No 4

SEPARATE
MINUTES from the Executive Board meeting on 18 March 2002

<u>Present</u>:

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

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Johan Gernandt, Vice Chairman of the General Council

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Kerstin Alm
Claes Berg
Hans Lindblad
Mårten Blix
Anders Eklöf
Jörgen Eklund
Leif Jacobson
Tommy Persson
Björn Hasselgren
Robert Sparve
Kerstin Hallsten
Staffan Viotti
Carl-Fredrik Petterson (§1)

§ 1. The current inflation assessment

It was noted that Mårten Blix and Anders Eklöf would prepare draft minutes of §§ 1, 2 and 3 on the agenda for the meeting.

The Executive Board began its discussion on the basis of information received since the last meeting on 13 March and the significance of this information for inflation prospects (section 1). Thereafter the Inflation Report was adopted (section 2).

1. New information on economic activity in Sweden and abroad

In the USA retail trade sales rose by 2.9 per cent in February, compared with the same period last year. This included an increase in car sales, which had fallen during November-December 2001 and in January 2002. One indicator of consumption trends, namely the University of Michigan's consumer confidence indicator for March, rose slightly more than market expectations. American industrial production rose 0.4 per cent in February. However, this increase was from a relatively low level and when compared with the figures for the same period last year indicates a fall in production of 4.1 per cent. Capacity utilisation increased somewhat, but remained at low levels.

In Sweden the consumer price index increased by 0.2 per cent in February compared with January and by 2.8 per cent when compared with the same month last year. Underlying inflation, measured as UND1X, rose slightly more, 0.3 per cent on a monthly rate and 3.3 per cent compared with the corresponding period last year. The price changes in January were in line with the Riksbank's forecast in the Inflation Report.

All in all, the Executive Board assessed that the statistics received since the deadline for the Inflation Report were in line with the picture painted in the Report.

On the financial markets, the American long term rates have continued to rise, partly as a result of continued signs of an upturn in economic activity. Long term interest rates in the euro area and Sweden have followed the upward trend, but on a lesser scale. The more positive economic prospects have contributed to lower interest rate differences between securities containing a certain measure of credit risk and treasury bonds.

Following the increasingly clear signals of a recovery in the USA, the surveys show that market participants are now expecting the Federal Reserve to move over from a downside risk in inflation and growth prospects to a neutral view at its next meeting. It is still expected that the US Fed funds target rate will not be raised before the summer. The same applies for the ECB's instumental rate. At today's meeting the Riksbank is expected to raise the repo rate by 0.25 percentage points, according to the pricing on the interest rate market and in surveys.

2 Report to the Riksdag Finance Committee on monetary policy/ Inflation Report 2002:1

Deputy Governor Lars Heikensten put forward a proposal for a report to the Riksdag Finance Committee on monetary policy/Inflation Report 2002:1, Annex A to the minutes. The Inflation Report is based on the presentation of reports to, and the discussions held by, the Executive Board on 7 and 13 March.

The Executive Board decided to adopt the Inflation Report in accordance with the proposal and to publish it on 19 March at 9.00 a.m.

This paragraph was confirmed immediately.

§ 2. The monetary policy discussion

The monetary policy discussion was based on the assessment described in the Inflation Report (section 1). The Executive Board's assessment of the monetary policy situation (section 2) was preceded by a report of the discussion in the monetary policy group. [1]

1 The Executive Board's assessment of inflation prospects

The assessment in the Inflation Report is that inflation will slightly exceed the Riksbank's target level one to two years ahead. There are increasingly clear signs of a recovery in both international economic activity and activity in Sweden. In addition, resource utilisation in Sweden is probably more strained than was previously assumed and this will contribute to a slightly higher rise in domestic inflation than estimated.

