No. 10:1

SEPARATE MINUTES of the Executive Board meeting on 23 August 2001

Present: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson

–

Claes Berg
Anders Borg
Jörgen Eklund
Mats Galvenius
Kerstin Hallsten
Björn Hasselgren
Leif Jacobsson
Ann-Kristin Johnsson
Hans Lindblad
Javiera Ragnartz (§ 1)
Robert Sparve
Anders Vredin
Martin Ådahl (§ 1)

§ 1. Monetary policy discussion

It was noted that Anders Eklöf and Pernilla Meyersson would prepare draft minutes of §§ 1 and 2 on the agenda for the meeting.

The meeting began with a discussion of the economic factors in Sweden and the rest of the world that are currently most important for inflation prospects and the formation of monetary policy (section 1). The discussion of each aspect started from analyses and assessments compiled by the Monetary Policy Department on the basis of the technical assumption that the repo rate would remain unchanged at 4.25 per cent until the end of June 2003. In conclusion, the members of the Executive Board summarised their views of inflation prospects (section 2) and presented their conclusions about the monetary policy situation (section 3).

1. Economic developments in Sweden and the rest of the world

1.1 Price tendencies in Sweden

The Board noted that in July the 12-month rate of both CPI and UND1X inflation was 2.9 per cent, which is in line with the assessment in the Inflation Report in May. For some UND1X components there were, however, certain discrepancies. Imported inflation (UNDIMPX) in June and July had been overestimated, by 0.7 and 1.4 percentage points, respectively, but this was counterbalanced by underlying domestic inflation (UNDINHX) being higher than anticipated, by 0.4 and 0.6 percentage points, respectively.

It was mainly lower prices for petrol and clothing that subdued imported inflation. The increase in domestic underlying inflation came to a large extent from rising prices for electricity and food products. During the rest of the year the increase in electricity prices will probably exceed what was assumed in the latest Inflation Report.

1.2 International economic activity and inflation

The Board noted that recent tendencies point to domestic demand in Europe and Japan being lower than had been foreseen in the Inflation Report. A worsening of economic prospects has also been noted in Southeast Asia, Latin America and Eastern Europe. Taken together, this warrants a downward revision of the outlook for global growth. A somewhat weaker global trend this year and possibly next year, too, had already been indicated at the time of the previous meeting in July and recent outcome data have accentuated this picture.

In the euro area there has been a clear shift, with a continued weakening of manufacturing activity. Manufacturing output in Germany fell 2.4 per cent from Q1 to Q2 and the picture in other euro countries is much the same. Clear signs of a slowdown are also evident in more forward-looking indicators such as business confidence and order inflows. In Finland, one of Sweden's primary trading partners, activity indicators have fallen sharply.

Unemployment's falling trend in the euro area has been broken. Together with high energy and food prices, this has tended to subdue private consumption. The British economy has also weakened.

In Japan, economic activity has continued to slacken and a broad majority of the Board members noted, for instance, that a considerably weaker inflow of manufacturing orders and a fiscal policy focused on consolidation are arguments for a considerable downward revision of this year's growth. In the coming years it is also considered that growth in Japan will be weaker than expected earlier. One Board member did, however, point out that the effects of the changes in fiscal policy are not so clear-cut because the signals indicate that there may be a shift to expenditures that have more immediate expansionary effects on the economy.

The Board noted that the U.S. economy is broadly following the path outlined in the March and May Inflation Reports, as well as in July, but that some downward revision of this and next year's growth may be called for. But there continues to be great uncertainty about how protracted and deep the slowdown will be. There are still no clear signs that a recovery has begun in manufacturing and the poorer global growth prospects are expected to hit exports. The outlook for profits is weak and it looks as though the problems with over-investment, above all in the IT sector, are even greater that feared earlier and this has contributed to a share price trend that remains subdued. Downward revisions of growth in 2000 suggest that the potential growth rate may be somewhat lower than assumed earlier. A poorer development of profits and profitability has also led to a somewhat more pessimistic view of future investment prospects.

The picture is not entirely negative, however. Household consumption has remained at a high level, supported by fiscal and monetary policy stimuli. Moreover, leading indicators point to less pessimism in the corporate sector. The construction and housing markets are still strong. Labour market developments have also been somewhat less negative than expected, with a diminishing number of applicants for unemployment benefits. Inflation continues to decrease, which can have positive effects on household real income and broaden the scope for further interest rate cuts.

