No. 3

SEPARATE MINUTES of the Executive Board meeting on 26 March 2001

<u>Present</u>: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
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Sven Hulterström, Chairman of the General Council
Johan Gernandt, Vice-Chairman of the General Council
–
Kerstin Alm
Claes Berg
Jörgen Eklund
Leif Jacobson
Björn Hasselgren
Hans Lindblad
Tomas Lundberg
Pernilla Meyersson
Javiera Aguilar § 1
Robert Sparve

Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

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

The Board's discussion was initiated with accounts of the information that had been received since the previous meeting on 15 March and its significance for inflation prospects (section 1). The Inflation Report was then adopted (section 2).

1. New information about international and domestic economic developments

1.1 The international scene

After the steep fall in previous months, in February consumer confidence in the United States rose to some extent, while manufacturing output declined. Leading indicators went on falling but do not yet show clear signs of a recession being imminent. Consumer and producer prices both rose in February. The Federal Reserve reduced its instrumental rate another 0.5 percentage points. In the euro area, manufacturing output dropped sharply in January but this should be seen against the background of the strong outcome in December. Both German and Belgian business tendency data indicate that in the coming months manufacturing activity will continue to weaken. In France, household consumption in February was low, while confidence remained good. In Japan, manufacturing activity is still very weak; the central bank has lowered its instrumental rate back to zero per cent and decided to purchase government securities in order to raise the banking sector's liquidity. The policy is to be continued until deflation ends.

Although the OPEC meeting on 16 March decided to cut oil production, the price of oil fell to the lowest level since last December. Factors behind the downward pressure on the oil price include increased oil stocks in the United States and a marked expansion of oil exports from Iran.

International financial activity has continued to be highly turbulent. Since the last Board meeting, stock markets have gone on falling, except in Japan. This has been accompanied by a further appreciation of the dollar against both the yen and the euro. Credit spreads have widened again in the United States and have also increased markedly in many emerging economies, Argentina in particular.

1.2 Developments in Sweden

Employment went in rising in February, when the 12-month increase was 3.3 per cent. The labour force also grew, while the number of new job vacancies fell. Retail turnover in January was 0.8 per cent up on December, with an increase of 3.9 per cent for infrequent goods. In February, however, figures from the Research Institute of Trade show that on a 12-month basis, retail turnover fell 1.1 per cent. In the March business tendency survey from the National Institute of Economic Research, the changes from the previous survey are small. Prospects are still comparatively discouraging, particularly in manufacturing. The inflow of both export and domestic orders has declined in recent months and production has stopped rising. In construction, however, activity reportedly rose in recent months.

The stock market has fallen more than another 3 per cent since the previous Board meeting. The krona has weakened against the euro as well as the dollar and the TCW index is as weak as it was in spring 1995. All but one of 14 market players expect that at today's meeting the Executive Board will leave the repo rate unchanged.

2. Monetary policy report (Inflation Report 2001:1) to the Parliamentary Standing Committee on Finance

Deputy Governor Lars Heikensten presented a draft of the monetary policy report (Inflation Report 2001:1) to the Parliamentary Standing Committee on Finance (annex A to the minutes). The Inflation Report is based on the presentations and discussions at the Board meetings on 8 and 15 March.

The Executive Board decided to adopt the Inflation Report as presented and to have it published at 9 a.m. on 27 March.

This paragraph was confirmed immediately.

§ 2 Monetary policy discussion

The discussion of monetary policy began with an account of the Board's assessment of inflation prospects (section 1). The Board's assessment of the situation for monetary policy (section 2) was preceded by a presentation of the discussion in the monetary policy group.[1]

1 The Board's assessment of inflation prospects

In the main scenario in the Inflation Report it is judged that, given an unchanged repo rate of 4.0 per cent, the 12-month rate of UND1X inflation (CPI inflation excluding transitory effects from changes in indirect taxes, subsidies and house mortgage interest expenditure) will be 1.9 per cent both one and two years ahead. The expected rates of CPI inflation are 1.9 per cent after one year and 2.0 per cent after two years. GDP growth in the main scenario has been revised downwards since the December Report, mainly in view of a more marked international slowdown. However, a weaker exchange rate and a more subdued import trend are judged to result in a development of net exports that is approximately the same as foreseen in December. Together with falling share prices, it is foreseen that a decreased risk of capacity restrictions and a declining inflow of orders will have a negative effect on investment activity. To some extent, the weakening of international activity may also explain why households are less optimistic about the future. This reassessment of future prospects and the concern over stock market trends are expected to contribute to consumption being weaker than envisaged earlier. Growth is also held back by stock adjustments during 2001. A GDP growth rate of 2.4 per cent is foreseen in both 2001 and 2002, followed by 2.7 per cent in 2003.

