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Separate minutes of the Executive Board meeting, No. 8

DATE: 28 April 2005

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg
Jan Bergqvist
Johan Gernandt
Claes Berg
Jörgen Eklund
Kerstin Hallsten
Karolina Holmberg (§1)
Ann-Christine Högberg
Bengt Pettersson
Anders Vredin
Arvid Wallgren (§1)
Martin Ådahl

§ 1. The current inflation assessment

It was noted that Bengt Pettersson and Martin Ådahl 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 in turn were mainly based on the assumption that the repo rate would remain unchanged at 2.0 per cent up to the end of 2007 Q1. The analyses also included forecasts of inflation and GDP growth under the assumption that the repo rate evolved in line with implied forward rates.

1. Recent data regarding economic developments

In Germany, growth in domestic demand remained weak and the Ifo indicator had shown a continued dampening of expectations in manufacturing. The six leading German forecasting institutes had recently revised down their joint forecast for GDP growth in 2005, from 1.5 per cent (in October) to 0.7 per cent. In France and Italy, too, indicators of industrial activity had dropped. Moreover, French and German unemployment was still at high levels. In the United Kingdom, however, growth continued to be firm and employment was rising. The latest economic data in the United States were somewhat mixed. A number of economic indicators pointed to a slowdown, including retail sales and housing starts, but without giving any clear indication of the long-term trend. Meanwhile, the oil price had been unexpectedly high. The equity market had weakened and long-term interest rates had continued to drop both in the euro area and the United States. The other parts of the world economy appeared to be still performing well. Notably, that was the case for large parts of Asia.

The rate of increase in Swedish exports of goods and industrial production seemed to have moderated. Growth in new orders in manufacturing had stagnated and manufacturing firms had revised down their expectations in March according to the National Institute of Economic Research's monthly business tendency survey. The expected improvement in employment and unemployment had so far not materialised, and the situation in the labour market had, according to Statistics Sweden's labour force survey, changed very little in the first quarter, compared with the quarter before. Growth in private consumption demand, on the other hand, continued to be firm. Retail sales were increasing strongly. In addition, developments in the construction sector and large parts of the services sector continued to be favourable.

Inflation, in terms of the CPI and UND1X, was still low, standing in March at 0.1 per cent and 0.5 per cent, respectively, which was marginally higher than the forecast in March. The rising oil price in March contributed to the inflation.

In Sweden, too, equity prices had fallen and long-term interest rates had dropped. The pricing in the forward market had changed since the Inflation Report. The expected time for a rate hike had been put back and there were also some signs of expectations that the Riksbank might lower the repo rate somewhat in the period ahead.

2. The economic outlook and inflation prospects

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

One member began the discussion by referring to the Inflation Report in March, in which global GDP was forecast to continue to grow firmly, albeit at a slower rate. Despite gradually increasing resource utilisation, international price pressures were expected to remain modest in the period ahead. This outlook for global economic activity was broadly unchanged. However, new statistics in the form of both business confidence and GDP indicators suggested that growth in the euro area would be somewhat weaker than expected. Recent data regarding the United States were mixed and were adding to uncertainty over the strength of international growth. The performance in other regions in the world economy appeared to be well in line with previous expectations, e.g. in the United Kingdom, the Nordic countries, Asia and Latin America. At the same time, the oil

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price had been unexpectedly high, which had probably contributed to the fact that demand in some areas was, and could continue to be, somewhat weaker than expected. All in all, this pointed to a somewhat slower global economic upswing than anticipated at the previous monetary policy meeting in March. That also meant that demand for Swedish exports could grow slightly slower than expected.

Another member pointed out that the distribution of global growth was becoming increasingly uneven. Developments in Germany, Italy and Japan were muted, while high-growth regions were continuing to perform strongly. Consequently, there was a risk that the current global imbalances would persist. The high oil price had doubtless had a dampening effect on both companies and households. However, given that the rise in the oil price was chiefly demand-driven, there would be an adjustment in the price if global growth were to weaken. The member also noted some signs of a moderation in one of Sweden's key markets – the UK – including a softening of house prices.

