# Separate minutes of the Executive Board, No. 7

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DATE: 27 April 2006
TIME 13:00

PRESENT:

Stefan Ingves, Chairman
Lars Nyberg
Kristina Persson
Irma Rosenberg
Eva Srejber
Svante Öberg

Jan Bergqvist, Chairman of the General Council
Johan Gernandt, Vice Chairman of the General Council

Claes Berg
Jörgen Eklund
Kerstin Hallsten
Jesper Hansson
Jyry Hokkanen
Ann-Christine Högberg
Pernilla Meyersson
Bengt Pettersson
Annika Svensson
Staffan Viotti
Anders Vredin
Arvid Wallgren (§1)

## § 1. The current inflation assessment

It was noted that Bengt Pettersson and Annika Svensson would prepare draft minutes of § 1 and 2 on the agenda for the meeting. The discussion was based on the new data and analyses 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.

In the euro area, both industrial production and orders in manufacturing rose in February. Orders increased by 13 per cent on an annual basis. Industrial production increased particularly significantly in Germany. The German IFO statistics for April, which show the sentiment in the German business sector, rose to their highest level since March 1991. The index had shown a strong upswing since last spring. In the euro area, HICP inflation amounted to 2.2 per cent in March, compared with 2.3 per cent during the previous month. Underlying inflation was 1.3 per cent in March.

In the United States, industrial production and orders of durable goods rose in March, and in April the US central bank's economic assessment, the Beige Book, indicated a continued increase in economic activity. There had been some slowdown in the housing market, but sales of newly-built housing showed a recovery in March and sales of existing properties also rose. Consumer confidence rose in April.

New national accounts statistics showed continued strong growth in Japan and the rest of Asia.

The oil price had risen to almost 75 dollars a barrel, and forward prices had also risen.

In Sweden, GDP increased by 0.7 per cent in the fourth quarter of 2005, compared with the previous quarter, according to Statistics Sweden's national accounts figures. This was slightly lower than the forecast in the February Inflation Report. At the same time, historical outcomes were revised upwards, putting growth for the whole year 2005 in line with the forecast figure. Exports increased more than expected in 2005, while investment was slightly weaker during the fourth quarter than had been forecast. Foreign trade statistics indicated that the trade balance had continued to improve. Exports rose by 10 per cent in the first quarter, compared with the same quarter in 2005, while imports were subdued. The purchasing managers index strengthened and new car registrations increased in March. The National Institute of Economic Research's confidence indicators and turnover in the retail trade rose in February. The situation in the labour market had continued to improve. Both employment and participation in the labour market rose during the first quarter. There was a marginal downturn in unemployment.

In March, CPI and UND1X inflation were 1.1 per cent and 1.2 per cent respectively, which in both cases was 0.3 percentage points higher than expected in the February Inflation Report. This was largely explained by petrol prices being higher than expected, as well as unexpectedly high prices for electricity, clothing and food.

Long-term interest rates had risen both globally and in Sweden. The ten-year bond rate in the United States had risen by around 0.5 percentage points to just over 5 per cent since the end of February. A similar upswing had occurred in Sweden, although from a lower level. The dollar had weakened and the euro had strengthened. The krona had strengthened slightly against both the dollar and the euro. Monetary policy expectations in both the euro area and the United States had shifted upwards. In Sweden, pricing in the financial markets indicated that expectations of future interest rate increases had been subdued somewhat in the short term, but risen slightly in the longer term. Implied forward rates were on the whole slightly higher than the path on which the inflation forecast was based in February.

## 1. The economic outlook and inflation prospects

### *1.1 The Executive Board discussion regarding the international economic outlook*

One member began by recounting the assessment in the February Inflation Report, where it was observed that international growth had been high and stable in recent years and that it could be expected to remain good over the coming years. The assessment for the United States was that growth would slow down somewhat in future, but still remain good. Since February, GDP growth for the final quarter of 2005 had been revised marginally upwards. Other new information received regarding the US economy had pointed in slightly different directions, but most indications were for continued favourable developments in line with the forecast in the Inflation Report. With regard to the euro area, a number of indicators such as the European Commissions barometers and other survey data had shown positive recent developments, which supported the expectations in the Inflation Report of a continued recovery in economic activity. In Japan and the rest of Asia, growth had been stronger than estimated and it looked as though there were reasons for a slight upward revision in the forecasts. All in all, international economic activity was looking slightly more favourable than it had in February.

