Separate minutes of the Executive Board meeting

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DATE: 14 March 2005

TIME: 1 p.m.

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

Claes Berg
Jörgen Eklund
Victoria Ericsson
Kerstin Hallsten
Jyry Hokkanen
Ann-Christine Högberg
Per Jansson
Pernilla Meyersson (§1)
Ulrika Wienecke
Anders Vredin

§ 1. The current inflation assessment

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

The discussion was based on the new data and analyses presented by the Monetary Policy Department. These analyses were in turn mainly based on the assumption that the repo rate would remain unchanged at 2.0 per cent up to the end of 2007 Q1. The Inflation Report now being published also contained a box with an assessment based on the assumption that the repo rate would develop in line with implied forward rates.

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, 9 March.

Inflation in terms of UND1X amounted to 1.1 per cent in February, which was 0.4 percentage points higher than forecast in the Inflation Report. This deviation from forecast could be explained in roughly equal parts by the frost in Spain that affected fruit and vegetable prices, by the fact that other foods and other imported inflation were higher than expected and by electricity prices not falling as far as anticipated. Both manufacturing output and order intake rose slightly between December and January. In the United States, the trade deficit for January was slightly higher than market expectations.

The oil price had continued to rise and now amounted to around 53 dollars a barrel. The factors believed to lie behind this development were higher demand due to the cold weather in the United States and Europe and the Saudi oil minister's initiative regarding a higher oil price interval for OPEC in 2005. Consequently, forward prices had also risen somewhat.

The dollar had weakened again since February. The rising oil price and higher inflation than expected, alongside the fundamental current account deficit in the United States, may provide part of the explanation. The weaker dollar had in turn led to an appreciation of the krona in terms of the TCW index.

In the United States, the upturn in long-term interest rates, which began in mid-February, continued, fuelled by a monetary policy speech made to Congress by Federal Reserve Chairman Alan Greenspan and the unexpectedly high inflation outcome. Long-term interest rates in the euro area and Sweden were in line with the forecast in the Inflation Report.

With regard to monetary policy, expectations of future interest rate hikes had moved slightly closer in the United States, while the opposite applied to the euro area and Sweden. At present, pricing in the forward market indicated expectations that the Riksbank would raise its repo rate by 25 points in December.

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

Deputy Governor Irma Rosenberg presented the Inflation Report 2005:1, Annex A to the minutes. The Inflation Report reflected the main features of the presentations and discussions at the Executive Board meetings on 24 February and 9 March.

According to the Inflation Report, international economic growth remained strong. There were many indications that growth would continue, albeit at a slower rate and that resource utilisation would gradually increase. Nevertheless, international price pressure was expected to be moderate, partly due to continued integration of low-cost countries into global trade.

Strong international demand for Swedish exports contributed to high GDP growth in Sweden last year. Investment also began to increase. More recently, the economy seemed to have entered a more stable growth phase, although growth was still expected to be relatively strong over the coming two years. There were numerous indications that investment and net exports would increase at a slightly more rapid rate than was assessed in

December and January. The forecast for GDP growth in 2005 was therefore revised upwards.

Despite last year's strong productivity growth, there was a fall in the number of persons employed. Continued strong GDP growth this year was expected to lead to an increase in employment. Meanwhile, the signals from the manufacturing industry were that capacity utilisation had increased recently. However, the weak labour market meant that resource utilisation in the economy as a whole was still expected to be relatively low. Growth during the forecast period was expected to remain at a level where unutilised resources would decrease.

Inflation had been low over the past year. It was primarily imported inflation that was lower than expected. In relation to the assessments made in December and January, the inflation forecast was now revised down. This was not due to any crucial change in the assessment of the general economic outlook, but rather to a number of specific factors. Imported inflation was expected to be affected by increased international competitive pressure. The forecast for domestic inflation had been revised down, partly due to price pressure in the food industry and lower rent increases. Inflation was therefore expected to remain low this year. From 2006 onwards, inflation was expected to rise as economic activity continued to strengthen and cost pressure intensified.

The risks of lower inflation were now considered to be offset by the risks of higher inflation. The total assessment was that CPI inflation would be 1.2 per cent one year ahead and 2.1 per cent two years ahead. The corresponding assessment for UND1X inflation was 1.1 and 2.0 per cent respectively.

The Executive Board made the assessment that the new information received since the meeting on 9 March did not give reason to change its views on inflation trends.

