No. 7

SEPARATE MINUTES of the Executive Board meeting on 30 May 2001

Present: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson

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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 (§ 1)
Claes Berg
Anders Borg
Hans Dellmo
Jörgen Eklund
Leif Jacobson
Björn Hasselgren
Hans Lindblad
Pernilla Meyersson
Robert Sparve
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Hans Dellmo and Pernilla Meyersson would prepare draft minutes of §§ 1, 2 and 3 on the agenda for the meeting.

The Board's discussion was initiated with accounts of the information that had been received since the previous meeting on 23 May (section 1). The Inflation Report was then adopted (section 2).

1 New information about economic developments internationally and in Sweden

1.1 The international scene

Recent statistics from the United States have conveyed mixed signals. GDP growth in 2001 Q1 has been revised downwards from 2.0 to 1.3 per cent, mainly on account of quicker stock reductions. Moreover, the order inflow for durable goods fell markedly in April. On the other hand, leading indicators rose in April, accompanied by increased household optimism. Preliminary GDP figures for Germany and France were lower than expected for 2001 Q1. Order inflows and industrial output both went on falling in the major euro countries in the past month and the business mood has become more pessimistic in Germany and Belgium. The Japanese economy is still in a state of stagnation. Industrial output and business confidence declined in April and there are growing signs of involuntary stock accumulation. Some increase in unemployment in April was accompanied by decreased private consumption. Moreover, exports have become markedly weaker.

Statistics from Germany, Italy and Belgium indicate that the rate of inflation in the euro area remained high in May. In both Germany and Italy the consumer prise rise in various *länder* and cities, respectively, exceeded market expectations. In Japan, on the other hand, preliminary figures point to an increasingly downward price trend.

The dollar has appreciated recently against most other currencies. To some extent, this can be explained by unrest in emerging markets and better economic prospects in the United States compared with the euro area. Foreign equity prices have gone on rising. This has contributed to a world-wide increase in bond rates. Uncertainty about inflation prospects, partly in the light of the high outcome figures in Europe in recent months, has also led to higher interest rates.

1.2 Developments in Sweden

Employment went on rising in April; the number employed was 2.8 per cent higher than a year earlier. Open unemployment fell to 3.7 per cent. But both the number of new job vacancies and unfilled vacancies continued to decline. The May business tendency survey from the National Institute of Economic Research shows a further weakening of industrial activity. The order inflow and expectations of production and employment have decreased. Preliminary figures indicate that exports fell from March to April, whereas there was some increase in imports. The Trade Research Institute (HUI) reports that the 12-month change in the volume of retail turnover has continued to slacken and was 1.0 per cent in April.

The growing signs of an economic slowdown have been accompanied in recent months by increasingly strong pressure in import and producer prices. Import and export prices both rose almost 1 per cent from March to April, while the increase in home market prices was more restrained. The price rise did, however, come mainly from items that normally show large price fluctuations, for example food and agricultural products and petroleum products.

The Swedish krona has depreciated in recent weeks, mainly against the dollar but also to some extent against the euro. Since the Inflation Report was compiled, the TCW exchange rate has weakened about 1 per cent. In this period the Swedish stock market has risen about ½ per cent, as measured by *Affärsvärlden's* general index. This has been accompanied by some increase in Swedish bond rates. Survey data show that market players count on the repo rate being left unchanged at today's meeting. Implied forward interest rates indicate expectations of a higher instrumental rate some months from now.

2. Inflation Report 2001:2 adopted

Deputy Governor Lars Heikensten presented a draft of Inflation Report 2001:2 (annex A to the minutes). The Inflation Report is based on the presentations and discussions at the Board meetings on 10 and 17 May.

The Executive Board decided to adopt the Inflation Report as presented and to have it published at 9 a.m. on 31 May.

This paragraph was confirmed immediately.