The oil price had risen substantially since the Inflation Report was published, and was now clearly higher than the forecast made in February. Forward prices had also risen, which meant that there could be reason to continue assuming a slightly higher oil price than had been presumed earlier. It was probably mainly strong demand that was behind the high oil price, but supply-related factors such as concern over future oil production in Nigeria and Iran could have contributed. Although experiences from recent years were that international economic activity had been surprisingly resilient to oil price increases, this development clearly comprised an uncertainty factor.

Another member agreed on the whole with the description of developments. Incoming data and indicators all implied slightly stronger growth than had been forecast in the Inflation Report. Share prices and rising long-term interest rates indicated continued optimism regarding growth. Industrial activity was strong, commodity prices were rising and capacity utilisation in manufacturing was increasing. This could lead to producer prices continuing to rise.

Other members agreed with what had been said earlier. One member emphasised that it was particularly interesting that economic indicators had now also clearly strengthened in the euro area.

### *1.2 The Executive Board discussion regarding financial market developments*

One member observed that expectations in the euro and the United States regarding future key rates had shifted upwards since the February Inflation Report. In Sweden, expectations of repo rate increases in 2006 had been slightly subdued in comparison with those used as a basis for the forecast in the Inflation Report, but in the long term expectations had been adjusted upwards. Bond rates had also risen relatively substantially in the United States, the euro area and Sweden. The driving force behind the upturn in interest rates appeared to be positive economic statistics both abroad and in Sweden. This, together with the fact that international growth was expected to be slightly stronger, meant that it would be reasonable to assume slightly higher market rates during the forecast period than in the most recent Inflation Report. The krona had appreciated roughly as expected since February, and there was still reason to assume some further appreciation over the coming years. House prices and household borrowing had continued to increase at a rapid rate.

Another member did not consider it surprising that long-term interest rates were rising. The surprise was that this had not occurred earlier. However, there were increasingly clear signals of less expansionary monetary policy in both Japan and the euro area. The member noted that the financial markets had been able to manage signals of tighter monetary policy, political unease in the Middle East and rapidly rising oil prices without any serious disruptions. There had been no major exchange rate adjustments and credit spreads remained at a low level.

A third member agreed with the positive description of developments in the financial markets, but pointed out that there were some risks. The member noted that the vulnerability of countries with large current account deficits had come increasingly under focus, particularly with regard to small economies. One concrete example was the turbulence surrounding the Icelandic economy. If the normalisation of long-term interest rates continued, the demands for yield could lead to poorer financing conditions for countries and companies with a high risk. Another risk factor stemmed from companies' earnings growth, which had been very good in recent years, but now earnings were being dampened by rising energy and commodity prices. The alternative to reduced earnings in companies was either to increase productivity or to transfer the cost increases to consumers, which would result in rising inflation.

One member agreed that there was concern in the financial markets over developments in countries with a current account deficit. However, it was not yet clear what conclusions could be drawn from the Icelandic example.

Another member emphasised that it was as yet too early to feel secure with regard to developments in the financial markets. The IMF were emphasising more than ever the risks entailed in the global imbalances. There could be dramatic changes and it was therefore important to continue to be vigilant with regard to developments.

### *1.3 The Executive Board discussion regarding the Swedish economic outlook and future inflation*

One member began by reminding the Board that the assessment for the Swedish economy in the February Inflation Report was that GDP growth would be relatively high over the coming years. The national accounts for the fourth quarter of 2005 showed that GDP growth was slightly weaker than expected at the end of the year, which affected the forecast in the short term. However, the new economic indicators since February outlined a positive picture of economic developments. The National Institute of Economic Research's business tendency survey and the purchasing managers index for manufacturing indicated a clear improvement in manufacturing activity since the middle of 2005, and this development had continued recently. Turnover in retail trade and foreign trade also implied that economic activity had strengthened again in recent months, after the slightly weaker end of 2005. All in all, the member's conclusion was thus that the forecast for GDP growth in the Swedish economy contained in the Inflation Report remained largely unchanged.

The member then observed that the positive developments in the labour market had continued in recent months. Both the number of persons employed and the supply of labour had risen largely in line with the February forecast during the first quarter. The new indicators received implied that employment would continue to rise.