The risk spectrum is also a part of the basis for monetary policy decisions. The uncertainty about international developments is great and the downside risk two years ahead is considerable. Even though international growth in the main scenario has been revised downwards, there is still considered to be a risk of the outcome being even weaker. The economic slowdown in the United States could both be deeper and have more marked effects elsewhere than the main scenario allows for. Against this there is an upside risk of domestic inflation being higher if wage increases turn out to be larger and/or productivity growth is weaker. It is also conceivable that the unexpectedly high domestic inflation is an indication of a somewhat less favourable relationship between growth and inflation. Another inflation risk is the weak exchange

[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.

rate, although it is reasonable to suppose that the risk of the exchange rate remaining weak co-varies to a high degree with the risk of weak economic activity. All in all, the balance of risks is judged to be somewhat on the downside both one and two years ahead. With the risk spectrum taken into account, it is judged that UND1X inflation will be 1.8 per cent both one and two years from now, while CPI inflation will be 1.8 per cent one year ahead and 1.9 per cent after two years.

The Board unanimously considered that the new information confirms the picture of inflation that is presented in the Inflation Report. In the opinion of one member, the slowdown's effects in Europe may be more marked and the recent statistics from the euro area point to a somewhat worse development. New statistics on Japan also suggest that the trend there may be weaker than expected.

The Board endorsed the Inflation Report. The discussion of monetary policy accordingly started from the main scenario in the Report, taking into account the risk spectrum as presented there.

Monetary policy is formed on the basis of the assessment of inflation measured by UND1X.

2 The Board's assessment of the monetary policy situation

2.1 The monetary policy group's view

Deputy Governor Lars Heikensten noted that the picture has changed appreciably since December and the downward revisions to the forecast are comparatively large. It is mainly the rapid worsening of international economic activity that dampens inflation and growth in Sweden. The international decline is countered by some domestic factors, for example a continuation of the good employment trend and a favourable development of disposable income. At the same time, household expectations point to harder times. The group agreed with the Inflation Report's picture of economic developments, that is, largely unchanged resource utilisation and weak inflationary pressure are expected to leave their mark on the Swedish economy in the forecast period.

The future development of international activity is highly uncertain. Together with a continued fall in stock markets, this means that the outcome could be considerably weaker than foreseen in the Inflation Report's main scenario. At the same time, there are still risks of future inflation being higher. Domestic inflation has been stronger than expected earlier. Wage increases to date are in line with the forecast but some major wage settlements have still to be concluded. Unduly high wage agreements in the local government sector, trade and construction could have effects elsewhere later on. There is also a risk of productivity growth slackening more than forecast.

The continued weakening of the exchange rate amounts to another risk of higher inflation. However, the recent depreciation is probably due to falling share prices and an economic slowdown; other factors are the general international unrest and earlier capital outflows in connection with pension fund investments. The current level cannot be explained in terms of Sweden's economic fundamentals; it is not even close to being reasonable. Moreover, an appreciation has been allowed for in market prices. It is therefore reasonable to count on the krona appreciating as foreseen in the main scenario but the possibility of the exchange rate remaining weak for a time cannot be ruled out.

All in all, the policy group found that the risks of inflation being somewhat lower than in the main scenario predominate. The appraisal of inflation prospects has recently changed substantially, from expectations of further interest rate hikes to a more neutral position. The outlook is also unusually uncertain and the financial situation is turbulent, not least in currency markets. Under these circumstances the group considered there are reasons for leaving the repo rate unchanged at today's meeting. But a high state of readiness should be maintained to act when the picture becomes clearer.

2.2 The Board's discussion

The members of the Executive Board all considered that in the light of the current inflation forecast, the repo rate should be left unchanged.

