



Separate Minutes Executive Board, No. 13:2

DATE: 04-06-2003

TIME OF MEETING: 1 P.M.

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

■ PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg

Johan Germandt, Vice Chairman of the General
Council

Kerstin Alm
Malin Andersson (§ 1)
Jörgen Eklund
Kurt Gustavsson
Kerstin Hallsten
Björn Hasselgren
Per Håkansson
Hans Lindblad
Annika Svensson
Anders Vredin

§ 1. The current inflation assessment

It was noted that Kurt Gustavsson and Annika Svensson would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

Recent information

The meeting began with an account of the new information received since 26 May. GDP in the USA had increased slightly more during Q1 this year than the preliminary results had indicated, which was primarily due to a stronger development in consumption. In April consumption showed a stable development, despite the war in Iraq and both consumers and

companies were slightly more optimistic in May. A new taxation package is in principle complete in the USA. These entail lower taxes for households, firms and income from capital as well as increased transfers to the federal states. The taxation package is expected to have relatively little effect on GDP. In the euro area, unemployment continued to rise slightly in April and firms were more pessimistic than those in the USA.

Developments in the financial markets since 26 May indicate that uncertainty has declined somewhat. Stock market developments have been positive both in Sweden and abroad. This may have contributed to the depreciation of the dollar against the euro and to the krona coming to a standstill. Expectations of an interest rate cut by the ECB may also have played a role here. The Swedish krona has weakened somewhat against the dollar and strengthened slightly against the euro. However, the movements have been small and in TCW terms the krona has been below 126 over the past week. Foreign long-term interest rates rose initially as a result of positive statistics in the USA, but they later fell concurrently with increased expectations of interest rate cuts in the euro area and the USA. All of the financial market analysts questioned say they expect an interest rate cut from the Riksbank by 0.25 or 0.50 percentage points and these expectations are reflected in market prices.

In Sweden the purchasing managers index fell in May, which indicates that industrial activity has slowed down somewhat. The sub-index for order inflow from abroad fell particularly heavily. Import and producer prices declined in April. The Swedish Municipal Workers' Union and its opposite parties the Swedish Association of Local Authorities and the Swedish Federation of County Councils have signed an agreement providing wage increases on a level of 3.95 per cent for the first year and 2.45 per cent for the second year covered. This agreement concurs with the investment in improving low wages agreed by the Swedish Trade Union Confederation during the previous wage bargaining rounds and is slightly lower than was assumed in the Inflation Report. Finally, economic data from March indicates that wages in both the private and public sectors have developed in line with the assessment in the June Inflation Report.

The Inflation Report

Deputy Governor Irma Rosenberg presented a draft of Inflation Report 2003:2 (*Annex A to the minutes*). This Inflation Report reproduces the main features of the presentations and discussions of inflation at the Executive Board meetings on 22 and 28 May 2003.

The Report indicates that the picture of international economic activity has gradually deteriorated. The expected recovery has been postponed and growth forecasts have had to be gradually revised down. There are several factors behind this. For instance, the adjustment in firms' and households' balance sheets following the burst share bubble has become more protracted, which has subdued consumption and investment. In addition, geopolitical unrest, which culminated in the war in Iraq, has hampered developments.

As the armed conflict in Iraq is now over, the focus is once again on the underlying strength of the global recovery. The statistics received so far still give no clear indication of a strengthening in economic activity. The labour markets in both the USA and Europe have deteriorated more than expected, which is expected to have a subduing effect on consumption. Household incomes in the USA also appear to be increasing at a slower rate than expected and in Europe growth is being subdued by tighter fiscal policy. This indicates a lower level of international resource utilisation and weaker world market growth in

comparison with earlier forecasts. The main scenario of the Inflation Report still assumes an economic upturn in the OECD area, but compared with earlier forecasts the recovery has been postponed somewhat. A modest level of resource utilisation abroad means that international price pressure will remain relatively low during the forecast period. Oil prices are expected to fall and the krona to appreciate during the coming two years. All in all, this gives a continued weak increase in import prices.

Weaker international economic activity is expected to lead to a weaker development in Swedish exports and to postponement of the anticipated upturn in investment. The basic picture still shows an economic upturn, but at a slower rate than was previously assumed. All in all, this means that resource utilisation is expected to be lower in Sweden during the entire forecast period.

The inflation rate has been slightly lower than expected. This is mainly explained by the fact that oil prices have fallen more rapidly than was predicted in the March forecast. In April, CPI and UND1X inflation were 2.3 and 2.4 per cent, respectively. Electricity prices have fallen in line with the Riksbank's assessment, which contributes to lower inflationary pressure. The weaker development in economic activity in Sweden and abroad entails lower inflationary pressure during almost the entire forecast period. The forecasts in the main scenario of the Inflation Report indicate CPI inflation of 1.3 per cent and 1.9 per cent respectively one and two years ahead. The corresponding figures for UND1X inflation are 1.1 and 1.6 per cent respectively. UND1X inflation adjusted for the effects of energy prices is expected to be relatively stable and to be just below 2 per cent for the greater part of the forecast period.

