Separate minutes of the Executive Board meeting on 22 February

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
Hans Dellmo
Jörgen Eklund
Jyry Hokkanen
Ann-Christine Högberg
Pernilla Meyersson
Annika Svensson
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment
It was noted that Annika Svensson 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. 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 Monetary Policy Department reported on new data received since the Executive Board meeting on 17 February. It was worth noting that the inflation outcome for January had been taken into account in the Inflation Report.

With regard to international developments, industrial indicators (the Philadelphia Fed survey) for the United States had implied continued firm growth in January, while they pointed to a relatively weak development in prices. The minutes of the most recent monetary policy meeting of the Federal Reserve had not had any effect on the financial markets. In the euro area, industrial indicators continued to rise slightly in December and producer prices in Germany continued to increase.

There had been large fluctuations in the oil price. After a downturn, the oil price had once again risen as a result of disruptions in production in Nigeria. However, over the past days, forward contracts had shown largely the same development as outlined in the Inflation Report.

With regard to Sweden, Statistics Sweden had corrected the calculation of underlying domestic inflation for January. The outcome had been revised upwards slightly and was now in line with the December forecast. This meant at the same time that imported inflation showed a larger deviation from the forecast.

There had only been small fluctuations in the fixed income market after relatively major changes in connection with the publication of the inflation outcome for January. Monetary policy expectations in the United States and the euro area remained largely unchanged from December. In Sweden, pricing in the financial markets indicated that expectations of future interest rate increases had been further subdued after a marked decline in connection with the inflation outcome. Implied forward rates were now slightly lower than the path on which the current inflation forecast was based. Pricing in the financial markets indicated that an increase in the repo rate was expected at today's meeting. Surveys showed that 18 out of 19 Swedish analysts were expecting an increase. The krona had weakened slightly against both the dollar and the euro.

2. The economic outlook and inflation prospects

Deputy Governor Irma Rosenberg presented the draft Inflation Report 2006:1, Annex A to the minutes. This Inflation Report reproduces the main features of the presentations and discussions at the Executive Board meetings on 9 and 17 February 2006.

It was observed in the Inflation Report that recent economic statistics indicates continuing good growth both in Sweden and abroad. Although the GDP growth rate had unexpectedly slowed down in both the euro area and the United States towards the end of last year, this was considered a temporary phenomenon. Other indicators of economic activity implied continuing positive developments over the coming period, in the euro area and the United States as well as in the world economy as a whole.

GDP growth in Sweden amounted to more than 3 per cent during 2005 Q3, compared with the corresponding period in 2004. Most indications were that the economy continued to expand at a rapid rate at the end of 2005. Over the coming years, household consumption was expected to grow at a slightly more rapid rate than was forecast in the December Inflation Report, as the labour market situation was expected to improve, and income to grow faster. Corporate investment was also expected to continue rising at a relatively rapid rate. International demand for Swedish goods and services was also expected to grow at a stable rate over the coming years.

The high growth rate had coincided with rapid productivity growth. The strong increase in productivity over the past ten years also appeared to have continued last year. Average productivity growth was now expected to be slightly higher over the coming years than was assessed in the December Inflation Report. All in all, there was reason to expect slightly higher average GDP growth in the Swedish economy than was anticipated in the earlier assessment.

The economic growth of the last few years also appeared to have led to a gradual upturn in the labour market. Employment rose at a slightly faster rate than anticipated at the end of last year. Other labour market indicators also pointed to a continued rise in employment. The rate of wage increase rose slightly last year, from a low level, and was expected to continue rising gently during the forecast period as the demand for labour increased. Capacity utilisation was expected to gradually increase over the coming years, but the continuing high productivity growth would mean that cost pressures rose only moderately.

In January UND1X inflation was 0.9 per cent. CPI inflation was slightly lower, at 0.6 per cent. The outcome for January was lower than the forecast in the December Inflation Report. Prices of imported goods in particular were lower than expected.

Despite the high growth in production and demand, inflation had remained low for a long period of time. This was due to both falling import prices and good domestic productivity growth. Behind these factors was increased competition, both international and domestic. These factors were expected to continue contributing to holding down inflation, although inflation would gradually rise and approach target level a couple of years ahead. The inflation forecast had been revised down slightly in comparison with the December forecast. The low outcome for January had effects on inflation in the short term, but the main factor holding back inflation in the longer term was productivity growth.

All in all, UND1X inflation was expected to rise gradually and to be close to the 2 per cent target a couple of years from now. This forecast was based on, for instance, the assumption of strong growth in Sweden and abroad and of gradual increases in the repo rate.

