Separate minutes of the Executive Board meeting, No. 14:2

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

DATE: 23 June 2004

TIME: 1 p.m.

PRESENT:

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

Jan Bergqvist, Chairman of the General Council
Johan Gernandt, Vice Chairman of the General Council (§ 2)

Kerstin Alm
Claes Berg
Jörgen Eklund
Mats Galvenius
Kerstin Hallsten
Leif Jacobsson
Per Jansson
Pernilla Meyersson (§ 1)
Cecilia Roos Isaksson
Lars Svensson
Åsa Sydén
Arvid Wallgren
Ulrika Wienecke
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Arvid Wallgren and Ulrika Wienecke would prepare draft minutes of paragraphs 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 were based in turn on the assumption that the repo rate would remain unchanged at 2.0 per cent up to and including 2006 Q2.

1. Recent data regarding economic developments

New macroeconomic data had not affected the markets to any significant extent despite, for example, a record-high deficit in the US current account in May. The yield on the Swedish 10-year government bond had risen 0.03 percentage points since the publication of the Inflation Report on 28 May, while the krona had weakened by just over a percentage point in TCW terms. Swedish equity prices had risen just over 2 percentage points. The financial markets were expecting the US Federal Reserve to raise their key interest rate by 0.25 percentage points at its monetary policy meeting on 29 and 30 June. In Sweden, market players were expecting an unchanged repo rate at the day's meeting, with a majority anticipating a first hike towards the end of the year.

Developments in the price of oil had been the focus of interest among economic analysts since the previous monetary policy meeting in May. OPEC had raised its production quotas at the same time as the supply of oil had been curtailed by terrorist attacks directed at production and transport in Iraq, disturbances in Nigeria and a strike by Norwegian oil workers. Having reached levels of around USD 40 per barrel in the spot market at the end of May, the oil price was currently standing at about USD 35 per barrel.

Economic growth abroad had been marginally stronger than expected in the May Inflation Report. In the euro area, the national accounts for the first quarter of 2004 showed that output grew by 1.3 per cent compared with the first quarter of 2003. In the United States, non-farm payrolls rose by 248,000 in May. In Japan, GDP had increased for two consecutive quarters, rising at an annual rate of 3.5 per cent in the last quarter of 2003 and 5.0 per cent in the first quarter of 2004.

The inflation rate had risen abroad during the spring. In the euro area, consumer prices increased during April and May by 2.0 and 2.5 per cent, respectively, partly due to higher indirect taxes. In the United States, inflation in the corresponding months stood at 2.3 and 3.1 per cent, respectively.

The national accounts for the first quarter showed that the Swedish economy continued to grow at approximately the same rate as during the second half of last year. Adjusted for differences in the number of working days, GDP rose at an annual rate of 2.4 per cent in the first quarter. This was marginally higher than assumed in the latest Inflation Report. New data regarding economic developments after the first quarter (manufacturing output and new orders in manufacturing in April, the National Institute of Economic Research's business tendency survey) pointed to continued growth in line with expectations in the previous assessment. The inflation rate in May was 0.7 per cent in terms of the CPI, while the annual rate of underlying inflation according to the UND1X measure stood at 1.4 per cent. The outcomes were somewhat higher than forecast in the Inflation Report.

2. The economic outlook and inflation prospects

2.1 The Executive Board discussion regarding the international economic outlook

One member began by noting that economic growth abroad had continued to develop largely as expected in the previous Inflation Report. Growth in the euro area, the United States and Japan had perhaps been marginally more robust than forecast. In the euro area, new data had shown that the economic recovery had now spread to domestic demand. In the United States, the national accounts for the first quarter had shown somewhat stronger developments than assumed in the Inflation Report. New labour market statistics showed that employment continued to rise in May and that the rate of increase was slightly faster than previously estimated. In Japan, there had been further signs that the recovery was continuing, and GDP had now increased sharply for two consecutive quarters.

International price pressures had also risen somewhat more than expected. The higher global inflation was mainly due to the rise in the oil price during the spring.

Another member pointed out that inflationary pressures were tending to mount in a number of countries, including Europe, the United States and China. The member stressed that this was more evident now than at the previous monetary policy meeting.

Another member highlighted the fact that inflation had remained relatively high in the euro area in spite of the slowdown in recent years, and considered this to be a source of some concern, not least because inflation would be likely to rise as the economic upswing continued. However, the member believed that the general concern over inflation that had been expressed recently in some Swedish and international media had been exaggerated, recalling in this context that the same media as recently as one year ago had warned of deflation in the world economy.

