Separate Minutes of the Executive Board, No. 14

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DATE: 25 October 2006

TIME: 1 p.m.

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

Leif Pagrotsky, Vice Chairman of the General Council

Jan Alsterlind (§1)
Claes Berg
Victoria Ericsson
Kerstin Hallsten
Jyry Hokkanen
Ann-Christine Högberg
Pernilla Meyersson
Marianne Nessén
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Victoria Ericsson and Sara Tägtström would prepare draft minutes of paragraphs 1 and 2 on the agenda for the meeting.
The discussion was based on the draft Inflation Report 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 Executive Board meeting on 19 October.

In the euro area, new orders in manufacturing increased by an annual rate of 14 per cent in August. The German IFO index, which shows the sentiment in the German business sector, continued to rise in October. The market had expected that the IFO index would have slowed down as a result of the German VAT increase to be implemented at the turn of the year.

The most recent information on economic activity in the United States (from the Conference Board and the Philadelphia Fed) indicates a continued slowdown. However, the picture is not clear-cut. The number of new unemployment claims was slightly fewer in the second week in October than the market had expected.

Long-term interest rates in Sweden, the United States and the euro area had continued to rise slightly over the recent period. In the foreign exchange market, the dollar appreciation against the euro had slowed down in recent days. The krona had appreciated in trade-weighted terms, particularly against the euro, but also against the dollar. Stock market prices had continued to rise around the world. 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 risen somewhat in the short term compared with June, but been slightly subdued in the longer term. Implied forward rates were now marginally higher than the path used as a base for the inflation forecast in the Inflation Report. Pricing in the financial markets indicated that an increase in the repo rate of 0.25 percentage points was expected at today's meeting. Reuter's surveys showed that 18 out of 18 Swedish analysts were expecting an increase.

2. The economic outlook and inflation prospects

Deputy Governor Irma Rosenberg presented a draft of Inflation Report 2006:3, Annex A to the minutes. This Inflation Report reproduced the main features of the presentations and discussions at the Executive Board meetings on 10 and 19 October.

It was observed in the Inflation Report that GDP growth in Sweden and abroad had remained high during the first six months of this year and was stronger than anticipated. Growth was also expected to be relatively strong during the remainder of the year and next year. However, the economy would gradually move into a calmer phase. There had been a clear improvement in the Swedish labour market during the year. There were numerous indications that employment would continue rising. Domestic cost pressure was expected to increase as productivity growth slackened and wages rose at a faster rate.

The strong economic growth in Sweden was also reflected in the credit and asset markets. During the summer, share prices recovered from the downturn noted in the spring. Companies and households had in recent years increased their borrowing relatively sharply seen from a historical perspective. At the same time, house prices had risen rapidly and household wealth had been boosted further. To a certain extent, these developments were the result of the expansionary monetary policy.

Inflation had risen gradually since the beginning of 2005. Over the coming years, UND1X inflation was expected to continue to rise as a result of costs increasing when economic activity improved. This forecast was based on the assumption that the repo rate would be gradually increased. However, inflation was expected to be moderate, despite good growth in economic activity. This was due to continued favourable supply conditions, such as a rapid increase in productivity and international price pressures. In addition, inflation was held down by temporarily falling energy prices.

The assessment was that there were risks linked to both domestic and international developments. All in all, the Riksbank's assessment was that the risks of higher inflation were now slightly greater than the risks of lower inflation. Risk-adjusted inflation measured according to UND1X was expected to be 1.7 per cent two years ahead and 2.1 per cent three years ahead. The risk-adjusted CPI inflation rate was expected to be 1.9 per cent two years ahead and 2.0 per cent three years ahead. The fact that inflation was expected to be slightly below the inflation target two years ahead was partly due to energy prices temporarily subduing the rate of price increase. When the restraining effect of the energy prices abated, inflation would rise.

The Executive Board made the assessment that the new information received since its meeting on 19 October 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 8 a.m. on 26 October.

