Separate minutes of the Executive Board, No. 4

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DATE: 29 March 2007
TIME: 1 p.m.

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

Leif Pagrotsky, Vice Chairman of the General Council

Claes Berg
Mårten Bjellerup
Kerstin Hallsten
Jesper Hansson
Ann-Christine Högberg
Pernilla Meyersson
Johan Rydelius (§1)
Staffan Viotti
Anders Vredin
Anna Webrell

§ 1. The economic outlook and inflation prospects

It was noted that Mårten Bjellerup and Anna Webrell 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.

1. International economic developments

One member began by observing that the international assessment in the February Monetary Policy Report appeared to remain valid. As expected, growth was continuing to develop strongly around the world. However, new information received indicated that growth in the United States would be slightly weaker than predicted in February. This is largely due to the fact that the outcome for GDP in the fourth quarter of 2006 has been revised down. The slowdown in the United States is mainly due to developments in the housing market and the car industry. Private consumption has nevertheless been held up and the indicators received during the first quarter point to a development in consumption well in line with the assessment in the Monetary Policy Report published in February.

Nevertheless, the uncertainty over developments in the United States has increased slightly compared with the situation in February. At the beginning of the year, it looked as though there had been some stabilisation, but the indicators in recent months show a more divided picture. The risk outlook in the United States has changed and one cannot rule out the possibility of continued weakening. The increased risk is partly concerned with developments in the part of the housing loan market aimed at households with low credit ratings, the sub-prime mortgage market. A rapidly growing percentage of these borrowers have suffered problems in following the set payment plans. It is difficult to assess how extensive the consequences of this could be.

In the euro area, on the other hand, growth during the last quarter of 2006 was slightly stronger than expected. The indicators that have come at the beginning of this year point to continued favourable developments. There may thus be reason to make a slight upward revision to the growth forecast, particularly for this year. Developments in the United Kingdom, Norway and many emerging markets are marginally stronger than was forecast in February. All in all, international economic developments are slightly stronger than expected, while the downside risks have increased slightly in the United States.

The oil price has risen recently. This also applies to forward prices, which gives reason to revise the oil price forecast upwards. The reasons for the price rise are probably mainly political unrest linked to Iran and cutbacks in production in the OPEC countries.

International inflation was in February expected to be lower in 2007 than in 2006, which still appears a reasonable estimate. CPI inflation in the United States has developed in line with the forecast, while that in Europe and Japan has been slightly lower than expected. However, the outcome for international producer prices in the fourth quarter of 2006 is definitely lower than the forecast made in February, which indicates that the forecast should be revised down.

Both the bond and stock markets showed a downturn at the end of February. Although share prices have recovered since then and interest rates in Europe have returned to their earlier levels, this does not mean that the unease on the financial markets has disappeared. It is likely that it is partly connected with the problems in the sub-prime mortgage market and the signals of weaker economic activity in the United States, where interest rates and stock markets have not recovered to the same extent. The monetary policy expectations in the United States have shifted downwards, compared with February, while those in the euro area remain largely unchanged in the short term, and are somewhat lower in the slightly longer term.

Another member agreed on the whole with the developments described and noted that the weaker economic growth in the United States so far is in line with the soft landing described in the February forecast. A downturn is also necessary if the deficit in the US current account is to be reduced. Future developments will depend largely on events in the housing market and the consequences this has for private consumption. Although the main scenario can be said to be unchanged compared with the picture painted in the February Monetary Policy Report, the risk outlook in the United States has now changed and there is a greater risk of an abrupt slowdown. If this risk scenario is realised, it could have serious consequences for the world economy, not least for the export-dependent countries in South East Asia. Nor is it possible to rule out the risk of negative chain reactions. Weaker US growth would probably be followed by a weaker dollar and falling stock market prices. Add to this the uncertain geopolitical situation in the Middle East and the situation would not be entirely unlike that in 2000 and 2001.

