Separate minutes of the Executive Board meeting on 31 March 2004

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DATE: 31 March 2004

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström (participating via telephone from Paris)
Lars Nyberg
Kristina Persson
Irma Rosenberg
Kerstin Alm
Claes Berg
Jörgen Eklund
Kerstin Hallsten
Björn Hasselgren
Per Håkansson
Jyry Hokkanen (§ 1)
Leif Jacobsson
Pernilla Meyersson
Carl-Fredrik Petterson (§ 1)
Cecilia Roos Isaksson
Anders Vredin
Martin Ådahl

§ 1. The current inflation assessment

It was noted that Cecilia Roos Isaksson and Martin Ådahl would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

1. Recent data regarding economic developments

The Monetary Policy Department reported on new data received since the final date for inclusion in the Inflation Report, 19 March.

According to the present monetary policy expectations in the United States, no interest rate hikes were foreseen before the end of the year, while expectations regarding the euro area had shifted marginally towards rate cuts. At the same time, the euro had weakened against the US dollar. The Japanese yen had appreciated against both the US dollar and the euro as a result of stronger growth in Japan. With regard to Sweden, expectations in the financial markets indicated a rate cut of 0.5 percentage points. The krona had at the same time weakened against both the dollar and the euro. Between the final date for publication in the Inflation Report and meeting date the TCW had weakened from 127.8 to 128.6, which corresponded to around 0.7 per cent. Implicit volatility in the stock markets had increased somewhat, but the terrorist actions in Madrid had not had any clear effects on the financial markets.

In Sweden the results for producer prices in February indicated somewhat higher import prices and somewhat lower export prices for manufactured goods than was assumed in the Inflation Report. The statistics for foreign trade in February showed a continued strong increase in exports of goods and a decline in imports of goods. The most recent business tendency survey showed that export orders and production volumes had increased in recent months. The strong retail trade figures in February supported the forecast regarding consumption in the Inflation Report. However, according to the most recently monthly survey, households were once again less optimistic with regard to their own finances, the Swedish economy and unemployment.

An account was given of the National Institute of Economic Research's most recent report on the Swedish economy in March 2004. It was noted, for instance, that the Institute's assessment of growth in the Swedish economy for the current year was somewhat more pessimistic than the Riksbank's forecast in the Inflation Report.

2. The economic outlook and inflation prospects

Deputy Governor Irma Rosenberg presented the Inflation Report 2004:1 (Annex A to the minutes). This Inflation Report reproduces the main features of the presentations and discussions of inflation at the Executive Board meetings on 15 and 23 March.

Economic activity in Sweden and abroad had recently strengthened, which was largely as expected. The assessment of future developments in the United States, Asia, central and eastern Europe as well as Latin America was now slightly more positive than in December. On the other hand, a slightly weaker development was forecast in the euro area, as a result of some dampening effect on euro area exports from the stronger euro rate. A gradual recovery in the global economy and in Swedish export markets was still expected over the next few years. All in all, the Riksbank's assessment was that GDP growth in the OECD area would be 3.2 per cent this year, 2.8 per cent in 2005 and 2.9 per cent in 2006, which was a small upward revision to the figures in the December Inflation Report.

The Swedish economy would recover gradually and largely follow the developments estimated in the Riksbank's December Inflation Report. This meant that the recent economic downturn was relatively mild. One of the driving forces behind the upturn so far had been international economic activity with rising exports, while consumption had increased at a stable rate. In future, the upturn was expected to be fuelled by an increase in investment, which would be partly stimulated by the increase in exports and partly by low interest rates. GDP growth was calculated at 2.8 per cent this year, 2.6 per cent in 2005 and 2.8 per cent in 2006. The annual results are affected by differences in the number of working days in the different years. At the end of the forecast period, the economy was expected to approach full resource utilisation.

Despite the economic upturn progressing largely as expected, inflation was at a low level and had fallen substantially since spring 2003. This was to a large extent due to a return of energy prices to more normal levels; a development in line with the Riksbank's forecasts over the past year. However, very recently inflation had been even lower than expected and the Riksbank had changed its views of inflationary pressure. This was partly connected with unexpectedly low import prices. The labour market had also developed more weakly than forecast and productivity had increased more rapidly, which had led to lower domestic wage and price pressure. The recent fall in inflation also appeared to have had some effect on inflation expectations.