§ 2. Monetary policy discussion

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

The prospects for the Swedish economy in the coming years looked more favourable now than they did at the monetary policy meeting in June. The labour market situation had also improved over the summer and employment had accelerated. Both production and employment were expected to increase slightly more rapidly than the June forecast had indicated. However, despite the fact that the real economy was expected to develop more strongly than expected, inflationary pressures did not appear higher than the Riksbank had earlier assumed. This year inflation was expected to be largely the same as in the June assessment. Over the coming two years, inflation was expected to rise gradually, although the forecast had been adjusted slightly downwards. This meant that UND1X inflation was expected to be in line with the target just over two years ahead.

The fact that inflation was so low was largely due to weak growth in import prices and rapid growth in productivity, i.e. favourable supply conditions. Import prices had fallen more than anticipated since June and productivity growth had also exceeded the forecasts, which held down cost pressures. Nevertheless, domestic inflation had been higher than expected in recent months, due to electricity prices soaring. All in all, inflation had thus been roughly as expected. The downward adjustment in the inflation forecast for next year was mainly due to import prices being expected to be lower than we had earlier assumed. The downward adjustment in the forecast for 2008 and at the beginning of 2009 was instead due to electricity prices no longer continuing to rise, but falling slightly.

The forecast was based on the assumption that the repo rate would rise in line with market expectations. The forecast thus indicated that the interest rate must be increased during the forecast period so that inflation would not be too high and to contribute to a balanced development of the real economy. The question was not whether, but at what pace the interest rate should be increased. Although inflation was expected to be slightly below target two years ahead, this was largely due to electricity prices temporarily slowing down inflation. When this effect abated, inflation would rise. It was also important that monetary policy was still expansionary and contributing to strong growth, an improvement in the labour market and continued rapid growth in credit and house prices. The favourable development indicated that the economy did not need as much stimulation from monetary policy as before. To obtain an inflation rate in line with the target and a balanced development in the real economy, her suggestion was therefore that the repo rate should be increased by 0.25 percentage points at today's meeting. It was also reasonable to assume that the repo rate would need to be increased further, roughly in line with recent market expectations. It was important to emphasise that the implicit interest rate path on which the inflation forecast was based was a technical forecasting assumption. The future monetary policy stance would depend as always on economic developments.

One member agreed with the picture presented, both with regard to the analysis and the conclusion. The increase in the repo rate of 0.25 percentage points that the financial markets were expecting at today's meeting would contribute to an inflation rate in line with the target just over two years ahead. Economic activity was slightly stronger than expected, both in Sweden and abroad. There was much discussion in the United States of what significance the slowdown in house prices might have for the economy and household sector demand. The fact that house prices were now falling, particularly in certain regions of the United States that had seen a sharp upturn, could be regarded as a natural consequence of the interest rate increases in recent years. Experiences from, for instance, Australia and the United Kingdom showed that an adjustment in house prices could occur under orderly forms, without any major effects on either demand or inflation.

The member noted that there was reason to be observant of the substantial monetary expansion in Sweden. The money supply, measured as M3, had increased at an annual rate of 19 per cent in August. The rapid developments in the money supply and credit could not continue at the same rate indefinitely without this having effects on inflation. Information from mortgage institutions indicated, however, that there had been some slowdown in the rate of increase in household borrowing as a result of higher interest rates. Households' purchase coefficient, i.e. the ratio between the market price of their house and the rateable tax value, had also begun to slow down. However, it was too early to say whether or not it was a question of a more lasting decline.

One member supported the picture presented initially and the proposal to raise the interest rate by 0.25 percentage points. Inflation was admittedly still low and there were a number of factors that might indicate continued low inflationary pressures. In recent years the downward pressures on prices in the form of high productivity growth and weak development in import prices had been underestimated. It was possible that these downward pressures would continue to have an unexpected effect. Nor was it possible to rule out a more sudden slowdown in economic activity in the United States, which could ultimately have a subduing effect on economic growth in Sweden. At the same time, there were several factors indicating continued strong growth in Sweden next year and rising inflationary pressures in the longer term. International economic activity was strong, which would push up growth in Swedish exports. Monetary policy had been expansionary for several years, which would stimulate the economy next year as well, given that the impact of monetary policy has a time lag. Fiscal policy was also expansionary this year and next year, which would further push up domestic demand. One uncertainty factor next year was the wage bargaining rounds in the labour market. The assessment in the Inflation Report was that there were relatively large labour reserves and the most likely result would be modest wage increases. However, there was a risk that the bargaining rounds would prove more problematic and result in higher wage increases than we had expected in the main scenario. The overall assessment was that the upside risks from domestic economic activity were on this occasion greater than the downside risks from international developments. The strong real growth and credit expansion also justified increasing the interest rate and that inflation should be brought back on target slightly beyond the normal two-year horizon.

