Separate minutes of the Executive Board meeting, No.2

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DATE: 12 February 2008

TIME: 9 a.m.

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

Claes Berg
Kurt Gustavsson
Jesper Hansson
Jyry Hokkanen
Karolina Holmberg
Per Håkansson
Ann-Christine Högberg
David Kjellberg (§1)
Pernilla Meyersson
Marianne Nessén
Britta von Schoultz
Annika Svensson
Staffan Viotti
Anders Vredin

§ 1. Economic developments

It was noted that Kurt Gustavsson and Annika Svensson 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 base for the draft in the form of an international outlook and status report had been presented by the Monetary Policy Department and discussed at a meeting on 16 January. Proposals for forecasts, articles and alternative scenarios had been presented and discussed at meetings held on 25 and 28 January. Forecasts and texts were tabled at the Executive Board meetings on 30 January and 7 February.

Since the most recent monetary policy meeting in December the financial market turmoil has continued to make its mark on international developments. The uncertainty over economic developments in the United States and contagion effects abroad remains substantial. The real economic indicators received have to a greater extent been weak than strong. This is partly in line with the December forecast. However, developments in the financial markets, with lower long-term interest rates and share prices, could be interpreted to mean that market agents assess the outcome as weaker than expected. The uncertainty over future developments is also pushing down long-term interest rates and stock market rates. The Federal Reserve's recent substantial interest rate cuts are expected to contribute to maintaining domestic demand in the United States. All in all, economic activity in the world around Sweden has so far slowed down roughly as expected in December, while future developments are expected to be slightly weaker. At the same time, international inflation is higher than before, pushed up by high energy and food prices.

The assessment of economic indicators and inflation prospects for the Swedish economy remains largely the same as in December. Economic activity is still good and the labour market is strong. However, recent developments indicate slightly lower growth in private consumption than expected. Similarly, employment growth has shown weaker growth, but unemployment has been largely in line with the forecast. Wage increases have been lower than expected in the autumn, which has led to the forecast being revised down. Despite many factors pointing downwards, little has changed with regard to inflation prospects, as other factors are counteracting them. Rents are expected to rise in the future, the krona exchange rate has been stronger than expected and at the same time inflation expectations have risen. After having risen rapidly in 2007 inflation will remain high over the coming year to then slow down in 2009 and 2010. Resource utilisation will be higher than normal to begin with, but will decline gradually. The forecast of how the repo rate will develop is largely the same as in December. In the main scenario the repo rate is raised and thereafter remains at roughly the same level over the coming year.

In addition to this main scenario, the draft also describes some alternative scenarios. As in October, there are still reasons to take into account the risk of a more rapid increase in wages and lower productivity growth than expected, although this scenario is not described specifically in this report. Moreover, the international economic downswing and the financial turmoil may be more substantial and more prolonged than expected in the main scenario. Finally, there is description of what will happen in Sweden if prices abroad increase more than in the main scenario, either as a result of generally higher inflation in the rest of the world or because of a higher oil price.

David Kjellberg from the Monetary Policy Department then reported on developments in the financial markets since the previous Executive Board Meeting on 7 February. The financial market turmoil has continued over the past week and credit spreads remain high. The concern over the effects of the financial turmoil on growth is continuing to have a negative effect on stock market developments. Since 7 February Swedish stock market rates have fallen 4-5 per cent. In particular the short-term, but also the long-term interest rates have fallen in the euro area, and to some extent also in Sweden. Interest rates in the United States have been volatile, but remained largely unchanged during the period.

The US forward rates indicate continued expectations of at least a 0.5 percentage point cut in the Fed Funds in connection with the next FOMC meeting. In the euro area forward rates shifted downwards after the ECB's press conference on 7 February and indicate expectations of interest rate cuts soon. In Sweden, surveys indicate that the Riksbank is expected to decide to leave the repo rate unchanged in February. Swedish forward rates have shifted downwards slightly over the past few days. All in all, market pricing indicates expectations of a slightly lower repo rate before the end of the year.

§ 2. Economic outlook abroad

Deputy Governor **Lars Nyberg** opened the discussion. He considered that the situation in the financial markets was in a few aspects better than it was a couple of months ago. The acute liquidity shortage in large parts of the bank system has declined, partly as a consequence of the US Federal Reserve in particular lending money before the end of last year at slightly longer durations than normal. It has become easier for the banks to finance themselves at least for durations up to 6 months, which has been reflected in falling interest rate spreads between bank securities and government securities. With regard to longer durations, however, the market is still thin. A number of banks, primarily in the United States, have also succeeded in restoring some of the capital they have lost. Government funds in Asia and the Middle East have contributed most of the capital.

