE: 1 December 2005

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg
Claes Berg
Mårten Bjellerup
Jörgen Eklund
Victoria Ericsson
Kerstin Hallsten
Jyry Hokkanen
Ann-Christine Högberg
Pernilla Meyersson
Anders Vredin
Arvid Wallgren (§1)

§ 1. The current inflation assessment

It was noted that Mårten Bjellerup and Victoria Ericsson would prepare draft minutes of § 1 and 2 on the agenda for the meeting.

The discussion was based on the analyses and new data presented by the Monetary Policy Department. These analyses are based on the assumption that the repo rate will develop in line with the financial markets' expectations, as reflected in implied forward rates. This is a technical assumption for the purposes of calculation and should not be interpreted as reflecting the interest rate path the Riksbank considers to be most desirable.

1. Recent data regarding economic developments

The Monetary Policy Department reported on new data received since the last Executive Board meeting, 24 November.

CPI inflation in the euro area in November showed an increase of 2.4 per cent on an annual rate. GDP growth during Q3 in the United States had been revised up to an annual rate of increase of 4.3 per cent, which exceeded market expectations. Consumer confidence in the United States had risen, following a two-month decline. Pricing of Fed Fund futures reflected an upturn in expectations of the US key rate to around 4.75 per cent at the end of the spring. Monetary policy expectations in the euro area had also risen and corresponded to a key rate of around 3.25 per cent one year ahead.

In Sweden, sales of durables showed an upturn of around 10 per cent on an annual rate in October, which contributed to stronger statistics from retail trade than market agents had expected. The consumer confidence indicator fell for the third month in a row, from 12.2 in October to 9.9 in November. The purchasing managers index for November had also fallen somewhat, compared with the previous month, but still indicated that the economy was expanding. Households' inflation expectations in October amounted to 1.9 per cent one year ahead.

In Sweden, short-term interest rates had risen slightly, while long-term interest rates had remained almost unchanged. Three-month FRA contracts with a maturity of less than one year had risen by 4 points. Some of this increase could be attributed to the market's reaction to Villy Bergström's speech on 25 November. The implied forward rates were now slightly higher than the average up to 11 November shown in the Inflation Report. The krona had weakened slightly against the dollar, while it had remained largely unchanged against the euro.

2. The economic outlook and inflation prospects

Deputy Governor Irma Rosenberg presented the draft Inflation Report 2005:4, Annex A to the minutes. This Inflation Report reproduces the main features of the presentations and discussions at the Executive Board meetings on 14 and 24 November 2005.

It was observed in the Inflation Report that world growth had increased again, following a slowdown earlier in the year. The assessment in the October Inflation Report was that global capacity utilisation would rise, but that GDP growth would slow down slightly. This picture remained largely unchanged. Since October the oil price had fallen more than expected, which had led the Riksbank to revise down its forecast for the oil price. Inflation had been unexpectedly high in both the United States and the euro area. An upward revision had therefore been made in the forecast for international price pressure in 2005 and 2006.

Interest rates abroad had risen since October. There were numerous indications that this was partly connected with the robust economic activity and rising inflation. These developments had also led to an increase in Swedish interest rates. The krona had been weaker than expected. However, the favourable growth prospects in Sweden and the surplus on the current account indicated that the krona would strengthen during the

forecast period. In addition, the interest rate differential vis-à-vis the rest of the world was expected to decline.

The data received since October confirmed the picture of continued good economic growth in Sweden, following the slowdown earlier in the year. The driving forces behind growth would be expansionary economic policy, good export market growth and large corporate earnings. There were also signs that the situation in the labour market was improving. All in all, this meant that capacity pressures would rise. Some upward revision had been made to the forecast for GDP growth this year and next year, partly because new information indicated that developments had been slightly more robust than expected. At the same time, the weaker exchange rate was expected to provide further stimulation to exports.

Inflation had risen somewhat recently but remained low. The assessment was that inflation would continue to increase, partly as a result of rising capacity utilisation in Sweden and abroad. However, the upturn was expected to be moderate. The effects of a weaker exchange rate and slightly higher international inflation would be partly counteracted by a lower forecast for the oil price than was made in October. All in all, UND1X inflation was expected to rise gradually and to be approximately in line with the 2 per cent target a couple of years ahead.

