Separate minutes of the Executive Board meeting, No. 4

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DATE: 5 February 2004

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg

Kerstin Alm
Claes Berg
Magnus Georgsson
Kerstin Hallsten
Björn Hasselgren (§§ 2-3)
Jyry Hokkanen (§ 1)
Tomas Lundberg
Pernilla Meyersson
Annika Svensson
Arvid Wallgren
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Annika Svensson and Arvid Wallgren would prepare draft minutes of paragraphs 1 and 2 on the agenda for the meeting.

The discussion was based on the new data and the analyses presented by the Monetary Policy Department. These analyses were based in turn on the assumption that the Riksbank's repo rate would remain unchanged at 2.75 per cent up to an including 2005 Q4.

1. Recent data regarding economic developments

Since the publication of the Inflation Report in December, equity prices had continued to rise, while both Swedish and international long-term interest rates had fallen. Thus, the financial markets were again sending somewhat contradictory signals about economic activity. However, it was possible that the decline in interest rates was partly reflecting a further drop in inflation expectations, both in Sweden and abroad. Moreover, Asian central banks' large-volume purchases of dollar-denominated debt securities may have had an impact on US interest rates. In Sweden, a survey had shown that 19 of 20 money market agents were expecting a repo rate cut of 0.25 percentage points at the day's meeting.

International economic activity had continued to strengthen. In the US, mainly household consumption and housing investment had continued to be unexpectedly positive, although net exports and inventory investment had also been somewhat more robust than expected towards the end of last year. The dollar had continued to weaken. In the euro area, industrial production had improved somewhat during the end of last year. At the same time, the euro had continued to strengthen.

New data on demand and production in Sweden was consistent with the outlook presented in the December Inflation Report. The outcome for the National Accounts in 2003 Q3 was in line with the Riksbank's forecast. Swedish foreign trade had been surprisingly positive, partly indicating good growth in world trade. Retail sales growth was in line with the December forecast, and households' expectations regarding their own finances were somewhat more positive in January. The business tendency survey for 2003 Q4 pointed to an upswing in industry, with rising export orders. The purchasing managers' index also confirmed the picture of a gradual improvement in industrial activity.

At the same time, employment had declined more than expected and the number of new job vacancies was continuing to fall. The rate of wage increases was in line with the December forecast for the private sector, while outcomes in the public sector were somewhat lower than expected. Productivity growth had continued to be surprisingly favourable, and all in all this had resulted in weaker domestic cost pressures than expected. According to the latest inflation data, CPI inflation stood at 1.4 per cent in December and UND1X inflation at 1.7 per cent compared with December 2002. Excluding energy prices, annual CPI and UND1X inflation had risen by 0.6 per cent and 1.2 per cent, respectively. The outcomes were slightly lower than expected.

2. The economic outlook and inflation prospects

2.1 The Executive Board discussion regarding financial market developments and the international economic outlook

One member began by noting that new data had generally confirmed the picture presented in the December Inflation Report. International statistics were showing increasing signs of a recovery in economic activity, as was also being indicated by developments in the financial markets. It appeared that US growth could prove somewhat more robust than expected in December, partly because of the continued weakening of the dollar. Economic activity in Asia, central Europe and eastern Europe also seemed stronger than anticipated by the Executive Board in December. In the euro area, the outlook was still mixed. So far, signs of a turnaround had mainly been evident in indicators of expectations, but were also partly beginning to be reflected in outcomes. At the same time, there was a risk that developments in the euro area would be weaker than expected due to the strengthening of the euro.

Another member pointed to the risks in the US and said that the deficits in the federal budget and current account could necessitate measures as soon as the presidential election was over. Were these to take the form of fiscal tightening, it could affect growth prospects for 2005. If the US government took no measures, there was a risk that interest rates would rise as the substantial federal deficit received increasing attention in the financial markets.

One member pointed out that the imbalances in US firms' balance sheets, which had previously given cause for concern, had decreased quickly. The improved economic activity had increased cash flows and enabled firms to reduce their debt. The member was also of the opinion that the current rise in equity prices and fall in market interest rates did not necessarily send conflicting signals about economic developments, but rather could be a natural result of increased buying pressure in equity and fixed income markets, caused by strong liquidity. From a longer-term perspective, it could also be an indication that inflation expectations had fallen and that the prospective real interest rate thereby had risen.

