Separate minutes of the Executive Board meeting on 15 October 2003, No. 22

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DATE: 15 October 2003

TIME: 13.00

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

Johan Gernandt, Vice Chairman of the General Council

Kerstin Alm
Claes Berg
Mårten Blix (§ 1)
Jörgen Eklund
Kerstin Hallsten
Björn Hasselgren
Jyry Hokkanen (§ 1)
Per Håkansson
Leif Jacobsson (§ 1)
Javiera Ragnartz (§ 1)
Arvid Wallgren
Ulrika Wienecke
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Arvid Wallgren and Ulrika Wienecke would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

1. Recent data regarding economic developments

The Monetary Policy Department reported new data received since the final date for inclusion in the Inflation Report, 6 October. The focus was on bilateral exchange rates, macro economic statistics as well as stock market trends and company reports for Q3 2003.

Long-term interest rates in the financial markets had risen, partly due to positive macro economic statistics (in particular figures from the US labour market) and a continued stock market rise in both the United States and Sweden. Thus far, only a small percentage of listed companies in the United States and Sweden had presented their interim reports for Q3, but a majority of those that had done so reported better results than expected. At the same time, the larger currencies had shown considerable volatility. There had been some appreciation of the dollar, partly due to the positive economic signals. However, there appeared to be a general opinion in the market that this was merely a recoil and that the weakening process would continue during the remainder of the year. The fluctuations in the value of the Swedish krona had been relatively slight. The market's expectations were that the krona would continue to strengthen, but at a slightly slower rate. All of the analysts questioned believed that the Riksbank would leave the repo rate unchanged, which was also reflected in the market prices.

Newly-received international statistics were in line with the assessments in the Inflation Report. Manufacturing output showed weak development in the three largest euro countries during August. However, in Germany there was an increase in new orders to the manufacturing industry (month-on-month, seasonally adjusted). The revised GDP figures for the euro area during Q2 were in total in line with the preliminary figures. Lower net exports and stockbuilding were counteracted by a slightly stronger domestic demand compared with earlier reports. In the United States, the deficit in the trade balance declined significantly in August, when measured in current prices. At the same time, the revised statistics showed that the deficit in July was lower than previously indicated. In Sweden, both manufacturing output and new orders to Swedish industry declined slightly (day- and seasonally-adjusted) between July and August.

CPI rose by 0.7 per cent between August and September, which gave an annual rate of 1.7 per cent. The corresponding figures for UND1X inflation were 0.8 and 2.2 per cent respectively. Both CPI and UND1X inflation were therefore 0.2 percentage points higher than the assessment in the Inflation Report. This deviation from the forecast was mainly due to higher prices for fruit and vegetables, more expensive oil products and higher clothing prices than expected.

2. Inflation Report 2003:3

Deputy Governor Irma Rosenberg presented a draft of Inflation Report 2003:3, which also comprised the Riksbank's account to the Riksdag Committee on Finance (Annex A to the minutes). This Inflation Report reproduced the main features of the presentations and discussions of inflation at the Executive Board meetings on 2 and 8 October 2003.

Decision

The Executive Board decided

- to adopt the Inflation Report as presented
- to present the report to the Riksdag Committee on Finance and

- to publish it on 16 October at 8.00 a.m.

Deputy Governors Villy Bergström and Kristina Persson entered a reservation against the decision to adopt the Inflation Report.

Villy Bergström made the following statement:

The Inflation Report somewhat underestimates the risks of a weaker real development in Sweden and a lower inflation rate than in the main scenario. Employment has been particularly weak in industry, while the stronger krona exchange rate now threatens to weaken economic activity in the basic industries and some of the engineering sector. Meanwhile, municipalities and county councils have strained finances and may be forced to dismiss staff and at the same time raise taxes. There is a risk that increased unemployment will subdue household consumption and further postpone the upturn in investment.

In my opinion, the weaker development in the labour market reduces the risk that the outcome of the wage bargaining rounds will threaten the inflation target. The weakening of the dollar against the krona subdues the impact of the rise in oil prices and in other commodity prices, while electricity prices no longer appear to be rising as much as last winter, as the flows to the reservoirs have improved. All in all, this means that I see a downside risk for inflation during the forecast period. In my opinion, therefore, the forecast for inflation should be marginally lower than in the Inflation Report, but still around the target level.

Kristina Persson made the following statement:

I agree in substance with the assessments in the Inflation Report, with the exception of the balance of risks. The picture painted in the Inflation Report of an upside risk for inflation in Sweden is not consistent with my impressions. My assessment is that the higher energy prices over the coming year will be counterbalanced by the weak labour market, while the situation will be the reverse towards the end of the forecast period. The labour market will remain weak for some time. The public sector is struggling with financing problems, and it will be some time before companies begin recruiting new staff. I therefore recommend a balanced risk spectrum with regard to economic activity and future inflation in Sweden. Together with some downside risk for international growth, this indicates a slightly negative overall risk spectrum.

This paragraph was confirmed immediately.