One member agreed to a large degree with the developments described, including the increased risks regarding US economic activity. However, the member wished to point out that the high global growth rate had been unusually prolonged, and that it had a good geographical spread. Growth in the OECD area is around 3 per cent a year, while the rest of the world, which accounts for around half of the world's GDP, is growing at a rate of around 7 per cent a year. Although growth in the United States is slowing down, our immediate surroundings are more important to the Swedish economy. As growth there is slightly stronger than was previously estimated, it should give stronger growth in the Swedish export markets.

Another member questioned whether the risk outlook for the US economy had really changed much, but otherwise agreed with the descriptions. House prices in the United States have primarily fallen in the parts of the country where they have earlier risen by a worrying amount. The fact that house prices have fallen in these areas without creating financial unrest is a healthy sign and, if anything, increases the probability that a slowdown can occur smoothly. The member did not want to describe this as an increased risk. This type of slowdown in the housing market is actually what many analysts, including the Riksbank, have envisaged.

With regard to housing finance in the United States, several institutions active in the so-called sub-prime mortgage market have experienced difficulties. These companies, which moreover are not under the supervision of the authorities, have evidently misjudged the credit risk among the households with low incomes or poor credit histories to which they have lent money. So far, however, the market has managed these problems. It is not unreasonable that institutions which have taken overly large risks are forced to default – on the contrary, this is the way a market should work. So far we have not seen any contagion effects in other parts of the housing market. If many borrowers cannot meet their interest and amortisation payments and are perhaps forced to give up their houses, this is of course a serious matter and may have effects on economic activity. However, there is nothing to indicate that developments in the sub-prime mortgage market need yet go this far.

One member considered that the world economy was doing well as a whole and emphasised that the good growth was well spread geographically. Seen from a Swedish perspective, it is clear that this is a positive reinforcement of the current strong domestic developments. Looking at developments in the financial markets, the pricing of bonds issued by emerging markets is still very low in historical terms. This means that the current impression among investors is that the strong economic growth will continue and if this proves not to be the case, risk is being priced incorrectly. Developments in the United States are spreading some uncertainty, particularly given that it was the rising house prices and increased lending to households that were previously holding up private consumption. Given that the developments continue to be orderly, the downturn in the housing market is a good thing and indicates that the slowdown in the US economy will be smooth. The fact that uncertainty has increased is an important observation, but with regard to Swedish monetary policy it is at present too early to draw any clear conclusions.

2. Swedish economic developments

One member began by observing that GDP growth according to the National Accounts for the fourth quarter of 2006 was slightly stronger than the forecast in the February report. However, the revisions to statistics published earlier meant that the outcome for growth in 2006 as a whole was in line with the forecast. However, there were some deviations for individual expenditure components in demand, including investment and foreign trade, which developed more strongly than expected. The indicators received since the February Monetary Policy Report was published are largely strong, for instance, the production and order figures and barometer date, and they indicate slightly higher domestic demand. There are some signs of weakness with regard to retail trade and foreign trade. All in all, developments indicate that a small upward revision needs to be made to the GDP forecast for this year.

Households' disposable incomes were lower than expected in 2006, according to the National Accounts figures. When disposable income is calculated, tax on capital gains is deducted, which has major effects during those years, such as 2006, when capital gains are unusually large. If the statistics are adjusted for this, the outcome for households' purchasing power is more in line with the forecast in the February report. For this year, it looks as though purchasing power will even be somewhat stronger than forecast.

The forecast for investments may need to be adjusted upwards, primarily for two reasons. Firstly, the outcome for public sector investment and housing investment for the fourth quarter of last year was stronger than expected. Part of this increase is probably due to a number of construction starts being brought forward, because of some building subsidies being abolished at the end of the year. Secondly, the investment survey in February indicates slightly more expansionary industrial investment plans than the October 2006 survey did.

