



Separate Minutes Executive Board, No. 3

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Johan Gernandt, Vice Chairman of the General Council
-
Kerstin Alm
Claes Berg
Jörgen Eklund
Anders Eklöf (§1)
Kerstin Hallsten
Jyry Hokkanen
Per Håkansson
Leif Jacobsson
Hans Lindblad
Tomas Lundberg (§1)
Pernilla Meyersson
Eva Uddén Sonnegård
Staffan Viotti
Anders Vredin
Martin Ådahl

§ 1. Monetary policy discussion

It was noted that Eva Uddén Sonnegård and Martin Ådahl would prepare draft minutes of paragraphs 1-2 on the agenda for the meeting.

The discussions were based on the analyses and assessments compiled by the Monetary Policy Department. These were in turn based on the technical assumption that the Riksbank's repo rate will remain unchanged at 3.75 per cent until the end of 2004.

1. Economic developments and inflation prospects

The Executive Board concluded that economic developments continue to be marked by the great uncertainty regarding the Iraq crisis, the uncertainty regarding the strength of international economic activity and increased savings resulting from households' and companies' balance sheets adjustments after the fall in share prices. Pricing in the financial markets indicates a slightly weaker development than was anticipated in the December 2002 Inflation Report. Share prices have continued to decline and long-term interest rates have fallen in both Europe and the US, compared with December last year, mainly due to uncertainty over the effects of security policy developments on the economy. The Riksbank's lowering of the repo rate in December has contributed to the lower short-term interest rates in Sweden.

The main scenario in the December Inflation Report anticipated modest growth in global markets. It was also assumed that international export prices would show a weak development. GDP growth in the 19 OECD countries that comprise Sweden's main trading partners was expected to be 1.4 per cent in 2002, 2.2 per cent in 2003 and 2.7 per cent in 2004. The aggregate CPI inflation in these countries was calculated in the December report to be 1.4 per cent in 2002, 1.6 per cent in 2003 and 1.7 per cent in 2004.

The prospects for the euro area now appear slightly poorer than expected, while the US economy has developed in line with the previous forecast. In the euro area, increased unemployment and deteriorating consumer confidence will probably lead to a slightly more subdued consumption than was anticipated in the December report. Retail sales have been weaker than was expected in the report. At the same time, the conditions for future industrial development have deteriorated somewhat when compared with the figures for December 2002, due to the higher oil prices and continued appreciation of the euro. The ECB's lowering of the refi rate in December had an expansive effect.

In the US an expansionary economic policy and strong productivity growth are creating relatively favourable conditions for a domestically-driven recovery. However, a more tangible economic upswing may be counteracted by rising oil prices and an increase in savings as a consequence of companies and households continuing to adjust their balance sheets. American households' consumption was moderated slightly towards the end of 2002 and GDP growth for the year as a whole amounted to 2.4 per cent. The signals regarding the US manufacturing industry are mixed; industrial production fell in December, while the purchasing managers' index rose as a result of an increased order intake. The latter indicates there will be an improvement in the near future. The Executive Board came to the overall conclusion that growth in the OECD area is expected to be marginally weaker than was anticipated in December 2002.

The assessment in the December Inflation Report was that growth in the Swedish economy would be modest, amounting to 1.5 per cent in 2002, 2.1 per cent in 2003 and 2.3 per cent in 2004. This assessment was based on a relatively slow international recovery, amongst other factors. Resource utilisation in Sweden was expected to be relatively high and

productivity growth relatively strong to begin with, only to slow down somewhat towards the end of the forecast period.

The picture of a gradual improvement in economic developments in Sweden, with an initial relatively high resource utilisation, has not changed. However, there is as yet no clear proof of stronger industrial activity, although there have been some positive signals. The National Institute of Economic Research's Business Tendency Survey published in January indicated that the production volume had increased slightly more than companies had anticipated during the fourth quarter of 2002. The order intake from the domestic market appears to have increased marginally, while that from the export market declined slightly. The current assessments regarding volumes of orders and stocks of finished goods have improved somewhat, compared with the previous survey. The confidence indicator for the manufacturing industry rose slightly in January and is now largely at an historical average level. The purchasing managers' index continued to rise in January and indicates some improvement in industrial activity. However, companies are continuing to show caution in their assessments of the future and appear to be estimating only moderate increases in production volume as well as continued cutbacks in their workforces during the first quarter of this year.

