Separate Minutes
Executive Board, No.16

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

DATE: 14 August 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
Malin Andersson
Claes Berg
Mårten Blix
Sophie Degenne
Jörgen Eklund
Anders Eklöf
Kurt Gustavsson (§ 1)
Kerstin Hallsten
Björn Hasselgren
Jyry Hokkanen
Leif Jacobsson
Jesper Johansson (§ 1)
Ulrika Wienecke
Staffan Viotti
Anders Vredin

§ 1. Monetary policy discussion

It was noted that Malin Andersson and Ulrika Wienecke would prepare draft minutes of paragraphs 1 and 2 on the agenda for the meeting.

The discussions were based on new data and analyses presented by the Monetary Policy Department. These analyses in turn were based on the technical assumption that the Riksbank's repo rate would remain unchanged at 2.75 per cent up to and including the second quarter of 2005.

1. Economic developments and inflation prospects

1.1. Financial market developments and the international economic outlook

In financial markets, long-term bond yields had risen since July at the same time as equity prices had continued to move higher, thus bringing to an end the period of contradictory economic signals noted earlier in the summer of falling yields and rising stock markets. The US Federal Reserve had toned down the risk of deflation somewhat, although the bank had stressed that an unwelcomely low rate of inflation could still not be ruled out. Furthermore, a number of positive economic signals had been observed, particularly regarding the US economy.

Following the Riksbank's rate cut in July to 2.75 per cent, money market rates were now pointing to expectations that the Riksbank would begin a series of rate increases next year, as was the case for the ECB and Federal Reserve. Equity prices on international stock markets had continued to rise since June. According to market participants, this had been partly due to a decrease in risk premiums since the conclusion of the war in Iraq, and partly to better-than-expected profit figures in the interim reports of many firms. The improved results had mainly been attributable to falling costs. Moreover, firms had remained cautious in their assessments of future demand and earnings. Market valuation, in terms of P/E ratios, was now close to the average for the 1990s. Since July the krona had depreciated somewhat against the euro. The consensus view on financial markets appeared to be that this, at least in part, was due to the current uncertainty surrounding the outcome of the autumn referendum on the euro.

There had been little new information to suggest any marked change in the international economic outlook since the previous Inflation Report or the July monetary policy meeting. In the US domestic demand in the second quarter had surpassed expectations, with primarily business investment increasing sharply. Total GDP growth was somewhat weaker than expected, however, owing to negative contributions from inventory investment and net exports. There had also been signs of economic recovery in Japan and South-East Asia. In the euro area, however, indications of a turnaround in the economy had not been as evident, despite some stabilisation of the labour market and somewhat higher turnover in retail sales over the summer. Both new orders and manufacturing output had continued to be weak in Q2.

Oil prices had continued to rise since the monetary policy meeting in July. Besides a slower-than-anticipated resumption of production in Iraq after the war, new data showed an unexpectedly large fall in the level of US oil inventories. In addition, forward prices of oil were pointing to somewhat higher oil prices in the time ahead compared with the previous assessment.

1.2. The Executive Board discussion of financial market developments and the international economic outlook

One member voiced concern about the fact that current account deficits around the world had not been corrected and the implications this could have for economic conditions. In addition, these imbalances could be aggravated by increasing differences in growth between the US and the euro area. While the member considered the outlook for the US to be considerably brighter than for the euro area and Japan in the long term, not least thanks to favourable demographic factors, these imbalances would not be sustainable in the medium term, particularly in the light of the twin deficits in the US.

Another member pointed out that financial market developments were indicating expectations of stronger growth in the future. In equity markets the number of share issues had increased again, and there had also been a rise in mergers and acquisitions activity, in Asia at least. Moreover, the yield spreads between government bonds and corporate bonds with different credit ratings had fallen back further, the number of defaults on bond payments had decreased and there had been a normalisation of long-term interest rates after a period of unprecedentedly low levels. Exchange rates between major currencies had, after a period of smooth adjustment, stabilised at least temporarily.

