



Separate minutes of the Executive Board, No. 9

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■ PRESENT: Stefan Ingves, Chairman
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Svante Öberg

Leif Pagrotsky, Vice Chairman of the General Council

Claes Berg
Bul Ekici §1
Victoria Ericsson
Lena Eriksson
Kerstin Hallsten
Jesper Hansson
Karolina Holmberg
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Gustav Karlsson §1
Per Kvarnström §1
Pernilla Meyersson
Ola Pettersson
Britta von Schoultz
Åsa Sydén
Anders Vredin

§ 1. Economic developments abroad

It was noted that Victoria Ericsson and Ola Pettersson would prepare draft minutes of paragraphs 1 and 2 on the agenda for the meeting. The discussion was based on the new data and analyses presented by the Monetary Policy Department.

1. International economic developments

First Deputy Governor Irma Rosenberg began by giving her assessment of international economic developments. Since the publication of the June Monetary Policy Report international growth has remained strong, although the signals received over the summer in

the form of economic indicators and survey data have been somewhat mixed. However, the unease in the financial markets meant that uncertainty is now greater than it was in June. The risks of a weaker outcome have increased, although it is still much too early to be able to assess what the financial and real economic consequences of the financial unrest will be.

In the United States GDP growth is probably slightly slower than forecast in the June assessment. This is partly due to the outcome for recent years having been revised down and providing a poorer starting point for growth this year, and partly because the financial unrest and downswing in the housing market will lead to a weaker development. It also appears reasonable to assume slightly weaker developments in the eurozone than was expected in June. Growth slowed down in the second quarter and developments in, for instance, industrial production and retail trade, indicate that activity may be slightly weaker than estimated. The financial unrest will probably have some negative repercussions also in the eurozone. Growth in Norway and Finland has been higher than expected. Economic developments have also been stronger than expected in several emerging markets. The main assessment is therefore that international growth in total will be roughly as forecast in June, but that the distribution between countries will be different.

Deputy Governor Lars Nyberg developed his view of the unrest in the financial markets, as far as could be judged in the current situation. These problems stem from the US sub-prime market, where credit has been granted on overly generous terms, particularly in 2005 and 2006. Sub-prime credits have also been gathered and packaged into so-called structured products for corporate loans (collateralised debt obligations, CDOs), which are then divided up into tranches with different credit risk. The best tranches have been assessed by credit rating institutes to have a very low credit risk and could therefore be sold to investors who previously only to a very small extent have invested in such risk. These investors can be found particularly in Europe.

The credit risk has often been invested in companies created specially for this purpose, what are known as structured investment vehicles, continued Mr Nyberg. These have sought to increase their return through loan financing and have financed parts of their balance sheets on the short-term money market through different types of asset-backed commercial papers, ABCPs. It is here the problems have arisen. When the uncertainty in the sub-prime market increased, investors did not want to buy new ABCPs when the old ones matured. It was not possible to assess where possible bad credits lay, as these were packaged and sold in a way that provided little transparency. Thus, it is not the bad sub-prime credits themselves that create problems; it is the lack of transparency in the packaging (securitisation) that has created uncertainty in the market. What we have seen so far is first and foremost a liquidity crisis, not a credit crisis.

ABCPs are normally guaranteed by loan promises from the banks and these are fulfilled when the investors no longer wish to participate in the bond programmes. In recent weeks the banks have in this way received large volumes of credit risk back in their balance sheets. This development will probably continue as large volumes of ABCPs will mature over the coming months. The banks are of course aware of this, which has meant they are hoarding liquid funds. It is in this situation that the ECB, the Federal Reserve and other central banks have chosen to intervene.

The uncertainty in the market is thus likely to remain for some time. The effects on demand and growth will depend in particular on future developments in the US property market. If property prices plummet, the problems may be aggravated. One conclusion can be drawn immediately. The price of risk has risen and will probably not fall back to earlier levels. This is essentially a healthy development, although one might have wished that the adjustment could have been smoother.

