Separate minutes of the Executive Board meeting, No. 16

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DATE: 19 August 2004

TIME: 1 p.m.

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

Kerstin Alm
Claes Berg
Jörgen Eklund
Mats Galvenius
Kurt Gustavsson (§ 1)
Kerstin Hallsten
Leif Jacobsson
Josef Svensson (§ 1)
Åsa Sydén
Arvid Wallgren
Ulrika Wienecke
Staffan Viotti
Anders Vredin
Helena Öström (§ 1)

§ 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

Developments in the financial markets in Sweden and abroad had been affected in recent weeks by factors such as expectations of the effects of higher oil prices on the real economy. The rise in oil prices had contributed to a fall in both long-term interest rates and share prices since the May Inflation Report was presented. The financial markets had also been affected by data from the United States, which indicated, for instance, a weaker development in employment than market analysts had expected. This had contributed to the US 10-year rate falling by approximately 0.5 percentage points during the summer. However, parallel with this, international inflation had risen more rapidly than the market had expected, particularly in the United States.

Swedish long-term interest rates had also fallen over the summer. The spread between the Swedish and German 10-year bonds had declined somewhat, and was currently around 0.3 percentage points. The Swedish krona had developed largely as expected in the May Inflation Report. According to market analysts, the lacklustre performance of Stockholmsbörsen over the summer was due to increased uncertainty in the stock market, partly regarding the effects of high oil prices and the strength of economic activity in the United States.

With regard to monetary policy, the Federal Reserve had raised its rate twice by a total of 0.5 percentage points, to 1.5 per cent, since the May Inflation Report. The financial markets were expecting further monetary policy tightening in the United States to a total of 0.75 percentage points up to the end of Q1 2005. Pricing for the euro area indicated expectations of an increase in the ECB's key rate of almost 0.5 percentage points up to next summer. With regard to Sweden, financial market analysts did not expect any change in the repo rate at today's meeting. Expectations had been adjusted downwards slightly over the summer, which was reflected in both pricing and the fact that fewer market commentators than before expected an increase during Q4 this year. Just under half of those questioned believed the rate would be increased before the end of the year, while the rest expected an increase during Q1 next year.

GDP growth in many countries had been more robust than was assumed in the May Inflation Report, including eastern and central Europe, Latin America and Asia, as well as the Nordic countries, the United Kingdom and the euro area. As a result, the average GDP forecasts for many of these countries in 2004 had been raised over the summer. The United States was an exception, as growth during Q2 there was slightly weaker than anticipated.

Swedish growth during 2004 Q2 exceeded the forecast in the Inflation Report. This was mainly due to unexpectedly strong net exports. At the same time, productivity growth was slightly stronger than anticipated. Business tendency surveys from the National Institute of Economic Research showed that capacity utilisation in industry had continued to rise, while labour shortage figures remained low. Taking into account the entire labour market as a whole, the number of redundancy notices had declined somewhat over the past month, although the number of job vacancies had also declined. New recruitment had increased in the consultant sectors, and the labour shortage in the IT sector had increased. However, the labour shortage was relatively slight, compared with the end of the 1990s. The companies in the National Institute of Economic Research's surveys mainly cited a lack of machinery and plant capacity. On the whole, developments in the number of employed had been in line with the assessment in the May Inflation Report, as had unemployment. However, the number of hours worked had been higher than expected, as the mean working time had been high.

Swedish price developments had been largely in line with the forecast in the Inflation Report. Deviations from the forecast path can be explained almost entirely by unexpectedly large fluctuations in petrol prices over the summer.

2. The economic outlook and inflation prospects

2.1 The Executive Board discussion regarding the international economic outlook

One member began the discussion by referring to the May Inflation Report, where the forecast was for international economic activity to continue to strengthen this year and over the coming two years. It was observed at the monetary policy meeting held at the end of June that there might be reason for slightly greater optimism regarding economic growth this year. The member claimed that the economic data received over the summer largely confirmed this picture and indicated that the international upturn would be slightly stronger than was assumed in the May Inflation Report. New information about the euro countries, including national accounts data for Q2, supported the picture of a continued recovery in line with the assessment in the Inflation Report. While there had been some less positive signals from the United States recently, which indicated that the growth forecast needed a slight downward adjustment, this was counterbalanced by some improvement in growth prospects in other parts of the world, such as Asia and eastern and central Europe.

