Separate Minutes of the Executive Board, No. 17

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

DATE: 14 December 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
Kerstin Hallsten
Ann-Christine Högberg
Pernilla Meyersson
Marianne Nessén
Bengt Pettersson
Johan Rydelius (§1)
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Bengt Pettersson and Sara Tägtström would prepare draft minutes of paragraphs 1 and 2 on the agenda for the meeting. The discussion was based on the new statistics 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 which the Riksbank considers to be most desirable.

1. The economic outlook and inflation prospects

1.1 The Executive Board discussion regarding the international economic outlook

One member began by referring to the assessment in the October Inflation Report, where it was observed that international growth had been both high and stable in recent years, not least during the first half of this year. GDP growth is expected to remain high in the coming years, although the rate of growth is expected to decrease slightly in future. The information received since October agrees well all in all with the picture of continued positive global economic activity described in the Inflation Report. Economic activity appears to become slightly weaker in the United States and in Japan than in the October forecast, although this is compensated for by stronger growth in the euro area, the United Kingdom and the Nordic countries.

For the United States, the outcome for GDP growth in the third quarter this year is slightly weaker than expected. This is mainly related to a surprisingly fast fall in residential investment. The effect of the slowdown of the housing market on household consumption is an important factor to take into consideration in assessments of the US economy in future. The most recent indicators of household consumption are not wholly clear-cut. Retail sales in November indicate continued stable demand. In the euro area, growth has been slightly stronger than the assessment in October. While GDP outcome for the third quarter this year was in line with the forecast, outcome for the second quarter has, at the same time been revised upwards.

Inflation abroad has been slightly lower than expected, which is largely explained by an unexpectedly fast fall in the oil price. Forward pricing also indicates a lower oil price during the first half of 2007. However, forward pricing for 2008 and 2009 indicates a higher price. In addition, the global producer prices for manufactured goods have developed more weakly than estimated. All in all, this has meant that CPI inflation in the United States and in the euro area has fallen slightly more than expected. In the United States, the underlying inflation, excluding energy prices and food, is still relatively high although it has slackened to some extent recently. All in all, the new information indicates slightly lower inflation abroad compared with the forecast in the Inflation Report.

Another member agreed on the whole with this description of developments. The economy has entered a mature phase led by the United States. However, the changes are not especially great compared with October. Growth in the world economy is high and the prerequisites for continued favourable development are good. The financial conditions remain expansionary. Asset prices are high, credit spreads low and credit growth high in most quarters.

One member pointed out that the problem of global imbalances persists and that the risks associated have not changed.

Another member considered, however, that the prospects for an orderly adjustment of the global imbalances can be considered to have improved. The dollar is falling in value and the rate of increase of housing prices has slowed down markedly in the United States. These two factors have previously been said to be important to achieve a gradual correction of the imbalances.

One member agreed that the global level of economic activity continues to develop positively even though the housing market in the United States has slowed down more than was previously assumed. Economic development is favourable in the euro area, the United Kingdom and our Nordic neighbouring countries which together receive a considerable proportion of Swedish exports.

The member considered that it is positive that the recent weakening of the dollar took place now and not a few years ago. The stronger level of economic activity means that the euro area can absorb a weakening of the dollar better than previously. As long as no abrupt corrections take place, the dollar and US house price developments are not major risk factors. So far, developments have not indicated that any damaging correction of the global imbalances is taking place. In order for more abrupt adjustment to take place, something extraordinary would probably have to happen, for instance, in the field of security policy.

Another member agreed that the probability of an orderly correction of the global imbalances has increased. In a saving perspective, the prospects have improved for a reduction or at least a stabilisation of the United States' current account deficit through an apparent increase in both public and private saving. Public finances in the United States have improved rapidly as a result of substantial tax revenues and the slowdown in the housing market can have contributed to the recent increase in saving by households.

1.2 The Executive Board discussion regarding financial market developments

One member noted that the implied forward rates have changed marginally compared with the assessment in the Inflation Report. Market expectations on future repo rate changes have shifted upwards slightly for the coming year, but downwards in the longer term. Long-term interest rates have decreased recently both in Sweden and abroad. One reason for this may be increased pessimism about the economy in the United States due to the slowdown of the housing market.

