# Separate minutes of the Executive Board meeting, No. 24

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DATE: 8 December 2004

TIME: 1 p.m.

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

Johan Gernandt, Vice Chairman of the General Council

Kerstin Alm
Claes Berg
Jörgen Eklund
Mithra Ericson
Mats Galvenius
Kerstin Hallsten
Jyry Hokkanen
Leif Jacobsson
Annika Svensson
Christina Wejshammar
Arvid Wallgren (§ 1)
Ulrika Wienecke
Staffan Viotti
Anders Vredin

## § 1. The current inflation assessment

It was noted that Annika Svensson and Ulrika Wienecke would prepare draft minutes of § 1 and 2 on the agenda for the meeting.

The discussion was based on the new data and analyses presented by the Monetary Policy Department. These analyses were based in turn on the assumption that the repo rate would remain unchanged at 2.0 per cent up to and including 2006 Q4.

## 1. Recent data regarding economic developments

The Monetary Policy Department reported on the new data received since the cut-off date for the Inflation Report, 29 November.

Despite a rise in the US purchasing managers index in November, weaker employment growth than expected by market players caused the yield on the 10-year Treasury bond to fall by around 15 basis points. That broke, at least temporarily, the upward trend seen in recent weeks. It also affected long-term interest rates in the euro area and Sweden, which continued to fall. The purchasing managers index in the euro area's service sector dropped somewhat in November, as did retails sales volumes. The dollar had continued to weaken against both the euro and the krona, and the krona had continued to strengthen in TCW terms. The oil price had dropped to USD 37 per barrel and was not notably affected by the bombing in Saudi Arabia.

Market prices showed that players were now expecting the Riksbank to raise interest rates at a somewhat later stage and that a hike of 0.25 percentage points was only priced in fully in forward contracts by the middle of next year. In the euro area, too, pricing indicated that rates were expected to be raised at a later stage, though only marginally later.

In Sweden, National Accounts data for Q3 showed a total GDP growth that was broadly in line with that expected in the Inflation Report, even though it appeared in some respects to have deviated somewhat from the forecasts. In 2004 Q3, Swedish GDP rose by 3.9 per cent compared with the third quarter in 2003, which meant that GDP in the first three quarters of this year had grown by 3.7 per cent. The number of hours worked in the whole economy so far this year had increased by 0.7 per cent and labour productivity in the economy as a whole by about 3.0 per cent.

Private consumption expenditures in Q3 rose by 1.8 per cent year-on-year, and the outcome for the first six months had been revised down slightly. Public consumption expenditures decreased by 0.5 per cent, mainly due to weak growth in central government consumption. Gross fixed capital formation increased by 8.8 per cent during the same period, and the outcome for the first six months this year had been revised up. That was somewhat higher than predicted. Exports of goods and services rose by 9.7 per cent in Q3, and by 10.3 per cent to date this year. Exports of goods fell during the third quarter while exports of services continued to rise strongly. Total imports increased by 8.2 per cent in Q3.

## 2. The Executive Board discussion of economic prospects and the inflation outlook

Deputy Governor Irma Rosenberg presented the Inflation Report 2004:4 *(*Annex A to the minutes*)*. The Inflation Report reflected the main features of the presentations and discussions at the Executive Board meetings on 23 November and 2 December.

According to the Inflation Report, global GDP growth was assumed to have peaked but resource utilisation was expected to continue to increase in the period ahead. New statistics since October indicated that international growth, particularly in the euro area, had not been quite as strong as previously assumed. At the same time, oil prices had been slightly higher than expected and the US dollar had weakened relatively substantially against both the euro and the krona. All in all, the forecasts for international growth and Swedish export market growth had been revised down slightly. Nevertheless, global economic activity was still forecast to continue to strengthen in the period ahead.

The weakening of the dollar had been a gradual process over a couple of years. The decline had accelerated of late. Most indications were that this had been driven by an increased focus on the large current account deficit in the United States. The Riksbank now predicted that the krona would be stronger over the coming years than was assumed in October.

In Sweden, GDP growth had been high over the past year. Growth had been supported by strong export activity, while household consumption had increased at a stable rate. Weaker international developments and a stronger krona had led to some downward revision since October in the forecast for growth next year. However, the view was still that economic activity would be strong and growth would be around 3 per cent over the coming two years.

The high growth rate over the past year had not yet resulted in any significant improvement in employment in terms of the number of employed. However, the number of hours worked had increased and productivity growth had been robust. Over the coming years, continued strengthening of economic activity was expected to lead to an increase in employment.