Exports increased slightly more than expected during the fourth quarter last year, but during the first quarter of this year the indicators for exports were slightly weaker than expected. Given a slightly faster rate of increase in export market growth and a slightly weaker krona than estimated, there should be a cautious upward adjustment made to the forecast for exports.

The labour market is continuing to improve, roughly in line with the forecasts in the February report. Indicators such as redundancies and the number of vacancies indicate a strong development in demand for labour, while supply is also increasing. All in all, this may very well be compatible with an unchanged forecast for unemployment. Despite some slowdown in productivity growth, it is still expected to be good.

The wage bargaining rounds for manufacturing resulted in an increase of 10.2 per cent over three years, while the situation for the wholesale and retail trade is still uncertain. Many central agreements still remain to be signed. If this goes according to the current plans, many of them will be completed by the end of May. The picture of the wage bargaining rounds will then be much clearer. Wage agreements are important in assessing inflation, as are the labour market and productivity.

The rising oil price contributes to the possibility that inflation may be slightly higher in the short term than earlier forecasts have indicated. At the same time, the fall in prices on the electricity exchange has not yet had an impact on consumer prices, which means it is reasonable to expect a negative contribution to inflation from here in the future. One factor that has an impact in the opposite direction is that the krona has shown weaker development than expected. The total effect will probably be that inflation does not fall as much over the coming year as was expressed in the February forecast, but that in the slightly longer term it will develop roughly in line with the assessment made in February. This means that the forecast for inflation, measured as UND1X, is still expected to be in line with the target a couple of years ahead.

Developments in the Swedish financial markets have been relatively similar to those in other countries. Following the publication of the Monetary Policy Report in the middle of February, both stock market prices and interest rates fell, but they have since risen again. The ten-year bond rate is marginally lower and the stock market index marginally higher than at the time of publication in February. The monetary policy expectations, as reflected in implied forward rates, have been adjusted upwards again and are currently at around the same level as prior to the publication of the Monetary Policy Report in February. The rate of increase for both house prices and lending to households has fallen, albeit from a high level.

One member pointed out that the new information reported since the last Monetary Policy Report indicated a stronger development in the Swedish economy than forecast. The National Accounts for the fourth quarter of 2006 were slightly stronger than expected. At the same time, earlier quarters were revised down, so that the annual average for 2006 was still in line with the forecast. If one looks at how the forecasts has been revised over a slightly longer period, it is possible to see a system in the revisions regarding developments in the real economy. Since the beginning of last year the forecasts have been gradually revised upwards. From 3.5 per cent to 4.5 per cent for GDP growth in 2006 and from 2.8 per cent to 3.5 per cent for GDP growth in 2007. The most recent information indicates a need for further upward revisions. The National Institute of Economic Research's forecast for GDP growth in 2007 is 3.9 per cent.

In addition, the Institute's business tendency surveys for February and March were very strong. Manufacturing activity has continued to improve and construction activity is at a record high. The retail trade is continuing to increase its sales and demand in the private service industries is continuing to rise. One sign of the generally strong situation is that the National Institute of Economic Research's new Economic Tendency Indicator is at a high level, above 110, which means that the economy is stronger than normal.

The picture of the labour market is also stronger now than it was in February. The labour force surveys in January and February indicate a faster increase in employment and a greater decline in unemployment than calculated. Employment was then on average 0.4 per cent higher and unemployment 0.2 percentage points lower than forecast. Seen over a threemonth period, employment has risen more rapidly than expected and is now growing at an annual rate of around 100,000 persons. Unemployment has fallen to 4.9 per cent, which is 0.9 percentage points lower than during the corresponding period last year.

The member also noted that the economic tendency survey published by the National Institute of Economic Research today also reported a very strong picture of the Swedish economy. Compared with the Monetary Policy Report in February, the Institute is predicting a stronger development in the real economy and employment this year and next year and also a slightly higher rate of increase in prices and wages. They also believe that the prevailing wage agreement situation will increase the pressure on wage developments and in turn on inflation developments. The risk of a similar development should be taken into account at today's meeting.

