Separate minutes of the Executive Board meeting, No. 12

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DATE: 23 August 2005

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg
Claes Berg
Jörgen Eklund
Kerstin Hallsten
Ann-Christine Högberg
Pernilla Meyersson (§ 1)
Bengt Pettersson
Annika Svensson
Anders Vredin

§ 1. The current inflation assessment

It was noted that Annika Svensson and Bengt Pettersson 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.

1. Recent data regarding economic developments

GDP growth in the euro area was 0.3 per cent in Q2, compared with the previous quarter, while GDP growth in the United Kingdom was 0.4 per cent. In the United States, historical data were adjusted when the new GDP figures for Q2 were published. The average growth rate for the period 2002-2004 was revised down from 3.1 to 2.8 per cent. At the same time, the average productivity growth rate was 0.5 percentage points lower these years and unit labour costs were consequently higher than in earlier outcomes. The number of persons employed in the United States increased by 207,000 in July, and the figures for May and June were revised upwards. Unemployment remained at 5.0 per cent in July.

International long-term interest rates showed an upturn in early July, rising more in the United States than in the euro area and Sweden. However, most recently they had fallen again. The terrorist attacks in London did not have any lasting effects on the financial markets. The krona depreciation, particularly against the dollar, but also against the euro, continued after the June monetary policy meeting. At the beginning of July there was a turnaround and since then most of the depreciation since the June meeting had been recovered. The oil price had continued to rise over the summer, while stock markets had shown a global increase.

In Sweden, the National Institute of Economic Research's most recent business tendency survey showed that the confidence indicator for manufacturing remained at roughly the same level as in the previous quarterly survey. Capacity utilisation in manufacturing appeared to have declined somewhat since the previous quarterly survey. According to Statistics Sweden, industrial production increased by 1.6 per cent between May and June. All in all, however, industrial production had declined by 0.3 per cent during Q2, compared with Q1. The purchasing managers' index rose by a few units from June to July.

In connection with the publication of the preliminary National Accounts for Q2, revised figures for Q1 were also published. In 2005 Q1 Sweden's annual GDP growth rate was 1.7 per cent, compared with 1.4 per cent according to earlier figures from Statistics Sweden. GDP growth in Q2 was 2.2 per cent. Private consumption and investment rose by almost 3 per cent and 10 per cent respectively, while exports increased by almost 4 per cent.

In the labour market, the number of new job vacancies continued to increase over the summer and the number of redundancy notices continued to decline. The quarterly business tendency survey indicated that employment was expected to increase in the construction industry and in private service sectors. However, manufacturing companies were expecting continued cutbacks during Q3. The Labour Force Survey for Q2 (in particular for the month of June) indicated both a rise in employment and a rise in unemployment. However, this was affected by the extensive changes to the surveys implemented in April 2005.

CPI inflation was 0.3 per cent and UND1X inflation was 0.7 per cent in July. This meant that inflation was higher in June and July than had been forecast in the June Inflation Report.

2. The economic outlook and inflation prospects

2.1 The Executive Board discussion regarding the international economic outlook

One member began by recounting the assessment in the June Inflation Report, where international growth was expected to be relatively strong both this year and during the coming two years. The member's assessment was that the statistics received since the report was published largely confirmed this picture. At the same time, international inflation had been slightly higher than expected, which the member said was partly connected to the larger increase in the oil price than anticipated in the June report. The member therefore considered that there was reason for a slight upward adjustment in the forecast for international price trends in the near future.

Another member considered that the uncertainty prevailing at the time of the interest rate decision in June had to some extent dispersed. Global economic activity looked better in the short term and the member felt greater confidence in developments over the coming year. However, there still remained uncertainty over longer-term developments. There was still reason for concern as to how the imbalances in the world economy, particularly the current account deficit and savings deficit in the United States, would be resolved. The member also observed that the longer it took for an adjustment of the imbalances, the greater was the risk that there would be a sharp correction. Oil price developments could become a trigger factor. The member would like to see studies of future trends in oil prices, given that the Riksbank's forecasts, like those of most other analysts, had proved incorrect so far.

