Separate minutes of the Executive Board meeting, No 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: 27 January 2005

TIME: 1.00 p.m.

PRESENT:

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

—

Jan Bergqvist, Chairman of the General Council

—

Claes Berg
Hans Dellmo
Jörgen Eklund
Victoria Ericsson
Kerstin Hallsten
Jyry Hokkanen
Ann-Christine Högberg
Pernilla Meyersson (§ 1)
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Hans Dellmo and Victoria Ericsson 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 oil price had risen to around 46 dollars per barrel. The US dollar had strengthened against most other currencies during recent weeks, after a long period of depreciation. The krona had weakened in terms of the TCW index since the December Inflation Report.

The Federal Reserve had raised its key rate by 0.25 percentage points since December. The financial markets were expecting a continued gradual tightening of monetary policy over the year. Monetary policy expectations in the euro area remained largely unchanged from the previous monetary policy meeting. Financial market analysts were not expecting any change in the Swedish repo rate at this monetary policy meeting. Monetary policy expectations, measured in terms of implied forward interest rates, had recently been adjusted downwards. Swedish long-term rates had fallen slightly in recent weeks, while long-term rates in the United States and the euro area remained at roughly the same level as at the previous monetary policy meeting.

New data regarding developments in the international real economy had given mixed signals. Both manufacturing output and the purchasing managers index in the euro had fallen since the December Inflation Report was published. However, the Ifo Institute's December survey gave positive signals regarding the German economy. New data from the United States indicated that the economic upturn was continuing. The number of people employed outside the agricultural sector rose by 157,000 in December. US households had become more optimistic regarding the economy and the Conference Board's leading indicators for growth had risen since the previous monetary policy meeting.

Swedish growth in Q3 was slightly higher than the forecast published in the December Inflation Report. Net exports and investment had developed more strongly than expected. However, the labour market remained weak. The number of people employed fell by 18,000 in December, compared with the previous month.

Both the CPI and the UND1X inflation rates had been slightly lower than was forecast in December. This was mainly because imported inflation (excluding oil products) had been slightly lower than expected.

2. The economic outlook and inflation prospects

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

One member began the discussion by referring to the December Inflation Report, where the forecast was for the international economic upturn to continue during 2005 and 2006. The international growth forecast had been revised down slightly in the previous Inflation Report, partly due to weaker growth prospects in the euro area. The reasons for the adjustment were weaker growth than expected during Q3, and also a stronger euro and higher oil prices. The new data on the euro area received since the previous monetary policy meeting had painted a split picture. While several indicators implied that growth in 2004 Q4 had been weak, the picture was not entirely clear, said the member. Optimism among German firms rose in December, according to a survey by the Ifo Institute. The member considered that there could be reason for some downward revision to the GDP growth forecast.

The member observed that growth in the United States had remained strong. Employment had accelerated over the past year. Although the growth rate had probably peaked, it was reasonable to believe that the strong economic upturn would continue. The member considered that developments in the US budget and current account deficits, and also the dollar rate, remained important elements of uncertainty when forecasting international developments. The current account deficit amounted to around 6 per cent of GDP and had not yet declined, despite the dollar weakening over the past three years.

The member noted that oil prices had fluctuated relatively substantially in recent weeks. In December, the oil price outcome was slightly lower than expected, but since then it had risen back to the path forecast in the December Inflation Report. The member therefore considered that there was no reason at present to alter the forecast for the price of oil. In conclusion, the member observed that international producer prices had developed roughly as expected.

The member then commented on developments in the financial markets. The low interest rates had been slightly lower than expected in recent weeks. This could give reason to adjust for an outcome where long-term interest rates were slightly lower in 2005 than had been forecast in the Inflation Report. However, the member did not see any reason to change the longer-term forecast. The member observed that the krona's TCW rate was roughly in line with the forecast in the December Inflation Report.