One member underlined that global GDP growth was still above trend, but agreed that there was unevenness in the global performance. The developments in Germany were a concern since the domestic market there continued to be weak and the only driving force was coming from external demand and exports. Neither monetary nor fiscal policy could contribute much to improving the situation in Germany, and many of the stimulus measures that had been taken on the supply side – e.g. restrictions in unemployment insurance – had in the short term led to lower consumer confidence. As regards the global imbalances and the twin deficits in the United States, the financing of these deficits was not yet proving to be a problem. The inflows of private capital to the United States remained strong, and the country was still the engine in the world economy.

Another member emphasised that growth in the world economy was still high, but the member agreed that it had become more unevenly distributed and that the performance seemed more uncertain than before. The oil price had remained at a high level for a considerably longer period than the Riksbank and other forecasters had expected. Economic developments in Europe continued to surprise on the downside. At present, we were seeing what appeared to be a “soft patch” in the United States. The question was whether we were also seeing a temporary pause in global growth or a lasting slowdown.

One member noted that several of the factors that normally lead to firm economic activity were in place, e.g. companies' balance sheets were strong and their earnings healthy. Nonetheless, there were concerns about the economic situation. The question was whether the factors now being discussed were such that they could be expected to derail the robust economic performance. The high oil prices could potentially dampen growth, especially if they were to persist for a long time, but as a previous member had said, they were largely driven by buoyant demand, which reduced the risk that they would derail the upswing. That the performance of the euro area’s large economies had been so weak had, of course, held back the global upturn, and seemed to be continuing to do so, but so far at least it had not been a serious obstacle to the relatively firm, broad-based global performance. Instead, the biggest risk that the global upswing would be derailed was most likely a slowdown in those regions that were growing briskly today. The pattern currently seen in US indicators – weaker retail sales and house prices at the same time as the manufacturing sector and labour market were practically unaffected – was almost identical to last year’s temporary slowdown in the US economy. That suggested that the weakening would be short-lived on

this occasion as well. The risks to the US performance stemmed mainly from rising inflation, high levels of household debt, and the budget deficit.

Another member said that risks related to the US current account deficit mainly derived from a fast adjustment of long-term interest rates and the dollar exchange rate, which would cause problems for growth in Europe.

A third member pointed out the risks to the world economy that stemmed from the fact that several Asian countries, not least China, had a fixed exchange rate against the dollar. This placed greater demands on other adjustment mechanisms than if these countries' exchange rate regimes had been more flexible. The more the imbalances were built up, the more difficult the adjustment problems would become. Were the Chinese authorities to decide to change their exchange rate regime, there would, under this scenario as well, be risks associated with sharp fluctuations in international interest rates and exchange rates.

One member summed up the discussion of international developments, observing that global economic activity was still firm but that the cyclical upswing would most likely be somewhat slower than expected at the previous monetary policy meeting. New statistics suggested that growth in the euro area would be slightly weaker than anticipated. The uncertainty over growth in the United States had also increased somewhat recently and the question was whether the decline in the US indicators was temporary or not. As before, the risks to the outlook stemmed mainly from the high oil price and the imbalances that had been built up in the world economy.

2.2 The Executive Board discussion regarding the Swedish economic outlook

One member began by saying that the assessment in the March Inflation Report was that economic activity would enter a slower phase in Sweden too, but that growth was nevertheless forecast to be relatively strong in the coming two years. Net exports were estimated to give a lower contribution to GDP growth than last year, but on the other hand growth in domestic demand was expected to be more vigorous. New data indicated that exports and industrial production had increased less than forecast. Developments in the construction sector and large parts of the services sector seemed to be still favourable, though. At the same time, the most recent indicators suggested that domestic demand was rising in line with the March forecast. Firm growth in real incomes and low interest rates were contributing to favourable developments in private consumption. However, employment growth in the first quarter had been somewhat weaker than anticipated, which meant that the uncertainty over the strength of the Swedish economic upswing had increased. Taken together, these developments gave cause for a marginal downward revision of the GDP forecast this year and next year.