One member observed in particular that the inflation outcome in January had been taken into account in the inflation forecast, but not the correction of this outcome made by Statistics Sweden and which meant that domestic inflation developed in line with the December forecast while imported inflation was much lower than the forecast. The member emphasised that, taken together, this should not affect the forecast for UND1X, but the analysis might perhaps have led to slightly different forecasts for sub-components if the new distribution had been known earlier.

The Executive Board made the assessment that the new information received since its meeting on 17 February did not give reason for a change in the view of inflation developments, compared with that presented in the Inflation Report.

The Executive Board decided

- to adopt the Inflation Report as presented and
- to publish the Inflation Report at 8 a.m. on 23 February.

§ 2. Monetary policy discussion

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

Growth in Sweden was at a high rate and both domestic demand and exports were expected to develop strongly in coming years. Despite this, inflationary pressure was low. However, the assessment was that inflation would gradually rise as capacity utilisation increased and approach the target a couple of years ahead. The forecast was based on the assumption that the repo rate would be increased by 0.25 percentage points at today's meeting and then gradually continue to rise. The forecasts thus showed that the interest rate needed to be increased over the year to avoid inflation rising too rapidly. The question was how quickly the rate should be increased.

Inflationary pressure had been low for a couple of years and was expected to remain low for a large part of the forecast period. However, this was not due to low demand. Growth had tended to be stronger than forecast in recent years and the forecast for the coming years had also been revised upwards since December. The low inflation rate was instead due to strong domestic productivity growth and weak growth in import prices. Inflation had thus been held down by changes of a supply nature, which had also been more lasting than predicted. The question in such situations was how quickly inflation should be brought back on target.

The Riksbank had in recent years conducted strongly expansionary monetary policy to bring inflation back up towards the target. This, together with the weakening of the krona over the past year, had stimulated the economy substantially. To try to push up inflation more quickly by continuing to conduct strongly expansionary monetary policy in a situation where the economy was already showing strong growth would increase the risks of severe fluctuations in the real economy. The stimulation from monetary policy contributed to household indebtedness and house prices continuing to rise at a rate that was hardly sustainable in the long term. This could lead to a situation in future with a sudden downward adjustment in house prices, which could result in large fluctuations in demand.

All in all, this indicated that monetary policy should be brought in a less expansionary direction. Interest rates needed to rise to prevent inflation from rising too quickly and to ensure it was near target level a couple of years ahead. My proposal is that the repo rate should now be increased by 0.25 percentage points. As before, there were reasons for also taking into account the fact that production and credit volumes were already growing rapidly. An interest rate increase at this point would reduce the risk of severe fluctuations in the real economy later on. At the same time, such a decision would mean, according to the Riksbank's current assessment, that the increases during the rest of the year could perhaps be made at a slightly slower rate than was assumed in the interest rate path on which the inflation forecast was based. This could mean that inflation rose slightly more quickly than in the Inflation Report. The fact that market expectations of coming repo rate increases had been adjusted downwards during the past few days appeared reasonable.

All of the members supported the decision to raise the repo rate by 0.25 percentage points. Similarly, all members shared the view that the increases during the remainder of the year might perhaps be made at a slightly slower rate than was assumed in the interest rate path on which the Inflation Report was based.

One member agreed with the picture painted in the Inflation Report. However, the member emphasised that forecasts were always encumbered with uncertainty and that several scenarios were possible. The real development could be slightly stronger over the coming years than had been assumed in the Inflation Report's main scenario. At the same time, inflation might be slightly lower than expected, at least over the coming year. The picture of low inflationary pressure in the near term was supported by the inflation outcome in January. The member also considered that there was reason to comment in particular the developments in the labour market. The Labour Force Survey for January had been relatively weak, but panel effects meant that these figures should best be analysed in terms of three-month moving averages. When regarded in this way, employment increased during the course of 2005. The number of persons employed during the three-month period November 2005 to January 2006 was just over 60,000 more than in the corresponding period one year earlier, but unemployment remained unchanged. This was not surprising, as it usually took some time before an increase in employment led to a decrease in unemployment. In the member's opinion, the continuing robust GDP growth over the coming years meant it would be reasonable to gradually shift to a more neutral monetary policy and to increase the key rate by 0.25 percentage points at the present meeting would be one step in this direction. The rate of the continued adjustment of monetary policy would depend as usual on the information received, but at present it appeared reasonable that the repo rate could in future be raised at a slightly slower rate than assumed in the Inflation Report. To understand the monetary policy stance, it was necessary to be aware that monetary policy normally has an impact with a slight time lag. Monetary policy was not aimed at the current low inflation rate, but at the expected inflation rate a couple of years ahead. The member pointed out that monetary policy could still be regarded as expansionary, even after increasing the repo rate to 2 per cent.