The member also noted that the forecast in the February Inflation Report was that inflation would rise at a moderate rate and be close to target in two years' time. Inflation had recently been higher than forecast, mainly due to unexpectedly high prices for energy; electricity, petrol and heating oil. In March, CPI and UND1X inflation were 1.1 per cent and 1.2 per cent respectively on an annual rate, which in both cases was 0.3 percentage points higher than expected in the February Inflation Report. The assessment was that the energy prices will in future be higher than was assumed in February. There was thus justification for an upward revision in the inflation forecast for the coming year. However, on the assumption that energy prices did not continue to rise, the effect on inflation would be temporary. At the same time there was, as before, reason to assume that inflationary pressures would gradually increase when the economic upturn led to capacity utilisation increasing both in Sweden and internationally. The basic assessment of inflation developments in coming years thus remained largely unchanged, taking into account the new information received since the Inflation Report.

Another member agreed with the picture of favourable economic developments. Growth was being stimulated by high international demand, which was pushing up exports, and by expansionary domestic fiscal and monetary policy. The picture of strong, broad growth was supported by the National Institute of Economic Research's business tendency survey, which was published today and showed strong developments in all sectors. The situation in the labour market had improved significantly. During the first quarter, employment had risen by just over 70,000 persons compared with the same quarter in 2005. However, unemployment fell only marginally, due to a strong increase in the labour supply. Although inflation was low now, it was expected to rise to just below 2 per cent two years ahead. However, there was considerable uncertainty over that time perspective for the inflation forecast.

Another member agreed with the picture of positive economic developments, but emphasised the continued strong dependence on exports as a driving force. Judging by the most recent investment survey, the predicted slowdown in investment growth might come sooner than expected. Thanks to low import prices, inflation in Sweden was very low at the starting point. However, towards the end of the forecast period this should be counteracted by, for instance, rising domestic capacity utilisation. The question was to what extent monetary policy should push up domestic inflation to compensate for price changes abroad.

One member agreed with the outline of the Swedish economy drawn by earlier members, and considered that economic growth could even be slightly better than expected. At the same time, it was surprising that the oil price had not had a greater effect on economic activity and underlying inflation. The member pointed out that if we had known a couple of years ago how the oil price would develop, we would probably have made a significantly different assessment of economic developments.

The member also observed that house prices and household borrowing were continuing to develop at a rate that was not sustainable in the long term. Moreover, households' fixedinterest periods were declining and Swedish households were becoming increasingly sensitive to a rise in interest rates. This differed from the situation in, for instance, the United States, where households were to a greater extent fixing their loans for long durations. This development did not comprise any threat to financial stability, but there was reason for concern over the real economic consequences if a rapid adjustment were to occur beyond the two-year horizon. In addition, the recent statistics showed that prices of commercial property were now also rising rapidly. In metropolitan areas, prices rose during the first quarter by between 10 and 25 per cent on an annual basis, despite a continued high vacancy ratio and unchanged rents. Prices appeared to be rising as a result of a decline in the direct return requirement. The fact that this was falling could be due to the low interest rates in 2005, or to increased tendency to take risks. This year prices had risen despite an increase in long-term interest rates. The risk level for commercial property had thus increased somewhat. Although it was important to remember that these observations of the commercial property market were made only over the past quarter, they contributed to greater concern that imbalances were also being built up on this market. The member also noted that the money supply, measured as M3, had increased by 12 to 14 per cent at the end of last year, which was not a rate that could be regarded as sustainable in the long term. All in all, developments in the financial markets provide a picture of strongly expansionary monetary policy.

One member agreed that developments in Sweden appeared to be slightly stronger now than had been expected in February. Strong international demand benefited Swedish export growth. In addition, the member considered it would be remarkable if growth were not high, given that economic policy was so expansionary, interest rates were so low and the krona was relatively weak. The good times were reflected in share price developments. The member agreed with the risks mentioned by another member regarding the continued strong developments in the housing and credit markets. The low interest rates and the expectations of continued low interest rates could lead to house prices and household indebtedness continuing to grow at a rapid rate. This increased the risk of a rapid downward adjustment when interest rates rose, resulting in repercussions on domestic demand.

The member pointed out that the value of households' total wealth had now been restored after the stock market fall at the beginning of the century. This meant that the covariation between household consumption and wealth, which declined after the most recent stock market downturn, could be reinforced again. This would mean that private consumption was to a greater extent affected by developments in household wealth, something that could also affect the impact of monetary policy.

The member shared the opinion that the current low inflation rate would not last in the long run. Inflation was expected to rise and be close to target towards the end of the forecast horizon, on the assumption that there would be gradual increases in the repo rate. Import prices had fallen over a long period of time. With high oil and commodity prices, rising international producer prices and rising capacity utilisation, it was reasonable to assume that import prices would rise in future. The member considered that the February inflation forecast was cautious, given the information now available. There was a risk of a "ketchup" effect and of surprisingly high import prices in future, at the same time as the credit expansion and house prices continued to give cause for concern.