International economic developments entail a downside risk for inflation during the forecast period. Adjustment problems in the global economy may be greater than estimated and a continued weakening of the US dollar could have a subduing effect on inflation in the euro area and Sweden. The primary risks for higher inflation still consist of electricity prices for consumers failing to decline as expected, contagion effects from high electricity prices being greater than estimated and wage results of the coming bargaining rounds being unexpectedly high. Compared with the assessment in the March Inflation Report, uncertainty over the war and its consequences for the global economy has declined. As a result of the downward revisions in global growth forecasts, the risk of even poorer development than in the main scenario should be considered smaller now than it was in March. The risks connected with domestic cost trends are also assessed to have declined somewhat, which is also indicated by recent developments in electricity prices and the lower level of resource utilisation. All in all, the probability of inflation being lower than in the main scenario one and two years ahead is assessed as greater than the probability it will be higher, while the degree of uncertainty has decreased somewhat in comparison with the previous Inflation Report.

Decision

The Executive Board decided

- to adopt the Inflation Report as presented
- to publish it on 5 June at 9.30 a.m.

This paragraph was confirmed immediately.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg began by presenting the monetary policy group's discussion of the Inflation Report¹. The Riksbank, like other analysts, has gradually revised down its growth forecasts and a further downward adjustment was made in this Inflation Report. The expected recovery is weak and there are few signs of a clear turnaround in the incoming statistics. The Riksbank's forecasts for inflation have also been revised down, which indicates that inflation will be clearly below the target level of 2 per cent one to two years ahead. This points towards lowering the repo rate, in connection with the rule of thumb applied by the Riksbank. The members of the monetary policy group discussed the inflation measure most relevant to monetary policy now. On the question of whether or not to lower the rate the conclusion is still the same, regardless of which inflation measure is taken into account, as the inflation forecasts including and excluding energy prices all give clear scope for a cut. The group was agreed that a cut in the repo rate of 0.50 percentage points was motivated, but opinions differed as to whether this should be done all at once or in two stages. The monetary policy group advocated a cut of 0.50 percentage points at the today's monetary policy meeting.

All of the members shared the monetary policy group's opinion that the repo rate should be lowered given the current inflation forecast and they were agreed on a cut of 0.50 percentage points.

One member considered the absence of signs of a turnaround in economic activity in Sweden and abroad to be worrying. This member pointed out that although there were some signs in the USA pointing in the right direction, there were more signs pointing the other way. In the euro area, particularly in Germany, prospects are even worse. In Sweden the outcome of the Municipal Workers' Union central wage agreement was better than expected from a national economy point of view, which reduces inflation risks. This member saw clear scope for more expansionary monetary policy and thus supported the proposal to lower the repo rate by 0.50 percentage points.

A second member agreed with the assessment made by the monetary policy group and by the previous member. This member considered that the Riksbank, like other analysts, has consistently underestimated the strength of the underlying factors weighing down economic development. According to this member, several factors will contribute to making growth weaker for a further period of time. Savings imbalances in the USA need to be adjusted, while there is a lack of dynamics in the European economies. The latter means that stimulation from the USA may not suffice to counteract the curbing effects in the euro area. In addition, the member felt that income trends in the USA have for a long time been most favourable for households with high incomes and low consumption tendencies, which contributes to subduing demand. During a large part of the 1990s, the stock market bubble concealed the underlying weaknesses in both the US and the European economy. This member also felt that there was a risk of an even more negative development than that explicitly discussed in the Inflation Report. Deflation, rather than inflation, could be the problem faced in Europe. The Riksbank should therefore develop its analysis and

¹ The monetary policy 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.

preparations further. All in all, the member felt that the subdued demand and weak impulses for price increases meant that there was scope to lower the repo rate by 0.50 percentage points.

One member noted that developments in Europe remained weak. However, this member also emphasised that it was possible to detect certain signals that the lowest point had been reached in the USA, for instance, in confidence among firms and consumers. If this was the case, it would take some time before the USA could give Europe a kick start. The member therefore predicted a continued weak situation - somewhat weaker than expected at the meeting in April. Prospects for Swedish industry are also gloomy, according to this member. Industrial production had earlier shown a recovery, but this appears to have come to a halt. The member also observed that an important upside risk – the Municipal Workers' Union wages – needed to be re-assessed following the outcome of the wage bargaining rounds. According to this member, the strike has to some extent failed and differentiation has become a new element in the agreement. This member observed further that the agreement gives a lower outcome in 2004 than many had expected and this should reasonably set a standard for next year's agreement. The central wage agreement also entails an opening for changes in relative wages. It is thereby possible to see the outcome of the Municipal Workers' Union strike as positive from a national economy point of view. Economic growth in Sweden is weak and redundancies in the labour market are increasing. In addition, the member pointed out that the krona appreciation entails tighter monetary policy. All in all, this motives an interest rate cut, said the member.

