No. 5

SEPARATE MINUTES of the Executive Board meeting on 25 April 2002

<u>Present</u>: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
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Kerstin Alm
Malin Andersson (§ 1)
Claes Berg
Anders Borg
Jörgen Eklund
Kerstin Hallsten (§ 1)
Björn Hasselgren
Jyry Hokkanen (§ 1)
Leif Jacobsson
Hans Lindblad
Christina Lindenius
Pernilla Meyersson
Tommy Persson
Cecilia Roos-Isaksson (§ 1)
Robert Sparve
Annika Svensson (§ 1)
Staffan Viotti

<u>§ 1. The monetary policy discussion</u>

It was noted that Anders Borg and Pernilla Meyersson 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 relevant 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 the end of March 2004. 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 internationally and in Sweden

1.1 The international scene

In the main scenario in the March Inflation Report it was judged that GDP growth in the OECD area would be 1.2 per cent this year, followed by 2.7 and 2.8 per cent, respectively, in 2003 and 2004. Inflation was calculated to be 1.6 per cent in 2003 and 1.9 per cent in 2004.

The Board found that global economic developments have broadly followed the outlines presented in the March Report. In the United States, activity in the early part of the year has turned out to be higher than expected. Above all, consumption growth has been relatively strong. Stocks seem to have been reduced somewhat more quickly than had been foreseen. Corporate and residential investment have been stronger than allowed for in the March Report. In the euro area, higher inflation outcomes and higher oil prices point to a somewhat greater risk of inflation developing less favourably. Economic prospects in Japan are still bleak. All in all, the revisions to international economic prospects have a marginal effect on world market growth for Swedish exports.

One Board member noted that the development of corporate profits in the United States now looks somewhat more favourable, which suggests that once stock adjustments have been completed, investment rather than consumption will be the primary force for growth. Moreover, the persistently high productivity growth is an indication that productivity's long-term trend has in fact improved. One reason why the Federal Reserve was in a position to keep the instrumental rate at as low a level as 1.75 per cent was probably that core inflation had remained low.

Another member considered that a recovery is now in progress at the same time as economic policy is still expansionary. Activity in the United States is picking up more quickly and vigorously than we had counted on. Moreover, with a continuation of high productivity growth and a better outlook for profits, the risk of a "double dip" in the United States seems to have diminished. Demand now appears to be rising even in the ICT sector. These developments will contribute to increased demand in the rest of the world. In this member's opinion, there are some signs that we may have underestimated the strength of the international upswing. Positive effects are already visible in Japan and the rest of Asia, where exports are picking up. This is a welcome pull for the Japanese economy but in the absence of steps to tackle the structural problems, growth there will probably remain weak while deflation continues. The persistently expansionary economic policy in the United States entails a risk of over-stimulation. An unduly protracted expansionary policy is liable to mean that the imbalances in the American economy remain. As to the prospect of oil prices remaining at the current higher levels, this member was now less concerned both in view of the large amount of surplus capacity and because among the oil-producing countries there was an interest in increased oil receipts.

A third member agreed with the picture of a stronger upswing in the United States but underscored that the March assessment, with a more subdued tendency in the second half of this year, still seems reasonable, perhaps more so than before. This is expected to lead to increased private saving and a reduction of imbalances. This member underscored that decreased imbalances also lessen the downside risk in the forecast.

Another member observed that while prospects in the United States seem to have improved, there is still the possibility of the recovery not being sustained, particularly as the outlook in Europe continues to give some cause for concern and constitutes a downside risk. The picture in Germany remains weak and it is not certain when a recovery will materialise. The large liabilities of many European telecom operators pose problems not just for Ericsson but for the entire ICT sector in Europe.

Yet another member agreed with the picture of a stronger tendency in the United States. A question that is raised from time to time is why the Federal Reserve's instrumental rate can still be so low. It is primarily stock adjustments that have raised growth in the United States. The slowdown began in the United States and the need to counter an excessively sharp downturn was probably greater than in other countries. Moreover, core inflation is low and falling. High productivity growth also means that potential growth is comparatively strong; together with rising unemployment, this means that despite a similar development of demand, more resources are becoming unutilised in the United States than in Europe. So when activity in the United States turns upwards, growth can presumably strengthen comparatively quickly.