Another member essentially agreed with the picture painted by the previous member. The member noted that export orders in the United States had increased substantially and that this was usually a good indicator of future export growth. This would indicate continued good growth in the United States. The member also shared the view that a continuing strong euro could induce a downward revision in the growth forecast for the euro area, but at the same time the member considered it improbable that the weak net exports in 2004 Q3 were largely due to the stronger euro. One reason was that the weaker net exports were almost entirely attributable to poorer net exports in Germany. Net exports for the other countries in the euro area remained largely unchanged. The weak net exports in Germany were a result of both soaring imports and falling exports. The rise in imports was partly due to the increase in domestic demand during Q3 and partly a result of German industry becoming established in the neighbouring new EU member states. The member said that this could entail a relatively stable upturn in imports in the near future. The member also observed that the fall in German exports was largely due to a marked decline in exports to China. There had been no corresponding fall in exports to China from other euro countries. This could indicate that the weak net exports in the euro area in Q3 were due to non-recurring factors rather than the weaker euro.

Two other members had obtained the impression from pessimistic statements made by central German analysts that developments in Germany were at present weaker than expected.

Another member noted that the United States now stood out more strongly than before as the growth engine in the global economy, and that rising oil costs may have held back the economic upturn, but had not broken it, despite the fact that the United States is more oildependent than most other industrial nations. A remaining problem in the global economy is the deficit in private and public saving in the United States. The member considered the weakening of the dollar over the past year to be a welcome occurrence from this point of view, as it created opportunities to reduce the US current account deficit. However, no signs of this had yet been noted in the statistics. It was essential that the Chinese currency should also be allowed to rise against the dollar to enable continued adaptation. The member noted in this context that growth in China remained at a high level. The present growth rates did not appear sustainable in the long term, although access to cheap labour was substantial. In the long term, this should lead to upward pressure on both inflation and the nominal exchange rate.

Another member agreed with the picture painted at the beginning. However, the member envisaged a risk of continuing strong demand from China and other emerging economies leading to higher oil prices. It was unlikely that the oil supply could be increased in the short term to meet an increased demand. This was indicated by relatively small oil reserves, together with the fact that it takes time before new oil sources can be opened. The member also saw a risk that imported inflation excluding oil products could be lower than expected in future. The member made the assessment that the US administration was not prepared to take sufficiently forceful measures to reduce the deficit. This meant that it was still a problem that the United States was acting as growth engine in the global economy and that no other country was capable of taking over. The high growth in China could partly counterbalance the weak growth in Europe and Japan, but not to a sufficient extent. There was also uncertainty over the sustainability of the growth rate in China.

Another member observed that international producer prices had risen at a relatively rapid rate over the past year. This had probably contributed, together with weaker productivity growth, to the rising inflation in the United States. The member also noted that inflation in the euro area had remained relatively stable around two per cent for some time, despite poor growth. Developments in Sweden thus differed significantly from the rest of the world. In Sweden, growth was high while inflation had remained low. The member claimed that it was not evident why the Swedish picture looked so different, and advocated some caution in the assessments of inflation over the coming years. The forecasts in the December Inflation Report were for international producer prices to increase at a gradually slower rate over the forecast period. This was not a self-evident conclusion, since resource utilisation in the global economy was expected to gradually increase at the same time.

The member had considered in December that there was a not entirely negligible risk that the krona could strengthen significantly more than was forecast in the main scenario. However, the rapid weakening of the dollar had now slowed down, while the krona had weakened slightly in recent weeks. The member considered that this indicated that the risk of a large appreciation of the krona in the near future had declined somewhat.

Another member considered that little had happened since the previous monetary policy meeting and thereby shared the other members' view that the assessment in the December Inflation Report remained essentially unchanged. The member thus did not share some analysts' assessment that the dollar would not weaken in future, but considered that there was a significant risk of continued weakening. Nor did the member believe in a distinct fall in the US budget deficit. One reason was that President Bush had recently asked Congress for more money to finance the two wars the United States was involved in. This meant that the probability of an improvement in the budget and current account deficits over the coming years was low. The member considered that a more marked correction of the current account deficit was needed, probably a further weakening of the dollar, particularly bearing in mind the fact that many countries had a fixed exchange rate against the dollar.