One member considered that it was important to look at the various components affecting the total inflation outlook. On the one hand, there was a strong development in economic activity that indicated rising price pressures in future, while growth in credit volumes and the money supply, as well as low interest rates, showed that monetary policy was expansionary. On the other hand, imported inflation was still subdued and productivity growth was strong. An important factor that was still worrying was the development of the oil price, although it had mainly only had transient effects on inflation so far. It was nevertheless important to be vigilant in case it led to more lasting secondary effects. Price changes regarding oil and individual products need not be so troubling. The important thing was how broad the change in inflation was. When several factors pointed in the same direction and prices began to rise on several markets at once, the development in inflation would become clearer. It now appeared as though the upside risk factors carried greater weight for inflation than the downside. The member also pointed out that the forecasts were based on the assumption of a gradually rising repo rate.

One member summarised the discussion and said that the picture of continuing good times was clear when one looked at international developments, which looked slightly stronger than had been expected in the February Inflation Report. This was reflected in the developments in the financial markets. Uncertainty over possible consequences of an adjustment in the depressed long-term interest rates was now declining as long-term interest rates around the world rose undramatically. In Sweden, too, there was strong expansion in the financial markets. We can also conclude that the general picture of good economic growth in Sweden as a whole and a gradual rise in inflation remain largely unchanged from the outlook in the February Inflation Report.

## § 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented a proposal for the monetary policy decision. All in all, the new information received since February largely confirmed the favourable economic picture outlined for Sweden in the Inflation Report. The international picture looked slightly stronger. The assessment of inflation prospects also remains largely unchanged, although inflation is higher than expected in the short term. In the February Inflation Report, good growth was expected to lead to production resources being employed to an increasing extent. Inflation was thereby expected to increase gradually and to be close to the 2 per cent target a couple of years ahead, given that the repo rate was gradually increased during the forecast period. The decision in February was thus to increase the repo rate by 0.25 percentage points.

If economic developments followed expectations, the interest rate would need to be increased gradually to ensure inflation was in line with the target. The question was how quickly it should be increased. Growth was strong and domestic demand was increasing at a good rate. Monetary policy was still stimulating the economy and one expression of this was that household indebtedness and house prices were continuing to increase at a rapid rate. There could be risks under these circumstances in continuing to stimulate the economy far into the economic upturn. At the same time, inflation was still low and this indicated that there was no urgency in increasing the repo rate a further stage. The fact that inflation was below target level, despite the strong economic activity, was largely due to weak growth in import prices and strong productivity growth in the Swedish economy. These were factors that were expected to continue affecting the economy. However, it was difficult to determine how much these factors would affect inflation and how long they would persist. The assessment was that they would continue to contribute to keeping down inflation, but that they would lose strength when economic activity continued to strengthen over the coming years.

The conclusion reached in connection with the repo rate increase in February was that the repo rate could perhaps be increased at a slightly slower rate than was assumed in the interest path on which the Inflation Report forecast were based. In that case, inflation might also rise slightly more quickly towards target level than assumed in the Inflation Report, where the forecast was that it would be close to target towards the end of the forecast horizon. This assessment still appeared reasonable. All in all, this indicated that the repo rate should be left unchanged at today's meeting. As indicated, it agreed well with the current market expectations of monetary policy in 2006. At the same time, it would soon be necessary to bring monetary policy onto a less expansionary path again to ensure that inflation would be close to target. Expectations of the repo rate in the long term had risen since the monetary policy meeting in February, and were now slightly higher a couple of years ahead than the path outlined in the Inflation Report.