However, in most other respects the situation appears to have deteriorated and the uncertainty appears to have increased since our last meeting in December, said Mr Nyberg. All in all, the crisis has taken a turn for the worse, rather than for the better. Questions have arisen regarding credit ratings and capital requirement in a number of credit insurance companies, known as monolines, and it is difficult as yet to gain a picture of the size of this problem. The concern that many banks will face considerable losses has increased, which has been expressed in rising costs for medium-term borrowing. The insurance premiums, in the form of CDS (credit default swaps) spreads required by investors to buy bank bonds, have risen. And share prices have fallen, in many cases quite substantially. Expected write-downs now refer not only to mortgages with a subprime content, but also to loans to the commercial property sector, credit cards and other consumer credits. This is partly linked to the US economic downswing appearing to be deeper than previously expected. The economic downswing increases credit losses and intensifies the financial crisis. At the same time, the financial crisis reinforces the economic downswing. When the banks receive less capital they tighten the terms for their lending. The fact that this has happened to a substantial extent can be seen in the Federal Reserve's survey, which is aimed at bank employees responsible for credit.

The Federal Reserve has cut its rate by as much as 1.25 percentage points since the Riksbank's monetary policy meeting in December. This is a uniquely powerful stimulation of demand with the aim of alleviating the economic downswing. It is also a measure which makes conditions in the financial sector easier, as the banks can obtain financing at lower interest rates. At the same time, the interest rate cuts have aroused some concern in the market that the economic downswing and financial crisis combined might be much more serious than was previously feared, said Mr Nyberg.

Although the financial crisis is essentially still American, we can expect to see effects in Europe, where investors have bought US securities with more or less complicated constructions, not only those with a subprime content. In addition, things are happening in Europe that cannot be related to developments in the United States. In the United Kingdom, falling residential and commercial property prices have forced the banks to make substantial write-downs. Credit terms have been tightened, just as in the United States. In Spain, too, where the property market has been overheated, a similar development is expected. Mortgage bonds from these countries have become increasingly difficult to sell to investors and these have demanded ever higher interest rates.

Governor **Stefan Ingves** observed that growth on a global level, as described in the Monetary Policy Report, remains good although we will probably not see the same high growth figures as in recent years. From this perspective, events in the US economy are an important component. Despite good growth in other areas, developments in the US economy probably cannot be entirely separate from the rest of the world. Globalisation entails interwoven economies both on the real and financial side.

As early as in December the assessment was that growth in the United States and the euro area would be slightly lower than in the forecast in the previous Monetary Policy Report. The conditions for international growth in the main scenario have now further deteriorated somewhat. This is primarily due to greater uncertainty over the contagion effects of the US mortgage crisis on the real economy in the United States and on other countries. This has subdued various indicators of household sector and corporate sector confidence. Share prices have also been affected. However, the Federal Reserve has decided on further easing of monetary policy. In addition, the Bush administration has produced a fiscal policy stimulation package, which is under consideration by the US congress. Even if this counteracts a slowdown in growth in the United States, international growth will probably be slightly lower than forecast at the most recent monetary policy meeting in December, said Mr Ingves.

The international financial turmoil is important both from a macroeconomic perspective, as described in the Monetary Policy Report, and also because individual institutions are affected. In the latter respect the picture now appears to have changed. There are now more widespread discussions than before as to how to deal with the problems at the level of individual financial institutions. It has become clearer that this is a process one must work one's way through, and which will take time. One consequence of this development is that we probably have a period ahead of us where interest rate margins will be higher than before. This gives some tightening effect which is independent of the monetary policy conducted, said Mr Ingves.

With regard to the international outlook, it is important to remember that it is not only the discussion of economic activity and the financial turmoil that are important. As a result of high energy prices and rising food prices, inflation is now rising in many countries. The long period with low inflationary impulses appears to have come to an end. This is also a factor that is important in Swedish monetary policy. In this context exchange rate developments may also be important. An appreciation of the krona could be a welcome contribution to subduing the external inflationary impulses.

Deputy Governor **Barbro Wickman-Parak** said that it is important to consider our forecasting history. The US economy is without doubt in a slowdown phase, something that was predicted earlier last autumn and also in December. As early as the October report, a substantial and well-motivated downward adjustment was made to the growth forecast for the United States, from almost 3 to 2 per cent for 2008. The forecast was then well below the consensus forecast at that time. In December the growth forecast was revised down further and is at the same level today. The forecast for the euro area was also revised downwards in October by almost half a percentage point to just below 2 per cent and is now down at 1.7 per cent.

Ms Wickman-Parak considered that the forecast made for the United States in December was well-balanced, but that there was still a risk of a more negative development. The same largely applies today. There is a substantial slowdown in the rate of growth. But whether this will turn into an actual recession is still uncertain. Unease in the financial markets regarding such a development has increased, which is reflected for instance in stock market rates. GDP in the United States remained largely unchanged at the end of last year and we are expecting a poor first half of this year. We should see continued weak figures during the spring and this can be expected to mean that the fear of a recession remains. In this situation it is important not to overreact to weak indicators. Given our economic outlook, the indicators should be weak and this need not lead to any further downward revisions. But of course they may signal an even weaker development than we are predicting in our current forecast.