The Board noted first that the situation is difficult to assess, above all on account of the uncertainty about international developments. There is most cause for concern as regards the U.S. economy but the worsening of prospects for the Japanese economy since the December Report has added to the complications. A Board member pointed out that the present downward revisions are admittedly large for 2001 but that for 2002 they are only marginal because a weak international trend in that year had already been included in the December assessment.

A member considered that the slowdown in the United States is largely confined to expectations, while so far the picture of the real economy is less clear. This member wondered how long the slowdown is likely to last.

A member pointed to the possibility of the path being closer to a simple U, instead of the more protracted recovery that is depicted in the Inflation Report.

A number of Board members noted that Japan faces increasingly serious problems in the financial sector. A member stated that it is not only Japanese banks but also insurance companies that may have difficulties in meeting commitments.

The Board discussed the recent fluctuations in financial markets. A member noted that the Swedish financial markets have functioned well in spite of the turbulence. Liquidity has not deteriorated in either the stock market or the currency market. There are signs of increased risks. Some forced sales have occurred in the wake of steeply falling share prices and banks and stockbrokers have called in additional collateral.

Concerning the effects on economic activity in Sweden, a member pointed out that the looked-for slowing of demand has now come about. At the same time, this member warned that the adjustment process may be longer and the downturn deeper than is desirable in the longer run.

A member noted that inflation is admittedly forecast to be around the 2 per cent target but that the rate of domestic price increases continues to be above 2 per cent. Low import prices are expected to pull the overall price rise down. This member observed that the downward price effects from deregulating the telecom and electricity markets are passing away, which means that total demand will govern domestic price pressure to a greater extent. Although the GDP forecast is now lower than in December, the expected growth rate is close to or just above the potential level. According to this member, fiscal policy is expected to be less tight, the exchange rate represents a stimulatory effect and interest rates are low. That makes it important to be alert to future price and wage tendencies in Sweden.

A member saw a clear improvement in the construction sector, with a recovery on its way there from very low levels. The member also considered that the timing of future investment in the third generation of mobile telephony (UMTS) is cyclically appropriate.

Another member noted that it has taken ten years for construction to recover from excessively large investments and the subsequent drop in the early 1990s. This member drew parallels with a conceivable path in the United States, where unduly large investments now call for an adjustment; this correction could take time, in which case the downturn in the United States may last longer.

Objections were raised to the notion that an adjustment of over-investment in the United States would take as long as the correction of Sweden's over-investment in real estate in the 1980s. A Board member called attention to differences in investment lifetimes; the duration of real estate investment is considerably longer than that of the investments in information technology that have predominated in the United States.

The Board noted that falling share prices have reduced household wealth but that house prices are still buoyant. This was followed by a discussion of how falling share prices affect households.

A member pointed out that since the Riksbank was wary of counting on unduly large effects on wealth and consumption when share prices were rising, the same should apply when household wealth is declining, unless the effects are considered to be asymmetrical or the view of wealth effects has changed. This member noted that, on account of comparatively widespread shareholding, wealth effects in Sweden may be greater than in other European countries and closer to those in the Anglo-Saxon countries.

A member observed that labour supply is still growing; the latest employment statistics give an increase of 103,000 persons or about 76 per cent of the increase in employment. The member saw this as a sign that the labour market is functioning more efficiently than expected. The member played down the concern about wage increases and argued that when allowance is made for productivity growth, they do not threaten the inflation target. At the same time, the member did see risks from compensatory demands in the trade and local government sectors and the effects they might occasion elsewhere.

This was supported by another member, who mentioned that wage increases in the construction sector are already alarmingly high and there are grounds for fearing a further increase. So the overall picture of the wage negotiations is not as positive as it is said to be. The member thought it might be wise to defer interest rate cuts until the outcome of the wage negotiations has become clearer. Two other members were also concerned about the development of wage negotiations.

Another member considered, however, that wage drift in construction always tends to be high on account of the high mobility there (inside the sector as well as between this and other sectors) and the piece-rate system. The member did agree that at a time when the level of agreements in manufacturing is relatively restrained, high wage increases in construction could mean that the future development of wages will pose considerable problems.

A member pointed out that as demand in the exposed sector of the economy is slackening, it is conceivable that any contagious effects there from relative wage adjustments in the unexposed sector will be smaller, at least in the short run. The member added, however, that it may be worth recalling that the rate of wage increases in Sweden still exceeds the level in large parts of Europe; it may be asked whether Sweden can count on future productivity growth being stronger than in the rest of Europe, so that unit labour costs do not rise faster than in competitor countries.

