

SEPARATE MINUTES of the Executive Board meeting on 5 June 2002

Present: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
–
Sven Hulterström, Chairman of the General Council
–
Kerstin Alm
Claes Berg
Anders Borg
Jörgen Eklund
Kerstin Hallsten
Hans Lindblad
Tomas Lundberg
Pernilla Meyersson
Carl-Fredrik Pettersson (§ 1)
Robert Sparve
Åsa Sydén
Staffan Viotti

§ 1. The current inflation assessment

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

The Board began its discussion in the light of the information that had been received since the previous meeting on 30 May and its significance for inflation prospects (section 1). The Inflation Report was then adopted (section 2).

1. New information about economic developments
in Sweden and internationally

In the euro area as well as the United States, purchasing managers indexes show that manufacturing activity is now recovering; the strength of the upturn exceeds earlier expectations in every respect. The preliminary Q1 figures for GDP in the euro area confirm the relatively weak domestic demand trend that is outlined in the main scenario of the Inflation Report. Moreover, a flash estimate indicates that in May, inflation in the euro area fell back from 2.4 to 2.0 per cent.

In May, Swedish households were as optimistic as before about their personal economy, according to the National Institute of Economic Research's survey of household purchasing plans, but their perceptions of the national economy had become somewhat less optimistic. This is accompanied by a negative shift in their views about unemployment. Expectations of inflation one year ahead were unchanged at 2.5 per cent. The purchasing managers index (ICI) rose more than two units to 59.0; the figures are historically high and this index seems to give a somewhat more positive picture of manufacturing activity than the National Institute's business tendency survey.

Wage outcomes for March show that wage increases in the first three months of this year from the corresponding period in 2001 average 3.9 per cent, which is 0.8 percentage points above the rate a year earlier.

The financial markets have remained turbulent in the past week, with falling share prices, a slight downward tendency in interest rates and a further depreciation of the dollar against both the euro and the Swedish krona. According to Reuters' survey, 12 out of 13 market agents expected that at today's monetary policy meeting the repo rate would be held unchanged.

The Board's assessment was that the new information is largely in line with the picture presented in the Inflation Report.

2 Inflation Report 2002:2 adopted

Deputy Governor Lars Heikensten presented the draft of Inflation Report 2002:2 (Annex A to the minutes). The draft started from the presentations and discussions at the Board meetings on 22 and 30 May 2002.

The Board decided to adopt the Inflation Report as drafted and that it shall be published at 9 a.m. on 6 June 2002.

Reservation

Second Deputy Governor Eva Srejber entered a reservation against the decision to adopt the Inflation Report and made the following statement:

After what seems to have been a shallow and brief slowdown, the global economy is now in a phase of recovery. However, the strength of the ongoing recovery is still highly uncertain. The risk of activity falling substantially – a so-called double dip – has decreased since the time of the March Report. There are four factors in particular that may contribute to activity in the rest of the world being somewhat higher than envisaged in the present Report's main scenario. One is that profits in the United States are developing more favourably than expected earlier, which could contribute to a quicker upturn in investment. Another is the likelihood of the upturns in manufacturing activity and the world economy being synchronous. Last year's

slowdown in manufacturing abroad was accentuated both by the simultaneous slackening of demand in a number of countries and by the decline in the IT and telecom sector after a period of excessive optimism. The links between different parts of the world economy proved to be stronger than assumed earlier. It is conceivable that the upturn in global manufacturing activity and world trade will likewise be concurrent and more marked than assumed. Thirdly, it looks as though the adjustment in the IT and telecom sector after excessively high investment is now nearing completion at the same time as the new technologies can be expected to contribute to productivity gains in the future, too. Finally, economic policy is still very expansionary in most countries. Against this background, GDP growth abroad, world market growth and international export prices will probably be somewhat higher than assumed in the Report's main scenario.

Sweden's economy is also in the process of recovering. This is occurring from a situation where resource utilisation is already high and where inflation and inflation expectations are above the target. The somewhat higher activity abroad contributes to somewhat higher growth and higher import prices in Sweden. In addition, the Report's assessment of labour supply and wage formation may turn out to be rather optimistic. All in all, I therefore consider that, given an unchanged interest rate and the given institutional framework, inflation in Sweden will be a couple of tenths of a percentage point higher than in the Report's main scenario.