Another member agreed with this. On the whole, the member also agreed with the initial summary of the international outlook, but saw a risk in underestimating the force of the upswing, now that the recovery appeared generally to have gathered pace. The member was also unsure of the somewhat negative outlook for the euro area, noting that there had been more positive signals from the euro area than implied by the December forecast; for instance, consumption of durable goods and passenger cars had improved. The member also said that world trade was likely to increase more than expected as international freight rates and other indicators of transport costs were very high. Moreover, the high price of oil was a sign of robust demand. The fact that employment was lagging behind could be a normal effect of the economic cycle. The member observed that the euro had indeed risen sharply against the dollar, but that it had regained its falls from recent years and was now roughly back at the levels seen in the mid-1990s. Furthermore, volatility in the fixed income and FX markets was generally low, which was not indicative of any dramatic circumstances.

One member pointed out that there appeared recently to be mainly three countries financing the US current account deficit, namely Japan, China and Taiwan. This was different to before when a large number of private investors had been financing the deficit. The member therefore believed that there was a considerable risk of the dollar weakening further. Another member pointed out that foreign private investors were buying large volumes of US corporate bonds.

One member wondered whether there was reason to revise the outlook for world trade against the background of increasingly stronger signs that it had gathered speed. The member believed that the Riksbank's forecast for world trade growth was perhaps too low in the light of the new signals. Another member contended that, given the international upswing, it wasn't surprising that recent indicators of world trade had been strong. The member believed that the outlook presented in the December Inflation Report still held true. A third member noted that the robust foreign trade statistics for Sweden could be a result of stronger world market growth than expected by the Riksbank in December, rather than Sweden taking larger market shares.

One member summed up the discussion by concluding that the international outlook was essentially unchanged compared with December. New economic data had confirmed a broad-based international upswing. It appeared that growth in the US and in some emerging market economies would be marginally stronger than expected in December, while the outlook was somewhat mixed for the euro area. The growth forecast for euro area GDP could possibly need to be revised down somewhat due to expectations of a stronger euro in the period ahead. International export prices were judged to rise somewhat less in the light of the low outcomes for 2002 and 2003. Moreover, the forecast in the December Inflation Report for the krona's performance in the period ahead remained unchanged, as did that for interest rates.

2.2 The Executive Board discussion regarding the Swedish economic outlook

One member noted that new data were increasingly indicating that economic activity was on the road to improvement in Sweden as well. Export growth at the end of last year was more vigorous than forecast in December, and there could be reason for somewhat greater optimism regarding future developments. However, growth in public consumption in the period ahead could prove slightly weaker than assumed in December, due to the weak public finances. In all, the outlook for demand was essentially the same as in December, and growth was therefore expected to continue to strengthen in the period ahead. However, labour market conditions had been somewhat poorer than expected in December. Labour shortages were small and employment growth weak, which in turn could contribute to a more subdued rate of wage increases than in the December forecast. Moreover, the decline in employment was reflected in better-than-expected productivity growth.

All members agreed with this summary. However, one member observed that if the rise in international economic activity was underestimated, which was relatively common in an economic turnaround, there was also a risk of underestimating the Swedish upswing. One member pointed out that households' expectations of the future were slightly gloomy in December but that this had changed in January.

Another member added that wage outcomes in the public sector had also been lower than expected during the autumn (since September). The member also said that the conditions for a moderate wage bargaining round had seldom been better, but that was not to say that problems could not arise in the negotiations. The member noted that the Riksbank had revised up its productivity forecast during the autumn, and that it was unusual to have such robust productivity growth at the level of economic activity seen in the past year. Even if the reasons for this were unknown, it was reasonable to attach some value to the new figures when forecasting inflation in the period ahead.

One member said that a structural improvement in productivity entailed better prospects for firms' profit margins, which would bolster a pickup in investment. It also entailed improved conditions for households, which could expect higher future rises in income. This could be one reason that demand in the household sector had held up relatively well and that indebtedness remained high. The previous member agreed that the employed could expect higher wages in the near future, but added that the vigorous productivity growth could curb demand if it were to result in an increase in employment being postponed.

2.3 The Executive Board discussion regarding inflation prospects

One member commented on the new price data, observing that domestic inflation had fallen somewhat more than expected. In the period ahead, the rate of wage increases could be slightly lower than anticipated, while productivity growth could be more positive. Moreover, revised statistics indicated somewhat lower international price pressures. In all, this gave cause for a downward adjustment in the inflation forecast of one or a few tenths of one per cent for all measures of inflation over the entire forecast horizon compared with the December Inflation Report.

