Separate minutes of the Executive Board, No.5

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DATE: 3 May 2007

TIME 1 p.m.

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

Johan Gernandt, Chairman of the General Council
Leif Pagrotsky, Vice Chairman of the General Council

Claes Berg
Victoria Ericsson
Kerstin Hallsten
Jesper Hansson
Ann-Christine Högberg
Björn Lagerwall (§1)
Pernilla Meyersson
Åsa Sydén
Staffan Viotti
Anders Vredin
Anna Webrell

§ 1. The economic outlook and inflation prospects

It was noted that Victoria Ericsson 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. In the short term there are some signs of slightly weaker developments in the United States and slightly stronger developments in the euro area. The slowdown that was expected in Germany as a result of the increase in VAT at the end of the year has not become as apparent as feared. Otherwise the new information is in line with the assessments made in February, both with regard to Japan, our Nordic neighbours and the United Kingdom

The oil price has risen further since the monetary policy meeting in March, which on this occasion may be considered primarily due to strong demand rather than supply shocks. This could be expected to lead to slightly higher inflation, particularly in the United States. In the euro area, inflation is in line with expectations.

Since the February report, long-term interest rates have risen a little in the United States and they have risen slightly further in the euro area and Sweden. International stock exchanges have strengthened since the downturn in February.

Monetary policy expectations have been adjusted upwards slightly in both the United States and the euro area. In the United States market agents are still expecting an interest rate cut in the longer term. In the euro area, where interest rates are lower, expectations of interest rate increases have risen as growth prospects have improved.

Another member observed that international developments are very strong. The International Monetary Fund (IMF) estimates that the GDP growth for the world economy will be around 5 per cent a year during the five years 2004-2008. It is not common to see such strong growth so many years in a row. The strong international development also has a broad geographical spread. Growth in the OECD area is almost 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. Growth in Asia is even more rapid. Even Africa, which is usually weakest in this context, is now growing at a rate of around 5 per cent a year.

Developments in the United States deviate from the international pattern, with growth continuing to slow down. Following a period of strong growth, rapidly rising property prices and moderate inflation, they now have the reverse situation, with low growth, a weak property market and overly high inflation. This presents a considerable challenge for monetary policy. The member claimed that the United States is ahead of Europe and Sweden in the economic cycle and that it is important to avoid Sweden ending up in the same situation as the United States.

The new information received since the monetary policy meeting in February indicates that total international growth is developing well in line with the forecasts in February, continued to the member. Developments are slightly weaker than expected in the United States and slightly stronger than expected in Europe. As the neighbouring areas are more significant for exports, this means, all in all, that the export market is growing slightly faster than was previously estimated.

One member agreed with the previous member's view of developments in the United States and pointed out that it is primarily the motor vehicle industry and the construction industry that are experiencing problems, while other parts of the US economy are still doing well. However, the uncertainty linked to developments in the United States is counteracted by the strong growth in the euro area and Asia. The member also observed that developments in the financial markets since the monetary policy meeting in April have been good. Stock exchanges have shown an upturn since the decline in February, with the exception of Japan. Credit spreads are low and volatility has declined. Insurance premiums in the credit market, as reflected in the price of credit derivatives, have fallen. The willingness to take risks appears to have returned to the same level as before the problems in the so-called sub-prime market were discovered in the United States. There are question marks concerning the economic situation in Estonia and even more so Latvia. The rapid growth in these countries has led to overheating, large current account deficits, negative real interest rates, a large credit expansion and rising property prices. Despite the fact that these countries are small, one cannot disregard the possibility that a negative development could create unrest on the international financial market, roughly as developments in Iceland did a year or so ago.

Another member agreed that the uncertainty marking developments in the United States is counterbalanced by the stable developments in Europe and other parts of the world. Inflation developments abroad are also stable. All in all, world inflation is around two per cent. Developments in Sweden are taking place in a stable international atmosphere, which benefits our country. However, there is a greater risk of an economic slowdown in the United States. Some signs of this are weaker productivity growth and dampened house prices. The member pointed out that it is too early to say anything about the consequences of the sub-prime problems in the United States, as this type of problem takes time to manage. All in all, however, the international economic situation looks both bright and stable.

One member pointed out that monetary policy in different parts of the world, with the exception of the United States, is gradually being tightened. This is the case both in the euro area and in Japan and is an important condition for retaining the stable inflation development. It is the central banks' task to work to achieve this.

Another member noted that one reason why monetary policy is not being tightened further in the United States is that they have already done so, as they are further ahead in the economic cycle. US productivity growth has slowed down and the interest rate has already been raised a number of times.

