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Separate Minutes of the Executive Board meeting on 4 December 2003, No. 27

DATE: December 4 2003

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

Kerstin Alm
Claes Berg
Mårten Blix (§ 1)
Jörgen Eklund
Anders Eklöf (§ 1)
Kerstin Hallsten
Björn Hasselgren
Jyry Hokkanen (§ 1)
Per Håkansson
Leif Jacobsson
Annika Svensson
Ulrika Wienecke
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Annika Svensson and Ulrika Wienecke 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, 25 November.

The US dollar had continued to weaken, which was assumed to be primarily due to market participants' recent increasing focus on the savings imbalances in the United States. The krona had strengthened against the dollar and remained stable against the euro. The TCW exchange rate development was in line with the Riksbank's forecast.

New statistics on economic activity largely confirmed the assessments in the Inflation Report. The National Accounts for Q3 in the United States had been revised upwards slightly, compared with earlier, preliminary figures. In the euro area, the upturn in the purchasing managers index that had persisted over the past six months was continuing with regard to both the manufacturing industry and the services sector. At the same time, the revised National Accounts for Q3 in the euro area showed a strongly positive contribution from net exports, although domestic demand was weak and stocks provided a clearly negative contribution. All in all, the new statistics were in line with the assessment of international economic activity presented in the Inflation Report.

In Sweden, the statistics on foreign trade in October indicated a continued strong increase. Optimism among Swedish households continued to decline in November, while the retail trade index rose. The most recent business tendency survey showed that order intake and production volume had increased slightly in recent months, but that companies' estimation of order stocks and inventories had not altered appreciably. However, the purchasing managers index continued to rise, which indicated that industrial activity had improved. GDP increased by 2.0 per cent on a calendar-adjusted basis during Q3 this year, compared with the corresponding period last year. During the first three quarters GDP increased by 1.6 per cent, which was in line with the assessment in the Inflation Report. Both export and import volumes increased slightly more than expected, while the outcome for investments was slightly weaker. The number of hours worked continued to decline during Q3. The actual reduction was slightly more than had been forecast in the Inflation Report.

2. Inflation Report 2003:4.

Deputy Governor Irma Rosenberg presented a draft of Inflation Report 2003:4 (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 20 and 27 November 2003.

The Riksbank's assessment of international economic activity as presented in the Inflation Report had not changed appreciably in recent months. However, the view of economic growth in the United States had gradually become more optimistic. Growth in the euro area had been slower than in the rest of the world this year, but there were now some signs of an economic upturn there, too. All in all, the Riksbank's assessment was that GDP growth in the OECD area would rise slightly, amounting to 2.0 per cent this year, 2.9 per cent in 2004 and 2.7 per cent in 2005.

International price pressure had been low recently. It was assumed that as global resource utilisation increased, international export prices would rise again. It was assumed that the krona would strengthen a little further during the forecast period, which would have some restraining effect on import prices.

The October Inflation Report forecast a slow recovery in economic activity in Sweden. This forecast remained essentially unchanged. GDP growth is still forecast at 1.5 per cent in 2003, 2.4 per cent in 2004 and 2.5 per cent in 2005. There had been some upward revision of export and import prices for this year. The forecast for public sector consumption had been revised down somewhat for the coming two years, due to strained local government finances.

The inflation rate had fallen back as assessed by the Riksbank in the October Inflation Report. However, energy prices had once again been unexpectedly high, while other price increases had been lower than anticipated. This applied to prices of both imported and domestic goods and services. One possible explanation as to why inflation adjusted for energy prices had developed more weakly than forecast could be that productivity growth had been unexpectedly rapid.

There was still a risk that international economic activity would be weaker and lead to lower inflation than in the main scenario. However, recent developments in the United States and Asia indicated that there was also a possibility of a more rapid recovery than expected and of inflation thereby being higher. The domestic risks of higher inflation, stemming from continued high electricity prices and overly rapid wage increases in the coming wage bargaining rounds, still remained. A new element in the balance of risks was that there were now also signs that domestic inflationary pressure could be lower than expected. One reason for this was that productivity growth had been surprisingly strong. Inflation adjusted for energy prices had also increased less than anticipated over the year. In addition, the weak labour market could lead to domestic demand being lower than assumed in the main scenario. All in all, the uncertainty in the assessment was slightly less than in October, while the risks of higher inflation were balanced by the risks of lower inflation.

The Executive Board decided to adopt the Inflation Report as presented and to publish it on 5 December at 9.30 a.m.

Deputy Governors Villy Bergström and Kristina Persson both entered a reservation against the decision to adopt the Inflation Report.