Deputy Governor Svante Öberg meant that it was still too early to make an assessment of the real effects of the recent turbulence in the financial markets. But at present it appears likely that international growth will be lower than was forecast in June, primarily in the USA but also in Europe, and that there will be a lasting increase in risk premiums after the crisis. The size of the impact will depend on how long it takes before the markets are functioning smoothly again, how much the risk premiums are raised and how much the credit situation is tightened and also how households' and firms' confidence in the future is affected by the turbulence.

Mr Öberg pointed out that there are a number of factors that are worrying in the current crisis. It originates in the United States, which is the world's largest economy and has considerable significance for other parts of the world. The crisis has also been underway longer than the periods of financial turbulence in recent years, and there is considerable uncertainty regarding what has happened and where losses might arise. Europe will be negatively affected by the developments in the United States, both directly through exports and through contagion via the financial markets. However, the consequences for Europe will be alleviated by the fact that the starting situation is good, both in the economy as a whole and in the financial sector. Europe does not have the same problems in the housing market as the United States.

Mr Öberg pointed out that there are also positive factors to be taken into account. The slowdown in the United States and Europe is balanced by stronger developments in Asia and eastern Europe. The forecasts for emerging markets such as China, India and Russia have been revised upwards over the summer. Our Nordic neighbours have also shown stronger development than expected. The weaker development in demand in the United States is part of the adjustment process of the global imbalances; although this adjustment has had a more dramatic course of events than was previously anticipated. Risk premiums have been unusually low for some time and a return to a more normal level is welcome.

Deputy Governor Barbro Wickman-Parak considered that the indicators for the United States which were published over the summer largely supported the forecast made in June. However, the balance between supply and demand in the housing market has been severely shaken. The stocks of unsold housing now correspond to around 10 months' sales. At the same time, many new houses are still coming out on the market. The problems in the sub-prime market are also a sign that many people may be forced out of their houses. Construction investments have declined significantly and the decline in the number of new construction projects and building permits points towards a continued decline in such investments. This will create downward pressure on GDP growth at least for some quarters.

The question is how US households will react to lower house prices. Previously, higher house prices have led to constantly increasing wealth, which has had positive effects on consumption. Now there is a risk of the reverse happening. As long as household income

continues to increase, the risk of this scenario is probably limited. However, we can also see some slowdown in the US labour market. It is therefore important to keep our eyes on both the labour market and house prices. The US economy has coped with many shocks. However, we will have to wait before we can draw any more definite conclusions. Since the mid-1980s the saving ratio has declined from 10 to 0 per cent. If the worst were to occur, and house prices, employment and incomes were all to decline, the prospects for the US economy would be relatively bleak. In this case there would be a risk of considerable contagion effects. At present we can only observe that uncertainty has increased significantly since June.

Governor Stefan Ingves observed that the problems in the United States have built up over a number of years and that experiences show that it may take a long time to finally resolve a financial disorder of this nature. Fundamental questions such as who is left with the problems in their balance sheets, and how large are the losses, must be answered.

If an important part of the US economy comes to a halt, there is of course a risk that this will also spread to other parts. As Ms Wickman-Parak observed, construction has not stopped. Construction companies also have loans to finance their operations. If losses arise from these loans, it will have an impact on the bank system. This would probably lead to GDP growth being lower. On the one hand, saving in the US economy has been too low for a long period of time, and what we are now seeing is part of the process of managing the global imbalances associated with this. On the other hand, the US economy has shown a good ability to make a fairly rapid recovery during earlier, similar episodes. The US economy is very flexible and tough. All in all, this means that uncertainty has increased significantly.

Mr Ingves pointed out that the European economy is particularly important to Swedish exports. Uncertainty is larger than usual here because of the financial unrest. To some extent the effects of the financial unrest appear to be taken up in the European financial sector. This will most likely have an impact on the banks' balance sheets. Here, too the problems will diminish in time. It is difficult to know how long this will take. This creates additional uncertainty, on top of the uncertainty always present in monetary policy.

