



Separate minutes of the Executive Board, No. 3

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§ 1. Economic developments

It was noted that Carl-Johan Belfrage and Bengt Pettersson would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

Bul Ekici from the Monetary Policy Department reported on developments in the financial markets since the previous Executive Board Meeting on 8 April¹. Both short-term and long-term interest rates have risen. The unease in the interbank market has continued. Interbank

¹ The Executive Board is informed regularly at its formal meetings of the developments in the financial markets in recent weeks. The Monetary Policy Reports and Updates published externally describe developments in a longer perspective and make comparisons with the situation at the time of the previous monetary policy meeting.

rates have risen in the euro area, the United States and Sweden. Some credit spreads have recently shown a slight decline in the United States, but this is mainly because the government bond rate has risen.

There has been a recent slight rise in the stock markets in the United States, the euro area and emerging markets. The euro and the krona have continued to strengthen against the dollar.

Market agents now no longer believe to the same extent in policy rate cuts, as concern over inflation has increased in the United States, the euro area and Sweden. In the United States market agents are expecting in terms of forward pricing that the US policy rate, the Fed funds, will be cut by 0.25 percentage points at the monetary policy meeting on 30 April. On 8 April the expectations were that the rate would be cut by 0.5 percentage points. Expectations for two years ahead have also been revised upwards. For the euro area, market expectations are that the policy rate will remain at around 4 per cent for the foreseeable future, which can be compared with the earlier pricing, which reflected expectations of an interest rate cut of 0.25 percentage points in 2009. In Sweden, too, monetary policy expectations have been adjusted upwards. The market is now pricing a repo rate around 0.25 percentage points higher in 2009 than was the case on 8 April and in practice an unchanged policy rate during the foreseeable future. It is assumed that the repo rate will be held unchanged at today's meeting. On the other hand, the long-term assessments differ. The majority of market agents are expecting that the repo rate path published tomorrow will be lower than that published in February.

Anders Vredin, Head of the Monetary Policy Department, presented a base for the Executive Board's discussion in the form of a draft Monetary Policy Update. He noted by way of introduction that an international outlook, a description of the current situation and proposals for forecasts had been presented by the Monetary Policy Department and the Financial Stability Department and discussed at a preparatory meeting on 15 April. At a meeting on 16 April forecasts and texts for a Monetary Policy Update had been discussed more closely.

Since the previous monetary policy meeting in February the financial market turmoil has persisted. Interbank rates and interest rate spreads remain high. There are some signs that global growth has been lower than was expected in February. Households' consumption growth and retail trade sales have been slightly more subdued than anticipated in both the United States and the euro area. Despite slower growth, inflation has at the same time been surprisingly high. The oil price has continued to rise and is now higher than expectations in February. Expectations of the future oil price, in the form of forward rates, have also risen.

In Sweden the inflation outcome has been roughly as expected. Swedish inflation, like international inflation, is being pushed up by rising energy and food prices. GDP growth in the fourth quarter of last year was slightly higher than expected, but the recent indicators point on the whole to slightly weaker growth than anticipated. Inflation expectations have been slightly subdued since February, but are still above the monetary policy target according to Prospera's survey.

Although conditions for growth in the global economy have deteriorated and forecasts for GDP in the United States and euro area have been revised down, continued good growth is expected in the world economy of around 4 per cent over the coming years.

In Sweden we have good economic activity and resource utilisation is above normal. However, growth is expected to slow down more quickly and resource utilisation is expected to be lower in future than was forecast in February. Unemployment is expected to increase more quickly as the forecast for employment has been revised down. Inflation is expected to be slightly higher than was forecast in February. Forward pricing indicates that food and energy prices will remain high.

The forecasts are based on an unchanged repo rate of 4.25 per cent and an unchanged interest rate path. The risk assessment also remains largely the same as in February.

§ 2. Economic outlook abroad

Deputy Governor **Lars Nyberg** opened the discussion. He pointed out that since the previous monetary policy meeting the financial turmoil had continued to dominate international reports. The price of short-term borrowing in the bank system, what is usually known as liquidity, has not declined, rather the opposite. The European Central Bank and the central banks in the United States and the United Kingdom have continued to take action to an undiminished extent to facilitate the situation. They are providing longer loans than normal and accepting less eligible assets as collateral. More and more people are beginning to wonder how the situation can be resolved. The US central bank, the Federal Reserve, has been forced to take emergency action to save a market agent outside of the bank system, Bear Stearns, which is unique in modern times. This will probably have profound consequences for the discussion of which institutions should be regulated and how this should be done.

Mr Nyberg considered that liquidity ought to have improved as losses have been reported openly and a number of larger agents have made significant write-downs. Liquidity is to a great extent a question of confidence. The fact that liquidity has not begun to return to normal levels implies that there is still a large confidence gap and that the market is waiting for more losses to arise – but it is not sure where. It is not until the banks feel confident that all potential holes in the balance sheets have been reported openly that we can count on the situation improving. This may take time, particularly as not all of the agents appear so willing to report their losses. Increased transparency would speed up the healing process.