§ 2. Monetary policy discussion

1. Account of the monetary policy group's view of the monetary policy situation[1]

Deputy Governor Irma Rosenberg presented the monetary policy group's view of the monetary policy situation. The general opinion of the group was that the repo rate should be left unchanged. According to the group, it had been difficult to forecast economic activity in recent times and developments had been far from clear-cut. The Riksbank had

[1] The monetary policy group is made up of Riksbank staff and is headed by Deputy Governor Irma Rosenberg. 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.

stated in the June Inflation Report that economic activity appeared weaker than previously. Since the summer there had been several positive signs, but the picture was still unclear. The monetary policy group emphasised that it was not yet possible to say what the next step would be; the likelihood of an increase in the repo rate was as strong as the likelihood of a cut. The assessment made in the Inflation Report put inflation, excluding energy prices, very close to the target level two years ahead. This was reason to leave the repo rate unchanged.

2. The Executive Board's discussion

One Executive Board member felt that the Inflation Report provided a basis for a decision on both leaving the rate unchanged and cutting the rate. Although the member was somewhat critical of the risk spectrum in the Inflation Report and therefore entered a reservation against adopting the report, the member did not advocate cutting the repo rate. One argument against cutting the rate was the information communicated in speeches and public comments by several members of the Executive Board prior to the meeting. These had been of a neutral nature and market expectations were thus for an unchanged repo rate.

Another member agreed that the signals prior to the meeting had been neutral, but considered that new information had been received since then. In line with the Riksbank's ambition to apply the monetary policy rule symmetrically, the repo rate should now be cut by 0.25 percentage points, given the member's slightly lower forecast for inflation one to two years ahead. The member emphasised the importance of the Executive Board being as active to make interest rate cuts, when these were necessary, as to increase the rate. It would be better to provide extra stimulation to the upturn at this stage than to wait until later on in the economic cycle. The inflation rate remained at the same level, despite the interest rate cuts during the summer and the labour market was still weak. Economic activity was unlikely to lead to an upturn in inflation before the end of the forecast period, according to this member, who repeated that an interest rate cut should be made.

One member agreed that two decisions were possible in the present situation and claimed that the risk spectrum was rather difficult to assess. The upturn in economic activity in the United States appeared to have become more robust since the summer. This applied in particular to employment, which reduced the risk of a jobless recovery. However, there was still a risk that private consumption would be subdued before investment picked up, but this risk would decline over time. At the same time, the positive economic signals meant that the probability of a dollar fall in the near future declined. The member also emphasised that the upturn was expected to continue beyond the forecast horizon. The arguments in favour of cutting the repo rate must be compared with this long-term picture. Experiences showed that once an upturn had begun, it often accelerated more quickly than economic analysts had expected. The member therefore recommended retaining the repo rate unchanged.

Another member expressed agreement on the whole with the previous member and said that the risk spectrum was currently the decisive factor. There was a risk that the recovery in the euro area would be slower than was now being forecast due to a stronger euro, although the recent positive signals from the United States meant that this probability had declined. Instead the member saw a risk that the strength of the recovery was being underestimated, partly because international statistics, with the exception of the euro area, had on the whole been surprisingly positive. The member also pointed out that the assessment of employment growth in the United States depended on which type of measure one used for employment. Surveys at household level showed that employment had risen slightly thus far this year, while surveys of companies indicated the reverse. This was probably due to the company surveys having difficulty in capturing newly-started companies. Consequently, the difference between the two survey approaches was greatest when economic activity was in a turnaround phase. This member felt that an underestimation of employment growth could help explain why private consumption in the United States had developed as strongly as it had. The fact that employment had risen slightly according to household-based surveys also meant a decline in concern that private consumption would deteriorate in the near future.

With regard to the coming wage bargaining rounds in Sweden, the member shared the view that there was little demand pressure on labour. New data from Statistics Sweden showed, for instance, that the number of unfilled job vacancies had declined. However, the member did not share the optimistic view of wage growth expressed by two other Executive Board members and called to mind the 1995 wage bargaining rounds. Despite low demand for labour, there was a risk that wage increases could be higher than forecast in the Inflation Report. To summarise, the member considered that the repo rate should be left unchanged, as the recovery was expected to continue from a situation where some measure of unutilised resources existed, but these would gradually be put into use, which meant that inflationary pressure was moderate.

One Executive Board member, given the reasoning pursued in the Inflation Report on energy prices, questioned whether the change in energy taxes could be compared with VAT changes. Energy taxes were on an increase trend, which would gradually raise the relative price of energy. The member pointed out in this context that the Riksbank's target was expressed in CPI inflation.

Another member emphasised that one should not focus on only one inflation measure, even though the target was formulated in terms of CPI inflation. The Executive Board should focus on the inflation measure that best captured underlying, demand-driven inflation at the present time. At present, UND1X excluding energy prices was probably the most interesting inflation measure for monetary policy. The main reason for the forecast of UND1X being below target level at the end of the period was the anticipated adjustment in electricity prices following the upturn over the past year. The assessment that the upturn in electricity prices so far had been <u>mainly</u> transient and that this also applied to the coming downturn, did not rule out the possibility of additional, more structural reasons behind the rise in electricity prices. This was an element of the price trend that was worth monitoring. However, it was probable that at least part of the price fluctuations visible now was due to structural factors.