However, the assessment in the slightly longer term is even more important. The chances of a recovery during the second half of the year are still realistic, said Ms Wickman-Parak. Housing investment has now fallen two years in a row, by a total of 30 per cent, and is back at the level from the end of the 1990s. As a percentage of GDP they are now slightly below a long-term average. They are expected to continue to decline during the remainder of the year but the fall will slow down. The negative contribution to growth will thus decline. Stocks of unsold houses are still at a high level, but have begun to slowly decline since last autumn. Companies' other investments were still increasing at a fairly good rate at the end of the year and orders to the capital goods industry do not indicate a sharp decline.

It is of strategic importance that household consumption does not weaken further. The conditions for ensuring that this does not happen should be better now than in December, considered Ms Wickman-Parak. The Federal Reserve has since then cut the policy rate by a full 1.25 percentage points and this should, for instance, make things easier for households renewing their loans. In addition, the long-term mortgage rate has fallen and applications to refinance mortgages have increased. Now there is also a stimulation package of just over USD 150 billion. It is estimated that they will start sending out tax rebate checks to households in the spring and this should boost household consumption. It can also be mentioned, as Mr Nyberg pointed out, that the Federal Reserve's interest rate cuts have the side effect of reinforcing the banks' earning capacity.

There is quite clearly considerable uncertainty regarding the US economy and a deeper financial crisis could lead to a much more negative situation than we are predicting. According to Ms Wickman-Parak, the time is not yet right to include such a development in the main scenario. But it takes a well-justified position among the risk scenarios described in the Monetary Policy Report.

First Deputy Governor **Irma Rosenberg** agreed that the uncertainty regarding the international outlook has increased compared with October when we most recently published a forecast for international developments, but she felt slightly more concern than was expressed in the main scenario in the Monetary Policy Report. It is above all the uncertainty over what the shocks in the financial markets might lead to that has increased, said Ms Rosenberg and referred to Mr Nyberg's description. The initial problems in the interbank market appear to have been alleviated to some extent, although interbank rates are still higher than normal. However, the problems have not declined as a result of this, the turmoil has continued and the problems have merely changed shape. For instance, it is still difficult to gain a general view of the write-down need for losses on structured products for international banks and other financial institutions. In the long run this can lead to a substantial credit crunch. The most recent manifestations of the crisis include the problems with downgrading monolines, that is, large insurance companies that insure bond loans for borrowers who do not themselves have the highest credit ratings.

In addition, there is the unease prevailing on the stock markets, with heavy price falls around the world. Ms Rosenberg agreed with Mr Nyberg that the financial crisis could be both more prolonged and more profound than has been forecast earlier. It is difficult to predict how this may affect economic developments around the world and the Swedish economy. But even if the Swedish financial sector is outside of the crisis area, because it has small direct exposures, both Swedish banks and the economy in general will be affected by a continued crisis with abnormally high interest rates and elements of credit rationing, said Ms Rosenberg.

At the same time the problems in the US housing market are continuing and property prices are falling. As long as the adjustment continues, there is a risk that the problems in the subprime market will be aggravated and the financial turmoil will intensify. GDP growth in the United States weakened substantially during the final quarter of last year and the fall in housing investments made a significant negative contribution. The financial turbulence can in turn aggravate the situation in the US mortgage market. How serious the slowdown in the United States risks being will depend to a great extent on how resilient households are, as private consumption in the United States corresponds to around 70 per cent of GDP. During the fourth quarter of last year household consumption was maintained fairly well. However, there are many indications that consumption will weaken. Falling asset prices, both property prices and share prices, will have negative wealth effects. The upswing in oil and food prices undermines households' purchasing power. Signs of weaker employment growth point in the same direction. Retail sales in December were weaker and consumer confidence has fallen. The purchasing managers' indices in the service sectors also fell heavily according to the most recently monthly data. The negative prospects are of course counteracted to some extent by the stimulation measures implemented, that is, the Federal Reserve's substantial interest rate cut and fiscal policy measures. The forecasts in the Monetary Policy Report entail fairly weak developments in the United States over the coming quarters, but Ms Rosenberg considered there is an evident risk that the problems would be more prolonged and the economic recovery would take longer than predicted.

In the euro area, too, developments appear weaker than in the forecasts from October and December. European households have so far been very restrictive with their consumption expenditure and retail sales fell at the end of last year. Consumer confidence has also fallen. Despite the fact that the assessment for the euro area has been adjusted down slightly, there is a risk that developments will be even weaker if the problems in the financial markets are more prolonged, concluded Ms Rosenberg.

Deputy Governor **Svante Öberg** considered that it is reasonable to revise down the forecasts for international GDP growth in the way that has been done in the Monetary Policy Report.

The problems in the financial markets will probably continue over the year and growth in the United States and Europe will probably slow down this year. At the same time, developments in emerging economies in, for instance, Asia and eastern Europe have so far been strong and to a greater extent been driven by an increase in domestic demand. The commodity-producing countries have reinforced their purchasing power as a result of the rising energy and food prices. The latter has led to rising inflation in both more developed countries and emerging economies. Underlying inflation has also risen.

