Separate minutes of the Executive Board meeting, No. 8

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DATE: 28 April 2004

TIME: 1 p.m.

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

Kerstin Alm
Jörgen Eklund
Kerstin Hallsten
Björn Hasselgren
Jyry Hokkanen
Per Håkansson
Leif Jacobsson
Alexander Nilson
Ulrika Wienecke
Staffan Viotti
Anders Vredin
Helena Öström (§ 1)

§ 1. The current inflation assessment

It was noted that Alexander Nilson 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 based in turn on the assumption that the repo rate would remain unchanged at 2.0 per cent up to an including 2006 Q1.

1. Recent data regarding economic developments

Formaterat: Engelska (Storbritannien)

Since the publication of the Inflation Report on 1 April long-term interest rates had risen, both in Sweden and abroad. At the same time the dollar had strengthened and the rise in equity markets had continued. Behind this were signals of an increasingly robust and more evident economic upswing. In addition there were expectations of a less expansionary monetary policy, notably in the United States. In Sweden a survey showed that all money market agents were expecting the repo rate to be left unchanged at today's meeting.

As regards international developments no data had been received that deviated markedly from the forecasts in the Inflation Report.

The most significant change in terms of the Swedish economic situation was the repo rate cut of 0.5 percentage points. Moreover, as a result of somewhat stronger international demand, export growth had increased more than expected. The proposals in the Spring Fiscal Policy Bill to increase central government grants and employment subsidies to local governments entailed a slight rise in consumption and investment in the public sector. The Bill also contained a proposal for a tax deduction for repairs, maintenance and improvement work on private homes where this affected household consumption.

Labour market data for Q1 showed that employment in Sweden had been somewhat weaker than expected and that labour demand was relatively low in the business sector. In recent weeks several central wage agreements had been concluded, which had largely been on a par with the previous Industrial Agreement. According to the latest inflation figures, CPI inflation was -0.1 per cent and UND1X inflation stood at 0.4 per cent in March compared with a year earlier. The outcomes were somewhat higher than anticipated.

2. The economic outlook and inflation prospects

2.1 The Executive Board discussion regarding financial market developments and the international economic outlook

One member began by noting that international developments had largely been in line with the forecasts in the Inflation Report. Outside the OECD area new data had generally exceeded expectations. Long-term interest rates had risen and the dollar had strengthened, particularly since the release of data showing vigorous jobs growth in the United States in March. As the labour market so far had been the missing link in the economic upswing the turnaround there had had an impact on expectations.

Another member underlined that the changed view of the US labour market appeared to be based on the outcome for one single month and that developments before that were weak. In addition the member was uncertain about the explanations that had just been put forward regarding the dollar appreciation. According to the member, higher growth in the United States compared with the rest of the world was leading to an increased import surplus, which in turn entailed a further deterioration in the current account. Since this in itself should result in a weakening of the dollar, other causal relationships should be sought.

One member pointed out that market players appeared to have changed focus in recent months. It now seemed to be expected yield spreads, rather than growth differentials, that were the central feature of the exchange rate analysis, at least as regards the dollar/euro rate. Another member called attention to yet another important difference between the United States and the euro area, namely productivity growth.

One member agreed with a previous member that it was mainly the robust jobs figure in the United States that was behind the change in pricing in the financial markets. The Federal Reserve had long been citing the weak labour market as one of the most significant reasons to keep key interest rates low. Expectations of less expansionary economic policy in the United States in the period ahead had thus been strengthened since the publication of the jobs data. The new US figures had also affected the view of monetary policy in the euro area, and the probability of further easing there had decreased. New information about the euro area was more ambiguous: strong statistics that supported the forecast recovery was mixed with more negative signals.

One member agreed that the Federal Reserve's actions had been significant for the financial markets. The fact that the Federal Reserve now expected a stable economic upswing meant that this view had taken firmer root among market players as well. The strengthening of the dollar should be seen in this context. The member also pointed out that the financial markets were obviously pricing risk lower than usual at present, which was apparent *inter alia* in the yield spreads between government bonds, on the one hand, and junk bonds and emerging market bonds on the other. This was likely an effect of the low interest rates and high liquidity in the world economy, both of which were encouraging the pursuit of higher returns. There was a risk of unease in the financial markets, including equity markets, if the return to normal risk preferences was to occur too quickly. However, the member did not believe that such a situation would be enough to derail the currently robust upswing in the world economy.