The member observed that OPEC's goal of keeping the oil price within the interval of 22-28 dollars a barrel no longer appeared to apply as OPEC had announced that production quotas could soon be reduced. The member's view was that a price interval of 35-45 dollars appeared to be the aim. There was thus a risk that oil prices could be slightly higher than expected. The member did not consider that an annual Chinese growth rate of 8-10 per cent was sustainable in the long term. However, it was difficult to make comparisons with other countries that had gone through a similar development phase, as China had such a large labour supply. The main obstacles to continuing very strong growth in China were, according to the member, the problems in administering the large amount of new investments and the expansion of the infrastructure.

The member noted that the annual percentage change in productivity in the United States fell substantially between Q2 and Q3 last year. On the one hand, this was not surprising given the very strong increase in productivity during 2003 Q3. The growth rate was also still high in a historical perspective. On the other hand, the quarterly change between Q2 and Q3 last year was relatively weak.

One member observed that the interest rate differences between treasury bonds and corporate bonds in different risk classes and between treasury bonds in industrial nations and in emerging economies, as well as the differences between 30-year and 10-year treasury bonds were beginning to fall from levels that were already low. This was probably not due to risk aversion becoming established at a permanently low level, but more a result of the expansionary monetary policy with low interest rates leading to liquidity seeking the best possible yield.

The expansionary monetary policy conducted after the share price fall had not had the same impact on demand as in a normal economic cycle since firms and households had not reduced their savings as they usually did when interest rates were low. This was in turn probably due to firms wishing to reduce their debts and at least some households saving as a precautionary measure. However, despite the balance sheet consolidation, the low interest rates had partly affected demand as intended through increased household credit and rising house prices. When interest rates normalised in future it would not be possible to ignore the risk of credit growth and house prices being subdued more than was assumed in the main scenario of the inflation forecast.

The member also indicated another possible effect of the expansionary monetary policy conducted in recent years. There was a risk connected with domestic inflation being pushed up too high to compensate for the low inflation on goods and services subject to international trading. It could be difficult to later bring down domestic inflation when imported inflation had begun to rise.

The member added, by way of conclusion, with regard to the discussion on the dollar development that it had not only weakened against the euro over the past year. Several Asian currencies, such as the South Korean won and the Japanese yen had strengthened against the dollar, albeit to very varying degrees.

Another member agreed in some respects with the picture painted by the previous member. Many companies now had strong balance sheets, good profits and good liquidity. There were few entrepreneurs who now claimed that lower interest rates would have more than a marginal effect on investment. At the same time, the member said it was not clear that the low real interest rates should comprise a problem for monetary policy. They stimulated economic activity. When an economic upturn has gained a foothold there should normally be good opportunity to raise interest rates. The risks were connected with possible unfoundedly high valuations in individual markets. If these occurred, the adjustment process could of course be more problematic.

Another member pointed out that there was also a possibility that real interest rates would not rise in future, despite a continuing economic upturn. This could cause problems later on. If economic activity were to decline again, real interest rates would need to fall from already low levels. Another member considered that if economic activity were to decline, the situation would become completely different. This could of course be a problem. However, the member considered that it was difficult to see how monetary policy could take this kind of potential scenario into account now.

The member who took up the issues regarding financial imbalances could envisage two scenarios; one with a normalising of interest rates and with rising employment and increased income, and a risk scenario with falling demand due to exaggerated market reactions to the normalising of interest rates.

One member then summed up the discussion. There appeared to be agreement that the assessment in the Inflation Report remained essentially unchanged. A marginal downward revision of the forecast for growth in the euro area was reasonable, while the opposite applied to growth in the United States. There were at present no strong reasons to change the forecast for oil prices to any significant extent. The member felt that only a short-term adjustment was necessary for long-term interest rates. In the slightly longer term, the reasonable assumption was that there would be an upturn in line with the earlier forecast. Nor was there any reason to change the assessment of the krona exchange rate.