One member pointed out that the labour market would have to improve if consumption and investment were to take over from export demand. There appeared to have been a slight slowdown in growth. The question was whether this was temporary or whether the upswing was coming to an end. That meant that the risks had shifted somewhat since the previous meeting and were now on the downside, without offsetting upside risks.

Another member shared the concerns that a turnaround would not come in the labour market and that consumption would therefore not pick up. Given that Swedish growth had been strongly dependent on exports, there was a risk that the situation would deteriorate

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before either inflation or interest rates had begun to rise. Conditions in the labour market could be weaker than indicated by employment and unemployment data. According to Statistics Sweden's labour force survey, the number of hours worked was falling and the number of employed in labour market policy measures was rising. The fact that the performance in parts of the services sector was not stronger could be an indication that there were obstacles preventing increased incomes and profits from being translated into demand for services. The large current account surplus could partly be taken as a sign of overly weak domestic demand and that both the rise in consumption and investment could have been stronger. The expectations were that domestic demand would increase at a faster pace at the same time as net exports would fall, but this most likely presupposed an improvement in the labour market.

Another member observed that not all indicators in the labour market had been weaker than expected; rather, some were reflecting a stronger underlying performance. Recruitment companies were doing well, as were IT consultants, and the number of temporary employees was continuing to rise rapidly. The member also emphasised that the low inflation rate implied greater scope for consumption. Households' real incomes were now rising rapidly and more than anticipated. In addition, a third member noted that various employment indicators were being affected by temporary effects such as cutbacks in the armed forces and a reduction in the number of holiday work opportunities in community care services.

Another member pointed out that at this stage of the business cycle we should expect falling productivity growth and rising employment. That we were not seeing any effect on employment was worrying, of course, but developments had occurred with a lag in the US economy, which was ahead of the Swedish one in the business cycle. Swedish households appeared to be still strongly optimistic. They were borrowing more and more, which was not only reflected in rising house prices, but probably also in the developments in retail sales. It was difficult to combine this picture with the view that consumption would slow down.

One member summed up by saying that a number of indicators were pointing to marginally weaker growth in Sweden than expected even though the economic outlook had not deteriorated to any significant extent. The member observed that fiscal policy was expansionary, real income growth was firm, interest rates were low and lending was increasing – factors that all pointed to stronger consumption. Moreover, the construction sector was performing strongly. However, unlike previous cyclical upswings, the labour market was weaker. Were the labour market to continue to be weak, it could have an impact on households' confidence in the future and potentially dampen consumption demand. All in all, the conclusion was that there was a risk of somewhat slower growth than estimated in the latest Inflation Report.

2.3 The Executive Board's discussion regarding inflation prospects

One member observed that inflation in March turned out marginally higher than expected in the Inflation Report. The CPI rose by 0.1 per cent compared with March in the previous year and UND1X increased by 0.5 per cent. The main reasons that the rate of price increases was still low were robust productivity growth and weak imported inflation. The oil price remained at a higher level than expected, contributing to a slight upward revision of the

inflation forecast one year ahead. UND1X inflation was expected, as before, to be in line with the target two years ahead.

The other members agreed with this assessment.

One member said that even though global consumer price pressures remained low in general, producer prices had begun to rise and inflation to pick up in a number of countries. Of the industrialised countries, it was mainly in the United States that there were incipient signs that companies' opportunities to pass on cost increases to consumers had increased and that concerns over rising inflation had heightened. In Sweden, CPI inflation was low but lending and a number of asset prices had continued to rise.

Another member underscored that the inflation forecast of 2 per cent two years ahead was conditional on an upturn in the labour market. Were this not to materialise there was a risk of lower inflation than expected. Nevertheless, the member was not yet ready to reconsider the Executive Board's fundamental outlook on inflation prospects.

In the light of the difficulties all forecasters had encountered in forecasting inflation in recent years, one member emphasised the importance of caution. So far the discussion had mostly focused on downside risks, but there were also risks on the upside. Over the past ten years there had been several periods with strong expectations of lower inflation due to conditions similar to those today, including low global price pressures. This was true, for example, of 1998-99. But contrary to what many expected at the time, inflation picked up. Signs of increasing inflation could be seen today internationally and were beginning to feed through to consumer prices, notably in the United States.