The forecast for inflation in the Report's main scenario assumes that growth prospects in the world around us have improved. The expansionary economic policy is expected to provide a good foundation for a continued recovery internationally in the coming years. At the same time, there are factors indicating that the rate of the rise may be relatively modest. The starting level for private savings is low, particularly in the USA, which indicates a cautious increase in consumption. Possible reactions from the stock markets and companies to subdued prospects for future profits also give cause for concern. In Europe, rigidity in both the product and labour markets could constitute a limitation when economic activity begins to increase.

In Sweden, too, incoming statistics show that economic activity seems to have bottomed. Interest rates are currently low and the exchange rate is weak. This, together with lower taxes and increased transfers, means that households are expected to increase both their consumption and their savings. Exports will also make a recovery, although the initial growth will be modest, in line with the international improvement in economic activity. The krona is also expected to appreciate during the forecast period. According to the main scenario, GDP is expected to grow by 1.6 per cent this year, 3.0 per cent in 2003 and 2.6 per cent in 2004.

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[1] This group comprises 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 assessment is that inflation will fall from the present high levels over the coming six months. This is largely due to the effects of temporary price increases on oil, electricity and foodstuffs last year subsiding. A slightly more strained resource utilisation during the forecast period will contribute to labour force costs and domestic inflation rising slightly more than was estimated in the previous Inflation Report. Imported inflation, on the other hand, is expected to show a weaker development. The main scenario estimates a CPI inflation rate of 2.2 per cent one year ahead and 2.4 per cent two years ahead. The corresponding forecast for UND1X inflation is 2.2 per cent for both one year ahead and two years ahead.

The risk picture also is also important in the formulation of monetary policy. Domestic inflation has continued to rise since the publication of the previous report. This rise has been greater than expected and can only partly be explained by factors of a temporary nature. Combined with the fact that wage increases in recent times have also been higher than expected, this raises questions regarding resource utilisation, inflationary pressure and the functioning of the economy. There has been some revision in the main scenario of the inflation propensity in the economy. Despite this, the assessment is that there is a further upside risk for domestic inflation. The total assessment is that UND1X inflation will amount to 2.3 per cent both one year ahead and two years ahead.

Since 1999, the Riksbank has chosen to clarify in connection with each monetary policy meeting which measure of inflation has guided monetary policy. Monetary policy has been shaped on this occasion on the basis of the assessment of UND1X inflation. This has been normal practice in recent years.

2 The Executive Board's assessment of the monetary policy situation

2.1 Report of the monetary policy group's view of the situation

Deputy Governor Lars Heikensten observed that the members of the monetary policy group supported the assessment of inflation in the Inflation Report. However, the assessment is relatively uncertain. The inflation picture also deviates to some extent from the usual assessment among external forecasters, including those in the market.

The gradual rise in underlying inflation, combined with the larger wage increases in the service industries in particular, indicates that resource utilisation in the Swedish economy has been higher than was assumed in the Riksbank's earlier assessments. It should also be noted that the incoming statistics imply that economic activity will show an upturn.

The starting point for the discussion on monetary policy was that inflation one to two years ahead is estimated to exceed the inflation target by a few tenths of a percentage point with an unchanged repo rate. Contrary to what has been normal in recent years, inflation is now also estimated to lie above the target level for a large part of the first year.

It was considered that simple rules of thumb could motivate an increase in the rate of at least 0.25 percentage points. However, it was not deemed desirable to deviate from the usual norm of changing the repo rate by whole quarters of a percentage point. The alternative to raising the rate by 0.25 percentage points would be a 0.50 percentage point raise.

There could be motivation for a raise of one half of a percentage point if it were considered important to demonstrate an ability to take action and influence inflation expectations. However, this was not considered to be the case now. Another argument for raising the rate by one half of a percentage point could be to compensate for the cut made in September. However, this argument was not considered to be on par with the inflation forecast, which is the normal determining factor in monetary policy. In addition, new information on economic activity and price trends will come in over the next months and may have unusually large importance for the way in which future inflation is viewed.

Given this, it was considered that there was no reason to raise the repo rate by one half of a percentage point at the meeting. It was felt that this kind of raise could create unnecessary unease and push up inflation expectations.