In trade-weighted terms, the krona has strengthened more quickly than expected, partly due to the general weakening of the dollar. The question is how long this trend will endure. Abrupt shifts often take place in the foreign exchange markets. However, it is natural for the krona to strengthen in the light of the favourable development of Sweden in relation to other countries both in terms of growth and inflation during the forecast period. The krona may very well become somewhat stronger in future than the Riksbank has previously expected.

The stock exchanges in Sweden and abroad have risen by around 10-15 per cent so far this year. An important contributory cause is the continued strong growth of corporate profits. Lending to Swedish households has continued to increase and housing prices to rise even if some slackening of the rates of increase may possibly have taken place during the autumn.

Two members considered, however, that it was too early to say where the Swedish credit and housing market was heading. Even though some slowdown has taken place, the rates of price rises and lending remain high.

1.3 The Executive Board discussion regarding the Swedish economic outlook

One member began by commenting that the Swedish economy had developed slightly more strongly than the assessment made in the October Inflation Report. Both GDP growth and productivity have been revised upwards for 2004 and 2005, and there are indications that growth may be somewhat stronger this year and next year than the Riksbank estimated in October. New national accounting statistics show that GDP growth in the third quarter was slightly higher than expected and indicators such as retail sales, the business tendency survey and the purchasing managers index provide evidence that growth will be higher than expected in the fourth quarter as well. Although consumption developed slightly more weakly than expected during the third quarter, indicators such as household purchasing plans indicate that households remain optimistic. Foreign trade has continued to develop strongly and there is reason to revise the short-term forecast upwards. However, investments have developed somewhat more weakly than expected.

Employment has continued to increase rapidly and this rise has been stronger than expected. Indicators such as the number of redundancy notices and vacant jobs also indicate that the labour market will develop well in future. The improved state of the labour market has also meant that labour supply has increased. Unemployment has therefore not fallen to the same extent as the rise in employment would otherwise have implied.

Productivity growth is very strong in the initial position even though the outcome of the third quarter this year was slightly weaker than expected. However, productivity growth is expected to slow down apace with the continued improvement of the labour market. According to the national accounts, wages have risen somewhat less than forecasted in the inflation report. In connection with the wage bargaining rounds, the Swedish trade union confederation, LO, has presented wage demands averaging 3.9 per cent per year during the agreement period and a special focus on those earning low wages. Estimates from the employers indicate that the costs for the wage demands presented will be higher. In October, the Riksbank's forecast was that wages (according to short-term wage statistics) would rise by almost 4 per cent annually in the coming years. At present, it is too early to determine whether there is any reason to change that assessment.

Inflation expectations have increased slightly overall in a two- and five-year time period, although the expectations of the money market are still around 2 per cent.

One member agreed with the picture of a favourable development of the economy. GDP growth is expected to be slightly stronger and employment considerably stronger than forecasted in the Inflation Report.

One member observed that the Executive Board has noted at a number of monetary policy meetings that growth was surprisingly strong. Growth has now retrospectively been revised upwards as well. The faster rise in employment also indicates a slightly faster growth in future than we previously believed.

Another member substantially agreed with the initial description. Productivity growth has slowed down and it should be lower in future when the labour market continues to improve. The member wanted, however, to tone down the risk for stronger growth having to lead to higher wages than expected. Collaboration between the business sector, those arranging education and training and the employment office often works well in the local/regional labour markets. Provided that resources will continue to be available for education and training of jobseekers, the parties should be well equipped to meet increased demand. While the collective bargaining rounds entail some uncertainty, the wage growth has often been overestimated in recent years.

One member agreed by and large with the previous contributions. The changes that have taken place since October are small. Growth and the increase in employment will probably be somewhat greater this year and next year compared with the forecast in the Inflation Report. Domestic demand is strong and the economy receives an impetus from abroad. Employment is increasing at a good rate and unemployment falling at the same time as shortage rates are increasing. In the light of the most recent results for unemployment, the member raised the question of whether the unemployment forecast was slightly high.

Another member observed that unemployment was unusually low in November, 4.3 per cent, although a more reliable picture is obtained by looking at three-month moving averages when analysing the state of the labour market. This is due to the so-called panel effect, which is due to three mutually independent samples being analysed in three consecutive months. If the panel effect and seasonal variation are taken into consideration, the picture of the state of the labour market is not as tight. Seasonally-adjusted unemployment was around 5 per cent during the three-month period September-November.