Deputy Governor **Lars E.O. Svensson** considered that the analysis of international events in the main scenario of the Monetary Policy Report, with a moderate downward revision of the international forecast, appears reasonable. More expansionary monetary policy in the United States, as well as more expansionary fiscal policy may alleviate the downswing there. There is a risk that more negative information on international economic activity will be received later, but the Executive Board will have to take this into consideration then if necessary.

Governor **Stefan Ingves** summarised the discussion of the economic outlook abroad and considered that there is reason for some downward revision to the international forecast in the main scenario in relation to the October Monetary Policy Report. At the same time, we can observe that there is still considerable uncertainty regarding both the effects of the financial developments in the United States and developments in global inflation.

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

Deputy Governor **Svante Öberg** opened the discussion. He considered that the view of economic developments in Sweden expressed in the Monetary Policy Report is reasonable on the whole. GDP growth is slowing down at the same time as inflation has risen and is above the target level during the forecast period. Mr Oberg wished to take up three questions in his contribution to the discussion: revisions to the forecasts, inflation and the monetary policy decision.

The differences between the forecasts in two Monetary Policy Reports following on from one another are usually fairly small. There is also reason to look back at the forecasts the Riksbank made a year or so ago.

GDP growth was lower in 2007 than the Riksbank was counting on just over one year ago, and inflation was higher. Developments in the labour market were underestimated. Employment increased by around 2½ per cent instead of the estimated around 1 per cent, and unemployment declined significantly instead of remaining unchanged. Productivity declined instead of increasing by around 2½ per cent, which was predicted then.

With regard to inflation, the forecasts for 2008 and 2009 have been adjusted upwards despite a higher repo rate, the financial market turmoil of the past six months and downward revisions to growth forecasts. This indicates that the Riksbank has earlier underestimated inflationary pressures. This of course does not necessarily mean that the current forecasts are incorrect, but there is considerable uncertainty and substantial scope for assessments to differ.

The second question concerns exactly how one should regard inflation. The high inflation rate is a problem. Measured in terms of the CPI it rose to 3.5 per cent in December and is thus above the inflation target and also the Riksbank's tolerance interval. The forecasts indicate that inflation will remain at this level during the greater part of 2008 and that, using different measures, it will exceed the 2-per cent level during the forecast period even after raising the interest rate. In addition, inflation expectations have recently shown a gradual increase. They are now above the inflation target both in the short term and medium term. It is important for monetary policy that inflation expectations are anchored at a level corresponding to the inflation target.

The high inflation rate and rising inflation expectations risk having consequences for inflation in years to come. Price increases in certain areas may spread to other areas. The high inflation rate may also lead to demands for higher wage increases. This could lead to a price and wage spiral such as we had in the 1980s, said Mr Öberg. Wage costs are expected to increase more quickly during the three-year period 2007-2009 than during the previous three-year period and productivity is expected to increase more slowly.

Mr Öberg has previously considered that the strength of the labour market has been underestimated also with regard to 2008. However, the recent statistics imply that the increase in employment may now slacken. Wage increases have so far been moderate according to the wage statistics. The financial market turmoil may have made companies more cautious with regard to costs. But wage increases may be underestimated as a result of selection effects, retroactive wage increases and the rapid increase in employment over the past year. The picture of wage developments will be more certain later in the spring. And it is difficult to predict productivity in the short term.

There are also downside risks for inflation. The high inflation in 2008 is partly temporary. When the energy price increases fall out of the twelve-month figures inflation will decline. Economic activity will slow down and this could have a dampening effect on inflation. Price increases on services have actually slowed down somewhat in recent months, which is positive.

All in all, Mr Öberg found that the upside risks weighed heavier with regard to the current monetary policy decisions.

One question which should receive attention during the spring is the qualities of the different inflation measures. The CPIX appears less and less appropriate as a central model variable, both as a result of the severe fluctuations in energy prices and as a result of the systematic difference between the CPI and the CPIX in the medium term.

With regard to the monetary policy decision, Mr Öberg proposed raising the repo rate by 0.25 percentage points to 4.25 per cent in accordance with the main scenario in the Monetary Policy Report. The inflation target must be the central issue when the Riksbank is deciding its monetary policy. The Riksbank can also take into account developments in the real economy, but only if this is compatible with the aim of keeping inflation at 2 per cent. In the current situation the Executive Board has to prioritise bringing down inflation. This is the Riksbank's task.

The forecasts actually motivate an interest rate path with a slightly higher repo rate in 2008 to bring down inflation to 2 per cent. Although inflation is expected to slow down and approach the inflation target, it is expected to exceed 2 per cent throughout the forecast period, even taking into account the effects of raising the repo rate. However, the uncertainty over economic developments at present justifies assuming a relatively unchanged repo rate for a period after this.

Deputy Governor **Lars E.O. Svensson** did not consider that there had been any dramatic deterioration in economic prospects in Sweden. The Swedish economy is still strong, even if there may be a risk that economic growth will be weaker than in the main scenario.

