Separate minutes of the Executive Board meeting, No. 12

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DATE: 27 May 2004
TIME: 1 p.m.

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

Kerstin Alm
Jan Bergqvist, Chairman of the General Council
Jörgen Eklund
Johan Gernandt, Vice Chairman of the General Council
Kurt Gustavsson (§1)
Kerstin Hallsten
Björn Hasselgren
Jyry Hokkanen (§1)
Leif Jacobsson
Cecilia Roos-Isaksson
Annika Svensson
Åsa Sydén
Staffan Viotti
Anders Vredin
Helena Öström (§1)

§ 1. The current inflation assessment

It was noted that Cecilia Roos-Isaksson and Annika Svensson would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

1. Recent data regarding economic developments

The Monetary Policy Department reported on new data received since the final date for inclusion in the Inflation Report, 17 May.

Developments in the financial markets had been marked by uncertainty in the past two weeks, which had resulted in price fluctuations. The focus of attention had been the high oil price and its effects on inflation, economic growth and central banks' actions. Expectations of what effects the recently high oil price would have differed between various market participants. Some believed that the impact on inflation was the dominant factor and that key interest rates would be raised by more and at a faster rate than was reflected in current market prices, while others were of the opinion that the negative effects on private consumption and economic growth had the greater influence, which instead could mean that central banks did not need to raise key interest rates as much as indicated by forward prices.

In both the United States and Sweden, long-term interest rates had dropped somewhat in recent weeks. This was attributable to the high oil price and geopolitical concerns, which had also contributed to the dollar weakening somewhat against the euro and the krona. In the United States, lower inflation than expected by market participants, as well as a slight deterioration in consumer confidence, had also affected interest rates. In Sweden, the release of the minutes from the previous monetary policy meeting, and the speeches that had been given by some Executive Board members, also appeared to have had some impact on interest rates, as did the discussion regarding transfers from the AP funds to the central government budget.

Despite favourable earnings growth and a rise in sales in Q1 for listed companies in the United States and Sweden, equity prices had fluctuated sharply since the time of the Inflation Report. This pointed to increased uncertainty over future developments. The year's rise in equity prices had been wiped out on many exchanges abroad, but the Swedish and Japanese markets were among the few that had recorded a positive performance.

According to both market analysts and market prices, the US Federal Reserve was expected to begin to raise its key interest rate in the summer. In Europe, forward interest rates were indicating a first hike of the ECB's refi rate in November. In Sweden, the Riksbank was expected to leave the repo rate unchanged at the day's monetary policy meeting. Surveys had shown that a majority of market participants were expecting a first rise in the repo rate in Q4 this year; similarly, implied forward interest rates were pointing to a first hike towards the end of the year.

The statistics that had been received since 17 May had largely been in line with the assessment in the Inflation Report. New data from the US manufacturing industry suggested a continuation of benign growth, even though the outcomes in May were somewhat lower than expected by market participants. US consumers' expectations regarding both the current and future economic situation were stable, and consumer confidence was unchanged in May compared with the previous month. In Germany, economic indicators were mixed. In Japan, GDP had now risen sharply for two consecutive quarters and private consumption had picked up.

In Sweden, there had been a comparatively large rise in April in the number of employed. However, seen in a three-month perspective, developments were in line with the assessment in the Inflation Report. Developments in unemployment had also been consistent with the forecast in the Inflation Report.

The May business tendency survey of the National Institute of Economic Research suggested that manufacturing activity had strengthened somewhat further, mainly due to robust net exports. Net trade data in April indicated that exports of goods had continued to increase strongly, while imports of goods remained weak. New orders from abroad had risen sharply, while new orders in the domestic market showed a more modest increase. The tendency towards a strengthening of construction activity, as shown by the quarterly business tendency survey, was continuing.

