



Monetary Policy Update

December 2007

At its meeting on 18 December, the Executive Board of the Riksbank decided to hold the repo rate unchanged at 4 per cent. During the first half of 2008 it is expected that the repo rate will need to be raised to around 4.25 per cent, but there is still considerable uncertainty as a result of the turmoil in the international financial markets. The Riksbank's assessment is that the development in the repo rate will contribute to an inflation rate in line with the 2 per cent target from 2009 onwards, at the same time as production and employment will develop in a balanced manner.

The Riksbank's view of the future repo rate path remains largely the same as in October. The fact that the view is largely the same is due to different factors pulling in different directions. Higher inflationary pressures indicate that the repo rate should be raised slightly more in the future, but signals of weaker economic activity in Sweden and abroad together with the continued financial unrest point in the opposite direction.

Figure 1. Repo rate with uncertainty bands
Per cent, quarterly averages

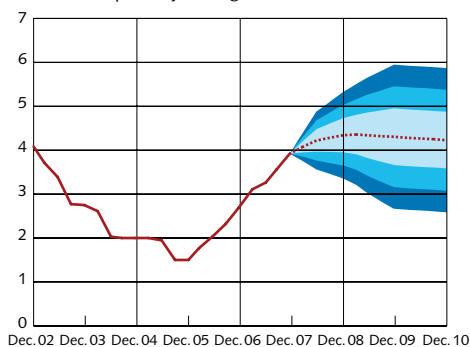


Figure 2. GDP with uncertainty bands
Annual percentage change, seasonally-adjusted data

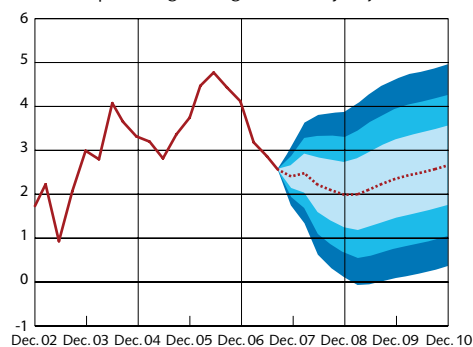


Figure 3. CPI with uncertainty bands
Annual percentage change

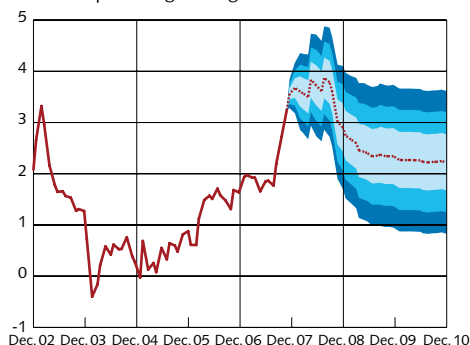
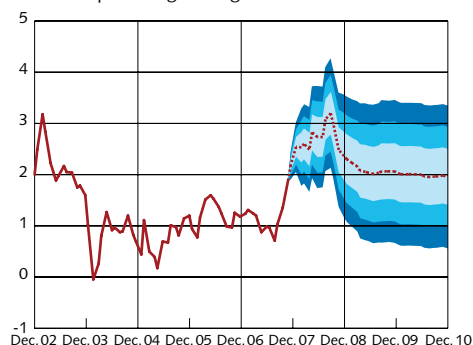


Figure 4. CPIX with uncertainty bands
Annual percentage change



— Outcome ■ 90%
..... Forecast ■ 75%
 ■ 50%

Note. The uncertainty bands in figures 1-4 are based on historical forecast errors. See the in-depth article entitled "Calculation method for uncertainty bands" in MPR 2007:1. The CPIX (previously UND1X) is the CPI excluding household mortgage interest expenditure adjusted for direct effects of changed indirect taxes and subsidies.

