Separate minutes of the Executive Board meeting, No. 11

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DATE: 20 June 2005

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg
Jan Bergqvist, Chairman of the General Council
Johan Gernandt, Vice Chairman of the General Council
Claes Berg
Jörgen Eklund
Victoria Ericsson
Kerstin Hallsten
Jyry Hokkanen (§ 1)
Ann-Christine Högberg
Per Jansson
Pernilla Meyersson
Bengt Pettersson
Staffan Viotti
Anders Vredin
Arvid Wallgren (§1)

§ 1. The current inflation assessment

It was noted that Bengt Pettersson and Victoria Ericsson 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 Q2. 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

The Monetary Policy Department reported on new data received since the Executive Board meeting on 14 June.

In the euro area, industrial production had risen by 0.6 per cent in April compared with the previous month, which was higher growth than expected in the markets. Inflation in May was 1.9 per cent.

Economic data for the United States was providing mixed signals. Industrial production in May grew by 0.4 per cent on the month before, while retail sales dropped by 0.5 per cent. Both CPI inflation and core inflation, which excludes food and energy prices, fell in May. The CPI stood at 2.8 per cent and the core measure at 2.2 per cent. Financial statistics showed that net capital flows to the United States had declined slightly in April. The US current account deficit in the first quarter was somewhat larger than the markets had anticipated.

In the recent week, long-term interest rates had increased in the United States, the euro area and Sweden. The yield curve in Sweden had dropped at short maturities but had risen at long maturities.

The oil price had risen in the recent period, with forward contracts in the past few days indicating an oil price close to USD 60 per barrel on average over the coming year. Explanations for the recent increase in the oil price included unexpectedly low inventories of distillate fuels and higher demand for petrol in the United States, as well as political unrest in the oil-producing country Nigeria.

Equity prices had risen in the past week in the United States, Germany and Sweden.

Pricing in the forward market was indicating expectations of a repo rate cut in the summer of up to 50 basis points in Sweden. Approximately one-third of Swedish analysts were anticipating a rate cut of 0.5 percentage points at today's meeting. Of the remaining analysts, the majority were expecting a cut of 0.25 percentage points at today's meeting and a further 0.25 percentage points at the meeting in August.

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

Deputy Governor Irma Rosenberg presented the Inflation Report 2005:2, Annex A to the minutes. The Inflation Report reproduced the main features of the presentations and discussions at the Executive Board meetings on 2 and 14 June.

According to the Inflation Report, growth in the world economy was still firm on the whole. Most factors suggested that the signs of weakness noted at the beginning of the year in the United States were temporary and economic growth in Asia remained high. In the euro area, however, growth had slackened more than previously expected. All in all, this meant that the forecast for growth in Swedish export markets had been revised down for this year and slightly for next year as well, compared with the assessment in March.

In Sweden, too, economic activity had slowed. In the first quarter, GDP growth was much lower than estimated by the Riksbank and other forecasters. The slowdown was on a broad scale, covering exports and also private and public sector consumption. The labour market also continued to be weak. Nevertheless, most indications were that growth in Sweden would remain relatively strong. The low interest rate environment had contributed to a continued rapid rise in household sector borrowing and in house prices. Investment and construction were showing strong growth. Exports were being stimulated by the good growth rate in the world market and by the low krona exchange rate. All in all, the strongly expansionary economic policy implied a stimulus to demand.

The assessment in the main scenario therefore was that the low growth in Sweden during the first quarter was primarily a temporary slowdown. However, the weak outcome so far this year led the Riksbank to make a fairly substantial downward revision to its forecast for GDP growth this year and a slight downward revision for next year. Against this background, capacity pressures were expected to be lower during the forecast period, compared with the forecast in March. This meant that domestic cost pressures would increase less than anticipated. At the same time, imported inflation was low, partly due to stiff competition in the world market. Capacity pressures and inflation would gradually increase, but inflation was nevertheless expected to be below 2 per cent over the coming two years.

Despite the substantial downward revision to the inflation forecast, the Riksbank's assessment was that the risks of inflation being lower than in the main scenario were slightly greater than the risks of inflation being higher. The risks were mainly connected with uncertainty over economic developments both in Sweden and abroad. As before, there were also other risks in the assessment of inflation, which were connected with the current account deficit in the United States, the effects of the high oil price, the rate of long-term productivity growth and the effects of various structural changes, such as increased competition.

The Executive Board made the assessment that the new information received since its meeting on 14 June did not give reason for a change in the view of inflation developments, compared with that presented in the Inflation Report.