The member also considered that the wage bargaining rounds had not begun very well. It appears that the wage bargaining rounds may result in rates of wage increase higher than was forecast in the February report. There are now two figures being mentioned with regard to the centrally-agreed wage increases. The first is a three-year agreement in industry which is said to entail a 10.2 per cent wage increase and the second is a not-yet signed three-year agreement in the wholesale and retail trade area said to entail a 12.6 per cent wage increase over three years. The fact that the agreements signed are for three years reduces uncertainty over wage cost developments. At the same time, it is a problem if the levels are above what is compatible with the wage forecasts in the February report. In addition to the agreed wage increases there will be wage drift and possible changes in wage-related fees.

Another member agreed that the forecast for GDP growth had needed to be gradually adjusted upwards over the past year but emphasised that this is no longer the case with the inflation forecast and that underlying inflation is still low.

A further member agreed that growth had once again proved to be higher than the forecasts and that the labour market also appeared to be developing more strongly than expected. The growth rate in house prices and lending has declined, but is still at levels that are not sustainable in the long term. The member noted in this context that there was no equivalent to the sub-prime mortgage market in Sweden. Although banks and other institutions lend money for consumption without collateral and at a high interest rate, this comprises an extremely small part of the total lending.

One member noted that lending has not increased at the same high speed as earlier, which is satisfactory. However, the future will show what effects the continued strong growth in the economy would have on the credit market and in turn on inflation and whether these effects would be visible within the monetary policy horizon. Such a development should still be regarded as an upside risk, but at present did not appear to have such large effects on inflation.

Another member agreed that developments in the labour market appear strong. The positive development in the domestic economy means increased purchasing power and reinforced private consumption, which may balance the downturn in exports that could be triggered by a possibly more pronounced slowdown in international economic activity.

Given the strong public finances, public investment, above all in the local government sector, is expected to be higher than was assumed in February. Despite these favourable conditions, there is still high unemployment that can be assumed to remain at a level above four per cent throughout the entire forecast period.

The member observed that according to the forecast, inflation would first approach the target level towards the end of the forecast period and then remain roughly in line with the target. While the Riksbank's assessments means that unemployment would decline somewhat and that inflation would rise, this does not mean that the correlation between inflation and the real economy is stable over time. A positive production gap need not necessarily lead to inflation being pushed up. This has several explanations, including the fact that globalisation means increased competition and thereby fewer opportunities to raise prices. The member therefore agreed with earlier statements that there was relatively little worry at present over inflation rising too rapidly.

One member summed up the discussion. Economic activity is developing strongly both in Sweden and abroad. Economic developments have in general been in line with the assessment made in February. Growth looks to be slightly lower in the United States, but slightly stronger in, for instance, the euro area. In Sweden, too, GDP growth may be somewhat stronger than expected. The same applies to developments in employment and the labour force. Lending and house prices are continuing to increase relatively rapidly, although the rates of increase have slowed down. The krona has shown slightly weaker development than expected.

The wage bargaining rounds so far indicate that wage increases may be slightly higher than forecast. The slightly stronger economic activity also indicates this. Developments in the labour market thus entail a slightly increased risk of higher inflationary pressures than expected. At the same time, there are several factors holding back inflation.

§ 2. Monetary policy discussion

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

The new information received since the February Monetary Policy Report was published indicates some slight changes to the outlook for economic activity and inflation made at that time. All in all, however, these are fairly marginal changes. Domestic demand in GDP growth may possibly be slightly stronger than expected and this also applies to employment. However, the labour supply is also increasing slightly more quickly and unemployment will therefore probably not be much lower during the forecast period than was described in the February report. The assessment was then that there was still plenty of spare capacity in the labour market and in this respect there has been no change. This indicates that the risks of a strained labour market situation have not changed.