The monetary policy group also discussed whether there was reason for any explicit communication regarding the future direction for monetary policy. It was considered reasonable to signal that further interest rate increases are possible if economic activity continues to strengthen as expected and unless new information is received that motivates a different analysis of the inflation propensity of the economy.

2.2 The Executive Board's discussion

All of the members shared the monetary policy group's view that the repo rate should be raised, given the current inflation forecast. Several members considered that a larger rise than 0.25 percentage points could be motivated on the basis of the inflation assessment. The Executive Board noted that the financial markets were expecting a raise of 0.25 percentage points. Several members also saw a risk that a raise of 0.50 percentage points could cause unnecessary drama. The discussion mainly concerned the size of the interest rate increase.

One member began by asserting that the strength and timing of the upturn in economic activity in the USA was of central importance to the assessment. In Sweden we can see a number of positive signals which indicate that the lowest point of the downturn may have been reached, but we also appear to have a very strained resource utilisation. The decline in economic activity appears to have been both briefer and less deep than we had feared earlier. The member emphasised that prices and wages in the Swedish economy had shown a worryingly strong development, particularly in the services sector and that employment is higher than expected. This indicated that the degree of available resources is lower than was previously assumed. It was therefore time to raise the repo rate in Sweden now, even if there is still uncertainty over the strength and timing of the economic recovery. The question was merely how much to raise the rate.

This member also noted that a raise in the repo rate would mean that the Riksbank became the first central bank in the OECD to make its monetary policy less expansionary. The Riksbank's inflation forecast on this occasion also deviates more than usual from those of other analysts in the market. There was good reason for making a cautious interest rate adjustment and giving the general public time to discuss the Riksbank's inflation picture. New information can also come and alter the nuances in the picture. It was important to point out that the Riksbank had no special information on which to base policy that was not available to other forecasters.

All in all, the member recommended a raise in the repo rate of 0.25 percentage points at the meeting, but pointed out that further increases could prove necessary unless new information was received in the coming months that significantly altered the picture painted in the Inflation Report.

Another member shared the monetary policy group's view of the situation and agreed that it was appropriate to show caution. This member emphasised that the recovery in economic activity was not yet secure. The question rather concerned when the USA would return to a situation of stable growth and what could happen before then. There was still a risk that economic activity in the USA could make a double dip, if investment did not increase. The lasting savings imbalances in the USA constitute a risk of an even deeper decline in the long run, with ensuing negative effects on economic activity for Europe and Sweden. Sweden still has a declining capacity utilisation. Unemployment is expected to increase slightly and private consumption was as yet not very strong. The member also expressed concern over developments within certain large Swedish export companies and their suppliers. The telecom sector had contributed to subduing growth in 2001 and would probably continue to do so in 2002. In addition, the 3-G investments had been postponed.

The member felt that the uncertainty regarding economic activity indicated that the repo rate should not be changed at the meeting and that it would be wise to await new information. At the same time, there were a number of signs of a worrying large domestic cost pressure, due to higher wage costs than in other countries during 2001, which indicated that capacity utilisation was high, at least during 1999-2000. This applied in particular to the services sector. The most important thing for the Swedish economy was thus structural reforms that would contribute to increasing potential growth, partly through increased productivity, increased labour supply, reduced absence due to illness, etc. Responsibility for such measures does not lie with the Riksbank, but they would contribute to creating more favourable conditions for monetary policy. All in all, the member made the assessment that the economy is facing a change in economic activity in a situation with fairly low unemployment and an inflation rate above the target level. The temporary effects on inflation are expected to drop out of the statistics fairly soon, but as the inflation forecast for one to two years ahead is also slightly above the target level, the repo rate should be raised to secure the inflation target. The member therefore recommended a raise in the repo rate of 0.25 percentage points and emphasised that it was important to wait for new figures and more in-depth analysis before taking the next step.