The Executive Board decided

- to adopt the Inflation Report as presented and
- to publish the Inflation Report at 9.30 a.m. on 21 June.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented a proposal for the monetary policy decision. In connection with the previous monetary policy meeting in April, the Riksbank observed that there was increased uncertainty over the strength of Swedish economic activity. The information received since then pointed to clearly weaker activity than expected and the GDP forecast had thus been revised down fairly sharply for this year and somewhat for next year as well. That meant that resource utilisation would not rise but instead was more likely to fall this year and that it would be considerably lower during the forecast period than previously estimated. Consequently, the inflation outlook had also changed, with inflationary pressures expected to be lower than previously forecast.

Even though inflation so far this year had turned out slightly higher than anticipated and was gradually rising, it was now projected to be well below the 2 per cent target in the years ahead. That suggested – according to the policy rule normally followed by the Riksbank – that the repo rate should be lowered. At the same time, household debt and house prices had continued to increase at a fast pace. There was still cause for some concern that these developments could result in markedly weaker growth in household demand in the future, for example when interest rates rose, even though the slowdown in economic activity should dampen the rate of price increases in the housing market. Below-target inflation and weaker demand during the forecast period now carried more weight than the debt situation, leading to the conclusion that there was reason for more expansionary monetary policy.

The question then was how much the repo rate should be lowered. The forecast based on the assumption that the repo rate tracked market expectations, as indicated by a fifteen-day average of the implied forward rates as at 1 June, suggested that a lower interest rate path than this was necessary in order to bring inflation back to target within a reasonable time frame. The proposal was that the repo rate be lowered 0.5 percentage points.

It was uncertain how large the effect of a rate cut would be on demand at the current juncture. Households were already increasing their borrowing at a fast rate, but in spite of that they were raising their consumption rather cautiously. Business investment was already rising sharply and companies had a good supply of own funds. The potential impact on the labour market was also uncertain. That depended on whether companies could continue to boost output without increasing employee numbers. This was something that monetary policy could not influence. The overall indication was that a rate cut would have a slight effect on both demand and employment.

The other members agreed with the conclusions presented, including the proposal to lower the repo rate by 50 basis points.

One member underlined that although it was uncertain what the exact effect of a rate cut would be, the main issue for monetary policy was to meet the inflation target.

Another member pointed out that there had long been strong arguments against a rate cut, but that the situation had changed now that the forecast for GDP growth in the current year had been revised down by one-third. Both private and public consumption, as well as industrial production, were growing weakly. That was also likely to decrease the probability that a continued fast rate of household borrowing would lead to excesses. The recent speculation that the preliminary GDP outcome was too lowly estimated and that upward revisions were likely to be made did not alter the picture of weaker economic conditions. The depreciation of the krona due to expectations of a lower policy rate would probably stimulate the export and manufacturing sectors, which rather was positive at this time. At the same time, large swings in exchange rates were not desirable. At the beginning of the year, too, the krona was by all appearances undervalued in a long-term perspective, and Sweden's trade surplus was considerable. So a further weakening was hardly to be desired.

One member said that the economic situation at present was peculiar, not to mention unique. Global growth was still firm, with the United States and Asia the main driving forces. In Sweden, companies were well consolidated and investment was picking up. Households' real incomes were increasing and equity prices were on the rise. Normally, this should be an appropriate time to tighten monetary policy. Nonetheless, many aspects now pointed to a rate cut. According to the member, there were primarily two factors: growth in Europe had again surprised on the downside, which had implications for Swedish exports. But above all, household demand was not increasing as it usually did at this stage of the business cycle and as it had done in countries that were ahead of Sweden in the cycle, e.g. the United States. The downward revision to the growth forecast for 2005 from around 3 per cent to about 2 per cent was of course a large and, in itself, worrying change. This pointed to a repo rate cut in line with the proposal.

The signals from the financial markets were also ambiguous. Long-term interest rates around the world had not risen as expected, which had surprised forecasters. The member pointed out that this might reflect a different economic situation than that seen in global growth data. Were world demand to slacken faster than anticipated, this was a notable downside risk to both economic growth and inflation.

However, were the repo rate to be lowered by 50 basis points, which was reasonable and in line with the Riksbank's policy rule, this could further stimulate both household borrowing and the prices in the housing market. There was reason to wonder what would happen when interest rates gradually began to rise again. The average fixed-rate term for households' mortgages had been falling for about a year. So households today were more sensitive to changes in interest rates than a year ago.