The member noted that the recovery which had been forecast for the second half of the year in the Inflation Report had already begun, and this had been largely confirmed by new data. The most recent statistics from the US had shown stronger growth than previously assumed. In the euro area, signs of higher activity had mainly been visible in indicators of expectations. Actual outcomes are compiled with a certain time lag compared with the US, and data for the most recent period had therefore not been available. The Japanese economy was continuing to grow faster than expected, and both central and eastern Europe as well as Russia and its nearest neighbours were also experiencing relatively strong growth. The downside risks for the world economy had therefore diminished over the summer, and the likelihood of deflation spreading outside Japan had decreased. Regarding other downside risks, the member shared the previous member's view that there was still a risk of an abrupt future adjustment of current accounts and exchange rates. Moreover, the member saw a persistent risk that a continuation of the sharp rises in yields and a new decline on the stock market could entail problems for pension funds, life insurance companies and consumers, among others. At the same time, the member observed that there was a risk that the highly expansionary economic policy, characterised by low key interest rates and the consequent sharp increase in liquidity in the world economy, would not be tightened quickly enough when the economy turned around. This could result in higher inflation and financial market imbalances in the future, beyond the Riksbank's forecast horizon.

A third member shared the cautious optimism about the economic climate, but also questioned the sustainability of the upturn as the growing US deficits could give rise to a new recoil. The persistent labour market weakness in the US and the euro area could also have a negative impact on confidence and the willingness to consume.

A fourth member observed that we now, as opposed to in the spring, were not just seeing positive signs in expectations variables but also outcomes that were pointing in the right direction, particularly in the US. Investment had been increasing more than expected and, by all accounts, on a relatively broad front, inventories were low and consumption had grown, partly due to tax cuts and low interest rates. The positive developments in the financial markets since July had continued, and there appeared to be renewed interest among stock market investors to provide firms with equity through share issues and IPOs. Furthermore, the Federal Reserve had toned down the risk of deflation and was no longer talking about keeping bond yields down through purchases of Treasury bonds with long maturities. While the risk of a recoil could not be ruled out, it appeared more likely now than in July that the economy had bottomed out.

To sum up, it was the view of the Executive Board that the new information that had been received since July had confirmed the Riksbank's forecast of a recovery in the world economy during the year. Growth had been marginally higher than expected in the US and marginally weaker in the euro area. In financial markets, prices were roughly in accordance with the projected level of economic activity.

1.3. The economic outlook and inflation prospects in Sweden

The preliminary National Accounts for Q2 had pointed to relatively strong activity, with somewhat higher growth in Sweden during the first half of the year than forecast in the Inflation Report. Indicators of economic activity were mixed, however; the July business tendency survey of the National Institute of Economic Research (NIER) had shown a slowdown in manufacturing activity, and the construction sector had continued to be weak. On the other hand, the purchasing managers' index had indicated a more positive outlook. The most recent data had also provided mixed signals about household consumption: the NIER's business tendency data provided a gloomy picture of sales volumes for durable goods, while retail sales figures from Statistics Sweden for durable goods and summer car-sales were better than expected.

Since the June Inflation Report UND1X inflation had fallen back roughly as expected while CPI inflation was somewhat lower compared with previous forecasts, mainly due to the Riksbank's rate cuts in the summer. Outcomes in May and June had been somewhat lower than forecast, owing to unexpectedly large declines in prices of clothes, shoes and vegetables. The dry summer and unusually low level in Swedish reservoirs had contributed to a rise in electricity spot and forward prices. Meanwhile, low oil inventories in the US and a sluggish resumption of oil production in Iraq had resulted in higher-than-expected oil prices during the summer. Due to the rise in energy prices in July, the rate of price increases between June and July had been underestimated somewhat. CPI inflation stood at 1.8 per cent and UND1X at 2.3 per cent year-on-year in July. Forward prices for electricity and oil for the coming year were indicating that the expected decline in consumer prices for energy could be less than forecast in June and July. In addition, poor harvests and the dry spell in Europe could lead to higher prices for fruit and vegetables in the short term.

1.4. The Executive Board discussion of the economic outlook and inflation prospects in Sweden

One member concluded that the economic outlook had not changed much since the previous monetary policy meeting. If anything, the most recent data had pointed to marginally weaker activity since then. Rising unemployment, particularly among younger age groups, persistent weakness in manufacturing, and the weak data concerning retail sales and construction were signs of this. Furthermore, the member noted that the Government had lowered its growth forecast and raised its unemployment forecast for next year. Nevertheless, the member concluded that inflation could be expected to be in line with the Riksbank's target two years ahead.