Under these conditions the situation will also be unstable in the sense that the rumours in the market can quickly have large-scale effects. Northern Rock and Bear Stearns are both examples of financial institutions that have gone from functioning companies, where the liquidity reserves have been judged to be satisfactory, to having liquidity problems and on to becoming insolvent in the course of a week or so. It is not impossible that similar events will occur in the future. Many banks and other financial companies are dependent on borrowing in the market, the long-term as well as the short-term. A touch of suspicion and market rumours have for instance affected the Icelandic banks in recent weeks.

Mr Nyberg considered that substantial financial risk had been transferred through the central banks' actions, which were necessary in this situation, from the shareholders to society. Nevertheless, a number of agents, who would not be able to maintain operations without the aid of the extraordinary measures taken by the central banks, were continuing to pay dividends to their shareholders. This situation should receive greater attention than has been the case. The banks currently need more capital, not less. A reduction in capital

increases the risk in the banks, but it can also lead to a credit crunch which will affect companies outside of the financial sector, that is, the banks' regular customers. The tendencies towards this type of credit crunch can be seen already in the United States, although some banks have succeeded in restoring some of the capital they have lost.

In the United States the financial turmoil has now clearly been passed on to the real economy, The developments in the financial sector are reinforcing the economic downswing, which in turn is increasing the financial turmoil in a vicious circle. This has caused us and others to make a downward adjustment in the forecasts for growth in the United States and the euro area.

At the same time as international growth forecasts are adjusted downwards, inflation forecasts are being adjusted upwards. The energy and food price increases have been larger than expected, and it is reasonable to assume that the increases will affect other prices and in this way have an effect in several stages. It is doubtful whether all countries, even those with an explicit inflation-targeting policy, will want to deal with these problems by raising interest rates. One can claim that the price increases are of a one-off nature and moreover that they are made necessary by supply factors in the world market and are thus difficult to combat with domestic monetary policy. In the United States the Federal Reserve appears to be currently focussing on a financial crisis and declining growth rather than problems of rising inflation. The same applies to the Bank of England. All in all, there is reason for concern that international inflation will accelerate and become entrenched in a way we have not previously had reason to expect.

Deputy Governor **Barbro Wickman-Parak** referred to Mr Nyberg's comments on developments in the global financial markets and that the effects of the turmoil were now clearly visible in the real economy, particularly in the United States. It is possible to make a long list of bad news from the United States. This would include falling house prices and falling employment. In February the Riksbank revised down its forecast for the US economy and it implied that we would see very weak indicators during the spring. Ms Wickman-Parak considered then that the write-down made was reasonable, but she also considered it possible that the indicators could signal an even weaker outcome. This has been the case and the growth forecast has once again been revised down.

It is fairly obvious that the US economy will be weak during the first half of this year, but what comes after that is more interesting. The question is whether the US economy will improve towards the end of the year and continue on this path in 2009. The important thing is how households will act. The large fall in consumer confidence, which is largely due to a more pessimistic view of the labour market, is worrying. The fiscal policy stimulus package, which includes cheques that will begin to be sent out during the spring will raise consumption during the autumn, but there is a risk that this will be temporary unless an upturn in production and employment makes an appearance.

However, Ms Wickman-Parak claimed that there are bright spots in the darkness. She pointed out that there has already been a major adjustment in the construction sector. Housing construction has fallen and this autumn the decline will have been going on for three years. We should reasonably be approaching the lowest level for housing investment at the end of the year, and when this is passed it will mean that a strong downward pull on growth disappears. It can be added that confidence in the construction industry has ceased

falling in recent months. The stocks of unsold houses are still at a high level, but they have fallen slightly from the peak in summer 2007. As house prices have fallen, the average household's ability to buy a house at the average price has risen considerably. The borrowers who have had or have subprime loans have been hit hard, but one should not forget that the large majority of borrowers can manage their loans. In addition, they have paid lower mortgage rates and the applications to renew loans at lower interest rates have therefore increased in recent months.

Ms Wickman-Parak also pointed out that US companies have a good starting situation. Their balance sheets are strong and profits are still at a high level from a historical perspective, although they have been dampened recently. There has not been over-investment in the same way as prior to the turn of the millennium and which then led to a downward adjustment. Moreover, there was some adjustment in the form of a slowdown in IT investment in 2006. There has not been a build-up of stocks as was the case prior to the new millennium and stocks are now low. Given the continued weakening of the dollar, exports should continue to support demand, which then needs to be met with increased production.

However, there is of course a considerable amount of uncertainty. Ms Wickman-Parak agreed with Mr Nyberg that it is difficult to assess how the financial turmoil will develop and what impact it will have on the real economy. Another major uncertainty factor is the oil price, which may rise further and undermine purchasing power more than is currently anticipated. The current uncertainty means it is not surprising that there are many different messages as to what direction the US economy will take. The most recent consensus forecast from April illustrates this clearly. The average forecast from the 25 or so professional analysts of growth in the US economy is just over 2 per cent for 2009, but the span between the highest and lowest forecast is unusually large. The lowest forecast is 0.6 per cent and the highest is 3.6 per cent. The Riksbank's forecast is slightly under the average. According to Ms Wickman-Parak this is a reasonable forecast. Time will tell whether it was too optimistic.

