Separate minutes of the Executive Board, No. 2

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DATE: 19 January 2006

TIME: 1 p.m.

PRESENT: Stefan Ingves, Chairman
Eva Srejber
Lars Nyberg
Kristina Persson
Irma Rosenberg
Svante Öberg
Jan Bergqvist, Chairman of the General Council
Johan Gernandt, Vice Chairman of the General Council
Claes Berg
Mårten Bjellerup
Jörgen Eklund
Kerstin Hallsten
Jyry Hokkanen
Ann-Christine Högberg
Pernilla Meyersson
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Mårten Bjellerup and Sara Tägtström would prepare draft minutes of § 1 and 2 on the agenda for the meeting. The discussion was based on the new data and analyses presented by the Monetary Policy Department. These analyses are based on the assumption that the repo rate will develop in line with the financial markets' expectations, as reflected in implied forward rates during a 15-day period up to 4 January. This is a technical assumption for the purposes of calculation and should not be interpreted as reflecting the interest rate path the Riksbank considers to be most desirable.

1. Recent data regarding economic developments

The purchasing manager's index for the manufacturing industry in the euro area had continued to rise in December. Other economic indicators for the euro area, such as the European Commission's barometers and the IFO index had provided relatively strong signals regarding recent developments. Revised national accounts figures for Q3 confirmed the preliminary figure of 0.6 per cent GDP growth in the euro area. Preliminary whole-year estimates of GDP growth in Germany showed that the economy had grown by 1.1 per cent during 2005, which indicated a relatively weak fourth quarter.

In the United States, the purchasing manager's index for the manufacturing industry fell slightly in December, albeit from a high level. Other indicators such as manufacturing output in December and leading indicators in November had given similar signals regarding recent developments. Revised GDP figures for Q3 showed marginally weaker growth than had been reported earlier. Statistics on US household consumption and retail trade turnover indicated that consumption demand in the US economy had slowed down during 2005 Q4. The number of persons employed had increased by 108,000 in December, while the November figure had been revised up.

Manufacturing output and leading indicators showed that the economy was continuing to expand in Japan. Despite the high oil price, there had also been essentially positive economic signals from the rest of Asia.

Since the beginning of December, the oil price had risen by just over 10 dollars/barrel, to around 63 dollars/barrel, which was a little higher than expected. Long-term rates had fallen slightly in the euro area and the United States, as well as in Sweden. The krona had strengthened against the dollar and the euro compared with the weaker levels at the end of last year. The result had been largely in line with the assessment made in December.

New national accounts figures showed that Swedish GDP had increased by 3.4 per cent on an annual rate (calendar-adjusted) during 2005 Q3. Both domestic demand and exports experienced relatively strong growth. After the revisions, developments in the immediately preceding quarters (from 2004 Q4 onwards) appeared to have been stronger than previous data indicated.

The most recent business tendency surveys continued to paint a relatively positive picture of the general situation in the sectors included in the survey. The purchasing manager's index for manufacturing also indicated an improvement at the end of 2005. With regard to consumption demand, the statistics on retail trade turnover and households purchasing plans indicated relatively strong growth during Q4. The indicators received for foreign trade in Q4 provided mixed signals. Indicators of export orders had developed relatively strongly, while foreign trade in goods up to the end of November indicated more moderate developments.

The information received regarding the labour market indicated there had recently been some improvement. Employment had increased by 1.5 per cent, or around 65,000 persons, in December 2005, compared with one year earlier, which was more than had been assumed in the December Inflation Report. At the same time, the number of new vacancies had continued to increase and the number of redundancies had continued to decrease.

In December, CPI and UND1X inflation were 0.9 per cent and 1.2 per cent respectively, which was in line with the forecast in the Inflation Report.