A second member concluded that the relatively strong GDP growth during the first half of the year indicated that growth this year would not be as weak as forecast by the Riksbank in the June Inflation Report. However, new data had provided a mixed and uncertain picture of economic conditions, and it was therefore too early to say for sure that an economic upturn had begun. At the same time, the repo rate cuts during the summer of 0.75 percentage points in total could be expected to stimulate the economy over the coming two years. For this reason, growth in both 2004 and 2005 as well could be somewhat stronger than forecast in June and July.

A third member expressed unease about developments in the labour market. A deterioration could lead to growth being overestimated for next year. Otherwise, the member mainly agreed with the assessment of the Swedish economic outlook. As the output gap was expected to be negative over the entire forecast period, the member was not concerned about inflation prospects.

A fourth member was somewhat more optimistic about economic developments. The member observed that as the fluctuations in the business tendency data and the purchasing managers' index appeared to coincide, there could be reason to attach greater importance to the latter, which was compiled later than the NIER's survey. Other signs that were indicating increased activity in Sweden included car sales and retail sales. While unemployment had risen, it also lags behind other economic developments. On balance, there was reason to expect fairly good growth in the near future and moderate resource utilisation. So far, inflation had been essentially in line with the Riksbank's forecast, although temporary supply factors could lead to higher prices for energy and foodstuffs in the future. Also, there had been a recent depreciation of the krona. All in all, this had increased the risk of rising inflation expectations, which would have an impact on wage growth.

Another two members said that they shared the other members' general view of the Swedish economic outlook. According to one of them, the risk was small that the recent supply shocks would have a lasting effect on inflation. To support this, the member pointed out that previous supply shocks had not had any permanent effects on inflation. The depreciation of the krona was probably a temporary effect associated with the uncertainty that surrounded the outcome of the referendum. Furthermore, the member was of the opinion that the Riksbank should analyse what implications revised growth estimates for the US and the euro area would have for forecasts of the USD/EUR exchange rate. A change in this exchange rate could result in a depreciation of the krona.

On balance, the Executive Board concluded that Swedish GDP growth this year would probably be somewhat higher than forecast in the Inflation Report. GDP growth in the coming two years was also expected to be somewhat stronger compared with the previous forecast, mainly due to the Riksbank's rate cuts of 0.75 percentage points in total in June and July. Capacity utilisation was still relatively low, and the NIER's business tendency survey had been showing evidence of very low labour-shortages in construction and the category "other business services". However, as a result of stronger growth, mainly this year but also in coming years, resource utilisation was expected to be somewhat higher than previously assumed over the entire forecast horizon. Inflation two years ahead should be revised upwards somewhat owing to the higher resource utilisation. UND1X inflation was forecast to be roughly in line with the inflation target towards the end of the forecast period, both including and excluding energy prices.

2. Assessment of the monetary policy situation[1]

Deputy Governor Irma Rosenberg presented the monetary policy group's view of the monetary policy situation. The repo rate had been lowered on two occasions during the summer by a total of 0.75 percentage points, and given the outlook for economic growth it could be assumed that inflation would be in line with the Riksbank's target two years ahead. The view of the monetary policy group was therefore that the repo rate should remain unchanged.

All members of the Executive Board were in favour of an unchanged repo rate. Several members also noted that the decision on this occasion was fairly straightforward.

§ 2. The monetary policy decision

The Chairman summarised the monetary policy discussion under § 1 and found there was a proposal to leave the repo rate unchanged at 2.75 per cent.

The Executive Board decided

- to leave the repo rate unchanged at 2.75 per cent and that this decision would apply from Wednesday, 20 August 2003,
- to leave the lending rate unchanged at 3.50 per cent and to leave the deposit rate unchanged at 2.00 per cent with effect from Wednesday, 20 August 2003,
- to announce the decision at 9.30 a.m. on Friday, 15 August 2003 with the motivation and wording contained in Press Release no. 48, 2003 (Annex to the minutes), and
- to publish the minutes of today's meeting on Thursday, 28 August 2003.

This paragraph was confirmed immediately.

Minutes by:

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[1] The monetary policy group is composed of Riksbank staff and headed by one of the Deputy Governors. 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.

Kerstin Alm

Checked by:

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