The member also considered that, given the fact that global growth was expected to be slightly stronger, it was reasonable to assume that Swedish export markets would grow at a slightly more rapid rate during the forecast period than was previously assumed.

The same member noted that the assessment in the May Inflation Report was that international inflation would increase over the year as a result of rising global resource utilisation. This was also indicated by the steep rises in commodity prices. The international price upturn since the beginning of June appeared to have been slightly stronger than expected, and was to some extent connected with the unexpectedly high oil prices. Consequently, it appeared reasonable to make some revisions to the forecasts for the international price pressure and oil prices. Nevertheless, the member felt there was still reason to assume that oil prices would fall over the coming years, which was also implied by pricing in the futures markets.

Another member agreed on the whole with the picture presented by the previous member, and observed with regard to oil prices that forward rates were higher than the forecast in the Inflation Report and that many analysts forecast a higher price path for oil prices.

In addition, this member pointed out that growth in the United States had slackened somewhat, while domestic demand in the euro area was not yet sufficiently strong, as economic activity there was still dependent on exports. The main exception was France, where domestic demand had developed positively in recent months. The upturn in Japan also seemed to have slowed down somewhat, and growth was not as strong as it had been in the spring. Despite signs of some slackening in the United States, the current account deficit was continuing to increase, which the member considered to be worrisome. This could lead to downward pressure on the dollar and cause problems for the countries that export to the United States.

Another member agreed on the whole with the description of international economic activity and emphasised that the assumptions regarding oil prices in the May Inflation Report were overly optimistic. The member noted, for instance, that oil prices were above the Riksbank's forecast as early as the beginning of the summer. According to the member, the difference between this increase in oil prices and those of previous years was that it was largely demand-related; new data indicated that demand was at the highest level for 20-30 years and the International Energy Agency (IEA) had recently made a further upward revision to its forecast for demand this year. At the same time, production capacity was strained, which further contributed to pushing up prices. This meant that the market reacted unusually strongly to news regarding disturbances in production as a result of sabotage or political unrest. The member pointed out that the expected stronger international GDP growth was not compatible with the oil price path forecast in the Inflation Report, and argued that there could be a case for basing oil price forecasts on the market's forward rates.

One member largely agreed with the first member's introductory presentation. The member emphasised that the subduing of growth in the United States had been the decisive factor behind the negative developments in the financial markets. The significance of US economic activity for the financial markets is probably due to the fact that it is still primarily in the United States that domestic demand can act as a driving force. The member wished for a discussion of the risk of the US economic upturn being broken – as this is currently the central issue with regard to the continued development of the international economy – and commented on some of the prominent arguments in the present debate. The member did not consider that oil prices comprised any great threat, although they could possibly slow down growth somewhat. As the price increases in oil appeared to be largely demand-driven, a marked decline in economic activity should lead to oil prices also falling. However, the loan-based upturn in domestic demand in the United States meant there was a possible risk to the recovery, which was pointed out by leading market analysts. With regard to economic policy, the member saw a clear risk that the costs of the war in Iraq were being underestimated on the eve of the presidential elections. Demand could thus be expected to receive more support from fiscal policy over the coming year than most people currently anticipated. However, in the longer term a tightening of policy must be expected. Summing up, the member forecast that developments in the United States would remain quite strong, but could be subdued somewhat by the higher oil prices.

The member further assessed that oil prices had to a great extent been influenced by concerns over disruptions in productivity and speculative elements in pricing over the past year, although the underlying cause was strong demand. It was difficult to see why oil prices should have risen as much as they did in the summer if the only reason was a change in the assessment of demand. It was nevertheless reasonable that the Riksbank should make some upward revision to its forecast for oil prices; in this situation perhaps the market's forward rates could be used as a basis for the forecasts.