In the short term, we can see that the financial unrest is creating liquidity problems. Similarly, the financial structure in Europe and the United States will probably be affected. The interest differential between lending at high and low risk respectively will increase. But it is more important to understand what will happen to the development of the economy in the longer term. To all appearances, we will see a lower global growth than before. However, it is important to remember that the fundamentals behind global growth remain.

Barbro Wickman-Parak commented on risk premium levels. These have increased since June. The difference between treasury and corporate bond rates in the United States is now back at a level in line with the average from 1995 onwards. During the years following the IT bubble, the rate for higher risk corporate bonds was much higher than it is now. The problem is not today's level. Unlike the years immediately following the turn of the millennium, it is not doubts concerning the earning ability of the manufacturing companies' which have caused increased risk aversion. The higher risk premiums have been triggered by problems in the housing sector and it is difficult to assess which direction the risk premiums will take in the future.

Lars Nyberg considered that it is important to distinguish between the effects of the financial unrest on liquidity and the effects on the real economy. With regard to liquidity in the money market, we will have much better information in a couple of months' time. Important questions for real economic developments are the amount of bad credits in the United States and Europe and whether more will arise as a result of poorer developments in the US housing market. At present, there is no one who can provide an answer. The calculations made regarding the size of the losses on sub-prime loans do not show any unmanageable amounts.

Stefan Ingves observed that all members agreed with Irma Rosenberg's description of international economic developments. The real economy has developed strongly. But uncertainty over future economic developments has increased since June. We are in a period of unusually large uncertainty in the financial markets, and there is also considerable uncertainty regarding the real economic effects this might have.

§ 2. Monetary policy discussion

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

The assessment in the June Monetary Policy Report was that the Swedish economy will grow strongly and that the slowdown in the GDP growth rate noted for the first quarter was temporary. The new information received since June largely supports this assessment. Growth in the second quarter was slightly higher than expected and various survey data point to economic activity having remained strong over the summer.

The labour market situation has continued to tighten in recent months. Employment has increased at around the rate we expected in June, but the labour supply has lagged behind. Open unemployment has therefore been lower than predicted. Various labour market indicators, such as redundancies and unfilled vacancies point to a continued increase in employment. A tighter labour market means a risk of more rapid wage increases, but as yet we have seen no such indications. Short-term wage statistics from the National Mediation Offices show very modest increases so far. However, this does not say very much as the spring's new central wage agreements are not yet included in this statistic. This should be monitored closely.

Ms Rosenberg considered that productivity growth is a key factor in the assessment of how inflation will develop over the coming years. It was much weaker than expected during the first quarter and, according to preliminary statistics from the National Accounts, it weakened further during the second quarter. The high productivity growth in recent years is one of the explanations as to why inflation in the Swedish economy has been so low. The question now is whether the weaker productivity growth will persist or whether it is a temporary change. The Executive Board has previously expected productivity growth to slow down this year, but not as much as occurred during the first half of the year. The conclusion in June was that it was a temporary slowdown and that productivity growth would become slightly stronger once again. Ms Rosenberg considered that this was still the case, if GDP were to develop at the rate predicted. But the weak productivity growth during the first half of the year means that we must expect slightly weaker growth for the whole year and thereby a slightly larger increase in unit labour costs this year. There are no reasons to make further

downward revisions to the productivity growth forecast for next year. However, productivity growth is difficult to assess. There is of course a risk that it will remain weak. In this case, it will lead to higher cost pressures, which may also have consequences for inflation further ahead.

Inflation has been slightly higher than expected over the summer. CPI inflation was 1.9 per cent and UND1X was 1.0 per cent in July. A slightly more rapid increase in costs means that inflation may be slightly higher in the short term than was assumed in the June forecast. In addition, food prices will probably also increase slightly more quickly, partly as a result of some commodity prices for foods having risen quickly on the world market.