With regard to wage formation, on the other hand, the risks of higher inflationary pressures appear to have increased slightly, although the new agreements signed in the industrial field are not patently incompatible with the wage forecasts made in February. The question now is whether these agreements will serve as guidance for the remainder of the labour market and how large the wage drift will be. In my opinion it is too early to draw any firm conclusions regarding the total result of the wage bargaining rounds. If the timing of the negotiations follows the current plan, the picture should be much clearer in just a couple of months. It is evident that there are some worrying signs, but I consider it wise to wait and see before drawing any conclusions regarding the consequences for inflationary pressures.

At the same time, as in February, there is reason to point out that we should consider factors contributing to keeping down cost pressures. During the fourth quarter of last year productivity once again increased slightly more than expected. Although the rate of increase will not be as high this year as last year, it will probably still be good. Price pressures from abroad are also expected to remain and, together with good corporate profits, this indicates that prices will rise fairly slowly. The rate of price increase for the current year needs to be revised up, but this is mainly connected with the fact that the oil price has risen again. If energy prices are excluded, the rate of price increase is still low.

All in all, these are only marginal changes in economic activity and inflation prospects, compared with the outlook in February. My assessment is therefore that the forecast for the repo rate on which the Monetary Policy Report in February was based still appears reasonable. My proposal for a decision, given this background, is that the repo rate should be kept unchanged at today's meeting. The forecast for the repo rate entails an increase of 0.25 percentage points over the coming months and a further equally large increase later in the forecast period. This slow increase in the repo rate is sufficient to give inflation in line with the target a couple of years ahead and at the same time to give a balanced development in the real economy.

However, there is of course great uncertainty as to how monetary policy will need to be balanced in future. We cannot emphasise enough that the interest rate forecast will need to be reconsidered if developments do not follow the path we have predicted. With regard to developments in the Swedish economy, it will be particularly important to follow what is happening in the wage bargaining rounds. On the international front, interest is mainly focussed on the United States. There is reason to be observant of the risks of a more pronounced slowdown in the United States and the consequences this might have for economic growth in the rest of the world.

However, one member considered that the upside risks have increased substantially since the monetary policy meeting in February. Developments in the real economy have been stronger than forecast and the labour market has continued to improve at a more rapid rate than predicted. At the same time, it appears that the wage bargaining rounds will result in higher wages than calculated. The member's assessment was therefore that a decision should be taken today to raise the policy rate by 0.25 percentage points and that the future interest rate path should be revised upwards. Even after this upward adjustment, the path would still be at a relatively low level.

The member cited three main reasons for this assessment. The first reason concerns general economic developments. International developments are very strong, with growth figures for the world economy of around 5 per cent a year. Growth in Sweden is also unusually strong with a GDP growth of 4.5 per cent in 2006 and around 4 per cent in 2007, alongside rapidly increasing employment. In this strong economic situation, both fiscal and monetary policy are expansionary. Households' real disposable incomes are expected to increase substantially this year, interest rates are still low and credit expansion is strong.

The second reason is that most of the new information received since the monetary policy meeting in February indicates that economic developments are stronger than we predicted at that time.

The third reason is the situation in the spring wage bargaining rounds. A decisive factor for future inflation and monetary policy is how the strong real developments will affect wage formation and in particular how this can be managed in the spring wage bargaining rounds. The member's earlier assessment was that the negotiations would most likely result in agreements within a reasonable time, at levels compatible with the inflation target and without major conflicts. At the same time, the risks then were on the upside. Despite the good experiences of recent years, the wage bargaining rounds could be much more difficult and market forces could push up the rates of wage increase to higher levels.

This risk scenario now appears likely to happen. Coordinated three-year agreements with a moderate level of wage increase could have been compatible with low and stable inflation. What now looks to be the case is instead weaker coordinated three-year agreements at union level with higher wage increases than previously anticipated. In addition, a continued strengthening of the labour market risks resulting in increased wage drift. Of course, there are also downside risks, but these have already been described in an earlier contribution.