§ 2 Monetary policy discussion

The discussion of monetary policy began with an account of the Board's assessment of inflation prospects (section 1). The Board's assessment of the situation for monetary policy (section 2) was preceded by a presentation of the discussion in the monetary policy group.[1]

1 The Board's assessment of inflation prospects

In the main scenario in the Inflation Report it is judged that, given an unchanged repo rate of 4.0 per cent, the 12-month rate of UND1X inflation will be 1.8 per cent one year from now and 2.1 per cent after two years. The expected rates of CPI inflation are 1.8 per cent after one year and 2.2 per cent after two years. The appraisal of real economic developments, internationally as well as in Sweden, is broadly the same as in the March Report. As at that time, international economic activity is expected to slacken, mainly on account of the comparatively rapid slowdown in the United States. Compared with the earlier

[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.

forecast, international growth this and next year has been revised marginally downwards, for example because the American slowdown's repercussions in the euro area and Japan are now judged to be somewhat larger. Domestic demand in Sweden is also marginally weaker this year, above all because a slower development of real disposable income and wealth compared with the earlier picture has impaired the prospects for the growth of consumption. Fixed real capital formation has also been adjusted downwards for 2001 now that, for example, business tendency data show a further fall in order inflows, production and capacity utilisation in manufacturing. All in all, however, GDP growth is judged to be much the same as in the March Report; a marginally weaker rate is foreseen this year, followed by some upward revision for 2002 and 2003. GDP is accordingly expected to rise 2.2 per cent in 2001, 2.5 per cent in 2002 and 2.9 per cent in 2003. Neither has the picture of total resource utilisation been revised at all appreciably; it is judged to be high and broadly unchanged in the coming years.

The risk spectrum is also a part of the basis for monetary policy decisions. The main factor in favour of inflation being lower than in the main scenario is the persistently large risk of a weaker international trend. The depth and duration of the slowdown in the United States continue to be an open question. Higher inflation is favoured by the risk of the krona remaining weak; this applies even though the exchange rate's path in the main scenario has been revised downwards. Moreover, domestic demand may be stronger than allowed for in the main scenario. All in all, the risk spectrum is judged to be balanced both one and two years ahead for CPI as well as UND1X inflation. At the same time, the uncertainty about future inflation is pronounced. In the short run, moreover, there are some upside risks of a more temporary nature, for example transitory effects from increased petrol prices, BSE and foot-and-mouth disease, electricity prices and the termination of subsidies for certain prescribed medicines. It is judged that these price effects will have disappeared after one to two years. It is concluded that even with the risk spectrum taken into account, the rate of inflation, given an unchanged repo rate, will be in line with the inflation target both one and two years ahead.

The Board unanimously considered that new information broadly confirms the picture of inflation's path that is presented in the Inflation Report. The monetary policy discussion could accordingly start from the Report's main scenario, taking the risk spectrum into account, as outlined in the Report.

Monetary policy is based on an assessment of inflation as measured by UND1X.

2 The Board's assessment of the monetary policy situation

2.1 The monetary policy group's view

Deputy Governor Lars Heikensten noted that as the monetary policy group's picture of inflation prospects had not differed appreciably from the assessment in the Inflation Report, the discussion had started from the latter.

The group had noted that domestic price pressure has grown. However, the major part of the price rise in recent months is a consequence of rather temporary factors that will drop out of the 12-month change figures within a year. Most Swedish analysts share this view. It follows that as monetary policy focuses mainly on influencing inflation 1 to 2 years ahead, the price rise in recent months ought not to carry any sizeable weight. It is important that the high inflation outcomes in recent months do not lead to higher inflation expectations. This is something which will have to be followed closely but that is not a matter of observations from some isolated measurement; it calls instead for a broad assessment. Moreover, short-run inflation expectations may move up without necessarily having implications for monetary policy. It should also be underscored that expectations are one of a number of factors in the inflation forecast and that policy is guided by the forecast, not by the expectations as such.

Inflation has also moved up recently in the euro area and the United States, partly due to rising prices for energy and food products. The underlying or core rate of inflation in Sweden is not higher than elsewhere. On the other hand, it has recently been rising somewhat faster because the price effects of earlier deregulations in electricity and telecom markets have dropped out of the 12-month change figures and rents have increased from a level that had been broadly unchanged for some years.

The policy group had noted that the exchange rate is still weak. Recently this tendency has in large measure had to do with the dollar‘s appreciation against virtually every other currency. The weak exchange rate does not yet seem to have had any sizeable effect on consumer prices for manufactured goods. At the same time, the level of the TCW index is clearly very low.

