Separate minutes of the Executive Board, No. 7

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TIME: 09:00

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

Leif Pagrotsky, Vice Chairman of the General Council

Carl-Johan Belfrage
Claes Berg
Lars Frisell
Kerstin Hallsten
Jesper Hansson
Karolina Holmberg
Ann-Christine Högberg
Martin W Johansson (§1)
Magnus Karlsson (§1)
Pernilla Meyersson
Christina Nyman
Britta von Schoultz
Åsa Sydén
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. Economic developments

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

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 Report. He noted at the start that the basis for the draft in the form of an international outlook and alternative scenarios had been presented by the Monetary Policy Department and discussed at a meeting on 29 May. At meetings held on 16 and 17 June, a report on the current state of the Swedish economy and proposals on forecasts and in-depth analyses were presented and discussed. Forecasts and texts were tabled at the Executive Board meetings on 23 and 27 June.

Since the previous monetary policy meeting in April, the turmoil on the financial markets has continued. The oil price has continued to rise rapidly and is now at a considerably higher level than was assumed in April. The increase is also greater than was outlined in the alternative scenario presented in the Monetary Policy Report in February. Inflation abroad has risen more than expected. As inflation has increased, market expectations of future monetary policy have shifted upwards. Increasing anxiety about inflation and expectations of future policy rate increases have contributed to a fall on the stock markets around the world. Growth in the first quarter of this year was, however, stronger than expected in both the USA and the euro area. There is reason nonetheless to expect weaker growth in the period ahead. It is calculated that the households' scope for consumption will decline more than was previously assumed as a result of the higher inflation. Indicators also show that the households have become increasingly pessimistic about future developments. The overall assessment is that the growth of the world economy will be somewhat weaker this year, and above all next year, compared to previous forecasts.

In Sweden, the GDP outcome for the first quarter is slightly weaker than expected. The households have also become more pessimistic about the future during the spring. Employment and the number of hours worked have continued to show strong growth but there are clear signs of a slackening in the labour market in the form of more redundancy notices and fewer vacancies. Inflation in May was higher than expected and has, as is also the case internationally, been driven by rising energy and food prices. It is, however, difficult to see any increase in inflationary pressures arising from labour costs. Inflation expectations have increased somewhat since April, according to the Prospera survey, and are higher than the Riksbank's inflation forecast in the main scenario two years ahead and higher than the target five years ahead. Lending to Swedish households has continued to increase rapidly. The slowdown in the housing market and rising interest rates suggest, however, that there will be a fall-off in lending in the period ahead.

The assessment of growth in Sweden has been revised downwards, while the figure for inflation has been revised upwards, compared to the assessment in April. Resource utilisation in the economy is currently assessed to be higher than normal. Over the coming year, resource utilisation is expected to fall relatively quickly and then stabilise at around a normal level. Inflation is expected to continue to rise and to remain high during the rest of the year and also during a large part of 2009. It is not expected that inflation will approach the target of 2 percent until 2010. The forecasts are based on an increase in the repo rate from 4.25 per cent to approximately 5 per cent towards the end of this year.

Magnus Karlsson of the Monetary Policy Department then reported on developments in the financial markets since the previous Executive Board Meeting on 27 June. Renewed anxiety about the credit situation and growth has, together with the high oil price, led to falling stock markets around the world. In Sweden, share prices have fallen by approximately 4 per cent since 27 June. Both short-term and long-term interest rates have risen in Sweden, the euro area and the UK. In the euro area, the increase in interest rates has been driven by the fact that the outcome for inflation in May was higher than the level expected by the financial markets, which in turn has pushed up interest rates in Sweden. In the United States, on the other hand, a slight downturn in interest rates has been noted as a result of the unease on the stock market and the fall-off in monetary policy expectations following the Federal Reserve's decision on 25 June to leave the policy rate unchanged. The krona has weakened slightly against the euro and in trade-weighted terms. Preliminary statistics on labour costs in April were in line with the Riksbank's forecast, while the outcome for retail trade statistics in May was somewhat lower than expected. According to surveys, the market players are largely united in the belief that the Riksbank will increase the repo rate by 0.25 percentage points and upwardly revise the repo rate path somewhat. The financial market's monetary policy expectations as expressed in the implied forward rates indicate increases in the repo rate in the future. However, these expectations are lower than the repo rate forecast in the report's main scenario. These calculations are, however, sensitive to assumptions about that part of forward rates that constitutes risk premiums and is not related to the expected repo rate.

Finally, Martin W Johansson of the Financial Stability Department presented the development of mortgage rates in Sweden and spoke about whether it was possible to trace any further tightening over and above monetary policy. The variable mortgage rates offered to households have increased since April, mainly as a result of the upward shift in monetary policy expectations. As in the case of credit spreads, the banks' profit margins on short-term loans to households have also remained stable since April. There has thus not been any tightening in addition to monetary policy since then. The banks' historically low margins suggest, however, that it is reasonable to expect a further tightening effect in the period ahead.

§ 2. Economic outlook abroad

Deputy Governor **Lars Nyberg** began the discussion by observing that the turmoil on the international financial markets has continued since the previous monetary policy meeting in April. It is still difficult to see any signs of the steady improvement that should take place when the credit losses gradually come to the surface and the credit institutions manage to replenish their reserves. To date, estimates indicate that losses of USD 400 billion have been realised and that new capital amounting to USD 320 billion has been provided. However, this has not been enough to restore confidence on the interbank market. The ECB and the central banks in the United States and the UK have continued to supply the market with loans at longer terms and against poorer collateral than previously. There are no signs of a return to a normal situation here. The market is still uneasy and sensitive to any bad news.

This winter's concern that there would be an acute liquidity crisis has, however, largely been replaced by concern about what a rapid rise in inflation may lead to in the form of rising interest rates and a quicker fall-off in economic activity than expected, resulting in new credit losses at the banks. There are serveral signs of this. In the United States, the housing market has not yet bottomed out and increasing losses are expected in the commercial property sector. Property prices are also falling in the UK – the value of commerical properties has fallen by 25 per cent in only six months. British mortgage institutions, as well as those in Ireland and Spain, are finding it difficult to finance themselves at reasonable prices on the bond market. It appears that there is still a long way to go before normal conditions are restored in the financial markets around the world.

In our neighbouring countries, it is above all developments in Estonia and Latvia that have been poorer than expected. Growth has declined dramatically – in Estonia it has almost come to a halt – at the same time as inflation has reached double figures and the current account deficits are considerable. House prices in Latvia have fallen by almost 40 per cent in real terms over the last 12 months. In Estonia, the corresponding figure is slightly over 6 per cent.