Inflationary pressures remain high and inflation expectations have risen. There is therefore a risk that inflation will be higher than in the main scenario. The uncertainty is considerable, but there is not sufficient new information to change the forecasts for inflation and the real economy more than marginally, or to make any major adjustments to the interest rate path.

The forecast in the main scenario shows high inflation in 2008, which gradually approaches the target in 2009, as well as high resource utilisation that gradually approaches a normal level. The forecasts in the main scenario look relatively good. The inflation path is possibly a little high. The interest rate path in the main scenario justifies raising the interest rate now by 25 basis points to 4.25 per cent and then maintaining a constant repo rate of 4.25 per cent.

Mr Svensson considered that 4.25 per cent could be a suitable long-term level for the nominal repo rate. The real repo rate is the nominal rate minus inflation expectations. With a long-term level for 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 can be considered a reasonable level for the real repo rate in the long term.

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 expectations are currently above 2 per cent, a repo rate of 4.25 per cent corresponds to a real repo rate of below 2.25 per cent. With inflation expectations of between 2.5 and 3 per cent one instead obtains a real repo rate of between 1.25 and 1.75 per cent, that is, a good deal below what is considered a reasonable long-term real repo rate. Measured in this way, monetary policy is thus still expansionary, rather than neutral, and it will remain expansionary as long as inflation expectations are above the target, said Mr Svensson. To lower the repo rate path in this situation and not to raise the repo rate would lead to overly expansionary monetary policy, given that inflation expectations are so high. One could even claim that the high inflation expectations rather motivate a slightly higher nominal interest rate path than the current one to avoid lowering the real interest rate path.

Mr Svensson also considered that it is important to emphasise that the repo rate path is forecast and not a promise. If the economic situation were to change in the spring, there could of course be justification for altering the interest rate path upwards or downwards depending on how the forecasts for inflation and the real economy change. If new information were to give clear indications of a dramatic deterioration in economic activity, there may of course be justification for shifting the interest rate path down rather substantially. The Federal Reserve has recently demonstrated that one does not necessarily need to pursue interest rate smoothing and only change the interest rate in small steps of 25 basis points. There is no reason why the Riksbank should not be able to change the repo rate in larger steps if this were appropriate.

Mr Svensson supported the proposal to raise the repo rate to 4.25 per cent.

First Deputy Governor **Irma Rosenberg** pointed out that inflation had risen gradually in recent years. On average, inflation measured in terms of the CPI was 2.2 per cent in 2007, that is, close to the inflation target. The upswing in inflation was partly due to resource utilisation having increased and cost pressures having risen. Hourly wages had increased more rapidly than before and productivity growth had slackened considerably. The fact that cost pressures rose was a condition for inflation, which had been very low for several years, reaching the inflation target last year. However, underlying inflation measured as the CPIX was still low, 1.2 per cent on average.

In autumn 2007, however, CPI inflation had risen very quickly and in December amounted to 3.5 per cent, much higher than the inflation target. CPIX inflation, which excludes households' mortgage interest expenditure, rose to 2 per cent in December. The rapid upswing in the autumn was largely due to rising energy and food prices. In particular with regard to energy, but also to some extent food, the developments in Sweden reflected a substantial rise in world market prices. We are unable to immediately counteract such rapid price impulses from abroad with monetary policy. It must be allowed to take some time. To some extent these effects are also assessed as temporary in the main scenario. If world market prices do not continue to rise at the same pace in future, inflation will fall back again. This is also what is forecast in the main scenario. But it is very important that such price increases are not allowed to push up inflation permanently. The risk of this increases if inflation expectations rise, which has been the case in the autumn. Inflation expectations have risen even in the longer term, both 2 and 5 years ahead. This is something we must monitor closely, said Ms Rosenberg.

This could in itself imply that the interest rate needs to be raised. But at the same time the forecast in the main scenario shows that growth will slow down this year and over the coming years. Wages do not appear to be rising as quickly as we had assumed when the new central wage agreements were signed last year and the forecast has been adjusted slightly downwards. The slowdown in productivity growth that took place last year is also more easily comprehensible following the publication of the National Accounts for the third quarter, which show clearly that production growth slackened last year. There are many indications that the weaker productivity growth indicates that companies will be more restrictive in their demand for labour rather than that the price increases will be rapid. In the main scenario employment growth is also expected to slacken considerably this year.

Ms Rosenberg's conclusion, taking into account the uncertainty linked to the financial turmoil and the risk of weaker international growth and ultimately also the Swedish economy, is that it may be wise to wait and leave the interest rate unchanged. However, given the high inflation expectations, Ms Rosenberg did not want to entirely rule out the possibility that the interest rate would need to be raised in the future. The decision-making problem is largely the same as the one the Executive Board faced in December and October.

Ms Rosenberg emphasised that an unchanged repo rate should not be regarded as an expression that the inflation target is being given lower priority. It is more a question of how long we can allow inflation to deviate from target in the current uncertain situation. One should also remember that the interest rate has been gradually raised in a number of steps in recent years. The effects of these raises have not yet had a full impact on the economy.