Market players have recently started to count on a future repo rate increase. This assessment was seen as not unreasonable but the outcome will depend to a large extent on developments in the United States. The group had noted that there are no expectations of a repo rate adjustment at today’s meeting.

Even with the risk spectrum taken into account, the prospects for inflation one to two years from now were judged to be broadly in the line with the inflation target. Against this background, the policy group had seen no strong reasons for altering the repo rate at today’s meeting.

2.2 The Board’s discussion

All the Board members shared the monetary policy group’s opinion that the repo rate should be left unchanged. The monetary policy discussion focused mainly on the risk spectrum.

One Board member underscored that the weaker economic development in the coming year should lead to lower capacity utilisation and thereby to an easing of upward price pressure. Another member noted that even with the slowdown, the Swedish economy is growing at approximately its potential rate, even though the precise level of this rate in the interval 2–2.5 per cent is an open question.

A third member noted that labour shortages are now decreasing on a wider front and the number of new job vacancies has levelled off. The increase in the number of hours worked is also coming to an end. The labour market situation accordingly indicates an economic slowdown that should contribute to lower inflationary pressure. This member considered that the economic indicators are currently sending conflicting signals from the real as opposed to the financial side. Financial tendencies point to a rapid recovery, while the statistics on the real economy indicate a trend that is slightly weaker than expected. In this situation the Riksbank's monetary policy ought to be guided by the assessment of real economic tendencies.

A Board member considered that the downside risk in the U.S. economy has increased in that financial developments — with a renewed increase in share prices and an even stronger dollar — could lead to the adjustment being unexpectedly abrupt. This is something for which the Riksbank must have a high state of readiness. In the opinion of another member, the large imbalances underscore this risk; at the same time, the adjustment could instead be more gradual and less dramatic and the productivity gains, although unrivalled in the post-war period, may continue. A third member now saw an increased risk of the U.S. economy following a W-shaped path. Even if private consumption does recover as a result of tax cuts, sooner or later the imbalances in the economy will have to be corrected, which points to activity weakening again but at a later date. This member was doubtful about trying to resolve the crisis in the United States via increments to disposable income.

Several members subscribed to the view that financial and real economic indicators are pointing in different directions. This applies in particular to the United States, where, according to one member, an improvement in consumer expectations seems to be having a stabilising effect on financial markets without this resulting in the expected effects on real economic activity. This has led, if anything, to greater uncertainty and an increased risk of a more protracted economic slowdown.

Yet another Board member noted that the Swedish economy seems to be at full capacity utilisation. What we now see is a slowdown in manufacturing that is mainly driven from abroad. This, moreover, has begun to affect the services sector; consumption is beginning to slacken and so is growth of the money supply. Employment is still rising but it is usually lagged in the business cycle. However, households and firms have sound balance sheets, which suggests they are not particularly sensitive to an economic slowdown. Credit growth also remains good. The member observed that rising inflation at a time when growth is weakening is a little disconcerting but hardly surprising. Once price stability has been established, there is a risk of price increases occurring late in the business cycle. The pricing behaviour of firms depends on, for example, expectations of future inflation and of how the central bank will act. If the players rely on inflation being held at a low level, they may be less prone to see a need to adjust prices for increments to costs that are perceived as temporary, for example. If their expectations prove wrong, however, price changes may be both rapid and large.

In Sweden, the stabilisation of inflation expectations in recent years may have caused firms to hold back price increases even though resource utilisation has risen. That in turn means that inflation cannot be expected to vary continuously with resource utilisation. The relationship between resource utilisation and inflation depends on, among other things, how the Riksbank is expected to react. If economic agents see that the central bank is not responding as expected to changes in resource utilisation, there will be a risk of inflation expectations moving up and inflation taking off. Simply studying inflation expectations as such can therefore be misleading because they allow for the central bank's expected response. The member also considered that the lowering of inflation in Sweden in the 1990s was aided by an ongoing international deflationary process that led to low price increases for imports despite the weak exchange rate. Sweden cannot count on such assistance in the present situation.

Another Board member countered that the low price pressure from manufactured products could indeed continue. To a large extent it is presumably a consequence of strong international competition. The global development of productivity should continue to contribute to a subdued price trend. This member also found it worth considering the sectorwise picture of capacity utilisation in Sweden and how the dispersion mechanisms function. The current round of wage negotiations has been completed and many of the settlements run for three years. That is relevant in this context because wage formation is one of the most important channels through which higher inflation expectations are liable to spread through the economy.