A third member agreed that it was difficult to forecast oil price trends but observed that the Riksbank already had regular contact with expertise in this field and that this was hardly a field where own investigations by Riksbank personnel would be profitable. Another member added that while it had been difficult to predict developments in oil prices, better forecasts for oil prices would not have contributed to better inflation forecasts. This was because the effects of oil prices on inflation had so far been much less significant than most analysts had expected.

One member said that there had been signs of a gradual adjustment of the imbalances in the world economy during the spring. The dollar weakened and the US trade balance improved. The member observed that developments had now returned towards an increase in the current account deficit in the United States, while the dollar had strengthened. According to the member, the current situation was similar to that in 1999 and the years immediately following that, when stock markets around the world showed a sharp rise. During a period of 2½ years market agents presented greatly differing analyses of the stock market upturn, with some considering this development to be reasonable given the "new economy" and others envisaging a bubble that would soon burst. Today it was possible to see the same discrepancy in the analyses, with some analysts considering that the United States' large current account deficit could remain so for a long period of time, while others believed there would be a dramatic adjustment with rising interest rates and a falling dollar. They were the same type of extreme views and the question was which direction developments would take. The member considered this to be particularly worrying given that the US key rate was 6.5 per cent when the IT bubble burst, while it was now at 3.5 per cent. There was thus very little scope for stimulation from monetary policy if this should prove necessary. Developments in the US housing market also gave cause for concern, as mortgages were being offered at 1 per cent interest to be paid in cash, while the remaining interest cost was added to the debt. This reflected expectations of house prices continuing to rise. The member also expressed concern that developments in Sweden would take a similar course.

Another member pointed out that it was important to distinguish between the effects of sharply falling house prices in the United States and the same development in Sweden. The risks of a depressive development that could be difficult to counteract were higher in the United States. This was because the United States was so large that rapid international growth would hardly be sufficient to counteract the fall in domestic demand. In addition, a sharp fall in demand in Sweden would probably be partly counteracted by a much weaker exchange rate, or this is at least what previous experiences would indicate.

One member agreed that the statistics received since the spring indicated that the real economy was developing in line with the June forecast. The member considered that the uncertainty over global economic activity had declined in the short term, as developments in the United States remained stable and Japan was showing some improvement. The member considered that the imbalances in the world economy appeared less acute in the short term. Continued improvement in the US public finances was not an unrealistic expectation. However, in the long term there remained the causes for concern taken up earlier by other members. At the same time, the oil price was higher than in the June assessment, which meant that there was reason to revise the forecast for international inflation somewhat. The member claimed that oil price developments also comprised a risk in so far as they could affect the behaviour of companies and individuals, if expectations of a more lasting high oil price than was indicated by current forward prices became established.

Another member questioned whether the improvement in the US federal budget noted recently could be assumed to be stable given, for instance, the background of planned increases in expenditure in the infrastructure field.

A further member considered that it was now clearer than during the early part of the summer that the weaker growth at the beginning of the year was a temporary phenomenon. Economic growth was more stable and gradually spread around the world with the growth centre being in the Pacific Ocean region. The fact that the global economy was growing at a higher rate than the trend level was reflected in the oil price developments. The oil price was largely demand-driven. The high growth led to an increased demand for oil, which pushed up prices. This would gradually contribute to lower growth and thereby lower prices.

One member pointed out that one means of adjusting the global imbalances was to have more flexible exchange rate regimes. The change in China's exchange rate policy and the revaluation of the currency meant that a step had been taken in the right direction. The speed and scope of any continued adjustments were uncertain, but Chinese leaders were presumably well aware of the problems that might otherwise build up.

Another member noted that this was one of the few occasions in recent years when there was no reason to revise down the growth forecast for the euro area. There had been some positive outcomes from indicators over the summer and developments appeared to be in line with the June forecast.

One member summed up the discussion by saying that the statistics received regarding international developments largely confirmed the good growth anticipated at the June meeting. With regard to the assessment of future developments, there was reason to adhere to the forecast published at that time. The uncertainty regarding the forecast path appeared to have declined in the short term. However, a slightly higher forecast for inflation abroad might be justified, given oil price developments. At the same time, several of the members had noted that the savings imbalances remained, which could lead to problems in the long term. However, the new information was not entirely clear-cut in this respect. Public finances in the United States had improved and the Chinese exchange rate changeover was another positive sign. Nevertheless, price trends in the US housing market gave cause for concern, while the current account deficit was growing. However, the foremost risk in the present situation was linked to the oil price and its future development, which were difficult to assess. If the price remained high, there was a risk that the expectations and behaviour of the general public would be affected, while it was also worth noting that oil price trends appeared to be largely demand-driven.