The member summed up the discussion, observing that inflation was likely to turn out a little higher than expected in the short run as a result of the high oil price. However, there was no reason to revise the previous assessment that inflation two years ahead would be in line with the target.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented the proposal for a monetary policy decision. The backdrop for this monetary policy decision was fairly similar to that at the last meeting. Growth was still expected to be firm, although a little lower than anticipated in March. Demand was continuing to strengthen, however, and households were responding to the expansionary monetary policy by sharply increasing their borrowing. Companies had ample liquidity and could invest to a large extent without needing to borrow. The low inflation was due in large measure to specific factors that in themselves had a stimulatory effect on demand. At the end of the forecast period, inflation was expected to be in line with the target. Ms Rosenberg recommended therefore that the repo rate be left unchanged.

In this situation, when indicators were providing a somewhat mixed picture of economic activity, the uncertainty in the forecasts increased and it could be difficult to determine whether a weakening of growth was temporary or not. Ms Rosenberg did not see reason at present to reconsider the entire economic outlook, but stressed that it was important to be attentive in case the situation should follow a different path than that expected. This applied not least to developments in the Swedish labour market, given the significance it had for demand. Were the economic upturn not to continue and resource utilisation therefore not

to continue to increase, it could influence the assessment of future inflation. It could then be necessary to give greater weight to the arguments in favour of stimulating the economy further through monetary policy.

One member was open to reconsidering the outlook if new information should point to a marked deterioration in economic activity, but the member was of the opinion that there had been too little new data and thus recommended that the repo rate be held unchanged. Another member agreed, but said that the situation gave cause for greater vigilance.

According to one member, the risk that an excessively fast increase in household debt would lead to a setback in demand later on had to be weighed against the risk that demand during the forecast period would not be sufficiently robust. Were the pick-up in demand and economic activity to slacken more than expected, a larger rate cut may be needed that would stabilise both real economic developments and inflation.

One member pointed to a monetary policy dilemma. Inflation was been held down partly by temporary effects such as stiffer competition in the retail food sector and abolished textile quotas, and partly by productivity gains. This had resulted in low interest rate levels. Moreover, the yield curve was reflecting expectations that the low interest rates would be sustained. Monetary policy had remained expansionary far into the cyclical upswing. That gave households the incentive to increase their borrowing, thus leading to rising asset prices, not least house prices. That in itself did not give cause to raise the repo rate now, but were interest rates to remain low as long as indicated by the yield curve, it would raise questions about the adjustment process when interest rates eventually began to normalise again. There existed other economic policy measures than the interest rate that could reduce the risks of excessive indebtedness and exorbitant house prices.

One member said that the fact that the Executive Board had been unanimous in its recent monetary policy decisions should not be taken to mean that there were no nuances in the assessments or that the assessments had always been straightforward. There was agreement that some indicators had weakened and that this should warrant greater vigilance. At the same time, in the recent period the exchange rate had weakened and long-term interest rates had remained low, resulting in a non-negligible stimulus to the economy. Even though the cyclical upswing had slowed somewhat and the labour market had remained weak, the fundamentals were in place for continued firm growth. As before, inflation was forecast to rise and be roughly in line with the target two years ahead.

§ 3. Monetary policy decision[1]

The Chairman noted that the members of the Executive Board were agreed that UND1X inflation at present provided the best picture of underlying inflationary pressures.

The Chairman found that there was only one proposal: to hold the repo rate unchanged at 2.0 per cent.

The Executive Board decided

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

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- that the repo rate would be left unchanged at 2.0 per cent and that this decision would apply from Wednesday, 4 May 2005,
- 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, 4 May 2005,
- that the decision would be announced at 9.30 a.m. on Friday, 29 April 2005, with the motivation and wording contained in Press Release no. 29, 2005 (Annex to the minutes), and
- that the minutes of today's meeting would be published on Tuesday, 17 May 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