This paragraph was immediately confirmed.

§ 2. Monetary policy discussion

The Board's monetary policy discussion started from the assessment in the Inflation Report (section 1). The Board's assessment of the monetary policy situation (section 2) was preceded by an account of the discussion in the monetary policy group.¹

1 The Board's assessment of inflation prospects

In the Inflation Report it is considered that inflation both one and two years ahead will be in line with the targeted rate. Inflation has fallen back as foreseen in the March Report and in April the UNDI_X rate was 2.8 per cent. Upward effects on inflation from various supply shocks have faded and this process is expected to continue for a time. But as economic activity improves, there is likely to be some gradual renewed increase in inflation.

The Report's main scenario implies that the economic upturn in the rest of the world has become more and more clear and that this year's growth in the United States will be somewhat stronger than expected earlier. That is judged to contribute to a recovery in Europe, although growth there is restrained by a weak development of

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.

consumption. At the same time, oil prices have risen since the time of the March Report, reflecting improved growth prospects as well as increased uncertainty in connection with the security policy situation in the Middle East. It is assumed, however, that the oil price will fall back from the current high levels. Towards the end of the forecast period, both the exchange rate and oil prices have a downward effect on inflation that can be assumed to fade beyond the forecast horizon. This contributes to the likelihood of inflation rising still further in the somewhat longer run.

The prospects for growth in the Swedish economy are largely the same as before. Manufacturing activity is in the process of improving. Most things still point to a tentative upturn in activity this year, followed by substantial growth in 2003 and 2004. Household consumption seems to be on the way to recovering and is favoured by a robust development of income, comparatively low real interest rates and rising property prices. With the repo rate increases and a less expansionary fiscal policy, however, investment and consumption are expected to be somewhat weaker than envisaged in the March Report. The stock market turbulence also acts as a damper. This means that compared with the March Report, the growth of domestic demand and thereby resource utilisation are now judged to be marginally lower in 2003 and 2004.

The spectrum of risks is also relevant for the formulation of monetary policy. As in the March Report, the predominant upside risk is considered to lie in inflationary pressure in a wide sense and wage formation in the Swedish economy. The price and wage increases in recent years may be a sign that underlying domestic inflationary pressure has been underestimated, perhaps because wage formation is functioning more unfavourably than expected and resource utilisation is more strained than assumed in the main scenario. Other risk factors that may subdue potential output are the rapid increase in sick leave and the combination of demographic changes and a possible reduction of working time. Sector-specific problems in manufacturing also complicate the assessment of productivity growth.

The overall assessment is that CPI inflation is judged to be 2.1 per cent one year ahead and 2.4 per cent after two years, while the corresponding forecasts for UNDIX inflation are 2.0 and 2.1 per cent.

In connection with every monetary policy meeting since 1999 the Riksbank has chosen to clarify the measure of inflation that has guided monetary policy. As has been normal in recent years, on this occasion monetary policy is being formulated in the light of the assessment of inflation as measured by UNDIX.

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

2.1 The monetary policy group's view

First Deputy Governor Lars Heikensten presented the monetary policy group's discussion about the Inflation Report. The group had agreed with the overall assessment of the prospects for inflation 1–2 years ahead that is presented in the Report. The new information had not altered the forecast or the risk spectrum at all

decisively. Most things suggest that activity is now turning upwards, as the Riksbank anticipated, but that demand will be somewhat weaker. At the same time there is a factor in recent developments that there are grounds for noting in particular. The dollar's marked fall could be an indication that a change in market assessments of the US economy is on the way. The weakening of the dollar seems to be continuing at the same time as new statistics imply a stronger upturn in the United States. There seems to be a market unrest that may herald a larger swing and could be a part of a somewhat different course. So far, however, this is mostly hypothetical.