Deputy Governor **Svante Öberg** considered it reasonable to revise down the forecasts for international GDP growth in relation to the forecasts given in the February Monetary Policy Report.

Economic activity in the United States has continued to deteriorate and this is largely connected with the problems in the financial markets. However, the United States is a country that can usually manage crises and a number of measures have been taken to put the problems right. Despite this, it is difficult to believe that a recovery can get started until there is a better picture of where the losses in the financial system are and until the fall in house prices has come to a halt. Experiences show that sharp falls in housing prices are usually related to more prolonged periods of low growth. There is therefore a risk that the slowdown in the United States will be more prolonged than is assumed in the Monetary Policy Update.

Europe has so far managed better. We have not seen much hard evidence of a weaker economy. On the contrary, there have been several positive surprises. However, there are tangible signs of a future slowdown in corporate and household confidence indicators. In

the light of the slowdown in the United States and the financial market turmoil it is reasonable to assume there will also be a slowdown in Europe.

However, Mr Öberg pointed out that growth in other parts of the world have so far been strong. The International Monetary Fund (IMF) assumes in its most recent report that GDP growth in what it calls "emerging and developing economies", which account for almost half of the world's GDP, will only be dampened from just under 8 per cent a year in 2006 and 2007 to 6 ½ - 7 per cent a year in 2008 and 2009, despite the fact that the IMF has a very pessimistic view of developments in the United States.

Mr Öberg also considered it reasonable to revise up the assessments of international inflation in relation to the forecasts published in the Monetary Policy Report in February. Energy and other commodity prices have risen rapidly in recent years. This has not merely been a case of temporary price increases on individual goods, but a broad inflation driven by the strong world growth, particularly in Asia. This has led to rising inflation both in the developing economies and in more developed countries. In the United States, CPI inflation is 4 per cent and in the euro area HICP inflation is 3.6 per cent.

The most probable outcome is that inflation will decline next year. But there is a risk that the inflation process will be more prolonged. This is indicated by a number of factors. One is that world growth, despite some slackening, can still be considered relatively high. This may continue to push up prices. Another factor is that more developed economies must find a balance in their monetary policy between on the one hand alleviating the downswing in the real economy and on the other hand counteracting the rising inflation. Giving priority to the first aim can mean that inflation will be above the desired level for a long period of time. A third factor is that several developing economies do not have the same credibility with regard to using monetary policy to keep inflation at a low and stable level. The IMF assumes, for instance, that inflation in emerging and developing economies will be 7.4 per cent this year in comparison with 2.6 per cent in more developed countries.

All in all, Mr Öberg therefore felt that there are downside risks with regard to world GDP growth, but upside risks with regard to inflation. One might perhaps think that it is strange to have a decline in growth at the same time as an increase in inflation. But this is what has happened; world growth has been dampened and world inflation has risen. This is also how the forecasts have been revised.

First Deputy Governor **Irma Rosenberg** began by pointing out that the financial market turmoil has persisted since the previous monetary policy meeting in February. Interbank rates have risen again. This shows that the liquidity shortage is still a real problem for banks internationally, despite the measures taken by the central banks. Many banks and financial institutions have met with difficulty in financing themselves and many have also been forced to make large write-downs, particularly in the value of subprime-related assets. There is still considerable uncertainty over how long it will take before the worst of the crisis is over and we can see what risks it entails for the future development of the real economy. Ms Rosenberg's concern over this had not diminished since February.

Ms Rosenberg felt that in February she was more concerned over developments in both the United States and the euro area than was expressed in the forecasts in the Monetary Policy Report. Now these forecasts have been adjusted downwards. The housing market in the United States is in a decline, with falling house sales and prices at the same time as a large

number of houses are being put up for sale. Housing construction has already fallen over a period of a couple of years, but as yet no slowdown can be seen. The Federal Reserve's latest Beige Book, which was published in mid-April, reports that building of commercial property is slowing down. The report's main message is that the economic conditions in the US economy have weakened since the previous report. In February Ms Rosenberg also saw risks that private consumption in the United States would be weaker than expected, given that employment had swung downwards, that purchasing power was undermined by rising oil and food prices and that property and share prices were falling, something that appears to be confirmed as early as the first quarter of the year. But the main uncertainty in February was whether the slowdown in the United States would be more prolonged than indicated in the forecast in the main scenario. Ms Rosenberg still saw such a risk, to some extent, although the forecast for US growth was now adjusted downwards.

It is primarily the forecasts for growth in the United States and the euro area that have now been revised down in the Monetary Policy Update. But according to Ms Rosenberg there are clear risks that developments will also be weaker in the rest of the world, not least because of the effects of the weaker outcomes in the United States and Europe. The financial turmoil and its effects on how the financial markets function are also one reason. Another is that domestic demand, which constitutes a driving force for growth in many developing countries, may be dampened by the sharp rises in energy and food prices which push up inflation. There is therefore a risk that growth in other parts of the world will be lower than is forecast in the Monetary Policy Update.

