Separate minutes of the Executive Board, No. 12

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DATE: 29 August 2006

TIME: 1 p.m.

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

Johan Gernandt, Vice Chairman of the General Council

Jan Alsterlind (§1)
Claes Berg
Hans Dellmo
Jörgen Eklund
Victoria Ericsson
Kerstin Hallsten
Jesper Hansson
Ann-Christine Högberg
Pernilla Meyersson
Anders Vredin

§ 1. The current inflation assessment

It was noted that Hans Dellmo and Victoria Ericsson 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. 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.

In the euro area, GDP rose by 0.9 per cent from the first to the second quarter, which was higher than the forecast in the June Inflation Report. This upturn was largely explained by an increase in domestic demand. The statistics for August showed that German companies were very optimistic with regard to the current situation, according to surveys by ZEW and IFO. On the other hand, optimism regarding the future had been subdued in recent months. Consumer confidence in Germany rose in July. In the euro area HICP inflation amounted to 2.4 per cent in July. Underlying inflation (excluding unprocessed foods and energy) amounted to 1.6 per cent.

In the United States, GDP rose by 0.6 per cent between the first and second quarters. This was marginally lower than assumed in the latest forecast. The rate of increase for both industrial production and orders of durable goods rose in July. Retail trade increased by around 7.5 per cent in July, compared with the same month one year ago. There had been a slowdown in the housing market. Sales of existing houses had fallen and in July reached their lowest point since the beginning of 2004. The number of existing houses for sale but remaining unsold was around 40 per cent higher in July than a year ago. In recent months the number of persons employed had shown a slower rate of increase and was 1.4 per cent higher in July than one year earlier. Inflation had risen in the past few months. CPI inflation amounted to 4.2 per cent in July, while underlying inflation (excluding volatile food prices and energy) amounted to 2.7 per cent.

New national accounts statistics for other parts of the world show continued strong growth in, for instance, the United Kingdom and China.

In Sweden, GDP increased by 1.4 per cent during the second quarter of this year, compared with the previous quarter, according to the national accounts. This was higher than the forecast in the June Inflation Report. However, the number of hours worked and the number of employees increased at a slower rate during the second quarter than had been expected in the June report, which reflects the fact that productivity growth was much higher than expected. Statistics on new vacancies, unfilled vacancies and redundancy notices indicated that the labour market situation was continuing to improve. The number of persons employed rose by around 0.8 per cent in July, according to labour force surveys. Unemployment fell to 6.0 per cent. The development of industrial production slowed down during the course of the second quarter. The purchasing managers index and business tendency survey confidence indicator rose in July. The National Institute of Economic Research's consumer survey for July indicated that household optimism had increased compared with June, but that it was lower than in April and May.

In July, CPI and UND1X inflation were 1.7 per cent and 1.4 per cent respectively, which in both cases was 0.1 percentage points higher than expected in the June Inflation Report. This deviation was largely explained by unexpectedly high energy prices. Excluding energy prices, the annual rate of change in UND1X stood at 0.7 per cent in July.

The oil price had risen since the previous monetary policy meeting. In July the oil price was around three dollars per barrel higher than had been expected in the Inflation Report. Forward prices had also risen and were currently around three dollars higher than the forecast made in June. However, the oil price had fallen from around 78 dollars per barrel at the beginning of August to around 69 dollars at the time of the meeting.

Long-term interest rates had fallen both abroad and in Sweden since the June Inflation Report. In the United States, the 10-year rate had fallen by approximately 0.4 percentage points to around 4.8 per cent. The decline in the euro area and in Sweden during the same period had only been half as great. The krona had strengthened against the dollar but remained largely unchanged against the euro since the previous monetary policy meeting. All in all, the krona had strengthened more than expected during the summer. Monetary policy expectations in the euro area had shifted upwards, while the reverse had occurred in the United States. In Sweden, pricing in the financial markets indicated that expectations of future interest rate increases had been adjusted upwards in the short term, but remained largely unchanged in the longer term. Implied forward rates were currently at an average of around 0.15 percentage points higher for the coming years than the forecast path used in the previous Inflation Report.

1. The economic outlook and inflation prospects

1.1 The Executive Board discussion regarding the international economic outlook

One member began by recounting the assessment in the June Inflation Report, where it was observed that international growth had been high and stable in recent years and that it could be expected to remain good over the coming years. New information since the previous forecast largely confirmed this picture.