In May, Swedish households again became somewhat less optimistic about the economic situation. Their expectations regarding both their own finances and the Swedish economy in a twelve-month perspective had turned less positive since the previous month. Expectations of inflation 12 months ahead had risen 0.5 percentage points since April, to 2.2 per cent in May.

2. The economic outlook and inflation prospects

Deputy Governor Irma Rosenberg presented the Inflation Report 2004:2 *(*Annex A to the minutes*)*. The Inflation Report reproduced the main features of the presentations and discussions at the Executive Board meetings on 13 and 19 May.

According to the Inflation Report, real economic developments abroad pointed to a broad-based economic upswing. The recovery in the United States and the euro area had advanced as expected in the previous Inflation Report. In Asia, as well as in central and eastern Europe, growth appeared to be somewhat stronger than previously assumed. All in all, the Riksbank forecast GDP growth in the OECD area to average around 3 per cent over the coming three years, which was in line with the assessment in the previous Inflation Report and at the most recent monetary policy meeting at the end of April. Financial market players had gradually brought forward the time at which they expect key interest rates, particularly in the United States, to begin to be raised. This had contributed to a global rise in market interest rates.

On the whole, the recovery in the Swedish economy had progressed largely as anticipated in the previous Inflation Report. New data suggested that net exports would be unexpectedly robust this year. However, the pickup in investment had been postponed somewhat. The labour market had been somewhat weaker than expected. Compared with the previous Inflation Report, GDP growth in the period ahead was expected to be somewhat stronger, partly owing to the most recent repo rate cut of 0.5 percentage points. All in all, GDP growth in the coming years was forecast to average just less than 3 per cent a year. The assessment coincided largely with that which formed the basis of the latest monetary policy decision in April.

As expected, inflation dropped sharply last year and at the beginning of 2004. The fall in the inflation rate was broken in March, when a slight rise was noted. While inflation was expected to rebound, the rise proved unexpectedly sharp mainly as a result of import prices, including the price of oil, increasing more than previously assumed.

Inflation was expected to increase in the period ahead as resource utilisation picked up in Sweden and abroad. Compared with the previous Inflation Report, faster GDP growth over the forecast period motivated an upward revision of the inflation forecast. However, due to a continuation of relatively weak labour market conditions and a favourable cost situation, the rise in inflation was forecast to be comparatively moderate.

One special circumstance on this forecast occasion was that Statistics Sweden had decided to change the way it calculates the inflation rate as from January 2005. According to estimates, the rate of inflation as measured according to the new method was expected to average 0.2 percentage points lower per year than with the current method. The forecasts of inflation from January 2005 onwards referred to the new definition.

As in the previous Inflation Report the overall assessment was that the risks of inflation being higher than in the main scenario outweighed somewhat the risks of it being lower. The risk of a faster inflation rate was above all associated with domestic and international economic developments. The main risk stemmed from underestimating the strength of the recovery and its effect on inflation. In addition, the uncertainty regarding the price of oil had increased recently. At the same time, uncertainty remained over productivity growth and international price pressures, which had recently had a dampening effect on inflation.

Taking into account the risk spectrum and the new measurement method, CPI inflation was expected to be 1.1 per cent one year ahead and 2.3 per cent two years ahead. The corresponding forecasts for UND1X inflation were 1.1 per cent and 1.8 per cent, respectively.

The Executive Board's assessment was that the new information received since the final date for inclusion in the Inflation Report, 17 May, did not warrant any change in the outlook for inflation.

The Executive Board decided

- to adopt the Inflation Report presented, and
- to publish the Inflation Report on 28 May 2004 at 9.30 a.m.

This paragraph was confirmed immediately.

§ 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 agreed that the repo rate should be left unchanged. Several factors in the inflation outlook supported this. Economic activity was strengthening

[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 members of the group.

as expected. Due to the repo rate cut of 0.5 percentage points in March, there was now reason to expect somewhat more robust economic activity in Sweden in the period ahead compared with the previous Inflation Report. The slightly higher economic growth over the forecast period advocated an upward revision of the inflation forecast. However, one particular factor to take into account in this assessment was the changes in method that Statistics Sweden had decided to adopt as from January 2005. It was reasonable to allow the effects of such a technical change to have a gradual impact on monetary policy.

