Separate minutes of the Executive Board, No. 11

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DATE: 19 June 2006

TIME: 1 p.m.

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

Claes Berg
Mårten Bjellerup
Kerstin Hallsten
Jyry Hokkanen
Ann-Christine Högberg
Björn Lagerwall (§1)
Pernilla Meyersson
Bengt Pettersson
Lars E.O. Svensson
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Mårten Bjellerup and Bengt Pettersson would prepare draft minutes of paragraphs 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.

1. Recent data regarding economic developments

The Monetary Policy Department reported on new data received since the Executive Board meeting on 7 June.

Industrial production in the euro area declined by 0.6 per cent in April, compared with March. The part of the German economic indicator ZEW index that describes the current situation rose from 8.7 in May to 11.9 in June. The part that measures expectations, however, fell from 50.0 to 37.8. Inflation in the euro area increased from 2.4 per cent in April to 2.5 per cent in May. Underlying inflation fell from 1.6 per cent in April to 1.5 per cent in May.

In the UK, unemployment rose to 5.3 per cent in April, while CPI increased by 2.2 per cent in May.

The US central bank's economic assessment, the Beige Book, indicated in June that economic activity was increasing, although there were some signs of a slowdown. The spare capacity in the labour market was declining, and higher energy prices had increased inflationary pressures in the economy. Retail trade sales rose in May by 0.1 per cent compared with April, while industrial production declined by 0.1 per cent in May. The current account deficit declined during the first quarter of this year to 6.4 per cent of GDP, from 7.0 during the fourth quarter of last year. CPI in the United States increased by 4.2 per cent in May, compared with the same period in 2005, while underlying inflation was 2.4 per cent.

In Japan, GDP had risen during the first quarter, according to revised preliminary statistics, by 3.5 per cent compared with the same period last year. Industrial production rose by 1.4 per cent in April compared with March, while orders declined by 1.8 per cent.

In both Sweden and the euro area, interest rates had recently fallen somewhat, but all in all the changes were relatively slight. In the United States, on the other hand, interest rates had risen recently. Since mid-May, the stock market indices in Sweden, the United States and Germany had fallen substantially. In the foreign exchange market the dollar had strengthened against the euro and the krona, while the krona had weakened marginally in trade-weighted terms since 7 June. Forward prices of oil had recently fallen slightly and were now marginally lower than the 15-day average in the Inflation Report. The most recent implied forward rates were largely in line with the path used in the Inflation Report.

2. The economic outlook and inflation prospects

Deputy Governor Irma Rosenberg presented a draft of Inflation Report 2006:2, Annex A to the minutes. The Inflation Report reproduced the main features of the presentations and discussions at the Executive Board meetings on 18 May and 7 June.

It was observed in the Inflation Report that economic growth both in Sweden and abroad remained high. Over the coming years, the economic upswing was expected to continue, but at a slower pace. International growth was expected to be higher than forecast in February. The forecast for Swedish GDP growth in 2006 had been marginally adjusted upwards, and there had been a shift between the different components of demand. Exports and investments were expected to increase more rapidly this year than was expected in the previous Inflation Report. On the other hand, the forecast for household consumption had been revised downwards as a result of unexpectedly weak outcomes both at the end of last year and the beginning of this year. However, several factors indicated good development in consumption in the near future, such as rising wealth and employment.

The strengthening in economic activity had led to continued improvement in the labour market. Employment was rising and indicators pointed to a continued rise in the future. The supply of labour was also expected to increase during the forecast period, which meant that unemployment would fall relatively slowly.

Inflation had risen over the past year. In May both CPI and UND1X inflation were 1.6 per cent. The higher rate of price increase was largely due to rising energy prices, but prices of other goods had also increased more quickly than before. Inflation was expected to fluctuate around the current level over the coming year and then rise a little more. A couple of years ahead, inflation was expected to be in line with the inflation target of 2 per cent. The forecasts were based on the assumption that monetary policy would gradually become less expansionary. The rise in inflation was being subdued by the fact that prices of imported goods were only rising marginally. Domestic inflation, on the other hand, was expected to rise relatively quickly in the future, due in part to rising domestic cost levels as economic activity improved.

The Executive Board made the assessment that the new information received since its meeting on 7 June 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 20 June.