2.2 The Executive Board discussion regarding financial market developments

One member began by observing that long-term interest rates had been surprisingly low. Since June, the krona had shown a weaker development than expected in terms of the TCW index. The member considered that this was justification for revising the forecasts in the short term, but that there was at present no reason to change the views expressed in June regarding longer-term financial conditions during the later part of the forecast period. In line with the assessment made in June, it was reasonable to expect that long-term interest rates would rise as global capacity pressures increased, while the krona should also strengthen, said the member.

Another member observed in conclusion that there was agreement among the members that, despite the fluctuations in the interest and exchange rate markets, there was no reason to make any significant changes to the assessments made in June with regard to future developments in the financial markets.

2.3 The Executive Board discussion regarding the Swedish economic outlook and future inflation

One member began by pointing out that the tangibly low growth rate in Sweden during Q1 appeared to have been a temporary phenomenon, as had been expected. Growth became stronger in Q2 and GDP growth was largely in accordance with the June forecast. Although revised data show that GDP growth during Q1 was not quite as weak as the initial figures indicated, the member considered that the assessment from June still stood, to the extent that growth and capacity pressures would be much lower this year than the Riksbank had assumed in March.

The member went on to comment on developments in the public sector and on fiscal policy. So far this year, both public sector consumption and employment had shown weaker development than anticipated, particularly in local government. The member considered that this might indicate that the forecast should be revised down. However, local government finances were expected to show relatively strong growth, which meant it was also possible that growth in local government consumption and employment would be stronger during the remainder of the year. During the summer months the public sector's financial balance had been higher and the central government's borrowing requirement had been lower than many analysts had expected. However, the member observed that on this point the Riksbank's forecasts had been relatively accurate. There had also been some signals that a more expansionary fiscal policy could be expected, although it was still too early to be more exact about the scope and total net effect on demand, and there also appeared to be scope for slightly higher expenditure without breaching the permitted expenditure ceiling. The Riksbank's forecasts were based on the scope beneath the expenditure ceiling being fully utilised, but did not assume the ceiling would be breached. All in all, the member therefore considered that there was no basis at present for altering the forecast for fiscal policy.

The member pointed out that employment appeared to have remained largely unchanged, compared with June, although the recent statistics were difficult to interpret because of the change in the definitions used in the surveys.

With regard to growth prospects for the Swedish economy, the member considered on the whole that there was reason to make a slight upward revision to the forecasts for GDP growth and capacity pressures over the coming years, given that monetary policy was more expansionary following the interest rate cut in June. In addition, the member felt that this, together with the high oil price, indicated that the inflation forecast should be revised upwards for the entire forecast period, compared with June. UND1X inflation, which the member said currently provided the best picture of underlying, cyclical inflationary pressures, was expected to return to target a couple of years ahead.

Another member felt that developments had been in line with the Riksbank's forecasts. Private consumption appeared to have accelerated and taken over the role as growth engine now that exports had weakened. Investment also appeared to be developing well. Fiscal policy appeared to be aimed at public sector measures to reduce unemployment, which would mean local government expansion. These measures appeared to be on a larger scale than was anticipated by the Riksbank, according to the member. This means that domestic demand could increase more rapidly than had been forecast. Companies had increased their borrowing in order to invest, while household borrowing had increased by almost 12 per cent, on an annual rate, over the past six months and house prices continued to rise. The rapid increase in house prices gave some cause for concern regarding what might happen when developments came to a halt or began to reverse. It would not necessarily require a fall in prices in the housing market to subdue consumption; it might be sufficient if prices stabilised. It was positive that there were signs that the situation in the labour market had improved. The number of redundancy notices was declining and the number of new vacancies increasing. An important issue for the future was what effects monetary policy would have on the housing market and private consumption. The member pointed out that the repo rate would perhaps need to be raised earlier than was currently implied by the inflation outlook.