2.2 The Executive Board discussion regarding the Swedish economic outlook

One member began the discussion by presenting an overview of the economic situation in Sweden. The national accounts for Q3 showed a slightly higher GDP growth rate than the forecast in the December report. Economic activity was expected to continue to develop strongly although growth would slow down somewhat in 2005 and 2006. So far, growth had been primarily supported by strong export activity, although it had been assumed that domestic demand would make an increasing contribution. It was a positive sign that investment had begun to pick up during 2004, after several years of weak development.

Employment growth had been somewhat weaker than assumed by the Riksbank in December. There had not yet been a turnaround in the labour market, but a continued strengthening of economic activity was expected to lead to a rise in employment and a drop in unemployment. At the same time, there were indications that the rate of wage increase in the business sector had been slightly lower than expected. As productivity had shown slightly more robust development than expected, unit labour costs had been lower than forecast.

Another member commented on the weak development of the Swedish labour market. There were as yet no signs of a rebound in the labour market, said the member. It was possible that some improvement could be detected in the fact that the number of redundancies had declined.

The same member pointed out that the record-high surplus on the Swedish current account should lead to some strengthening of the krona. The rapid strengthening of the krona had so far led to price changes on export and import goods for producers rather than changes in volumes. The effect on volumes could come later. In addition, the member noted that exports of services had developed strongly and pointed out that a large part of the upturn was due to merchanting, which involved Swedish firms outsourcing their manufacturing to other countries while the head office remained in Sweden.

Another member agreed with the assessment that the krona should strengthen if the large current account surplus remained. At the same time, there was a risk that firms would choose to invest their profits abroad instead of in Sweden. This could mean that the Swedish labour market remained weak. Merchanting could cause jobs to be created abroad. The member went on to say that if investment in Sweden did not increase for structural reasons, it would lead to lower growth and a weaker labour market. In that case, an interest rate cut would not help to increase investment. This was a development that monetary policy could not affect. The member observed that there was a need for a long-term growth policy that would create employment in Sweden, something that lay outside of the monetary policy area.

A further member pointed out that with regard to the long-term development of the krona it should be remembered that Sweden had had a surplus on its current account for a long period of time, without this creating a strong exchange rate. The member observed that the last time growth in Sweden had been higher than in the euro area, the krona had appreciated significantly against the euro. An inflow of capital to investment in the IT sector and large corporations such as Ericsson had probably also contributed to this. Nevertheless, it was evident that the relationship between a strong current account and the development of the krona was very uncertain.

The member went on to observe that the recent information on the situation in the Swedish labour market indicated a slightly weaker development than was forecast in December. However, the member said, redundancies had declined and the number of job vacancies reported had increased. This should mean that employment increased in future.

Another member agreed that there were substantial differences now from when Sweden last experienced an economic boom. Over the past ten to fifteen years the world had experienced increasing globalisation, with an increase in cross-border savings. Since the late 1990s, the EU had gained new member states which were rapidly becoming integrated and this had led to a new division of labour and increased trade between the countries. It was as important to follow this development, as what happened in China and the rest of Asia, because of Sweden's proximity to the Baltic countries and Poland, said the member. The member noted that some of the Swedish capital outflow went to the EU's new member states, while the profits returned to Sweden through, for instance, merchanting.

The same member went on to point out that the entire balance of payments, and not merely the current account, must be studied to capture what governs the exchange rate.

Otherwise the member agreed with the initial summary of the economic situation in Sweden.

Another member observed that growth had been strong last year, significantly above the long-term potential rate, and pointed out that forecasts indicated this would also be the case next year. Investments were increasing, the export sector was strong and confidence indicators were stable. The member pointed out that this would normally have led to an increase in employment. Instead, productivity had continued to be higher than during the most recent economic upturns. The United States, which was a couple of months ahead of Sweden in the economic cycle, had also experienced productivity growth above normal levels. However, they experienced an upturn in investment first and then employment accelerated. The member felt that the strong productivity growth had displaced the Swedish economic cycle and claimed that there were several indications that the course of events in Sweden would follow that in the Untied States. This meant that employment could be expected to increase in the future.