Ms Rosenberg observed that if one only looks at the new information on the Swedish economy received since June, the conclusion would be that inflationary pressures are slightly stronger and that the forecast for the repo rate therefore needs to be adjusted slightly upwards. But the unrest in the financial markets will probably slow down growth in the Swedish economy somewhat, too. All in all, her conclusion was therefore that the repo rate will need to be raised at around the same pace as assumed by the Executive Board in June. Ms Rosenberg's proposal for a decision was to raise the repo rate by 0.25 percentage points.

Deputy Governor Lars E.O. Svensson emphasised the importance of analysing how the new information, given an unchanged repo rate path, would change the forecasts for inflation and resource utilisation in comparison with the June report. If the new information alters the forecasts for inflation and resource utilisation so that they no longer look good, there is justification for changing the interest rate path to ensure the resulting forecasts look good again. Good here means that inflation is approaching target and resource utilisation is approaching a normal level at a suitable pace.

Mr Svensson agreed with Irma Rosenberg's description of both economic developments and inflation prospects. Real economic developments have been slightly stronger than expected, the labour market somewhat tighter than expected and cost pressures slightly higher than expected. With an unchanged interest rate path the forecasts for inflation and resource utilisation rise somewhat in comparison with the June report. The consequences of the international financial unrest are difficult to assess. The analysis made by the Monetary Policy Department indicates that the forecasts are slightly lower with an unchanged interest rate path. All in all, this leads to no major change in the inflation forecast and to the assessment that resource utilisation will still be balanced. This means that the interest rate path from June still represents a well-balanced monetary policy. Mr Svensson therefore supported Irma Rosenberg's proposal to raise the repo rate by 0.25 percentage points.

Deputy Governor Svante Öberg supported the proposal to raise the interest rate by 0.25 percentage points and agreed with the picture of economic developments painted by Ms Rosenberg and Mr Svensson. The Swedish economy has developed more strongly up to July this year than predicted in the main scenario of the most recent Monetary Policy Report. However, the recent turbulence in the financial markets has at the same time reduced the risks of overheating. Mr Öberg's assessment was, despite this, that inflationary pressures will be strong over the coming years and that the main risk is that the policy rate will need to be raised more than was reflected in the June interest rate path. This assessment may change if the financial turbulence is prolonged.

Deputy Governor Barbro Wickman-Parak agreed with Irma Rosenberg's description of the Swedish economy. She pointed out that there were some factors in particular which guided her decision to vote in favour of raising the interest rate by 0.25 percentage points. The labour market has continued to tighten. Employment measured as the number of persons has increased largely as expected, but the labour supply has not increased as much as predicted. The demand for labour can be expected to continue rising; according to the NIER's business tendency survey, firms' employment plans are still expansionary. Productivity was lower than expected in the second quarter. There are many reasons to assume that this is a temporary problem. The stiffer competition is continuing to put pressure on companies and higher wages may reduce the number of new recruitments. But there is nevertheless considerable uncertainty as to how productivity will develop in the future. One cannot rely too heavily on comparisons with other countries, but in the United States productivity growth has slowed down over the past two years.

According to the NIER's quarterly business tendency survey published in July, shortages in the labour market continued to rise, while the Swedish economy has a substantial labour reserve. Companies may be forced to increase their remunerations to attract qualified labour, which may increase wage drift. In other cases, companies may be forced to lower their requirements regarding qualifications, which may have an effect on productivity. Ms Wickman-Parak said that she had pointed this out at the previous monetary policy meeting, and that the analysis still held.

Inflation has only increased marginally compared with the June forecast, but cost pressures are continuing to rise. We can also see that commodity prices are rising and food prices in particular have been discussed regularly over the summer. They have begun to climb and the NIER business tendency survey indicates this upswing will continue. During the spring the majority of companies expecting to see price rises was around 15 percentage points. This was how things appeared with the statistics available to the Executive Board at the previous monetary policy meeting. The figure has risen substantially, to almost 50 percentage points, over the summer.