A third member agreed that there had been a turnaround for the better in the labour market. However, there is still a long way to go to full resource utilisation and domestic inflationary pressure. Stiff international competition and weak employment growth in the Swedish service sector were keeping down inflation. The more expansionary fiscal policy being proposed would mainly create jobs in the public sector, which would probably have less effect on inflation in the short term than if jobs were created in the private sector. Developments in the labour market did look more favourable now, but many problems still remained. In addition, there were the consequences of a stabilisation or possible fall in prices in the housing market.

One member noted that the Riksbank had made a substantial downward revision to the forecast for growth at the previous monetary policy meeting. However, growth during the summer had been good. The stock market had developed strongly and companies' results had been on the whole better than expected. Banks' lending to the corporate sector was increasing and companies were both expanding their operations and investing in machinery and other equipment to make operations more efficient and thereby reducing costs later on. Production capacity was increasing, which was normal at this point in the economic cycle. In addition, company acquisitions indicated there was full activity in the corporate sector. The situation in the labour market had improved somewhat, although not to the extent that was normal in the prevailing phase of the economic cycle. With regard to house prices and lending, the member shared the concern expressed by other members that this development was not sustainable in the long term. Prices were rising not only in metropolitan areas, but also in other, less rapidly-growing regions. Developments had now gone so far that there were some similarities with the situation prevailing at the beginning of the 1990s. If a price adjustment were to coincide with a general slowdown in economic activity, there was a risk now, too, that it would have a considerable effect on total demand.

Another member observed that developments during the summer had been in line with the assessment made in June. The picture painted at that time by other analysts and the media was excessively negative. The opposite appears to apply now. The member also said that caution should be exercised when making comparisons between the housing market at the beginning of the 1990s and that of today, mainly because the effects of an adjustment would probably be quite different with a floating exchange rate. Real interest rates were significantly higher when the exchange rate was defended and it was difficult to envisage this kind of upturn in real interest rates now. Developments in the housing market had given cause for concern for some time.

One member agreed that there were problems in making comparisons with developments during the 1990s, also because there was speculation in commercial property then, which was not the case today. Moreover, the member claimed that the difference between now and June was that the climate was quite different, rather than that economic activity had developed much more strongly than expected. However, companies were showing good profits. The negative picture shown in surveys in the spring had not left any impression on the statistics since then. Demand for consultants' services was rising rapidly. There were signs of a capacity shortage in the construction sector, where new recruitment was increasing. If there had not been labour force immigration from, for instance, some of the new EU member states, it was probable that the construction industry would have become overheated already.

Another member said that while one could point to many positive factors, growth had nevertheless been weaker than the Riksbank had anticipated in March. The member repeated that the positive growth during the summer was in line with the Riksbank's forecast in June. The difference was that exports had been weaker than anticipated, while consumption and investment had developed slightly better than expected. With regard to the labour market, developments in the construction industry had been strong, but there was ample spare capacity in the remainder of the economy. The picture painted in June, that the overall weaker growth this year meant that the spare capacity would be greater than was expected in March, still appeared accurate.

One member agreed with an earlier member's argument, which emphasised developments in corporate sector, with rising profits and increased borrowing. The climate in itself also had a positive effect on the economy. The figures for GDP growth in Q1 had been revised upwards, which was in line with an impression gained in June that the first outcome had probably been excessively low. International developments appeared more secure. In Sweden there had been a shift in growth from the export sector to domestic demand. At the same time, the krona had weakened, which was good news for the export sector.

Developments in the labour market were positive, particularly in the construction industry. The member summarised the situation as more positive and stable than it had been before the summer.

Another member emphasised that the situation looked better and that there was reason for optimism in the short term. However, the problem was that the large corporations, despite large profits, were continuing to lay off staff. For various reasons, conditions were not as good for small companies to expand. The stiffer competition from new manufacturing countries in eastern Europe and Asia also made greater demands for flexibility and a good climate for small companies to work in. It is necessary for the private service sector to accelerate in order for the labour market to provide support for the economic upturn.