Indebtedness was hardly a problem for the household sector as a whole, and nor for the banks, but it was evident that an increasing number of individual households could run into payment difficulties in the event of a future rate increase. As regards house prices, historically these had varied fairly sharply in Sweden in real terms, even in the absence of speculative bubbles. A future rise in interest rates could lower demand at the same time as the supply of housing was growing due to an increase in residential construction. That was especially true in the big cities. It was not possible to disregard the risk that residential property prices could fall quite sharply in some regions.

Another member agreed with much of what had been said, but emphasised that the global economy excluding the euro area was still growing robustly. Moreover, the high oil price was mainly an effect of high demand and therefore would fall if demand were to drop. The Federal Reserve's interpretation regarding a soft patch in the United States appeared reasonable. The signs of weakness in the spring were most likely temporary. As regards economic activity in Sweden, much of the dampening was an effect of weak growth in public consumption and was not particularly related to the business cycle. Public consumption dropped 1.2 per cent in the first quarter compared with the same period a year earlier. On the whole, there were good reasons to accept the picture presented in the Inflation Report, with a temporary slowdown in growth during the first quarter and a return to firm growth in the coming years.

The member said that there was cause for some concern over household borrowing and house prices a few years ahead. The phenomenon of rapidly rising house prices was evident in other countries, too, even though the prices had softened in some of the countries that were further into the business cycle, e.g. Australia and the United Kingdom. It was unlikely that house prices and borrowing could continue to increase at the same fast rate indefinitely. Were there to be a correction, the question was whether it would be a small adjustment such as that in the Netherlands, with a stabilisation of prices and lending, or whether it would come in the shape of a pronounced fall in house prices, which would have a greater impact on demand and inflation. Even the stabilisation in the Netherlands had resulted in negative effects on demand through a sharp moderation in private consumption. An additional problem was that a future correction could come about in a low interest rate environment, which meant that the scope for further monetary stimulus, in the event it was necessary given the inflation target, would not be great. The Riksbank's function was to achieve price stability not only 1-2 years ahead, but also beyond that. A rate cut now would entail a risk of a further escalation of house prices and household debt, which, when a correction came in the future, could dampen demand and inflation considerably. This advocated a cautious approach. Countering that were the arguments put forward by other members. All in all, the proposal to lower the repo rate by 50 basis points was reasonable.

Another member observed that it was not only public consumption that had grown weakly during the first quarter, but also exports and private consumption. The temporary weakening of Swedish economic activity should perhaps instead be described as the beginning of a gentle slowdown, continued the member. The member said that world economic growth had slackened partly due to the high oil price and because the strong economic policy stimulus in the United States had come to an end. There were also indications of a slowdown in growth in China; for example, the rate of investment growth was half that seen in the same period last year, import growth had decreased and the Chinese current account surplus had widened. Taken together, a continued weak economic performance in Europe and the simultaneous slowdowns in the United States and China were leading to a moderation of demand in the world economy.

The member also noted that there were now indications of an improvement in the Swedish labour market, but that these were not enough in themselves to make up for the international decline. It was worrying, continued the member, that such a large proportion of the working age population was outside the labour force. That meant that a substantial amount of public resources was financing transfers, when the funds instead could have been used for growth-promoting investment in infrastructure, research and development, marketing of Sweden and education. Total investment had picked up, but it was still lower in Sweden than in other countries, as reflected in a record-high current account surplus, among other things. The undervalued krona meant that Swedish purchasing power was weaker than it otherwise could be.

The same member said that there was a risk that the gentle slowdown in Sweden would lead to an underestimation of inflation, partly because the effects of the specific factors on the economy's supply side were difficult to assess. On the other hand, there were risks to the international economic situation stemming from the imbalances in the world economy and property price bubbles in various areas of the United States and Europe.

Another member disagreed with the previous member's somewhat negative view of international economic conditions, pointing out that the slowdown in the United States had been temporary, that the Japanese economy had gathered pace and that international growth in general was firm.

One member said that the decision was not straightforward. At the monetary policy meetings in March and April it was right not to further stimulate growth through a rate cut, since the forecast at the time pointed to a growth rate above the potential level. At the same time, the credit expansion and house price developments entailed distinct risks to demand and employment in the longer term. The latter was illustrated, as mentioned earlier by another member, not least by what had happened in the Netherlands after house prices there had stabilised a few years ago. New information had been received, including National Accounts data for the first quarter. Although some forecasters were expressing doubts over the figures, the Riksbank did not have sufficient arguments at present to assume a different picture than that provided by Statistics Sweden's data.