Another member agreed with the assessment that demand growth might well be even stronger than expected. However, this would not have an impact on inflation until a couple of years from now. The present inflation rate had been pushed down by supply factors, such as low import prices and strong productivity growth. The member considered that there were obvious risks with stimulating domestic demand to compensate for the low imported inflation. This could lead to overheating in the economy further ahead. In addition, both household borrowing and house prices were growing rapidly. If this development continued at the same rate, there was a risk that it could lead to a situation further on with a sudden downward adjustment in house prices. This indicated that inflation should be brought back to the target level fairly cautiously. Little was known as yet of the real effects on consumption and demand of a severe fall in house prices. The member agreed with the proposal to increase the repo rate by 0.25 percentage points and also agreed that recent developments indicated that the repo rate could be increased at a slightly slower rate than in the Inflation Report. However, this depended on future developments confirming the picture of future macro economic developments the Riksbank had now, and which appeared to be shared by financial market agents. The member emphasised that the increase in the repo rate should not be regarded as contractionary monetary policy; on the contrary, monetary policy was still very expansionary. In the current situation, with GDP growth exceeding the long-term sustainable level, it was necessary to raise the repo rate sooner or later. The member considered it reasonable to do so now.

One member considered that low import prices and strong productivity growth, which were an expression of the general improvement in competition over several years both in Sweden and abroad, had contributed to low inflationary pressure. However, it was difficult to judge how long these factors could continue to hold back inflation. On the one hand, there was a positive development abroad and in Sweden, in growth, exports, consumption and the labour market, as well as a large rise in house prices. These factors indicated rising price pressures in future. In addition, monetary conditions were expansionary, with high lending to households and companies, strong money supply growth and historically low real interest rates. On the other hand, there were supply and structural factors that had the opposite effect and subdued price pressures. An overall assessment of the consequences of these factors for inflationary pressure led to the conclusion that increasing the repo rate gradually over the year was reasonable, according to the member. Higher interest rates were necessary for the inflation rate to come close to the target two years from now. Monetary policy would thereby become slightly less expansionary, but the member emphasised that it was not a question of any dramatic change. Careful vigilance should be maintained regarding macro economic developments and inflationary pressures in order to determine at what rate the adjustment of the repo rate should be made. The analyses indicated that the interest rate adjustment perhaps could be made at a slightly slower rate than was assumed in the Inflation Report's main scenario if the repo rate were increased at today's meeting. Such a measure now could be justified, in the member's opinion, out of concern for the stability of the real economy. If monetary policy were too expansionary far into the economic upturn, there would be a greater risk of severe fluctuations in the real economy further ahead.

One member agreed with what had been said earlier and observed that the members appeared to be in greater accord than usual. The conditions for continued robust international economic activity were good. It was particularly important for Sweden that the euro area was now showing signs of picking up. The Nordic countries, Russia and central and eastern Europe had good economic activity, while the United Kingdom appeared to have succeeded with its soft landing. In Japan optimism was spreading; exports were going well thanks to strong growth in China, investment was increasing and households were beginning to be more optimistic.

The member pointed out that the conditions for Swedish growth were better than they had been for a long time. The strong growth in exports had now received assistance from domestic demand, which was encouraged by large company profits and the increase in households' disposable incomes. In addition, both fiscal and monetary policy were expansionary. Private consumption thus appeared likely to show very strong growth. Conditions were therefore ideal for the labour market to continue improving, said the member. The upturn in private consumption should lead to new jobs being created in the services sector. Although Statistics Sweden’s October survey showed some decline in company’s investment plans, the conditions were right for continued good growth in investment.

With regard to Swedish inflation, the member's view was that the initial low capacity utilisation meant that there was only a slight risk of strongly inflationary wage increases. In addition, price pressures abroad were low as a result of the stiffer competition arising from the increasing integration of eastern and western Europe and globalisation in general. An increase in capacity utilisation could mean that domestic prices pressures would increase. All in all, the forecasts indicated that inflation would be close to the target at the end of the forecast period, although it was expected to be below target for most of the forecast period. However, the member considered that the predominant tendency in the world market was for low-cost countries to contribute to low price pressures, but that this trend was at present balanced by the effects of strong economic activity and rising commodity prices. The problem was what might happen in the longer term, when the good global economic activity slowed down. Sweden might then risk entering a period with even lower price increases.