One member agreed with a previous member that data were indicating rising inflationary pressures in several countries. The member pointed out that this was partly a result of the increase in the oil price. In the euro area, hikes in indirect taxes, such as tobacco taxes, were also contributing to the higher rate of price increases. The member observed, however, that the mounting inflationary pressures were also due to cost pressures feeding into consumer prices as economy activity strengthened. There was reason therefore to expect a continued rise in inflation in the period ahead.

According to another member, both supply and demand factors were contributing to the rising inflationary pressures abroad, but in addition, there were underlying structural effects of increased global competition, which resulted in international developments in the prices of manufactured goods remaining weak. Among other things, this had been reflected in low imported inflation. The member believed that there was reason to expect low global capacity utilisation for a relatively long period ahead and that the rise in inflation that now was discernible did not therefore constitute any immediate problem.

One member agreed that the effects of trade integration were clear, but recalled that the weak price developments for manufactured goods had occurred against the background of ample unutilised resources, first in the aftermath of the Asian crisis at the end of the 1990s and then as a result of the recession that followed the fall in equity prices from spring 2000 onwards. Unutilised resources were now decreasing quickly in several countries, and this would cause a rise in inflationary pressures abroad.

Another member said that the offshoring of production to countries such as China and India could affect international price developments in several ways. On the one hand, production costs decreased when production was offshored, and this tended to dampen international price developments. On the other hand, rising demand and production in low-wage countries, as in the case of China, contributed to driving up commodity prices. This tended to lead to higher international inflation, also for those goods manufactured in the low-wage countries. Thus, there were several offsetting factors to take into account. But given that global resource utilisation was increasing, it was likely that gradually higher price pressures were to be expected in the period ahead.

Another member pointed out that there was spare capacity globally, but that there nevertheless was a risk of bottlenecks building up in individual sectors or countries. However, according to the member, the threat of inflation should not be exaggerated. The current rises in the oil price were still small in real terms compared with those during the 1970s. Moreover, in the main scenario of the latest Inflation Report, the oil price was expected to fall back over the coming two years.

The same member saw two risks regarding the oil price. First, there was a risk that it would remain at its current level and not fall back as anticipated. Such a scenario risked giving rise gradually to contagion effects to other prices in the economy and thereby to higher inflationary pressures. The probability that this would derail the economic upswing appeared small, however. Second, there was a risk that the situation would deteriorate, fuelled by increasing geopolitical unrest in the Middle East and resulting in a sharply higher oil price. However, such a development would markedly subdue global demand and thereby have a negative impact on inflation, according to the member, who considered this scenario to be relatively improbable.

One member pointed out that the very large labour reserve in China, for example, meant that competition pressures would continue to be strong for many years. Among other things, this meant that Swedish firms could have difficulty holding up their prices, which would necessitate restraint as regards wages and other costs. Even though there were overheated sectors in China, the dominant effect of the present supply shock was general downward pressure on prices. Besides the geopolitical risks, the member believed that there was a risk of weaker developments in demand, caused by the tightening of economic policy that should come next year. This was especially true of the United States, where a tightening of both monetary and fiscal policy could be expected after the presidential election in the autumn. Rising interest rates and a new correction of the dollar exchange rate could have negative consequences for growth outside the United States as well.

Another member pointed out that the competition effects of globalisation, as well as the change towards tighter economic policy, were already taken account of in the main scenario in the Inflation Report. The scenario also included competition effects and price effects resulting from the integration into the EU of central and eastern Europe. The member also believed that the inflationary threat from the rise in the oil price was likely somewhat exaggerated in the media debate, pointing out that the ECB does not expect any second-round effects in the euro area from the oil price increase. According to the member, it was most likely that both the real effects and the effects on inflation in the long term would be small.

One member pointed out that the costs of the international geopolitical threat were apparent in the financial markets in the shape of higher risk premiums, thereby constituting a cost for the world economy. The member underlined, however, that any risks associated with the deficits in the US budget and current account were not being reflected in financial market expectations. The markets judged the most likely development to be a continuation of robust growth in the United States and an appreciating dollar.

One member summed up the discussion of the international economic situation. Developments had largely confirmed the assessment in the previous Inflation Report. There were tendencies towards higher growth in some countries, including the euro area, Japan and the United States. As a result, developments in the coming year could be somewhat stronger than previously forecast. As regards the inflation outlook there were tendencies towards higher inflation in a number of countries. However, there was no reason to change the main features of the previous assessment in the Inflation Report, according to which international inflation would rise gradually as global resource utilisation increased. The recent rise was mainly a result of increasing oil prices. The rise in the oil price did not currently risk threatening the broad-based upswing in the world economy.

2.2 The Executive Board discussion regarding financial market developments

One member began by noting that developments in the financial markets had largely been in line with the scenario in the latest Inflation Report. The assessments at that time regarding developments in equity markets, exchange rates and interest rates still applied.