A fourth member agreed essentially with the previous member's analysis. This member observed that the inflation assessment was below the target level and that there was thus reason to lower the repo rate. The member also observed that the global economy in total had moved sideways recently, but agreed with the previous member that a number of positive figures had come in from the USA after the Iraq war. In addition, other parts of the world are showing relatively positive developments, such as parts of Asia, the EU candidate countries and the former Soviet Union states. However, the situation in the euro area and in particular Germany appears weak. As the euro area comprises almost half of Sweden's foreign trade, developments there are important to the Swedish economy. This member also observed, however, that there are advantages with a slow-moving recovery. The adjustment of balance sheets, which is at different stages in different parts of the world, can thus be expected to continue. The low long-term interest rates, which the major central banks appear to be helping to keep down through their comments, are also facilitating this adjustment. Even from a central bank perspective the member considered that the slow recovery was beneficial, as it leads to lower price pressure. The member considered that in this situation the central bank did not need to subdue developments by means of higher interest rates and thereby risk a slower adjustment in balance sheets. The member also observed that in the slightly longer term demographic factors gave cause for some concern with regard to labour supply. However, the member felt that in this context it should not be forgotten that new technology continues to spread throughout the world, which leads to greater productivity and thereby larger profits for firms, lower inflationary pressure and greater purchasing power. The member supported the decision to cut the rate by 0.50 percentage points and saw no reason to divide it into two stages.

A fifth member began by pointing out the importance of clarifying which measure of inflation is in focus. Recently, the Riksbank has taken into account UND1X inflation adjusted for energy prices, as these have fluctuated severely due to temporary supply shocks. The member noted that these shocks were not expected to affect inflation prospects two years ahead and interest should therefore once again focus mainly on UND1X towards the end of the forecast period. However, the member observed that the inflation assessment using both measures gave clear scope for lowering the repo rate. It was possible that one argument in favour of proceeding with caution when adjusting interest rates was that economic activity was nevertheless expected to improve. In this situation, the member considered there could be reason not to lower the rate so much, as tighter policy might be needed relatively soon. However, this is not the situation at present; economic activity is weak and there is a downside risk. In addition, there is little scope for expansionary fiscal policy. The exchange rate has also strengthened and is expected to become even stronger. Finally, the upside risk for Swedish inflation from domestic factors has declined somewhat as a result of the outcome of the wage bargaining in the municipal workers field. This gives a guideline for next year's wage bargaining rounds that is on a different level from what the Riksbank had anticipated. All in all, this member considered there was scope to lower the repo rate by 0.50 percentage points. It is not possible today to adopt a position on the future development of the repo rate and there is thus no reason to comment on this question, said the member.

Another member referred to a previous member's analysis of the collective wage agreement for the Municipal Workers' Union and felt that it was understandable if the agreement creates tension among the wage-earners covered by this agreement. It means that certain groups will have lower centrally-agreed increases than the agreement they revoked would have provided. However, this member considered that the result had been favourable from society's point of view. The Municipal Workers' Union has achieved larger wage increases for the groups with labour shortages and the agreement has a profile that is probably more acceptable to other groups in the labour market. The member also agreed with the previous member's reasoning with regard to measures of inflation. The reason for the Executive Board's recent emphasis on inflation excluding energy prices is not that energy prices lack significance when balancing monetary policy. It is due to a desire to disregard the effects of the severe fluctuations in energy prices that began with increases during the winter and that are expected to continue when prices fall again. This member also made the following clarification. Over the coming two years it will be important to monitor whether energy prices continue to fall as the Riksbank has predicted and that the secondary effects will not become greater than before. The focus on UND1X excluding energy prices does not mean that energy prices lack significance for monetary policy in the short-term perspective. Regardless of which inflation measure is used, there is a clear scope for lowering the repo rate, said the member.

The Executive Board concluded that monetary policy in general over recent years has been based on forecasts of UND1X inflation. This index was chosen because it is less sensitive than CPI to temporary effects on inflation connected to changes in indirect taxes, subsidies and interest costs for home owners. Recently, developments in energy and oil prices have also been taken into account. The price increases on these products have to all essentials been assessed to be the result of temporary supply shocks and thereby not relevant to the shaping of monetary policy. At present the Executive Board's assessment is that these

temporary factors still affect inflation one year ahead, but that the effects two years ahead have abated to a considerable degree. There is therefore no motivation to disregard changes in energy prices when assessing inflation two years ahead.

§ 3. Monetary policy decision²

The Chairman summarised the monetary policy discussion under § 2 and found there was a proposal to lower the repo rate by 0.50 percentage points.

The Executive Board decided

- to lower the repo rate by 0.50 percentage points to 3.00 per cent and that this decision would apply from Wednesday, 11 June 2003,
- to lower the lending rate by 0.50 percentage points to 3.75 per cent and to lower the deposit rate by 0.50 percentage points to 2.25 per cent with effect from 11 June 2003,
- to announce the decision at 9.30 a.m. on 5 June 2003 with the motivation and wording contained in Press Release no. 38 (*Annex B to the minutes*) and
- to publish the minutes of today's meeting on Wednesday, 18 June 2003.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

Lars Heikensten

Eva Srejber

Villy Bergström

Lars Nyberg

Irma Rosenberg

Kristina Persson

² Board members who are present and do not enter a reservation have participated in and agreed to the Board's decision.