It seemed natural, continued the member, against the background of the weaker economic performance and the downward revision to the inflation forecast, to lower the repo rate by 0.50 percentage points. Such a rate cut was well justified by the forecast in the Inflation Report, based on an unchanged repo rate. The same picture was provided by the forecasts predicated on market interest rates.

The member agreed with what had been said initially: that it was uncertain how strong the effects of a rate cut would be. Private consumption to date had grown weakly, despite the steep rise in household borrowing. Productivity growth was still robust, and even if demand were to pick up in the period ahead employment might not rise as much as anticipated.

The previously stated reason against a rate cut – that economic growth would probably be higher than the potential rate – was no longer as relevant. Growth would be weaker this year, and even if it increased again next year, the slowdown would result in lower resource utilisation throughout the forecast period, compared with the assessment in March. On the other hand, house price developments and the credit expansion in the country still warranted considerable attention and gave cause for some caution.

The member underlined that monetary policy only had one instrument and one interest rate at its disposal. In the current situation with a fast credit expansion, it would have been nice as an Executive Board member to have several interest rates to work with, but that was impossible of course. Future developments in house prices and borrowing were dependent, among other things, on the actions of households, banks and the concerned public authorities. In addition, tax policy and existing regulations had the potential to influence the expansion in credit. The responsibility for this lay outside the field of monetary policy, however. All in all, the reasons in favour of a repo rate cut of 50 basis points were in the majority.

Another member said that it was a problem if a rate cut only caused households to save more, rather than boost their consumption. The question was also why saving was increasing so sharply in Sweden. The rise in households' real incomes was being used to increase saving instead of to raise consumption. One possible explanation was uncertainty over future developments in the labour market and pensions. Swedish households were both borrowing and saving. US households were borrowing and consuming.

One member noted that, when interest rates fell, it was cheaper to refinance loans at lower interest rates in the United States than in Europe. That had stimulated US consumption in recent years.

Another member agreed that it was a difficulty for monetary policy that households were already increasing their borrowing at a fast pace at the same time as they, in contrast to what had previously been the case in such situations, were cautious to consume. Monetary policy could not influence how households decided to allocate increased borrowing between saving and consumption. It therefore was uncertain how large the effect of a rate cut would be on consumption.

Another member pointed out that the rate cut most likely would contribute to a reduction in saving.

Another member observed that private consumption would rise if employment picked up. The member also noted that saving was very low in the United States. The job of monetary policy was to keep interest rates as low as possible without risking the inflation target. A turnaround in the labour market was required for the economy to be able to grow at a faster rate, but that was outside the scope of monetary policy.

One member stressed that the only instrument of monetary policy, the repo rate, was a rough tool. We were able to influence demand and inflation a few years ahead. But representatives of the Riksbank should avoid being too normative and expressing wishes that households and firms should do this or that. It was up to households themselves to judge how much they wanted to save or consume. In light of the problems in the labour market and lower future pensions there may be very good reasons for individual households to save.

The member underscored that it was also important in this context to be fairly clear about what could happen with interest rates in the period ahead, partly in view of developments in the exchange rate. Given the information available today, a rate cut of 0.50 percentage points would mean that monetary policy was well balanced and that the repo rate should not be lowered further. There was still good reason to not only focus on the inflation forecast but also to take account of the credit expansion and developments in house prices. Looking forward, it was also worth recalling – as a couple of members had done earlier – that the picture presented in the main scenario entailed a higher growth rate as early as the second half of the year.

Another member agreed with the previous member and concluded that the forecast in the Inflation Report pointed to a temporary slowdown in Swedish economic activity this year and that economic growth would again become relatively firm in the period ahead. Were this scenario to hold up, a further rate cut would not, as far as can be judged, come into question.

§ 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 lower the repo rate to 1.5 per cent.

The Executive Board decided

- that the repo rate would be lowered to 1.5 per cent and that this decision would apply from Wednesday, 22 June 2005,
- that the lending rate would be lowered to 2.25 per cent and that the deposit rate would be lowered to 0.75 per cent, with effect from Wednesday, 22 June 2005,
- that the decision would be announced at 9.30 a.m. on Tuesday, 21 June 2005, with the motivation and wording contained in Press Release no. 44, 2005 (Annex to the minutes) and
- that the minutes of today's meeting would be published on Tuesday, 5 July 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

Footnote:

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