The Board went on to note that the barrel price of crude oil has risen approximately USD 2–3 more than had been foreseen in the March Report, partly as a result of growing unrest in the Middle East. Other factors have been the improved economic prospects in the United States and OPEC's voluntary production cuts. However, there are no grounds for altering the earlier assessment of the somewhat longer run. The oil price can be assumed to fall from the current relatively high levels, mainly on account of an increased supply from non-OPEC countries. Forward prices point to some gradual fall in oil prices, though the uncertainty is unusually great.

The Board's overall assessment was that recent international economic developments have broadly followed the picture in the March Report. It would now appear that the changeover towards a more expansionary economic policy last year has laid the foundation for a recovery. Growth in the United States in the early part of this year seems to have been stronger than assumed earlier. Developments in the euro area have been more subdued than in the United States but there are signs of a cautious upswing in line with the March assessment. The continued imbalances in the United States, manifested for example in low national saving, contribute to there still being some uncertainty about the recovery's strength and permanence. Other sources of uncertainty are the unrest in the Middle East and the higher oil prices recently. The higher inflation outcomes in the euro area are another cause for concern. To sum up, there are no reasons to alter the assessment in the Riksbank's March Report, namely that the global economy recovers gradually this year, with relatively high growth thereafter. For the OECD area, this implies GDP growth rates in the coming years of 2.5–3.0 per cent. The Board also agreed that the development of international export prices will be approximately in line with the assessment in the December Report.

1.3 Financial markets

The Board noted that since March, short-term interest rates in Sweden have risen as a result of the repo rate increase and expectations that monetary policy will continue to tighten. Money market prices indicate expectations that the Riksbank will raise the repo rate about 0.5 percentage points in the coming three months and by 0.75 percentage points to 4.75 per cent by the end of the year. The TCW exchange rate has become somewhat weaker since the March Report.

Both long-term interest rates and the differential with Germany have also risen to some extent, presumably due to some concern about domestic inflation in Sweden. The stock exchange has fallen about 15 per cent since the time of the March Report, above all in connection with developments in the ICT sector and Ericsson's quarterly report. The share price fall also contributed to falling market interest rates and the weaker exchange rate.

All in all, the Board considered that, notwithstanding the somewhat weaker exchange rate, the higher short- and long-term market interest rates and a weaker stock market imply that recent financial market developments will have a less expansionary effect on the future course of demand.

1.5 Demand and supply

The GDP growth rate for Sweden was judged in the March Inflation Report to be 1.6 per cent this year, followed by 3.0 per cent in 2003 and 2.6 per cent in 2004. The acceleration was grounded in a recovery of international activity, a comparatively weak exchange rate, low real interest rates and an expansionary fiscal policy. The rate of inflation, measured by UND1X with the risk spectrum taken into account, was calculated to be 2.3 per cent in March 2003 as well as in March 2004.

The Board noted that manufacturing activity in Sweden seems to have strengthened in the early part of the year. In the latest three-month period, both incoming orders and output have tended to recover. A recovery is likewise indicated by various surveys of business confidence. In connection with Ericsson's quarterly report the company stated that incoming orders are weaker than it had expected and that a recovery in this sector may be further delayed; this in turn may contribute to a slower improvement in manufacturing activity.

Preliminary figures for the volume of exports and imports point to a continued increase in the early part of the year, which seems to confirm the impression of a recovery in manufacturing and rising economic activity. The main conclusion is that manufacturing output has started to pick up but that the improvement is comparatively cautious.

Retailing statistics for February and March from Statistics Sweden and the Research Institute of Trade (HUI) contain some signs that household consumption is recovering. Similar indications are to be found in households' notably optimistic assessment of their own economic prospects and a comparatively rapid increase in demand for notes and coins. While property prices did tend to fall from January to February, on a 12-month basis the level continued to rise. If the stock market were to remain weak – a prospect that is naturally uncertain – it might tend to subdue household consumption. But despite the price fall for Ericsson shares, the stock market in general has declined less, which implies that the impact on wealth and consumption does not have appreciable consequences for the assessment in the March Report.

The February investment survey from Statistics Sweden indicates that gross fixed investment in 2002 will be unchanged from the previous year, which is in line with the latest forecast. In the coming years, however, the increased interest rates and problems in the telecom sector may entail a somewhat weaker development of investment.