Sources: Statistics Sweden and the Riksbank

New information since the October Monetary Policy Report

- New information implies a slightly lower GDP growth in the United States compared with the assessment in the most recent Monetary Policy Report published in October (MPR 2007:3). Household consumption expenditure showed weak development in both September and October. Car sales figures in November did not show any tangible recovery, which implies that consumption is slower than was expected for the fourth quarter. One reason may be that the scope for household consumption has declined as a result of the soaring oil price in recent months. At the same time, there are some indications that the labour market has shown slightly weaker growth than anticipated. Moreover, in October there was a decline in investment in construction of commercial property, which is a sign that the problems in the construction sector are no longer limited to the housing market. Corporate profits also declined, which means that the scope for investment and new recruitment has diminished.
- The most recent statistics indicate that growth in the European economies has also slowed down and that future developments will be weaker than expected in the October assessment. Consumption growth has been moderate this year and in recent months household optimism has declined significantly. At the same time, business tendency surveys and purchasing managers' indices show that companies' views of the economic situation have also become more negative.
- The most recent outcomes and indicators also point to marginally weaker GDP growth in the world as a whole compared with the assessment made in October.
- The oil price has been higher than expected. Both spot and forward prices for oil for delivery over the coming 3 years have risen by around 10 dollars, or almost 15 per cent, since mid-October. Spot prices on the Nordpool exchange have also risen more than expected.
- The financial market turmoil is continuing. Interest rates in the interbank market have risen, at the same time as interest rates on safer assets, such as government securities, have fallen. The US market has been hardest hit. This has resulted in a substantial rise in differences between interbank rates and treasury bill rates (the so-called TED spreads have increased). This applies primarily to durations extending into next year. The US TED spread for a three-month duration has risen by around 1 percentage point since the beginning of November and is once again at the same high level as it was in August.
- In Sweden, higher interbank rates have led to an increase in loan costs for households and companies of an estimated 0.5 percentage points since August. This is considerably more than can be motivated by the future repo rate expectations.
- Data for the third quarter indicate that both house prices and lending to households in Sweden rose by almost 12 per cent on an annual rate. During the autumn, however, there have been signals indicating that the housing market may be on the verge of cooling down. Prices of tenant-owned apartments in the three major cities have fallen during the autumn, while Statistics Sweden's purchase price coefficient shows that house prices on a national level have remained unchanged. The annual growth rate in the broadest money supply aggregate, M3, has increased rapidly since July. In October the annual growth rate was 20 per cent. The upswing is due to the fact that the general public's holdings of debt securities in SEK, such as bank certificates and mortgage bonds with durations up to two years, have continued to increase rapidly during this period. However, the most recent monthly figure for October indicates slightly lower growth rates for the narrower money supply aggregates M2 and M0.

- In Sweden GDP growth was 2.5 per cent (calendar-adjusted data) during the third quarter of this year, compared with the corresponding quarter in the previous year. This was almost one percentage point lower than expected. This was because the quarterly growth for the third quarter was unexpectedly weak at the same time as the outcome for the first half of the year was revised down substantially. The components that showed weaker development than expected were public consumption, fixed gross investment and above all exports.
- Indicators for the fourth quarter point to a continued slowdown in GDP growth in Sweden. There are many indications that the slowdown will be slightly more pronounced than was assumed in October. For instance, the consumer tendency surveys and retail trade sales statistics up to the end of October have been weaker than expected.
- The most recent National Accounts show that growth in the number of hours worked was not as strong during the third quarter as during the immediately preceding quarters. Although the outcome was in line with the forecast, there are several indications that the rate of increase will slow down slightly more in the short term than was assumed in October. According to the labour market surveys, the number of persons employed (aged 16-64) rose by 2.4 per cent from November 2006 to November 2007, which was slightly less than expected. The number of unemployed (aged 15-74, EU definition, not seasonally adjusted) was 5.2 per cent in November. Statistics for the period up to the end of November show that the number of job vacancies has increased slightly more slowly in recent months. In addition, employment plans according to the business tendency survey indicate that employment growth will slow down somewhat during the fourth quarter.
- Productivity growth was slightly weaker than expected during the first three quarters of 2007. During the third quarter the decline slowed down and indicators for GDP and employment for the fourth quarter indicate a continued recovery in productivity growth.
- During the autumn the US dollar has continued to weaken against the euro. The current rate is 1.44 USD/EUR. The dollar depreciation is linked to the signs of weaker economic activity in the United States and the deficit in the US current account.
- The krona has weakened against the dollar and the euro since October. In terms of the TCW index the krona has weakened by around 2 per cent since the most recent Monetary Policy Report. Developments so far during the fourth quarter indicate a TCW forecast that is almost 1 per cent lower than the most recent assessment.
- In November, households' inflation expectations were 2.5 per cent for twelve months ahead. This was 0.3 percentage points lower than in October. However, Prospera's survey indicates rising inflation expectations since October. At one, two and five years ahead all actors expect inflation to be 2.6, 2.5 and 2.4 per cent respectively. The largest adjustment has been made one year ahead.
- The CPI and the CPIX increased by 3.3 per cent and 1.9 per cent respectively on an annual rate in November. This was a good 0.6 percentage points higher than expected. Energy and food prices (particularly fruit and vegetables) increased at an unexpectedly rapid rate. When adjusted for energy prices the rate of increase in the CPIX was 1.9 per cent, which was approximately 0.2 percentage points higher than forecast. The main reason for the more rapid increase in the CPI than the CPIX is rising interest costs for home-owners which contribute 1.1 percentage points to CPI inflation.