One member observed that the employment forecast in the Inflation Report was somewhat cautious. This leads to the forecast now having to be adjusted upwards. At the same time, it is difficult to make good forecasts when large structural changes are taking place in the labour market and in the economy. What is interesting is the effect that all these changes will ultimately have on inflation.

One member summarised the discussion. Abroad, the economy has substantially developed in line with the assessment in October. It seems that growth will be slightly lower in the United States and Japan but, on the other hand, somewhat stronger in the euro area and the Nordic countries. In Sweden, GDP growth appears to be somewhat stronger than expected this year and some upward revision of the forecast for 2007 would seem to be justified. The same applies to the forecast for employment and the labour force.

1.4 The Executive Board discussion regarding future inflation

One member started the discussion by noting that the annual rate of increase of CPI and UND1X amounted to 1.7 and 1.3 per cent respectively in November, which was in line with the forecast in the Inflation Report. Revised national account statistics show that the cost pressure was lower in both 2004 and 2005 than previously reported due to productivity growth being somewhat higher and the wage growth slightly slower. Since prices are to some extent rigid and react slowly to cost changes, this should affect the assessment of inflation in future. Furthermore, in the near future, inflation will be held back by lower energy prices and a stronger krona than we calculated with in October. However, just as before, it is reasonable to expect inflation to rise gradually when resource utilisation increases. In the longer term, inflation prospects are substantially the same as in October. This means that inflation measured with the underlying measure UND1X is expected to be close to, although at the lower edge of, the inflation target margin two years' ahead. This assumes a gradual increase in the repo rate.

Other members substantially shared this assessment.

One member thought it was also conceivable that we will see an even greater fall in energy prices and thus lower inflation during the coming year. On the other hand, it is important to be observant to what is happening to the underlying inflation, where different types of measures have shown a gradual increase during the past year. A continued expansion of the service sector can be expected to lead to higher inflationary pressure since productivity growth in this sector is in general lower than in the manufacturing sector. Within a time frame of a couple of years, it is reasonable to assume that inflation will be close to the target.

One member agreed that there are factors that indicate a continued low inflationary pressure in the near future. However, there are also a number of factors which indicate rising inflationary pressure in the longer term. One special uncertainty factor next year is the wage bargaining rounds in the labour market. Wages have increased moderately in recent years. Even though the rate of wage increases can be expected to increase slightly in the next few years, when the state of the labour market improves, it is still most probable that the agreements will lead to relatively moderate wage increases. At present, there is a relative abundance of unutilised resources in the labour market, which should restrain the rate of wage and price increases. Institutional changes such as an improved framework for wage formation and an increased credibility of monetary policy have also contributed to wage formation functioning better in the past decade than previously. At the same time, employment is rising at a rapid rate and there is naturally a risk that the bargaining rounds will be more problematic and result in higher wage increases than expected. Together with the stronger real growth, the upside risk for inflation mentioned in the Inflation Report appear more clearly.

One member pointed out that if a shortage situation were to arise in the labour market, there would be a risk, due to a greater input of local wage formation, of it having an impact more quickly in a higher rate of wage increase than before. The wage bargaining rounds are naturally an uncertainty factor. However, high corporate profits mean at the same time that a higher rate of wage increase does not necessarily have to lead to rising consumer prices.

One member agreed that the inflation assessment from October remains valid in all essentials. Domestic and international developments only entail marginal changes. All in all, the picture is about the same as it was before. At the same time, it is necessary to carefully monitor the development of wage formation in the current buoyant economic situation. The financial development also supports the picture of a strong state of demand.

Another member underlined the statements made by previous members about the risks. We are in an economic upswing with an expansionary fiscal and monetary policy. The faster increase in employment and rising shortage rates also cause some concern about next year's wage bargaining rounds. The buoyant state of the economy is also reflected in a fast growth of credit and the growth of the money supply. This is something to continue to pay attention to.

One member emphasised that inflation would be held back in the short-term by energy prices although, in a situation with a rapid increase in domestic demand, it is important to monitor price movements in different areas. The development of electricity prices is a temporary supply effect which monetary policy should not take into consideration. Adjusted for energy prices, domestic inflation is increasing as forecasted. As before, inflation is held down by low imported inflation. As previous members have taken up, the increase in asset prices and credit growth continues to be high even if some slowdown may have taken place in the recent period. As before, this means a continued risk for a strong decline in demand in the longer term, which can eventually lead to inflation being below target. At the same time, the member noted that inflation expectations have increased in a two- and five-year period both among the social partners and purchasing managers.