The same member observed that while the rise in oil prices contributed to subduing economic activity to some extent, there were other factors counterbalancing this, which motivated a slight upward revision of international growth prospects. The high oil prices did not appear to have spread throughout the economy and the forward rates indicated that they would fall during the forecast period. The effects on inflation should thus be limited, judging by the current situation.

Another member also agreed on the whole with the introductory assessment of international economic activity, but claimed that uncertainty had increased slightly since the previous monetary policy meeting in June. The member observed that the supply restrictions, in the form of e.g. the geopolitical situation in Iraq and the problems with the Russian company Yukos, which had contributed to the rise in oil prices, would hardly disappear within the immediate future. According to the member, the factor that could entail lower oil prices in future was a clear slackening of international economic activity, which was a potential risk, particularly in the United States.

With regard to the risk picture, the member considered that a strong dependence on exports and thus US economic activity could lead to weaker growth in Europe in both 2005 and 2006. The risks connected with developments in the United States were in turn the higher oil prices, a tightening of economic policy, a continuing weak labour market and higher long-term interest rates, which could lead to abrupt and severe exchange rate fluctuations.

A further member saw the rise in oil prices as the real "villain of the piece", as almost no-one had expected this development. Firstly, demand for oil had been higher than expected, with around 30 per cent of the increase being attributable to China. Furthermore, there was no indication of an impending slowdown in the Chinese investment boom, according to the member. In addition, uncertainty over the supply of oil had increased, and there were as yet no signs of increased stability in the various crisis spots around the world. It was not possible to count on new oil sources emerging over the coming years. The assumptions in the Inflation Report on the future path of oil prices should therefore be revised. However, the member was doubtful as to whether forward rates were a better instrument for making forecasts than the current system.

With regard to the subduing of growth in the United States, the same member pointed out that the Federal Reserve evidently considered this to be oil-related. At the same time, the recent flattening of the yield curve in the fixed income market reflected the fact that growth had been lower than expected and that there was still uncertainty over the future. Nevertheless, the member did not consider these factors to be sufficient to break the upturn and pointed out that the main scenario still assumed an economic upturn, albeit slightly subdued by high oil prices.

One member summarised the discussion of the international economic situation. Since the May Inflation Report and the monetary policy meeting in June, new information had been received, which indicated a need for some upward revision to the forecasts for both global growth and Swedish export market growth. There was some tendency towards slackening in the United States, but this was counterbalanced by stronger growth prospects in, for instance, the Nordic countries, Asia and central and eastern Europe. At the same time, economic activity in the euro area had developed largely as expected. The Executive Board's assessment was that international prices would be slightly higher than assumed in the

Inflation Report, which could be partly attributed to oil prices, but also to underlying explanatory factors.

The same member observed that the Executive Board had taken into account in its assessment the upturn in oil prices that had occurred over the past month, and was now assuming that oil prices would not fall to equally low levels as previously assumed during the forecast period. The higher oil prices meant that demand was expected to develop at a slightly slower rate than would otherwise have been the case, although the assessment was still, for other reasons, that GDP growth would be slightly stronger than forecast in the May Inflation Report. Regarding the effects on inflation, the assessment was that the developments in oil prices did not at present motivate any major revision in the view of general price trends over the coming years. The decisive factors were that the upturn in oil prices would not become more permanent, spread throughout the economy or lead to higher inflation expectations. As yet there were no signs of this. However, there was every reason to carefully monitor future developments.

In conclusion, the member pointed out that a slightly higher international growth rate constituted an upside risk in the May Inflation Report. This risk remained. Now it appeared as though the international risk picture was more balanced, particularly with regard to the economic effects of high oil prices.

2.2 The Executive Board discussion regarding financial market developments

One member began the discussion by noting that the international financial markets had recently been affected by the uncertainty arising over the strength of the economic upturn in the United States and over the effects of the increase in oil prices on international economic activity. Long-term interest rates had fallen since the end of May, as had international stock markets. The krona had weakened marginally in terms of the TCW index.

The same member observed that the long-term interest rates had been slightly lower than expected, but otherwise developments in the financial markets had largely been in line with the assessment in the May Inflation Report. There was at present no reason to change the view of future financial conditions. Long-term interest rates could be expected to rise when global resource utilisation rose, while the krona should strengthen, given, for instance, the continuing large trade surpluses.