Employment rose to some extent in March, while the number of redundancy notices decreased for the fourth consecutive month. The statistics show a rising number of new jobs in recent months but an earlier registration of holiday jobs complicates the interpretation. On account of persistently high absenteeism and a continued reduction of overtime work, in the early months of this year the tendency for hours worked has been relatively weaker than for persons in employment. So for the time being, the picture of hours worked does not confirm an increase in the level of economic activity. This is in line with the March Report, where it was considered that an increased level of activity would be achieved initially through higher productivity growth. Preliminary wage statistics for January are available only for public sector employees, for whom the rate of wage increases moved up to 4.7 per cent from 4.2 per cent in December.

One Board member considered that the somewhat higher oil price may last longer but that its effect on other prices may not be as great in that it also tends to subdue demand. Moreover, in a forward-looking perspective the impact that Ericsson's problems may have on economic growth and the general price trend should not be exaggerated even though there is a tendency to weaken growth. The major problem is wage formation. Last year's average wage rise exceeded 4 per cent. The new outcome data for the public sector amount to 4.7 per cent. The discussion about the tight labour market situation and wage formation – currently the principle threat for inflation – has started.

Another member referred to three phenomena that are currently characterising the economy. One is the adjustment after the ICT boom. Such an adjustment can be troublesome, with declining wealth and decreased employment. It is not just a matter of a financial bubble but also of a real economic bubble in these sectors. But although the process is difficult, not least for those whom it affects more directly, it is basically an unavoidable adjustment that now seems to be under way in comparatively orderly forms. Another current characteristic of the Swedish economy is a clear slowdown in manufacturing, where employment is also falling. But there are certain signs that an upturn in Sweden is imminent, though not as notable as in the United States. These two restraining tendencies are overshadowed, however, by the third characteristic: the expansion of both private and public services. Employment here has grown markedly and both prices and wages are rising. So the picture of activity is not as sombre as is sometimes suggested.

A third member agreed about the problems to do with wage formation and prices in the services sector but expressed some concern about the development of wealth and its impact on future consumption. Perhaps consumption will not be as strong as the Riksbank predicts. Adjustments in the ICT sector and the general slowdown in the past year have consequences for the services sector as a whole, though with some time lag. It could be that the decline in this sector of the economy has not yet reached a low. Indications to this effect are an increased supply of vacant premises in central Stockholm, for example, and the recent fall in the level of rents. There is a risk of growth not picking up before next year, in which case the development of wages and prices in the services sector during 2002 will be checked somewhat more than was assumed in the March Report.

Another member agreed with the description of the three characteristics and noted that a majority in Sweden is engaged in other activities than manufacturing. Moreover, the decline in manufacturing does not seem to have had so much of an effect on the services sector, a phenomenon that is not confined to Sweden. This member found it important to underscore that the ICT bubble on the stock market has burst but that the share index suggests that developments in other parts of manufacturing are less unfavourable. There are many signs of a good economic development, for example the continued increases in house prices and in borrowing and the upturn in the number of job vacancies. Furthermore, a weaker development of demand in Sweden could be offset, at least in part, by the international recovery probably being stronger than assumed earlier. This member also shared the concern, voiced in the discussion, about the functioning of the labour market. In this member's opinion, the difficulties in the Swedish economy are basically connected with low productivity growth.

Yet another member agreed that while the Swedish economy is characterised by a comparatively good development of demand, there are some troublesome tendencies. The member also agreed that wage developments give cause for concern in view of the large shortage of personnel in certain services, particularly in certain parts of the public sector. This can be assumed to be an additional driving force for wage increases. As profit shares have fallen and cannot be said to be abnormally high, there is a major risk of the wage increases leading to rising prices. The member referred to sick leave and wondered whether it has structural aspects and what part it will play in labour market developments. On the other hand, there are certain indications of diminishing demand for bank loans and this must be watched closely; it could be a sign of investment – and thereby demand – not coming up to expectations.

A Board member asserted that the negative effects, for instance lower corporate borrowing and lower office rents, could be a delayed consequence of last year's economic slowdown, in which case forward-looking indicators for households, such as house prices and credit flows, are more important for forecasting future inflation.