One member summarised the discussion by inflation being expected to be close to target two years' ahead, approximately in line with the assessment in the Inflation Report. In the short term, inflation may be slightly lower than expected primarily due to lower energy prices. The member noted at the same time that a number of members expressed concern for the buoyant state of the economy leading to higher inflation than expected.

§ 2. Monetary policy discussion

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

The Swedish economy is developing somewhat more strongly than our assessment in the October Inflation Report. This applies both to GDP and employment. However, the consequences for resource utilisation are unclear since labour supply is also increasing more quickly. To date, it does not seem as if inflationary pressure has increased. Cost pressure was lower both in 2004 and 2005 than previously reported and in the short term inflation will be held back by lower energy prices and a stronger krona than we estimated in October. However, in the longer term, the inflation prospects are substantially the same as in October, and inflation is accordingly expected to be close to, although at the lower edge of the target margin two years' ahead. The changes in market expectations of the Swedish repo rate have been small compared with the basis for our assessments in the October Inflation Report.

Inflation is below the inflation target for a large part of the forecast period. This could *per se* be an argument in favour of raising the repo rate slightly more slowly than expected by the market. It is assumed that the favourable supply conditions in recent years will continue to hold back inflation during the forecast period although to a gradually lesser extent apace with the strengthening of the labour market. It is, of course, possible that cost pressure may continue to be lower in future than we have expected. However, monetary policy is still expansionary – one indication is that the growth of credit is strong – and one cannot disregard the risks of continuing to stimulate the economy with a low interest rate when it is growing so quickly. In my opinion, it is therefore justified to raise the interest rate by 0.25 percentage points even if this means that it will take somewhat more than two years before inflation reaches 2 per cent.

According to our present assessment, further increases in the repo rate will be necessary. However, the rate at which this takes place depends on how the economy develops. The strong growth and the new government's economic policy means that demand for labour will probably increase. However, labour supply will also be affected and all indications point to there being a substantial labour reserve at present. While the proportion of companies specifying a shortage of labour power is increasing, it is still not high with the exception of certain sectors, for instance, the construction sector. The consequences that this will have on inflation will not least depend on how well matching functions in the labour market. This is something that we must monitor carefully in the future. Taking into consideration, the information currently available, it is reasonable in my assessment to expect that the repo rate may need to be raised at approximately the rate expected by the market recently.

In the light of the previous discussion of the state of the economy and the inflation prospects, all members supported the proposal to raise the repo rate by 0.25 percentage points.

One member pointed out, however, that the inflation forecast could also justify an interest rate path that means a slightly slower increase in the interest rate in future, which would produce a more favourable real economic development. However, the member considered that the risks associated with the strong state of the economy and the ongoing wage bargaining rounds mean that there is no reason to take a discrepant view at present.

One member noted by way of summing-up that the new information received does not provide a reason to change the assessment from October in any crucial direction. The buoyant state of the economy is subsequently expected to lead to an increase in domestic cost pressures, apace with a slowdown in productivity growth and a faster rise in wages. This means that inflation will rise. Inflation, measured by both CPI and UND1X, is, however, expected to be moderate despite a healthy development of the economy. This is due to a low domestic cost pressure initially and low international price pressures. In addition, inflation is held down by temporarily falling energy prices and a strengthening of the krona. Compared with the assessment in October, the forecast for inflation may need to be adjusted downwards in the short-term primarily as a result of lower energy prices. Otherwise, the analysis of the situation is approximately the same as in the October Inflation Report and it is reasonable to expect that the repo rate will have to be increased further, approximately in accordance with recent market expectations.

The future conduct of monetary policy will as usual depend on the new information received about economic development abroad and in Sweden and the effects that this may have for Swedish inflation prospects.

§ 3. Monetary policy decision

The Chairman found that there was only one proposal: To raise the repo rate by 0.25 percentage points to 3.0 per cent.

The Executive Board decided unanimously

- that the repo rate would be raised to 3.0 per cent and this decision would be applied from Wednesday, 20 December 2006,
- that the lending rate would be raised to 3.75 per cent and that the deposit rate would be raised to 2.25 per cent, with effect from Wednesday, 20 December 2006,
- to announce the decision on 15 December 2006 at 9.30 a.m. with the motivation and wording connected in Press Release no. 53 2006 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Wednesday, 2 January 2007 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