The other members agreed essentially with this description although one member expressed some hesitation regarding a lower forecast. Internationally, prices in early stages of the production process had ceased to fall and instead had begun to rise or at least stabilise, according to the member, which was not very surprising against the backdrop of increased production and demand as well as rising commodity prices. Thus, the question was how long it would take for this to filter through to consumer prices and by how much. In addition, there was a risk that the price of oil would remain higher than expected in the period ahead. The Riksbank's forecast was lower than that of most other forecasters, said the member. Supply could not be expected to increase that much and demand was strong in the wake of the economic upswing.

Another member agreed that the forecast for the price of oil may need to be revised up compared with the December Inflation Report, given a more firmly rooted upswing over the forecast period. At the same time it was important to monitor international price pressures from manufactured goods in the period ahead, in order to see whether these pressures would rise as expected. It was difficult to know today the extent to which the weak price developments in recent years had been caused by slacker economic activity. The developments seen so far could also, at least in part, be a result of structural changes in the world economy. The member also observed that rent negotiations were so far indicating that rent increases in 2004 would be roughly as expected, which meant that the risk of rising inflation had diminished.

§ 2. Monetary policy discussion

1. Account of the monetary policy group's view of the monetary policy situation[1]

Deputy Governor Irma Rosenberg presented the monetary policy group's view of the monetary policy situation. The group concluded that developments in the real economy had been roughly as expected. It also appeared that the economic upswing that the Riksbank expected, and which had been postponed on several occasions, was now materialising. However, inflationary pressures were anticipated to be somewhat lower, which meant that the forecast of inflation one to two years ahead was now judged to be slightly below target. In light of this, a majority of the group members saw reason to cut the repo rate by 0.25 percentage points. There had been a discussion as to which measure of inflation best mirrored the underlying, cyclical rate of inflation, and the conclusion was that it was still UND1X excluding energy.

2. The Executive Board discussion

One member expressed support for the monetary policy group's view that the inflation assessment gave cause for a repo rate cut of 0.25 percentage points. However, the member

[1] The monetary policy group is made up of Riksbank staff and is headed by Deputy Governor Irma Rosenberg. The main features of the group's discussion are presented at the Board meeting. The opinions expressed in the minutes are not necessarily shared by all the members of the group.

believed that from the point of view of economic activity it was less important now to cut the repo rate than in December. To speed up the recovery or improve the weak labour market, a larger cut than 0.25 percentage points was necessary, said the member. Were the Bank to implement a bigger cut in accordance with demands from external sources and with a view to achieving exactly this, it would, according to the member, entail a change in strategy by the Riksbank to a more discretionary and growth-focused approach than before, similar to the US Federal Reserve. This would entail a risk to the confidence in the Riksbank. The Riksbank had so far demonstrated a high degree of interest rate smoothing in its monetary policy, and it was appropriate to continue with this, said the member.

Another member would have liked to see a cut in October or December as data at the time justified such a move. Since then, domestic price pressures and import prices had been lower than expected, and there was reason to believe that this would continue. According to the member, the low import prices and high productivity were explained by structural factors that could persist in the upswing that now appeared to be on the way. Structural changes were occurring at global level, partly characterised by the transfer of production to low-wage countries in South-East Asia, but also by the increasing integration of eastern Europe with the EU. This would have implications for the labour market, productivity and prices in Sweden and could enable key interest rates to be kept low, even during an upswing. Thus, the member believed that the current inflation forecast allowed scope for a repo rate cut of 0.50 percentage points. The member did not agree that a cut of this size would imply a more discretionary approach and a change in strategy by the Riksbank. On the contrary, the Riksbank had a duty not to have higher key interest rates than justified by price pressures.

A third member shared the monetary policy group's view and said that not much had happened in the real economy since the publication of the Inflation Report. However, inflation was expected to be somewhat weaker than in the December forecast. According to the member, this meant that even small increases in nominal wages could raise real wages, which ought to facilitate a wage agreement that would not fuel inflation. In addition, current productivity growth meant that the Swedish economy should be able to accommodate the rise in activity for a longer period without hitting its capacity ceiling and thereby driving up inflation. Moreover, the risk of contagion from electricity prices appeared lower now. The member believed that all of these factors allowed room at present for somewhat looser monetary policy. At the same time, the Swedish economy was two months closer to the upswing that was becoming increasingly evident and that gradually would give cause for a rise in the repo rate. However, it did not appear as though the upswing would be so robust and fast that it would speak against an easier monetary policy at present.