The Executive Board decided

- to adopt the Inflation Report as presented and
- to publish the Inflation Report at 9 a.m. on 15 March.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg presented the proposal for a monetary policy decision. Inflation in Sweden was at present very low. This applied to the rate of price increase on both domestically-produced and imported goods. Part of the explanation for this was increased competitive pressure both on the global market and in the Swedish economy. The fact that domestic cost pressure was low was also due to the fact that there had been an ample supply of unutilised resources for some time and to strong productivity growth. Over the coming years growth was expected to be higher than the long-term sustainable rate. This meant that resource utilisation and thereby cost pressure would gradually increase and inflation would rise. According to the forecast in the main scenario, which was based on the assumption of an unchanged repo rate, inflation would be in line with the target a couple of years ahead. This indicated that the repo rate should be held unchanged.

Inflation was expected to be lower than the target level of 2 per cent for a large part of the coming two-year period. In line with the Riksbank's clarification of monetary policy published in 1999, there were at present reasons against cutting the repo rate. Inflation had been very low in a situation where demand was already showing strong growth. Business sector investment showed an upturn last year and was expected to continue to increase at a good rate. The low inflation was therefore not due to weak demand, but to special supply factors that were stimulating growth, namely the rapid productivity growth, low imported inflation and increased competition, particularly in the food industry. Interest rates were unusually low at present, which contributed to a rapid increase in household borrowing and in housing prices. If the repo rate were to be cut, it was possible that inflation would reach the target level slightly sooner, but it would probably be necessary to raise the rate again fairly quickly. It was uncertain what effect this would have on investment, particularly in a situation where interest rates were already very low and access to liquidity was good. All in all, this called for a certain measure of caution in monetary policy, and the proposal was thus that the repo rate be held unchanged, said Ms Rosenberg.

The forecasts for growth and inflation made under the assumption that the repo rate would follow implied forward rates indicated that market expectations of future monetary policy were fairly reasonable. This did not prevent other possible interest rate paths leading to the fulfilment of the inflation target. Altogether, the different assessments included in the Inflation Report indicated that there was no reason for urgency in raising the repo rate, observed Ms Rosenberg.

One member agreed on the whole with the conclusions just presented. However, the member wished, given the fact that inflation was expected to be below the target level for a large part of the forecast period, to raise the question as a matter of principle, how activist should monetary policy be? If the interest rate were cut now, the target would be achieved more quickly. The member then wondered, was it reasonable to accept a low inflation rate over a long period of time on the grounds that this would avoid raising the rate at a later stage?

Another member said that strong activism was often based on a belief that economic activity could be fine-tuned, which the member did not actually believe was possible. Given the already expansionary monetary policy, strong demand and rising resource utilisation, the member questioned what effect an interest rate cut would have at present.

A further member observed that the present low inflation rate was not cyclical, but structural. The reasons for the low inflation rate were largely beyond the scope of monetary policy, and it would therefore be inappropriate to cut the repo rate.

One member felt that it was difficult to discuss activism versus non-activism in general terms. The member compared the present decision situation with that of a year earlier. There was then a risk – albeit not a very large risk - that economic activity would not accelerate, which was grounds for cutting the interest rate. Now, economic activity appeared more robust, and resource utilisation was increasing relatively rapidly. Moreover, the recent global upturn in long-term interest rates called for some caution when conducting monetary policy. At the same time, the member agreed with what had been said earlier regarding the effects of an interest rate cut at the present time; interest rates were unusually low, access to liquidity was good and domestic demand was increasing rapidly.

Another member felt that the discussion on an activist monetary policy was based on a belief that monetary policy could fine tune cyclical paths and that one actually had a fairly precise knowledge of how future monetary policy measures would affect future growth and inflation paths. However, this was not the case. It was therefore reasonable to make each decision separately and await developments, as was usually the case. Cutting the rate now on the grounds that it could be raised again later in the autumn did not appear to be well-grounded. Robust demand, combined with the assessment that economic activity would continue to improve, were grounds for holding the rate at its present level. In addition, the present low inflation rate was largely due to specific structural factors, which should be taken into account.

One member agreed on the whole that it was more specific, structurally-oriented factors that had led to the recent very low inflation rate, but nevertheless claimed that one should be cautious in categorising them as temporary factors. Globalisation and increased competition had contributed to pushing down inflation over a number of years. Monetary policy had taken this into account. However, one problem was that the effects were not stable; they varied from one year to the next and sometimes from one month to the next. At the end of the 1990s, this type of factor had a relatively large impact on inflation, but the effect appears to have been much less during the early 2000s.