The inflation rate remained low. In October, CPI and UND1X inflation stood at 0.8 per cent and 1.3 per cent, respectively. Next year, inflation was expected to increase as a result of rising international and domestic cost pressures and higher capacity utilisation. Nevertheless, it was expected to remain moderate in the period ahead because of favourable cost conditions and relatively plentiful unutilised resources. Compared with the assessment in October, the krona was expected to be stronger in terms of the TCW index over the next few years, which should subdue inflation. This, on the other hand, was countered by the assumption of higher oil prices. The forecast also extended further across the economic cycle, which was expected to give a higher inflation rate at the end of the forecast period. All in all, the inflation outlook was largely unchanged since October.

The assessment regarding the balance of risks was now that there was a downside risk to the inflation outlook. For example, a more dramatic fall in the dollar could cause a sharper slowdown in world market growth. Taking into account the risk outlook, CPI inflation was expected to be 1.6 per cent one year ahead and 2.4 per cent two years ahead. The corresponding forecasts for UND1X inflation were 1.5 per cent and 2.0 per cent, respectively.

One member asked why there, according to the new National Accounts data, had been such a broad, vigorous rise in exports of services of late. Another member commented that there was always considerable uncertainty regarding real estimates of this item in the National Accounts. Yet another member pointed out that the GDP outcome for Q3 was somewhat higher than the forecast in the Inflation Report because both investment and net exports had grown more robustly than expected. One member said that the current data for both private and public consumption made it difficult to reach the growth figures that the Riksbank had forecast for the full year 2004 for these expenditure components of demand.

Developments in the number of hours worked were also worrisome. The question was whether the labour market would develop as forecast.

Another member said that central government consumption was difficult to assess because it fluctuated sharply between quarters and was often revised considerably. It could, for example, reflect the timing of defence deliveries. The member agreed that the outcome for private consumption to date this year was somewhat lower than forecast. Overall, there was currently no reason to review the GDP forecast, but it could become necessary to revise the forecasts for the different expenditure components of demand in the period ahead.

The Executive Board's assessment was that, in spite of the issues raised, the new information received since the cut-off date for the Inflation Report, 29 November, did not warrant any change in the outlook for inflation.

The Executive Board decided

- to adopt the Inflation Report as presented and
- to publish the Inflation Report on 9 December 2004 at 9.30 a.m.

## § 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 supported the assessment in the Inflation Report. The forecasts for GDP growth in both Sweden and abroad had been revised down somewhat but growth was nevertheless predicted to be relatively strong in the period ahead; at the same time, the inflation outlook, having taken account of the fact that the forecast horizon had moved further ahead, was judged to be largely unchanged compared with October. The firm growth would result in increased resource utilisation and thereby rising inflationary pressures, which, however, would be countered by the robust productivity growth and - despite a high oil price - low price increases for imports. The main change since the previous Inflation Report in October was a shift in the balance of risks. In October the rising oil price was highlighted as the main inflationary risk in Sweden. In the current assessment, this had been partly taken account of in the main scenario by way of an upward revision of the forecast for the oil price and a slight downward revision of the forecast for growth abroad. Now, it was rather the weakening of the dollar against the euro, but also against the krona, that was seen as the crucial source of uncertainty in the forecast for Swedish inflation. The dollar's decline against the euro and the krona had been ongoing for a couple of years but had accelerated in recent months. With sharp fluctuations in exchange rates it is difficult to determine how much the forecast should be adjusted. In the Inflation Report the forecast had been revised relatively moderately towards a stronger krona in the main scenario, compared with the October forecast. In the risk outlook it was taken into account that the krona could strengthen further, thus dampening growth and inflation. The monetary policy

[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.

group deemed this to be a reasonable balance between the main scenario and the risk outlook.

The assessment was that inflation was rising and that it would be in line with the target towards the end of the forecast horizon. This was still the case even though there, all in all, was a downward risk to inflation compared with the main scenario. Against that background, the group's view was that the repo rate should be left unchanged.

## 2. The Executive Board discussion

One member agreed with the monetary policy group's assessment, observing that international economic activity was now somewhat weaker in general. In Germany, which is the most important European market for Swedish exports, developments were particularly worrisome, while the budget deficits in at least five euro-area countries were larger than, or on the border of, the Stability and Growth Pact's limit. This meant that fiscal policy in these countries was, in practice, locked. The member also pointed to the risk to Swedish exports of a continued decline in the dollar. There was also a risk that the dollar could become much weaker if its role as a reserve currency were to be questioned in earnest and the Asian central banks were to reallocate their assets.