Growth prospects for the world economy and the Swedish economy were now judged to be slightly less uncertain. However, there was still some uncertainty over economic developments and inflationary pressures linked to the oil price and to global imbalances. Important domestic uncertainty factors were, as before, developments in productivity and increased competition. In addition, there was a risk that the krona, particularly in the short term, would not strengthen as anticipated, despite fundamental factors still indicating a stronger krona. The Riksbank's assessment was now that the risks of higher inflation than in the main scenario were greater than the risks of lower inflation.

The Executive Board made the assessment that the new information received since its meeting on 24 November did not give reason for a change in the view of inflation developments, compared with that presented in the Inflation Report.

The Executive Board decided

- to adopt the Inflation Report as presented and
- to publish the Inflation Report at 9.30 a.m. on 2 December.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented a proposal for the monetary policy decision.

Growth in the Swedish economy was assessed as good over the coming years and the forecast had been revised upwards slightly for 2005 and 2006, compared with the October forecast. The information received since then had also to some extent dispersed uncertainty over economic activity in Sweden and abroad, and the assessment was that inflation would rise when capacity utilisation increased. Given this, it was reasonable that the time was approaching to steer monetary policy in a slightly less expansionary direction. As before, there was also reason to consider the increased risks that followed on from the rapid increase in house prices and household indebtedness.

However, there were also reasons why there might be a further delay before increasing the interest rate. The inflation picture was essentially favourable. Inflation was still low, as were cost pressures, and this was linked to productivity growth. The assessment was that inflation would rise when capacity utilisation increased in Sweden and abroad, but at a relatively slow rate. The forecast in the main scenario meant that inflation a couple of years ahead was expected to be in line with the target of 2 per cent, while the real economy was expected to show balanced growth. Nor was there any problem with inflation expectations; they were on the whole well in line with the target. The labour market was still weak. There were clear signs that an improvement was on the way, but employment had as yet showed only a limited increase. The labour market policy measures were increasing fairly strongly and next year they would account for a substantial part of the increase in employment. Total unemployment, i.e. open unemployment and labour market policy measures in total, was expected to remain close to the same high level in 2006 as in 2005.

The inflation forecast was based on the assumption that the repo rate would develop in line with market expectations, as reflected in average implied forward rates during a 15-day period up to 11 November. That meant on this occasion that the repo rate was expected to remain unchanged at the present meeting and that increases were expected to begin some time early next year. This was expected to lead to inflation being in line with the target a couple of years ahead and to stable developments in the real economy. If the repo rate were instead assumed to remain constant throughout the forecast period, inflation would rise at a slightly more rapid rate and would be marginally above the target level towards the end of the two-year forecast horizon. In the considerations of when would be the right time to raise the repo rate, the market's expectations of some time at the beginning of next year therefore appear reasonable. My proposal for a decision at today's meeting is that the repo rate should be held unchanged.

One uncertainty factor worth special comment was the development of the exchange rate. The krona had shown weaker development than expected. Many factors suggested that this was largely connected to short-term financial flows that were affected by expectations of the development in different central banks' key rates over the coming period. The krona was still expected to strengthen, although the forecast for the future development of the krona had been adjusted down somewhat. This had also led to a slight upward revision in the inflation forecast. If the krona were to remain weak longer than had been forecast, and several economic agents were to begin to regard the weakening as permanent, there was a greater risk that inflation would be pushed up more than expected. This could force the Riksbank to make a quicker and sharper adjustment to the repo rate than the market was now expecting.

One member agreed with the revised picture, both with regard to the analysis and the conclusions. The member considered that there was now reason for greater confidence with regard to economic developments abroad, particularly in the United States and China. Growth in China remained strong and investments appeared to have been subdued somewhat in the most overheated sectors, such as property and infrastructure. This indicated that a soft landing was possible. The Chinese authorities were exerting themselves to attain a more balanced development, for instance, by improving the conditions for an increase in domestic demand. The revaluation of the currency in July could be regarded as a stage in this work. Economic developments in Asia were also supported by increased growth

in Japan. In addition, there were signs of a broad upswing in the US economy; for instance, the most recent labour market statistics had been better than expected and the temporary effects of the hurricanes were abating.