Villy Bergström made the following statement:

Economic activity has largely been sustained by private consumption in recent years. Investment has developed weakly. The labour market is now being weakened due to a lower level of employment in industry and to budgetary problems in the public sector leading to tax increases and redundancies. Households' expectations of their own finances and of the labour market have become less optimistic. At the same time, resource utilisation is low and seems likely to remain so at least during next year. There is therefore a risk that private consumption will no longer contribute to economic activity in the same way as before and that investment will be further postponed. In addition, the stronger krona entails some monetary restraint. Next year could therefore be a year with a weak labour market, low level of demand and inflation below the target level. Contrary to the assessment in the Inflation Report I therefore consider there to be an overall downside risk for inflation because of economic activity in Sweden.

Kristina Persson made the following statement:

Like Villy Bergström, I see a downside risk for inflation in Sweden, but I place greater emphasis on the supply side. The underlying inflation rate is very low and price increases will not come until long into the forecast period. Inflation may also develop more weakly than forecast as a result of a weak labour market, with slightly lower wage increases and productivity once again being stronger than expected. Although the expected international upturn is being confirmed to an increasing extent by incoming statistics and indicators, the turnaround in Sweden is progressing slowly. According to the National Institute of Economic Research's Business Tendency Survey for November, only a few sectors are satisfied with their order intake and employment is continuing to decline. I see a risk of the investment upturn being postponed slightly and the growth forecast for 2004 in the Inflation Report is therefore somewhat overestimated.

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 was agreed that the repo rate should be left unchanged. The picture of economic activity was largely the same as in October. However, international developments had been slightly stronger than expected, according to the group. The economic upturn had begun in both Sweden and abroad, and resource utilisation was expected to increase slightly during the forecast period. Several members of the group considered that UND1X inflation excluding energy provided the best measure of underlying, cyclically related inflation. According to the assessment in the Inflation Report, this measure was expected to be close to the inflation target both one and two years ahead.

2. The Executive Board's discussion

One Executive Board member felt that the recent statistics and confidence indicators were continuing to show a clear upward trend in economic activity abroad. In many areas, the figures had been surprisingly positive; particularly in the United States and Asia. Some of the figures were at levels that had not been seen for many years. Growth remained good in the former Soviet republics and the candidate countries, and there had been an improvement in economic activity in Latin America. Newly-received information on the euro area was in line with the growth forecast. In addition, the member felt that the upturn in commodity prices reflected accelerating industrial activity. Trade was increasing and freight prices were high. All in all, the member's assessment was that recent statistics indicated that international developments could prove stronger than was anticipated in the Inflation Report. However, consumer price increases remained low, although producer prices had begun to rise in both

[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 the members of the group.

the United States and Europe. In several countries, low interest rates were encouraging households to increase their debt burdens while companies still appeared to be consolidating their balance sheets.

The member's opinion was that Sweden had also been drawn into the international upturn, which could be seen in the export and import figures as well as the most recent business tendency survey. The krona was back on the intended path and the substantial weakening that occurred during 2001 had been corrected. However, the exchange rate could not be termed strong in a historical perspective. The member considered it reasonable to forecast a continued upturn in growth in Sweden in future, with growth rates of around the potential level and a gradually declining output gap.

Furthermore, the member observed that the statistics showed continued increases in productivity and low shortages, while capacity utilisation in industry was expected to rise from an already high level. As yet there was no clear increase in the demand for labour and employment had so far followed the same pattern as in earlier upturns, such as during the first half of the 1980s. The forecast for 2004 and 2005 was cautious and assumed a much lower increase in employment than at the beginning of the 1980s. It therefore took into account continued increases in productivity and savings in the public sector. The result of the wage bargaining rounds remained to be seen, the member pointed out. The outcome for total wage increases over the past decade had not always been affected by the labour market situation. The coming wage bargaining rounds would follow on from a wage agreement period with higher inflation than expected and with inflation expectations for a couple of years ahead slightly above the target level.

Regarding monetary policy, the member agreed with the monetary policy group that the repo rate should remain unchanged. The member pointed out that monetary policy was already expansionary: real interest rates were low and the krona was not strong in a historical perspective. At the same time, the discretionary measures taken by the central government would continue to help increase demand this year and next year. A downside risk for this forecast came from the possibility of an irregular adjustment of exchange rates and current account balances in the global economy, but this situation would have to be managed if it arose, said the member.

Another member pointed out that the legislators' intention was that monetary policy should support growth and employment when this was compatible with the inflation target. The member said that we were experiencing such a situation now and therefore called for an interest rate cut. A weak labour market with lower wage increases could lead to even lower inflation in the near future, and productivity could once again exceed expectations. This would mean that potential growth was slightly higher and that the output gap was larger than the Riksbank was now assuming, which would also motivate an interest rate cut.