Thus, against the background of the inflation forecasts that were presented in the Inflation Report, the monetary policy group recommended an unchanged repo rate.

2. The Executive Board discussion

One member observed that conditions were currently favourable in Sweden, with a fast rate of growth relative to the rest of the world and low inflation. However, the member pointed out that the very low inflation at present was highly due to a technical circumstance, as it could be seen as a consequence of the high inflation of one year ago, which in turn was attributable to developments in energy prices. The inflationary tendency in the economy had most likely not changed to any significant extent. At the same time, it was evident that there wasn't any substantial risk of inflationary pressures from the labour market in the near future, since the centralised wage agreements had resulted in acceptable wage increases and there weren't any signs of problematic wage drift. Moreover, an expected strong krona exchange rate should dampen inflation via import prices. According to the member, a continued gradual appreciation of the krona was to be expected in the somewhat longer term, against the background of repeated current account surpluses and the reduction of Sweden's foreign debt. However, the member stressed that developments in property prices were a cause for concern, notably the price rises for houses and also for leisure homes. The situation did not constitute a serious threat at present, but should be monitored carefully so that excessively inflated prices were observed in time. Furthermore, according to the member, the Riksbank had some responsibility to ensure that property prices were not driven higher. The member supported the monetary policy group's proposal to leave the repo rate unchanged.

Another member agreed that the repo rate should be left unchanged. The uncertainty that previously surrounded the strength of the economic upswing had gradually diminished with recent data releases from the United States, Japan and Sweden. The impact on the financial markets proved less serious than many had feared when the US Federal Reserve began to signal less expansionary monetary policy and Japan stopped supporting its own currency. However, the uncertainty surrounding the oil price had increased, especially in the light of the fact that terrorist threats appeared more tangible compared with the beginning of spring. Nevertheless, the member regarded the inflation forecast in the Inflation Report to be well-founded. There were no clear signs that bottlenecks, e.g. in the labour market, would change this picture.

In addition, the member stressed the importance of communicating that the repo rate would eventually be raised so that households would avoid being surprised and could prepare themselves in time for rising interest costs. However, the timing of the rate hike depended of course on new data. The member observed that this message appeared to have been taken in given recent reactions in the market. In addition, the member pointed out that, according to the Financial Stability Report that would be published on 2 June, it was mainly households that had financial and real assets, as well high incomes, that were substantially indebted, which suggested that these households had margins to cope with a rise in interest rates. In other words, there was no danger to the stability of the financial system even in the event of sharp rises in rates.

Yet another member supported the monetary policy group's proposal to leave the repo rate unchanged. Underlying inflation was low and could very conceivably remain so for a time to come. Like a previous member, the member believed that there were many factors contributing to this, including the currently relatively low resource utilisation, the normalisation of electricity prices, a stronger krona exchange rate, and China's and India's entry into global trade, partly on the strength of their cheap labour. All in all, this suggested that prices would be restrained in spite of the fact that so many factors now indicated a stable economic upswing. At the same time, it could not be ruled out that the upswing would be short-lived; there were elements in the global outlook that could give rise to a so-called boom-and-bust scenario in the years ahead, with vigorous growth in the current year, rising asset prices and accelerating inflation, which could turn into a sharp decline in the event that interest rates were to rise faster than expected. Such a situation could be aggravated by the US budget deficit developing worse than expected due in part to the costs of the Iraq occupation. Speaking against this scenario, however, was an incipient rise in activity in the euro area and Japan. According to the member, the important thing now was to, despite increasing activity, rising inflation and high oil prices, retain a long-term perspective and not over-react; most factors suggested that it could be a while before rises in interest rates in Sweden would become necessary.