Thereafter, the member pointed out that the debate on budget problems was often focused on the euro area, while the question of how to address the deficit in the US federal budget was not discussed as frequently. The Clinton administration succeeded in consolidating the US finances mainly through sharp cutbacks in military expenditures, but now the number of employees in the US armed forces was rising. At the same time, the current administration had promised not to raise taxes. According to the member the situation looked bad for the US federal budget, and there was a risk of steep rises in interest rates if credibility were to be shaken, although this could slow the dollar's decline. Domestic demand in the United States was still buoyant, however. The situation also looked good in South-East Asia. The earlier concerns of a hard landing in China due to excessively sharp economic tightening appeared to be over for the time being. The Japanese economy had slowed recently, due in large measure to the slowdown in China.

As regards oil prices it seemed that we would have to endure sharp fluctuations for another while, according to the member. Demand was high and output close to its maximum level, implying that more capacity was needed. It would take 12-18 months before we would see whether capacity could be increased. Given this, the oil price was sensitive to events that heightened concerns over supply being affected negatively, which is why it surprised the member that the bombings in Saudi Arabia did not have any marked impact.

The member continued by observing that Sweden had seen somewhat weaker growth in industrial production during the autumn. At the same time, developments in house prices appeared to have been dampened somewhat, notably in the Stockholm area. On the positive side, inflation expectations were anchored around the inflation target, despite high prices of petrol and heating oil. That pointed to considerable confidence in the Riksbank's monetary policy. The member also added that the winter did not appear to have any problems in store for electricity prices. The inflow to Swedish reservoirs was strong and the water level was in line with the average. One worrisome factor, however, was that the manufacturing sector had been hit by high price increases for commodities. Tough competition made it difficult for firms to pass on the costs to consumers, thus shrinking their profit margins. We had seen a recovery in investment recently, but as a share of GDP it was historically low and Sweden had experienced a downward trend in this regard for 30 years. In light of this, the member wondered how the robust productivity growth could be held up if the capital stock were not renewed. The member shared the monetary policy group’s view that the repo rate should be left unchanged.

Another member essentially agreed with the monetary policy group's assessment and with the previous member's description of the situation. The dollar decline was likely to continue, and the euro would have to bear a large part of the adjustment in the period ahead as well, which meant that the euro area would have to carry the heaviest burden. How the necessary shift in demand, from domestic to more export-driven demand in the US and the reverse in the euro area, would come about in practice was more uncertain. More expansionary economic policy in the euro area might be needed to facilitate this process. At the same time it was very doubtful that the budget deficit in the United States would decrease sufficiently. That was worrying, especially given that the country in the long term would see sharply increasing costs for medical care, health care and pensions. The member deemed that, all in all, this entailed a risk of rising market interest rates and thereby falling house prices in the US. The risk of recession in the coming two-year period could therefore not be ruled out even though it was relatively small. The member supported the assessment in the Inflation Report nonetheless, but expressed some concern that the optimistic forecasts for growth in the world economy in 2005 and 2006 would not be met. According to the member the euro area could find it increasingly difficult to compete with the United States and Asia, which – if no policy measures were taken – could lead to a slowdown in the economy and thereby have an adverse impact on Sweden’s export prospects.

The member also commented on the weak developments in the Swedish labour market, pointing out that they were largely due to structural factors, which monetary policy cannot influence. Another important question for future developments in Sweden was whether we could meet the competition from low-wage countries, which, according to the member, would place great demands on our ability to adapt. Swedish investment was lowest in Europe and must reasonably increase as a share of GDP. Inflation was low and the krona had strengthened, mainly against the dollar but also against the euro. This suggested that we would not see any significant inflationary pressures until towards the end of the forecast period, if the growth forecast were to be met. The global exchange rate adjustments were a big source of uncertainty in the period ahead. The member agreed with the monetary policy group’s proposal to leave the repo rate unchanged.