Another member observed that the financial markets had been handling the unwinding of risks well recently. For example, hedge funds had exited a considerable number of their positions, which had caused yield spreads between highly and lowly valued bonds, which in some cases had been unjustifiably narrow according to the member, to widen again. This process was continuing without any apparent disruptions in the market.

One member summed up the discussion by concluding that there was no reason to change the main features in the assessment of interest rates, equity markets and exchange rates that was presented in the Inflation Report.

2.3 The Executive Board discussion regarding the Swedish economic outlook

One member began by presenting an overview of the economic situation in Sweden. Some new data had been released since the previous monetary policy meeting, and these mainly confirmed the assessments at that time. This included, for example, the national accounts for the first quarter. Gross capital formation had indeed been somewhat weaker than expected, but at the same time investment surveys suggested that activity was going to increase in the period ahead. Thus, it did not appear that the forecast for investment needed to be changed. For private consumption, too, outcomes and indicators were in line with the previous assessment. Export market growth had risen somewhat faster than expected, but foreign trade data showed that growth in exports had been somewhat weaker than assumed in the Inflation Report. Imports, however, had been more robust in the first quarter. On the whole, developments in the first quarter according to the national accounts corresponded well with the assessment in the Inflation Report, and there was therefore no reason to change the forecasts for the supply and use of resources or economic growth.

The same member said that employment growth was marginally stronger than expected in April and May, while unemployment and wage outcomes were in line with the forecast. Thus, all in all, the picture of the labour market was still relatively weak, even though employment, in accordance with the previous assessment, was expected to rise in the period ahead.

Another member raised the problem of the combination of weak investment and fast productivity growth. The member expressed concern that investment as a percentage of GDP had been low in Sweden compared with other countries for a long time, but particularly over the past 4-5 years. This applied not least to infrastructure investment. The favourable developments in productivity meant that output growth could hold up for some time, but were investment not to pick up, problems would be certain to arise sooner or later.

One member agreed generally with the first member’s assessment. The member saw no reason for concern regarding capacity utilisation in the short term, but agreed that the low capital formation was a worry in a longer-term growth perspective. However, the member thought that signs of an increased willingness to invest as well as tendencies towards more recruitment could be perceived while travelling in different parts of the country during the spring, even though this still appeared to be reflected in the statistics to a limited extent.

The next member also agreed with the first member’s picture of the economic situation. Swedish listed companies were better consolidated now than for a long time, while profits in the banking sector were substantial. Consequently, there didn't seem to be any financial restrictions that could hamper a pickup in investment. Another factor that pointed to an imminent recovery in investment was the rapid growth in exports. The member stressed that the rise in investment could be even faster than expected.

Another member observed that developments so far were consistent with a normal cyclical pattern. In the most recent boom, there was overinvestment in the business sector, which in the past few years had resulted in vigorous productivity growth and a weak rate of investment. Now, however, demand was mounting both in Sweden and abroad, which in all likelihood should generate new investment. Were investment not to rise as expected, however, it would entail problems for the recovery in the labour market and give cause to reconsider the Riksbank's forecasts of economic growth and inflation, according to the member.

Another member saw two explanations for why productivity had been so robust in spite of the weak developments in investment: on the one hand, firms in recent years had reduced staff numbers and streamlined production, and on the other, it was likely that the investment in new technology during the second half of the 1990s had begun to pay off. The member noted that firms’ investment plans suggested that investment was now going to pick up. At the same time, there were still plenty of unutilised resources and therefore no reason for concern that a shortage of production capacity should hold back growth in the short term. However, the member agreed that weak investment could become worrisome in the longer term.

One member summarised the discussion of the Swedish economic situation. The outcome of the national accounts for the first quarter was essentially consistent with the forecast in the latest Inflation Report. Export market growth and imports had increased somewhat faster than expected, while private consumption was well in line with the previous forecast. Gross capital formation continued to be weak, but investment surveys suggested that the expected rise could be imminent. Unutilised resources in the economy were assumed to decrease relatively slowly, partly as a result of the robust productivity growth. All in all, there was no reason to change the forecast of resource utilisation in the period ahead.

2.4 The Executive Board discussion regarding inflation prospects

One member noted that inflation in Sweden was somewhat higher than expected in May, mainly because prices of oil products and other imported goods rose slightly more than forecast. Inflation was expected to rise gradually in the period ahead, as resource utilisation in Sweden and abroad increased. However, favourable cost conditions meant that the rise in inflation was judged to be relatively moderate. Developments in the price of oil in the past month did not call for any change in the forecasts in the latest Inflation Report. The assessment of inflation one to two years ahead was essentially unchanged since the previous forecast occasion. Thus, towards the end of the forecast period, UND1X inflation was anticipated to still be in line with the Riksbank's target.