The member also underlined that it was important to be vigilant regarding developments in households' debt burden. The ratio of debt to income was now approaching the levels observed before the crisis at the beginning of the 1990s and the increase appeared to be continuing. At the same time, low interest rates had made it possible to bear the debt. Households' increased propensity to borrow could be a natural result of the change to a low-inflation economy, which was also associated with expectations of permanently low interest rates. However, it was not really known how households would react once interest rates rose again after a long period when the debt burden had increased gradually, said the member. In Sweden, the majority of mortgages were variable-rate loans. It was quite possible that households viewed their interest costs in their monthly budgets without taking full consideration of the fact that these could increase markedly in the event of a rise in interest rates. If this were the case, it was likely that households would be forced to curtail their consumption more than planned. But this also depended, of course, on developments in incomes and wealth.

Another member pointed out that the Executive Board, in its conduct of monetary policy, was supposed to focus on inflation prospects mainly one to two years ahead, and that presently this did not advocate a repo rate cut of 0.50 percentage points but rather a cut of 0.25 percentage points. The external debate on monetary policy had partly concentrated on the weak labour market. But monetary policy could not have more than a very marginal effect on the labour market in the short term. Thus, the fact that employment growth was currently weak did not in itself constitute an argument in favour of a larger cut. Firstly, it took time for a rate cut to have an impact on demand, and, secondly, employment was affected with a lag in the economic cycle. But were the labour market to remain weak for a longer period than expected, it could prove significant for the Riksbank's inflation forecast.

One member objected in part to this line of reasoning and said that the forecast in the Inflation Report together with the data that had been received thereafter did not suggest that a cut of 0.50 percentage points would be excessive.

The next member observed that Sweden was following the international economic upswing and said that households' increased indebtedness could be due to positive expectations about the future. The member also noted that the downturn had been mild and not as dramatic as the public debate sometimes suggested. Growth last year was favourable from a European point of view and was also judged to be so in the period ahead when it would be in line with or slightly above its potential, said the member. Inflation had been moderate, even if somewhat below target recently. Hopefully, labour market conditions would lead to wage outcomes that would not disrupt the inflation outlook, but it was uncertain whether this would be the case as the wage bargaining round was still in progress. Like a previous member, the member noted that the Swedish economy was getting further into an upswing and therefore the time of a future rate hike was also coming closer. However, the member agreed that the current inflation forecast allowed a repo rate cut of 0.25 percentage points.

Another member essentially agreed with the previous member. The assessment of economic activity in the period ahead was rather bright, but inflation had been somewhat weaker than expected and was forecast to be below target throughout the coming two years. There were therefore arguments in favour of cutting the repo rate by 0.25 percentage points. The member also pointed out that even if the impression was that the economic upswing had taken root, which gradually would entail a rate hike, there were many factors currently indicating that the upswing could be protracted, and there also remained uncertainty as to whether it would be sustainable. The member also shared another member's view that there was cause for vigilance regarding households' debt burden, which could entail a risk to developments in the period ahead, for instance if interest rates were to rise markedly without economic activity strengthening.

§ 3. Monetary policy decision[2]

The Chairman summarised the monetary policy discussion under § 2 and noted that the members of the Executive Board were in agreement that UND1X inflation excluding energy still provided the best picture of underlying, cyclically-related inflationary pressures. It was therefore natural that monetary policy should be guided to a large extent by this measure.

The Chairman found that there were two proposals: to lower the repo rate by 0.25 percentage points to 2.50 per cent and to lower the repo rate by 0.50 percentage points to 2.25 per cent.

The Executive Board decided

- to lower the repo rate by 0.25 percentage points to 2.50 per cent and that this decision would apply from Wednesday, 11 February 2004,
- to lower the lending rate by 0.25 percentage points to 3.25 per cent and to lower the deposit rate by 0.25 percentage points to 1.75 per cent with effect from Wednesday, 11 February 2004,
- that the decision would be announced at 9.30 a.m. on Friday, 6 February 2004, with the motivation and wording contained in Press Release no. 6, 2004 (Annex to the minutes) and
- to publish the minutes of today's meeting on Thursday, 19 February 2004.

Deputy Governor Kristina Persson entered a reservation against the decision to lower the repo rate by 0.25 percentage points. She recommended instead that the repo rate be cut by 0.50 percentage points with reference to the fact that the inflation forecast in December had already pointed to room for a rate cut and that developments thereafter were indicating even weaker price pressures, partly because productivity growth had continued to improve. Employment growth had been weak and Mrs Persson saw reason to believe that it would take time before the economic upswing resulted in a marked improvement in labour market conditions and thereby to greater upward pressure on wage costs.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

Lars Heikensten	Eva Srejber	Villy Bergström
Lars Nyberg	Kristina Persson	Irma Rosenberg

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