Governor **Stefan Ingves** began by pointing out that growth in the world economy remains strong, despite the weakening in the United States and the euro area. Global growth is expected to be around 4 per cent this year. This can be compared with the IMF's assessment that growth of 3 per cent or lower is required for the world economy to be regarded as in a growth recession.

The financial markets have now made progress in dealing with the problems related to the US subprime market and which gave rise to the financial turmoil six months ago. A number of problematic subprime loans still remain, but many are being renewed within the coming six months and then the major part of the loan has been dealt with. They have made more progress in their adjustment process and there are currently several discussions on active recapitalisation of banks, primarily in the United States but also in other parts of the world. The United States appears to be further ahead in this field than the euro area. The effects on the real economy of the financial turmoil are lower growth in aggregate demand both abroad and in Sweden. This should lead to lower inflation in the world, but inflation has risen both in Sweden and abroad as a result of sharp rises in energy and food prices. The oil price is now higher than when our forecasting work for the Monetary Policy Update began and now the high food prices have to be added to this.

As growth in the world economy is falling at the same time as inflation is rising, a number of countries are facing a not particularly pleasant choice: Should monetary policy focus on declining growth or on rising inflation? The choices made have effects on a small open economy like ours. The situation now is therefore different than that of two years ago. There is greater uncertainty now as there is a risk of larger fluctuations in economic activity, which in turn can affect the Swedish economy and monetary policy. One interesting aspect that can be noted recently is that market expectations of monetary policy have shifted

upwards both in the United States and the euro area. This indicates that more market analysts believe in a recovery and that the focus has at least to some extent shifted from the risks of less growth to the risk of rising inflation.

Deputy Governor **Lars E.O. Svensson** emphasised the role of international developments for a small, open, trade-dependent economy like Sweden's. The real economy developments in Sweden are affected through international trade. Rising global oil and food prices will lead to higher inflation abroad, but will also entail international relative price changes. The relative price changes will spread to the Swedish economy through international trade. However, there is some difference between relative price changes relating to some commodities abroad and a broad international inflation, that is, an upswing in almost all international prices. A broad inflationary impulse from abroad or a permanent broad upswing in international inflation will not prevent the Riksbank from keeping Swedish inflation under control. The Riksbank is capable of conducting a policy which will mean that the krona strengthens so that international inflation expressed in krona will not be higher. It is thus possible to shut out the effects of global inflation on the Swedish economy. However, Mr Svensson agreed with Mr Ingves that the rest of the world's monetary policy reaction to international inflation could have real economic consequences abroad for real interest rates and production and thereby real economic consequences for the Swedish economy.

Mr **Ingves** summarised the discussion by saying that the financial turmoil persists. It is managed slightly differently in different regions. The adjustment in the financial sector has now been underway slightly longer, although it is not complete. Growth in the United States and the euro area has slowed down and the forecasts have been adjusted downwards, but at the same time inflation has risen. There is greater uncertainty over developments in the world economy than before. This means that the challenges for Swedish monetary policy are also greater than before. If global demand declines further than expected or if global inflation rises more quickly than anticipated, this will have different consequences for Swedish monetary policy.

§ 3. Economic developments in Sweden and the monetary policy discussion

Deputy Governor **Svante Öberg** began by proposing that the policy rate be held unchanged at 4.25 per cent and that the Monetary Policy Update be based on the same interest rate path as in the February meeting.

Mr Öberg agreed on the whole with the picture of economic developments in Sweden painted in the Monetary Policy Update and merely wished to take up one question, namely the risk assessment. In his opinion there is a slightly greater probability of an increase in the policy rate during the year than of a cut in the rate. CPI inflation is above the inflation target throughout the forecast period, which in itself indicates a higher interest rate path. Moreover, there are upside risks for inflation.

Mr Öberg considered that one upside risk was international inflation, something he had commented on previously. Higher international inflation over the coming years would mean that the policy rate in Sweden would need to be higher during a transition period to

counteract inflationary impulses from abroad. Such a development was illustrated in an alternative scenario in the Monetary Policy Report published in February.

Another upside risk is that the inflation upswing in Sweden will be more persistent than estimated. There is a risk that increases in energy and commodities prices will spread to other goods and services.

The high inflation can affect wages through demands for compensation for price rises, although at present this does not appear very probable, said Mr Öberg. Wage increases were moderate last year, although they may have been underestimated to some extent. The only wage statistics available for this year are for the public sector in January. We will have a better picture of wage developments when the statistics on business sector wages for January and February are published at the end of this month.

Mr Öberg pointed out that one problem in this context is that inflation expectations are above the target level, although they declined slightly in the most recent surveys. This also applies to the inflation expectations two and five years ahead. It is important that inflation expectations do not become entrenched at a higher level, but move down towards the inflation target again, said Mr Öberg.

Another problem, according to Mr Öberg, is that the analysis of underlying inflation at the beginning of the year is made more difficult by the unusually large effect of changes in weighting in CPI in January. This means that measures of underlying inflation are difficult to interpret and that the uncertainty over the initial situation is greater than normal. He considered it would be good to have an in-depth analysis of these problems prior to the monetary policy meeting in July.