Swedish banks account for almost 90 per cent of the banking system in Estonia and for approximately 50 percent of the banking system in Latvia. A dramatic decline in economic activity in the Baltic countries with an associated increase in the credit losses of the banks would thus affect the Swedish banks that operate there. Even though lending in these countries only accounts for 10 to 15 per cent of the total lending of the Swedish banks, concern about future developments has already led to falling share prices and credit assessments for the Swedish banks involved. Ultimately, this will lead to higher borrowing costs on the international markets for the Swedish banks, costs that will eventually have a negative effect for Swedish borrowers in the form of higher lending rates. There is thus a risk that poorer developments in the Baltic countries will also have concrete effects on Swedish borrowers.

Apart from this, the Swedish banks have not been affected by the financial crisis other than that their borrowing costs have increased as investors around the world have wanted to be paid more for the credit risks they take. The Swedish banks have managed better than most others. Nevertheless, they still have to pay approximately 0.5 percentage points more for their borrowing in relation to the government bond rate than they did a year ago. The difference can be seen as an extra tightening factor over and above monetary policy, a factor that reflects the increase in the price of financial risk. For the borrowers, of course, interest rate increases make themselves felt wherever they come from. A simple illustrative calculation shows that a house owner with a loan of SEK 1.5 million and an interest rate adjustment every third month today pays over SEK 1 300 more per month before tax than a year ago, even though the banks and mortgage institutions have not yet passed on all of the increase in their financing costs to the borrowers. It is thus not unlikely that we will see further increases in mortgage rates in the future in addition to those that relate to increases in the repo rate.

Governor **Stefan Ingves** pointed out that despite all the discussions about financial turmoil and increasing oil prices global growth is still relatively good, even though it has declined in trade-weighted terms. The latter is of course significant for economic activity in Sweden. However, global inflation is also increasing and, at least in the OECD countries, this is creating a context for monetary policy decisions similar to our own, that is rising inflation in combination with declining growth.

This is also the case in the United States. A few years ago, however, it was said that there was a need for an adjustment in the United States. The financial imbalances had to be corrected both nationally, by solving the mortgage crisis and increasing saving, and in international terms by reducing the current account deficit. These two adjustment processes are now taking place, although the adjustment of the global imbalances has so far been more dramatic than most people imagined.

Europe is facing the same problem in its deliberations that we are, that is that inflation is higher than it has been for a long time at the same time as economic activity is weakening. The threat of inflation is increasing in Asia too, where growth continues to be high while the fact that several countries have tied their currency to the dollar is creating extra inflationary pressures in addition to those stemming from, for example, the high oil price.

The price of oil is now USD 40 higher than in the April forecast. This is increasing inflationary pressures in large parts of the world. As both the supply of and the demand for oil are relatively inflexible in the short term, the ability to handle large relative price changes globally will be decisive in determining the extent to which the economic adjustment to the higher oil price will be more successful now than previously. Ingves said that we will probably see the results varying widely between different countries depending on whether they allow relative price changes to have their full impact or not. Different views on the need to phase out energy subsidies may play a decisive role here. The larger the subsidies, the greater the risk of economic and social unease in the future when these become costly and perhaps must be phased out.

Food prices can also be expected to be a source of concern in the period ahead. Although supply can probably be increased, energy is an important input in the production of food. This makes it difficult to imagine a rapid return to previous price levels. Barriers to trade also make the adjustment more difficult. The prices of iron, steel and coal have also risen dramatically as a result of increased global demand. This may further fuel inflation as these price increases affect production costs for energy as well as for industrial products.

Ingves referred to Lars Nyberg's discussion of the turmoil on the financial markets, which will soon have been with us for a year. Ingves agreed that the problems still remain. Nevertheless, he felt that so far there is no reason, apart from the effect on growth, to take any special account of this financial turmoil when determining Swedish monetary policy. The problems that arise as a result of the turmoil must be handled some other way.

On the whole, global developments indicate that we are moving towards a situation with a greater degree of uncertainty and probably greater fluctuations than previously. It is not obvious what this means to Swedish monetary policy but the Riksbank must be prepared to act quickly if the global picture changes. A floating exchange rate can to a certain extent provide protection against inflationary impulses from abroad. This requires a credible monetary policy and a repo rate level that shows that combating inflation is a matter that is taken very seriously. Ingves explained that this should not be interpreted as him having any particular level for the exchange rate in mind, but that it is naturally valuable if the krona is strengthened so that the inflationary impulses from abroad are counteracted.

Deputy Governor **Barbro Wickman-Parak** said that she agreed with much of what had already been said and that she therefore intended to limit her comments to developments in the United States. She began with a reminder that she had previously been one of those who were more optimistic about developments in the United States. She noted, however, that the situation still looked relatively bleak for the economy in the United States. As mentioned by Lars Nyberg, the housing market has not yet bottomed-out. House sales have shown some signs of stabilising at a low level, but it will probably take a number of months before it is possible to discern a turnaround.

The distribution of the first round of tax-rebate cheques marks the launch of the fiscal policy stimulus. This seems to have had an effect on household consumption, which increased more than expected in May. On the other hand, consumer confidence has fallen further since April and is now down to levels that we have not seen since the recession of the early 1990s. This applies not only to the assessment of the current situation but also to expectations of the future. Consumer confidence is not always a good indicator of what will happen, but dramatic falls in confidence are certainly worthy of our attention. Pessimism about the labour market has also continued to increase. A majority of the households expect to see a fall in incomes. This has not been the case for at least 30 years.

The darkest prophecies about the US economy, that is that it is already experiencing a recession, have not come true. The forecast in the Monetary Policy Report of a level of growth of just under 1.5 per cent may still be realised. But there is a great deal of uncertainty about how things will develop in the slightly longer term. As Lars Nyberg has already mentioned, the turmoil on the financial markets has continued. What has also happened since April is that the dramatic increases in energy prices have reduced the purchasing power of the households, which were already under severe strain. This is not a good sign. The risk of weaker developments in the United States remains, and has, if anything, increased since April.

In the euro area, growth in the first quarter was stronger than expected, but the indicators are now unambiguously pointing towards a slowdown in the rate of growth thereafter. If we take a weighted sum of the growth rates of our most important trading partners we arrive at a figure of just under 2 per cent this year and 1.5 per cent next year. This means that Sweden cannot count on any major growth impetus from abroad.

First Deputy Governor **Irma Rosenberg** agreed that there is still a lot of anxiety on the financial markets. The price of short-term borrowing in the bank system is still high compared to levels in the past and the prices of bank shares have fallen more than stock market averages. The price of credit risk as expressed, for example, in CDS premiums is moving upwards again, and in both the United States and the euro area the banks are reporting stricter credit conditions for both households and businesses. It is now clearer that the financial turmoil is contributing to the real slowdown in above all the United States and Europe, but also globally.