Another member pointed out that new data for the most part had been unexpectedly strong, with the exception of the three largest euro area countries. The more vigorous international activity would probably spread soon to these countries as well. As expected the increased growth had resulted in gradually rising price pressures that now could be observed increasingly further along the production chain, although there was as yet no cause for great concern.

One member said that it would be favourable if domestic demand picked up in Europe before a slowdown came in the United States and Asia. In that way economic activity abroad would become less synchronised and the upswing would perhaps last longer as a result. Furthermore the member noted that inflation was rising from a low level, notably in the United States and China.

Another member expressed concern that the weak activity in the euro area was not receiving sufficient stimulus from economic policy. A further appreciation of the euro, which was probably inevitable in connection with a correction of the large US current account deficit, would be able to derail the fragile recovery.

One member observed, against the background of the previous member's arguments, that interest rates, and particularly long-term rates, were already historically low in the euro area. This was true in particular in those parts of the euro area that only during the past decade, thanks to EMU, had conducted a stability-oriented policy, e.g. Italy. Subsequently the member wondered what view should be taken of the recent rise in energy prices. The developments could be seen from two perspectives: on the one hand it led to higher inflation and on the other it reduced households' purchasing power, especially in Europe, which could have an opposite, restraining effect on economic activity and inflation. The member had no clear answer as to which of these mechanisms was the more significant, but said that it was an important factor to consider in the period ahead.

Thereafter, to sum up, the member noted that international developments had essentially followed the paths forecast in the Inflation Report. The other Executive Board members agreed with this assessment.

2.2 The Executive Board discussion regarding the Swedish economic outlook

One member began by observing that new data regarding economic activity in Sweden had also essentially followed the forecast developments. The most significant change was probably the repo rate cut. The overall effect of the measures presented in the spring budget also pointed to somewhat stronger growth. In spite of this the labour market was expected to be somewhat weaker than previously estimated, at least during the current year. As regards wage developments, additional agreements had been concluded that were largely on a par with the previous Industrial Agreement.

One member pointed to question marks concerning developments in domestic demand, especially with regard to investment and inventories. While redundancy notices remained at a high level and the labour market continued to be weak, exports had been stronger than expected, which on the whole gave reason to believe that the forecast in the Inflation Report was reasonable.

Another member pointed out that there had been few unexpected developments recently besides robust export growth, which could be related to strong international investment activity. This appeared, however, to result in Sweden going from large current account surpluses of four to five per cent of GDP to even greater surpluses of six to seven per cent. It was surprising that this did not seem to be affecting the exchange rate. Sooner or later, appreciation pressures should arise on the krona, according to the member.

One member stressed the positive side of the fact that Swedish exporters appeared to have been able to adjust their exporting to partly new markets. As regards the current account surplus the member observed that Sweden might need to reduce its foreign debt further as an adjustment ahead of the strains that the demographic situation would entail.

One member expressed an interest in analysing developments in the current account from the perspective of capital flows. From normative points of departure it was presumably appropriate that Sweden currently had a substantial current account surplus taking into account, for instance, demographic factors in the way put forward by the previous member. The question, however, was whether this was the real driving force. A more worrying interpretation was that the surpluses and capital exports were due to shortcomings in the business climate, taxes, etc. that had resulted in both capital flight and offshoring of finance departments or entire companies.

Another member shared this concern but said that a possible interpretation of the current account surplus and capital outflows could also be that Swedish investors had a smaller degree of preference for domestic investments than in many other countries and that our opportunities to invest capital in other countries via the pension system and fund saving had contributed to this.

One member said that we in Sweden had an extreme "home bias" during a long period of regulation, which thereafter had given rise to a protracted adjustment with capital outflows. In addition the member pointed out that the current account did not appear to have had a strong connection to developments in the exchange rate, neither in Sweden nor in the United States. Instead exchange rate movements had primarily been correlated with capital flows.