First Deputy Governors **Irma Rosenberg** observed that inflation has largely been in line with the forecast in the February Monetary Policy Report. In March CPI inflation was 3.4 per cent, that is, a good bit above the target of 2 per cent. Approximately one percentage point of the upswing in the CPI is connected to the higher interest costs for house-owners that ensue from the interest rate raises made by the Riksbank over the past two years. The rise in inflation is also to a great extent due to rapid price increases in the world commodities markets for energy and food. This is the primary reason why CPI inflation rose by just over 1.5 percentage points in just a few months during autumn 2007. The effects of these rapid price impulses on the inflation rate cannot immediately be counteracted by monetary policy. Such fluctuations are also very difficult to predict and it is therefore not possible to assume that the effects on inflation can be entirely avoided, considered Ms Rosenberg.

Ms Rosenberg asked the question of how monetary policy should react to such international price impulses. She considered that the difficulty faced by both the Riksbank and other central banks now was that the energy and food price rises were on the one hand pushing up inflation and on the other hand subduing growth as they mean that companies' costs increase and households' purchasing power is undermined. A tighter monetary policy will then contribute to dampening inflation, but will at the same time put further downward pressure on activity in the real economy in a situation where economic activity is slackening anyway. The Riksbank's method of conducting monetary policy means that one has to weigh these effects against one another. Inflation must be close to the target within a two-year period, but at the same time inflation and the real economy should not fluctuate too much.

In practice this is a far from simple process, said Ms Rosenberg. It is not so easy to capture all of the effects an increase in commodity prices can be expected to have on the economy. One difficulty is assessing how lasting the price impulses can be expected to be. It is not necessary to use monetary policy to counteract shocks to inflation which are only expected to have temporary effects. The forecast now, as in February is based on energy and food price increases being partly temporary and not being expected to continue to rise at the same rate. However, this is of course uncertain. One reason for the rapid rises in energy and food prices is a strong consumption demand, particularly from emerging economies as their purchasing power increases. Another reason is increased use of some commodities in the production of biofuels. It is difficult to determine how lasting these effects will be. If the international price impulses become stronger and more lasting than expected, inflation will be higher. But according to Ms Rosenberg it is not impossible that the international price rises will slow down more quickly than expected, leading to inflation falling more quickly. This could be the case if international economic activity slows down more suddenly than expected. Both of these risk scenarios have been referred to in earlier reports. There are also some indications that energy and commodity prices have recently been pushed up by increased interest in the financial markets in portfolio investment in energy and commodities. If the expectations of future returns on these investments change, it could contribute to a more sudden slowdown in the prices of these goods and therefore also to consumer inflation. According to Ms Rosenberg, all of this indicates considerable uncertainty over the durability of the price impulses.

Ms Rosenberg also pointed out that regardless of whether international price impulses in themselves prove to be temporary or lasting, it is important that they are not allowed to push up inflation permanently, through secondary effects and effects on inflation expectations. The risk of this has increased in that inflation expectations have risen during the autumn. There has been a marginal shift downwards in expectations, according to Prospera's April survey, and according to the National Institute of Economic Research's Consumer Tendency Survey there was a slightly larger downward adjustment in inflation expectations in March. But expectations are still rather too high in the longer term. This combined with the fact that inflation can be expected to be above the target for some time to come and that growth is still fairly good indicates that the repo rate should be held unchanged today, said Ms Rosenberg and proposed such a decision. She also thought that the situation implied that the interest rate may need to remain at its current level for a while.

At the same time Ms Rosenberg pointed out that GDP and employment growth were now expected to be slightly lower next year than in the forecast in the main scenario published in February. During the past six months households have become increasingly pessimistic regarding developments in the Swedish economy and unemployment and to some extent their own finances. The rate of increase in retail sales has also slowed down and this indicates that households have become slightly more restrained in their consumption. Labour market developments are also important for households' willingness to consume and there have been some signs that the labour market is about to cool down. For instance, the number of new vacancies registered has fallen substantially, although the level is still high. The recruitment plans in the Business Tendency Survey are also pointing downwards in many cases. Ms Rosenberg also said that she believes, as she did in February, that the weak productivity growth indicates that companies' demand for labour will slacken. This could contribute to holding back the rate of wage increase even in the future. Given this and the

risks of weaker growth resulting from the financial turmoil and the slackening in growth abroad, Ms Rosenberg could nevertheless not rule out the possibility that the interest rate might need to be cut later in the forecast period.

Governor **Stefan Ingves** emphasised that there is now greater uncertainty than before with regard to international developments. One might add to this that it is usually more difficult to make assessments regarding turning points in the economic cycle.

Resource utilisation is higher than normal to start with, but the cyclical peak has been passed and lower growth in the future will lead to a fall in resource utilisation, which is expected to subdue inflation.

However, lending to both companies and households remains high. Inflation expectations are above the target although they have recently fallen slightly. If the currently very weak productivity growth does not increase, unit labour costs will gradually rise. These are upside risks which may prolong the period with inflation above the target level and can lead to a higher interest rate.