2. The economic outlook and inflation prospects

2.1 The Executive Board discussion regarding the international economic outlook

One member began by recounting the assessment in the December Inflation Report, where international growth was expected to be good. The member's assessment was that the information received since then indicated slightly stronger growth than was assumed in December. The national accounts for the euro area in Q3 confirmed the picture of broad growth, with both domestic demand and exports growing at an increasing rate, while the upturn was on a broader geographical scale than previously. In addition, although GDP growth in the United States during Q3 was slightly weaker than had previously been reported, other economic indicators, such as the purchasing manager's index, pointed in the opposite direction. All in all, the new US statistics indicated that developments would be roughly in line with the assessment in the Inflation Report. The member also saw signs of slightly stronger growth prospects in Asia. The oil price had gone up slightly since the December report and this required an upward revision to the previous assessment. International inflation had been slightly subdued, mainly in the United States, but also in the euro area, which could be explained by a fall in the oil price compared with the high levels during the autumn. All in all, this indicated slightly more subdued inflation in future.

Another member agreed on the whole with the description of events. This was a broad growth that had also spread to the countries in the euro area that had previously shown weak growth. Equity prices had continued to rise so far this year, with the exception of the past few days, and there appeared to be a high risk appetite, while interest rate differentials between bonds with differing risks remained low. It also appeared as though there was still confidence in good growth in the corporate sector. However, the member was doubtful that international price pressures would be more subdued than had been forecast in December. International producer prices were rising, although many industrial nations had not yet shown evidence of any substantial upward pressure on consumer prices. On the other hand, consumer prices had risen in several Asian countries, partly due to lower energy subsidies, which had resulted in higher interest rates. Moreover, it was not only energy prices that had risen; metal prices continued to be surprisingly high due to large demand. Energy prices had not yet had any secondary effects in the form of higher inflation expectations in industrial nations, but the indirect effects were visible in the statistics, for instance, price trends in the transport sector, and could be expected to increase. This was pointed out with regard to the euro area, for instance, in the European Commission's quarterly report 2005:4. The member also referred to the US central bank's most recent Beige Book, which showed that companies perceived higher prices received. Rising house prices and substantial household debts in many countries were worrying signs. In a couple of countries that were further ahead in the economic cycle, such as Australia and the United Kingdom, the rate of increase in house prices had slowed down. This had contributed to a slowdown in the rate of increase in private consumption and inflationary pressures.

A third member essentially agreed with the assessment of economic activity and also pointed out that the labour market in Europe was looking brighter, for instance in France and Germany. China still appeared to be showing strong, stable growth although the reliability of the statistics might be questionable. Despite the positive picture, it was difficult to envisage any forthcoming international inflationary pressures. In the United States the indications were rather of a slowdown in inflation and house prices might very well be starting to stabilise. The member expressed some concern over the sustainability of international economic activity; there was a lack of stable growth engines in the global economy and there were both political and economic risks that could lead to a rapid deceleration. There was no great concern that this would occur during the current year, but in a couple of years' time the situation might be quite different. On the whole, the prospects for the world economy were still good in the near future.

Another member emphasised that the high growth rate in China should not be regarded as a sign that they were taking over reduced demand in the United States, that is to say, it was not a question of a shift in demand from the United States to China. A better balance could be achieved if domestic consumption were to increase in China.

One member agreed on the whole with the initial description of international economic activity. Growth in the United States would be somewhat subdued this year, but this would be counterbalanced by stronger growth in the euro area and Japan, while inflationary pressures were in general low. The member felt that there were certain risks linked to the financial imbalances, the oil price and rising house prices, but also that there was a tendency to revise the forecasts for growth in the world economy upwards and that the overall risk picture was therefore balanced one year ahead. The oil price would probably remain high and volatile, and it was doubtful whether the fall in the oil price on which the Inflation Report was based would actually materialise.