Ms Wickman-Parak observed that inflation expectations have risen steadily since the beginning of 2006 and for households they are now, according to the NIER, at around 2.5 per cent one year ahead. There is every reason to monitor these data. A few more words on lending and house prices, that is, some of the background variables we have reason to take into account. Household borrowing and house prices have continued to rise at a relatively rapid rate.

There are thus strong domestic reasons for raising the interest rate and these reasons in themselves could, one might say, justify a slightly higher interest rate path than that presented in June. But given the uncertainty regarding prospects in the United States and the contagion effects of these on the rest of the world, Ms Wickman-Parak considered that the need for interest rate increases to balance Swedish developments was reasonably expressed in the June interest rate forecast. The interest rate is still low, given the strong economic activity and increasing cost pressures. Should the worst come to the worst; a severe decline in the United States with major effects on the rest of the world, the Executive Board will have reason to reconsider its stance.

Governor Stefan Ingves began by observing that the macro outlook in relation to June shows stronger economic activity than expected, which indicates that the interest rate should be raised in accordance with Ms Rosenberg's proposal. The money supply and lending are also continuing to grow quickly and support an interest rate increase. All in all, the international uncertainty does not outweigh the strong domestic reasons for raising the interest rate at today's meeting.

Mr Ingves observed that the great uncertainty prevailing in the financial markets means that the interest rate path from June should be retained, although there were factors in favour of an upward revision. Much has happened both in Sweden and abroad, but overall this does not give reason for a change in view at today's meeting. Developments over the coming months must, as always, be followed closely. Mr Ingves supported the proposal to raise the interest rate by 0.25 percentage points and observed that the interest rate can be expected to develop in line with the June forecast.

Deputy Governor Lars Nyberg also agreed with Irma Rosenberg's picture of the economic situation in Sweden. Mr Nyberg observed that domestic developments spoke in favour of a higher interest rate path than in June, but the uncertainty connected with the sub-prime problems in the United States and the financial unrest means that there is reason to wait and see. Mr Nyberg noted that the Swedish banks have so far only been indirectly affected by the financial unrest, in the form of higher loan costs. The banks' direct exposures to the sub-prime market are minimal. Mr Nyberg pointed out the most important reasons for raising the interest rate. Business tendency data and other newly-received statistics indicate a stronger development than anticipated. The weak productivity growth is an important reason for the rising cost pressures. One central question is going to be whether or not productivity rises again. There is reason to closely follow inflation expectations, which have risen in recent months. Developments in house prices and lending are not sustainable in the long term.

Deputy Governor Svante Öberg wanted to further develop the reasons for his starting point differing from that of his colleagues. Mr Öberg had expected stronger economic activity back in June and higher inflationary pressures than shown in the main scenario of the Monetary Policy Report. One additional element is the turbulence in the financial markets over the past month and the fact that it reduces the risk of overheating. But Mr Öberg's assessment was nevertheless that the risks were still on the upside, that is, cost and inflationary pressures were more likely to be higher than in the main scenario of the Monetary Policy Report than lower.

GDP growth in the second quarter was slightly higher than expected. All parts of expenditure contributed to the increase; investment and exports contributed most. However, productivity showed weak development, and was much weaker than expected, which has significance for cost pressures.

The labour market has developed strongly. The labour market surveys have shown a continued strong increase in employment and falling unemployment. Employment increased during the three-month period from May to July by almost 110,000 persons compared with the same period last year, which was in line with the forecast in the Monetary Policy Report. But the labour force increased more slowly and unemployment thus declined more quickly than anticipated. According to Mr Öberg, the statistics so far indicate a stronger increase in

employment and a more rapid fall in unemployment than was forecast in the June Monetary Policy Report. It is difficult to believe that the increase in employment will slow down as quickly as predicted in the report. Companies' employment plans according to the business tendency surveys and the National Labour Market Board statistics indicate a continued strong increase in employment.