The Business Tendency Survey also indicates that companies' pricing is restrained. On the export market there have been more price reductions than price increases and there is still a larger percentage of companies expecting to lower export prices than expecting to increase them. On the domestic market, there is a slight majority of companies planning price increases.

During 2002 households' real disposable incomes increased by around 5 per cent. Nevertheless, the preliminary National Accounts figures for the first three quarters of 2002 indicate a slightly weaker level of private consumption than expected. Consumption is now assessed to have increased by around 1 per cent last year. This could be a sign that households have perceived the increase in their incomes as temporary and therefore put a large part of it into savings. It could also be an effect of the reduction in households' financial wealth due to the continued fall in share prices. The household purchasing plans survey (HIP) shows that optimism regarding households' private economies has been subdued over recent months. It is probable that higher tax rates introduced by many municipalities and county councils, as well as concern over a potential war in Iraq and higher energy prices have been contributory factors here.

The National Accounts have been revised since the December Inflation Report was published. An analysis of these indicates that productivity growth has been higher, and resource utilisation slightly lower, than was estimated in December. According to the new calculation methods used in the National Accounts, however, growth was weaker during 2001 than was shown in the data published earlier. During the first three quarters of 2002, growth was 1.9 per cent compared with the equivalent period during the previous year. This outcome indicates that growth for 2002 as a whole may have been slightly higher than the 1.5 per cent anticipated in the December report. At the same time, new labour market statistics indicate that average working hours declined slightly more than expected last year. This means that labour productivity in the economy as a whole also increased more than expected in 2002. There is at present no sign that the average number of hours worked will begin to rise. At the same time, the number of overtime hours worked is continuing to

decline. This means that in 2003 the number of hours worked will probably be slightly lower and productivity growth will probably be slightly higher than was anticipated in the December Inflation Report.

The figures for labour shortage in the manufacturing industry are still at an all-time low. In service industries such as contract work and computer consultancy, the level of capacity utilisation is also relatively low. There are signs that the recruitment problems in the public sector have declined. The short-term wage statistics also indicate a slightly lower rate of wage increase than expected in the public sector, although not all of the local wage bargaining rounds in this sector are complete yet or registered in the statistics.

The Executive Board's overall assessment was that domestic demand would probably continue to rise slightly during the forecast period. Growth in the Swedish economy was expected to be slightly weaker than estimated, in conformity with the international economy.

In the most recent Inflation Report it was assessed that CPI inflation, taking into account the risk spectrum, would amount to 2.2 per cent in December 2003 and 2.1 per cent in December 2004. The corresponding forecasts for UND1X inflation were 1.9 per cent and 1.8 per cent respectively. In December 2002 the CPI inflation rate was 2.3 per cent and UND1X was 2.2 per cent, i.e. slightly above the assessment made in the Inflation Report, which was mainly due to the rise in energy prices.

Oil prices are currently approximately USD 5/barrel higher than when the previous assessment was made. The price rise is due to factors such as the increased risk of war in Iraq, strikes in Venezuela and colder weather than usual in the northern hemisphere. Stocks of oil and oil products in the US are currently at their lowest levels for several decades. OPEC has increased its production quotas to compensate for the reduced supply from Venezuela. The production increase has not yet reached the higher quota and it will also take time before the oil comes onto the market.

The water shortage in the hydro power reservoirs that followed on from the unusually dry summer and cold weather has led to soaring electricity prices in December and January. Futures prices on the electricity exchange for delivery during the first quarter of 2003 were more than double the level applying at the time of the December report. More recently, however, futures prices have returned almost to the same level that applied at the beginning of December. Information from the electricity companies indicates they are planning continued increases in their interim prices. When the water supply for hydro power is replenished and the weather becomes warmer, electricity prices are expected to decrease again.

The risk spectrum is dominated by the international security policy situation. The uncertainty over the consequences of a potential war in Iraq and over the possibilities of achieving a stabilisation in the region constitute a downside risk, which could slow down developments with regard to investment and growth in the entire OECD region. This reinforces the uncertainty in the financial markets. These problems are currently overshadowing the more ordinary inflation risks that should be taken into account when assessing inflationary pressures during the forecast period. The upside risk from increased resource utilisation and the increasing wage pressure outlined in the Inflation Report are assessed to have declined

somewhat. Uncertainty over the contagion effects and wage compensation claims that might arise from the energy price increases could comprise a further upside risk.