In the emerging markets there are more and more signs that activity is weaker than expected. Output fell in Q2 in a number of Asian economies where growth is dominated by IT exports and manufacturing output is declining in the region as a whole. The economies in Eastern Europe also seem to have been hit in the past quarter, above all by the slowdown in the euro area. South and Latin America are affected by the protracted debt crisis in Argentina and the economic slowdown in the United States. Two members pointed out, however, that there are examples of a good recent development in emerging markets, above all in China and Russia.

All in all, it looks as though the international trend will be somewhat weaker than was foreseen at the time of the July meeting.

1.3 Financial markets

The Board noted that the two-year interest rate, which rose in connection with the Riksbank's monetary policy signalling at the end of June, has fallen back and is currently somewhat lower than when the May Inflation Report was published. The nominal long-term rates have also fallen since then and are now lower than in July. The tendencies are partly connected with a downward shift in inflation expectations and the deterioration of growth prospects internationally as well as in Sweden. The long-term interest rate differential with Germany has decreased since July and the level is now the same as in May, around 30 basis points.

Moreover, monetary policy expectations have moderated since the interest rate decision on 5 July. In SME's latest survey, market players count on an unchanged repo rate three months ahead and an increase of another 25 basis points in one year's time. The publication of the minutes of the Board's monetary policy meeting in July and the signs of an economic slowdown have tended to subdue expectations of further repo rate increases, particularly in the short run. Survey data indicate that market players expect today's meeting to result in an unchanged repo rate.

The Board noted that the July repo rate increase motivates some upward adjustment of the path of the shortest interest rates compared with the Inflation Report but did not find grounds for revising the interest rate forecast in the long term.

Since the previous appraisal of inflation, the Swedish krona has appreciated, above all against the dollar, but is broadly unchanged against the euro. The krona's TCW index continues to be weaker than foreseen in the May Inflation Report but is somewhat stronger compared with the assessment in July.

Even with the appreciation in recent weeks, the exchange rate is still appreciably weaker than in the Inflation Report's main scenario. The Board considered that fundamental factors continue to favour an appreciation during the forecast period but the path is somewhat weaker than envisaged earlier. It is foreseen that the krona's recovery will be held back by the general economic slowdown, with declining export orders on account of, for example, uncertainty about demand for telecom products, as well as by such factors as portfolio adjustments by Swedish investors. When these factors cease to act, an appreciation of the krona ought to be feasible.

1.4 Import prices

Although the oil price has fluctuated during the summer, its average level has been in line with the forecast in the Inflation Report. When growing stocks of petrol and weaker global activity had caused an unexpectedly large fall in the oil price in July, OPEC decided to cut its production quotas by 1 million barrels/day as of September. The decision has been followed by a renewed price increase and the average level up to 16 August was USD 25.4 per barrel; both this and the forward prices are in line with the forecast in the Inflation Report. Other commodity prices are, however, still weak.

Lower capacity utilisation in the United States, Japan and the euro area, as well as in a majority of the export-intensive emerging markets, has helped during the past quarter to subdue the development of international prices for manufactured exports, leading in certain cases to price cuts.

On account of the exchange rate's somewhat weaker path compared with the assumption in the Inflation Report, it is foreseen that import prices two years from now will be marginally higher than forecast in the Report. However, lower international export prices are expected to counter this. The weaker international export prices motivate some downward revision of import prices compared with the assessment in July.

1.5 Demand and supply

The Board noted that during the spring the Riksbank was more pessimistic than most other economic observers. In the Inflation Report in May it was judged that GDP growth for Sweden would be 2.2 per cent this year, 2.5 per cent in 2002 and 2.9 per cent in 2003. In July it was noted that the available statistics suggested that the slowdown this year could be even more marked than had been foreseen in the

Inflation Report. The main development since July is a further weakening of growth in the rest of the world but consumption has also been lower, which motivates a somewhat more subdued appraisal, at least in the short term.

GDP growth in 2001 Q2 from the same quarter a year earlier was 1.4 per cent according to the preliminary national accounts. This implies that in the first half of 2001 GDP rose 1.8 per cent from the first half of 2000. Exports of goods fell sharply and household consumption expenditure rose less than expected.