One member noted that international economic activity had developed roughly as expected, with the possible exception of Europe and Japan, where growth had turned out somewhat weaker than anticipated. The member said that this was due, among other things, to the high oil prices and the dollar’s decline. Given such robust economic developments in the world, we should be seeing greater tendencies towards price increases as well as falling productivity. But we hadn’t been seeing this. Central and eastern Europe's, as well as Asia's, low production costs and fast entry into the world economy had helped to keep down prices of finished goods, despite quickly rising commodity prices. At the same time, firms in many countries, including the United States and Sweden, had been able to boost output without any increase in employment further into the cyclical upswing than normal. That was unusual, if not unique, at this stage of the business cycle. In Sweden it was evident that we had taken another step in the economic upswing, as partly reflected by the fact that investment had begun to pick up, albeit from a low level. This had not yet shown up in inflation, but the high commodity prices were likely to make higher consumer prices more acceptable. However, low international inflationary pressures, high productivity growth and the stronger krona were countering this tendency so far. For this reason the member thought that a rate hike could be delayed another while.

As regards the risk outlook, the member pointed out that neither the dollar's decline nor the krona's appreciation should be a cause for surprise. Both had been predicted for a long time in light of the current account deficit in the United States and the corresponding surplus in Sweden. There were some signs in the housing market that prices were levelling off. The picture was mixed, however. In Stockholm it seemed that tenant-owned apartments in newly built areas that had previously been difficult to sell could now be sold without any discounts. According to the member, there was no reason to allow these circumstances to affect the assessment of the interest rate situation.

Another member agreed with the monetary policy group's conclusions, pointing out that economic growth in the world in 2004 would probably be at its highest for three decades. Furthermore, the growth was distributed over the great majority of the world's countries, firstly because the cyclical upswing was unusually coordinated, and secondly because many former planned economies and developing countries had now become highly integrated into world trade. This had resulted in high demand and rising prices for many commodities and intermediate goods, but also in new competition for the industrial countries in the market for manufactured goods, as reflected in the prices of these goods. Growth was expected to remain firm into 2005 and 2006, but the rate of increase would be more subdued. That meant that capacity utilisation would continue to pick up and that the output gap in most countries would close or turn positive in the coming two years. We were currently in a phase where price pressures had so far mainly been evident in producer prices. However, in the period ahead, it was likely that the continued high prices of commodities and intermediate goods, coupled with increasing resource utilisation, would result in the price rises spreading to consumer prices as well.

According to the member there were tensions in the world economy, which should be seen against the background of continued expansionary economic policy. In its wake had followed high prices for other kinds of assets than equities, increasing household debt in several countries and low saving. This had resulted in tensions in current accounts and thereby in exchange rates when saving was reallocated between countries. An abrupt adjustment of these could of course lead to lower growth and inflation, though so far the adjustments had been orderly.

As regards Sweden, the member predicted firm growth and moderate inflation. Economic policy was still expansionary. In Sweden, too, we had been seeing increased household indebtedness and rising house prices, due in part to the low level of interest rates but also structurally to the fact that loan financing is tax deductible. The question was whether it is good for Sweden in the future for this kind of development to continue. The fact that employment growth had not yet picked up in earnest was likely to restrain wage increases in the period ahead, even though many companies had reported healthy profits due in part to high productivity. The question was what wage developments we would see in the longer term when the labour market improved and also how long the robust productivity could be maintained if capital intensity were not to increase. As regards the Swedish saving and investment balance the member pointed out firstly that the krona, in light of Sweden's current account surplus, appeared to be still undervalued, and secondly that it would probably have been better to have had higher public saving, i.e. a smaller deficit in the central government budget and lower private saving due to higher private investment. All in all, the member saw no reason to raise the repo rate on this occasion, but said that the need to do so was coming closer given the favourable economic outlook.

One member said that it was a fairly natural decision not to change the repo rate at present. The member said that it was striking how uneasy the mood in the world economy was at present. Much was probably due to the rapid movements in exchange rates. Another element was the debate on jobless growth. This concern was not fully reflected in the Inflation Report, but nor had we seen any clear signs yet that the unease had had an impact on real economic developments.

The main development of late was that the dollar adjustment had accelerated. US forecasters now expected this to continue and were even encouraging it. This was a radical change from only a year ago when forecasters still believed and argued that the dollar would continue to be strong. The member therefore said that the risk of depreciations for competitive reasons, where countries would keep their currencies as weak as possible, could not be ruled out. The adjustment problems in the world economy had become increasingly evident recently, not just between countries, as in the case of the exchange rate problem, but also within countries. In the latter case it was a question of shifts in demand in the wake of exchange rate movements, but also of fast structural change influenced, among other things, by globalisation.

Like some other colleagues, the member thought it most likely that growth in Sweden would continue to be fairly strong in the period ahead – above the potential rate – even though economic signals had been somewhat gloomier than expected in recent months. The high productivity had contributed to the weak developments in the labour market, but it was important to underline that this entailed both higher real wages and higher profits. In due time the higher wages and profits should have an impact on demand in the form of higher consumption and investment.