Another member agreed that the imbalances in the USA gave cause for concern and felt that these should gradually decline as the dollar depreciated, as described in the Inflation Report. To underline this, the member pointed to simple calculations showing that the dollar needed to become almost 40 per cent weaker to avoid an overly large foreign debt in relation to GDP. This type of significant depreciation would be necessary, as exports would need to increase considerably in order to slow down the growth of the external debt. This type of dollar fall occurred in the mid-1980s. A significant depreciation of the dollar would risk slowing down the upturn, as private consumption would develop less strongly.

In addition, there was evident concern that an increase in the threat situation regarding Iraq could have far-reaching consequences, for instance, oil prices could become higher than the forecast in the Inflation Report. Higher oil prices could lead to a slightly higher inflationary pressure in Sweden. The member also pointed out that the recovery was clear in the USA and Asia, but less so in Europe.

The member emphasised the Swedish labour market as a source of concern. Wage rises, amounting to approximately 4.2 per cent, had been too high in relation to productivity growth. Wages should probably increase no more than 3.5 per cent to be in line with the inflation target. At the same time, wage increases differed considerably between sectors. A particularly high increase had been noted in service industries, which indicates imbalances. In manufacturing, white-collar workers' wages had increased more rapidly than blue-collar workers' wages. This, together with considerable problems in attracting qualified personnel to certain areas of the public sector, risked triggering requirements for compensation and an increased wage drift in future. The member emphasised that there had been a worrying upward trend in UND1X inflation for a long period of time – even after adjustment for supply disturbances – which risked continuing unless the Riksbank raised the repo rate. There was a risk in waiting too long before making a sufficiently large adjustment in the repo rate. The monetary policy situation in summer 2001 could be compared with the prevailing picture of economic activity. The repo rate was then higher than it is today, 4.25 per cent, despite the poorer economic prospects and the fact that wage formation was not considered to comprise any threat to inflation. The primary risk for inflation then stemmed from the weak exchange rate, which has now strengthened somewhat. Economic activity was probably in an upward phase now and this indicated that the repo rate should be returned to a more neutral level. The member therefore recommended a rise of 0.50 percentage points.

Another member agreed with this and pointed out that today's question was how much the repo rate should be raised now and how much it should be raised later. The interest rate cut of 0.50 percentage points in September 2001 was made mainly because economic prospects had been affected by the terrorist attack, but could also be motivated as an insurance policy with regard to the stability of the financial system. The uncertainty that existed then had now disappeared. This and the clear turnaround in economic activity certainly indicated that a raise of 0.50 percentage points could be motivated. However, the member concluded that market participants' expectations were focused on a raise of 0.25 percentage points and that there was reason not to create unnecessary volatility in the financial markets that would result in higher risk premiums. Given this, the member recommended a raise of 0.25 percentage points.

Several other members shared the opinion that there was reason not to surprise the market. This could create unwarranted drama with regard to the inflation problem, as well as having undesired effects on expectations.

One of these members pointed out that the inflation assessment could motivate an increase of 0.50 percentage points, but that it would be better, in order to avoid surprising the market, to raise by only 0.25 percentage points on this occasion, and at the same time signal that further increases could be expected if developments were in line with the forecast. As usual, monetary policy will in future be influenced by the information received and by the analyses and assessments made within the Riksbank. The difference between raising the repo rate by 0.50 percentage points now and raising it by 0.25 percentage points at this meeting and the same amount at the next meeting would be slight with regard to consequences for the real economy.

This member emphasised that while inflation was expected to fall in the near future, monetary policy was not conducted in this time perspective. The focus is now on the period 2003-2004.

It was also important to underline that it was not reasonable to include dramatic, unforeseeable events such as terrorist attacks and a possible conflict in Iraq in the risk-weighted inflation assessment. This type of event should instead be dealt with if and when it arose. The member received support from another member, who pointed out that the total economic policy has a stimulatory effect on the economy and in an economic upturn this could help build up other risks, such as an exaggerated price trend in the asset markets.