In addition to the unease on the financial markets, concern has also emerged during the spring that the rapid price increases on the world markets for energy and other commodities have driven up inflation. Rosenberg does not see this as being a case of one type of problem replacing another. It is rather a case of the problems mounting and together reinforcing the risk of a further downturn in the global economy.

The oil price has continued to rise since April and, as can be seen in the Monetary Policy Report, this has contributed to an upward shift in expectations regarding the policy rates of the central banks in Sweden, the United States, the euro area and several other countries. The increases in energy and food prices have undermined the purchasing power of the households and have a dampening effect on demand. This should also contribute to a decline in the demand for oil. An important driving force behind the oil price increase is of course the increasing demand from the developing countries, not least China and India. As Ingves also pointed out, the use of oil is subsidised in these and several other developing countries. The rise in the oil price on the world market is thereby prevented from having its full effect on consumers and from contributing to a reduction in the demand for oil in these countries. But the higher the oil price becomes, the more difficult it will be to maintain such subsidy systems. Several countries, including China, have begun to reduce these subsidies, which is driving up oil prices and inflation on their domestic markets. This may lead to a dampening of domestic consumer demand and thus of growth to a greater extent than expected even in the developing countries. This would also have an impact on the demand for oil and the oil price on the world market.

In addition, Rosenberg pointed out that the housing market in the United States is in sharp decline. House prices and house sales are still falling rapidly. The number of houses for sale has reached record levels which indicates that it may take some time for the situation to improve. Housing investments are falling and applications for building permits and housing starts do not indicate that there will be an upturn in the construction of housing in the near future. The number of delinquencies is also rising rapidly. Consumer confidence has fallen significantly in the United States. A factor that has contributed to this is in all likelihood that employment is falling. A large part of the tax rebates decided on by Congress have already been paid out and had some positive impact on retail sales in May. More will be paid out, but there appears to be a significant risk of a more marked slowdown in household consumption once this period is over. The forecast for growth in the United States in the main scenario has been adjusted downwards for next year compared to the forecasts presented in April and February. But the forecast is still based on there being a fairly rapid recovery in the course of 2009. Rosenberg sees rather a risk that growth in the United States next year may even be somewhat weaker than in the main forecast.

In the case of the euro area, the growth forecast for GDP is largely the same as in April. The outcome for the first quarter was a little stronger than expected. However, various indicators point to weaker growth in the second quarter. The confidence indicators in the European Commission's barometer are falling for both households and the business sector. The purchasing managers' index in both the industrial and service sectors has fallen below 50, which is regarded as the cut-off point between expansion and contraction. Order books are shrinking and industrial inventories are increasing. Industrial production is growing at a slower rate. There has been a clear decline in retail sales over recent months. In Europe too, the mood of the households and their propensity to buy is probably being dampened by the high energy and food prices. The recovery predicted in the forecast will take place more gradually in the euro area than in the United States. The forecast for growth in the euro area therefore perhaps looks more realistic.

Deputy Governor **Svante Öberg** largely agreed with the picture of international developments presented in the Monetary Policy Report, but agreed with Barbro Wickman-Parak and Irma Rosenberg that developments in the United States may be weaker than forecast. Öberg raised the issue of the development of the global economy and the risk of higher international inflation. Such an alternative scenario is also presented in the Monetary Policy Report.

GDP growth in the world as a whole has been very strong over the last four years. Not since the early 1970s, prior to the first oil crisis, have we seen such strong growth in the world for such a long period of time. This rapid growth is the predominant factor behind the dramatic price increases for commodities. The rapid growth also entails an increase in the demand for energy. Rising incomes, urbanisation and changes in diet are leading to an increase in the demand for food. Commodity prices have therefore increased for several years, and these increases have accelerated over the last two years. We are witnessing a broad increase in prices due to the fact that global demand has risen faster than supply and this has initially affected commodity prices as these are more flexible than other prices.

The increases in commodity prices have in turn led to an increase in inflation in the world. The world as a whole is a closed economy. The rise in inflation cannot therefore be explained in terms of imported inflation. A more likely explanation is that the world's overall monetary policy stance has been too expansionary.

Rising inflation would not be a problem if it was just a question of a temporary rise and if inflation expectations remained at a low and stable level. However, if second round effects arise in the price and wage formation processes, and if inflation expectations increase, then monetary policy may need to be tightened. We can now see that inflation expectations have increased in several countries.

Nevertheless, the most likely development is that inflation will decline next year. When adjusted for energy and food prices, inflation has thus far been relatively stable. World growth will probably weaken this year and next year and there has recently been a rise in monetary policy expectations towards higher interest rates in several countries.

But there is a risk that the inflation process will be more prolonged. It is estimated that growth in the world will continue to be relatively strong, despite a slowdown in the United States and the euro area. This is largely due to the strong development of the emerging and developing countries. In its latest forecast, for example, the OECD estimates that average annual GDP growth in the BRIC countries, that is Brazil, Russia, India and China, will be between 5 and 10 per cent in 2008 and 2009, and even though monetary policy is generally being tightened more countries will probably pursue a relatively expansionary monetary policy. The real policy rate in the United States is negative and many countries have tied their currencies to the dollar and are thereby importing the United States' expansionary monetary policy. The real interest rate is also close to zero in the euro area.

Deputy Governor **Lars E.O. Svensson,** like Svante Öberg, agreed with the picture of the global economy presented in the Monetary Policy Report. He also pointed out that it is a problem that many countries have chosen to have a fixed or almost fixed exchange rate against the dollar. This means that to a great extent they import the monetary policy of the United States. The expansionary monetary policy pursued in the United States is not the best policy for many of these countries as they are experiencing strong growth. In this situation they will pursue a monetary policy that is too expansionary, which in turn may lead to higher global inflation. It would be better for these countries to instead allow their currency to float and to pursue an independent monetary policy that is adapted to their particular economic situations. When inflation and inflation expectations rise in a country, the nominal rate should normally be increased more than the inflation expectations in order to slow down the economy and stabilise inflation, but this has not been the case in these countries. Instead, the real interest rate has fallen. But as long as the Riksbank conducts an independent monetary policy we can to a great extent keep world inflation outside our borders, mainly due to a strengthening of the krona.