Growth in the United States was marginally weaker than expected during the second quarter. At the same time, the growth figures for the first quarter had been revised upwards. The signs of cooling in the housing market would indicate, however, slightly weaker growth next year than had been estimated in June. The increase in GDP in the euro area had been stronger than expected during the second quarter. From a geographical point of view, growth was broad-based. The new information received otherwise had pointed in slightly different directions, but most indications were that developments would continue to be positive and that growth would be slightly higher than forecast in June. Other parts of the world had all in all shown stronger developments than expected. International economic activity was thus looking slightly more favourable than it had in June.

All of the members agreed on the whole with this description of developments.

Two members considered that there was some risk that the current cooling in the US housing market could lead to weaker growth both in the United States and globally, compared with the assessment in June. One of the members considered that the slowdown in the housing market, together with a high oil price and the fact that the policy rate in the United States had been gradually increased risked leading to a clear slowdown in household consumption. At the same time, the relatively high inflation at present meant that the Federal Reserve had not had the same opportunities to cut its policy rate to stimulate the economy as was possible at the beginning of the 21st century. The member also considered that developments in China were uncertain and another member agreed with this. The uncertainty regarding China was particularly great in the longer term. A more balanced development would entail domestic demand growing at a faster rate in the long term, which in turn would require the building-up of social safety nets and substantial reforms in the financial markets. The member also considered that forward-looking indicators for the euro area showed some uncertainty regarding future growth. There were thus considerable downside risks in the slightly longer term.

Another member felt that the uncertainty factors in the current situation were not new, but had existed for some time. The risks from abroad were currently around the same as at the time of the previous monetary policy meeting. The probability that these risks would be realised was also largely unchanged. At present, the risks from abroad did not affect the forecast or monetary policy to any great extent. On the other hand, if these risks were realised, the situation would be quite different and the forecast for the Swedish economy would need to be revised.

1.2 The Executive Board discussion regarding financial market developments

One member observed that policy rates in several countries had risen since the previous Inflation Report. Pricing in the financial markets indicated that expectations of interest rate increases in Sweden had been adjusted upwards over the summer. Implied forward rates were currently at an average of around 0.15 percentage points higher for the coming years than the forecast made in the previous Inflation Report. The Riksbank's press release in June and the strong national accounts figures were the primary reasons why the repo rate was expected to be higher in future than was predicted in June.

Long-term interest rates had fallen both in Sweden and abroad. This was probably a consequence of the conflict in Lebanon, the threats of terrorism and subdued economic prospects in the United States. The international stock market fall in May and June could also have led to increased demand for safer assets such as long-term bonds.

The member observed that the krona had strengthened more than expected during the summer. This indicated that a minor upward adjustment was necessary to the forecast for the trade-weighted exchange rate (TCW). The large stock market fall in mid-May and June had been checked and share prices had now risen somewhat since the June Inflation Report. Lending to the corporate and household sectors continued to increase at a rapid rate and was more than 10 per cent higher in July than in the same month last year. House prices had also continued to increase at a rapid rate. According to Statistics Sweden's figures for house prices, these were around 12 per cent higher during the period May to July than in the same period last year.

Another member noted that the assessments of the financial markets differed from the assessments made prior to the monetary policy meeting in June. Now the market was expecting a more rapid increase in the policy rate over the coming year than was the case prior to the June meeting. This change was also in line with the opinion expressed by the majority of the Executive Board at the meeting in June.

A third member noted that the strong economic activity was reflected in the banks' profit and loss accounts and balance sheets. Lending to the corporate sector was increasing on a broad front and now also included small and medium-sized companies. Profits were high and loan losses low. With regard to the risks, the member pointed out that the new financial instruments that transferred credit risk from the banks to other institutions around the world, primarily credit derivatives and securitisation, had increased very rapidly in recent years, although they were not commonly used in Sweden. Many European investors bought, for instance, housing loans, as well as car loans and credit card loans that had been packaged in the United States. It might be wondered whether these investors had made a correct assessment of the credit risk they had purchased. When the credit cycle changed direction and loan losses increased, there was a risk that investors who did not naturally manage credit risk in their portfolios would want to sell it, which could give rise to liquidity problems and rapidly falling prices for credit risk instruments. Given the large volumes, it was not possible to disregard the possibility that such a course of events would have real economic consequence for the world market.