Ms Rosenberg therefore advocated a decision to wait before raising the interest rate, at the same time as she considered the interest rate path should show that the next step may very well be a raise.

Deputy Governor **Barbro Wickman-Parak** pointed out that the forecast for Swedish growth in 2007 and 2008 was adjusted downwards in December. The current forecast remains largely the same. If one looks across the three-year period 2007-2009, average growth is expected to be just over 2 per cent. This is a significant slowdown compared with the three-year period 2004-2006. Indicators such as the Economic Tendency Survey confirm that the economy is cooling down. But it is worth pointing out that the levels for the various sectors are high and so far are signalling a strong economy. Given the international forecast the assessment for the Swedish economy is realistic and not overly optimistic.

Employment growth is now expected to be slightly lower compared with the October forecast. But the forecast for the labour supply has also been adjusted downwards. This means that unemployment during the coming years will be at roughly the same level as predicted in October. Resource utilisation in the economy is higher than normal at the outset.

With regard to wages, the outcomes appear to be lower than was previously predicted and the forecasts have been adjusted down compared with the October report. The forecast for productivity has also been adjusted downwards. This means that unit labour costs for 2008-2009 are only expected to be marginally lower than in October. They are thus still expected to increase significantly in the future. During the three-year period 2004-2006 these costs were largely unchanged, but during the period 2007-2009 they are expected to increase by around 3 per cent on average. This is a significant turnaround and it is important when assessing inflation prospects.

Ms Wickman-Parak also pointed to other factors that contribute to a rise in inflation, such as food prices, which Ms Rosenberg also mentioned. They had earlier held back inflation, but have clearly swung upwards. And more is probably to come. According to the Economic Tendency Survey, 75 per cent of food retailers are notifying raised prices and if one looks a further step back along the line, at the wholesale trade, an even larger percentage of companies are notifying price increases. The fact that food prices rise is an international phenomenon when commodity prices rise. These price increases, like oil price increases, cannot be directly affected by monetary policy. But there may also be certain specific Swedish elements with regard to food prices. Increased competition through the establishment of low-price supermarket chains has previously pushed down prices. The new establishments appear to be waning now and this means that the earlier price pressure from this direction will subside.

Another element in the inflation outlook is that goods prices have begun to rise. This is a clear change compared with the years 2004-2006, when they fell during a large part of the period. The rates of increase are very moderate when foods are excluded, but it should still be pointed out that more price increases are in the pipeline regarding other goods. Producer prices for consumer durables have risen. If one weighs together domestic market prices and import prices for these goods they have risen substantially during the course of 2007 and at the end of the year the increase was 3.5 per cent.

It can also be added that the oil price forecast was raised in December and it remains at this level. The krona is weaker than in December. The forecast assumes the krona will appreciate somewhat, but not to the same extent as in previous forecasts.

There is still uncertainty over productivity growth, although it will probably recover in line with our forecast. And even if labour market developments are expected to slow down, the shortages remain high, which may affect wage drift.

Ms Wickman-Parak pointed out that inflation expectations have risen. For one year ahead they are at 3 per cent, according to Prospera's survey, which is not surprising given the high actual inflation rate. But two years ahead they are still at almost 3 per cent. Five years ahead they are at just over 2.5 per cent, which is a good deal higher than the inflation target. This is something that should be taken seriously. Mr Öberg has already described the vicious circle that can arise if these expectations become entrenched at a high level.

Ms Wickman-Parak admitted that there was well-founded uncertainty over international economic activity. But after having weighed this together with the inflation outlook she nevertheless agreed with the proposal to raise the repo rate by 0.25 percentage points. She also expressed support for the interest rate path in the main scenario of the Monetary Policy Report, and which has the interest rate remaining at around 4.25 per cent in the future. The risks of higher or alternatively lower inflation, with differing consequences for the policy rate, which are described in the alternative scenarios of the Monetary Policy Report adequately reflect the considerations that may be appropriate in the future.

Ms Wickman-Parak noted in conclusion that the decision is based on a situation with a relatively low interest rate of 4 per cent. Mr Svensson has developed the reasoning on nominal and real interest rates and whether monetary policy shall be regarded as neutral or expansionary. Although it is difficult to express any exact opinion, she considered that one should be able to go so far as to say that an interest rate of 4.25 per cent is much closer to a level that can be described as neutral than a level connected with contractionary monetary policy.

Deputy Governor **Lars Nyberg** considered that we in Sweden had so far been able to regard the financial crisis primarily as onlookers. The banks have not been directly affected, as they have not to any great extent invested in assets related to the US mortgage market. Nor have we seen the negative development in the property market that is being experienced in several European countries. However, Swedish mortgage bonds are also difficult to sell outside of Sweden at rates that would provide acceptable financing costs for house-buyers.

In Sweden we have not seen the clear economic downswing that has been evident in the United States, and which lies behind the US interest rate cuts. Although the economy is expected to slow down during the coming year, it remains strong with good growth and a substantial shortage of labour in some sectors. The Monetary Policy Report depicts this well.