Lars Nyberg noted that the discussion largely has concerned developments in the United States. Over the last 12 months, the United States has suffered three crises – a financial crisis, a mortgage crisis and an energy crisis. In the short term, it is probable that all three will contribute to growth being somewhat lower than we previously expected. However, in the slightly longer term the economy of the United States may very well be strengthened by these crises. The energy crisis entails dramatic increases in energy costs. These reduce the scope for consumption but also lead to restructuring programmes in industry with temporary unemployment as a result. In the longer term, the forecast appears to be more positive. The age structure indicates that a large number of new households will be formed over the next few years and this will create a natural demand for new housing. This suggests that the mortgage crisis will after all come to an end in the not too distant future. The financial crisis, once it is over, will have given rise to a financial system that is stronger in several respects. With an adjusted dollar exchange rate, American industry should also have clear competitive advantages internationally once it has adapted to the new energy prices.

Svante Öberg shared Lars Nyberg's view that there is reason to believe that developments in the United States will be positive in the slightly longer term. In this context he wanted to highlight the question of what may happen to energy and food prices once there is a recovery in economic activity in the United States and the euro area. Will there then be a risk that the problem of rising commodity prices will return? Several emerging countries will probably experience rapid growth for some time to come. This is something that we should pay attention to in the future.

Öberg also said that it was interesting to examine the difference between domestic demand and GDP in the United States. Domestic demand, which increased by 1.5 per cent in 2007, has now come to a halt. Growth in the United States is therefore being maintained more or less by exports alone, which have increased at a good pace as a result of global growth and the depreciation of the dollar. The decline in domestic demand in the United States and the fall in the value of the dollar are helping to correct the global imbalances that previously attracted so much attention, even though the impression is that this is happening in a somewhat disorderly way.

Stefan Ingves also thought that there are good reasons for continuing to monitor the development of commodity prices. He added that in a longer-term perspective the strong growth in, for example, China and India would lead to a relative redistribution of income around the world. How this will affect patterns of demand and price trends in the future is, however, difficult to say at the moment.

Barbro Wickman-Parak said that adjustments in the economy, like the one we are now seeing in the United States, seldom take place as smoothly as one would like. She agreed that the long-term economic outlook for the United States is positive. She said, however, that in the short-term perspective that the Riksbank must adopt when determining monetary policy we must accept the situation as it is in the United States at present and the consequences that this may have for the Swedish economy.

Irma Rosenberg did not see any reason to be pessimistic about the outlook for the global economy in the long term either, but said that we should take into account that we are not only witnessing the correction of old imbalances but also the creation of new ones, including those relating to the fact that certain currencies are tied to the dollar.

Stefan Ingves summarised the discussion by noting that all of the members of the Executive Board supported the international forecasts in the Monetary Policy Report, even though several of the members also pointed out the risk of more adverse developments. It appears that the financial unease remains, but there is still good growth at the global level despite a slight slowdown. The rising oil prices are generating inflationary pressures that monetary policy around the world must deal with. This is made more difficult by the fact that the exchange rate regimes in some countries in practice prevent them from conducting an independent monetary policy.

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

Deputy Governor **Lars E.O. Svensson** began the discussion by noting that the Swedish economy is in a more difficult position than previously due to higher inflation, higher inflation expectations and signs of a weaker development of the real economy. The Riksbank conducts a flexible inflation target policy, which is particularly appropriate for systematically handling such trade-offs. This means that the Riksbank seeks to stabilise inflation around the inflation target but also attaches importance to stabilising resource utilisation around a normal level. Here one must always remember that monetary policy cannot affect the long-term level of resource utilisation. What is normal resource utilisation is determined by other factors such as technology, the supply of labour and the functioning of the economy. A flexible inflation target policy thus requires that, at the time of every repo rate decision, a repo rate path consistent with a well balanced monetary policy is adopted. Well balanced means that the forecasts for inflation and resource utilisation look good in the sense that inflation is approaching the target and resource utilisation is approaching a normal level at an appropriate pace. The time horizon over which inflation and resource utilisation will reach the target and a normal level, respectively, cannot be specified in advance but varies depending on the state of the economy when the forecast is made and the shocks it is believed the economy will be subjected to. The balance that the Riksbank strikes between stabilising inflation and resource utilisation is presented in the forecast of the main scenario. The alternative repo rate paths presented in chapter two of the Monetary Policy Report provide further information about the trade-offs involved.

The repo rate path of the main scenario implies an inflation forecast in which inflation is high initially but then gradually approaches the inflation target and is close to the target at the end of the forecast period, that is in three years time. According to the forecast for resource utilisation, as expressed in the output gap, the labour market gap, the employment gap and unemployment, resource utilisation will be higher than normal initially but will fall and reach a more or less normal level by the end of the forecast period. It would be desirable to have better measures of resource utilisation, particularly a better measure of potential output, but this is what we have at our disposal at the moment. Given these forecasts for inflation and resource utilisation, Svensson found that the repo rate path in the main scenario represents a well balanced monetary policy. A lower repo rate path would imply a too high inflation forecast, while a higher repo rate path would imply an unnecessarily low level of resource utilisation.

The new repo rate path is considerably higher than the repo rate path adopted in April and may give the impression of a much more contractionary monetary policy than the policy adopted at that time. But this impression arises from a comparison of the nominal repo rate paths. It is the real repo rate path that matters for the effects of monetary policy on inflation and the real economy. Comparing the real repo rate paths therefore provides a fairer picture. Such a comparison is made in Figure R7 in the box on the development of the real interest rate in the Monetary Policy Report. There we can see that the real repo rate path in April began at a level of approximately 1.5 per cent and then gradually increased towards a level that is close to a reasonable long-term level, which can be estimated to be approximately 2.25 per cent. The main scenario's real repo rate path begins from an equally low level but then increases to a level that is almost 0.5 per cent above the long-term level, after which it gradually decreases towards the long-term level. Given the long-term level of the real repo rate and the situation in April, it may possibly be claimed that the real repo rate path at that time was a little too low and that the new real repo rate path represents a better balance. Considering that inflation is expected to be above the target throughout the forecast period while resource utilisation is expected to be rather good, it is very reasonable that the real repo rate path lies above the long-term level for most of the forecast period.

A better measure of how expansionary or contractionary monetary policy is would be provided by a comparison between the real repo rate path and the forecast for a so-called state-dependent neutral repo rate instead of a comparison with the long-term real repo rate. Svensson said that it would be very good if the Riksbank could develop methods for calculating and producing forecasts for such a state-dependent neutral repo rate path. Such work is also currently underway at the Riksbank within the framework of one of the projects developing various aspects of the general equilibrium model Ramses.