Another member observed that the different factors that hold prices down or push them up can have different degrees of impact over time and these must be offset against one another. In line with the clarification published in 1999, the member felt that stable real economy developments in a longer-term perspective should also be taken into account. The weak labour market, despite good growth, lay in one scale pan, while the other contained households' increased borrowing and the risk of a housing market bubble building up. Given that an interest rate cut would probably not have such a large effect on employment, this was outweighed by the risks linked to asset prices. This indicated that the interest rate should not be cut at the present time.

One member agreed that cutting the interest rate would increase pressure in the housing market. The argument in favour of cutting interest rates put forward by external analysts was often based on conditions in the labour market, rather than on inflation, despite the fact that more expansionary monetary policy could scarcely make any improvement in the labour market. The member considered that, in practice, monetary policy appeared to have different levels of effectiveness during economic booms and recessions. The member agreed with the colleague who had earlier claimed that the upturn was now broader and more stable than it had been a year ago.

Another member noted that the rate of increase in unit labour costs would remain low. The member also pointed out that the economic situation was favourable, with high levels of growth and productivity and low inflation. On the other hand, it appeared to be taking longer than usual for employment to pick up. This had also been the case in the United

States until a year or so ago, but since then employment had increased at a good rate. It was possible that there would be a similar development in Sweden. However, in the United States it had been the services sector that accounted for a large part of the increase in employment. The Swedish services sector did not have the same favourable conditions, particularly with regard to services aimed at households and individuals. At present, supply and demand were limited by public monopoly and tax wedges. The member noted that this was not something that monetary policy could remedy; it was a matter for the government and parliament.

Given the prevailing economic climate, the same member continued, long-term interest rates and risk premiums were at an unusually low level. This could be partly explained by the short-term inflation outlook appearing favourable internationally, but it was also possible that the high level of liquidity would lead to underpricing of risks. Although long-term interest rates and some spreads, for instance, Swedish housing spreads, had increased somewhat recently, the level was still low. There was a risk that investors and borrowers would be lulled into a false sense of security, believing that the present low interest rates would endure. This could in turn lead to exaggerated borrowing and continuing asset price rises, for instance, for housing. The longer an exaggerated credit boom and exaggerated asset prices prevailed, the greater would be the risk of an abrupt adjustment to a more balanced level of debts and house prices.

The member said that there could thus be grounds in the present situation with good growth, gradually increasing resource utilisation and inflation pushed down by supply effects for not utilising the scope for an interest rate cut offered by the inflation forecast according to the simple policy rule.

One member observed that there was much discussion of market prices for currencies, debt securities and oil. There were also attempts to interpret these prices as though they were in all aspects and on all occasions really equilibrium prices that reflected supply and demand on a free, efficient market. However, the member pointed out that this was not the case. It was clear in the oil market that OPEC was trying, with varying degrees of success, to affect supply and thereby market prices. With regard to the bond and foreign exchange markets, it was fairly clear at present that they were being disturbed by a number of Asian countries choosing to peg their currencies to the dollar. This meant that the central banks in these countries were buying large quantities of US treasury papers at prices that were probably higher - and thus interest rates that were lower - than commercial agents were willing to pay. The member noted that this was keeping up the dollar exchange rate and pushing down US bond yields.

However, a build-up of reserves could not continue indefinitely, continued the member. Sooner or later, at least some of the reserves would be sold in one way or another and then the dollar rate would fall and interest rates would rise. And the more the reserves grew, the more worried the market would become over this threat. This could of course make private agents even more willing to buy US treasury bonds, as they could lose money both on an interest rate increase and a dollar fall. It could also happen very quickly.

The member observed that two important conclusions could be drawn from this. Firstly, that it was not surprising if the long-term dollar rate remained at a low level for some time yet, but also tended to fluctuate, perhaps substantially. Secondly, that investors were seeking alternative investments, which in turn was pushing down risk premiums on other debt instruments. The member concluded that this would lead to underpricing of risk in the market. Another member noted that a further aspect of financial developments was that a reduction in households' willingness to invest in shares and bonds would contribute to pushing up house prices. Instead of investing money in the stock market, households were clearly investing in new accommodation and in renovation.

A further member observed that if long-term interest rates remained low, households would become more willing to increase their burden of debt. It was difficult to get away from the suspicion that some of them were ignoring the discussion of what would happen when interest rates began to rise again. There were several signs that an increasing number of households were approaching the borderline where the debt burden could prove troublesome when loans needed renegotiation and monthly costs might double. The member pointed out that there was greater reason now than, for instance, six months ago to consider whether some households were not taking greater risks than they actually realised.