The unexpectedly low imported inflation was probably connected in part to the krona appreciation over the past year (particularly against the dollar) and in part to the currently weak rise in producer prices abroad. This was partly a cyclical phenomenon and foreign price pressures were expected to increase somewhat during the forecast period, as unutilised resources in the world economy were put to use and because commodity prices had risen relatively strongly. However, the upturn was assessed as weaker than historical patterns would indicate. Stiffer competition and increased trade with low-wage countries may have contributed to a decline in global producer prices for manufactured goods.

Inflation was expected to be significantly lower on average than the Riksbank's inflation target over the coming two years. However, it was expected to rise gradually as resource utilisation increased. The upturn in inflation was expected to be slower than previously calculated as a result of both domestic cost pressure and imported inflation being significantly lower.

Since the December Inflation Report, the risks of poorer international and domestic economic activity had declined and the probability of a stronger development had increased. This provided some upside risk for inflation from economic activity. The risks were balanced with regard to domestic price and cost pressure. The risk of higher wage increases than assumed in the main scenario had declined as a result of the central wage agreements signed so far, while there was considerable uncertainty regarding the sustainability and strength of productivity growth. Taking into account the risk spectrum, CPI inflation was expected to be 1.2 per cent one year ahead and 2.0 per cent two years ahead. The corresponding assessments for UND1X inflation were 1.0 per cent and 1.7 per cent respectively.

The Executive Board's assessment was that the new information received since the stop date for the Inflation Report did not provide motivation for a change in the assessment of future inflation.

The Executive Board decided

- to adopt the Inflation Report as presented
- to present the report to the Riksdag Committee on Finance and
- to publish it on 1 April 2004 at 8.00 a.m.

This paragraph was confirmed immediately.

§ 2. Monetary policy discussion

1. Account of the monetary policy group's view of the monetary policy situation[1]

Deputy Governor Irma Rosenberg presented the monetary policy group's view of the monetary policy situation. The group agreed that one reason why inflation was very low was that energy prices had fallen as expected subsequent to their substantial increase just over one year ago. The effect on inflation of fluctuations in energy prices was expected to abate towards the middle of 2005. The group therefore saw no reason to take special account of energy prices or to adjust the assessment of inflation to these when formulating monetary policy.

The group claimed that the factors contributing to inflation being subdued at present – surprisingly low import prices and a lower domestic cost pressure than expected – were probably not merely cyclical phenomena, but would also have more lasting elements, which would contribute to inflation according to the main scenario being lower than the target level both one and two years ahead. Although economic activity both in Sweden and abroad appeared to be continuing to improve as expected and there was thus a small upside risk for inflation, the assessment of inflation clearly indicated a rate cut. The group advocated a cut of 0.5 percentage points, but a discussion was held as to how quickly this should be implemented.

2. The Executive Board discussion

One member considered it quite clear that the rate should be cut in accordance with the Riksbank's rule of action and the recent inflation forecast. However, this member called for caution with regard to the size of the cut, considering 0.25 percentage points to be reasonable, at least to begin with. There had not been any real economy changes since the previous monetary policy meeting that motivated a large cut. It was only four weeks until the next meeting and more information would have been received by then, according to the member. If the inflation picture still looked the same, the Riksbank could then cut the repo rate by a further 0.25 percentage points. The member expressed some concern that a large reduction could create too much drama. Cutting the rate by 0.5 percentage points should be reserved for more extreme situations, said the member.

