No. 5

SEPARATE MINUTES of the Executive Board meeting on 26 April 2001

<u>Present</u>: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg

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Sven Hulterström, Chairman of the General Council
Johan Gernandt, Vice-Chairman of the General Council

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Kerstin Alm
Malin Andersson
Claes Berg
Anders Borg
Hans Dellmo
Jörgen Eklund
Anders Eklöf
Mats Galvenius
Björn Hasselgren (§ 1)
Leif Jacobson
Hans Lindblad
Christina Lindenius (§ 1)
Tomas Lundberg (§ 1)
Pernilla Meyersson
Javiera Ragnartz
Robert Sparve
Annika Svensson (§ 1)
Eva Uddén Sonnegård (§ 1)
Staffan Viotti
Anders Vredin

§ 1. Monetary policy discussion

It was noted that Hans Dellmo and Anders Eklöf would prepare draft minutes of §§ 1 and 2 on the agenda for the meeting.

The meeting began with a discussion of the economic factors in Sweden and the rest of the world that are currently most important for inflation prospects and the formation of monetary policy (section 1). The discussion of each aspect started from analyses and assessments compiled by the Monetary Policy Department on the basis of the technical assumption that the repo rate would remain unchanged at 4.0 per cent until March 2003. In conclusion, the members of the Executive Board summarised their views of inflation prospects (section 2) and presented their conclusions about the monetary policy situation (section 3).

1. Economic developments in Sweden and elsewhere

1.1 Price tendencies in Sweden

The Board noted that in March the 12-month rate of both CPI and UND1X inflation was 1.9 per cent, which is 0.4 percentage points higher than the assessment in the Inflation Report. Higher domestic prices and higher import prices, chiefly for petrol, each account for approximately half of the discrepancies between forecasts and outcomes.

Underlying domestic inflation (UNDINHX) continued to rise more strongly than expected; the 12-month rate of 2.9 per cent in March was 0.3 percentage points higher than had been forecast. The largest upward contribution to UNDINHX came from the services sector, while the contribution from food prices, rents and home-owner's costs was almost as large. Price increases for meat, partly in connection with foot-and-mouth disease, also lay behind the rising rate of inflation, as did higher electricity and telecom prices.

1.2 International activity and inflation

The average GDP growth rate for the OECD area was judged in the March Inflation Report to be just over 2 per cent this year, around 2.5 per cent in 2002 and almost 3 per cent in 2003. Consumer price inflation was judged to be about 1.8 per cent in both 2001 and 2002.

The Board noted that both real and financial indicators in the United States were sending mixed signals. Domestic demand is continuing to follow the forecast path. New housing construction remains strong and the growth of household consumption early this year was higher than had been expected. There has, moreover, been some stabilisation of households' expectations. But employment declined unexpectedly in March, while unemployment moved up marginally to 4.3 per cent. Manufacturing activity is still subdued and the order inflow has gone on falling. With the poorer global activity and a stronger dollar, the outlook for exports has worsened somewhat more than expected. Further profit warnings and weaker prospects for many American firms, particularly in the IT sector, have contributed to large fluctuations in U.S. stock markets. Since the March Inflation Report was compiled, however, the Federal Reserve has lowered its instrumental rate another 100 basis points, to 4.5 per cent, and this has contributed to a stabilisation and some recovery in stock markets.

In view of the mixed signals from the U.S. economy, the Board saw no strong reasons at present for altering the assessment of growth prospects that was presented in the March Report. The Board underscored the large element of uncertainty about economic developments in the United States and the need to keep a close eye on future tendencies.

The Board noted that economic activity in Japan is still stagnant and that the central bank has chosen to resume a zero interest rate stance until CPI-inflation registers a stable level of zero per cent or more. Manufacturing output in February was considerably weaker than expected and the Tankan survey indicated that firms had become more pessimistic about the future.

The Board also observed that Euroland manufacturing activity shows clear signs of slackening; output fell in January and indicators of business confidence point to decreased activity in the future. The fall-off in manufacturing is particularly pronounced in Germany, where the inflow of orders went on falling in February, mainly due to lower export orders. However, the negative manufacturing tendency in Euroland is offset by households still being relatively optimistic about future prospects, partly in view of a favourable development of real wages and employment.

The Board noted that in the United States as well as in Euroland, consumer prices have risen somewhat faster than expected earlier, above all in the services sector. Prices have been raised even though growth prospects have become weaker.

All in all, the Board considered that the recent statistics are broadly in line with the main scenario in the March Inflation Report.

1.3 Financial markets

The Board noted that since the March Report was compiled, the Swedish ten-year bond rate has largely followed the international tendency and risen about 0.3 percentage points. The signs of a stock market recovery may have contributed to the upward interest rate tendency. The long-term interest rate differential with Germany has increased somewhat, to about 0.1 percentage point.