The risks for the world economy remained. Neither the geopolitical risks nor the uncertainty over how the adjustment in global imbalances would be made had declined. The more time that passed before an adjustment in the imbalances, the more troublesome it could prove to be. The uncertainty over how soon the adjustment would come now appeared to be an uncertainty factor, particularly in the slightly longer term. In the immediate future, the risks were perhaps mainly connected to domestic developments in the United States. The developments in house prices in recent years risked causing a setback to the economy. Rising US interest rates could subdue house prices and growth more quickly than had been anticipated and could lead to an abrupt adjustment. All in all, this could have dampening effects on the Swedish economy and inflation. On the other hand, it was possible that the effects of the Swedish economic upturn on inflation were being underestimated. The member supported an increase in the repo rate of 0.25 percentage points and agreed that there might be reason to proceed more slowly with continued increases than had been assumed in the inflation forecast.

Another member noted that the market’s downward revision in expectations of future developments in the repo rate, in relation to expectations of key rates in other parts of the world, could lead to a greater risk that the krona would not appreciate as assumed in the main scenario of the Inflation Report. With a greater expected differential in short-term interest rates in future, there was once again an incentive for market agents to take currency positions that might lead to downward pressure on the krona. The longer the krona remained weak, the greater was the risk of an impact on consumer prices. This risk was further reinforced by the fact that Sweden was in a growth period with ever fewer spare resources. The member supported the risk outlook in the Inflation Report, but said that there was reason to be observant with regard to the future development of the krona.

In addition, the member considered that the expectations of a slower rate of increase in interest rates increased the risk of house prices and household indebtedness continuing to grow at an undiminished pace. This could in turn increase the risk of a rapid downward adjustment when this finally came, perhaps not until some time beyond the forecast horizon. That would have severe repercussions on domestic demand, both via lower consumption and fewer construction investments. Inflation might then be very low, particularly if import prices continued to fall. There were many countries in the world that found themselves in the same situation, with high house prices and a high level of household indebtedness. As the large upturns began at roughly the same time, one could not rule out the possibility that a downward adjustment might occur at the same time. Demand would then risk slowing down in several parts of the world, which would in turn lead to spare capacity and push down producer prices around the world and thereby also Swedish import prices. However, this was a risk that probably lay beyond the forecast horizon.

Another member noted that inflation, according to the Inflation Report, was expected to be low for a large part of the forecast period and to approach the target towards the end of the period. Given this, it was particularly important for the Riksbank to explain to the market agents that the old policy rule for monetary policy was no longer applicable. The assumption of an unchanged repo rate during the forecast period, on which this rule was based, no longer applied. The inflation forecast was now based on the assumption of a gradual increase in the repo rate, as reflected in implied forward rates.

One member observed in summary that there was unanimity among the Executive Board with regard to the main scenario in the Inflation Report and the main features of the risk outlook. The members were also agreed that increasing the repo rate was the most reasonable course of action at present. Growth was robust and expected to remain good during the forecast period. Although inflation was currently low, as capacity utilisation increased, domestic cost pressures were expected to rise in future at the same time as the effects of the supply factors that had contributed to holding back inflation for several years declined somewhat in strength. The assessments in the Inflation Report indicated that there was a need for a gradual increase in the repo rate to prevent inflation from rising too rapidly and to ensure it was close to the target at couple of years ahead. Monetary policy would still be expansionary, even after the increase. Several aspects of the risk outlook had been mentioned in the discussion. Some members had referred to the rapid credit growth and increase in house prices possibly entailing risks with regard to the development of the real economy and inflation in a slightly longer perspective. Some members had pointed out that the speed of the increase in the repo rate could be discussed. As on earlier occasions, the decision on the timing of an increase was affected by both the inflation forecast and the risks connected with the expansion in credit and the stability of the real economy. All members supported the view that the increases during the remainder of the year might possibly be made at a slightly slower rate than was assumed in the interest rate path on which the Inflation Report was based, given the information currently available.

§ 3. Monetary policy decision (1)

The Chairman observed that the members of the Executive Board were agreed that UND1X inflation at present provided the best picture of underlying inflationary pressures.

The Chairman found that there was only one proposal: To raise the repo rate by 0.25 percentage points to 2 per cent.

The Executive Board decided after voting

- that the repo rate would be raised to 2 per cent and that this decision would apply from Wednesday, 1 March 2006,
- to raise the lending rate by 0.25 percentage points to 2.75 per cent and to raise the deposit rate by 0.25 percentage points to 1.25 per cent with effect from Wednesday, 1 March 2006,
- to announce the decision at 8.00 a.m. on Thursday 23 February with the motivation and wording contained in Press Release no. 10 2006 (Annex B to the minutes) and
- to publish the minutes of today’s meeting on Wednesday, 8 March 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