■ The economic outlook and inflation prospects

The Riksbank's current appraisal of economic indicators and inflation assessments is based on the assessment made in the October Monetary Policy Report and the revised forecasts presented in this update.

■ ■ Slightly weaker international picture with continuing financial turmoil

Growth prospects for the United States have been revised down further since the October Monetary Policy Report. In a short-term perspective uncertainty has increased regarding the problems in the US mortgage and housing markets and the size of their effects on the real economy. There are now also signs that, for instance, household consumption will grow more slowly than was assumed in the earlier assessment.

The continued uncertainty in the financial markets has meant that investors have sought investments with low risk and high liquidity. This has led to a rise in the so-called interbank rates in many countries. Companies and private persons have therefore experienced a larger upturn in borrowing costs than is motivated by expectations of future policy rates. This development is expected to subdue demand in the short term, both in Sweden and abroad. The financial turmoil also creates general uncertainty regarding economic developments, which can affect plans for investment and consumption.

All in all, international GDP growth has been revised down slightly, but growth remains good from an historical perspective.

The assessment of inflation abroad has been adjusted upwards both for this year and next year. This is linked to energy and food prices rising more than expected. Energy prices are expected to remain higher in the future, judging from forward prices, which contributes to pushing up international inflation.

■ ■ Good economic activity in Sweden but signs of weakening

GDP growth has slowed down since 2006, but developments in the Swedish economy are still relatively good. During the third quarter growth was weaker than expected, and indicators such as the consumer tendency survey and retail trade sales statistics point to the fourth quarter also being weak. The growth forecast for 2007 is therefore being revised down. The increase in the number of hours worked also slackened during the third quarter. The number of employed according to the labour market surveys increased slightly more slowly than expected in November, which indicates a slightly lower growth in the number of hours worked during the fourth quarter, compared with the assessment in the October Monetary Policy Report.

The GDP forecast is also being revised down slightly for the coming years. This is a consequence of the financial market turmoil and ensuing credit crunch. The slightly weaker international economic activity will also contribute to subduing growth. The number of hours worked and the number of employed are expected to continue to increase during the forecast period, but at a declining rate. In line with the downward revision to GDP growth, employment growth is now expected to be slightly slower in 2008 and employment is expected to be slightly higher during the forecast period, compared with the forecast in October.

All in all, this indicates a slightly lower resource utilisation during the forecast period, compared with the assessment in October. However, resource utilisation is currently expected to remain high and to gradually fall towards a normal level during the forecast period.