Inflation is also rising and is expected to exceed the 2 per cent target over the coming years, according to the Monetary Policy Report. It is also expected to exceed 3 per cent during a period of time; the upper limit of the tolerance interval we have set in our inflation target. At the same time, the general public's inflation expectations have risen, both in the short-term and the slightly longer term. This can perhaps be explained by the fact that everyone has so clearly seen that food, electricity and petrol prices have risen over the past year.

However, it is no less serious for that. Not since the mid-1990s have inflation expectations been as high as in the most recent survey.

With regard to monetary policy, Mr Nyberg considered that the balance was unusually difficult. Domestic events indicated on the one hand fairly clearly that the interest rate should be raised roughly at the pace stated by the Riksbank in December. And Swedish monetary policy must of course be conducted in the light of the economic situation in Sweden.

On the other hand, international events, and particularly the financial markets, appear much more uncertain than at the time of the previous monetary policy meeting. If the crisis worsens, which is a possibility that cannot unfortunately be disregarded, and if the economic downswing in the United States becomes steeper than calculated earlier, which many analysts including the Federal Reserve evidently cannot rule out, the effects on the world economy could be much greater than expected. In addition, the developments in the property markets in several European countries are worrying. All in all, this entails a risk for the Swedish economy, too, and this risk is not negligible. It is of course difficult to assess both the seriousness of these events and the risk of contagion for the Swedish economy. But when one cannot clearly see the way ahead it may be wise to stand still.

With regard to the balance between raising the repo rate and waiting to make a raise, Mr Nyberg preferred the latter alternative. It is possible that conditions in the financial markets may look better in a couple of months and that an interest rate raise will be appropriate then. This will be decided at that time.

There has already been some tightening of monetary policy. The situation in the financial markets has increased the financing costs for the Swedish banks by around half a percentage point, and this cost increase will gradually be passed on to the general public in the form of higher interest rates. Mortgage institutions will also meet higher financing costs when they are forced out on the international market, and these costs will be passed on to borrowers. The price of risk has increased and this will also affect us Swedes.

Concern over the rising inflation is also alleviated somewhat by the fact that a not insubstantial part consists of increases in international food and energy prices. These cannot be influenced by Swedish monetary policy. In addition, they are only calculated to have an effect on inflation during a year or so.

The fact that there has been a tightening of interest rates, regardless of the repo rate decision made, at the same time as the inflation upturn is temporary and to a great degree determined by factors that cannot be influenced by monetary policy should also be considered when making the decision on the repo rate.

Finally Mr Nyberg considered that there is reason for some caution as we in Sweden are also close to an economic downswing. The cyclical peak appears to have been passed. All experience indicates that the most difficult thing for a forecaster is to predict exactly when and with what strength a turnaround will come. And the forecasting models used, which are in most cases very useful, generally give least joy in these situations. In addition, financial developments, which appear particularly important today, are always difficult to capture in the forecasts. Mr Nyberg agreed with Ms Rosenberg's view that the repo rate should not be raised now, although a raise could very likely be appropriate in the near future.

Governor **Stefan Ingves** observed that two forces were standing in opposition to one another with regard to the assessment of inflationary pressures in Sweden: a dampening force from the international financial turmoil and an upward force from the Swedish real economy and international price rises. The upward force weighs heavier.

Although resource utilisation in Sweden is slowing down, it is still higher than normal, both with regard to the goods and services markets and the labour market. Productivity growth has been surprisingly low. The wage forecast has been revised down slightly, but wage increases will nevertheless be higher than they have been in recent years. This means that wage costs will increase. At the same time CPI inflation is clearly above the target, partly as a result of higher energy and food prices. Underlying inflation, measured as the CPIX, is also rising. Information received since the previous meeting and which may cause concern also includes the high inflation expectations two and five years ahead, as already mentioned.

The Riksbank's inflation target means that, despite the opposing forces, the repo rate now needs to be raised. It is too risky to "wait and see" what happens with inflation. It is important that inflation expectations are brought down and that resource utilisation in the Swedish economy becomes more balanced. This means that a well-balanced monetary policy in the main scenario entails a raise of 0.25 percentage points today. After this it is reasonable that the repo rate remains around 4.25 per cent over the coming year. In this way the Riksbank shows that it takes the inflation target seriously. If the interest rate is not raised today, there is a risk that inflation expectations will remain too high. This could require much larger increases in the future. If one describes this in real interest rate terms, it does not entail an unreasonably high real interest rate. In addition, the lending rate in the financial sector is still in double figures as an annual percentage change. This also indicates that it is right to raise the interest rate now, said Mr Ingves.

It is chronically difficult to assess exchange rates, but one can note that it is good if the Swedish economy is somewhat isolated from international price impulses through an appreciation of the krona. From this point of view, too, it is right to raise the interest rate now, and then to allow it to remain roughly around this level. In addition to the direct monetary policy measures, higher interest rate margins will possibly also lead to some tightening. The fact that economic activity may now slow down both in Sweden and abroad does not make it any less important to raise the interest rate to attain the inflation target in the long term. An economic slowdown is forecast in our main scenario.