One member pointed out that the downturn in long-term interest rates indicated that bond market participants had become more pessimistic with regard to growth prospects. However, the still rising share prices indicated continued optimism. The various participants in the financial markets thus seemed to be making different assessments of future economic developments.

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

One member began by reminding the Board that the assessment for the Swedish economy in the June Inflation Report was that GDP growth would be relatively high over the coming years. The national accounts for the second quarter of 2006 showed that GDP growth had been even stronger than expected. The most positive surprise had come from consumption and investment. Exports had also shown slightly stronger growth than expected and this applied in particular to exports of services. However, both the number of persons employed and the number of hours worked had shown weaker development than expected. This reflected the fact that productivity growth had been unexpectedly strong. Companies had thus been able to increase production without needing to take on so many new employees. The most recent outcome for employment from July had been in line with the forecast, but it was difficult to draw any conclusions from one single result.

The new economic indicators that had come in since June outlined a continued positive picture of economic developments. Most indicators showed that the labour market would improve in future. This indicated that the upturn in productivity was largely temporary. As economic activity continued to improve, the labour market would show stronger development and productivity growth would slow down. All in all, the member's conclusion was that GDP growth in the Swedish economy would probably be higher this year and also next year than had been assumed in June, despite an upward adjustment in expectations of repo rate increases.

Another member considered that a slowdown in productivity growth would be normal in this phase of the business cycle. It was difficult to try to explain an individual quarterly figure. The strong productivity outcome for the second quarter could be temporary. The figure might be revised. It was important not to draw overly far-reaching conclusions from one individual outcome.

A third member pointed out that employment tended to follow production with some time lag. Moreover, production normally varied more than employment. This meant that there could be major changes in productivity between two quarters. The member agreed with the previous member that one should not over-interpret an individual outcome as revisions were often made at a later date. However, there was nothing to indicate that the strong productivity outcome for the second quarter would necessarily be revised downwards.

Preliminary results were often closer to the average development than the final outcome. This meant that the final outcome could be stronger than the preliminary outcome.

Another member agreed that one should not draw overly far-reaching conclusions from a preliminary outcome. The member also observed that although the krona had recently developed more strongly than expected, it was important to remember that the level of the krona exchange rate was still relatively weak. This meant that the krona still had an expansionary effect on the Swedish economy.

One member observed that inflation had risen over the past year. The annual rate of increase in CPI and UND1X was 1.7 per cent and 1.4 per cent respectively in July. This outcome was marginally higher than expected, which was mainly due to unexpectedly high energy prices. This inflationary impulse was to some extent counteracted by lower unit labour costs. Inflation was expected to rise this year and be higher than assumed in the previous forecast. The effects from energy prices were expected to subside at the beginning of 2007, when rising unit labour costs would instead provide an increasing contribution to inflation. Inflation was expected to be in line with the inflation target a couple of years ahead. The member emphasised that these assessments were based on the assumption that the Riksbank would increase the repo rate more quickly than was assumed in the June forecast.

Another member pointed out that given the assumption that the interest rate would develop in line with market expectations, it would take time before inflation reached the target level. Although the situation in the labour market had improved, wage increases were moderate and there had not yet been any clear slowdown in unemployment.

One member pointed out that although there were no reliable statistics on developments in the prices of tenant-owned apartments, there were signs that the market was developing at a calmer pace after the summer, particularly in Stockholm. It was as yet too early to determine whether the rising interest rates had begun to affect demand. Credit volumes to households had continued to increase.

Another member summed up the discussion on prospects for economic activity and inflation by saying that new information indicated unexpectedly strong GDP growth so far this year, particularly in Sweden but also to some extent internationally. This indicated that growth in Sweden would be higher this year and also next year than was anticipated in June. Despite strong GDP growth, the number of hours worked was showing unexpectedly weak development, which was reflected in the fact that productivity growth had been much higher than expected. The upturn in productivity was probably largely due to temporary factors. As economic activity continued to improve, the labour market would show stronger development and productivity growth would slow down. Inflation was also expected to be slightly higher than assumed in the previous forecast. This was mainly due to unexpectedly high energy prices. It was estimated that energy prices would continue to be higher than was forecast in June. This inflationary impulse was to some extent counteracted by lower unit labour costs. During the beginning of 2007 the energy price effects would subside, while rising unit labour costs would contribute increasingly to inflation. Inflation was expected to be in line with the inflation target a couple of years ahead. The member emphasised that this assessment presupposed a gradual increase in the repo rate.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented a proposal for the monetary policy decision.