The member also pointed out those tendencies in the domestic economy had fluctuated significantly over the course of the past year. Following a relatively pessimistic mood during the autumn, which risked affecting consumption, signs of a recovery came during the first months of the year with strong retail trade figures and increased expectations. However, during the past month households' expectations and views of the labour market had

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[1] The monetary policy group is made up of Riksbank staff and is headed by Deputy Governor Irma Rosenberg.
The main features of the group's discussion are presented at the Board meeting.
The opinions expressed in the minutes are not necessarily shared by all members of the group.

deteriorated once again, which indicated weaker activity in the economy. The recent central wage agreements in certain sectors were in line with the forecast in the report and did not indicate higher inflation. At the same time, the member pointed out that there had been a rise in commodity prices, and it was as yet difficult to assess the impact of this on inflation. The member concluded that as usual there were arguments in favour of different alternatives, but that it would be wise to take one step at a time. There was always the possibility to make a further reduction of 0.25 percentage points at the next meeting.

Another member shared the view of the monetary policy group and advocated a cut of 0.5 percentage points. The member said that this cut was coming at a rather late stage, considering the turnaround in economic activity and the already clear downturn in inflation. Given the inflation forecast, however, there was no reason to make a cut of less than 0.5 percentage points. There was no inflationary pressure in the economy; on the contrary, developments in the labour market were weak. The member pointed out that while investment was rising, there were plenty of unutilised resources in the economy and that the labour market was not expected to strengthen before 2005. In addition, the member claimed that there had been an upturn trend in productivity growth and that potential growth had therefore increased, which should provide conditions for keeping interest rates at a low level for a long time to come.

A further member agreed that it was clear that the inflation forecast indicated an interest rate cut. However, the amount of the cut was not evident, as Sweden was in an upward phase of the economic cycle, where resource utilisation was increasing both in Sweden and abroad. The international recovery was accelerating well in most countries, with the exception of three or four countries in the euro area; the turning tide was strong enough to carry all of the boats, including Sweden. If the curves were drawn out beyond the normal, two-year forecast horizon, inflation would be seen to rise to 2 per cent with an unchanged repo rate – despite a cautious import price forecast – and of course it would rise even faster given an interest rate cut, said the member. If traditional economic cycles were repeated, the upturn in import prices could actually be stronger than forecast.

The same member discussed factors that had kept inflation down during the 1990s. The member listed these as monetary policy aimed at price stability in an increasing number of countries, fiscal policy aimed at budget consolidation, low commodity prices, high productivity growth, deregulation in product markets and last, but not least, the integration into world trade of former planned economies in Europe and Asia, which had led to low international import prices and falling prices in Asia. The member then asked the question of what these factors were now indicating. Commodity prices had risen substantially; falling prices in Asia had changed into inflation, except in Japan and a couple of smaller countries. The question was whether the rest of the world could avoid being affected by the return of inflation in Asia. The counteracting forces would be productivity increases and competition in trade, although it was uncertain whether these would be sufficient when both monetary policy and fiscal policy were very expansionary in most areas, particularly in the United States. The member went on to point out that asset prices and household indebtedness had risen in several countries. Based on historical experiences, the combination of expansionary monetary policy and fiscal policy, high asset prices, rapid credit expansions and turning inflationary pressure did not appear compatible with low long-term CPI inflation – despite increased competition, openness and high productivity. This entailed an upside risk for inflation, according to the member.

Based on the metaphor of the Swedish economy as a small boat lifted by the economic upturn on the sea of the world economy, the member's opinion was that although the wind had stilled temporarily in the small Swedish bay and the sky was cloudless, the risk of a storm still remained. At such times it is wise to have a well-constructed boat and not to overload it. Asset prices and household indebtedness have also increased in Sweden, although not to the same extent as in other countries. Debts have approached the levels seen at the end of the 1980s, although the burden from interest and amortisation payments is low because of the present interest rates. However, if households borrow too much money, this may have negative effects in the future. There were calculations of households' resilience to cost increases that indicated considerable sensitivity. The interest rate is the instrument at the Riksbank's disposal to influence household indebtedness. The member summarised by observing that inflation would rise as unutilised resources were put into use, but that it should remain below the target level two years ahead, in line with the forecast and only rise further beyond that point. At the same time, it was desirable that monetary policy should not contribute to excessively high asset prices and indebtedness among households. The strength and sustainability of the increase in productivity were also uncertain, which indicated caution. There would be further opportunities in the future to assess the situation. The member therefore advocated a cut of 0.25 percentage points.