■ ■ Cost pressures rising

Hourly wages have increased more slowly than expected so far this year. In accordance with the new wage agreements, they are expected to rise relatively rapidly during the fourth quarter and at the beginning of next year when retroactive wage payments are expected to enter the statistics. A higher rate of increase in hourly wages and weaker productivity growth compared with the immediately preceding year lead to higher production costs and gradually rising inflationary pressures. Growth in productivity is then expected to increase and develop roughly in line with the trend rate of increase, which will contribute to subduing cost pressures.

All in all, domestic cost pressures are expected to be marginally lower during the forecast period, compared with the previous assessment. The downward revision is primarily motivated by the labour market situation not being as tight as previously expected, which in turn will slow down wage drift. To some extent this is counteracted by a slight downward revision in the productivity forecast.

■ ■ Higher inflation in 2008

Inflation is expected to rise relatively quickly in the coming year. This is partly linked to energy and food prices rising rapidly lately and being expected to continue to rise. The CPIX is expected to increase by an average of 2.7 per cent in 2008, which can be compared with the average rate of increase in 2006 and 2007 of 1.2 per cent. When adjusted for energy prices, inflation shows a more gradual rise, as a result of the rising cost pressures.

CPI inflation is expected to exceed 3 per cent on average during 2008. Almost one percentage point is explained by rising mortgage interest expenditure. Towards the end of the forecast period the economy will enter a calmer phase, at the same time as the recent rise in energy prices falls out of the twelve-month comparisons. This means that inflation will slow down and stabilise around 2 per cent. CPI inflation will also exceed CPIX inflation towards the end of the forecast period, when household mortgage interest expenditure continues to rise more quickly than other components in the CPI.

Compared with the forecast in the Monetary Policy Report, the inflation forecast is revised up in the short term, which is primarily linked to energy prices having increased at a faster rate, although rising food prices have also contributed. Rising food prices will also contribute. The forecast for the CPIX excluding energy has also been revised upwards slightly for next year. During 2009 and onwards the forecast for CPIX inflation is in line with the earlier assessment.

■ ■ Largely unchanged interest rate path

The Riksbank holds largely the same view of how the repo rate will develop in the future as in June and October. Although inflation is expected to be higher in the short term, which could indicate a higher repo rate, this is counteracted by the upturn in inflation being primarily due to rising energy prices, which are expected to have a temporary effect on inflation in 2008. From the middle of 2009 onwards inflation is expected to be in line with the target.

Weaker growth in Sweden and abroad, together with continued financial market turmoil and higher interest rates, is expected to subdue demand more than was anticipated in October. This could indicate a lower interest rate path. However, consideration must also be given to the fact that resource utilisation is currently assessed as higher than is normal.

The repo rate is now 4 per cent. During the first half of 2008 it is probable that the interest rate will need to be raised to around 4.25 per cent, but there is considerable uncertainty as a result of the turmoil in the international financial markets. This development in the repo rate is considered to contribute to an inflation rate in line with the 2 per cent target from 2009 onwards, at the same time as production and employment develop in a balanced manner.

There is as usual considerable uncertainty over future economic developments and thus there is considerable uncertainty as to how the repo rate will develop in future. The Riksbank may, for instance, need to raise the repo rate more if cost pressures are higher than forecast. However, if the financial turmoil continues and economic activity in Sweden and abroad is weaker than expected, the interest rate may instead need to be lower.

The future direction for monetary policy will depend, as usual, on how new information on economic developments abroad and in Sweden will affect the prospects for economic activity and inflation in Sweden.