It was important to remember that the assessment of economic activity and inflation that formed the basis of the Board's decision was based on the assumption that the repo rate would develop according to market expectations. This assessment assumed that the repo rate would be raised gradually. Our own communication in connection with the Inflation Report and the new economic data received during the summer had contributed to an upward adjustment in interest rate expectations, which were now focused on a slightly faster increase in the repo rate, particularly during 2007, than had been forecast in June.

It was primarily changes in three areas that in her opinion had given reason to reflect when a decision was made on the repo rate, namely energy prices, GDP growth and productivity growth.

Rapid increases in energy prices meant that inflation had been higher than the Riksbank's forecast over the summer. The assessment was that the direct effects of higher energy prices on inflation were transitory, but that there was a risk that the effects of energy price increases might have underestimated. Energy prices could continue to rise, and there could be contagion effects that would push up inflation further ahead. The risks would of course increase during a period of strong economic activity.

The high GDP growth in itself indicated that inflation could rise more quickly in future than had been assumed in June. However, the strong productivity growth contributed to holding back cost pressure and the rate of increase in unit labour costs was therefore estimated to be lower this year than was assumed in June. It was more difficult to assess how cost developments would be affected over the coming years and there was considerable uncertainty. Productivity growth could remain strong, which would mean that companies did not need to recruit new employees, that the labour market would remain weak and that cost pressures would be held back. However, there were a number of indications that the labour market had now strengthened and that a more rapid increase in employment would probably contribute to rising cost pressure in future. The overall assessment was therefore that inflation would rise. A couple of years ahead, inflation was expected to be in line with the target, on the assumption that the Riksbank gradually raised the repo rate. This applied to underlying inflation, UND1X, which is adjusted for the direct impact of changes in interest rates and Ms Rosenberg therefore considered most relevant to the monetary policy decision. CPI inflation could exceed 2 per cent at the end of the current year.

Swedish growth thus looked to be higher this year and next year than was estimated in June, but this had not led to any major revision of the inflation outlook. However, there was considerable uncertainty as to how energy prices and productivity growth would affect inflation.

Developments in economic activity and inflation thus indicated that the repo rate should be increased and Ms Rosenberg's suggestion was that it should be raised by 0.25 percentage points at the present meeting. Inflation prospects still looked favourable and there was no reason to proceed at a faster pace. The assessment of the prospects for economic activity and inflation over the coming years indicated that it was reasonable to assume that the repo rate would need to be raised further in future, roughly in line with expectations in the financial markets. However, she considered that developments should show what pace would be appropriate for the increases.

The discussion continued with one member observing that the policy rate was currently too low to achieve stable developments in the long term. It should be raised at a stable and even tempo. The most important and decisive reason why the policy rate should be increased was that inflation could otherwise be too high. The current forecasts indicated that inflation would rise to approximately two per cent a couple of years ahead, on the assumption that the policy rate was raised in accordance with market expectations. The strong real growth also supported the assessment that it was reasonable for monetary policy to become less expansionary. A low policy rate would risk further fuelling an already strong real growth, which could thus reinforce fluctuations in economic activity.

One area where monetary policy at present risked strengthening cyclical fluctuations was in the housing market. House prices and household borrowing had continued to increase at a rapid rate. Both international and Swedish experiences indicated that rapid changes in house prices could lead to substantial fluctuations in private consumption. There was a risk that the current low policy rate would push up consumption to an untenably high level, which could result in a severe slowdown at a later stage.

Another area where there was reason to be observant in future was how resource utilisation developed, particularly in the light of the problems that might arise in future agreement negotiations in the labour market and the effects they might have on inflation in the longer term. The member considered that there was a risk that resource utilisation would rise during the forecast period to a level that was higher than was compatible with the inflation target in the long term. The member supported the proposal to raise the policy rate by 0.25 percentage points at the current meeting. The member envisaged two further increases of 0.25 percentage points during the autumn, on the assumption that the economy developed as expected.

One member agreed with the previous member's description of the situation. Credit growth remained high and house prices were continuing to rise, at a rate that was not sustainable in the long term. A house price rebound could lead to subdued demand further ahead through both household consumption and reduced investment in construction. This type of development could lead in the longer term, beyond the forecast horizon, to an inflation rate below the Riksbank's target. The member also observed that there was a risk that inflation could in the short term be higher than expected as a result of the droughts and torrential rain, which could lead to rising prices for fruit and vegetables as well as electricity. This could in turn affect inflation expectations in a situation where inflation had already begun to rise. All in all, this indicated that less expansionary monetary policy was appropriate and the member supported the proposal to raise the repo rate by 0.25 percentage points.