Inflation expectations over various horizons are now higher than in April. It is therefore misleading to compare nominal interest rates and interest rate paths now and in April. The real repo rate paths in Figure R7 are calculated as the nominal interest rate path minus the forecast for four-quarter inflation in the respective main scenarios, but a calculation using the inflation expectations according to surveys would give the same impression. The question is how problematic it is that inflation expectations have increased. Svensson said, as he did in April, that it is normal for expectations to increase when actual inflation is increasing. The question is therefore whether expectations have increased normally given the increase in actual inflation or more than normally. A study of the residuals from a regression of inflation expectations on actual inflation indicates that the increase in inflation expectations is of a normal magnitude, not abnormal. From this perspective, the moderate increase in inflation expectations need not be an extra cause for concern so far. However, such a study of the residuals is based on the assumption that inflation expectations will fall as soon as actual inflation falls, that is that there is no irreversibility or ratchet effect that prevents a reversal of inflation expectations. If there is such an effect, this will become evident when actual inflation declines. Svensson also said that there will be cause for concern if inflation expectations then remain at the higher level, but that so far there is no need to be so concerned about such an effect that this in itself justifies a tighter monetary policy than the repo rate path in the main scenario.

All in all, Svensson felt that the forecast for inflation and the real economy looks good with the new repo rate path and thus expressed his support for the repo rate path in the main scenario in the Monetary Policy Report and for an increase at the present meeting of 0.25 percentage points.

Deputy Governor **Svante Öberg** largely agreed with the picture of economic developments in Sweden presented in the report and chose to comment on inflation in more detail. Inflation is now considerably above the inflation target and has increased more than expected. Inflation expectations have also increased and are above the inflation target. The important thing for monetary policy in this situation is to prevent the price increases on the world markets for energy and food from spreading to other areas via price and wage formation.

Öberg said that he wanted to make four observations about the development of inflation. First he pointed out that it is sometimes claimed that nothing can be done about energy and food price increases. But this is not the whole truth. Of course Sweden's ability to influence oil and food prices in dollars on the world market is negligible. But the prices in krona are also affected by the exchange rate of the krona against the dollar and this rate is affected by the Riksbank's monetary policy. This is an argument for a monetary policy that tends to strengthen the krona rather than a policy that tends to weaken it.

Öberg's second observation was that the price of food in the shops is, in addition, not only dependent on prices on the world markets but also on price and wage formation in Sweden. In this context, it is interesting to note that food prices have increased at a higher rate in Sweden than in the euro area. This indicates that specific Swedish conditions also have an impact, for example the development of wages and costs.

The third observation was made with reference to Svensson's comments on the significance of inflation expectations. It is important to monitor price trends in the period ahead at a detailed level to see whether the price increases are spreading to other areas. One way of doing this is to study different measures of underlying inflation. The rate of increase of the CPIX excluding energy and food declined in January, but this is probably explained by the unusually large effect of weighting changes in the CPI. If we look instead at the HICP excluding energy and food we can see that underlying inflation remained stable at just under 2 per cent last year, which does not indicate any secondary effects. Other measures such as TRIM85, where the 7.5 per cent highest and lowest price increases are excluded, have on the other hand increased from below 2 per cent in 2007 to approximately 4 percent in May 2008. We get the same result if we exclude the 25 percent highest and lowest price increases, which may be an indication that there are secondary effects via price formation.

Öberg's fourth observation was that it nevertheless does not seem very probable in the current situation that inflation in the short term will drive up wages due to demands for compensation for price increases. The slowdown in growth and the weakening of the labour market are factors that weigh against such a scenario. There are also three-year agreements on large sections of the labour market that regulate agreed wage increases and these do not contain, as was the case in the 1970s and 1980s and is still the case in some other countries, price development guarantees that provide automatic compensation for price increases. It is, on the other hand, important that inflation and inflation expectations fall to around 2 per cent ahead of the next round of collective bargaining in 2010. With the current inflation forecasts, average inflation over the three preceding years will then have been over 3 per cent, which may be a problem.

Öberg then moved on to discuss monetary policy. He said that events since the previous meeting justify an increase in the repo rate and the repo rate path. This is mainly because inflation has continued to increase more than expected, inflation expectations have increased and are still above the inflation target and expectations regarding policy rates abroad have changed from falling policy rates to rising policy rates. Despite the higher repo rate path, the inflation forecast in the main scenario has been revised upwards by approximately 0.5 per cent both this year and next year.

However, there are also changes that have occurred since April that motivate a lowering of the repo rate and the repo rate path. GDP growth in the first quarter of this year was somewhat weaker than expected and the forecast for GDP growth has been revised downwards by an average of approximately 0.5 percentage points per year both this year and next year. The labour market, however, has so far been stronger than expected and resource utilisation is still higher than normal.

Öberg's conclusion was that the factors that motivate an increase in the repo rate and repo rate path are stronger than the factors that motivate a reduction. He therefore advocated increasing the repo rate to 4.50 per cent and supported the repo rate path in the main scenario of the Monetary Policy Report which entails an additional couple of increases this year.

The situation on the financial markets is still unstable. If events occur abroad, for example in the Baltic countries, that tangibly alter the conditions for monetary policy then these should be taken into account in future decisions.

Getting back to a rate of inflation of 2 percent in two years time would probably require a further increase of the repo rate over and above those increases already included in the repo rate path, which would decrease growth next year by an additional tenth of a percentage point or so. However, given the considerable initial deviation of the level of inflation from the target, and considering that there is still a great deal of uncertainty on the financial markets, Öberg agreed with Lars E.O. Svensson that it is now better to aim to reduce inflation to approximately 2 per cent three years ahead.

First Deputy Governor **Irma Rosenberg** noted that inflation is considerably higher than assumed in April. The main reason for this is that the oil price has continued to rise. If the forecast in the Monetary Policy Report is realised, in other words that the oil price develops as indicated by the forward prices and remains at a high level but does not increase further, then the direct inflationary impulses from the oil price will gradually weaken. There is of course a great deal of uncertainty about what direction the oil price will take. It may very well be the case that it continues to rise and this will further strengthen inflationary pressures. But there are also arguments to the effect that the oil price could fall, as Rosenberg mentioned earlier in the discussion of the international economic outlook, and this could lead to a more rapid dampening of inflation than in the main scenario. This incidentally also applies to food prices on the world market. All in all, Rosenberg thought that the assessment of energy and food prices in the Monetary Policy Report is reasonable. A fall in these prices is analysed in an alternative scenario in the report. Rosenberg's view was that such a development is not unlikely, even though she felt it was not the most likely.

However, even though the direct inflationary impulses from energy and food prices are largely temporary, current developments are still worrying. Inflation prospects are largely determined by how great the risk is that wages and other prices are affected. This means that there are good reasons for monitoring the development of consumer prices excluding energy and food prices. This is not to say that the Riksbank has a target for these prices, but that it is important to check whether they begin to increase more rapidly. In this context, Rosenberg wanted to take the opportunity to comment on Svante Öberg's statement that food prices have recently increased more rapidly in Sweden than in the euro area. If we look a little further back into the past, we can see that Sweden has previously had a considerably lower rate of price increases for food than the euro area for several years. Rosenberg explained that she is not so concerned about the fact that these prices are now rising a little more quickly here as this can differ slightly from time to time. If this trend lasts, however, then it may become a matter for concern.