The weak development of foreign trade motivates a downward revision of the forecasts for both exports and imports of goods this year. The forecasts for the coming two years may also have to be adjusted downwards but the Board observed that the picture is difficult to assess. A weaker path for the exchange rate compared with the assessment in the Inflation Report should act as a stimulus to Swedish exports. In the short run, however, the Board noted that this does not offset the weakening of export markets. Manufacturing activity has continued to slacken. Both manufacturing output and the inflow of orders have decreased in recent months. The changes in the August business tendency survey from the National Institute of Economic Research are relatively small but order inflows do show some tendency to stabilise. Manufacturers' expectations are subdued and they count on the volume of production being broadly unchanged in the coming months. There also seems to have been a stabilisation of activity in construction.

Household consumption expenditure in the first half of 2001 was 1.1 per cent up on the first half of the previous year; this was less than expected for both Q1 and Q2. It is mainly infrequent purchases that are falling sharply. With a marginally smaller wage bill and somewhat higher prices, it is now probable that this year's growth of real disposable income will be lower than forecast in the May Inflation Report. Wage increases have been comparatively moderate; the 12-month rates in April and May were 2.8 and 2.7 per cent, respectively. Share prices have gone on falling, while the price rise for houses has been slackening.

1.6 Price effects of deregulations, trade liberalisation, political decisions and interest expenditure

The Board noted that the Government has proposed a property tax cut for 1 and 2-family houses that will apply retroactively and accordingly have a downward effect of about –0.2 percentage points on the CPI (but not on UND1X) this year. A property tax cut for apartment buildings has also been proposed but not until next year; it would have much the same effect on both the CPI and underlying inflation.

The CPI contribution from house mortgage interest expenditure in July was somewhat larger than expected earlier, mainly because the repo rate was increased and all the calculations start from the technical assumption of an unchanged repo rate.

1.7 Inflation expectations

Inflation expectations as measured in the survey of household purchasing plans (HIP) fell back in July to 2.2 per cent one year ahead, having moved up in June from 1.9 to 2.4 per cent. Implied inflation expectations, derived from nominal and real bond rates, have also tended to fall back since July but are still somewhat higher than at the time of the May Inflation Report.

A Board member noted that the repo rate increase in July seems to have had an effect in that inflation expectations have moved down. It was precisely as a precautionary measure to secure the formation of expectations that the interest rate had been increased.

All in all, the Board considered that the new statistics point to growth this year being somewhat weaker than foreseen both in the Inflation Report and in July. Even with the downward revision, there are still grounds for counting on a cautious recovery in the coming years. Growth will be supported by a gradual international recovery, expansionary fiscal conditions and the combination of a weak exchange rate and relatively low interest rates. The depth and duration of the international slowdown have left their marks on developments in Sweden. Growth and resource utilisation — and thereby inflationary impulses — will be weaker than envisaged in both May and July.

2. The Board’s assessment of inflation prospects

2.1 The Board’s discussion

In recent years the formation of monetary policy has been based on UND1X because the CPI has been affected by factors with an impact on inflation that is not considered to be permanent. The Board found no reason to change the formation of policy in this respect. Monetary policy is therefore based on an assessment of UND1X inflation.

The Board noted that the weaker activity in the euro area and accentuated tendencies to a recession in Japan warrant some further downward revision of global economic prospects, mainly for this year but also for 2002. A broad majority of the members also expressed some fears that the international economic slowdown may become both deeper and more protracted than seemed likely earlier. In the opinion of one member, however, the strong growth in China and India could result in a better development in Asia excluding Japan. It also looks as though domestic demand in the region is being maintained at a relatively high level. Moreover, in recent years many countries have implemented reforms to improve economic efficiency.

A number of Board members also indicated that they were still highly concerned about the U.S. economy. In particular, a number of members questioned whether, in view of the saving imbalances there and the poorer economic prospects in the rest of the world, the easing of American monetary and fiscal policies will be sufficient to maintain a high level of private consumption. One member also expressed some concern that the federal finances could deteriorate and that many observers’ opinions about of the U.S. economy’s potential growth are very optimistic.