Another member agreed that the changes since December indicated stronger growth, which now appeared to be both deeper and broader. However, there were still dangers in many countries linked to house prices and household borrowing, and there were signs of overvaluation of houses in, for instance, the United Kingdom and the United States. Although there is a risk of a rapid adjustment in prices having substantial effects on demand, experiences so far indicate that the adjustment could be fairly orderly. When interest rates were raised in Australia and the United Kingdom with the aim of limiting growth in total demand, this led to a slowdown in the housing market, but not to the large price falls that were sometimes feared. The same applied to the Netherlands. The main scenario was that the world economy would manage the development towards higher interest rates without this leading to any substantial fall in house prices. However, one problem was that so little was known of the real effects on consumption and demand if house prices should nevertheless fall substantially. There was reason to follow developments closely in the United States, in particular, as savings were low there.

One member emphasised that a clear decline in the rate of consumption had been observed in Australia and the Netherlands. In the United Kingdom, consumption growth had been significantly lower last year and the lower rate of increase in house prices was probably one explanation.

Another member summarised the discussion and observed that the international picture looked strong, but pointed out that the forecasts in the main scenario were based on the assumption that there would not be any abrupt adjustment of the major imbalances in the world economy over the coming years.

2.2 The Executive Board discussion of developments in the financial markets

One member observed that the European Central Bank had raised its key rate on the day of the Riksbank's Executive Board meeting in December and that since then the US central bank had raised its key rate. Expectations of future key rates in the US and the euro area had shifted downwards since then. Long-term interest rates had fallen slightly in the United States and the euro area, as well as in Sweden. The krona appreciation that had occurred since December was probably related to changed expectations of future short-term interest differentials. The member considered that there was no reason for any significant change in the view of future financial conditions. The other members agreed with this assessment.

2.3 The Executive Board discussion regarding the Swedish economic outlook and future inflation

One member began by observing that the newly-received statistics indicated that growth in Sweden had been slightly stronger than was assumed in December. According to the December report, GDP growth would continue to rise this year and then slow down somewhat over the coming years. Since then the national accounts figures for Q3 had been published. The new figures indicated that GDP growth had been 3.4 per cent on an annual rate, which was slightly higher than expected. However, the rate of increase between Q2 and Q3 had been only marginally higher than expected. The revision in the national accounts figures showed that developments since 2004 Q4 had been much stronger than the data had previously indicated. This meant that the assessment of the whole year 2005 was adjusted upwards, which would also have consequences for the growth rate in 2006. Both consumption and investment were developing slightly more strongly than was assumed in December. On the other hand, public sector consumption looked slightly weaker. Both exports and imports had continued to develop strongly during 2005 Q3. All in all, the member’s assessment was that growth could be slightly stronger in 2005 and also 2006, than was forecast in the December Report.

The member then went on to comment on developments in the labour market. The employment situation had improved and the number of persons employed had increased slightly more than expected. Indicators such as the number of job vacancies and notices of redundancy implied favourable developments in the labour market. The employment plans expressed in the National Institute of Economic Research’s business tendency survey also provided positive signals, which gave an overall picture of the labour market being stronger now than in December. Productivity growth was also expected to strengthen. All in all, the member said that this provided a similar picture of inflation to that shown in December. Rents were expected to show weaker growth, but this would be counteracted by a higher oil price. The inflation assessment therefore remained essentially the same as in December.

Another member agreed that the situation for the Swedish economy looked good. Seen in a longer-term perspective, growth was good, inflation was low, the current account was showing a large surplus and public sector finances were also showing a surplus. However, unemployment was still high and employment had only just begun to increase. GDP growth had on average been around 3 per cent a year over the past two years and the economy appeared to have come a good way into an economic upswing. Growth was driven by a strong growth in exports, expansionary fiscal and monetary policy and the inherent strength in the economic upswing itself. Inflation had been low over the past two years, although the previous year had shown a tendency towards rising price increases. The inflation forecast of inflation around the target level two to three years ahead appeared reasonable, but it was important to remember that this assumed a stronger krona, a fall in the oil price and rising interest rates in line with market expectations.