One member agreed that the risks of higher inflation come largely from overly high rates of wage increase, but pointed out that it is too early to evaluate the effects of the wage bargaining rounds and that concern over rising inflation thereby need not be so great. There was plenty of spare capacity and a slightly more strained labour market need not necessarily lead to higher inflation. Norway and Denmark have much tighter labour markets than the Swedish one, without inflation having accelerated for that reason. Moreover, Swedish firms have good profit margins, which means that they have the possibility to raise wages without raising prices. The increasingly stiff competition also means that it is difficult in general to raise prices. The member therefore considered that one should not exaggerate the upside risk from the wage bargaining rounds and the strong developments in the labour market. This was in addition balanced by the risk of a slowdown in the world economy, primarily due to developments in the United States. Based on this, the member considered that the repo rate should be kept unchanged.

One member shared the speaker before last's view with regard to the strength of the economic developments, both in Sweden and abroad, and the effect the economic upturn could have on the results of the spring wage bargaining rounds in Sweden. The member also expressed concern over the continued strong growth in credit and pointed out that there is still considerable uncertainty regarding the influence of monetary factors on both growth and inflation. In the view of this member, insufficient new information had been received in relation to the Monetary Policy Report to motivate raising the policy rate at today's meeting, but the future interest rate increases should be made at a more rapid rate than was foreseen in February.

Another member agreed that economic growth had continued to be strong both in Sweden and abroad. Slightly weaker growth in the United States is balanced by better demand in Europe and in the emerging markets. In Sweden, the outlook for wage developments, as far as this is now known, and a strong increase in real disposable incomes point to a future inflation rate that is possibly slightly higher than predicted in the February report.

At the same time, one cannot rule out the possibility that there have been structural changes in the economy, such that inflationary pressures will remain low. The profit share in the business sector is still at a good level, which reduces the need to pass on costs to consumers. Productivity growth is good, which holds back pressure on prices when wages rise. Low or falling import prices as a result of globalisation leads to permanent competitive pressure and thereby hold back prices.

All in all, in the member's view, this means that there is at present no reason to raise the policy rate. Nor has there come in sufficient new information since the last monetary policy meeting to motivate a new view of the future interest rate path. The forecast that the interest rate should be raised further over the coming months still stands. At the same time, the risks to inflation are now on the upside. If it were the case that wage developments are much higher than forecast, the view of the repo rate path should be reconsidered in future. If this is the case, the interest rate will need to be raised more than the current path indicates in order to attain the inflation target.

Although the member did not see any reasons to now change the assessment of how Swedish monetary policy should be formed, the previous uncertainty regarding international developments still remains. The global imbalances, the development of the oil price, the geopolitical situation and concern regarding overly low risk compensation in the financial markets – all these are factors that may affect the assessment in future.

§ 3. **Monetary policy decision**[1]

The Chairman found that there was one proposal to keep the repo rate unchanged and another to raise it by 0.25 percentage points to 3.50 per cent.

The Executive Board decided after voting

- that the repo rate be kept unchanged at 3.25 per cent and that this decision would apply from Wednesday, 4 April 2007,
- that the lending rate be kept unchanged at 4.00 per cent, and that the deposit rate be kept unchanged at 2.50 per cent, with effect from Wednesday, 4 April 2007,
- to announce the decision at 9.30 a.m. on Friday 30 March with the motivation and wording contained in Press Release no. 15 2007 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Monday, 16 April at 9.30 a.m.

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

Deputy Governor Svante Öberg entered a reservation against the decision to keep the repo rate unchanged and stated the following: The upside risks have increased significantly since the monetary policy meeting in February. Developments in the real economy have been stronger than forecast, the labour market has continued to improve more quickly than anticipated and the wage bargaining rounds appear to be resulting in higher wages than expected. My assessment is therefore that the policy rate should be raised by 0.25 percentage points today and that the future interest rate path should be revised upwards.

This paragraph was confirmed immediately.

Minutes by:
Ann-Christine Högberg

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