One Board member observed that the Riksbank had noticed the slowdown in the American economy at a relatively early stage and that developments were broadly in line with the forecast. However, the strength of the links to Europe had been underestimated. This member also noted that some of the leading indicators in the United States had turned upwards some time ago, which suggests that the adjustment of stocks and production capacity in American manufacturing could be moving towards an end. The persistently weak stock market is a cause for concern; it constitutes the greatest risk and should be monitored carefully. The member also said that while a considerably poorer development in the United States naturally cannot be ruled out, there have been no signs of this to date.

Another Board member agreed and added that it would be wrong to underestimate the persistently strong consumer confidence in the United States, particularly as it is only now that the easing of economic policy is beginning to have sizeable effects.

Despite the monetary and fiscal stimuli in the past year, it seems that many American observers have become increasingly pessimistic about the future. A Board member considered that this could lead to a negative effect on consumer confidence. This member also noted that the picture in Japan looks considerably worse and it will be a long time before effects of structural reforms materialise.

A Board member outlined two conceivable scenarios for the U.S. economy. One involves a slow and gradual adjustment of the saving imbalances as household saving rises, with the result that the global economy has to manage without the United States as a driving force for several years. In the other scenario a more abrupt adjustment results from a rapid depreciation of the dollar when investors are no longer prepared to finance the U.S. current-account deficit and accordingly choose to avoid American assets. The member considered that the risk of the latter occurring has grown in that more mobile portfolio investments have become more prominent in the recent years' capital inflows to the United States. All in all, the member perceived a risk of international activity being considerably weaker than had been envisaged at the time of the July meeting.

Another Board member, whose appraisal of the U.S. economy was also somewhat more negative, pointed out that the euro area probably could not act in place of the United States as the driving force behind the global economy. One reason was that there was no major possibility of stimulating activity via a political coordination of fiscal policies in the euro area.

The Board unanimously agreed that even domestic demand in Sweden had weakened to some extent during the summer and that there were grounds for a downward revision of this year's forecast growth.

A Board member pointed out that the slowdown had come mainly from infrequent purchases. The fall-off in money supply growth towards the end of last year had indicated that a downturn was on the way. One explanation could be a weaker development of asset prices. Against this background, a recent increase in money supply growth and a persistently rapid expansion of credit could point to some recovery of private consumption this autumn.

A number of Board members saw some risk of investment remaining subdued for a longer period, particularly in view of the surplus capacity that seems to exist in the telecom sector, which is important for the Swedish economy. One of these members compared the situation with the drop in residential investment in the early 1990s, which had acted as a damper on the economy for a long time.

Another member saw a parallel between developments in the United States and Sweden, with notably weak manufacturing activity in both countries and a development of private consumption that still looks comparatively stable. In this member's view, favourable disposable income and a fairly good development of employment are currently having a stabilising effect.

Two Board members pointed to other reasons for not being unduly pessimistic about the economic prospects. One of them observed that in Sweden, too, the direction of certain leading indicators had become somewhat less negative and the weak exchange rate ought to be of some benefit to exports. The other judged that the monetary conditions, in Sweden as well as internationally, favour a future economic recovery. Moreover, the tendency in growth of the money supply and a more expansionary fiscal policy point to a recovery of domestic demand. Moreover, even with the downward revisions, growth is in line with the potential rate and conditions are not bleak in every sector.

A Board member noted that the picture of economic activity and inflation is now less complex than at the time of the July meeting, when there had been a rapid weakening of the exchange rate, rising inflation (admittedly judged to be transient) and some, though not a dramatic, increase in inflation expectations. Since then there has been some worsening of international economic prospects, a fall-off in domestic demand and inflation in line with the forecast path. The member also pointed to some stabilisation of the exchange rate — at least the marked, uncontrollable fall has ceased — and a fall in international export prices that has subdued import prices and counters the pass-through from the weak exchange rate. Moreover, inflation expectations are now more clearly in line with the target.

Another Board member pointed out that the weak exchange rate does not yet appear to have had appreciable inflationary effects. But although the export price fall and lower capacity utilisation are counter-forces here, there is still a high degree of uncertainty about the weak krona's pass-through to prices.