Another member objected to the picture of a stable economic upturn. The United States and Asia were showing strong growth, but developments were much weaker in the euro area. The US economy remained dynamic but at the same time showed record-high deficits in its budget and current account. The United States was growing on borrowed money. According to some studies, the US external net debt, which was already at a record-high level, would increase dramatically if the exchange rate remained unchanged. It was therefore probable that a large exchange rate change would occur, with the euro strengthening against the dollar, which would in turn delay the upturn in the euro area. In addition, the US labour market remained weak and personal bankruptcies and credit card withdrawals are at a record-high level, despite the very low key interest rate of 1 per cent. The member's opinion was that US fiscal policy needed to be tightened, probably after the coming presidential election. Households were heavily in debt and rising interest rates could cause an overly rapid application of the brakes. The world economy was strongly dependent on the United States and it seemed to be taking a long time before the euro area can take its place. China was continuing to grow strongly, but price pressure on Chinese goods was subdued by the access to a very large reserve of labour. Although China's share of world trade had increased from approximately 1 per cent to 5 per cent since the beginning of the 1990s, this was not enough to make it an international growth engine.

One member commented the previous member's darker picture of international economic activity and considered that, even though there were question marks in Europe and dangers linked to the US budget deficit and it's financing, the picture of an overall, stable economic upturn was now even clearer than at the previous monetary policy meeting.

The member also pointed out that the gradual integration of India, China and eastern Europe into the world economy supplied large new production resources that could affect not only the international distribution of labour, but also lead to growing demand for products and knowledge from the rest of the world. This could provide a possibility for higher growth and rising incomes even in traditional industrial nations. However, it would also demand changes in the industrial structure similar to those experienced in Sweden when the textile industry and later the shipyard industry were exposed to international competition. In the United States, the business sector was in many respects skilled at managing this type of readjustment process, where new businesses emerge and replace those that have lost competitiveness. The member considered that there was greater reason to be concerned over the traditionally more regulated economies in central and southern Europe.

With regard to inflation, the member's opinion was that changes in the international distribution of labour appeared to have contributed to holding back prices for finished goods. Large readjustment processes often led to bottlenecks arising in different parts of the economy, which could affect prices. There was reason to pay attention to this with regard to the countries presently showing strong growth.

A further member pointed out that there were major problems in France, Germany and Italy, while very positive signals were being received from the United States, Japan, China and also European countries outside of the euro area, such as the United Kingdom and Norway, which were countries important for Swedish trade. In the meantime, the international debate was giving increasingly serious focus to the risk of the budget deficit in the United States leading to a dollar fall and the potential consequences of the expected tightening of the US budget. However, something the member did not feel should be regarded as a negative element was the rapid US productivity growth and outsourcing. Although this could lead to low growth in employment in the initial stages, it would at the same time enable domestic redistribution of labour and resources to the services sector, so that this could meet the requirements of an ageing population, a development that also applies to Sweden.

However, another member warned that the unemployment that can follow a rapid structural change can be long-lasting and lead to private demand falling too far during the transition period.

Yet another member considered that even though international economic activity had developed largely in line with the assessment in the previous Inflation Report, the inflation impulses had become lower, productivity growth stronger and the situation in the labour market weaker than expected. In this respect there were similarities between Sweden and the United States. All in all, the member's opinion was that developments in the forecast indicated an interest rate cut of 0.5 percentage points. A cut of 0.25 percentage points would with the current forecast motivate a further cut of 0.25 percentage points at the next meeting in four weeks' time. It did not appear likely that the forecast would change significantly during this relatively short period.

The member considered developments in household indebtedness to be an important question in this context. An interest rate cut would most probably lead to households continuing to increase their borrowing. Regardless of how much the interest rate was now cut, it was conceivable that debts in relation to income would be slightly above the level prevailing before the crisis at the beginning of the 1990s. While the low interest rates meant that households' monthly costs for a loan of a given size were now lower than they had been then, growing indebtedness meant that households' sensitivity to rising interest rates would increase.