One member agreed that growth appeared slightly stronger now than it did in December. The member noted that real interest rates were at a low level, which would reasonably stimulate investment and consumption.

Another member agreed that the labour market looked stronger and that there were clear signals that demand for labour was increasing. Given that wage statistics are both reported with a lag and are preliminary 12 months back, it was difficult to see whether the increase in demand had had any effect on wage formation. So far this did not seem to have been the case. Productivity had remained good during 2005 and, given that the most recent revision and the new data on the number of hours worked were correct, it had been higher than was previously assumed. However, the member found it difficult to understand why the number of hours worked had not increased more, given the increase in employment and the increase in the number of persons working. The increase in the number of persons working was also greater than the increase in employment, as some persons who had previously been on sick leave had now returned to work. Given these developments, the member expressed some doubts as to whether any upward adjustment was necessary in the forecast for productivity growth. There was also a risk that the inflation forecasts had not sufficiently taken into account the indirect effects of energy price increases, said the member.

One member agreed that the Swedish economic outlook appeared to be improving. Various indicators pointed to this, such as investment, exports and imports, which had all shown stronger growth than expected. However, unemployment remained high despite the good growth, and a broader upturn in employment, particularly in the private services sector, would be necessary to change this situation. Although there had been some improvement in the labour market, a rapid upturn was not expected and it was therefore difficult to envisage any inflationary pressure arising from wages. The assessment in the December Inflation Report still stood, but one change since the previous meeting was that the risks for inflation appeared to have shifted from upside to downside, according to the member. It was not unreasonable to imagine even stronger productivity growth or more rapid krona appreciation than had been assumed. The member was of the opinion that a much stronger labour market was needed in the present economic upswing before a distinct inflationary pressure could arise.

Another member summarised the discussion, saying that both new and revised statistics provided a picture of slightly stronger economic activity than was previously assumed and that there was therefore reason for making some upward revision to the forecasts for GDP growth in both 2005 and 2006. The situation on the Swedish labour market appeared to have brightened somewhat, while productivity growth was stronger than estimated, which all in all gave an inflation rate in line with the forecast in the December Inflation Report. Furthermore, the member observed that lending to both the household and corporate sectors had increased at a rapid rate and that the property market was developing strongly.

This development in the financial markets had contributed to an increase in domestic demand and would continue to do so.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented a proposal for the monetary policy decision. Good growth was expected in the Swedish economy over the coming years and capacity utilisation was expected to increase. In addition, the situation in the labour market appeared to have brightened somewhat. This could also mean that inflation would be higher in future. However, productivity had once again risen more than expected, which contributed to subduing domestic cost pressures. The krona had strengthened roughly in line with the assessment in the December Inflation Report. All in all, inflation prospects appeared more or less unchanged from December. Inflation was low and was expected to rise slowly towards the target of 2 per cent, as capacity utilisation increased. At the same time, the real economy was showing balanced growth. This assessment was based on the assumption that the repo rate would be increased in line with expectations in the financial markets. These expectations had increased slightly compared with the interest rate path on which the December forecast was based. Expectations were now disposed towards increases in the repo rate beginning at the start of the year and continuing in gradual stages. Given the information currently available, these expectations appeared fairly reasonable. As before, there was also reason to take into consideration the fact that house prices and household indebtedness were continuing to rise rapidly. The reason was that if this development continued at the same rapid rate there could be a risk of a severe subsidence in growth and employment further ahead. However, the forecast was that debts and house prices would grow at a slow rate when interest rates increased. All in all, this indicated that it was now time to raise the repo rate and the proposal was an increase of 0.25 percentage points.

It was important to be aware that monetary policy would remain expansionary, even after this measure, but that inflation would nevertheless rise only slowly. The current view of the interest rate path would of course be based on the assessments of future economic developments and inflation made at this meeting. The future stance of monetary policy would depend on developments in the economy and how the new information that became available affected future assessments.