Another member also agreed that the repo rate should be left unchanged on this occasion. Looking at the global situation it was evident that economic growth was increasing, and it was forecast to be the highest in 15-20 years. Also in the euro area, there were now clearer signs of recovery. At the same time, economic policies in many countries continued to be highly expansionary. It remained to be seen how this situation would unwind in a satisfactory way. There was a risk that inflation, in a couple of years, could surprise more on the upside than expected in the current risk spectrum. For example, according to the purchasing managers' index, the rise in the prices of goods purchased by US manufacturing firms was at its highest level in over 20 years. At the same time, unutilised resources in manufacturing were quickly diminishing as a result of increased demand, and it appeared only to be in the United States that there was any significant amount of unutilised resources. This should result in international price pressures on the upside that could spread in the value-added chain out to customers and then affect import prices in Sweden.

The member pointed out that rises in commodity prices, except for oil, had been subdued somewhat. The member did not express any divergent view of the main scenario for oil price developments compared with that in the Inflation Report, but underlined the risks that the oil price could remain elevated for some time. The predicted rise in demand was expected to approximately match the possible increase in supply in the short term. This meant that prices in the oil market would be sensitive to new information. As a result, it was likely that the oil price during the summer would not be much lower than at present. In the autumn, demand for oil was expected to continue to mount owing to both a build-up of inventories, in preparation for heating requirements in the winter in the northern hemisphere, and the continued global economic recovery. The member also pointed out that the recent increase in demand for oil was not only driven by the Asian countries but also by the countries in the OECD area.

One member wondered whether the supply of oil had become lower than expected due to large declines in conjunction with sabotage in Iraq. Another member said that it was not a question of a drop in supply today, but rather reflected concern over supply shocks in the period ahead as a result, for example, of terrorist attacks. This had led to speculation with substantial price effects.

One member resumed, observing that Sweden was being pulled along in the international economic upswing, underpinned by expansionary domestic economic policy. The labour market had displayed signs that it was stabilising. At the same time, households had continued to accumulate debt, and the propensity to consume was favourable. House prices were also continuing to rise firmly. Firms had stopped reducing their bank borrowing and were judged to be well-prepared to invest. As the normal forecast horizon proceeded, the inflation forecast would pass the target of 2 per cent in the absence of any new developments. Although domestic inflation had been dampened more by higher productivity and poorer labour market conditions than the Riksbank expected last autumn, the unexpectedly low inflation was mainly due to surprisingly weak developments in import prices. There was a risk that import prices, with the high expected growth abroad, could surprise on the upside. The member agreed with a previous member that the developments in household debt and in house prices did not pose a problem to the stability of the payment system. Were households - owing to the benign interest rate situation, increased optimism and rising property prices - to increase their debt above what they consider to be desirable in the long term, less expansionary economic policy and a stabilisation of property prices could, however, later on prompt households to reduce their debt. This in turn could have a markedly negative impact on their propensity to consume and thereby also on demand in the economy with attendant lower growth and inflation. Nevertheless, the member did not see any need to adjust the repo rate on this occasion.

Yet another member supported a previous member’s view that developments in the property market and in household debt did not constitute a problem for the stability of the payment system. It appeared that the situation in the property market could be explained satisfactorily by fundamental factors such as household incomes, population developments and interest rates. Households’ debt ratio was indeed high but their interest burden was relatively low at present. This member also pointed to the not yet published Financial Stability Report and the fact that those households that had substantial debt also had healthy margins. The member was therefore not concerned at present that property prices were so strongly elevated, or that household debt was so high, that there were risks of considerable negative effects on the real economy later on.

Another member believed that there nevertheless was reason for concern over the effects of increased household debt if property prices were to continue to rise and there was then a shift in sentiment due to interest rate hikes. Households may then have to adapt their demand in such a way that would hamper growth undesirably. The effects were partly dependent on whether households had chosen variable- or fixed-rate loans. The member also pointed out that there was no cause for concern regarding the stability of the financial system since the household sector was seldom able to cause the banks substantial losses.