One member expressed agreement with the view that the interest rate should be increased by 0.25 percentage points at the present meeting and with the arguments put forward, but did not consider the future monetary stance to be clear-cut. Inflation was low at the outset and was expected in the main scenario to be 1.6 per cent two years ahead, in terms of UND1X. This could be interpreted to mean that the interest rate path on which the inflation forecast was based was too tight. The member questioned whether this could be regarded as inflation in line with the target and wondered if the conclusion would be the same with an inflation forecast of 2.4 per cent. A strict interpretation of the inflation target could imply waiting before increasing the interest rate, but consideration for real economy developments nevertheless spoke in favour of an increase at the present meeting. There might be scope for more expansionary monetary policy ahead than the interest rate path implied by pricing in the financial markets, without any threat to the inflation target. The member observed that monetary policy could also have been more expansionary in recent years, which could have contributed to better growth in the labour market.

A decisive factor for future monetary policy was the development of the spare capacity in the economy. There were currently many individuals of working age who for various reasons were outside of the labour market. Some of these would probably be able to return to the labour market and thus contribute to keeping down the rate of wage increase. If the proposed changes in fiscal policy succeeded in stimulating an increased supply of labour, there would be less risk of bottlenecks arising that could push up the rate of wage increase. If the labour supply increased, the interest rate could also be increased at a slightly slower rate than the market was currently expecting. If this effect did not materialise, there was a risk of increased inflation due to rising wages. One could not rule out the possibility that the recovery in the labour market and the strong economic activity both in Sweden and abroad would justify the interest rate being increased in line with the path on which the inflation forecasts were based. However, there was so much uncertainty over future developments that great caution should be exercised when expressing the pace for future interest rate increases. It still remained to be seen what would happen in the US economy, and it was uncertain what effect the supply stimulating measures in Sweden would have. The upside and downside risks for inflation could well cancel one another out. The member pointed out that it was appropriate in this situation to signal some uncertainty with regard to the future interest rate path.

A further member supported the proposal to increase the repo rate by 0.25 percentage points to 2.75 per cent. The member agreed with both the picture painted of future developments and the motives behind the decision. The risk outlook in the Inflation Report, where the upside risk for inflation was greater than the downside risk, provided a good reflection of the economic situation. The inflation forecast was based on the repo rate developing in line with expectations in the financial markets, i.e. in this case the interest rate being increased gradually. It would be better to gradually increase the interest rate than to wait and perhaps need to tighten monetary policy substantially further ahead. The expansionary fiscal and monetary conditions also indicated that it was appropriate to conduct less expansionary monetary policy. There could be justification from time to time for bringing forward interest rate changes for these reasons.

The member observed that it still remained to be seen what the net effect would be of the changes the new government planned with regard to property tax. When tax rates changed, this had a one-off effect. However, it was not the change in the level of tax rates that would generate rising inflation, but continuous prices increases. While a change in property tax might lead through wealth effects to increased consumption, this was something taken into account in the normal forecasting work and could be managed by well-balanced monetary policy. The member noted that fiscal policy was expected to be expansionary in the June Inflation Report. The new government's fiscal policy was probably even more expansionary than anticipated, but as it was expected to have effects on both demand and supply, this did not give any reason for additional concern with regard to inflation.

Another member agreed with the earlier members who had pointed out that monetary policy had been expansionary for several years and, as its impact comes with a time lag, it would also boost the economy next year. There was a risk that this would contribute to a continued high rate of increase in household borrowing and house prices. This would increase vulnerability in household balance sheets. If the liabilities were given and the value of the assets was to decline, this would probably lead to increased saving and reduced consumption. A fall in house prices often leads to a reduction in construction investment. All in all, this could lead to a severe decline in demand, which in the longer term could lead to inflation being below target. The member pointed out that, given this background, it was better to have slightly lower inflation in the short term than to risk a severe decline in demand and low inflation further ahead. In addition, the inflation forecast in itself provided reason to increase the interest rate. The low forecasted rate of inflation in 2008 was partly due to the expectation that electricity prices would fall. This was thus a supply effect. If the inflation rate was adjusted for these electricity prices, the picture looked rather different.