All in all, the Executive Board made the assessment that inflation will be in line with the Riksbank's target at the end of 2004. At present, the inflation rate is strongly affected by the rise in energy prices. This means that the inflation rate is expected to be on average above the target level during 2003 and below it in 2004.

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

2.1. The monetary policy group's view¹

Deputy Governor Irma Rosenberg presented the monetary policy group's view of future inflation and the monetary policy situation.

The monetary policy group concluded that the new information and data received since December 2002 had not, in any significant way, altered the assessment in the Inflation Report's main scenario. There are few signs that economic activity has picked up speed. Developments in the US appear to be roughly in line with the previous assessment, while the situation in the euro area is slightly poorer than anticipated. The uncertainty due to the security policy situation has increased, which obscures the normal patterns of the business cycle and thus complicates the assessment of inflation prospects. It is difficult, for instance, to assess how the behaviour of households and companies will be affected by various security policy scenarios. Several risk scenarios connected with a potential war in Iraq were discussed by the monetary policy group, as were the effects of energy price rises resulting from oil and electricity price increases. There was agreement that this price rise is a typical example of a supply shock, with temporary effects on inflation to which monetary policy does not need to react at present. However, there is a risk that the rise in energy prices could lead to contagion effects. This risk can nevertheless be regarded as limited in the prevailing situation of subdued economic activity.

There was also agreement within the group on recommending that the repo rate be left unchanged. This was because the new information received did not significantly alter the picture of economic activity in Sweden and because there was still considerable uncertainty.

2.2. The Board's discussion

The Executive Board was agreed that the effects on inflation of the energy price rises should be regarded as temporary and that monetary policy should be based on UND1X inflation at present.

It was also the opinion of all of the Board members that the repo rate should be left unchanged. There was agreement that the new information did not give cause to reappraise the monetary policy situation and that there was still great uncertainty because of the risk of a war in Iraq. As the Board members shared the basic view of the economy presented, the discussion mainly concerned the risk spectrum. One member felt, however, that given the

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.

security policy situation it could be appropriate to lower the repo rate later in the year. Another member was of the opinion that the choice was between an unchanged repo rate and a reduction in the rate.

Three members particularly wished to emphasise the downside risks for future inflation. One of these felt that, in addition to the international increase in inflation due to rising oil prices, there were also tendencies in the opposite direction, i.e. indications of possible deflation risks in Germany and the US. It is mainly prices on goods that have been weak. This member also had a slightly more pessimistic view of international economic developments than that presented. The effects of a war in Iraq could be more prolonged and less benign than anticipated. In addition, private consumption could be weaker than the monetary policy group's assessment.

A second member pointed out that the uncertainty over a war in Iraq had considerable effects on stock markets and noted that a war could, paradoxically, lead to a rise on the stock markets. This is because the uncertainty would be reduced if an actual war broke out. Real investment is also being held back by the uncertainty over a potential war and its consequences. A short-lived war could thus lead to the realisation of investments that have been postponed, which could have positive effects on demand. In the US this effect could be considerable. This can be seen as an upside risk. However, the member also emphasised the risk of rapid changes in levels of consumption and saving in Sweden in the near future. There could be a downside risk when the general public see their pensions declining in value and their financial savings being eroded. The member also called to mind the developments of the 1990s, when net savings showed a rapid turnaround from being negative to being very positive.