§ 2. Monetary policy discussion

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

Inflation had been low in recent years, despite good GDP growth and rising capacity utilisation. This was largely due to import prices still being low, while domestic cost pressures had been very subdued. Inflation over the coming years was to a great extent dependent on to what extent these factors would continue to have a restraining effect on the rate of price increase.

During the spring, inflation had been higher than expected. This was mainly due to energy prices rising more than had been forecast; an effect that was largely judged to be temporary. At the same time, the risks of indirect effects from the upswing in energy prices increased when economic activity continued to strengthen, i.e. energy prices would have an impact on consumer prices through increased production and distribution costs. In recent months the prices of certain other goods, mainly imported goods like clothes and food, had risen more than estimated. The forecast was nevertheless that import prices excluding energy would continue to develop weakly and contribute to slowing down the inflation rate during the forecast period.

Domestic inflation had not risen at all yet this year, if one did not include electricity prices. However, domestic cost pressures showed an upswing as early as last year, as a result of productivity growth slowing down at the same time as hourly wage costs increased at a slightly faster rate. The rate of increase in production costs was expected to increase slightly further as economic activity strengthened and it was then expected to have an impact in the form of a more rapid domestic inflation rate. UND1X inflation was thus assessed to be close to 2 per cent in a two-year perspective, but it is important to remember that this assessment assumes that the repo rate was gradually increased.

Both GDP growth and employment in Sweden appeared to be developing very favourably. Capacity utilisation had risen in recent years, and according to the Inflation report, several indicators pointed to a roughly normal level this year, although unemployment was still relatively high. At the same time, monetary policy was still expansionary and credit growth and the rate of increase in house prices were high. Both the inflation forecast and developments in the real economy in the future therefore indicated that the repo rate should now be increased. Her proposal was that the repo rate should be increased by 0.25 percentage points. It was also reasonable to assume that the repo rate would need to be increased further during the forecast period, roughly in line with expectations in the financial markets. However, she considered that developments should show what pace would be appropriate for the increases.

One member supported the proposal to raise the repo rate by 0.25 percentage points and emphasised that the forecast in the Inflation Report showed continued good growth in Sweden. There was a need for interest rate increases so that inflation would not exceed the target further ahead. The continued rapid expansion in credit and the rapidly rising property prices were signs that the economy was reacting to the expansionary monetary policy. During an upturn this contributes to stimulating demand, but at the same time it also contributes to creating vulnerabilities in households' balance sheets. Assets can fall in value, while the value of the debts remains the same, which can in turn generate lower demand and an undesirably low inflation rate further ahead. To avoid a build-up of larger imbalances in the balance sheets, monetary policy should continue to be conducted in a less expansionary direction to reduce the risks linked to excessively large build-up of debts. This would probably be done slightly more quickly than was generally being expected by the market, said the member.

Another member noted that the uncertainty in forecasts two to three years ahead was considerable, but that the risks linked to the main scenario were not greater than usual. However, the member pointed to two risks that could lead to a different development than that outlined in the main scenario. The first was that the consequences of the strong development of the real economy and the rising capacity utilisation for inflation were being underestimated, and that inflation in 2007 and 2008 was therefore also being underestimated. This could mean that monetary policy reacted too late. The other risk was that wages would rise more rapidly than expected in the light of a rapid increase in employment, rising inflation and inflation expectations and good corporate profits. At the same time, the central agreements covering most of the labour market would be renegotiated next year. Of course, the rate of wage increase could also turn out to be slower than expected, for instance, due to strong international competition or to the labour supply increasing more quickly than anticipated; something that could subdue the need for interest rate increases. The picture of developments in the labour market, particularly the labour supply, had changed relatively significantly since the previous Inflation Report, which further emphasised the importance of following developments in the labour market field prior to the coming meetings. Monetary policy was at present very expansionary and the repo rate of 2 per cent was very low from an historical perspective. The same assessment applied to the real interest rate. The member considered that it was worrying to have such a low interest rate, given the strong development in the real economy and the expansion in credit. The policy rate should therefore be gradually increased towards a more normal level. The question was at what pace this should be done. The member considered that a few more interest rate increases would probably be required over the coming year than was in line with market expectations. In this context, the member pointed out that several small increases were preferable to fewer and larger increases, as the former could lead to less fluctuation in market pricing and expectations. The member agreed with the provider of the summary that the interest rate should be increased by 0.25 percentage points at the current meeting. If no unforeseen circumstances were to occur, the member envisaged a further increase of 0.25 percentage points at the meeting in August.