Another member said that the unusually high price of electricity for this time of the year could constitute a problem in the period ahead. The low water levels in Swedish reservoirs meant that there was a risk of an inflationary impulse next winter, as happened in autumn 2002.

One member pointed out that the most central aspect in the forecast of inflation a few years ahead was unit labour costs. The wage agreements that had been concluded appeared to be well in line with the inflation target. Furthermore, productivity growth was strong, even though there was reason to expect it to slacken somewhat in the period ahead when labour market conditions improve. According to the member, it seemed now that the biggest inflationary risk stemmed from international price pressures. Were inflation to become stronger than expected in the United States and the euro area, it would have repercussions for Sweden as well. The member called for an in-depth analysis of international price developments ahead of the autumn's monetary policy discussions.

One member pointed out that the global economy for the first time in a long time had embarked upon a simultaneous, robust cyclical upswing caused, among other things, by expansionary economic policy in many countries. This entailed a challenge for economic policy to ease the stimulus before inflationary pressures became too high.

Another member emphasised that there was also a risk that inflation would remain at today's low level and that the inflation target would thereby not be reached. The member pointed out that the forecast of UND1X inflation in the latest Inflation Report was somewhat below target two years ahead as well.

One member referred in this context to the change in method for measuring inflation that Statistics Sweden was going to implement at the beginning of next year. The member observed that this would have a downward effect of a couple of tenths of a percentage point on the forecasts of inflation in 2005 and 2006 and was thereby one of the reasons that inflation in the years ahead was expected in the Inflation Report to be somewhat below target.

One member summarised the discussion and concluded that the assessment of inflation in Sweden was essentially unchanged since the previous meeting in May. Inflationary pressures in the short term were low, but they would rise gradually as economic activity strengthened. Neither did there appear to have been any significant changes in the risk outlook.

§ 2. Monetary policy discussion

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

The monetary policy group concluded that the economic outlook in Sweden and abroad was largely unchanged compared with the Inflation Report in May and that new data releases confirmed that the recovery was continuing as expected. Resource utilisation in Sweden and abroad was anticipated to rise during the forecast period, but favourable cost conditions were judged, as in May, to contribute to the rise in inflation being moderate.

At the latest monetary policy meeting, the Executive Board judged there to be a small upside risk to inflation that was mainly associated with international and Swedish economic developments. There was a risk in underestimating the strength of the recovery. Resource utilisation could in this case increase faster, resulting in higher price pressures. The monetary policy group concluded that the new information since May did not give reason to change that assessment either.

One issue that had attracted great interest during the spring was developments in the oil price. This had fallen back somewhat since the latest Inflation Report, and the assessment was still that it would continue to drop. However, there was still considerable uncertainty regarding future developments in the oil price. Were the oil price to become entrenched at a high level, inflation could be somewhat higher than estimated. But it was at least as likely that the confidence in low inflation would remain and that the effects of a high oil price would thereby be limited. A persistently higher oil price could also, via indirect effects on demand and potential output, curtail growth in the world economy. The risk of this was greatest if the price were to rise in conjunction with a larger geopolitical crisis. In such a case, the dampening effects on the world economy could be considerable.

[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.

One factor contributing to bringing down the inflation forecasts for 2005 and 2006 was the change in method for calculating the inflation rate that Statistics Sweden was going to implement at the beginning of next year. As in May, the monetary policy group deemed it reasonable to allow the effects of such a technical change to have a gradual impact on monetary policy.

All in all, the forecast of inflation one to two years ahead was unchanged from May. At the end of the forecast period, UND1X inflation, which was judged to provide the best picture of underlying, cyclical price pressures, was largely in line with the inflation target. Thus, the monetary policy group was in agreement that the repo rate should be left unchanged.

2. The Executive Board discussion

All members agreed with the monetary policy group's view of the monetary policy situation.

§ 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 on this occasion provided the best picture of underlying, cyclical inflationary pressures. The Chairman found that there was only one proposal: to keep the repo rate unchanged at 2.0 per cent.

The Executive Board decided

- that the repo rate would be left unchanged at 2.0 per cent and that this decision would apply from Wednesday, 30 June 2004,
- that the lending rate would be kept unchanged at 2.75 per cent and that the deposit rate would be kept unchanged at 1.25 per cent with effect from Wednesday, 30 June 2004,
- that the decision would be announced at 9.30 a.m. on Thursday, 24 June 2004, with the motivation and wording contained in Press Release no. 41, 2004 (Annex to the minutes) and
- to publish the minutes of today's meeting on Thursday, 8 July 2004.

This paragraph was confirmed immediately.

Minutes by:

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

Kerstin Alm

Checked by:

Lars Heikensten

Eva Srejber

Villy Bergström

Lars Nyberg

Kristina Persson

Irma Rosenberg