The Board considered the fact that since the December Report the exchange rate has been considerably weaker than foreseen at that time. The Board saw a number of explanations for this.

In the opinion of one member, the depreciation has more to do with financial factors than with real economic variables. This member identified three factors: a flight to safer currencies in uncertain times; portfolio effects in connection with pension saving; and foreign investors' sales of IT shares on the Stockholm Exchange. This has hit Sweden's currency.

A member considered that although the krona is not the only currency that has recently depreciated quite considerably, its high volatility is a drawback. It constitutes an undesirable shock that has consequences even for the real economy. Other members agreed. This member also pointed out that the financial portfolios of Swedish households are already considerably more diversified than elsewhere in Europe and this should favour an appreciation of the krona in the longer run.

A member stated that exchange market intervention is an instrument that is available to the Riksbank for supporting the krona.

Up to the mid 1990s a depreciation of the krona was usually accompanied by a wider interest rate differential with Germany because Swedish economic policy lacked credibility. A number of members noted that at present this has not been the case; interest rates in Sweden have stayed around the levels in Germany. Neither do market or press comments express any concern about the Swedish economy; on the contrary, in several contexts recently Sweden has been held up as a good example of a stability-oriented policy combined with structural reforms.

A member was critical of the view — expressed from time to time in the public debate — that a depreciation of the krona is a good thing because it favours exports. In the member's opinion, the burden of adjusting to a general economic slowdown ought not to be shifted onto other countries. The member observed that it is not possible for all countries to let their currencies weaken simultaneously in order to counter such a slowdown. In the case of the krona, moreover, the shock-absorbing effect has not been particularly symmetrical — the exchange rate has not strengthened appreciably in periods of high activity. The member added that a weak exchange rate in the longer run eases the pressure to transform the economy and erodes purchasing power.

A member argued against the notion that a weak exchange rate shifts the burden onto other countries. It could just as well be claimed that, for example, an adjustment of wages transfers the burden to other countries. The member pointed instead to the benefit of an exchange rate adjustment occurring when the export sector is experiencing a real fall.

A member raised the question of which measure of inflation is to guide the Riksbank's policy and underscored the importance of adhering to the Board's decision at the beginning of 1999 about the clarification of monetary policy. According to the member, this meant that the Riksbank ought to start from the consumer price index (CPI) if there are no specific reasons for departing from this on a particular occasion. However, the member was not going to enter a reservation against using UND1X as a guide because at present policy is not affected by this.

Other members agreed that the Riksbank shall specify the measure that is being considered when the interest rate is set. That is the spirit of the Board's clarification. UND1X has the advantage over the CPI of not being affected by changes in interest rates, indirect taxes and subsidies. Adhering to this measure also simplifies the evaluation of monetary policy.

A member considered that the assessment of inflation in the Inflation Report's main scenario could warrant an interest rate cut. At the same time, monetary policy is not mechanical and the uncertainty in the assessment is greater than normal. The member pointed out that the Riksbank has acted symmetrically in that it has been cautious about raising as well as lowering the repo rate. Moreover, the present repo rate is low, considerably lower than in the United States and the United Kingdom, for example. Other members agreed. One member noted that activism should be symmetrical.

All the members agreed that the Riksbank shall maintain a state of readiness to act quickly should that prove necessary.

A member considered that there is a bias in favour of an interest rate reduction. Other members were not so sure about this and therefore did not want to send such a signal. Much can happen before the next meeting. The former member had not intended to imply that a future interest rate cut should be signalled but considered that the asymmetry in the risk spectrum spoke for itself. Yet another member saw the arrangement with the Inflation Report, forecasts, the risk spectrum and so on as an advantage in that market players and others who follow developments can compare their assessments with those of the Riksbank, so that normally there is no need to point explicitly to a future direction of monetary policy.

§ 3. The monetary policy decision

The Chairman summarised the monetary policy discussion under §2 and noted that an unchanged repo rate had been proposed. The Executive Board decided that the repo rate is to be held unchanged at 4.0 per cent and that this decision shall be announced at 09.00 a.m. on 27 March with the motivation and wording contained in Press Release no. 17, 2001 (Annex B to the minutes).

This paragraph was confirmed immediately.