With regard to monetary policy, one should take into account the fact that the financial turmoil in itself has a restraining effect. Increased interest rate spreads in practice mean a rise in interest rates without any change in monetary policy. In terms of the real interest rate, that is, if one takes into account inflation expectations, monetary policy is not particularly tight.

It is a question of weighing the upside risks to inflation in terms of rising energy and food prices against the downside risks in terms of the slacker world economic activity. All in all, this is not the right situation to change the interest rate or the interest rate path. The interest rate path provides a good reflection of the decision situation with the prevailing upside and downside risks. Although a lot has happened since the most recent monetary policy meeting, the overall picture has not changed. The interest rate path as it now looks is appropriate as it also gives the exchange rate some support and thereby comprises a counterbalance to external inflationary impulses in the form of import prices. It is therefore important that interest rates do not become too low in relation to the rest of the world and the existing interest rate path is well placed in this respect. However, it should be emphasised that it is chronically difficult to make predictions about future exchange rates.

Deputy Governor **Barbro Wickman-Parak** concurred with the picture of future inflation painted by Irma Rosenberg. The forecast for Swedish GDP points to a slightly stronger growth this year and the mild decline predicted for next year is a natural consequence of international developments, according to Ms Wickman-Parak.

There are some signs that inflationary pressures may be subdued in the future. Although there is still good activity in the labour market, the number of vacancies has just begun to fall and the National Institute of Economic Research's Economic Tendency Survey shows that recruitment plans have been subdued. Resource utilisation also appears to be rapidly moving down to a normal level. Ms Wickman-Parak also referred to Stefan Ingves' comment that the stronger krona exchange rate had a restraining effect on inflation. In addition, she pointed out that unit labour costs will be slightly higher this year than was predicted in the February report, but lower next year, and that the Riksbank's forecasts now

indicate that unit labour costs are expected to increase slightly less during the forecast period as a whole than was stated in the February report.

Ms Wickman-Parak pointed out that there are risks that economic activity abroad will be much weaker with consequences for growth and inflation in Sweden. However, in this context it is worth highlighting a positive factor in the Swedish economy that can function as a shock absorber. This is that Swedish households are currently in a strong position. They received good reinforcement of their income last year. Disposable incomes increased by around 4 per cent last year and are expected to increase by around 2 per cent over the coming years. Savings are high initially and although households have become more pessimistic with regard to the Swedish economy, expectations of their own finances remain at a relatively high level. The fact that households are continuing to borrow – although the rate of increase has fallen slightly it is still high at 11 per cent a year – also indicates that households are not overly worried about the future. Unlike in the United States, Swedish households have not had to see their housing assets erode.

Ms Wickman-Parak also observed that what we now know about inflation is that it is high and above the target, that cost pressures are still high although they appear slightly lower than was forecast in the February report, and that the oil price has risen more than expected. Producer prices for consumer durables have risen constantly since the beginning of the year. If one weighs together domestic market prices and import prices for these goods, they are now increasing by almost 6 per cent. It is uncertain to what extent this will spill over into the consumer sector, but it is a sign worth noting.

With regard to the uncertainty over the inflation outlook, Ms Wickman-Parak mentioned that productivity may not recover as estimated, which would in this case lead to unit labour costs increasing more than expected. It has also been necessary to adjust the forecast for the oil price upwards several times and there may be a risk that this will be repeated. Moreover, the rise in food prices may not slacken as expected and international inflation in general may rise more in the future.

Ms Wickman-Parak explained that she is well aware of the downside risks with regard to international economic activity and the effects this could have on economic activity in Sweden. However, these risks are outweighed by what we already know about inflation and the potential upside risks. Ms Wickman-Parak therefore explained that her conclusion was that she supported the proposal to hold the repo rate unchanged at 4.25 per cent. She also supported the interest rate path presented in the Monetary Policy Update. If the risks of a higher inflation rate manifest themselves, there will be reason to adjust the interest rate path upwards, and if the risks of lower growth manifest themselves, the path will need to be adjusted downwards, but Ms Wickman-Parak did not consider the time to be ripe to take this step and adjust the path in either direction.

Ms Wickman-Parak concluded that while the Riksbank has to make a difficult balance, it is nevertheless a favourable situation bearing in mind the good Swedish growth.

Deputy Governor **Lars E.O. Svensson** pointed out that with the same repo rate path as in February the Riksbank's forecasts show that resource utilisation is still high but will fall to a more normal level. Inflation is also high but falling towards the target a couple of years ahead.

According to Prospera, inflation expectations are lower than they were in February, but still high. However, they can scarcely be regarded as abnormally high compared with their usual relation to actual inflation. It is namely the case that in a regression of inflation expectations on actual inflation, the residual is currently close to zero. The residuals in such regressions can to some extent be interpreted as an expression of the credibility of monetary policy. Mr Svensson explained that at the previous monetary policy meeting in February he felt greater concern over inflation expectations than he does now. He explained that it would be interesting to further study the determinants of inflation expectations in the future.

Mr Svensson explained that the repo rate path can now be approximated to a constant repo rate of 4.25 per cent, which may be a reasonable long-term level for the nominal repo rate. The real repo rate is the nominal repo rate minus inflation expectations. With a long-term level of inflation and inflation expectations of 2 per cent, 4.25 per cent for the nominal repo rate would correspond to 2.25 per cent for the real repo rate, which could be a reasonable long-term average.