Another member pointed out that it was the labour market situation that determined inflationary pressures and the inflationary impulses from this direction were still moderate. Productivity was stronger than expected and there was still spare capacity in the economy. Despite this, it was the right decision to raise the repo rate to ensure that inflation would be in line with the target a couple of years ahead. Interest rates were low in relation to growth in the Swedish economy, and also in relation to other countries and from a historical perspective. It was therefore reasonable to continue to tighten monetary policy. On the other hand, it would be inappropriate in this situation to further push up monetary policy expectations. The member supported the proposal to raise the repo rate by 0.25 percentage points.

One member observed that the background to the current monetary policy discussion was that general demand in the economy was growing rapidly, and that growth had been higher than was forecast in the June Inflation Report. Energy prices had also been unexpectedly high. The demand for loans likewise remained high and property prices were rising at a double-digit rate. The monetary conditions remained expansionary. Against this background, the inflation forecast had been revised upwards somewhat. It was also very important to note that the analysis was based on an assumption of a gradually rising repo rate across the forecast horizon. The assessment was that this type of interest rate development would lead to target fulfilment a couple of years ahead. If the repo rate were held unchanged, inflation would soon exceed the target level.

This picture was fairly similar to the picture presented earlier in the year and which had been based on a need to gradually increase the repo rate. Today's decision was a further step in this process. Given this, an interest rate increase of 0.25 percentage points was reasonable. The member considered that, given the forecast made in June and developments since then, the interest rate could also need to be increased in future – without for that reason entailing any commitment as to what future interest rate level would apply. The interest rate level would be determined by the future general economic developments and by inflation prospects.

With regard to the risk outlook for the inflation rate, there were upside risks that arose from energy prices, electricity and oil, including contagion effects in the economy as a whole. There was also a risk that the rate of wage increase would rise in an economy with a very good growth rate and that this would push up inflation. It was important to following the coming wage bargaining rounds. If the upside risks were to materialise, the interest rate could in future need to be increased more than in the interest rate path now envisaged.

The downside risks were largely the same as before, i.e. the risk of a global slowdown following on from a correction of the global imbalances, unrest in the Middle East and a continued unexpectedly high productivity growth as well as international price pressures.

The member noted that the risk outlook did not alter the need to raise the repo rate at the current meeting by the proposed 0.25 percentage points. The market's assessment of future interest rates also appeared reasonable. The member pointed out that the inflation forecast and the general economic developments in themselves warranted an increase in the interest rate. Developments in the credit and property markets pointed in the same direction.

One member summarised the discussion, concluding that all members were agreed that an increase in the repo rate of 0.25 percentage points was the most reasonable decision at present. New information pointed to unexpectedly strong GDP growth so far this year, primarily in Sweden but also to some extent internationally, compared with the June forecast. Inflation was also expected to be slightly higher than assumed in the previous forecast. The fact that household indebtedness and house prices were continuing to rise rapidly supported the picture of strong demand. To ensure that inflation remained close to target and to contribute to the real economy developing in a balanced manner, the monetary policy conducted should gradually become less expansionary. It was reasonable to assume that the repo rate would need to be increased further, roughly in line with market expectations. However, the future stance of monetary policy would as usual depend on new information regarding economic developments in Sweden and abroad, and the effects these developments might have on Swedish inflation prospects. The member observed that the members of the Executive Board were agreed that UND1X inflation at present provided the best picture of underlying inflationary pressures.

§ 3. Monetary policy decision1

The Chairman found that there was only one proposal: To raise the repo rate by 0.25 percentage points to 2.5 per cent.

The Executive Board decided after voting

- that the repo rate would be raised to 2.5 per cent and that this decision would apply from Wednesday, 6 September 2006,
- that the lending rate would be raised to 3.25 per cent and that the deposit rate would be raised to 1.75 per cent, with effect from Wednesday, 6 September 2006,
- that the decision would be announced at 9.30 a.m. on Wednesday, 30 August 2006, with the motivation and wording contained in Press Release no. 32, 2006 (Annex to the minutes), and
- to publish the minutes of today’s meeting on Tuesday, 12 September 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.