To sum up, one member concluded that the new data that had been received indicated that Swedish economic activity was continuing to strengthen largely as forecast in the latest Inflation Report. Some adjustments were warranted given the repo rate cut, the government's Spring Fiscal Policy Bill and the continuation of vigorous export growth. All in all, this pointed to somewhat higher GDP growth compared with the Inflation Report. Despite this, the labour market was expected to be somewhat weaker this year than previously estimated. The other Executive Board members agreed with this overall assessment of Swedish economic activity.

2.3 The Executive Board discussion regarding inflation prospects

One member observed that the outcome for inflation in March had been somewhat higher than expected. At the same time the repo rate had been cut, making it reasonable to expect a slightly higher inflation rate than in the latest Inflation Report.

One member pointed to a risk that the price of oil could follow a higher path, thus leading to increased inflation. On the supply side, disruptions in production could arise in Iraq. At the same time, however, Russia was expected to boost its production and the OPEC countries appeared to be continuing to produce above their quotas. Therefore, the most important question was how strongly demand would develop. An upward revision of the forecast for the dollar price of oil appeared reasonable, but developments in the krona determined the extent to which such a change might affect the price in kronor. However, another member pointed out that it was still too early to come to any conclusions about the possible consequences of a continued rise in energy prices.

One member summed up the discussion. As a result of the Executive Board's assessment that Swedish GDP growth would probably be somewhat more robust than forecast in the Inflation Report, inflation could also be expected to be somewhat higher. This meant that inflation, though currently low, was anticipated to be roughly in line with the target two years ahead. The other members agreed with this assessment.

§ 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 had concluded that monetary policy conditions had

[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.

not changed significantly since the previous meeting besides the repo rate cut. According to the group's assessment, the inflation rate was expected to be in line with the target towards the end of the forecast period. The group recommended therefore that the repo rate be left unchanged.

2. The Executive Board discussion

One member pointed out that the member had recommended a smaller rate cut at the previous meeting with a view to wait and see, since nothing dramatic had occurred to warrant such a large step. Nor had there been any considerable changes ahead of this meeting, and thus it would be logical now to conclude that the interest rate should be raised somewhat. However, according to the member, the differences in the views of an appropriate interest rate level were not very significant and the member could therefore support an unchanged repo rate, even if there was a risk of faster rises in property prices and a continued build-up of debt. This could lead in the long run to problems for economic activity.

Another member agreed that although the repo rate probably had come down to a rather low level given developments in the economy, the difference did not advocate a rate hike now. A third member wondered how this view could be reconciled with the forecast in the Inflation Report, which indicated an inflation rate well below target. The previous member replied that the rising economic activity suggested that the inflation forecast would be above target beyond the Riksbank's forecast horizon. Against the background of historical experience, it did not appear likely that increased productivity and competition would be able to fully counter mounting price pressures. An additional aspect was that confidence in central banks in general was higher today than in corresponding situations before, which could result in a time lag before the built-up inflationary pressures showed up in consumer prices. Meanwhile households were continuing to increase their debt and their balance sheets at a fast pace. This was boosting consumption today but in the period ahead, when households may want to reduce their indebtedness, it could lead to lower demand during the period of adjustment. Yet another reason for caution was that if the potential rate of production in Sweden had been raised, it also entailed a rise in the equilibrium real rate of interest. However, the member believed that there was scope to wait and see, and concluded that the repo rate should be left unchanged.

One member pointed out that the risks to the banks, connected with increased lending, should not be exaggerated. The member referred to further studies within the Riksbank that had analysed how changed conditions in the future could affect households as a group. These studies did not indicate general difficulties for households to deal with reasonable changes in the interest rate level and unemployment.

§ 3. Monetary policy decision[2]

The Chairman summarised the monetary policy discussion under § 2 and noted that the members of the Executive Board were in agreement that UND1X inflation on this occasion provided the best picture of underlying, cyclically-related inflationary pressures.

The Chairman found that there was only one proposal: to keep 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, 5 May 2004,
- 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, 5 May 2004,
- that the decision would be announced at 9.30 a.m. on Thursday, 29 April 2004, with the motivation and wording contained in Press Release no. 24, 2004 (Annex to the minutes) and
- that the minutes of today's meeting would be published on Wednesday, 12 May 2004.

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.