■ Tables

Table 1. Key figures, annual averages

Annual percentage change, unless otherwise specified

| Key figures | 2006 | 2007 | 2008 | 2009 | 2010 |
|---------------------------|------|-----------|-----------|-----------|-----------|
| CPI | 1.4 | 2.2 (2.1) | 3.6 (2.9) | 2.4 (2.4) | 2.2 (2.2) |
| CPIX | 1.2 | 1.2 (1.1) | 2.7 (2.0) | 2.1 (2.0) | 2.0 (2.0) |
| CPIX excl. energy | 0.6 | 1.4 (1.4) | 2.3 (2.0) | 2.2 (2.2) | 2.2 (2.2) |
| Repo rate, annual average | 2.2 | 3.5 (3.5) | 4.2 (4.3) | 4.3 (4.4) | 4.3 (4.3) |
| Employed (aged 16-64) | 1.8 | 2.5 (2.6) | 1.4 (1.5) | 0.2 (0.2) | 0.1 (0.0) |
| GDP, Sweden | 4.1 | 2.6 (3.1) | 2.4 (2.8) | 2.1 (2.3) | 2.8 (2.6) |
| GDP, OECD | 3.0 | 2.7 (2.5) | 2.1 (2.3) | 2.4 (2.6) | 2.6 (2.7) |
| GDP, world | 5.4 | 5.0 (5.0) | 4.5 (4.6) | 4.4 (4.4) | 4.4 (4.5) |

Note. The assessment in the most recent Monetary Policy Report is shown in brackets. CPIX is CPI excluding household mortgage interest expenditure adjusted for direct effects of changes in indirect taxes and subsidies.

Sources: Statistics Sweden and the Riksbank

Table 2. Inflation, twelve month figures

Annual percentage change

| | Dec. -07 | Dec. -08 | Dec. -09 | Dec. -10 |
|-----------------------|-----------|-----------|-----------|-----------|
| CPI | 3.6 (2.8) | 2.9 (2.8) | 2.3 (2.3) | 2.2 (2.2) |
| CPIX | 2.2 (1.5) | 2.4 (2.2) | 2.1 (2.1) | 2.0 (2.0) |
| CPIX excluding energy | 2.1 (1.8) | 2.1 (2.1) | 2.3 (2.3) | 2.2 (2.2) |

Note. The assessment in the most recent Monetary Policy Report is shown in brackets. The CPIX is CPI inflation excluding household mortgage interest expenditure adjusted for direct effects of changes in indirect taxes and subsidies.

Sources: Statistics Sweden and the Riksbank

Table 3. Repo rate forecast

Per cent, quarterly average

| | Q4 2007 | Q1 2008 | Q2 2008 | Q3 2008 | Q4 2008 | Q4 2009 | Q4 2010 |
|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Repo rate | 3.9 (3.9) | 4.1 (4.1) | 4.2 (4.3) | 4.3 (4.3) | 4.3 (4.4) | 4.3 (4.4) | 4.2 (4.3) |

Source: The Riksbank

Table 4. Latest outcome and previous forecasts for central forecast variables

Annual percentage change unless otherwise specified

| Key figures | Period | Outcome | MPR 2007:3 |
|--|-----------|---------|------------|
| GDP, calendar-adjusted | Quarter 3 | 2.5 | 3.5 |
| Number of hours worked, calendar-adjusted | Quarter 3 | 3.0 | 3.1 |
| Employed (aged 16-64) ¹ | Quarter 4 | 2.1 | 2.8 |
| Open unemployment, seasonally-adjusted ^{1,2} | Quarter 4 | 4.5 | 4.3 |
| Open unemployment aged 15-74 (EU definition), seasonally-adjusted ^{1,2} | Quarter 4 | 6.0 | 5.8 |
| Exchange rate, TCW index, level ³ | Quarter 4 | 124.1 | 123.4 |
| CPI | November | 3.3 | 2.6 |
| CPIX | November | 1.9 | 1.3 |
| CPIX excluding energy | November | 1.9 | 1.7 |

¹ Outcome for Quarter 4 refers to the mean value for October and November.

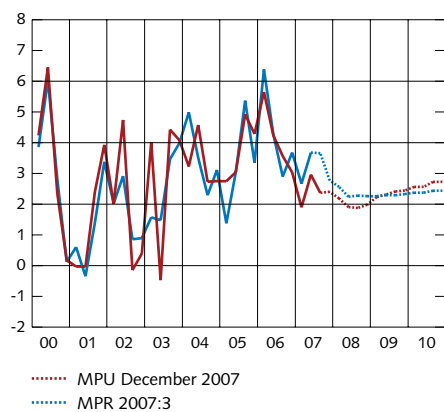
² Percentage of the labour force.