2. Swedish economic developments

One member began by observing that the forecast for GDP growth in February indicates continued strong growth in the Swedish economy. All in all, the new information received is in line with the forecast, although the various indicators point in slightly different directions. Business tendency data may indicate slightly stronger developments than anticipated in the February forecast, while outcome data for the retail trade and exports of goods tend to point towards weaker developments.

Otherwise there is reason to review the assessments, taking into account the proposals in the Government's Spring Budget Bill. This is partly because public consumption may increase more rapidly, particularly next year, as a result of various expenditure reforms, and partly because households' disposable incomes will increase more as a result of the proposed tax cuts. This, combined with higher wage increases, is expected to contribute to more rapid growth in consumption next year.

More wage agreements have been signed and the outcomes so far appear to be slightly higher than is compatible with the wage forecast made in February. At the same time, the labour market situation is continuing to improve. Employment during the first quarter appears to have risen roughly in line with the forecast in the February report. However, the labour supply appears to have increased slightly less than expected. Unemployment has there been slightly lower than predicted. Labour shortages have also increased in the business sector as a whole, according to business tendency surveys. This indicates in total that there is reason to adjust the forecast for wage increases upwards over the coming years.

Inflation in March was slightly higher than in the February forecast, mainly due to oil prices being higher than expected. This was something that had been predicted at the previous monetary policy meeting. The assessment even then was that inflation would not fall as much during the current year as the February forecast indicated. This also entailed some upward adjustment to the forecast for inflation over the coming years. Higher wage increases also contribute to inflation being expected to increase more than was forecast in February.

One member asked the question of whether the weak exports could be a new phenomenon and how this would affect GDP growth ahead. While the export market has rather grown slightly faster than was previously assumed, Swedish goods exports appear to have shown weaker growth than anticipated during the first quarter. Net trade gave a smaller but at the same time significant surplus during the first quarter of this year, compared with the corresponding period last year. The question of the significance of foreign trade for growth this year must be closely analysed prior to the next monetary policy meeting in June. The National Accounts figures for the first quarter will also have been published then.

Another member pointed out that it is surprising to see such weak export growth, given the good growth in the euro area. A further member noted that both imports and exports had slowed down, while the international picture had changed only marginally. The question is whether Swedish exports are a good indicator of what is happening abroad.

One member noted that exports and imports have been increasing at a stable, high rate over a long period of time and said that recent developments must be followed closely. Another member pointed out that foreign trade statistics indicate that exports have weakened more compared with the forecast than imports, and that this means that there is a risk of a lower GDP outcome than expected for the first quarter of this year.

Another member observed that Swedish economic developments have been very strong. GDP growth is high, employment is increasing rapidly, inflation is low and both public finances and the current account are showing substantial surpluses.

However, the new information received since the monetary policy meeting in February is slightly divided with regard to developments in the real economy. However, with regard to the labour market, the new information indicates that pressure has increased. According to the Labour Market Surveys (AKU) for the first quarter of this year, employment continued to increase by an annual rate of just over 100,000 persons. However, the labour supply did not increase as quickly as estimated. Consequently, unemployment declined slightly more than expected. Unemployment was 5.0 per cent during the first quarter, which is a reduction of 0.8 percentage points compared with the first quarter last year. When seasonally adjusted and shown as a three-month moving average, unemployment continued to decline at the beginning of the year. The increase in unemployment over the year that was predicted in the February Monetary Policy Report has not yet been realised. The number of latent job seekers has also begun to decline now. All in all, the number of unemployed and the number of latent job seekers declined by 50-60,000 persons on an annual rate during the first quarter of this year, observed the member.

The National Institute of Economic Research's Business Tendency Survey for the first quarter was very strong. Labour shortages in the business sector are increasing rapidly and are currently close to the top noting from 2000. Labour shortage is currently the main obstacle to increasing production in an increasing number of sectors. One important question is what consequences the increasingly hot labour market will have for wage developments. The ongoing wage bargaining rounds look to result in higher wages than calculated. It was forecast in the February report that wages would increase by approximately 4 per cent a year. The wage agreements signed so far indicate that hourly wages will increase by an annual rate of at least 4.5 per cent a year over the coming three years, said the member.

The member considered that the current development was similar to the risk scenario described in the February Monetary Policy Report. This risk scenario included wage increases of around 4.5 per cent a year and resulted in slightly lower GDP growth, while inflation slid above the two-per cent level and the repo rate needed to be raised by a further 0.50 percentage points up to the end of the forecast period.