A third member did not share the views of the two previous members as to how quickly monetary policy should be tightened. The situation could not be regarded as stable other than in a short-term perspective and there was considerable uncertainty regarding the future. The slowdown in the United States and a possible correction of the global imbalances could occur more quickly than expected, which could have negative effects on the world economy. We had not yet seen the total effect of rising oil prices, the interest rate upturn, weakening house prices in the United States and stock market turmoil. In Sweden the labour supply could increase more rapidly than expected. There was a large unutilised potential of non-employed. Many who were reaching the age of retirement could choose to continue working in the light of uncertainty regarding future pensions. Unemployment was still around 5 per cent and a further 3 per cent or so of the labour force were in labour market policy programmes. It was not very probable that inflation would rise substantially as a result of conditions in the labour market. At the same time, the possibility of bottlenecks in certain sectors could not be ruled out, which could have effects on central wage negotiations, said the member. The rising inflation rate mainly reflected higher energy prices both in Sweden and globally. The inflation forecast did not indicate that there was any urgency in making substantial changes to the repo rate. At the same time, the expansionary monetary policy had led to a development in house prices and credit expansion that was not sustainable in the long term. Without this, it would have been possible to wait a little longer before increasing the repo rate. The member therefore expressed support for the proposal to increase the repo rate by 0.25 percentage points and also agreed that the repo rate would probably need to be increased further during the forecast period, in line with financial market expectations. The member emphasised the importance of continuing to follow economic developments and incoming statistics in order to gain an impression of future monetary policy.

Another member pointed out that the present situation was fairly well in line with the picture painted in the February Inflation Report. Economic activity was good and inflation was gradually approaching target level. The rapid increase in house prices and in lending to both companies and households still comprised risk factors and monetary conditions were very expansionary. To simplify, inflation developments in the forecast are divided into two parts, with rising domestic prices but low import prices. The forecast was based on a gradually rising repo rate in line with implied forward rates, and the member expressed support for the proposal of an increase of 0.25 percentage points. However, the member stressed that, as usual, there was considerable uncertainty over the future path of the interest rate. The outlook in the present economic situation implied that the increases could possibly be made more quickly than the market expected, rather than at a slower rate.

One member shared the view that market expectations of interest rate increases were on the low side, but did not want to go into more detail at present with regard to how quickly the increases should be made. The member emphasised that monetary policy and the monetary conditions were still on the whole expansionary and that this could entail, in the current strong economic situation, a risk of the inflation effects being underestimated. The interest rate increases so far did not appear to have led to household demand for credit declining appreciably and competition in the credit market had led to continuing very favourable loan terms. There was still concern regarding the effects that might ensue for house prices and above all the real economy if this development continued.

One member observed in summary that all members were agreed that an increase in the repo rate of 0.25 percentage points was the most reasonable decision at present to ensure an inflation rate close to target and to contribute to a balanced development of the real economy. As before, household indebtedness and rapidly rising house prices should be taken into account. It was also reasonable to assume that the repo rate would need to be increased further. At the same time, the member noted that the Executive Board expressed a general concern based on a combination of strong developments in the real economy, low interest rates, and a continued rapid increase in lending and household indebtedness. Although the risks linked to this developed were difficult to quantify, they could nevertheless have tangible effects on inflation further ahead. The majority opinion was therefore that there was possibly a need for slightly more interest rate increases over the coming year than recent market expectations implied.

§ 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 raise the repo rate by 0.25 percentage points to 2.25 per cent.

The Executive Board decided after voting

- that the repo rate would be raised to 2.25 per cent and that this decision would apply from Wednesday, 21 June 2006,
- that the lending rate would be raised to 3.00 per cent and that the deposit rate would be raised to 1.5 per cent, with effect from Wednesday, 21 June 2006,

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

- to announce the decision at 9.30 a.m. on 20 June 2006 with the motivation and wording contained in Press Release no. 29 2006 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Monday, 3 July 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