One member pointed out that the Riksbank's application of the inflation target was equilateral; an inflation rate below the target would be regarded as equally serious as an inflation rate above the target. However, the decisive factor was the economic circumstances and the direction and speed at which inflation was expected to change.

Another member emphasised the importance of ensuring the application of the inflation target was equilateral. House price trends and household borrowing currently gave no reason for concern with regard to financial stability. However, there could be problems for individual households. Raising the interest rate in this situation was a preventive measure. The risk of a decline in demand which some members had claimed as an argument in favour of an interest rate increase at the current meeting lay probably at least a couple of years ahead. A lot could happen before that with regard to, for instance, house prices, borrowing, international economic activity and monetary policy. The monetary policy framework in itself can take into consideration the situation in which Sweden finds itself. A span of 1-3 per cent for inflation was appropriate, as was sometimes allowing longer time than a couple of years for inflation to reach the target level. However, the question was how many years could be considered reasonable for inflation to be below target in a situation where there was plenty of spare capacity in the labour market. In addition, inflation would have been much lower in recent years if the oil price had not risen.

One member commented the expected deviations from the inflation target and pointed out that it was possible to draw a parallel to the situation in 2003 when high energy prices pushed up inflation above target level. As the energy price rise was assumed to be temporary, the interest rate was not increased. When the effects abated the following year, inflation was low, which did not lead to any interest rate change either. The current electricity price forecast had a profile that contributed to temporary low inflation a couple of years ahead.

One member pointed out that although the rate of increase in house prices and lending by mortgage institutions had slowed down somewhat, the levels remained high. The member agreed that the proposed changes in property tax would give rise to one-off effects that need not be problematic.

One member took up the question of how monetary policy should take into account energy prices. The dry summer in 2003 contributed to a temporary rise in energy prices, which then fell again. In this situation, changing the interest rate was not justified. In the current situation, there was reason to believe that the upturn in electricity prices in part was of a structural nature. Swedish electricity prices would probably gradually approach the higher price level in the rest of the EU. Monetary policy must take this development into consideration, as it would have a more lasting effect on the rate of price increase. However, even now it was partly a question of temporary effects due to low water levels in reservoirs. The temporary effects were expected to subside in 2008-2009 and this type of shock need not be counteracted by monetary policy.

Another member observed that both supply and demand effects had been behind energy price developments in recent years. The increased demand, for instance for oil in emerging economies in Asia in particular had pushed up the oil price. These emerging economies' increased participation in world trade had at the same time led to downward pressure of prices of manufactured goods. It would be asymmetrical to remove the effect of energy prices but not the effect on manufactured goods. Demand-driven inflation normally gave reason for monetary policy measures, but if the price movements were instead driven by supply shocks, monetary policy should not react to the direct price effects. One member objected that it was not always easy to separate these effects from one another.

One member concluded the discussion, by observing that all members were agreed that an increase in the repo rate of 0.25 percentage points was the most reasonable decision at present. Continued good economic activity and rising inflation meant that the repo rate would need to be increased gradually. Inflation was forecast at slightly below target level two years ahead, partly due to temporarily falling energy prices, but was then expected to rise. It was reasonable to assume that the repo rate would need to be increased further, roughly in line with recent market expectations. The exact rate at which this should be done would as usual be determined by economic developments.

§ 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 2.75 per cent.

The Executive Board decided after voting

- that the repo rate would be raised to 2.75 per cent and that this decision would apply from Wednesday, 1 November 2006,
- that the lending rate would be raised to 3.50 per cent and that the deposit rate would be raised to 2.0 per cent, with effect from Wednesday, 1 November 2006,
- to announce the decision at 8.00 a.m. on Thursday 26 October with the motivation and wording contained in Press Release no. 47 2006 (Annex to the minutes) and
- to publish the minutes of today's meeting on Wednesday, 15 November 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

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