The member pointed out that two clarifications might be necessary in this context. The first is that it is not a catastrophe if wages were to increase by 4.5 per cent instead of 4.0 per cent a year. This is still a good development compared with the 1970s and 1980s when wages increased by around 8 per cent a year. But it means that monetary policy must become stricter than would otherwise have been possible, in order to keep inflation at a low and stable level. The other comment is that the Riksbank is not a party in the wage negotiations. It is the social partners who are responsible for the wage bargaining rounds. However, the outcome will affect inflation and monetary policy. For the Riksbank it is therefore one of the further circumstances that must be taken into account in monetary policy.

Fiscal policy is another such external circumstance that must be considered. Fiscal policy is expansionary, with large tax cuts and increased real expenditure, continued the member. The Spring Budget Bill and the announcement that property tax will be phased out mean that fiscal policy is more expansionary than was anticipated earlier. Household incomes are increasing very strongly this year, partly as a result of the expansionary fiscal policy.

The member observed that the real development is very strong, while inflation is still low. There are still forces holding back inflation. Productivity has developed strongly and import prices have been kept down. Profitability is very good, which means that companies can in the short term bear a higher cost increase than would otherwise have been possible without inflation rising. At the same time, this is a factor that pushes up the rate of wage increase over the coming three years and thereby inflation in the longer time. Fiscal policy also includes measures that have a directly dampening effect on prices, including the abolition of property tax, and others that will stimulate the labour supply in the long term. As usual, the assessment of future inflation will involve a balance between the forces that push it upwards and those that hold it back.

During the first three months of the year, inflation has not been as low as expected in the February forecast. This is partly, but not solely, due to energy prices having been slightly higher than calculated. In February the rate of increase in CPI was expected to fall from 1.6 per cent in December 2006 to 1.5 per cent in March 2007. It has instead risen to 1.9 per cent, a difference of 0.4 percentage points. The rate of increase for UND1X was expected to fall from 1.2 per cent in December 2006 to 1.0 per cent in March 2007. It has instead remained unchanged at 1.2 per cent, a difference of 0.2 percentage points. The member observed that the most recent information indicated that an upward revision would be necessary to the inflation forecast for this year.

One member emphasised that the picture of the real economic development is slightly unclear. The statistics describing economic expectations show a stronger growth than expected during the first quarter of this year, while outcome data shows a slightly weaker development during the same period. Is the weak net export due to weaker demand from abroad, which in turn could have subduing effects on Swedish growth, or is it due to an increased domestic consumption which in turn could push up growth further. Depending on what has affected net export developments, the effect on growth may differ considerably. The member observed that there are often large variations in export statistics, and that it is important to know the reason for the slowdowns that have occurred.

The fact that economic developments are strong cannot be disregarded. So far, the agreements signed in the wage bargaining rounds have been at higher levels than expected. Labour shortages are continuing to rise and are high in the construction and industrial sectors. Vacancies in the labour market are continuing to increase, while the labour supply is not increasing as rapidly as expected. There are clear overheating tendencies in certain industries. The shortages indicate that there could be further wage increases above the agreements already signed. Companies may be able to afford this, as their finances are good. But even if competition is considerable in many markets, there is an evident risk of higher wages gradually being transferred to consumers in the form of higher prices.

In addition, growth in the money supply remains high. As usual, it is difficult to determine with any certainty exactly how this affects demand. But, as the Governor of the Bank of England, Mervyn King, noted this week, when too much money is chasing too few goods, prices tend to rise. Prices in the property market have also continued to rise, albeit at a slightly lower rate than before. The slowdown expected at the beginning of the year does not appear to have materialised. The alleviation in property tax will have a one-off effect on prices, but should not push up the rate of price increase. However, particularly in metropolitan areas this one-off effect may have some significance.

One member observed that inflationary pressures on the whole are slightly higher now than they were in the February report. It is important to note that there are factors affecting a higher inflation rate, such as the wage bargaining rounds. The agreements that have been signed are higher at the beginning of the period, which means that they will push up inflation more at the beginning than at the end. GDP growth in Sweden is expected to be slightly higher than previously expected, which also contributes to a stronger labour market, higher wage increases and higher inflationary pressures. At the same time, there are still factors having the opposite effect, such as the strong global competitive pressure and the high productivity growth. There is also still spare capacity in the labour market. On the whole, there has been no dramatic change since the Monetary Policy Report was published in February and economic developments do not appear to be dramatically different than before. The reduction in property tax is expected to have a one-off effect on property prices, but it is important to be vigilant with regard to possible secondary effects of tax changes on inflation. Property price developments are still a source of unease, particularly in a longer term perspective. This is a development that must be closely followed in future.