The member asked how this might provide cause for concern. The member noted that this did not concern the stability of the banking system, which had been established in a number of contexts. If the banks' loan losses from lending to households were to increase, this should worry the stock market long before financial stability was threatened. Perhaps the worry was that individual households could experience problems? This was not a problem for society as a whole, even if it were to lead to major personal tragedies. The concern from a monetary policy point of view is rather that if households have misjudged the speed and amount of a rise in interest rates, they could be forced to reduce their consumption sooner and more drastically than they had intended. However, this could mean there was no longer a need to raise the interest rate as much or as soon as would otherwise have been the case.

The worry over household indebtedness was instead more closely related to house prices, observed the member. When households borrowed more, house prices would probably continue to rise. If house prices were then to fall rapidly, this could affect household demand and, in the longer term, employment. In principle, this type of price development could perhaps create scope for lower interest rates that counteracted a decline in the economy, but experiences of earlier rapid falls in asset prices showed that in practice it was not easy to compensate for this with monetary policy measures. There was thus always reason to be vigilant with regard to house prices, particularly when developments were as rapid as they had been in recent years.

Another member pointed out that the imbalances in the global economy – the US credit bubble and over-investment in China – were interconnected. The weak financial structure in China, with a large percentage of bad loans and a large inflow of capital for the purpose of speculation, constitutes a risk factor for both stability and economic activity, particularly in South East Asia. The member noted that the possible bubbles in the European and US housing markets could be added to these global imbalances as part of the risk outlook.

One member observed that not very much had happened in the economy since the previous monetary policy meeting. One point worth noting was that investment had increased, which was a welcome development from the point of view of demand and long-term productivity growth. The member asked what this could be thought to entail for employment. This time the investment upturn was mainly in the pulp, paper and mining industries, as well as the construction sector. The first three industries were capital intensive, which meant that there would probably be little effect on employment. The exception was the more labour-intensive construction sector.

Another member pointed out that the most recent investment survey indicated a relatively large upturn in investment, which supported the forecast. Although investment was taking place in capital-intensive sectors, it would have a contagion effect in the Swedish labour market. This would lead to employment increasing in computer services and other companies in the services industries. A further member agreed with this reasoning.

However, one member observed that if the investment upturn had taken place in the engineering industry, it would have had even greater effects on employment. With regard to the construction sector, another member noted that some jobs were probably already going to labour from other countries. This meant that the upward pressure on wage costs could be lower than might be expected.

Another member observed that there was potential for a rise in employment in the services sector. However, as an earlier member had pointed out, there were political and structural obstacles. Removing these obstacles would have a greater effect on employment than low interest rates.

The Chairman summarised the discussion by observing that there was broad agreement on holding the repo rate unchanged at 2 per cent. The assessment indicated that inflation would be in line with the target a couple of years ahead. However, during a large part of the coming two-year period inflation was expected to remain low. There were several interlinking factors that called for caution in this situation. Firstly, demand was already strong, both with regard to corporate investment and household consumption. It was not likely that a further interest rate cut in the present situation – with historically low interest rates and good access to liquidity – would have such a large effect on developments, particularly as a cut now when economic activity was good could be expected to lead to bringing forward future increases. Another, partly related, aspect was that the low inflation was largely due to positive supply factors, including increased competition, which was stimulating the economy. There was considerable uncertainty over how lasting the effects on inflation would be. The current low interest rates had also led to a rapid rise in household borrowing and house prices. The main risk here was that some households were now taking on more loans than they would be able to manage in future if interest rates rose. Although this would not provide any threat to the banking system, it could contribute to subduing consumption significantly and thus have negative effects on both general demand and employment. All in all, these arguments, which had been put forward in different ways by all members, indicated that the repo rate should be held unchanged.

§ 3. Monetary policy decision[1]

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.

The Chairman found that there was only one proposal: to hold the repo rate unchanged at 2.0 per cent.

The Executive Board decided

- that the repo rate would be left unchanged at 2.0 per cent and that this decision would apply from Wednesday, 16 March 2005,
- that the lending rate would remain unchanged at 2.75 per cent and that the deposit rate would remain unchanged at 1.25 per cent with effect from Wednesday, 16 March 2005,
- to announce the decision at 9.00 a.m. on 15 March 2005 with the motivation and wording contained in Press Release no. 19 2005 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Friday, 1 April 2005.

This paragraph was confirmed immediately.

Minutes by:
Ann-Christine Högberg

Checked by:
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg

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