The policy group was agreed that further instrumental rate increases may be called for if the picture outlined in the Report materialises. As the months go by, the forecast of inflation two years ahead will probably deviate more and more from the target. Considering that in the coming two years the krona's expected appreciation and the falling oil price will be tending to hold inflation down, this is more evident in the case of domestic inflation. At the same time, inflation two years ahead is currently forecast to be in line with the target. Moreover, as the first central bank among the industrialised countries, the Riksbank has raised its instrumental rate, by a total of 0.5 percentage points. This provides scope for deferring additional measures for the time being. But an increase could presumably be motivated already in July.

2.2 The Board's discussion

All but one of the Board members shared the opinion of the policy group that the repo rate should be left unchanged. The member who differed considered instead that the repo rate ought to be raised 0.25 percentage points.

The latter member motivated this with the argument that making smaller increases in good time with a view to subduing growth during the recovery is preferable to waiting and possibly being obliged to tighten monetary policy when activity is slackening again. This member also pointed out that activity in Sweden is already rising at a time when resource utilisation is strained initially and inflation is already above the target today. The member considered, moreover, that in this situation inflation expectations are important because what households and firms believe about inflation's future path can affect its actual development. The member observed that, according to a variety of indicators, inflation expectations are above 2 per cent and pointed out that the actions of the central bank are important for how expectations develop.

A number of Board members declared they had an open mind about an increase already at today's meeting. One of them noted that signalling had been such that there were no market expectations of a repo rate increase and this was a reason for waiting. Another member said that one reason for waiting was the possibility of obtaining additional information that confirms the Riksbank's assessment. The economic signals point to a clear upswing that could become more rapid; the threatening clouds that exist mainly have to do with the financial market unrest. This member noted that other central banks had chosen to wait and see; moreover, the International Monetary Fund had recommended such an attitude. Against this background and after the two earlier increases, there were now grounds for waiting for at least a month.

Yet another member agreed that, by itself, the Inflation Report can motivate an increase but one could also wait. This member underscored that the economic improvement can be more rapid than the assessment implies. It is not unusual for the strength of an upswing to be underestimated just at the turning point. Tendencies in manufacturing and household confidence in the future may point in this direction. However, the stock market unrest can warrant waiting somewhat longer before raising the repo rate again.

The view that an interest rate increase could be undertaken today was not shared by all the Board members; two of them considered that the new Inflation Report does not contain sufficient reasons for an increase.

All the members held the view that further tightenings may be required, given that the picture of an economic recovery with the attendant strains on resource utilisation continues to be confirmed. Opinions differed, on the other hand, about the exact timing. The date of the next interest rate increase will depend on the overall assessment of inflation prospects 1–2 years ahead. Three of the Board members who supported today's decision considered there may be grounds for acting already at the Board's next meeting.

Another member argued that an increase as soon as at the next meeting was difficult to motivate unless a more marked change in the rate of price increases is foreseen immediately beyond the two-year horizon. If that were the case, it would be a reason for leaving the interest rate unchanged today and then raising it in July.

A Board member emphasised that when the effects of the krona's appreciation have faded, inflation will rise above the target more quickly. The member who had previously raised certain questions about developments immediately beyond the forecast horizon shared this concern about a rising underlying rate of domestic price increases and the consequences of the fact that in the somewhat longer perspective a slackening appreciation of the krona can no longer be assumed to have such an appreciable downward effect on UNDEX inflation.

A Board member asked what the Riksbank stands to gain or lose by waiting. According to this member, if the economy keeps rolling the Riksbank will hardly acquire additional insights by waiting a month or so. The real repo rate (i.e. adjusted for inflation) is still low. The Riksbank has only taken back last autumn's precautionary cut in the wake of the terrorist attacks in the United States on 11 September. Besides the low real interest rate there are the stimuli from an under-valued krona and an expansionary fiscal policy. Today we have a policy that is expansionary as a whole at a time when a future increase in resource utilisation is expected from an initial level that is already high at the same time as current inflation is already high, too. The situation today differs from the upswings in the 1990s; at that time there were plenty of unutilised resources, today the margins are small.

Another Board member elaborated somewhat on the assessment that economic policy is expansionary. In this member's opinion, determining the relevant real interest rate is difficult; it is no doubt low today but perhaps not as low as the former member

considers. And while fiscal policy has clearly been very expansionary in recent years, how expansionary it will be next year is more uncertain.