Although the imbalances in the world economy remained and were increasing, the risk of an abrupt adjustment in the near future appeared to have declined. However, the longer the period until an adjustment began, the greater was the risk of a more sharp correction further ahead.

With regard to the Swedish economy, a positive trend appeared to be confirmed by increasing investment, an upswing in private consumption and the beginning of a labour market rebound. The member agreed that the time for an interest rate increase was approaching, but that the repo rate should be left unchanged at today's meeting.

Another member observed that international growth was fairly good. The United States was still the growth engine, and had been so for the past decade. The member noted that the risks faced by the world economy connected with the US current account deficit would increase as long as the United States held this dominant position.

Growth in Asia had also been good. The recovery in Japan appeared to be stable and persistent, which was positive for world trade. There were also some positive signs in the euro area. However, the member expressed doubts that the new German government's intention to raise VAT in 2007 would lead to households bringing forward some of their consumption. Nor could the German government count on falling long-term interest rates assisting in the planned budget consolidation, which Sweden could benefit from in the mid-1990s. Germany thus constituted a braking factor. Some of Sweden's other major trade partners in the euro area were also experiencing economic problems. These countries' planned budget consolidations reduced the scope for growth in demand over the coming years. However, Sweden's export markets were on the whole showing a growth rate of around 6 per cent, which was in line with the historical average. If the krona depreciation continued, there was a chance that Swedish companies would increase their market shares abroad. There were no clear effects of the high oil price visible in the real economy.

Monetary policy could easily lag behind, given the Swedish economy's present situation, continued the member. At present, all components of demand were showing rapid growth. The increase in consumption would be supported by a substantial improvement in real disposable incomes next year and the rate of increase in investment was higher than that for GDP growth. Public expenditure had increased only marginally over a long period of time, but was expected to rise sharply and exports were strong, with an increase of around 6 per cent. Moreover, the upswing in exports might have been underestimated, given the weak krona. There were signs of a strong increase in exports among small companies. The fact that the labour market was the weak point in the economy was due to structural factors and not to low demand. One sign of this was increasing demand for staffing services, which was further increased by a regulatory framework that restricts ordinary recruitment. In addition, the construction sector stated that there was a shortage of labour, despite relatively high unemployment in the sector. Fewer redundancy notices and more job vacancies indicated that the situation in the labour market was improving.

The economic cycle and the parliamentary cycle were reinforcing one another on this occasion, which meant that developments could move more quickly than was forecast in the

risk assessment. Low interest rates, a weak exchange rate and expansionary fiscal policy generated increases in real income, which could contribute to a substantial increase in consumption in 2006.

The member considered it appropriate to recuperate some of the interest rate cut of 50 points in June to avoid acting too late. This would also function as a signal that could subdue house price trends and household indebtedness. Given this, the member advocated raising the repo rate by 25 points, and considered that the next increase could then wait until a few months into 2006.

A third member agreed with the assessment made in the Inflation Report. The statistics received since the cut-off date for the Inflation Report confirmed that growth abroad had improved roughly in line with the forecast. New information indicated stronger developments, if anything, for instance growth in the United States in Q3 had been revised up to 4.3 per cent on an annual rate. In the euro area, too, the data indicated that the forecast for the whole year 2005 probably needed to be revised upwards. The member objected to the previous member's description of the euro area's fiscal policy causing a risk of lower growth. According to the existing plans, the structural deficit would remain largely unchanged over the coming two years. With regard to Asia, the upturn appeared stable in Japan and South Korea, too. Inflationary pressures had also risen, which had led to several central banks raising their key rates or signalling future raises. However, in many cases the increased price pressures were as yet only visible in producer prices and no marked secondary effects from the high energy prices had been noted.