One member observed that the situation in the property market differed from that in the 1990s. It was difficult to trace clearly speculative tendencies; rather there was a kind of healthy restraint. As an example of this, the member pointed to a number of properties in different parts of the country that had proven difficult to sell. Like a previous member, the member believed that much of the developments in the property market could essentially be attributed to fundamentals. As regards investment, the member pointed out that there were no indications that it was being curbed by an inadequate supply of bank credit. In general, firms also had stronger balance sheets and ample liquidity.

Thereafter, another member described the present decision-making situation. Initially, it was observed that UND1X inflation currently was judged to provide the best picture of underlying, cyclical inflationary pressures and that monetary policy should therefore be based on this measure.

In addition, the member noted that all the members had expressed greater certainty over the recovery both in Sweden and abroad and that there were factors, such as the rise in long-term interest rates, that supported expectations of more robust growth and higher inflation. At the same time, the Swedish labour market, for example, was showing no signs of bottlenecks and the negotiated wage increases appeared reasonable from an inflationary perspective. Moreover, the member was of the opinion that the concern over the inflationary effects of oil price developments was probably exaggerated. Essentially, this was because there was considerable confidence in the West in low-inflation policies. In addition, the member said that developments in productivity were as usual of crucial importance for inflation in the period ahead, but it was still uncertain to what extent the recently high productivity growth would last. The member also agreed with a previous member that global price pressures, which were affected by the integration of countries such as India and China into the world economy, could have considerable, albeit transitory, effects on inflation. According to the member, there were evidently many different sources of uncertainty. However, the risk-adjusted forecast that the Executive Board had adopted was intended to incorporate these.

Finally, the member observed that the risk-adjusted forecast for UND1X inflation two years ahead was 1.8 per cent. This could possibly have been put forward as an argument to cut the repo rate at present. However, that inflation was forecast to be below target was on this occasion strongly due to the change in method for measuring inflation that Statistics Sweden had decided to implement. It was reasonable that such a technical change would not have a quick impact on monetary policy, but that the consequences would be dealt with more gradually. Furthermore, we were further into an economic upswing. This was not necessarily a reason against cutting the repo rate, which was sometimes the impression given in the general debate, since it was inflation that was the focus of monetary policy. But at the current juncture, when the economic upswing was evident and had been under way for some time, at the same time as international interest rates had turned markedly higher, it was uncertain that an additional rate cut would have the desirable effects. The member did not envisage any problems by leaving the repo rate unchanged in the present situation. Although it was likely, as things stand today, that the next rate adjustment would be a rise, the member believed that it was hardly meaningful to speculate about this. The crucial factor for when the repo rate would be changed was how Swedish inflation prospects developed in the period ahead. The Riksbank's current view of this was evident in the forecasts in the Inflation Report.

§ 3. Monetary policy decision[2]

The Chairman noted that the members of the Executive Board agreed that UND1X inflation at present provided the best picture of underlying, cyclical inflationary pressures and that it was therefore natural that monetary policy be guided primarily by this measure of inflation.

The Chairman summarised the monetary policy discussion under § 2 and found there was a proposal to leave the repo rate unchanged.

The Executive Board decided

- that the repo rate be left unchanged at 2 per cent and that this decision would apply from Wednesday, 2 June 2004,
- that the lending rate be left unchanged at 2.75 per cent, and that the deposit rate be left unchanged at 1.25 per cent, with effect from Wednesday, 2 June 2004,
- that the decision would be announced at 9.30 a.m. on Friday, 28 May 2004, with the motivation and wording contained in Press Release no. 33 (Annex B to the minutes), and
- to publish the minutes of today's meeting on Friday, 11 June 2004.

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.