One member summed up the discussion. Economic activity in Sweden would continue to strengthen. Exports had increased strongly for a period of time, now investment was also increasing. However, new data received since December indicated that employment had been slightly weaker than was previously assumed, although there were signs that a turnaround was imminent, for instance the upturn in the number of hours worked and a slight increase in the number of job vacancies reported.

2.3 The Executive Board's discussion regarding inflation prospects

One member began the discussion by observing that CPI and UND1X inflation were 0.4 and 0.8 per cent respectively in December, which was lower than the forecast made in December. This was a result of imported inflation being lower than expected. The member said that developments in imported inflation warranted a slight downward revision of the inflation forecast, particularly in the short term, compared with the most recent assessment. As economic activity was expected to continue to develop strongly, it was reasonable to assume that inflation would rise gradually. UND1X inflation was expected to be roughly in line with the target at the end of the forecast period.

Another member observed that as the increase in employment had not really begun yet, it would be some time before price pressure from wage costs made an impact. The member pointed out that the question in the slightly longer term was how long productivity could remain this high and how total wage costs would develop when it slowed down. The member also noted that the fluctuations in the rate of increase of Swedish labour costs had not been entirely irrelevant. Over the past three years, the rate of increase had varied between almost two per cent and more than five per cent. The member also said that the point made by a colleague earlier, of developments in Sweden following those in the United States with a time lag, could push up unit labour costs faster than expected. The member continued the discussion by reminding colleagues that the surprisingly low import prices for consumers could also stem from domestic factors, such as the stronger krona and profit margin effects from increased competition. One should therefore be cautious in drawing conclusions. The member concluded by observing that inflation had on the whole developed in line with the forecast in the December Inflation Report.

Another member shared the view that Swedish economic activity would continue to strengthen. Domestic demand would play an increasingly strong role; investment would increase and the krona would appreciate slightly, was this member's scenario. This would be combined with low inflation resulting from both low import prices and a weak labour market. There must be a much tighter situation in the labour market for inflation to increase. However, there was a risk that increased investment would not generate new jobs in Sweden as a result of global competition and high productivity. The member made the assessment that international price developments could be weaker than expected as a result of the abolishment of import quotas on textile goods. Import prices for consumers had remained below the Riksbank's forecasts and there was a risk that this would continue, said the member.

One member agreed that there was a risk of lower inflation than in the forecast as a result of the abolition of quotas for textile imports. However, the member also pointed out that there were possible upside risks for inflation. One was a weaker productivity growth than expected, particularly in the United States, which could lead to rising global prices.

One member summed up the discussion. Inflation had developed slightly weaker than forecast in the December Inflation Report as a result of unexpectedly low import prices. It was reasonable to believe that imported inflation, and thereby also UND1X inflation would rise slightly more slowly than was previously assumed. This was partly due to deregulation and to the general increase in competition in the trade area. However, there was no reason to make more than a marginal adjustment to the inflation forecast on this occasion.

§ 2. Monetary policy discussion

1. Monetary policy proposal

Deputy Governor Irma Rosenberg presented her view of the monetary policy situation. The forecast for growth in Sweden and abroad over the coming years remained largely unchanged. Inflation was expected to remain low during the greater part of the coming two-year period, although economic activity was expected to develop relatively strongly, which would cause resource utilisation to rise both in Sweden and abroad. Inflation was therefore expected to increase during the course of 2006 and thereafter. UND1X inflation was thus expected to be roughly in line with the Riksbank's target two years from now.