The member observed that incoming figures regarding Sweden were also roughly in line with the forecast of an increasing growth rate. Exports were improving, consumption was accelerating, disposable incomes were increasing and the labour market situation looked brighter. House prices and credit growth were continuing to increase substantially. It would not be surprising if Swedish growth in 2005 was higher than the current forecast in the main scenario of the Inflation Report. In future, growth could also be higher if households returned to the historical pattern of utilising increases in real wealth for increased consumption, which could be the case if the labour market improved, for instance.

The member agreed with the previous member regarding the monetary policy situation. Economic policy was very expansionary. Compared with the June Inflation Report, the forecast for GDP growth for the current year had been revised up by 0.5 percentage points. The early part of 2005 was not looking as weak as it had done in June. Since then, fiscal policy had become more expansionary and the krona had been weaker than expected.

The forecasts based on both implied forward rates and a constant repo rate showed that the rate would need to be raised during the forecast period to prevent inflation exceeding the target. The question was whether this should begin now or at the beginning of next year. Given the information available in June, it was reasonable that the monetary policy considerations emphasised capacity utilisation and inflationary trends a couple of years ahead. At the same time, less emphasis was placed on developments in house prices and indebtedness and the risks they entailed for demand and inflation in the slightly longer term. Now the constant repo rate forecast was indicating that inflation would exceed the target towards the end of the forecast period, and growth was good. It would therefore be reasonable to begin raising the rate by 25 points at the current meeting. This reduced the

risk of the krona remaining weak and thereby the risk of even higher inflation than assumed in the main scenario. An increase in the repo rate would also contribute to reducing the risk of clearly exaggerated house prices and excessive indebtedness.

Another member observed that the assessments made in the Inflation Report could support different conclusions, but that a rate increase at the present meeting would surprise financial market agents. It was important to prepare both the financial markets and the general public for changes in the repo rate, particularly if these entailed the beginning of a new interest rate trend.

The member emphasised that the focus of the monetary policy decision should lie on the inflation forecast, unless there were very strong reasons otherwise. According to the forecast for which all of the Executive Board members had expressed their support, inflation would be clearly below the target one year ahead, even if the Riksbank waited a little before raising the repo rate. After that, inflation would rise slowly and be in line with the target two years ahead.

It was true that demand was growing rapidly, but the decisive factor for inflation was not normally demand in itself, but capacity utilisation. It did not appear that there would be any dramatic increase in capacity utilisation in the near future, at least not in the labour market. Wage negotiations for large areas of the economy would be held in 2007, which meant that there would hardly be any significant changes in the rate of wage increase over the coming year. For the same reason there was no need to raise the interest rate now to signal to social partners that they should show restraint. However, rising house prices were a cause for concern. Rising interest rates would mean there was reason to expect the rate of price increase on housing to slow down, or even for prices to fall. If there were an abrupt adjustment, it could have negative consequences for the real economy. The difficult consideration was when and at what pace the interest rate should be raised.

In the United States, monetary policy tightening did not begin until a clear rebound could be discerned in the labour market. With regard to the euro area, the interest rate raise should be regarded in the light of inflation having been above 2 per cent for a number of years, which meant that the situation was not directly comparable with Sweden's. Differences in capacity utilisation and inflation assessments could therefore explain why there was reason to have a lower interest rate in Sweden than in, for instance, the United States and the euro area.

The interest rate differential appeared to be the most important reason for the recent weak development in the krona. During the autumn there had been a strong link between the development of the krona and FRA contracts. When the monetary policy signalling resulted in interest rate movements, it also had immediate effects on the value of the krona. The recent depreciation of the krona had therefore not been linked to any fundamental concern regarding the Swedish economy and inflation in the long term; it was more due to temporary conditions in the financial markets.

It was evident that an interest rate rise would be needed as capacity utilisation increased and inflation rose. The reasoning regarding recovering the cut made in June was reasonable, but according to the assessment in the Inflation Report, the adjustment could be made some time after the New Year. Given this, the member supported the proposal to hold the repo rate unchanged at today's meeting.

A further member observed that there was no immediate inflation risk during the forecast period. According to the Inflation Report, Sweden was in a phase of the economic cycle where a gradual interest rate upturn was to be expected. The question was when this should begin and at what pace. The member claimed that several small interest rate adjustments were preferable and indicated three reasons for taking a preliminary step and raising the rate by 25 points now.