A Board member referred to the path of wages in Sweden and considered it was too high in relation to what can be regarded as compatible with the inflation target.

Another member saw no reason to signal when an increase may occur. This member argued that the economic situation is uncertain; the recovery is proceeding slowly and it will be some time before demand takes off. It is above all in the ICT sector that developments are not stable and this can delay an upswing. At the same time, this member saw risks of inflation further ahead – around 2003 and 2004 – partly on account of labour shortages in Sweden. That could motivate an increase in the autumn. The dichotomy in the Swedish economy seems to be having a smoothing effect on the cyclical path. The previously strong development of activity in the services sector is now slacker at the same time as at least parts of manufacturing are recovering. All in all, this cyclical picture implies a falling rate of inflation in Sweden. This member also underscored that a steep drop for the dollar could affect other asset prices and pointed out that the stock market fall in 1987 occurred in the wake of a weaker dollar. All in all, the member found it hard to see what could give the Riksbank cause to raise the interest rate so soon as at the next meeting.

A number of Board members declared they did not share the opinion that a weakening of the dollar would be negative for the global economy. One member argued instead that a depreciation of the dollar in a controlled manner would be welcome in that it could help to reduce the imbalances in the US economy. This view was supported by another member, who took the opportunity of noting that in the event of something dramatic occurring, the Riksbank would then have to take it into account, in much the same way as in connection with the terrorist attacks in the United States last autumn.

A number of Board members expressed concern about the weak stock market, which they saw as a possible reason for being cautious about monetary policy. In one member's opinion, however, the picture of corporate profits in the United States needs to be followed closely; if it turns out to be stronger than expected, optimism may rise rapidly, given the positive economic signals we see.

A Board member found it hard to understand why the stock market was so weak relative to real developments. This member pointed out that stock exchange trends in the United States may have to do with factors that are specific for that country, for example uncertainty about certain companies' accounting principles, and perhaps do not affect Europe to the same extent.

Another Board member considered, on the other hand, that the stock market fall is an adjustment after the bubble that had been blown up on many bourses around the world in the late 1990s. As a result of the fall, the aggregate threat to the world economy has now decreased instead. The risks would have been greater if the expansionary policy had tended to accentuate the imbalances by postponing the necessary adjustment.

A Board member noted that the earlier upward phase was not used to consolidate the public finances in the euro area. Unemployment has now begun to rise and is around 8 per cent. This means that Sweden cannot count on any quick pull from Europe.

This member also commented on the arguments put forward earlier by another member. Profits in the United States have turned upwards but from a low level. What we have seen is the largest fall in profits for more than four decades. It must take many quarters before earlier levels are reached again. The fact that the slowdown was synchronous does not necessarily mean that the upswing will be, too; it may be slowed by the dollar's fall.

The other member in question rejoined that a clear upturn is visible in terms of the broader indicator of profits that covers more companies. Recently, moreover, there has been an increase in gross margins and profits are picking up from levels that, for these broader indicators, have not been unusually low. As to the ICT sector, this member counted on a quicker recovery on account of short write-off times. Concerning a synchronous upturn, finally, this member pointed out that in addition to trade links, one must look at other mechanisms such as financial links.

A number of Board members referred to the observation that as regards an interest rate increase, other central banks have chosen to wait and see.

§ 3. Monetary policy decision²

The Chairman summarised the monetary policy discussion under § 2 and noted that there were proposals for, respectively, an unchanged repo rate and a repo rate increase of 0.25 percentage points. A vote was taken and the Executive Board decided to hold the repo rate unchanged at 4.25 per cent and that the decision be announced at 9 a.m. on 6 June 2002 with the motivation and wording contained in Press Release no. 36 (Annex B to the minutes). The Board also decided that the minutes of today's meeting are to be published on Wednesday 19 June, 2002.

Deputy Governor Eva Srejber entered a reservation against the decision to keep the repo rate unchanged and stated that the repo rate should be raised 0.25 percentage points with reference to the motivation that had been submitted for her reservation against the decision under § 1.

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.