Another member agreed with this assessment and pointed out that the adjustment of the financial markets functioned smoothly, despite substantial price changes.

A further member pointed to the fact that risk aversion had evidently increased during the summer. This was reflected in the stock markets, which still appeared to be valued fairly low, given the present phase of the economic cycle. One member noted that the large earnings in the business sector were in contrast to recent weak stock market developments.

Another member wondered if the krona was correctly valued and whether it would appreciate as expected. The weak domestic investment growth was one explanatory factor behind the strong current account balance. The member considered that the Riksbank should make a deeper analysis of the factors that governed the valuation of the krona.

One member summarised the discussion by observing that increased uncertainty in the financial markets regarding developments in the United States, and ultimately in the world economy as a whole, had led to long-term interest rates being slightly lower than expected, and had also affected share prices. The member observed that exchange rate developments had in general been in line with the assessment made in June. There was no reason to significantly alter the view of financial conditions.

2.3 *The Executive Board discussion regarding the Swedish economic outlook*

One member began the discussion by reminding the Board of its earlier assessment in June, when it was observed that GDP growth in Sweden would increase this year and become relatively strong over the coming two years. The member considered that the new information received, including national accounts data for 2004 Q2, meant that there was reason to believe in an even higher growth rate for the Swedish economy this year. It was mainly exports that were growing at a surprisingly high rate. One positive signal was that the upturn in investment, which the Riksbank and other analysts had long awaited, appeared to have begun. At the same time, household consumption was continuing to grow at a stable rate, and other new data indicated that economic activity would remain strong.

In addition, the member noted that the labour market had so far shown weak development and there were as yet no clear signs of a rebound, which was not really expected in the current situation. However, the recovery in economic activity signalled that there would be an improvement. The member saw no reason for any major change in the view of the labour market. Employment had developed in line with the most recent assessment. It appeared as though it might be necessary to make some upward revision to the forecast for the number of hours worked.

The same member observed that productivity growth during the first six months had remained high. The assessment in May was that the increase in productivity would be lower in future, as the recovery progressed, and this assessment still applied. Resource utilisation had increased somewhat, but labour shortages were still at a very low level. As there were relatively plentiful unutilised resources in the economy, the member did not foresee any problems with bottlenecks in the near future.

Another member observed that the large current account surplus indicated that Swedish competitiveness was currently good, as export growth was very strong. Sooner or later this should affect both the value of the krona and the Swedish investment volume. The strong current account balance was partly an expression of the fact that a significant part of investment goes outside of Sweden. The member considered it important that this trend should be broken. Finally, the member pointed out the importance of carefully monitoring developments in both house prices and lending to households. Interest rates were unusually low, and it was important that the Riksbank should have a well-founded perception of how future developments could affect total demand via effects from house prices and wealth.

Another member pointed out that bank lending to companies was now increasing, both with regard to operating capital and investment capital. This supported the Riksbank's forecast that an upturn in investment was imminent.

One member agreed with the first member's assessment of the economic situation and at the same time concurred with the second member's arguments on the importance of analysing how house prices and household borrowing can affect demand and inflation.

Another member considered that the robust productivity growth and an increasing tendency to invest abroad indicated that the recovery in the labour market would be slow. While the economic upturn would lead to more new jobs, structural obstacles would lead to employment growth being insufficient. The member identified the tax and social insurance systems and also the low level of entrepreneurship as obstacles to employment growth picking up speed. The increasing international competition would increase the importance of making Sweden a more attractive country to invest and work in.

A further member observed that economic activity in Sweden had strengthened slightly more than expected during the first six months of the year, and that the Riksbank's already relatively optimistic assessment would thus need to be revised upwards for this year. In addition, the member considered it important to carefully study future employment trends sector by sector, to see whether the trends were following normal patterns and whether forecasts proved correct. Moving jobs out of Sweden did not comprise a problem in itself; it was a normal element in the structural transformation into a more global economy, according to the member. The decisive factor was rather the labour market's capacity to handle these changes. Resource utilisation was looking fairly good, from an inflation perspective, but the member considered that there was reason to assume that unutilised resources would be employed at a slightly more rapid rate in future than was forecast in the May Inflation Report.