³ Outcome for Quarter 4 refers to the mean value up to 13 December 2007.

Sources: Statistics Sweden and the Riksbank

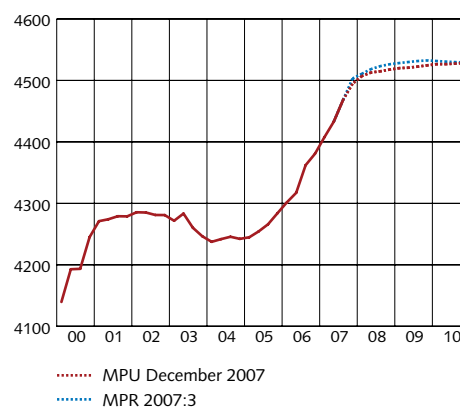
Figures

Figure 5. GDP
Quarterly changes in per cent calculated as an annual rate, seasonally-adjusted data



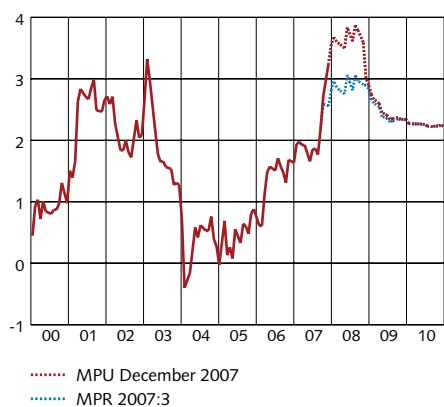
Sources: Statistics Sweden and the Riksbank

Figure 6. Number of employed
Thousands of persons, seasonally adjusted data



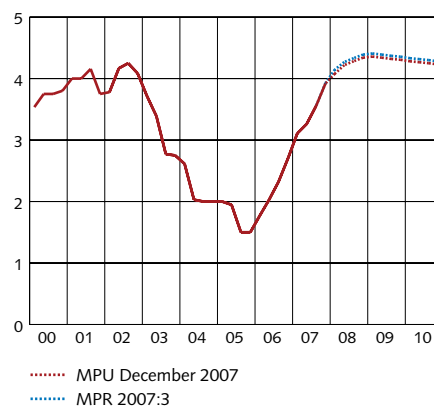
Sources: Statistics Sweden and the Riksbank

Figure 7. CPI
Annual percentage change



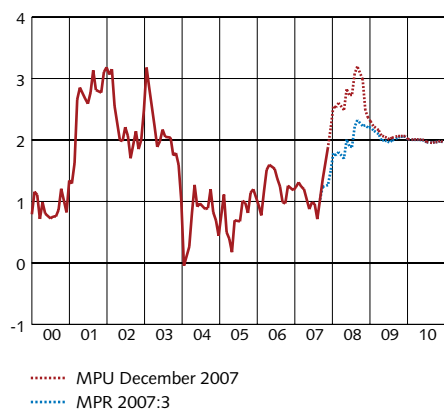
Sources: Statistics Sweden and the Riksbank

Figure 8. Repo rate
Per cent, quarterly averages



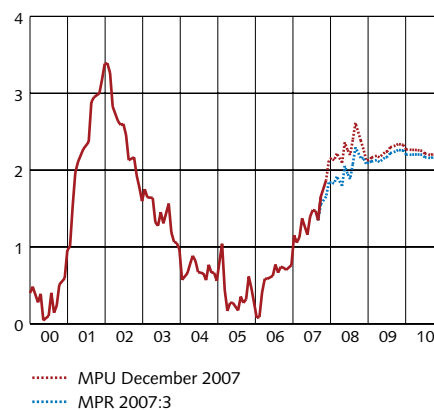
Source: The Riksbank

Figure 9. CPIX
Annual percentage change



Sources: Statistics Sweden and the Riksbank

Figure 10. CPIX excluding energy
Annual percentage change



Sources: Statistics Sweden and the Riksbank

Note. MPU refers to the Monetary Policy Update and MPR refers to the Monetary Policy Report. Broken lines represent the Riksbank's forecast.