Rosenberg also noted that, as discussed at the most recent monetary policy meetings, inflation expectations have increased and are also high in the long term. There has been a further increase in expectations since April. It should be emphasised that the Riksbank does not have a target for inflation expectations. These are to a large extent affected by current inflation, as already pointed out by Lars E.O. Svensson. If they remain at a high level, however, the risk that inflation will become entrenched at a high level will also increase.

According to the data presented in the business tendency survey and Statistics Sweden's business survey, capacity utilisation is still high. This also increases the risk of secondary effects. Altogether, Rosenberg felt that these factors motivate an increase in the repo rate of 0.25 percentage points.

With regard to monetary policy in the period ahead, Rosenberg was more doubtful about the repo rate path on which the forecasts in the main scenario are based. She felt that this entails an unnecessarily tight monetary policy and went on to explain why she believed this to be the case.

There are now clear signs that the labour market is cooling off. The number of vacancies is falling and the number of redundancy notices is increasing. According to both the business tendency survey and the purchasing managers' index, employment plans show a clear downward trend. A cooler labour market reduces the risk that wage increases will accelerate, as Svante Öberg also mentioned. Although the wage statistics for 2007 are not definitive as yet, it appears that wage increases have been rather limited. Despite the fact that employment has increased rapidly, it seems that the wage outcome for 2007 will be below 3.5 per cent, or 0.5 percentage points lower than the forecast made in February last year before collective bargaining began. Wage increases over and above the agreed levels seem to have been very limited. Although wages did increase more rapidly at the start of this year, the forecast for hourly wage rates for 2009, and to a certain extent also for 2010, are in fact somewhat lower than the assessments made in April.

Cost pressures are also affected by productivity. The fact that productivity fell last year contributed to a fairly rapid increase in unit labour costs, but this does not seem to have fuelled inflation more than expected. Productivity increased slightly in the first quarter of this year, but is still weak. However, Rosenberg saw no reason to change her assessment from February and April that the weak development of productivity last year was above all related to the slowdown in GDP growth. This indicates that employment will slow down rather than that firms will introduce dramatic price increases. Rosenberg said that she is not particularly concerned about the development of wage costs so far but that this is of course a factor that must be monitored carefully.

Another reason for Rosenberg's assessment that the proposed repo rate path is unnecessarily tight is that household consumption now appears to be slowing down more than is forecast in the main scenario. The households have become much more pessimistic about the labour market and the Swedish economy, and about their own financial situation in the period ahead. The fall on the stock market and the weaker development of house prices are reducing the wealth of the households. Real disposable incomes are being undermined by the high price increases for energy and food. These are categories of goods that account for a fairly large part of household budgets. There are now clear signs that private consumption is cooling down without the need to increase the repo rate so much. One such sign is that the consumption of durable goods, that is that part of private consumption that is most sensitive to interest rates, fell in the first quarter of this year. This usually heralds a more widespread dampening of household consumption. If consumption is weaker, inflation may also be lower than in the main scenario.

Rosenberg referred here to Lars E.O. Svensson's arguments about the real interest rate and pointed out that in the time frame within which monetary policy affects the economy it is not possible to only focus on the real interest rate in order to assess the monetary policy stance. The forecast in the main scenario entails higher nominal interest rates and more rapid price increases than in the assessment in April. Both of these changes contribute in the short term to a reduction of the households' real purchasing power and thus of demand. Whether an increase in the real interest rate is needed or not in order to bring inflation back to the target a couple of years ahead is due in part to how lasting the inflationary impulses are and to what other changes are taking place in the economy.

Instead of the repo rate path in the main scenario in the Monetary Policy Report, Rosenberg would prefer to see a lower repo rate path with a certain probability, less than 50 per cent, of one more repo rate hike during the autumn. Nor did she believe that resource utilisation in the main scenario will return to normal by the end of the forecast period. Rosenberg agreed with Lars E.O. Svensson that the output gap, according to the measure available, does not provide an adequate picture of resource utilisation. In her assessment, the repo rate path in the main scenario means that resource utilisation will fall more rapidly and be weaker than normal even during the latter part of the forecast period.

Rosenberg summed up her position by saying that she would vote for an increase in the repo rate of 0.25 percentage points but enter a reservation against the repo rate path in the main scenario in the report in favour of a lower path.

Deputy Governor **Barbro Wickman-Parak** reminded the meeting that her view at the meeting in April was that there was a considerable risk of a slowdown in economic activity but that inflation was considerably higher than the target and there were risks on the upside. Her assessment then was that this overall situation called for an unchanged repo rate and that the rate should remain unchanged for the rest of the year. At that time, she also mentioned that there was a risk that the oil price would continue to rise and further fuel inflation.

Wickman-Parak could now note that such a situation has arisen. The oil price has continued to rise dramatically and is higher than in the alternative scenario presented in the February report. As a result, CPI inflation is higher than expected and it has been necessary to adjust the forecast upwards. However, this is not all that has happened. The economic outlook abroad is weaker than previously estimated and there is a risk that the financial turmoil in combination with rising energy prices will undermine global growth more than in the current forecast.

Signs of weaker growth prospects in Sweden have become clearer since April. As already mentioned by Svante Öberg, GDP growth in the first quarter was, for example, significantly lower than forecast. Wickman-Parak felt that we should not make too much of this figure, however, as the preliminary outcomes are often subsequently revised upwards. Nevertheless, other figures and indicators all point to slower growth. These include, for example, outcomes for new orders and production, but also a sharp fall in production expectations in Swedish industry according to the business tendency survey. The purchasing managers' index also indicates weakness, as do the outcomes for the retail sector. Otherwise, Wickman-Parak noted that Irma Rosenberg had already presented a catalogue of the clear signs of a slowdown.

Following the rapid increase in employment, it was possible already in April to see signs that the labour market was cooling down. Wickman-Parak pointed out that she and several other Executive Board members at the previous monetary policy meeting highlighted the reduction in vacancies, the decline in the figures for labour market shortages and the reduction in employment plans in the business tendency survey as examples. These trends have continued, as Irma Rosenberg also mentioned, and Wickman-Parak felt that this is important with regard to inflationary pressures in the period ahead.

As far as the current decision was concerned, Wickman-Parak declared that despite all of the unmistakable signs of a weakening of the economy she nevertheless supported an increase in the repo rate of 0.25 percentage points. She underlined the fact that inflation will be significantly above the target this year and next year and that it must be made clear that inflation is always the Riksbank's first priority. It is the task of the Riksbank to do what is necessary to prevent the high energy prices spreading to other prices, as Svante Öberg pointed out, and ultimately leading to increasing wage demands with the spiral effect that could follow.