Mr Svensson claimed further that it is real interest rates and not nominal interest rates that are important to economic agents' decisions and for the effects of monetary policy decisions on the real economy. As inflation and inflation expectations are currently above 2 per cent and gradually approaching 2 per cent from above, this means that the real repo rate is now well below 2.25 per cent, almost down at 1.25 per cent, and that the path for the real interest rate is slowly rising up towards 2.25 per cent. Thus, the real repo rate path indicates that monetary policy is currently slightly expansionary. On the other hand, the spread between the interest rates faced by households and companies and the repo rate has increased slightly since February. In addition, the real repo rate should actually be compared with the forecast for what is known as the neutral real interest rate, the neutral real interest rate path. This is partly dependent on the forecast for growth in potential production. Mr Svensson expressed a hope that the Riksbank's analysis methods will be developed further and allow these real interest rate paths to be discussed at future monetary policy meetings.

At present, monetary policy is mostly discussed on the basis of different nominal interest rate paths, but it could be claimed that real interest rate paths are more fundamental and more informative. If, for example, one was to choose to stick to a particular real interest rate path, this would mean that the nominal rate should be shifted up one to one with increased inflation expectations.

All in all, Mr Svensson thought that the forecast for inflation and the real economy looks fairly good with an unchanged repo rate and thus wished to support the proposal of an unchanged repo rate and unchanged repo rate path in relation to that published in February. He also stressed that the Riksbank's repo rate path is a good path for the expected mean of the future repo rate. The future repo rate is uncertain, which is illustrated by substantial uncertainty bands around the expected future mean. Future repo rates could thus be higher or lower than the repo rate path, depending on the forecast for inflation and resource utilisation at that time. The probability now of future repo rates agreeing with the current expected future mean is very slight. The fact that the repo rate path is being kept unchanged on this occasion thus does not mean that the repo rate will necessarily remain unchanged in the future.

Deputy Governor **Lars Nyberg** pointed out that the banks in Sweden have largely avoided investing in US mortgages of dubious quality and in various forms of structured products that have been difficult to evaluate in the market. The Swedish overnight market has also functioned without disruption, that is, the banks have continued as usual to lend to one another overnight without collateral. Together these factors have contributed to the banks being able to enjoy continued confidence in the international market, despite the fact that they are all dependent on external funding. However, the price of this funding has of course risen as the price of risk has increased in the world market. When the banks gradually transfer the rising funding costs to their customers in the form of a higher interest rate this has a constraining effect on the economy in the same way as an increase in the repo rate.

Mr Nyberg noted further that in Sweden we have not seen any signs of a credit crunch other than the changes in terms for lending that are normal in a market situation like the present one. The Swedish banks do not have any shortage of capital that could motivate a pure credit crunch.

Mr Nyberg pointed out that despite all of the worrying factors, the Swedish economy has continued to grow, this year slightly stronger than expected. Households have become more concerned over the country's economy, but are apparently still optimistic regarding their own finances. Consumption growth remains largely unchanged and growth in the banks' lending is in two digits. However, house prices have levelled off and in some areas even fallen this year. Industrial orders and sales do not indicate any rapid downswing and cost pressures remain at an unchanged high level. It does not look as though labour costs per unit produced will fall until next year. This means that the economic downswing has been postponed slightly compared with the forecast made in February.

However, the falling international growth, largely related to the financial crisis, means that next year looks poorer than was previously forecast. As balance sheets are strong, both for households and companies, there is, however, reason to hope that there will be a soft landing, according to Mr Nyberg. We have good financial buffers and what is more fiscal policy will provide a greater contribution than was previously estimated, said Mr Nyberg.

Mr Nyberg could not see any reason to change either the repo rate or the repo rate path, given the overall international and Swedish background. He considered that slightly poorer growth next year is balanced by an increased concern over how inflation will develop as a result primarily of internationally-determined factors, but also of domestic cost pressures. But as there is great uncertainty over how prolonged the financial crisis will be and what real effect it will ultimately have on the world economy, Mr Nyberg considered it was far from impossible that the outcome would be poorer. If this were to be the case, Mr Nyberg believed there would be reason to reconsider the view of the interest rate path at the meeting in June.

Mr Nyberg also agreed with Mr Öberg that it is difficult to know whether the price increases regarding energy and foods should be regarded as transitory or whether they risk spreading and having a more lasting effect on underlying inflation.

Barbro Wickman-Parak declared that she tended to agree with Mr Nyberg on the importance of being on one's guard against the inflationary effects of rises in energy and food prices. She thought that one often hears inflation figures that have been adjusted in

various ways but that when households see that the prices they are actually meeting are rising rapidly they change their inflation expectations accordingly.

In addition, she reminded that inflation expectations are still at a high level and that when we are approaching the next wage bargaining rounds it is important that inflation expectations are in line with the target. Otherwise there could be problematic spiral effects when wage-earners may demand compensation for rising prices.