All of the members supported the decision to raise the repo rate by 0.25 percentage points.

One member considered that the inflation outlook provided reason to raise the interest rate but that there was also a possibility to wait and see. However, several reasons, including those mentioned above, pointed towards an increase at today's meeting. Still, there were no reasons apparent at present for proceeding at a rapid pace. Future actions would depend on the new information received. The housing market appeared to have reacted to earlier signals, which should lead to changes in expectations and thereby probably have an effect on prices. House prices and household indebtedness should be included in monetary policy assessments to the extent that an adjustment in these could have a negative effect on demand, and thereby inflation, at a later stage. The member also felt that it was difficult to exactly meet the inflation target of 2 per cent. In the short and medium term it was reasonable to assume that inflation could vary within the tolerance interval of 1 to 3 per cent. In addition, it was also important to be clear that the Riksbank also takes into account the real economy, as long as the inflation target is not threatened. Given the slow recovery predicted for the labour market, there was reason to proceed with caution as regards future interest rate increases, said the member.

Another member agreed that there were reasons both for and against raising the repo rate at today's meeting. Inflation had been low for a couple of years, occasionally below the lower limit of the Riksbank's tolerance interval. Capacity utilisation had been relatively low, the rate of productivity increase had been high and wage increases had been moderate. These factors had had an effect in recent years and should continue to do so, which could keep inflation down. However, the forecast was based, as was pointed out earlier, on the oil price falling, the krona appreciating and the key rate increasing. Without these conditions, the inflation forecast would have shown a higher rate of inflation than was the case now. Moreover, it was important to emphasise the uncertainty of the inflation forecasts. This uncertainty entailed difficulties in meeting the target exactly and the variation in the forecasts was also slight in relation to the variation in the outcome. The factors in favour of an interest rate increase included the facts that the present economic upswing had been under way for 2-3 years and that the key rate was very low, which meant that the question was now not if, but when, the interest rate should be raised. The choice of time was largely a question of fine-tuning of stabilisation policy and the importance of raising the interest rate today compared with waiting a month or so should not be exaggerated. The risk of waiting was that larger increases might be needed later. A further reason for raising the rate was the significance of the interest rate differential for the exchange rate. During the period January to November 2005 the krona depreciated by around 10 per cent and such a large depreciation entailed a risk of a significant inflationary impulse. However, since the December meeting, the financial markets' altered expectations of interest rates had led to a stronger krona. Although there was no specific target for the krona, it was nevertheless important to take into consideration the development of the krona when assessing inflation. To summarise, the member felt that the still relatively weak labour market and the expected modest inflation rate indicated that an increase in the repo rate could wait, while the good growth and risk of a weaker exchange rate and the effects of these on inflation indicated that the rate should be increased from its present low level. The overall assessment was thus that the interest rate should be raised by 0.25 percentage points.

A further member emphasised that the present economic outlook meant that the question was when the repo rate should be increased, not whether it should be increased. The time aspect had been discussed intensively at the previous Executive Board meeting in December and the strong growth since then had strengthened the argument in favour of an increase. The inflation forecast supported the proposal to raise the rate by 0.25 percentage points. The member emphasised that the inflation target was the guiding factor. The exchange rate, house prices and household indebtedness were significant to the extent that they affected the possibility of meeting the inflation target in the longer term. An interest rate increase would strengthen the krona, which would contribute to reducing the risk of demand-driven inflation. The minutes from the previous monetary policy meeting seemed to have had that effect already. If an interest rate increase contributed to a slowdown in the rate of increase for house prices and household indebtedness this should be regarded as a bonus. However, it would be an important bonus, as it would reduce the risk of prices and indebtedness growing to levels that were not sustainable in the long term. So far, however, the rate of increase in house prices and borrowing in Sweden were merely average in an international comparison. Moreover, households in Sweden were not merely borrowing – they were also saving to a significant degree.