However, the member observed that the situation did not comprise any problem for the stability of the payment system, even if the interest rate were to gradually rise or house prices to fall. Most households could manage reasonable interest rate rises without suffering economic problems, although there might be households living close to their margins. With regard to property prices, they had certainly continued to rise in Göteborg and Malmö, but not in the rest of the country, in the way they had in the late 1980s. Nor did it appear as though they had risen to the extent that there was reason to talk of a "bubble".

Finally, the member considered that there was nevertheless a danger to households if they were surprised by coming interest rate rises. The picture of economic activity painted in the Inflation Report indicated a closing of the output gap and rising inflation towards the end of the forecast period. An interest rate cut in the present situation would therefore, if the forecast for stronger economic activity and gradually increasing inflation was correct, result in future interest rate increases coming at an earlier stage. Given this, the member claimed that it was essential that households should have a sufficient buffer in their monthly income to manage rising interest rates.

One member added that sensitivity to changes in monetary policy would only increase to the extent that households increased their debts at a floating interest rate. If they fixed their loans at the current rates, sensitivity to monetary policy would decline.

Another member shared the previous member's view of the significance of developments in household indebtedness. This member did not see any problems at present from the point of view of financial stability. The member observed that interest rate cuts normally lead to an increase in household indebtedness, but as an increased aggregate demand is one of the purposes of a rate cut, it is not surprising if indebtedness is affected. Naturally, there was a risk that some households might borrow too much, but that risk existed even at the present interest rate level. Increased borrowing meant that demand could be affected more strongly when the interest rate was increased in future, but it need not comprise a problem from a monetary policy perspective. It might, however, affect the strength of monetary policy measures that needed to be taken to obtain the desired effect on demand. In any case, the member considered that this did not affect the current choice between cutting the rate by 0.25 percentage points or 0.5 percentage points. In addition, there were plenty of unutilised resources in the economy and it would take some time before they were put into use. The risks of inflationary pressure building up rapidly were therefore fairly slight. The choice of 0.25 or 0.5 percentage points thus did not appear particularly dramatic, according to this member. As the inflation forecast provided scope for a cut of 0.5 percentage points, the rate should be cut by this amount.

One member called once again for caution in the interest rate decision. Although the stability of the banking system was not under threat, it was important to avoid subjecting households to a troublesome situation. Although a purely liberal view might say that households are capable of taking their own decisions, the member felt that monetary policy should contribute to avoiding excessive indebtedness.

The same member questioned the difference between cutting the rate by 0.5 percentage points at once and by 0.25 percentage points on two different occasions. Was there a nonlinearity here? The member asked whether reactions would not be stronger to a large cut than to two smaller cuts.

Another member replied that the market had already assumed a cut of 0.5 percentage points, which indicated little drama if such a cut was made. Some mortgage institutions had already adapted to this and cut their mortgage rates.

The member then described the present decision-making situation. A gradual reassessment of inflation had been made since November and December 2003. This was not mainly based on any individual event, but on information received regarding productivity, wages, inflation expectations and price trends in Sweden and abroad. There had been arguments in favour of cutting the repo rate in December, but they were less evident then. A significant change took place up to February, which created the basis for an interest rate cut and there had now been such a large overall change, compared with December, that the inflation forecast showed inflation below target level both one and two years ahead, despite the cut in February.

The member further observed that all of the Board members appeared agreed that the repo rate should be cut. According to the inflation forecast, there was scope to cut the rate by 0.5 percentage points. The member said that if the rate was cut by only 0.25 percentage points, there would remain expectations of a further but of 0.25 percentage points, unless new information called for a revision of the inflation forecast. The main factor against a cut of 0.5 percentage points was that Sweden was so far advanced in the economic cycle. Connected with this was a risk that international price pressures could increase in future. At the same time, there as still a number of unutilised resources that could be put to use and resource utilisation was expected to increase relatively slowly. Given this background, there should be plenty of time to take action and raise the rate in future; when there was reason to believe that inflationary pressures were growing.