One member considered that the decision was not entirely an obvious one and that there were several important issues to be discussed in this regard. Uncertainty in inflation forecasts in the longer term indicated that we should also take into account developments in the real economy and credit expansion. Monetary policy was currently very stimulating. If we were only to take into account developments in the real economy, we would have much higher interest rates today. Now monetary policy was not aimed at developments in the real economy, but at maintaining inflation at a low and stable level. However, this did not rule out the possibility of taking developments in the real economy into account when setting the interest rate, as long as this did not jeopardise the low inflation rate. Another important question was whether, and if so how, we should give particular consideration to domestically-generated inflation or whether we should only look at total inflation. There were risks in conducting a very expansionary monetary policy to stimulate the domestic economy and push up inflation on domestic products to compensate for low imported inflation. This could cause bottlenecks and lead to overheating in certain sectors, which could have consequences for the central wage negotiations next year and for wage developments. It was also important to look ahead when setting interest rates and to take a stand with regard to the interest rate path on which we based our forecasts. For the member the choice was between a slightly more rapid upward path to a neutral level for the key rate in mid 2007, and a slightly slower upward path to a neutral level at the beginning of 2008. The member considered in this context that the suggestion that the Riksbank should publish its own interest path forecast was reasonable and an issue to which the Executive Board should return. Taking into account the inflation forecast, and in particular the rising domestic inflation, the strong growth in the real economy and the credit boom we should not wait too long before making the next increase in the repo rate. However, the member supported the proposal to hold the repo rate unchanged at present, but assumed that the same conclusion would not be reached in June, given the information now available.

One member agreed that these were important issues, but that they required a larger discussion, that dealt not merely with current monetary policy and prevailing interest rates, but also the current monetary policy framework. This applied, for example, to the question of whether the Riksbank should publish its own interest rate path. The member considered that this was a discussion that would be conducted within the framework of the development work that was continually conducted within the Riksbank's analysis operations and that there would thus be reason to return to this issue and for the Executive Board to express their opinions.

A further member agreed with the importance of discussing such issues, although the decision that was now being held concerned the level of the repo rate. The low initial inflation rate indicated that it was possible to wait a while before the next interest rate increase. In addition, unemployment remained high and capacity utilisation was expected to increase at a slow rate, which did not indicate that the interest rate should have been higher now. Furthermore, Sweden was a very open economy and the effects of globalisation meant that increased capacity utilisation would not have as much of an impact on prices as before. The member did, however, foresee a need for less expansionary monetary policy to avoid inflation rising above target at the end of the forecast horizon.

One member agreed that there were dangers with stimulating the domestic economy, which were difficult to foresee, even if the target was CPI. The member supported the proposal to hold the repo rate unchanged, but with some hesitation. International economic activity was probably better than expected. In Sweden, prices in the housing market had continued to rise with undiminished strength, which emphasised the fact that monetary policy was still very expansionary. Although inflation was still low, concern over growing imbalances in the property and credit markets had probably increased rather than decreased.

Another member said that on the one hand, the Swedish economy still had spare capacity and continued low inflationary pressures this year. On the other hand, growth was strong, while there was a risk of various financial imbalances building up. The member agreed that there was concern over what would happen to inflation when capacity utilisation became more strained, particularly given that inflation did not normally change calmly and peacefully. However, the member considered it reasonable to hold the repo rate unchanged at today's meeting, although there was reason for considerable vigilance over developments, given the positive statistics received and developments in property prices and household indebtedness. If this development continued, there could be reason to increase the interest rate in June, concluded the member.

Another member considered that there were factors that indicated continuing relatively moderate price pressures, such as productivity growth and import prices. At the same time, one could observe that the general economic developments in the world and in Sweden were good, and that the Swedish labour market was gradually improving. The oil price was continuing to rise and the possibility of secondary effects on inflation could not be excluded. In addition, the developments in the financial markets were continuing, with strong growth in lending and money supply. This picture called for a gradual increase in the repo rate to ensure that inflation did not exceed the target towards the end of the forecast horizon. It was a question of judgement whether the next increase should be made today or in June. The member supported the proposal to hold the repo rate unchanged, but made it clear that monetary policy would need to become less expansionary in future, given that the economy continued to develop largely as forecast.

The member summed up by saying that all members were agreed that an unchanged repo rate was the most reasonable decision at present, although the discussion had shown that this was by no means self-evident.

## § 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 was only one proposal: to hold the repo rate unchanged at 2 per cent.

The Executive Board decided after voting

- that the repo rate be left unchanged at 2 per cent and that this decision would apply from Wednesday, 3 May 2006,
- that the lending rate be held unchanged at 2.75 per cent, and that the deposit rate be held unchanged at 1.25 per cent, with effect from Wednesday, 3 May 2006,
- to announce the decision at 9.30 a.m. on Friday 28 April with the motivation and wording contained in Press Release no. 20 2006 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Thursday, 11 May at 9.30 a.m.

This paragraph was confirmed immediately.

Minutes by:
Ann-Christine Högberg

Checked by:
Stefan Ingves, Eva Srejber, Lars Nyberg, Kristina Persson, Irma Rosenberg, Svante Öberg

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