The first reason was that the economic upturn appeared strong, not insignificantly stronger than at the monetary policy meeting in June, when the Riksbank cut the repo rate by 50 points. International growth had been higher and seemed less uncertain now than then, in particular in the United States, Japan and the rest of Asia. In Sweden, companies were reporting good profits, investment was increasing and retail trade turnover was growing. The labour market, where there was a substantial question mark last spring, was showing signs of recovery. Demand for labour had increased, which was clear from the statistics provided by staffing services companies. In addition, economic policy was strongly expansionary.

The second reason was linked to the fact that the krona had been weaker than expected. The member agreed with the assessment that the interest rate differential with regard to the euro area and the United States appeared to have significance for the krona rate at present. If the ECB chose to raise its rate at today's meeting, there was a risk the krona would depreciate further, which could provide even more stimulation for demand in Sweden.

The third reason was connected with the fact that house prices and household indebtedness had continued to increase during the autumn and would probably increase further in the positive main scenario outlined in the Inflation Report. However, economic activity would gradually slow down again. If households then experienced that their level of indebtedness was too high, they might want to increase their savings rapidly. Then demand for housing would decline and prices would fall. This could lead to households perceiving themselves as poorer and therefore wishing to increase their saving even more, which would further accentuate the downturn in economic activity. There is reason to be very cautious of these self-reinforcing spirals. An interest rate increase would send the signal that the house price trends of recent years were not sustainable in the long term. The member pointed out that in both Australia and the UK, limited interest rate increases had caused the rate of price increase on housing to slow down.

Another member pointed out that the proposal to raise the repo rate did not entail a change in the monetary policy strategy. The forecast in the main scenario provided an inflation rate in line with the target, but the forecast using the assumption of a constant repo rate showed inflation exceeding the target two years ahead. The member considered that the interest rate differential with regard to the euro area and the United States would increase if the repo rate was not increased at the present meeting. This could lead to continued krona depreciation, which would increase the risk of inflation exceeding the forecast.

One member pointed out that several of the colleagues advocating an increase in the repo rate had primarily referred to strong demand and not directly to the inflation forecast. According to the Riksbank's clarification, monetary policy was primarily aimed at influencing inflation one to two years ahead. It was not until well into the second year that inflation

would exceed the target if the repo rate was not increased, and it was therefore not at all self-evident that the rate should be raised now.

The member also pointed out that the interest rate differential was a problem that could be managed in different ways. One way was, as some members had advocated today, to raise the repo rate by 25 points. Another was to clearly communicate that interest rate raises were necessary in the near future, and that they might need to be stronger than market pricing currently indicated.

A further member considered that it was not possible, given the inflation forecast of very slowly rising inflation over the coming two years, to justify an interest rate increase at the present meeting. This would almost be a case of questioning the inflation forecast. That would certainly be the case since there was no sign of strain in the labour market. So far the number of hours worked was increasing and not the number of persons employed, which meant that it could be some time before inflationary pressures were created in the economy. At present it was difficult to see where the inflationary threat would arise. It would be good if the Swedish economy developed so strongly that there was soon reason to raise the repo rate. This situation would probably arise some time at the beginning of next year.

One member objected to the comment that an interest rate increase in this situation would entail questioning the inflation forecast. The member considered that the assessments in the Inflation report provided scope for both leaving the repo rate unchanged and for raising it by 25 points. The entire Inflation Report reflected that the time for tighter monetary policy was approaching, the question was merely when. Taking a cautious first step towards less expansionary policy would be quite in line with the inflation target.

One member agreed with this and at the same time pointed out that the reference to other countries' interest rate policy was not made with the intention of claiming that the Riksbank should follow them; the intention was to stress that inflationary pressures abroad had risen to such an extent that there had been interest rate increases in some parts of the world. With regard to growth, it was understood that increased growth led to higher capacity utilisation. Given the risks of rising property prices and household indebtedness, the forecast justified an interest rate increase so that inflation would not exceed the target. The situation was right for recovering some of the interest rate cut made in June, said the member.