In recent months, inflation had been lower that forecast in the December Inflation Report, due to unexpectedly weak price growth on imported goods. This warranted a slight adjustment in the short-term inflation forecast, compared with the December forecast. One question was, of course, whether there was also reason for a downward revision of the inflation forecast in the longer term. The weak price growth on imported consumer goods was largely due to increased global competition, which would probably affect price trends in the coming years. At the same time, prices for commodities and intermediate goods had risen rapidly as a result of strong demand in the global market, and if the international economic upturn continued as expected, there was reason to believe that it would contribute to a gradual rise in prices on imported goods. One uncertainty factor with regard to future developments was the abolition of import quotas on textile imports and the effects of this on inflation. These factors made it very difficult to assess how long the low import price pressure would endure. However, so far there did not appear to be reason to change the long-term forecast for import prices.

Another question was what attitude one should take to the low inflation now that was largely due to supply-side factors in the economy and that monetary policy could not directly affect. There would be long-term risks in trying to completely counteract the weak price growth in imported goods by rapidly pushing up the rate of price increase on domestically-produced goods by conducting even more stimulative monetary policy in a situation where domestic demand was already strong. If price impulses from abroad increased more rapidly than expected again it could be the case that domestic price pressure had become excessively high. At the same time, it should be remembered that resource utilisation in the Swedish economy was not particularly high at present and that the risk of rapidly-accelerating domestic inflation should therefore be limited.

To summarise, inflation was expected to be below the target level in the immediate future, but the decisive factor for monetary policy would, as usual, be how it developed in the long term. Demand was expected to remain strong and to contribute to an increase in resource utilisation over the coming years. Inflation was therefore expected to be in line with the target a couple of years ahead. Given these factors, Deputy Governor Irma Rosenberg proposed that the repo rate should remain unchanged at present.

2. The Executive Board's discussion

One member agreed with the previous member's assessments and observed that it was a dilemma that the low inflation rate was now largely due to supply-side factors that monetary policy could not directly influence. The member said that if domestic inflation were to increase as a result of monetary policy, it would be difficult to subdue domestic prices again once imported inflation had normalised.

Another member pointed out that there was a risk of lower inflation due to causes already discussed. However, there was no need to cut the repo rate at present. It might need to remain at the present level for a longer period of time.

Another member observed that if the objective was to increase domestic prices, this would mean in practice pushing up wages in the service sector. However, this type of development could be difficult to turn around if it should prove necessary, continued the member.

Another member agreed that the interest rate should be kept unchanged and pointed out that although inflation was slightly below target level, it was important to view the whole trend. The member pointed out that the economic upturn was expected to continue and that demand in the Swedish economy was clearly increasing. Regarding the issue of interest rates and household borrowing, the member noted that fewer households were expecting higher house prices.

One member observed that the simple rules that had governed monetary policy so far worked well. As monetary policy was focussed on a time horizon 1-2 years ahead, and the forecast had been published, the monetary policy had led to an inflation rate in line with the target level over the past 10 years and this had been made clear. At the same time, the member agreed that there could be risks linked to pushing up domestic inflation. However, these risks should not be exaggerated as the labour market situation was weak and domestic inflation was low. There was a credit boom in Sweden, while house prices were rising. It was doubtful at present whether this presented a major problem for monetary policy. Nevertheless, it would be reasonable to give this some consideration in the monetary policy stance. The main issue now was perhaps that demand was increasing at a significantly rapid rate and that this would of course push up resource utilisation. Although there was no reason at present to assume that inflation would exceed the target over the coming two years, it was possible that this would occur relatively soon after the normal forecast horizon. In this situation, changing the interest rate was not warranted. Of course, the situation could be completely different if demand were to flag and this was the factor behind a downward revision of the inflation forecast. In the present circumstances it is appropriate to wait and leave the repo rate unchanged, concluded the member.

§ 3. Monetary policy decision[1]

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, 2 February 2005,
- 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, 2 February 2005,
- that the decision would be announced at 9.30 a.m. on Friday, 28 January 2005, with the motivation and wording contained in Press Release no. 7 2005 (Annex A to the minutes), and
- to publish the minutes of today's meeting on Thursday, 10 February 2005.

This paragraph was confirmed immediately.

Minutes by:

Ann-Christine Högberg

Checked by:
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg

---

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