One member summarised the discussion by saying that there was reason to expect stronger growth in the economy this year than had earlier been anticipated, mainly as a result of slightly stronger GDP growth in Q1. With regard to the coming years, there was reason to expect slightly higher growth rates than had been expected, partly due to more expansionary interest rate policy. Fiscal policy also appeared to be becoming slightly more expansionary than the Riksbank had previously anticipated, but it was as yet too early to assess the extent of this. Some members had spoken of a more positive view of economic activity over the summer, which could perhaps be interpreted as meaning that there was greater reason than previously for feeling confident that developments would remain stable, that is, that uncertainty had declined. However, this did not mean that the assessment had been changed in any significant way. There were slightly clearer signs now of a turnaround in the labour market and the fact that productivity growth had slowed also supported the forecasts for an upturn in employment. Inflation appeared to be slightly higher as a result of a higher oil price and increased capacity pressures. Several members had noted the strong price trend in the housing market and that household debt was continuing to increase. Concern over the possible consequences of this development had increased.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented a proposal for the monetary policy decision. The new information that had become available over the summer had been largely in line with the assessments in the June Inflation Report. However, there was justification for an upward adjustment of the forecasts for GDP growth, capacity pressures and inflation over the coming years, partly due to the more expansionary monetary policy conducted.

Household borrowing and housing prices had continued to rise at a rapid rate. There was still reason to feel concern that this could result in a destabilising real development later on that would also have consequences for employment and inflation. It was therefore important to continue monitoring developments closely. At the same time, there was reason to note that households' consumption demand was not as weak at the beginning of the year as initially indicated by data and that consumption had clearly strengthened in Q2. This indicated that monetary policy, which had now been expansionary for some time, had stimulated not only borrowing and house purchases, but also to some extent household consumption. This did not appear to be the case previously and was something that several members mentioned at the previous monetary policy meeting.

Inflation was expected to rise at a relatively slow rate and be roughly in line with the target a couple of years ahead. There was still justification for taking into account the rapid increase in household debt and the rise in house prices. All in all, this indicated that the repo rate should be held unchanged. The inflation outlook indicated that raising the repo rate was not urgent.

All members supported the proposal to hold the repo rate unchanged. However, one member pointed out that the economic situation looked better now than it did in June. The member said that if the National Accounts for Q1 had shown then what they showed now, it might have had some significance for the assessment of future growth and inflation. The expansionary monetary policy was pushing up house prices and household borrowing. This did not constitute a threat to the stability of the financial system; the institutions could absorb any losses that would arise if developments were to deteriorate. However, individual households might suffer, which could result in slower demand. Historically, an adjustment in households' balance sheets following an exaggerated upturn in credit and house prices takes a longer time and leads to greater negative effects on demand than the corresponding adjustments for companies following excessive share prices and corporate credit. According to an IMF study, the former takes an average of 4 years and the latter takes 2 years. These were factors that needed to be taken into account in future discussions of when parts of the current monetary policy stimulation should begin to be withdrawn. The member also observed that house prices could be affected by changes in the tax system, but did not consider it natural to discuss what might be considered suitable measures.

Another member noted in conclusion that many people seemed concerned over house price developments. However, it was difficult to say how this should be managed in practice. If developments in an economy had shown a clear upturn and capacity pressures and the labour market had improved significantly, then the conditions would exist for less expansionary monetary policy. The situation would be different if there were continued uncertainty over economic developments; then there would be a risk that less expansionary monetary policy might take us away from the inflation target. The picture that had been painted at this meeting was that the assessment of economic developments, capacity pressures and employment appeared more secure. If this picture remained true, it would normally mean that the time for raising the interest rate was coming closer. However, it did not appear likely that the interest rate would be raised in the near future. The member agreed that at present it was appropriate to hold the repo rate unchanged.

§ 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 1.5 per cent.

The Executive Board decided

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

- that the repo rate would be left unchanged at 1.5 per cent and that this decision would apply from Wednesday, 31 August 2005,
- that the lending rate would remain unchanged at 2.25 per cent and that the deposit rate would remain unchanged at 0.75 per cent with effect from Wednesday, 31 August 2005,
- that the decision would be announced at 9.30 a.m. on Wednesday, 24 August 2005, with the motivation and wording contained in Press Release no. 48, 2005 (Annex to the minutes), and
- to publish the minutes of today's meeting on Monday, 12 September at 9.30 a.m.

This paragraph was confirmed immediately.

Minutes by:

Ann-Christine Högberg

Checked by:

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