One member summed up the discussion. It was observed at the monetary policy meeting in March that economic activity in Sweden and the surrounding world remained strong. The new information received since then does not alter this picture to any great extent. Compared with the assessment made in February, growth looks to be slightly lower in the United States, but slightly stronger in the euro area. In Sweden, the recently presented fiscal policy proposals are expected to further increase production and demand in the Swedish economy. Developments in the labour market are continuing to be strong. Both employment and the labour force are increasing at a good rate and unemployment is continuing to fall. Lending and house prices are continuing to increase relatively rapidly, although the rates of increase have slowed down. In March, CPI inflation amounted to 1.9 per cent and UND1X inflation was 1.2 per cent. This was slightly higher than expected in February, which was mainly explained by rising oil prices. The outcome of the wage bargaining rounds so far indicates that wage increases will be higher than was forecast. The stronger economic prospects in Sweden also indicate this. All in all, this means that inflationary pressures are now considered to be slightly higher than was forecast in February.

§ 2. Monetary policy discussion

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

The new information received in recent months indicates that inflationary pressures will be slightly higher than was expected in the monetary policy report in February and at the monetary policy meeting in March. One reason for this is that the Government's Spring Budget Bill looks to be slightly more demand-stimulating, at least next year, than was previously anticipated. Another reason is that the wage bargaining rounds so far have resulted in agreements that indicate wages may increase more rapidly during the forecast period than was assumed in the February report. In the strong labour market situation currently prevailing it is reasonable to count on wage increases above the agreements being higher than they have been in recent years. How high the wage increases are will depend on how the labour market functions, among other things. Important questions are whether the labour supply will increase to the extent we have expected, whether the matching of demand for and supply of labour will work and what consideration is given the labour market situation in the wage negotiations. Developments in the first quarter indicate that the labour market situation has become slightly more strained than was forecast in February. Employment appears to have risen roughly in line with the forecast, but the labour supply appears to have increased slightly less than expected. Unemployment has therefore been slightly lower than predicted. Labour shortages have also increased in the business sector as a whole, according to business tendency surveys. There is still spare capacity in the labour market, but perhaps not to the same extent as indicated in the February forecast. At the same time, the wage agreements appear slightly higher than forecast, despite there still being fairly large labour reserves in total.

According to my assessment, developments on the whole indicate that the repo rate will need to be raised more during the forecast period than was indicated in February, so that inflation is in line with the target and the real economy shows a balanced development. But I do not consider that the changes to the economic picture have been so great, which indicates that there is no hurry to change the repo rate at today's meeting. Inflation is still low and the assessment is that it will rise slowly. This is because there are still several factors holding it back. Price pressures from abroad are expected to continue and productivity is expected to improve at a good rate. Corporate profits are good and the business tendency date for the first quarter indicates that profitability in the business sector has continued to improve. This may of course mean that companies are more willing to allow wage increases, but it may also partly serve as a buffer against prices rises.

The important thing now is to balance the pace of the interest rate increases so that inflation does not accelerate more rapidly than expected, but not to slow down growth in production and employment too soon. My proposal for a decision today is therefore that the repo rate be kept unchanged. But, as I said initially, my assessment is that inflationary pressures have increased slightly more than expected and the repo rate will therefore need to be raised more during the forecast period than we anticipated in February. We should return to the question of how quickly and how much the rate should be raised in our June Monetary Policy Report. There will then be more information available on both the wage bargaining rounds and growth and productivity during the first quarter.

One member on the whole agreed with the previous member's analysis, but did not support the conclusion presented. The member proposed instead that the repo rate should be raised by 0.25 percentage points at today's meeting and also that the interest rate path should be adjusted upwards. It is better to raise the interest rate now than to wait until June. The real economy looks strong, despite some question marks. Developments in the labour market are hotter than expected. There are more vacancies, weaker growth in the labour supply and in addition wage bargaining rounds where the outcomes have been higher than we expected in February. Property prices have continued to rise, as have loans to the household sector. Property prices do not entail any target for monetary policy, which the Riksbank has pointed out in many contexts. However, as before, there is reason to take into account the risks of overheating in the property market, as overheating and the ensuing price adjustment could have negative effects on the real economy. The risk of overheating has been used at earlier meetings as a motive for bringing forward an intended interest rate increase. This is a factor that should be brought into today's discussion, considered the member.