Wickman-Parak declared that with regard to the repo rate in the period ahead, she did not support the path presented in the main scenario of the Monetary Policy Report. She advocated a lower repo rate path instead.

Explaining her position, she said that she had a more pessimistic view of the underlying strength of the Swedish economy now than in April, for example in her assessment of the resilience of the households given their good financial situation initially. Since April, revised National Accounts have been presented for 2007 and over the course of the year it is clear that there was a gradual dampening of consumption, a trend that continued in the first quarter of this year and that has subsequently been followed by weak retail trade figures.

It is evident that the households have become more cautious in their spending. The high food and energy prices are limiting the scope for consumption. Private consumption may be weaker than forecast in the Monetary Policy Report even without the additional repo rate increases in the forecast in the main scenario. With regard to Lars E.O. Svensson's point that it is the real interest rate that is important to the development of demand, Wickman-Parak noted that although the real repo rate is indeed low today this will probably not play a decisive role in the short-term perspective of this discussion. The households cannot do anything about their cash inflows in the short term at the same time as necessities such as food and energy will command an increasing share of their incomes. If they also have loans, increasing interest payments will also add to the load.

In addition, consumer confidence has also declined considerably since April and the confidence indicator is now significantly below its long-term average. The increasingly negative view of the labour market in the period ahead is also worrying.

With regard to CPI inflation in the period ahead, Wickman-Parak said that she saw no reason to make a different forecast for the oil price than that presented in the Monetary Policy Report. The oil price will remain at approximately the current level and when the recent increases disappear from the twelve-month figures the rate of inflation will decline over the course of 2009 irrespective of the repo rate decisions that are made. As far as domestic cost pressures are concerned, she pointed out that there has been a clear turnaround compared to the period 2004-2006, but that cost pressures will weaken in the period ahead when the labour market cools down.

Forecasts for productivity are always uncertain, but productivity in the first quarter increased more or less in line with the forecast presented in the latest Monetary Policy Update. This is also a factor that weakens cost pressures. Wickman-Parak said that she has previously felt a fair measure of uncertainty about the productivity forecast but that developments in the first quarter indicate that the forecast of a recovery in productivity may be correct. At the same time, the rise in producer prices for consumer goods slowed down in April and May, which eases the upward pressure on consumer prices.

To sum up, the rising rate of inflation stems mainly from external factors such as rising energy prices. It is significant that the forecast for the CPIX excluding energy for 2008 is 2 per cent. It has been at approximately this level ever since the forecast presented in the summer of last year. The same applies to the forecast for 2009.

Wickman-Parak said that the oil price will contribute to a considerable weakening of inflationary pressures in 2009 and that this process will be supported by a dampening of domestic cost pressures. The question remains of to what extent monetary policy needs to be tightened to ensure that inflation is brought back to the target within a reasonable time frame at the same time as the economy approaches a normal level of capacity utilisation. Wickman-Parak's assessment is that the proposed increase in the repo rate, together with the previous increases, will strongly contribute to such a development in a situation where the underlying cyclical slowdown has already become so clear. With the repo rate path she advocates, there may nevertheless be some probability that an additional repo rate increase may be necessary further ahead.

The economy is in a fragile situation and there is a clear risk that there will be a weaker development of economic activity both at home and abroad. The initial position of the Swedish households is quite strong, but they are not immune to events in the world around them and this is becoming increasingly apparent. It is also worth noting that following a period in which borrowing has been high, and largely at variable interest rates, the households are sensitive to interest rate increases.

Wickman-Parak concluded by pointing out that inflation expectations are too high in relation to the inflation target but that, as Lars E.O. Svensson pointed out, they covary with actual inflation. Now that we have a period with rising inflation, inflation expectations are also rising. However, if expectations were to remain high when the rate of inflation falls, then this would be serious and have consequences for monetary policy.

Deputy Governor **Lars Nyberg** noted that the monetary policy discussion in Sweden, in common with much of the discussion internationally, has in recent months increasingly concerned rapidly rising energy and food prices and how central banks in general and the Riksbank in particular should react to these. Normally, there is no reason to compensate for such price increases for particular groups of goods with a higher policy rate if they only lead to a temporary increase in inflation. One can, as Lars E.O. Svensson pointed out, always compensate by means of an repo rate increase that has a sufficient effect on the exchange rate, but this would entail unnecessary costs, for example in the form of an increase in unemployment. In the current situation, there are also other factors that must be taken into account. One is that the price increases, above all for fuel, have been so large that it is difficult to see how they can fail to spread to other parts of the distribution channel when various users are forced to compensate for increased costs. Another is that some elements of the rising inflation are also due to domestic cost pressures. Economic activity in Sweden has been strong for several years and resource utilisation is high.

In addition, the price increases have led to a rise in inflation expectations to a level that we have not seen for more than ten years. In the case of the short-term inflation expectations this is perhaps not so strange. Increases in the prices of food and fuel are among those most visible to the public and it is not unreasonable for such increases to affect expectations. What is worse, however, is that the public's inflation expectations for the long term have also increased. It is easy to call to mind the 1970s and 1980s in Sweden when inflation became entrenched as the result of a more or less established compensation mentality – what is sometimes called a price and wage spiral. The new monetary policy with an inflation target came into existence precisely so that we would not have to relive this experience.

Nyberg also asked whether this is to over-interpret the significance of the inflation expectations. He felt that this is possible as we actually do not know very much about the factors that govern the long-term expectations and how these affect inflation. The extensive index clauses of previous decades no longer exist and this has weakened the link between inflation and inflation expectations. However, the combination of a rate of inflation significantly above the target, the clear risk of secondary effects from energy price increases, a high level of resource utilisation and rising long-term inflation expectations means that there is a need to raise the repo rate.

As far as monetary policy in the period ahead is concerned, Nyberg declared that he is far from certain that the two additional repo rate increases in the proposed repo rate path will actually be needed to achieve the inflation target of 2 per cent in approximately two years. There may very well be a more rapid slowdown in economic activity than anticipated. The figures for consumer confidence and trends in the retail sector that have appeared in recent weeks clearly point in this direction. The expectations of the households concerning their own economic situation and the Swedish economy as a whole are now lower than at any other time since the turn of the century. This is perhaps not so remarkable. We see the increases in food prices every time we shop for food, and no one who has had to fill up their car can have missed the fact that petrol has become more expensive. The price increases act as taxes that reduce the scope for consumption and transfer purchasing power from the households to the producers of oil and food in other countries. Nor does the forecast in the main scenario include the possibility that prices will fall, only perhaps the possibility that they will stop increasing. Added to this are rising mortgage rates, a falling stock market, a property market that appears to be weakening more rapidly than expected and a weaker labour market. Nyberg also said that he would not be surprised if the discussion during the autumn shifts again to focus more on falling demand, growth and employment rather than on energy and food prices. He therefore shared Irma Rosenberg's and Barbro Wickman-Parak's view of the repo rate path and supported their reservation.