A third member felt that continued arms inspections in Iraq could lead to a prolongation of the uncertainty, which is worse – purely from the perspective of economic activity – than if war actually breaks out. On the other hand, the outcome of a war could be worse than anticipated. The member also pointed out that there were mixed signals from the US. The long-term US developments are dominated by a high level of productivity growth and low wage cost development. This entails low unit labour costs, which paves the way for good profit developments. In the short term, a strong depreciation of the dollar has contributed to an improvement in US competitiveness. Nevertheless, the deficit in the current account of approximately 5 per cent of GDP is expected to continue to increase. This is because the initial price effect of the weaker dollar affects the current account before volumes have had time to adapt. The budget deficit is expected to be 2-3 per cent of GDP this year - not including the costs of a war or the proposed tax reductions. The US is at the same time an example of the fact that the effect of monetary policy is in certain situations too weak to be able to break a downward trend in economic activity. Two years of interest rate cuts, from a rate of 6.50 per cent to 1.25 per cent have not yet managed to turn around the trend; monetary policy appears to primarily hasten a turnaround when it has already occurred. In addition, this member felt that the situation for Germany looks gloomy, with a low rate of growth and a high rate of unemployment, which has a negative effect on Swedish export market growth. In addition, there is a risk that disposable incomes will develop more weakly in Sweden this year, while the trend on the labour market may take a downward turn and unemployment could begin to rise. If this occurs, it will have a negative effect on private consumption.

A fourth member made a slightly more positive assessment of the economic situation. Global growth increased in 2002, despite the security policy uncertainty and a historically very large adjustment in share prices and thus also in wealth and debts. In most areas of the world the growth rate is still slightly below its potential, but is expected to rise and reach the potential level over the coming years. The process of adjustment in the financial markets has so far been orderly, although it is uncertain whether this process is now complete. An increased risk aversion has created an over-reaction with a transfer of investments from shares to bonds. Low interest rates have in turn affected property markets in several countries. Debt adjustment is at different stages in different countries. There are still savings imbalances between countries, which will probably require further adjustments in exchange rates and growth. This member shared the monetary policy group's assessment of the risk scenarios.

When it comes to Sweden, this member felt that resource utilisation was high, although not as strained as during 2000 and parts of 2001. The driving forces behind, and course of events for, the Swedish economy have not been changed by revisions in the statistics. The economic situation is balanced with a growth rate close to the potential level. If the forecasts for 2003 prove correct, this will be the third year in a row with inflation above the target level. Expectations and low figures for labour shortages indicate that inflation will be close to the target level in 2004, with import prices holding down the total inflation rate, while domestic inflation continues to rise at a steady rate.

In this context, the member brought up some issues regarding the forecast: What will happen to inflation in Sweden if import prices are no longer held down by a stronger krona? Is the high level of domestic inflation an expression of costs on markets with a shortage of competition being passed on to consumers in a situation where the demand situation enables implementation of price rises? Why are wages rising so much despite a high level of total unemployment? Is there a risk of demands for compensation in the coming wage bargaining rounds because of the fact that inflation has been above 2 per cent for almost three years? How can Swedish prices begin to approach the average price levels in the EU, through lower Swedish inflation or through a weaker krona?

One member felt that the only factors indicating a higher inflation rate – compared with the assessment in the December Inflation Report – were the price increases on oil and electricity. These are a result of temporary supply shocks. Whether the energy price rises will have an impact on inflation in the perspective of one to two years from now will depend mainly on whether they affect wage formation. We will not know this until the autumn or perhaps even later, when the wage bargaining rounds are well under way. It is only then that one can see whether compensation demands and other contagion effects are arising. At the same time, there are factors indicating a slightly lower inflation rate than anticipated in the December report. There have been no dramatic changes in Europe, but developments will probably be marginally weaker than expected. If so, Sweden will be affected. There is also a downside risk for consumption in the light of, for instance, the poorer development in incomes. The new figures in the National Accounts also indicate that resource utilisation could be slightly less strained. All in all, this indicates that inflation prospects are currently balanced. It is not impossible that new information in the coming months will indicate weaker economic activity. At the same time, the uncertainty over how energy price increases will affect inflation in a slightly longer term will remain.

§ 2. Monetary policy decision²

The Chairman summarised the monetary policy discussion in § 1 and found there was a proposal for an unchanged repo rate. The Executive Board voted unanimously to leave the repo rate unchanged at 3.75 per cent and to announce the decision on Friday, 7 February, at 9 a.m. with the motivation and wording contained in press release no. 10 (Annex to the minutes). It was also decided that the minutes of today's meeting would be published on Thursday, 20 February, 2003.

This paragraph was confirmed immediately.

Minutes taken by:

Kerstin Alm

Adjusted by:

Lars Heikensten

Eva Srejber

Villy Bergström

Lars Nyberg

Kristina Persson

Irma Rosenberg

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