The member considered that the international economic upturn had been confirmed by incoming statistics. However, there was still a risk of a setback as a result of the large savings imbalances that could lead to higher interest rates. Similarly, the geopolitical situation could entail renewed uncertainty that would subdue economic activity. Interest in holding US government securities had declined and the net inflow of investment into the United States had recently fallen considerably. It was therefore probable that the dollar would continue to weaken. The risk of a setback was particularly high after 2005, said the member, as fiscal policy restraint could be expected after the presidential elections. All in all, however, this member said there was a balanced international risk spectrum, with the risk that a synchronised upturn could exceed expectations. In addition, the member noted that the large structural changes that had occurred in the global production and trade patterns in recent years, with increasingly advanced production in typically low-cost countries, were tending to lead to lower price pressure in the world economy.

In addition, the member observed that employment growth in Sweden looked bleak: companies were envisaging further cutbacks, and the compensation from personnel increases in the public sector was coming to an end as a result of poor public finances. Increases in taxes and charges were also coming too early in the economic cycle and risked pushing down private consumption. This, together with the downside risk for Swedish inflation, motivated more expansionary monetary policy at present, said the member, repeating a request for an interest rate cut.

A third member felt that international developments, with the exception of the euro area, had been surprisingly positive in recent months. The uncertainty that existed a few months previously had declined considerably and there was greater confidence in the stability of the recovery. Investment and employment in the United States had improved and the threat of deflation, which dominated the debate during the summer, appeared to have receded. Developments in the financial markets also gave clear indication of an economic upturn. With regard to the balance of risks, the member pointed out the possibility that stronger demand could put further upward pressure on house prices in countries where prices were already worryingly high, such as the United States, the United Kingdom, the Netherlands and Ireland. If this were to happen, the housing market, which did not slacken during the economic slowdown in these countries, could become an issue requiring increased attention. A problem of a different nature could be that a few central banks in Asia were sitting on very large holdings of US treasury bonds. If these central banks were to rapidly sell off their holdings it could create unease in the financial markets, which have so far managed the fall in the dollar rate in an orderly manner. Such unease would in turn probably slow down the economic upturn. However, the member considered the risk of such developments to be slight.

With regard to economic activity in Sweden, the member expressed some understanding of the two members who had entered a reservation against adopting the Inflation Report. The labour market had developed more weakly than expected, and this development could be expected to prevail over the coming months. Inflation was at the lower edge of the target margin. However, the member considered that a number of factors were against cutting the interest rate. Inflation expectations were above target level, capacity utilisation was rising and there was a risk of contagion effects from the high electricity prices. All in all, the member agreed with the main scenario and risk assessment in the Inflation Report and advocated that the repo rate should be left unchanged.

One member said that the high house prices could be one reason to exercise caution in cutting interest rates. An interest rate cut could aggravate house price developments, resulting in a further increase in mortgages and household indebtedness. However, the member considered that prices in the property market had been checked somewhat, at least in metropolitan areas.

The member then put forward five reasons why an interest rate cut was motivated. Firstly, the member made the assessment that resource utilisation in Sweden would be slightly lower next year than this year and in 2005. This left scope for an interest rate cut. A cut would contribute to stimulating the economy and enable Sweden to avoid a situation like that in Denmark, where growth had been negative for the past two quarters. Secondly, the member observed that the labour market had weakened. Here the Riksbank should take notice of the National Labour Market Board's forecast, which indicated that unemployment would be above five per cent next year. Thirdly, there had been monetary restraint over the past year as a result of the stronger krona. This provided scope for cutting the interest rate as compensation. Fourthly, expectations in the household sector had deteriorated, the labour market was weak and there were signs of a jobless recovery in industry. This constituted a risk that private consumption, which was the driving force behind the Swedish economy, would slacken before investment accelerated. The member thus claimed that there was nothing to lose by cutting the interest rate. It would not push up inflation next year. Finally, the member pointed out that the next monetary policy meeting would take place when the wage bargaining rounds were in full swing.

One member, who supported the assessment in the Inflation Report, noted that there was considerably less uncertainty in international economic activity now than before. The picture for the United States was more positive, which had led to an upward revision in the growth forecast. The member said that statistics indicated that the uncertainty over an upturn in economic activity had declined somewhat in the euro area. In Sweden, the picture painted showed stable demand in the household sector and the National Accounts for Q3 supported the forecast in the Inflation Report. The member agreed that the weak labour market could comprise a risk for consumption. However, labour market developments were a factor with time-lag effects in the economic cycle. The member therefore considered that there was no motivation for an interest rate solely on the basis of current labour market developments. However, if the labour market remained weak, this could lead to slackening demand and provide reason to consider cutting the interest rate. All in all, the member was satisfied with the assessment made and saw no reason to change the repo rate at present.