Another member pointed out that if property prices rise as a result of fundamentals of this nature, it is not a problem for monetary policy. A tax change that leads to an adjustment in property prices is not in itself something that monetary policy should counteract. If, however, the rising property prices mean that households experience that they have become wealthier and thereby increase their demand, then monetary policy must of course take this into consideration.

Another member observed that the risks on the upside have increased substantially since the monetary policy meeting in February, and supported a previous member's proposal that the repo rate needs to be raised by 0.25 percentage points at today's meeting and that the future interest rate path should be revised upwards. Economic developments are very good. Growth rates are high both in Sweden and abroad. In this strong economic situation, monetary policy is still expansionary. Interest rates are still low and credit expansion is strong.

Since the monetary policy meeting in February the conditions have changed in three aspects, said the members. Firstly, the new information received indicates that the pressure on the labour market is stronger than was predicted then. Secondly, the spring wage bargaining rounds appear to be resulting in higher agreed wage increases than expected. In addition, the continued strengthening in the labour market risks pushing up wage drift. Thirdly, fiscal policy is more expansionary than expected. All in all, the changed conditions motivate an upward adjustment in the future interest rate path.

One important question here is when the interest rate should be raised. The member pointed out that there are reasons for a more rapid increase at the beginning of the period covered by the interest rate path. Firstly, monetary policy has an impact with a substantial lag. The longer the decision on an increase is postponed, the greater is the risk that wage increases will be higher than is compatible with the inflation target and that inflation will overshoot the target. The risk of coming “behind the curve”, as was the case in the period 2001-2002 increases. Secondly, there are upside risks, even after a revision in the expected rate of wage increase to 4.5 per cent a year. It is more likely that the labour market will be stronger, that the labour shortage will be greater and that wages will develop more rapidly than this.

Another member agreed that inflationary pressures are slightly higher than calculated and that there is thus reason to raise the interest rate more quickly than was predicted in February. The interest rate could be raised at today’s meeting, but there are several reasons for keeping it unchanged. UND1X inflation is still low and is expected to rise only slowly. The wage bargaining rounds are not complete. It is therefore better to wait for more information, even if the wage increases already appear to be higher than was forecast in February. Productivity and global competition hold back inflationary pressures and the overall resource utilisation in the Swedish economy is still relatively balanced. The member considered that the difference to the economy between an interest rate increase at today’s meeting and at the next meeting is very limited and it is then better to wait for a more complete analysis in the next monetary policy report. The member therefore wanted to hold the repo rate unchanged, but emphasised the need for gradual interest rate increases in future. The interest rate path will need to be revised upwards in future, in comparison with the forecast in the February Monetary Policy Report. It is most probable that there will be a balanced, orderly slowdown in economic activity in relation to last year’s strong figures. If it were to be the case further ahead that the economy is moving towards a situation with wage increases that are incompatible with a balanced economy, excessively expansionary fiscal policy and over-optimistic financial expansion, where these factors threaten the inflation target, there will be consequences for monetary policy in terms of a higher interest rate path and accompanying slowdown in both the real and financial side, so that price stability is maintained. It is important to avoid this development.

The member pointed out that, as always, there is great uncertainty over future economic developments. It is therefore also uncertain how the repo rate will develop in the future. This will depend on new information about economic developments in Sweden and abroad and the effects these may have on the prospects for economic activity and inflation in Sweden.

§ 3. Monetary policy decision

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, with the Governor using his casting vote,

- that the repo rate be kept unchanged at 3.25 per cent and that this decision would apply from Wednesday, 9 May 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, 9 May 2007,
- that the decision would be announced at 9.30 a.m. on Friday, 4 May 2007, with the motivation and wording contained in Press Release no. 19 2007, (Annex A to the minutes), and
- to publish the minutes of today's meeting on Friday, 18 May at 9.30 a.m.

Deputy Governor Svante Öberg and Deputy Governor Lars Nyberg entered a reservation against the decision to keep the repo rate unchanged and stated the following: Our joint assessment is that the upside risks have increased significantly since the monetary policy meeting in February. Economic developments are stronger, the wage bargaining rounds appear to be resulting in higher wages, fiscal policy is more expansionary than predicted and credit expansion remains high. Our assessment is therefore that a decision should be taken today to raise the repo rate by 0.25 percentage points and that we should revise our view of the future interest rate path upwards.

This paragraph was confirmed immediately.

Minutes by:
Ann-Christine Högberg

Checked by:

Stefan Ingves　　Lars Nyberg

Irma Rosenberg　　Svante Öberg