Financial market prices indicate expectations that in the coming three months the Federal funds rate will be lowered around 0.5 percentage points. In the euro area, instrumental rate expectations have been adjusted upwards to some extent, to a cut in the ECB’s rate of about 0.25 percentage points in the coming three months. In the Swedish money market, survey data as well as market prices point to expectations of little change in the repo rate twelve months from now.

The Swedish krona’s TCW index has fluctuated in the past month between 132 and 134 and is currently somewhat stronger than when the March Report was compiled. The Board considered that the large stock market fluctuations have probably contributed to the exchange rate movements. In that the uncertainty about stock market tendencies is likely to persist for a time, the Board judged that in the short run the krona may remain weak. All in all, the Board found no fundamental reasons for altering the assessment of the krona's future appreciation.

1.4 Import prices

The barrel price of oil went on falling after the March Report was published; it reached a low of USD 22.6 at the end of March and has subsequently risen to USD 26. Factors behind the increase are low petrol stocks and fears of shortages in the summer, while increased oil exports from Iraq have had a downward price effect. To date the oil price has accordingly been broadly in line with the assessment in the March Report, which also pointed to rising oil prices in the summer and autumn. One Board member considered that the relationship between supply and demand in markets for oil and petrol suggests that the oil price increase in the summer and autumn could be larger than assumed in the March Report.

In the March Report it was judged that the average level of import prices to consumers would fall 0.2 per cent this year and then rise 1 per cent in 2002. The Board found that in the perspective that is currently most relevant for monetary policy, there are no strong reasons for revising the import price forecast.

1.5 Demand and supply

GDP growth in Sweden was judged in the March Report to be 2.4 per cent both this year and next, followed by 2.7 per cent in 2003. This path was considered to lead to total resource utilisation being broadly unchanged during the forecast period.

The Board noted that a weaker consumption tendency, in line with the forecast, had been confirmed by a further fall-off in the growth of retail turnover. The rate of increase in the money supply aggregates M0 and M3 had continued to slacken since the March Report. Households have become somewhat more pessimistic than expected both about their own economic situation and about the national economy. Moreover, share prices have remained very volatile. However, stock markets have recovered to some extent during April.

The negative wealth effects from the stock market trend in recent years are partly countered by house prices continuing to rise in Sweden as a whole. In March the level of house prices was 10 per cent higher than a year earlier. Moreover, lending to the Swedish non-bank public has gone on rising at an annual rate of around 7 per cent. All in all, the Board considered that the recent statistics broadly agree with the latest household consumption forecast.

No new information has been obtained since the March Report to alter the appraisal of public consumption.

The Board noted that the recent statistics confirm and somewhat strengthen the picture of a slowdown in manufacturing activity. In the Q1 business tendency survey from the National Institute of Economic Research, for example, a fall in volume output is reported by more manufacturing firms than in the preceding survey. Moreover, the purchasing managers index (ICI) fell three points in March, bringing it below the 50 per cent level for the first time since the beginning of 1999. The picture in other parts of the corporate sector is still varied, with an upward tendency in construction and a fall in car sales, for example. Stock investment is judged to be broadly in line with the forecast.

The Board noted that employment is still developing comparatively favourably. This has been accompanied by a weak development of hours worked, which may indicate some worsening of demand. The National Labour Market Board's latest statistics on job vacancies and dismissal notices also suggest that demand is beginning to slacken. The number of dismissal notices rose in February, albeit from a low level and to a large extent in connection with developments in manufacturing. All in all, the picture of employment is well in line with the assessment in the March Report, where it was assumed that the increase will level off in the course of this year.

Wages are also developing in line with the forecast. Further agreements have been concluded since the March Report. The three-year settlement in trade gives negotiated annual wage increases of 3.5–4.0 per cent. The agreements in the central government sector imply wage increases of 2.7 per cent; the agreement for this sector's salaried employees affiliated to SACO (Confederation of Professional Associations) does not contain any negotiated increases.

The Board observed that since the March Report, the picture of total resource utilisation has not changed appreciably. Thus, resource utilisation is judged to remain high in the coming years. The business tendency survey indicates that production capacity in manufacturing will continue to expand, albeit at a diminishing rate, and the proportion of firms reporting shortages of skilled workers and salaried technicians is falling. Moreover, the proportion of firms where output is mainly restricted by plant and machinery capacity has become somewhat smaller. In the services sector the picture still varies. All in all, the Board considered that at present there are no strong reasons for revising the March Report's assessment of resource utilisation.