Another member agreed that regulations were important for the creation of new jobs, but considered that these conditions were not new phenomena that had arisen during the present business cycle. Increased growth in this economic upturn, as in previous ones, would lead to more new jobs.

Another member considered that regulations and the conditions for starting up new companies did not comprise any major problems for the functioning of the labour market. Instead the compressed wage structure was seen as an important obstacle to the creation of more jobs in Sweden.

One member summarised the discussion of the Swedish economic situation. There was reason to expect a higher growth rate this year and perhaps also during the following years. This would mean that unutilised resources would be employed at a slightly faster rate. However, the effects of capacity utilisation would be partly counteracted by stronger productivity growth than expected. As in the June assessment, the labour market was expected to gradually strengthen over the coming year.

2.4 The Executive Board discussion regarding inflation prospects

One member began the discussion by observing that inflation was still low; in July the CPI inflation rate was 0.7 per cent and the UND1X rate was 1.1 per cent. This outcome was in line with the forecast in the May Inflation Report. Over the coming year, inflation was expected to be relatively stable, and then to increase gradually as a result of rising international and domestic resource utilisation. However, a favourable cost situation meant that inflation was expected to be moderate.

The same member noted that the stronger growth rate indicated that inflation would be slightly higher in the near future than was assessed in June. Developments in oil prices over the past month did not at present motivate any substantial revisions to the inflation outlook over the coming years. The crucial aspects were that the rise in oil prices did not become more permanent, spread throughout the economy, or lead to higher inflation expectations. UND1X inflation still appeared to be in line with the target two years ahead.

The other Executive Board members agreed on the whole with these assessments.

One member summarised the discussion by observing that the view of inflation trends had not changed to any great extent since the previous monetary policy meeting. Inflation was expected to be marginally higher during the forecast period, partly due to higher oil prices and partly due to more robust growth. However, a favourable cost situation meant that inflation was expected to be moderate. Over the coming years, inflation was expected to increase gradually as a result of rising international and domestic resource utilisation. UND1X inflation was expected to be in line with the inflation target two years ahead.

§ 2. Monetary policy discussion

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

The monetary policy group considered that the economic data received over the summer indicated that international growth would be somewhat more robust than was expected in the May Inflation Report, even though recent signals from the United States had been slightly less positive. The international price increases had also been somewhat stronger than was estimated in May. The oil price rises were due both to strong demand and to disruptions in supply. Although there was reason to expect higher oil prices than were forecast in the Inflation Report, the monetary policy group's assessment was still that oil prices would most probably fall again over the coming years. As monetary policy focuses on developments in inflation a couple of years ahead, the present high oil prices need not have any great monetary policy significance so long as the price increase did not become permanent. There was still considerable uncertainty over oil price trends and their effects. Thus, the group considered there was every reason to carefully monitor future developments.

The monetary policy group observed that the national accounts for the first half of the year indicated that growth in the Swedish economy this year would be higher than expected. At the same time, inflation was still low and had developed well in line with the forecast in the May Inflation Report. However, the stronger growth indicated that inflation would be slightly higher in future. UND1X inflation, which was currently assessed to be the best gauge of underlying, cyclical inflationary pressure, was still expected to be in line with the inflation target at the end of the forecast horizon. The group's members were therefore in agreement that the repo rate should be left unchanged at the present time.

[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.

2. The Executive Board discussion

The other Board 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, 25 August 2004,
- that the lending rate would remain unchanged at 2.75 per cent and that the deposit rate would remain unchanged at 1.25 per cent with effect from Wednesday, 25 August 2004,
- that the decision would be announced at 9.30 a.m. on Friday, 20 August 2004, with the motivation and wording contained in Press Release no. 49, 2004 (Annex to the minutes) and
- to publish the minutes of today's meeting on Thursday, 2 September 2004.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

Lars Heikensten

Eva Srejber

Villy Bergström

Lars Nyberg

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

Kristina Persson

Irma Rosenberg