Governor **Stefan Ingves** said that he supported the analyses and forecasts in the report. Inflation is now the highest it has been for 15 years and is far above the inflation target. Similarly, inflation expectations are above the target and are also the highest they have been for a long time. Energy and food account for a large part of the price increases that are now being registered, but it is also the case that we have had, all be it from a low level, a generally rising rate of inflation since the period with low interest rates. Wage increases are also higher than previously, although moderately so. Ingves said that inflation expectations so far appear to be fairly well anchored as the long-term expectations have not risen very much. Nevertheless, it is worrying that they are above the target. He also said that it is now important to conduct a monetary policy that is such that the long-term inflation expectations do not begin to creep upwards. Given this background it seems natural to increase the repo rate.

The price increases for oil, with a real oil price that is at record levels, and imported foods are changing Sweden's terms of trade with the rest of the world and reducing the standard of living in Sweden, and there is not much that monetary policy can do about this. What is important now is that the relative price changes are implemented without generating more general price impulses that are translated into a lasting high level of inflation. Monetary policy can influence this process and this is why it is important to raise the repo rate. In this perspective, it is also important that the fact that real wages did not increase this year does not lead to a general demand for compensation. In an economy where foreign trade represents approximately 50 per cent of GDP, we must expect that there will be some short-term shifts in the development of real wages. The experience of the 1970s, which were marked by general demands for compensation, was not good and it is important to make sure that this process is not repeated.

Ingves also said that the general anxiety about worsening economic prospects, and consequently weaker inflation pressures, may be weighed against this, but that as far as he was concerned this is not a factor that weighs heavily enough. Safeguarding the inflation target of 2 per cent entails accepting that economic growth will periodically be below the long-term trend in the short term. With low inflation this is counterbalanced by good economic development in the longer term. With a current account surplus and sound public finances, Sweden is also in a strong position to deal with a period of necessary adjustments

The basis for the proposed repo rate increase and the upwardly-adjusted repo rate path is that monetary policy will have a tightening effect at the same time as the price impulses from abroad are expected to subside. If the latter does not occur, it will be necessary to monitor the upside risks very carefully. Both the current repo rate and the repo rate path need to be increased if monetary policy is to have the desired effect. According to Ingves, an additional couple of repo rate increases are appropriate given the information that is currently available. This will have a certain tightening effect at the same time as the repo rate, in an historical perspective, is not remarkably high. The levels of both the nominal and real repo rates during the period entail a necessary, but by no means extreme, tightening of monetary policy.

The financial turmoil has also partly contributed to a situation in which mortgage rates, for example, have risen more over the last twelve months than can be attributed to the monetary policy conducted, at the same time as lending has continued to grow rapidly. This development partly acts as a tightening in itself, but it does not neutralise the need to both increase the repo rate now and subsequently a couple of times more as indicated by the repo rate path in the main scenario. Given the responsibility that the Riksbank has for the inflation target, it is more important to act now than to wait and see. In an uncertain world, another alternative is to hold off on increasing the repo rate and to leave the repo rate path unchanged. But if inflation then becomes entrenched this will lead to even greater repo rate increases in the future. If, on the other hand, the rate of inflation falls rapidly towards the target it is always possible to reduce the repo rate further ahead. All in all, given the uncertainty that now prevails, Ingves said that the repo rate path proposed in the main scenario is the most appropriate.

Lars E.O. Svensson commented on Lars Nyberg's point about the high costs of combating inflationary impulses from abroad via a strengthening of the exchange rate by saying that under certain circumstances these costs could in fact be very small. A pure increase in inflation abroad in relation to inflation in Sweden would, given an unchanged real interest rate and unchanged real development abroad, lead to a gradual strengthening of the krona which would exactly counteract the increase in global inflation and imply that global inflation measured in terms of the krona would not increase.

Stefan Ingves summarised the monetary policy discussion. Inflation has risen substantially and is at its highest level since the mid-1990s. The main reason for the high inflation is the large increase in energy and food prices on the world market. But increasingly high domestic resource utilisation in recent years has also contributed to rising inflation. At the same time, inflation expectations remain high. Resource utilisation is still slightly higher than normal. However, growth in Sweden and abroad is slowing. One reason for this is the international financial turbulence we have been experiencing since last year. It is still not possible to say when the situation on the financial markets will return to normal. The growth in economic activity will continue to slow down and the labour market situation will slacken. Resource utilisation is thus falling but is expected to be normal at the end of the forecast period.

The view of how the repo rate will develop in the period ahead has changed somewhat since April. The dramatic energy price increases and the high inflation expectations require a higher repo rate in order to bring inflation back to the target a couple of years ahead. There is, however, a lot of uncertainty in the assessment and the discussion indicates some subtle differences between the views of the members of the Executive Board with regard to the lasting nature of inflationary pressures and the weakening of economic prospects in Sweden, and thus in the support for the repo rate path presented in the Monetary Policy Report. It is clear, however, that 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 inflation and economic activity in Sweden.

§ 4. Monetary policy decision

The Chairman noted that there was a proposal to increase the repo rate by 0.25 percentage points to 4.50 per cent.

The Executive Board decided after voting

- to adopt the Monetary Policy Report according to the proposal, Annex A to the minutes,
- to publish the Monetary Policy Report on Thursday 3 July 2008 at 9.30 a.m.,
- to raise the repo rate by 0.25 percentage points to 4.50 per cent and that this decision would apply from Wednesday 9 July 2008,
- to raise the lending rate to 5.25 per cent and the deposit rate to 3.75 per cent, with effect from Wednesday 9 July 2008,
- to announce the decision at 9.30 a.m. on Thursday 3 July with the motivation and wording contained in Press Release no. 27 2008 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 9.30 a.m. on Wednesday 16 July.

Executive Board Members Lars Nyberg, Irma Rosenberg and Barbro Wickman-Parak supported the decision to increase the repo rate by 0.25 percentage points but entered a reservation against the main scenario's paths for the repo rate, inflation and growth in the period ahead. They all advocated a lower repo rate path. Their assessment was that the slowdown of the economy that is now taking place would dampen inflationary pressures to a greater extent than assumed in the main scenario. There would therefore be less need to continue increasing the repo rate.

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