The member added that import prices had contributed to keeping down inflation so far. It was rising import prices rather than increased domestic cost pressure that lay behind the expected upturn in inflation in the main scenario.

Another member said that while the upturn was consumption-driven and possibly partly financed through increased household borrowing, households' interest rate expenditure in relation to income (debt/equity ratio) remained low. The member pointed out that increased indebtedness in the household sector was a phenomenon that could be observed in many countries, which had successfully endeavoured to achieve price stability and thereby low interest rates. The increased level of indebtedness could quite simply be an adjustment to a low-inflation society. The member asked the question of whether households' debts constituted a risk to future developments in Sweden. Higher interest rates could reasonably lead to lower consumption by households. However, a higher interest rate would probably be linked to an acceleration in economic activity and lead to an increase in households' incomes and consumption. In this type of situation it would probably be desirable to subdue consumption. If consumption were instead to fall as the result of increased uncertainty among households, the situation would be worse. The question is why households, which have continued to borrow during a long economic downturn and a heavy stock market fall, would change their behaviour now that an upturn appears increasingly certain.

One member added that households in Sweden did not appear to be borrowing for the purpose of consumption. It was rather purchases of houses or rented apartments being converting to tenant-owned apartments, which had led to increased borrowing.

Given that one member, who wanted to cut the interest rate, did not exclude the possibility of interest rate hikes towards the end of next year, another member pointed out that the effects of a change in the repo rate have a time lag. One could therefore wonder whether the effects in 2004 of a cut of 0.25 percentage points at the present time, followed by an increase next autumn, would be very substantial. Interest rate policy was a good tool for keeping inflation and inflation expectations at a stable, low level, but not to fine-tune economic activity. The earlier member replied that an interest rate change would have an effect on demand at an early stage, although the full impact on prices would not occur until the end of the forecast period. In addition, capacity utilisation would remain low during the entire forecast period, according to the Inflation Report, which meant that there was little risk if one reacted now.

One member agreed with several earlier members in their view of economic developments. The member said that international statistics received since the stop for including data in the Inflation Report indicated that developments were in line with the forecast or even slightly stronger. In Sweden, developments have been roughly as expected. With regard to employment, it is difficult, as others have already mentioned, to determine whether developments are following the normal cyclical pattern. The labour market normally tends to lag behind in the economic cycle. The member advocated an unchanged repo rate, but considered the decision was not clear-cut. The discussion of risks in the Inflation Report made it clear that there were signs that supply conditions in Sweden had developed better than expected. For example, productivity growth had been surprisingly strong, while several measures of underlying inflation showed lower price pressure than expected. The member considered it important to closely follow and see whether economic activity strengthened as anticipated and how Swedish supply conditions develop. If economic activity did not clearly strengthen as expected or if the weak labour market and supply conditions in future were assumed to lead to lower inflation than currently expected, an interest rate cut might be motivated in February.

The member also pointed out that each individual monetary policy decision should not be dramatised. The consequence of not cutting the rate now was merely that it would take longer time before it needed to be raised in future, all else being equal.

In conclusion, the member noted that inflation was still affected to a large degree by energy prices and that fluctuations in these could be regarded as essentially temporary. The most natural action at present was therefore to base the decision on UND1X inflation excluding energy. However, one member noted that it was very difficult to distinguish the temporary and permanent components in the energy price upturn. There is a trend increase under way in energy prices, partly due to higher energy taxes.

§ 3. Monetary policy decision[2]

The chairman noted that the members of the Executive Board were agreed that UND1X inflation excluding energy 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 leave the repo rate unchanged at 2.75 per cent and to cut the repo rate by 0.25 percentage points.

The Executive Board decided after voting

- that the repo rate would be left unchanged at 2.75 per cent and that this decision would apply from Wednesday, 10 December 2003,
- that the lending rate would remain unchanged at 3.50 per cent and that the deposit rate would remain unchanged at 2.00 per cent with effect from Wednesday, 10 December 2003,
- that the decision would be announced at 9.30 a.m. on Friday, 5 December 2003, with the motivation and wording contained in Press Release no. 60 (Annex B to the minutes) and
- that the minutes of today's meeting would be published on Thursday, 18 December 2003.

Deputy Governors Villy Bergström and Kristina Persson entered a reservation against the decision to leave the repo rate unchanged. They advocated that the repo rate should be cut by 0.25 percentage points, taking into account the reservation they entered against the Inflation Report.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

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

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