Another member underscored that the Riksbank is primarily interested in the average rate of wage increases, not the distribution over different groups. Average wage increases have been too high for a long time, a considerable problem that is really not new. But last year, wages rose even more than expected. At the same time there are some features which are presumably healthy in the longer run. Wages are rising in sectors where employment is strong, so it looks as though demand is affecting relative wage developments. There may be some risk of demands for compensation but the weak demand in certain sectors and the moderate wage increases there in recent years suggest that the possibility of realising such demands is limited. Had it been possible to obtain higher wage increases, clear signs of this would probably have appeared already.

All in all, the Board judged that developments in Sweden are essentially in line with the main scenario in the March Report. The level of activity in the services sector has been maintained comparatively well and there are now signs of a recovery in manufacturing. The overall direction of economic policy is expansionary, as is evident from, for example, low real interest rates, a weak exchange rate and the increased transfers and tax cuts that are adding to the scope for household consumption. Together with the problems in the telecom sector, the oil price rise and weak stock market may contribute to demand being somewhat slacker than assumed earlier. Still, a recovery approximately as foreseen in the March Report is expected in the coming years. In Sweden, too, GDP growth is accordingly assumed to be in the interval 2.5–3.0 per cent.

2. The Board's assessment of inflation prospects

The rate of CPI inflation was judged in the March Inflation Report to be 2.2 per cent in March 2003 and 2.4 per cent in March 2004. At both these time points the corresponding rate of UND1X inflation was forecast to be 2.2 per cent. A part of last year's price rise was judged to be transitory and to disappear during 2002.

The Board noted that inflation expectations measured as the spread between nominal and real bond rates, have moved up. On the other hand, the February survey shows that households' expectations of inflation one year ahead are unchanged. Inflation expectations in the corporate sector have risen, according to the National Institute of Economic Research's business tendency survey, from 1.8 per cent in January to 1.9 per cent in April.

Since the time of the March Report, outcomes have been published for CPI and underlying inflation in February and March. The 12-month rate of underlying inflation (UND1X) in March was 3.4 per cent, which is marginally higher than foreseen in the March Report. Both domestic and imported inflation were somewhat higher than expected.

The increased oil prices are likely to result in higher import prices during 2002 but as oil prices are expected to fall back, imported inflation's contribution next year will presumably be smaller. The changes in domestic inflation (UNDINHX) are marginal. In the short run there is a downward effect on domestic inflation from the introduction of special support for dental care for the elderly as of July this year. The UND1X forecast for this and next year is affected most by the revision of import prices; thus, UND1X inflation is now assumed to be somewhat higher this year and somewhat lower twelve and twenty-four months ahead. Excluding petroleum products, the changes in the UND1X forecast are small.

The Board's overall assessment was that in the coming six months inflation will still fall back from the current high levels, mainly because the effects of last year's transitory price increases will disappear. It is conceivable that the higher petrol and oil prices will counter the downward tendency to some extent in the short run. After that it is foreseen that the relatively high resource utilisation will contribute to some renewed increase in labour costs and domestic inflation.

The economy's inflation propensity is still an upside risk for domestic inflation. The questions about resource utilisation, inflationary pressure and the workings of the economy that were highlighted in the March Report remain relevant. At present there is no reason to alter the assessment in the March Report: inflation one to two years ahead – the perspective that guides monetary policy in the first place –is still calculated to be somewhat above the Riksbank's 2 per cent target.

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

3.1 The monetary policy group's view[1]

First Deputy Governor Lars Heikensten presented the view of the monetary policy group regarding the path of inflation and the situation for monetary policy. The group's appraisal of inflation was essentially the same as the Board had now expressed. The rate has risen marginally more than expected but a downward shift is still foreseen. The overall assessment implies that inflation continues to be somewhat above the target, making it natural to raise the repo rate 0.25 percentage points. But a larger increase is difficult to motivate at present.

The policy group had noted that Ericsson's quarterly report has affected the mood in the public discussion, so perhaps there could be narrow tactical arguments against an increase on this occasion. In reality, however, there seemed to be no reason to assign so much importance to the report for inflation prospects 1–2 years ahead. Ericsson employs only about one per cent of the total labour force, for example. Refraining from an increase would be bound to generate more, not less, uncertainty in financial markets.