Mr Ingves also pointed out that it is important to remember that the interest rate path in the main scenario entails a kind of balance between the dampening force from the financial turmoil and the upward pressure from resource utilisation and inflation expectations in Sweden. It is not possible to rule out the possibility that, regardless of today's interest rate decision, one of these forces will tip the balance more tangibly and a completely new interest rate path will be needed further ahead. A deeper international downturn could contribute to lower inflation in Sweden. According to one alternative scenario, this could mean that interest rate cuts will begin as early as this year. Higher international inflation, for instance as a result of a much higher oil prices, could on the other hand make continued raises necessary. As always, economic developments are uncertain, perhaps particularly so at present, but this does not alter the need to choose a path now, concluded Mr Ingves.

Svante Öberg commented what had been said earlier by Mr Svensson that monetary policy would still be expansionary rather than neutral given the real interest rate. For his own part, Mr Öberg considered that monetary policy was relatively neutral. After the interest rate raise the real policy rate will be around 2 per cent, depending on how one deflates the nominal policy rate, which is a relatively neutral level. In the euro area and the United States the real interest rate has varied roughly between 0 and 4 per cent, with an average of around 2 per cent, over the past 10-15 years.

Lars E.O. Svensson considered that with the current high inflation expectations one would obtain a real repo rate that was well below 2 per cent. However, to attain an even better estimate of how expansionary monetary policy is, one should compare the real interest rate with a state-dependent neutral real interest rate instead of a long-term real interest rate, but the work on estimating such a state-dependent neutral real interest rate has not yet progressed far enough.

Stefan Ingves said that there were different ways of calculating the real interest rate and that it has varied quite substantially over time. The Riksbank has therefore previously spoken of fairly broad intervals for what can be regarded as a normal level for the real interest rate.

Irma Rosenberg also emphasised that one must be cautious in establishing what is a neutral real interest rate. This depends on the conditions in the economy, which vary. She therefore considered that the Riksbank cannot tie itself to a particular level.

Stefan Ingves noted that the financial sector in Sweden has essentially been an onlooker in the financial turmoil. Now the Swedish economy was being indirectly affected by the crisis in the United States. This is very different to a crisis being generated by the Swedish financial sector itself.

Stefan Ingves summarised the discussion of economic developments in Sweden and of monetary policy. The assessment of economic indicators and inflation prospects for the Swedish economy remains largely the same as in December. Economic activity in Sweden remains good and the labour market is strong. GDP growth will slow down over the year and the increase in employment will slacken. Resource utilisation in the economy will nevertheless be higher than normal. Inflation has risen rapidly in Sweden in 2007 and will remain high over the coming year. The inflation rate has been pushed up by higher energy and food prices, but at bottom there are also high cost pressures. Inflation expectations have also risen.

The view of how the repo rate will develop in the future remains largely the same as in December, although the discussion indicates some subtle differences. But there is considerable uncertainty in this assessment. Monetary policy must take into account different counteracting forces. On the one hand, inflation and domestic cost pressures are high. On the other hand, there are risks linked to the turmoil in the international financial markets and to slower international economic activity. 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[1]

The Chairman found that there was one proposal to raise the repo rate by 0.25 percentage points to 4.25 per cent, and another to keep it unchanged at 4 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 13 February 2008 at 9.30 a.m.,
- to raise the repo rate by 0.25 percentage points to 4.25 per cent and that this decision would apply from Wednesday, 20 February 2008,
- to raise the lending rate to 5.00 per cent and the deposit rate to 3.50 per cent, with effect from Wednesday, 20 February 2008,
- to announce the decision at 9.30 a.m. on Wednesday 13 February with the motivation and wording contained in Press Release no. 6 2008 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 9.30 a.m. on Monday, 25 February.

Deputy Governor **Lars Nyberg** and First Deputy Governor **Irma Rosenberg** entered reservations against the decision to raise the repo rate and against the Monetary Policy Report 2008:1 and the main scenario presented in the Report. There are now signs that economic activity in Sweden is slackening, but growth is expected to remain relatively good. Cost pressures are high and inflation is above the target. In addition, inflation expectations have risen, both in the short-term and the slightly longer term. Domestic developments thus indicate that the interest rate should be raised. On the other hand, the uncertainty over developments in the international financial markets has increased since December. Given the risks this entails for much weaker growth in the world economy and therefore also in the Swedish economy, Mr Nyberg and Ms Rosenberg considered that there was reason to wait before raising the interest rate and to hold the repo rate unchanged at today's meeting. At the same time, they wished to leave the door open for raising the repo rate further ahead if conditions in the financial markets improve.

This paragraph was confirmed immediately.

Minutes by:

Ann-Christine Högberg

Checked by:

[1] Board members who are present and do not enter a reservation have participated in and agreed to the Board's decision.

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