Svante Öberg clarified that it was not merely oil and food prices he was referring to in his earlier comments on the need for a clearer picture of underlying inflation; it was also the importance of technical factors such as changes in the weighting of the CPI and the systematic difference between the CPI and the CPIX. He illustrated this by calculating underlying inflation in an arithmetic example based on actual inflation of the current rate of 3.4 per cent. The extraordinary effects of weight changes in the CPI in January probably mean that one should add 0.3 percentage points and this gives us 3.7 per cent. The interest rate change accounted for 0.7 percentage points of this. The interest rate change was largely due to the repo rate decisions, but is also affected to some extent by the margin between the repo rate and the banks' short-term lending rate and by changes in long-term rates. Here one can note that the difference between the CPI and the CPIX was 1.1 percentage points in March and thus included more than the Riksbank's interest rate increases, including the effect of rising property prices and changes in indirect taxes and subsidies. If one deducts the effect of interest rate increases, one thus comes down to 3.0 per cent. If one also deducts the difference in inflation including and excluding energy (0.3 percentage points) and foods (1.0 percentage points), one obtains an underlying inflation rate of 1.7 per cent. However, CPIX inflation excluding energy and foods was only 1.0 per cent in March. It is important to determine whether underlying inflation is currently 1.0 or just over 1.7 per cent. Mr Öberg pointed out the need for closer analysis of this in the future.

Stefan Ingves commented that the experiences of the oil crises in the 1970s were not edifying. Even if the way the economy functions has changed and oil dependency has declined significantly since then, it may be of value to look back at the way the oil price rises then had an impact on inflation.

Lars E.O. Svensson referred back to Stefan Ingves' earlier observation regarding the experiences of inflation in connection with the oil price rises in the 1970s. He pointed out that the oil price has risen over a long period of time and that on this occasion we have seen much smaller effects on growth and inflation, partly as a result of the increased confidence in monetary policy and the way it is conducted. With regard to confidence in monetary policy, he looked with satisfaction at the diagram shown initially of how Swedish forward interest rate curves were increasingly approaching the Riksbank's repo rate path. The best thing would be for these curves to adapt completely to the repo rate path.

Svante Öberg considered there is a risk that inflation will remain at a high level even if growth slackens. Persistency in inflation is a subject that it would be good to analyse more closely. There are also international studies of this that may be beneficial.

Lars E.O. Svensson pointed out again that the residuals from a regression analysis of inflation expectations dependent on actual inflation can provide an interesting picture of the credibility of the Riksbank's monetary policy. If we begin to see that the residuals become

positive, that is, that inflation expectations become higher than the normal dependency on actual inflation, we must be on our guard. In addition, a lower regression coefficient, that is, a reduced dependency on inflation expectations of actual inflation, can in itself be interpreted as better credibility. As said earlier, it would be interesting and valuable to have an in-depth analysis of the determinants of inflation expectations, including actual inflation, and an incorporation of the results of such an analysis in future material used as a basis for monetary policy decisions.

Svante Öberg agreed with Mr Svensson that inflation expectations to a high degree are explained by actual inflation. The interesting thing is whether inflation expectations will fall in future when inflation falls. If this does not happen, it is unfortunate.

Stefan Ingves summarised the monetary policy discussion. The global financial market turmoil has persisted since the monetary policy meeting in February. It has contributed to subduing households' and companies' expectations for the future in many countries. At the same time, energy and food prices have risen more than expected, which has reduced household purchasing power and increased inflation. All in all, this means that economic activity abroad will be weaker.

Economic activity is still good in Sweden, with high growth in consumption and employment. Exports have also shown good growth. However, the weaker international economic activity will contribute to a slowdown in the Swedish economy. Rising energy and food prices mean that inflation is also high in Sweden and it is expected to be slightly higher next year than was forecast in February.

The view of the future repo rate path remains the same as in February. The repo rate is expected to remain at 4.25 per cent during the forecast period. As before, the Riksbank has to take into account different counteracting factors. On the one hand, inflation is still high, as are inflation expectations. On the other hand, the increasingly weak international economic activity will have an effect on Swedish growth and inflation. There is considerable uncertainty regarding economic indicators and the inflation outlook. The interest rate path is a forecast and not a promise. The future direction for monetary policy will depend on how new information on economic developments abroad and in Sweden will affect the prospects for economic activity and inflation in Sweden.

§ 4. Monetary policy decision

The Chairman found that there was one proposal to hold the repo rate unchanged at 4.25 per cent.

The Executive Board decided unanimously

- to adopt the Monetary Policy Update according to the proposal, Annex A to the minutes.
- to publish the Monetary Policy Update on 23 April 2008 at 9.30 a.m.,
- To hold the repo rate unchanged at 4.25 per cent and that this decision would apply from Wednesday, 30 April 2008,

- to hold the lending rate unchanged at 5.00 per cent, and the deposit rate unchanged at 3.50 per cent, with effect from Wednesday, 30 April 2008,
- to announce the decision at 9.30 a.m. on Wednesday 23 April with the motivation and wording contained in Press Release no. 15 2008 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 9.30 a.m. on Wednesday, 7 May 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 and Svante Öberg