Another member observed that all of the members agreed that monetary policy was facing a situation where tighter policy would be required and that the discussion mainly concerned the timing for an interest rate increase. It was natural to base the interest rate decision on the main scenario in the Inflation Report, given the risk assessment. Assuming that capacity utilisation would rise at a slow rate in the main scenario and that the inflation forecast was well in line with the target, there was scope to wait and see before raising the interest rate. This was the assessment in the current situation. If it were to become evident, as many had claimed today, that growth was stronger than expected, both the Riksbank's actions and the market's expectations would be adjusted accordingly.

One member objected to the claim that there was scope to wait before tightening monetary policy and once again put forward the argument that there were risks connected with beginning to tighten policy too late. If the market saw the situation in the same way, their expectations would lead to an upswing in the forward rate curve. This would in turn mean that the inflation forecast one to two years ahead would again be close to the target, but of

course it did not provide any reason for not raising the rate now. According to the forecast based on a constant repo rate, inflation would be 2.2 per cent towards the end of the forecast period, which indicated that the repo rate could not be held constant over a long period of time. It was not self-evident when the increases should begin, but the member advocated that the rate be increased now.

A further member pointed out that the situation in the labour market had played a minor role in the discussions. One argument against raising the interest rate at today's meeting was that it could slightly hold back the recovery in the labour market. This, too, should reasonably be taken into account in the Executive Board's repo rate decision.

One member observed in conclusion that there was agreement on the assessment made in the Inflation Report, but that in this case the report had evidently been interpreted to justify different actions. The inflation outlook showed an upswing in inflation over the coming years, but this was a slight upturn and employment growth had not yet picked up. House prices, household indebtedness and the weak krona gave some cause for concern among all members. This picture had led to some slightly different conclusions regarding the timing for tightening monetary policy. Given that several members advocated an increase in the interest rate, there might be reason, even if the repo rate were left unchanged at today's meeting, to clearly mark in the press release that the interest rate could in future be increased by more than the market was assuming.

§ 3. Monetary policy decision [(1)]

The Chairman observed that the members of the Executive Board were agreed that UND1X inflation at present provided the best picture of underlying inflationary pressures.

The Chairman found that there were two proposals; one to hold the repo rate unchanged and one to raise it by 0.25 percentage points.

The Executive Board decided after voting

- that the repo rate would be left unchanged at 1.5 per cent and that this decision would apply from Wednesday, 7 December 2005,
- that the lending rate would remain unchanged at 2.25 per cent and that the deposit rate would remain unchanged at 0.75 per cent with effect from Wednesday, 7 December 2005,
- that the decision would be announced at 9.30 a.m. on Friday, 2 December 2005, with the motivation and wording contained in Press Release no. 74 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Thursday, 15 December at 9.30 a.m.

Deputy Governor Villy Bergström, Deputy Governor Lars Nyberg and First Deputy Governor Eva Srejber entered reservations against the decision to hold the repo rate unchanged and stated the following: The forecasts of the Swedish economy presented by the Riksbank in June indicated significantly poorer growth than had been assumed earlier. Given this, the

repo rate was then cut by 0.50 percentage points. However, developments during the summer and autumn have meant that some of the uncertainty from June has disappeared and that the signs of a stable, lasting economic upturn have increased. Capacity utilisation has increased and the labour market has improved slightly.

Today's Inflation Report indicates that the repo rate will probably need to be raised in a number of stages over the coming years. It is always difficult to determine when the first increase should be made. However, economic policy is at present very expansionary and the effects of this have recently been accentuated by a weak krona. Demand is now growing on a broad front. Our opinion is that in this situation it is desirable to begin the gradual recovery in monetary policy that we see before us. It reduces the risk of the krona weakening further as a result of rising interest rates in Europe. An interest rate increase would also send a signal to the housing market that the current rate of price increase is not sustainable in the long term.

This paragraph was confirmed immediately.

Minutes by:
Ann-Christine Högberg

Checked by:
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg

1. **Footnote:**

1) Board members who are present and do not enter a reservation have participated in and agreed with the Board's decision.