Yet another member questioned the notion that international price trends might not continue to benefit the situation in Sweden. Moreover, the price level here is about 20 per cent above the EU average, which indicates that Swedish prices have a long way to fall if competition continues to grow.

A Board member considered that the monetary policy decision is basically self-evident, given the picture in the main scenario and the risk spectrum. With the risk spectrum taken into account, inflation one to two years ahead is on the target. The repo rate should accordingly be kept unchanged. The higher inflation we are now observing is a consequence of transitory factors. If there were to be a future increase in inflation expectations in a wide sense, i.e. a number of indicators pointing upwards, that would have to be taken seriously. The question at present concerns the Riksbank's working hypothesis. Is the monetary policy regime so fragile that the interest rate has to be raised before inflation expectations move up? Or is confidence such — after almost a decade of low inflation and a consistent policy — that we can act in accordance with monetary policy's intellectual framework? The member considered that the latter hypothesis applies.

According to another member, it is an open question whether the regime has been firmly established. Capacity utilisation has not been this high at any time since the inflation target was introduced. The need to be watchful is particularly great. Much of the present rapid price rise can admittedly be attributed to occasional factors. But notwithstanding all such factors, we are seeing a number of price increases that would not have occurred if the sellers had not considered they were feasible vis-à-vis competitors and consumers. This member went on to express concern over the exchange rate continuing to be weak. This can affect expectations and thereby pricing behaviour. The member considered that opinions about the path of the krona have tended to shift towards the view that it may remain weak for some time. Moreover, the monetary conditions are regarded as expansionary and a tightening of fiscal policy is not foreseen.

In this member's opinion, the main argument against raising the interest rate is that the international economic trend may become appreciably weaker in connection with a rapid adjustment of the dollar and the U.S. current account. In such a situation, prices would be more subdued. However, it is not self-evident how such a risk should be reflected in decision-making. It could very well be argued that if this were to occur, we will face a new situation and monetary policy should be adjusted then but not before.

Another member pointed out that the current picture of inflation in Sweden is better than in, for instance, the United States and the euro area. Neither will it evidently become worse in the years ahead. There are certainly grounds for being alert but it is also important to see the recent developments in Sweden in a broader, international perspective.

A member was uneasy about oil prices remaining at a high level and the dramatic increase in advertised prices for charter travel next autumn and winter. People are currently booking and buying their holiday trips. The member agreed that there is now a need to be very much on the alert. The media attention the rising inflation has received is liable to have an undue effect on expectations. The member called for an analysis of whether price increases for certain goods and services affect inflation expectations to a greater extent than rising prices for other products.

A member pointed out that in monetary policy there may be a risk in reacting too quickly. By reacting too soon to expectations that perhaps have not yet materialised, the central bank may trigger an increase in inflation expectations. Another member noted, however, that once inflation expectations have begun to move, the Riksbank must act to demonstrate that it is serious about the inflation target. Prompt action avoids a drastic tightening later on. A third member warned against basing monetary policy too much on vague arguments about inflation expectations. They are admittedly an element in the Riksbank's forecast but the crucial thing is to construct an inflation forecast and act accordingly.

The economic situation is difficult to assess and it is important, said another member, that we see the total picture and adhere to monetary policy's intellectual framework. A large part of the increase in inflation has to do with transitory factors and one should not focus too much on isolated figures. Inflation expectations are stable and ought not to occasion any deliberations about a repo rate adjustment. Neither was this member all that surprised about the path of the exchange rate as long as it can be said to reflect the dollar's strength rather than the krona's weakness. Moreover, the krona is sensitive to financial unrest.

The chairman summarised the discussion by noting that all the members supported the main scenario and attached slightly different weights to the risks that are presented in the Inflation Report.

§ 3. The monetary policy decision

The Chairman summarised the monetary policy discussion under §2 and noted that an unchanged repo rate had been proposed. The Executive Board decided that the repo rate is to be held unchanged at 4.0 per cent and that this decision shall be announced at 09.00 a.m. on 31 May with the motivation and wording contained in Press Release no. 33 2001 (Annex B to the minutes).

This paragraph was confirmed immediately.