One member emphasised that the forecast showing inflation in line with the target a couple of years ahead was based on an assumption of a series of not insignificant interest rate increases. At the same time, the inflation forecast, which was based on this interest rate path, was below the target for a large part of the time. The decision-making situation meant that the Executive Board must reach a balance between deviating from the inflation target in the short term and deviating from it in the longer term. House prices were continuing to rise in Sweden, too, although expectations of rising interest rates appeared to have contributed to a slight slowdown. Households were continuing to increase their borrowing and indebtedness was at a high level, although the debt ratio calculated across all households remained at around 4 per cent. If the calculation were instead based only on the households with loans, which the member said was more reasonable, the debt ratio was higher. If house prices were to stagnate or even to begin falling, there could arise a risk of greater deceleration in consumption growth. This could be severe and rapid, or could be a prolonged process over several years. In both cases consumption and demand would slow down, which could in turn lead to inflation being substantially below the target level. If the interest rate were not raised at the present meeting, there was a risk that house prices and household indebtedness would continue to increase at the same rate as before. House prices would thus fall a greater distance when the adjustment had to be made, and the need for adjustment in household debts would also be greater. This would mean that the ensuing slowdown in consumption would be greater, as would the decline in inflation that it would cause. As growth in the Swedish economy was now broad and uncertainty had declined since June 2005 and it would require increases in the repo rate to achieve the inflation target within a normal period of time, it would be reasonable to begin raising the rate now. On the other hand, there were reasons for proceeding with caution. This was partly due to indications from the inflation forecast and partly due to the fact that a rapid, severe adjustment of house prices was not desirable as it could lead to the sharp fall in consumption that one wished to avoid.

Another member observed that there were arguments both for and against the proposal to raise the repo rate by 0.25 percentage points. The current situation and the forecasts indicated stable economic growth both in Sweden and abroad, while productivity and import prices had a subduing effect on inflation. It was therefore important to maintain a longer-term perspective and to remember that macroeconomic developments had been good and stable during the period that inflation targeting had been applied. There was reason to safeguard this, which implied an increase at today's meeting. In addition, the member agreed with the earlier argument, which led to the conclusion that the repo rate should be raised and emphasised that it was important to point out that the inflation forecast was based on the assumption of a gradually rising interest rate. The future stance of monetary policy would as usual depend on new information received regarding economic developments in Sweden and abroad, and the effects these developments might have on Swedish inflation prospects. Finally, there was also reason to continue to take into account developments in the krona, as well as in house prices and household borrowing, given their effects on future inflation. These considerations do not entail any new targets for the Riksbank. The discussion and stance are accommodated within the intellectual framework of flexible inflation targeting that the Riksbank currently applies.

§ 3. Monetary policy decision1

The Chairman noted that the members of the Executive Board were agreed that, with the information available, UND1X inflation was expected to be in line with the target two years ahead if the repo rate were increased gradually.

The Chairman found that there was only one proposal: To raise the repo rate by 0.25 percentage points to 1.75 per cent.

The Executive Board decided

- that the repo rate would be raised to 1.75 per cent and that this decision would apply from Wednesday, 25 January 2006,

- to raise the lending rate by 0.25 percentage points to 2.50 per cent and to raise the deposit rate by 0.25 percentage points to 1 per cent with effect from Wednesday, 25 January 2006,

- that the decision would be announced at 9.30 a.m. on Friday, 20 January 2006, with the motivation and wording contained in Press Release no. 4, 2006 (Annex to the minutes), and

- to publish the minutes of today's meeting on Thursday, 2 February at 9.30 a.m.

This paragraph was confirmed immediately.

Minutes by:

Ann-Christine Högberg

Checked by:

Stefan Ingves, Eva Srejber, Lars Nyberg, Kristina Persson, Irma Rosenberg, Svante Öberg

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