Inflation has been even higher than predicted in the June Monetary Policy Report. Underlying inflation measured as UND1X excluding energy has increased steadily since the trough at the beginning of 2006 and was up at 1.5 per cent in July. If one looks at the rate of increase during recent months in seasonally-adjusted terms, it was around 2 per cent in July. In addition, there are a number of other indications of rising inflation. According to the NIER, inflation expectations have risen and are now above 2 per cent a year. The producer price index (PPI) increased by an annual rate of 5.5 per cent in July. Previously the increase in PPI mainly referred to intermediate goods, but in 2007 the price rises have increasingly covered consumer goods, too. The rate of price increase for domestic supply regarding consumer goods has increased from around 0 per cent at the beginning of the year to 2.7 per cent in July. The price increases on services according to the service price index are 3 per cent or above for most product groups. Food prices have begun to increase and almost half of the companies in the food industry are planning to raise prices. One can question the relevance of each of these figures, but taken together they form a pattern of rising inflation.

Mr Öberg pointed out that we as yet have no good picture of wage developments this year. He made the assessment that the central wage agreements signed in the spring will lead to a rate of wage increase of 4.5 to 5 per cent a year during the three years the agreements cover. But the agreements have not yet entered the wage statistics to any great extent. We will not gain a better picture of wage developments until the end of November/beginning of December, when the statistics for September become available.

Developments up to the end of July indicate a scenario with stronger cost and inflationary pressures than in the main scenario of the June Monetary Policy Report.

Mr Öberg further observed that the recent turbulence in the financial markets has reduced the risks of overheating, but that it is too early yet to draw any more definite conclusions regarding the effects of the financial crisis. His assessment was that the most probable scenario is that inflationary pressures will be strong over the coming years, despite the financial turbulence, and that the policy rate will need to be raised more than indicated in the interest rate path in the Monetary Policy Report. This assessment may change if the financial turbulence is prolonged.

Governor Stefan Ingves observed that much had been said about the unrest in the financial markets. However, it is important to note that the Swedish money market has continued to function smoothly, although the international unrest has not passed unnoticed. Mr Ingves emphasised that the consequences of possible contagion effects in the Swedish money market would be monitored closely. All members agreed that this was important.

Mr Ingves summarised the monetary policy discussion. The Swedish economy is continuing to show strong growth. The signals from abroad have been mixed, but on the whole developments have been good. Swedish GDP growth during the second quarter was slightly higher than expected and the labour market has been tighter than the Riksbank anticipated in June. Lending and house prices have increased rapidly. At the same time, cost pressures

have been slightly higher than expected as productivity was unexpectedly low during the second quarter. Rising food prices also contribute to higher inflationary pressures than the Riksbank had anticipated in June. At the same time, households and companies have adjusted their inflation expectations upwards for the coming year. The view of economic developments is also affected by the recent unrest in the financial markets. A general increase in uncertainty and less willingness to invest in higher risk assets has led to falling share prices and higher risk premiums. These developments are linked to the problems in the US sub-prime market. It is reasonable to assume that this will have some negative consequences for growth in Sweden and abroad. It is as yet too early to determine the extent and duration of these effects. The assessment is that the interest rate needs to be raised further in the future at around the same pace as forecast in June.

§ 3. Monetary policy decision

Chairman Stefan Ingves found that there was only one proposal: to raise the repo rate by 0.25 percentage points to 3.75 per cent.

The Executive Board decided

- to raise the repo rate to 3.75 per cent and that this decision would apply from Wednesday, 12 September 2007,
- to raise the lending rate to 4.50 per cent and the deposit rate to 3.00 per cent, with effect from Wednesday, 12 September 2007,
- to announce the decision at 9.30 a.m. on 7 September 2007 with the motivation and wording contained in Press Release no. 35 2007 (Annex A to the minutes), and
- to publish the minutes of today's meeting on 20 September 2007 at 9.30 a.m.

This paragraph was confirmed immediately.

Minutes by:

Ann-Christine Högberg

Checked by:

Stefan Ingves,
Lars Nyberg,
Irma Rosenberg,
Lars E.O. Svensson,
Barbro Wickman-Parak,
Svante Öberg