The policy group considered there were grounds for providing some indication of monetary policy's future direction. According to the overall assessment, an economic recovery is in progress in Sweden. Even if inflation does fall back in the coming months, the high resource utilisation is contributing to an inflationary pressure that is likely to affect future price tendencies. This suggests that further interest rate increases may be required. At the same time it should be underscored that the repo rate's appropriate path in the future is uncertain and that as usual this depends on what

[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.

happens and the outcome of our analyses. There is also reason to emphasise that with an increase today, monetary policy will have been tightened by 0.5 percentage points.

3.2 The Board's discussion

The Board unanimously considered that monetary policy should be based on UND1X inflation. All the members shared the policy group's opinion that the repo rate should be raised 0.25 percentage points.

One member was worried about the upward shift in inflation expectations in a broad sense. This shows that there may be some concern that inflation could continue to exceed 2 per cent. Survey data can be interpreted as indicating that a growing proportion of people believe that inflation will be higher and this can affect inflation's path. Moreover, rising long-term interest rates, the larger long-term interest rate differential and a weakening exchange rate point in the same direction. Inflation seems to be more persistent than expected.

Another member declared that in view of the economic situation and the high rate of price increases recently, it is hardly surprising that inflation expectations in financial markets have moved up – that is what usually happens. This member pointed out that different measurements have yielded different results and that the upward tendency in inflation expectations derived from market prices could have to do with other factors. There have, for example, been a number of recent occasions when Riksbank statements and interest rate increases have affected market prices.

A third member found it important to underscore that inflation will fall back and that the current high rate is not troublesome because it stems to a substantial extent from transitory factors. Monetary policy's normal perspective is instead the rate of price increases in the coming years and in that context it is resource utilisation and wage developments that are highly important.

Another member considered that by themselves, neither forecast inflation nor inflation expectations warrant a repo rate increase of 0.25 percentage points today. But grounds for an increase of 0.25 percentage points still exist in view of the high wage increases, the comparatively tight labour market and the risk of ensuing demands for compensation. It is important at this stage not to be committed to further interest rate increases but to wait and see how activity and prices develop.

Another member agreed that the repo rate ought to be raised 0.25 percentage points. The uncertainty about the strength of the economic recovery speaks in favour of deferring an increase but the labour market situation favours the opposite and weighs more heavily. There is no reason at present to decide whether further interest increases will be called for; that should wait until more information is available.

A Board member considered there were grounds for raising the repo rate. With the relatively high resource utilisation, there is some inflationary pressure in the economy, which therefore does not need more stimulation from economic policy. Real interest rates are low and the exchange rate is weak. There is a risk of inflation not falling quite as much in the coming six months as the Riksbank assumed earlier, while after that inflation may rise more rapidly. This member went on to say that fundamental factors could clearly motivate a repo rate increase today of 50 basis points but that an increase of only 0.25 percentage points would be wise in view of market developments and the signals that have been sent. But in connection with the decision it should be stated that further increases may be required to ensure that inflation develops in line with the Riksbank's target.

The Board's overall assessment was that a repo rate increase of 0.25 percentage points is motivated. The Board also noted that, as always, the future direction of monetary policy depends on the Riksbank's appraisal of inflation prospects. If the growth of demand continues to strengthen and there is no cause to revise the assessment of the inflation propensity, further steps towards a less expansionary monetary policy may be called for. However, since the beginning of the year the Riksbank has raised the repo rate 0.5 percentage points. The rate at which further interest adjustments may be needed is uncertain and will depend, as usual, on the information that becomes available and how it is interpreted.

§ 2 Monetary policy decision[2]

The Chairman summarised the monetary policy discussion under § 1 and found there was a proposal to raise the repo rate 0.25 percentage points. A vote was taken and resulted in six votes in favour of an increase of 0.25 percentage points.

The Executive Board accordingly also decided to raise the deposit and lending rates, to 3.5 and 5.0 per cent, respectively, with effect from 2 May and to announce the decision at 9 a.m. on 26 April with the motivation and wording contained in Press Release no. 21 2002 (annex to the minutes).

This paragraph was immediately confirmed.

[2] Any present Board member not having registered a reservation in the minutes, is to be understood having taken part in and been in agreement with the decision by the Executive Board.