1.6 Price effects of deregulations, trade liberalisation, political decisions and interest expenditure

Tax-financed subsidies for two prescribed medicines were terminated in April; the upward effect of this on both CPI and UND1X inflation is calculated to amount to almost 0.1 percentage point as of April this year. The CPI contribution from house mortgage interest expenditure in March was much as expected.

1.7 Inflation expectations

According to Statistics Sweden, households' expectations of inflation moved up in April from 1.4 to 1.8 per cent. The Board noted that inflation expectations continue to be well in line with the inflation target.

2. The Board's assessment of inflation prospects

In the main scenario in the March Report it was judged that the 12-month rate of CPI inflation would be 1.9 per cent one year ahead and 2.0 per cent after two years. UND1X inflation would be 1.9 per cent both one and two years ahead. The risks in the CPI and UND1X inflation forecasts were judged to be predominantly on the downside both one and two years ahead. With the risk spectrum taken into account, both CPI and UND1X inflation would be 0.1 percentage point lower than in the main scenario both one and two years ahead and accordingly somewhat below the inflation target.

2.1 The monetary policy group's appraisal

The Board's discussion of inflation prospects was preceded by an account of a corresponding discussion in the Bank's monetary policy group.[1]

Deputy Governor Lars Heikensten observed that the new statistics since the March Report were broadly in line with the forecast presented there.

However, the situation was still difficult to assess. There are signs that demand in Sweden may have become somewhat more subdued at the same time as resource utilisation remains fairly high. Moreover, inflation — underlying domestic inflation (UNDINHX) in particular —has recently moved up more than expected. This may have to do with a variety of factors. One is a normalisation of prices that have fallen in recent years. Another may, however, be that resource utilisation or the economy's inflation propensity has been somewhat higher than expected.

Inflation was judged to be above 2 per cent in the short run but the main determinants in the longer run are economic activity and resource utilisation. The downside risks for international economic activity were still considered to apply, though the downward price effect could be countered to some extent by a persistently weak exchange rate. All in all, the policy group judged that even when the risks are taken into account, inflation prospects one to two years ahead are largely in line with the inflation target.

2.2 The Board's discussion

In recent years monetary policy has been formed on the basis of UND1X inflation because the CPI has been affected by factors that are judged to have no permanent effect on inflation. The Board noted that at present there are no grounds for a change in this respect and that consequently monetary policy would be based on an assessment of UND1X inflation.

The Board members all considered that recent statistics on international economic developments have been broadly in line with the assessment in the March Report. But

[1] The group is made up of Riksbank staff and is 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, including the chairperson.

the element of uncertainty was still judged to be considerable, particularly as regards the United States, where the latest figures have sent mixed signals. One Board member observed that the increasingly pessimistic expectations of American households give cause for concern and considered, along with another member, that even in the event of a quick economic recovery, for instance as a result of the expected tax cuts, the large imbalances in the U.S. economy would probably continue. As the imbalances were not judged to be sustainable in the longer run, in that case the correction would presumably occur later on instead. A third Board member pointed out that the recent American statistics have been partly positive. Share prices have risen markedly and the Federal Reserve was seen as having a high state of readiness to cut interest states even more if growth prospects continue to worsen.

Two Board members pointed out that neither Europe nor Japan is in a position to take over as the global locomotive now that growth in the United States is falling. Europe has structural problems and potential growth is considered to be lower than in the United States, while growth in Japan may become even more subdued in the short run as a result of measures for tackling the country's economic problems. One of these members pointed out that although the global situation is basically better than in 1997, there is a risk of international activity deteriorating even further if the economic problems in countries such as Turkey and Argentina deepen and spread. The member therefore perceived a somewhat increased risk of weaker international activity. Other members did not, however, see any reason at present to revise the picture of risks for international activity that was presented in the March Report.

All the Board members agreed that there was no reason to alter the exchange rate forecast. One member did consider, however, that the weak exchange rate recently and the krona's difficulty standing up to periods of unrest about international economic activity pointed, if anything, to an increased risk of the krona being weaker. At the same time, this member underscored that to date the weak exchange rate has been accompanied by weak economic activity, which raised the question of what the net effect on inflation would actually be. Another member pointed out that to a large extent the weak exchange rate recently may be a consequence of the stock market fall and the large fluctuations in share prices. Investors have increasingly shifted from shares to interest-bearing assets. Partly because short-term interest rates in Sweden are lower than in most other countries, this has meant that purchasers of interest-bearing assets have preferred other countries with higher interest rates. In the current situation this has put Swedish assets at a disadvantage. This member perceived an increased risk of external inflationary impulses both in view of a greater risk of a weaker exchange rate and because the oil price might be higher in the short run than was assumed in the March Report. A third member agreed that the weak exchange rate was partly a consequence of the low short-term interest rates in Sweden and considered that a permanently weak krona's effect on inflation could be such that it has consequences for the repo rate.