The member reflected on the krona appreciation and noted that, previously, when the krona under a floating exchange rate had been weak, the real effects were fairly strong and the pass-through to prices was rather marginal. If this relationship proved to be symmetrical when the krona now strengthened, it could give rise to problems, and so the question had to be monitored closely in the period ahead. Even though it was natural at present not to adjust the repo rate, the member predicted a gradual adjustment of interest rates in the period ahead as the increases in the prices of intermediate goods spread to consumer prices and resource utilisation picked up. How quickly changes would be needed was highly uncertain, however. The balance of risks indicated that. All in all, this assessment appeared to be in line with the market view.

Another member noted that growth would be high this year, both in Sweden and abroad. The economic upswing was forecast to continue to be robust in the period ahead as well. It was thus natural to expect rising resource utilisation and mounting inflationary pressures, and eventually a higher level of interest rates. But it was difficult to say when this would happen. There were some unusual circumstances in the current phase of the business cycle that were important to monitor in the period ahead: on the one hand, import prices were still low, in spite of the fact that producer price inflation had risen due to higher oil and commodity prices, and on the other hand productivity had been remarkably high. As a result, cost increases were low. The productivity growth had also meant that labour market developments had continued to be weak. So far, employment had only increased in terms of hours worked. In terms of the number of employed, employment now seemed to be lagging behind more than usual in the expansionary phase and there were no signs of bottlenecks up to now.

One member agreed that 2004 was going to be a strong year, but said that there was great uncertainty over future developments. Large exchange rate movements could have an adverse effect on growth, even if they weren't abrupt. Furthermore, there was little scope in most euro-area countries to stimulate domestic demand through fiscal policy. That raised the question of whether it really was reasonable to expect increasing growth in the euro area in the period ahead. So, there was a risk of more subdued developments in the world economy before the exchange rate adjustment – which moreover hadn't yet begun in Asia – had come to an end and settled. Were the krona also to appreciate sharply the member did not rule out that the next interest rate adjustment in Sweden could be a rate cut.

Another member said that as a result of the euro appreciation it was possible that rate hikes by the ECB could be postponed. In that case this could stimulate domestic demand in the euro area; not least in Germany, which so far during the cyclical upswing had only relied on exports. That could enable a gradual adjustment of the imbalance between exports and domestic demand. Against the background of the robust GDP growth, the member thought it natural that the next rate adjustment in Sweden would be a hike.

One member pointed out that we appeared to be in the midst of a fairly strong, coordinated upswing in world economic activity, at the same time as everyone seemed to be worried in various ways about the future. That did not have to be a drawback, given that "the new economy" during the previous cyclical upswing caused far too little unease if anything. As regards the US current account deficit the member wished to point out that the adjustment of the dollar exchange rate, which was hardly at an end yet, also had effects on the current account. A weaker dollar made it more expensive for Americans to buy foreign goods and also boosted exports. Both had an impact on the trade balance in the right direction. At the same time it became more attractive for players abroad to buy US equities and bonds, thus facilitating the financing of the deficit. In other words, the dollar's decline helped reduce the imbalances in the world economy. For the imbalances to unwind, however, the dollar would have to be allowed to fall against the Asian currencies, too, not least the Chinese.

Another member pointed out that the United Kingdom also had a large current account deficit and highly elevated property prices. As the UK was an important trading partner for Sweden, this also constituted a risk for Sweden. In a situation with growing competition problems in Europe, a more expansionary fiscal policy was preferable to the protectionist measures that we at worst risked facing.

The Chairman summed up the discussion, concluding that economic growth, both in Sweden and abroad, was expected to be fairly robust in the period ahead as well. There were downside risks, however, mainly stemming from exchange rate developments. The repo rate would, if the main scenario were to materialise, sooner or later need to be raised, but recent developments had increased the uncertainty over when this would occur.

## § 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 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, 15 December 2004,
- that the *lending rate* would be left unchanged at 2.75 per cent and that the *deposit rate* would be left unchanged at 1.25 per cent with effect from Wednesday, 15 December 2004,
- that the decision would be announced at 9.30 a.m. on Thursday, 9 December 2004, with the motivation and wording contained in Press Release no. 66, 2004 (Annex B to the minutes), and
- that the minutes of today’s meeting would be published on Wednesday, 22 December 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.