In addition, the member wished to defend the risk spectrum for wage formation and energy prices outlined in the Inflation Report. The wage increases forecast in the main scenario were low from a historical perspective. This assessment could very well prove to be somewhat too optimistic even if the labour market remained weak. With regard to energy prices, the risk did not mainly consist of continued high prices but of the price upturn spreading to other parts of the economy and affecting inflation expectations.

One member objected to the statement that the Inflation Report's assumptions of wage increases were low. This year the forecast was for 3.6 per cent, next year for 3.7 per cent and in 2005 for 3.9 per cent.

Another member pointed out that at the present time it was natural to base monetary policy on the forecast of inflation excluding energy prices, as these had fluctuated substantially in recent times and their effects could be regarded as transient. When this inflation measure was used, the inflation forecast was well in line with the target. The member's opinion was that a reasonable way of motivating an interest rate decision was to contemplate whether there was reason to reconsider the assessment made at the most recent monetary policy meeting. Events since then indicated that the repo rate should not be changed. Recent statistics were well in line with earlier assumptions. The prospects for households still looked fairly good: private consumption had been upheld and lending for housing and consumption was increasing. With regard to investment, the member said an increase could be expected when the upturn in economic activity made an impact in the form of increased production and sales. An interest rate cut at the present time would be unlikely to affect investment in the short term.

One member commented on an earlier contribution by another member on the issue of whether the Executive Board had acted symmetrically regarding forecasted deviations from the target. The member said that the Executive Board had acted symmetrically and referred to the actions in 2000, when the Riksbank did not raise the repo rate despite forecasts slightly above target level. The member also pointed out that so-called transient effects, which had often been discussed recently in Inflation Reports, should be treated symmetrically as long as they did not give rise to contagion effects. The member also pointed out that inflation had been slightly higher than the social partners had anticipated when they signed the previous wage agreements. It remained to be seen what effects this would have on the coming wage bargaining rounds, the member concluded.

One member pointed out that underlying inflation was weak and would be below target level both next year and in 2005. The slow growth rate in the euro area and the dollar depreciation would lead to low price increases on imports, while the Swedish labour market would not recover until the end of the forecast period. The upturn in economic activity appeared to have begun, but future recoils could not be ruled out. The situation was also uncertain on the financial markets. In addition, the member believed that the dollar depreciation and the krona appreciation would continue. The member's conclusion was that it would be some time before the upturn in economic activity stabilised and that the Swedish economy would have unutilised capacity throughout the forecast period. This meant there was no risk in cutting the repo rate at present.

One member emphasised that the increasing unemployment rate was not primarily due to lower employment but to the number of participants in labour market policy programmes declining. The member considered that the economy was probably not so far from full resource utilisation and that shortages could arise in parts of the labour market as early as within one year. This could in turn affect wage drift.

With regard to the monetary policy decision, the member emphasised that the situation was not clear-cut. However, the member considered the wisest choice was to leave the repo rate unchanged at present. If the expected economic upturn failed to materialise, but was postponed in the same way as it had been in the spring, there would be reason to cut the rate in future. This was one of the issues the Executive Board should consider at its coming monetary policy meeting.

§ 3. Monetary policy decision

The Chairman summarised the monetary policy discussion under § 2 and found that there were two proposals: to leave the repo rate unchanged at 2.75 per cent and to cut the rate by 0.25 percentage points.

The Executive Board decided after voting

- that the repo rate would be left unchanged at 2.75 per cent and that this decision would apply from Wednesday, 22 October 2003,
- that the lending rate would remain unchanged at 3.50 per cent and that the deposit rate would remain unchanged at 2.00 per cent with effect from Wednesday, 22 October 2003,
- to announce the decision at 8.00 a.m. on 16 October 2003 with the motivation and wording contained in Press Release no. 60 (Annex B to the minutes) and
- to publish the minutes of today's meeting on Wednesday, 29 October 2003.

Deputy Governor Kristina Persson entered a reservation against the decision to leave the repo rate unchanged. She argued that the repo rate should be cut by 0.25 percentage points, one reason being that the Swedish economy would have unutilised capacity throughout the entire forecast period. Another reason was that the dollar depreciation and krona appreciation would lead to lower increases in import prices in the near future and underlying inflation would be below the Riksbank's target both in 2004 and 2005. Although the recovery appeared to have begun, the labour market was still weak. It would take some time before companies began to recruit new staff and before economic activity stabilised. As the risk that inflation would be above target was currently considered to be very slight, the expected recovery should be given some stimulation in the form of an interest rate cut.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

Lars Heikensten	Eva Srejber	Villy Bergström
Lars Nyberg	Kristina Persson	Irma Rosenberg