The member also observed that the stability of the banking sector was not currently under threat and that households did not on the whole have any problems with a high level of indebtedness. The member agreed with several colleagues that this overall, less alarmist picture could very well be combined with concern for individual households. However, the question was how far the Riksbank could, and should, go. The bank's statutory responsibility was aimed at price stability and at contributing to a safe and efficient payment system. The Riksbank should be cautious in shouldering any responsibility over and above this. There were limits to what could be achieved with one single instrument – the repo rate. The main responsibility for individual households' loan situations lay with the households themselves and with those who lent to them, mainly the banks and mortgage institutions. What the Riksbank can to is to highlight this fact and to emphasise that it is probable that interest rates will rise in the future and that those who borrow should ensure they have the reserves to manage such a situation.

The member considered that exchange rate should also be taken into account when formulating interest rate policy. The Swedish krona had been affected by lower market rates and interest rate expectations. This could have a possible effect on the scope for further interest rate cuts in future. In conformity with another member, the member further observed that an interest rate cut now would probably mean that future increases in the interest rate would come sooner. However, it was not possible to say with any certainty when this would occur. The member concluded by advocating a cut of 0.5 percentage points.

A further member said that it was not possible to say how long it would be before monetary policy would change direction. One should not forget that future decisions must be based on the situation prevailing at the time, taking into account price and cost pressure in Sweden and abroad.

§ 3. Monetary policy decision[2]

The Chairman noted that since the end of 2002, temporary fluctuations in energy prices have made a strong impact on inflation. The Riksbank had therefore chosen during this period to attach greatest importance to inflation measures that excluded energy prices. These temporary effects were expected to have abated from the middle of 2005. There was therefore no reason at present to adjust for energy prices when deciding on monetary policy.

The chairman observed that the members of the Executive Board were agreed that UND1X inflation at present provided the best picture of underlying, cyclically-related inflationary pressure. It was therefore natural that monetary policy should now be primarily guided by this measure of inflation.

The chairman summarised the monetary policy discussion under § 2 and found that there were two proposals: to cut the repo rate by 0.25 percentage points and to cut the repo rate by 0.5 percentage points.

The Executive Board decided after voting

- to lower the repo rate by 0.5 percentage points to 2 per cent and that this decision would apply from Wednesday, 7 April 2004,
- to lower the lending rate by 0.5 percentage points to 2.75 per cent and to lower the deposit rate by 0.5 percentage points to 1.25 per cent with effect from Wednesday, 7 April 2004,
- to announce the decision at 8.00 a.m. on Thursday, 1 April 2004 with the motivation and wording contained in Press Release no. 17 (Annex B to the minutes) and
- that the minute of today's meeting would be published on Tuesday, 20 April 2004.

Deputy Governors Villy Bergström and Eva Srejber entered reservations against the decision to cut the repo rate by 0.5 percentage points. They advocated a cut of 0.25 percentage points.

They put forward three reasons for their reservation:

Firstly, that growth in Sweden and abroad was in an upturn phase, which meant that resource utilisation would show a gradual increase in the future. As this increased, Swedish

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

inflation with regard to consumer prices would also increase towards and then beyond the inflation target. In a few months, when the normal forecast horizon was moved forwards, this would also be visible in the Riksbank's forecasts.

Secondly, there was reason for caution because of the charges the expansionary economic policy in many parts of the world had injected into the world economy. Asset prices, risk propensity and commodity prices had risen substantially. While commodity prices comprised only a small part of the final cost of goods, the margins were under pressure from these increasing costs and price trends for input goods were beginning to reflect the increase in world growth. The spread to later links in the supply chain had already begun. The counteracting force, which was expected to keep down import prices and thus consumer prices, was increasing productivity and lower pricing power as a result of increased competition due to more countries being integrated into world trade, but the strength and sustainability of this process was uncertain. The effects on economic activity could be underestimated and the spread could be greater as demand and capacity utilisation increased. There would be further opportunities in future to assess the situation.

The third reason for caution was that household indebtedness and house prices had risen to high levels even in Sweden, although developments in Sweden were less striking than in some other countries. It was unnecessary to provide strong encouragement for increased indebtedness through a cut of 0.5 percentage points, when there had been no dramatic occurrences since the previous meeting.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

Lars Heikensten

Eva Srejber

Villy Bergström

Lars Nyberg

Kristina Persson

Irma Rosenberg