Some members discussed whether a possible escalation in concern over a conflict in Iraq could lead to rising oil prices, which one member had argued for earlier. One member noted that the most recent conflict in this region had not led to higher oil prices. In addition, another member pointed out that Saudi Arabia had a surplus capacity that could be used in the event of an escalation in the conflict.

A couple of members emphasised the importance of an even stronger, more in-depth analysis of the domestic economy. One of these members pointed out that more sector-based analysis would be desirable in future. The fall in economic activity noted was primarily related to the part of the Swedish economy dependent on foreign trade. It is also mainly in the domestic sectors of the economy that inflationary pressure is visible in the form of higher wage increases and rising inflation. At an aggregate level, this, together with statistical revisions to the GDP, has affected the estimate of resource utilisation, although there is still a clear need to understand more of the underlying process at a disaggregate level. It is important now to be open to the possibility that new information may motivate further changes in the views of how the economy functions. The uncertainty over rather fundamental relationships in the inflation assessment is one reason for proceeding gradually with changes in the repo rate. Nevertheless, the member felt that further interest rate increases would be required in the future if the picture painted in the Inflation Report held out.

This member also referred to the question of how the current repo rate level of 3.75 per cent looked compared with the situation during summer 2001. Comparisons of this nature were seldom simple; much has happened since then. The repo rate of 4.25 per cent that prevailed last summer should be regarded in the light of the rapid weakening of the krona that risked continuing and contributing to rising inflationary pressure. This is a problem that does not exist today. Even then there were also question marks concerning domestic pricing that comprised an upward risk for inflation and that were included in the picture when the repo rate was raised in July. The latter was also an important reason why the Riksbank did not lower its rate as much as, for instance, the ECB did, in the autumn.

§ 3. The monetary policy decision

The Chairman summarised the monetary policy discussion in § 2 and found that there was one proposal to raise the repo rate by 0.25 percentage points and one to raise it by 0.50 percentage points. The Executive Board decided to raise the repo rate by 0.25 percentage points to 4.0 per cent, to apply from Wednesday, 20 March 2002, and to announce the decision on Tuesday, 19 March 2002 at 9.00 a.m. with the motivation and wording contained in press release no. 15, Annex B to the minutes. It was also decided that the minutes from the meeting would be published on Monday, 8 April 2002. In addition, the Executive Board decided that the lending rate would be raised by 0.25 percentage points to 4.75 per cent, and the deposit rate would be raised by 0.25 percentage points to 3.25 per cent.

Deputy Governor Villy Bergström entered a reservation against the decision to raise the repo rate by 0.25 percentage points and alleged that the repo rate should be raised by 0.50 percentage points.

Villy Bergström went on to allege: "Underlying inflation, measured as UND1X excluding the price changes that are assessed as temporary (petrol, heating oil, electricity, telecommunications, meat, fruit and vegetables), has risen for the past two years. There are also some signs that inflation expectations have risen. Given this, there are also a couple of tangible inflation risks that I consider motivate a larger raise in the repo rate at this meeting. Firstly, there is a risk of increased unease over a possible conflict in Iraq, which could mean that the oil price forecast is rather too low. Secondly, the unexpectedly high wage increases last year, of 4.2 per cent, constitute an inflation risk. The service industries have shown higher wage increases than the average throughout. In addition, wages for white-collar workers have increased more rapidly than those for blue-collar workers in manufacturing. This risks leading to future requirements for wage compensation from the blue-collar workers, particularly if economic activity improves. All in all, I consider there is cause to raise the repo rate by 0.50 percentage points to give a clear signal that the Riksbank intends to ensure that the inflation target is achieved."

This paragraph was confirmed immediately.

Minutes taken by:

Kerstin Alm

Checked by:

Urban Bäckström	Lars Heikensten	Eva Srejber
Villy Bergström	Lars Nyberg	Kristina Persson