All the Board members considered that since the March Report was published, growth prospects in Sweden have not changed at all decisively. One member pointed that developments in the labour market are still positive at the same time as the negotiated annual wage increases amount to about 3 per cent. Against this background, disposable income was expected to support rather than weaken the development of private consumption. The share price fall in the past year could tend to dampen consumption but the member observed that a large proportion of the losses are only latent. Another member noted that while private consumption has slackened, the recent statistics do not warrant a further downward revision. But if growth in the United States were to worsen more than expected, a downward adjustment might be called for. A third member did not rule out the possibility of an upturn in the United States occurring relatively soon, in which case share prices would develop more favourably and the krona would appreciate. Another member considered, however, that as the economic imbalances in the United States are not sustainable in the longer run, such a scenario would simply mean that the adjustment occurs later. Yet another member pointed out that employment in Sweden has been surprisingly positive recently at the same time as other indicators have pointed to more subdued demand. If the employment statistics are a more reliable economic indicator, this may point to growth being higher than expected.

In the opinion of one member, since the wage agreements to date have been broadly in line with the forecast, there is less risk of wage increases being higher than in the March Report's main scenario. This member also considered that it is widely accepted that wage increases for local government employees should be somewhat higher than in other sectors, so this should not lead to other employees demanding compensation. Another member believed, on the contrary, that if local government employers were to obtain higher wage increases than other employees, in the coming years the effects of this would gradually spread through the labour market. Higher wage increases for local government employees might also affect arrangements for the next round of wage negotiations.

Two members considered it important to obtain a clearer picture of why price increases have recently been higher than expected. One of these members wondered to what extent this represents a normalisation of prices that have fallen in recent years and why the prices have risen just when activity has slackened. Perhaps the economy's inflation propensity is greater in some sense than the Riksbank believed earlier. Inflation will probably be somewhat higher than expected in the short run, while its path in the longer term is determined by economic activity. Another member noted the importance of not drawing unduly rapid conclusions from the unexpectedly high inflation in recent months, though the situation did call for close attention.

A Board member pointed out that for the first time since the early 1990s, output in the coming years is expected to be more or less in line with the potential level. In the past decade there have been a number of changes in the Swedish economy that may have affected trend labour supply and productivity; this is a source of some uncertainty about the relationship between growth and inflation. This member considered that the recent increase in consumer prices could be a sign of insufficient competition and flexibility in a number of markets where prices have been raised even though unutilised capacity exists or can be anticipated. Moreover, when price stability has been established, the member saw nothing remarkable about price increases occurring late in the business cycle.

All in all, the Board members unanimously considered that even when the risks are taken into account, the prospects for inflation one to two years ahead are largely in line with the Riksbank's inflation target. In the short run, however, inflation is expected to be higher than foreseen in the latest forecast.

3. The Board's assessment of the monetary policy situation

3.1 The monetary policy group's appraisal

The policy group noted that the new information in recent months shows that international and domestic demand are following the path outlined in the March Report. In the short run it was considered that inflation would continue to move up and exceed 2 per cent, partly due to effects of petrol prices being higher than expected. In the longer run, however, the international economic slowdown would probably tend to ease the pressure from domestic demand. The policy group noted that inflation expectations are firmly anchored around 2 per cent. With the risks taken into account, the prospects for inflation one to two years ahead are judged to be largely in line with the inflation target. The policy group also observed that there are no expectations of a repo rate adjustment at today's meeting. Against this background the policy group considered that the repo rate should be kept unchanged at 4.0 per cent.

3.2 The Board's discussion

All the Board members concurred with the opinion expressed by the policy group. A number of the members noted that the high degree of uncertainty at present calls for close attention. New information, above all about developments in the United States, can alter the prospects for economic activity and inflation; the Riksbank should be in a high state of readiness to adjust the repo rate if necessary when the picture has become clearer. Elaborating on this, one of these members pointed out that if the recent positive share price tendency were to continue, economic prospects could improve more than expected. Under those circumstances, a repo rate increase might be called for in the light of the high resource utilisation in Sweden at present. If activity in the United States were to go on deteriorating, on the other hand, the monetary policy conclusion could be the opposite.

§2. The monetary policy decision

The Chairman summarised the monetary policy discussion under §1 and noted that an unchanged repo rate had been proposed.

A vote was taken and the Executive Board unanimously decided that the repo rate is to be held unchanged at 4.0 per cent, that this decision shall apply from Wednesday, 2 May, and that the decision be announced at 9.30 a.m. on 27 April with the motivation and wording contained in Press Release no. 28 2001 (Annex A to the minutes).

This paragraph was immediately confirmed.