Besides the exchange rate, two Board members noted that electricity prices are an uncertain factor in the assessment of inflation. Electricity prices are currently expected to contribute a considerable part of the forecast increase in inflation one year ahead. It follows that a price fall for electricity would have substantial consequences for inflation prospects. One of these members feared, however, that in view of the relatively limited competition in the electricity market, prices there could remain high for a longer period.

In conclusion, the Board judged that resource utilisation is still relatively high but that in the coming years there will be somewhat more unutilised resources than assumed earlier. If it were to remain weak for a longer period, the persistently weak exchange rate could constitute a threat to price stability. At the same time, a somewhat lower future economic trend, in Sweden as well as internationally, and a slower increase in international export prices, are factors that tend to dampen inflation. All in all, the Board considered that when allowance is made for the various perceived risks, the path of inflation in the coming two years is approximately in line with the target.

3. The Board’s assessment of the monetary policy situation

The Board’s discussion of the monetary policy situation was preceded by an account of a corresponding discussion in the Bank's monetary policy group.[1]

3.1 The monetary policy group’s appraisal

While the changes in the economic picture since July should not be exaggerated, the recent statistics do point to a somewhat weaker international trend in the coming one to two years. The implications of this for the Swedish economy are not entirely clear but demand is now judged to be somewhat lower, above all this year and presumably also during 2002. Resource utilisation is still high but in view of recent developments, in the coming years the unutilised resources are expected to be somewhat larger than envisaged earlier. This in turn implies that inflation may be somewhat lower. The measurements of expected future inflation support this view. After tending to move upwards in the latter part of the spring, inflation expectations are now once more in line with the target.

The depreciation of the krona has been checked, though the exchange rate is still weak. A weaker appreciation of the krona is a reasonable assumption. At the same, lower international prices and lower resource utilisation reduce the risk of higher imported inflation.

All in all, the policy group considered that the repo rate should be kept unchanged. That is also what market players expect. Whether the interest rate will need to be lowered or raised in the future is an open question.

3.2 The Board’s discussion

The Board members unanimously considered that the repo rate should be left unchanged at today’s meeting. Two members did judge that the balance of risks in the inflation assessment is somewhat on the downside but found an unchanged repo rate acceptable. In their opinion, a repo rate cut at today’s meeting did seem logical but might introduce an undesirable erratic element to monetary policy. An interest rate cut, perhaps of even 50 basis points, might be called for in the future. One of them

[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.

said that neither could an increase be ruled out if there were to be a clear economic recovery internationally and in Sweden.

Another Board member considered that the lower resource utilisation could have motivated a cut at today's meeting but this is counterbalanced by the risk of a persistently weak exchange rate. So all in all, the risks are balanced and this member advocated an unchanged repo rate. The member underscored the importance of good readiness to adjust the interest rate both upwards and downwards. Somewhat lower inflation expectations suggest that the interest rate increase in July was justified; the increase was a small price to pay for securing long-term price stability.

According to another member, the persistently weak exchange rate could be a reason for tightening the monetary stance but as the recent general weakening of economic activity acts in the opposite direction, the repo rate should be left unchanged. But high domestic inflation still indicates that the relationship between growth and inflation is not as favourable as one could have thought. Considering that the monetary conditions can be said to be expansionary and both the money supply and credit are growing strongly, at present there are no firm grounds for expecting inflation to be below the target two years ahead.

Another Board member pointed to three changes since the July meeting. One is that the concern about the rapid increase in inflation in the spring has eased now that the surprising rate of price increases has slackened and the path of inflation is more in line with the target. Another is that inflation expectations have returned to the target. Thirdly, the dramatic weakening of the exchange rate has been checked, although the krona is still weak. In the light of all this, together with some slowing of both international economic activity and domestic demand and the prospects of lower inflationary pressure from abroad, inflation seems to be less obviously a problem — inflation in line with the target is the probable outcome. All in all, the member considered that this motivated an unchanged repo rate.

§ 2 The monetary policy decision

The Chairman summarised the monetary policy discussion under § 1 and found there was a proposal to leave the repo rate unchanged.

The Executive Board decided to keep the repo rate unchanged at 4.25 per cent and the lending and deposit rates unchanged at 5.0 and 3.5 per cent, respectively. The decision applies from Wednesday 29 August 2001 and is to be announced at 9.00 a.m. on 24 August 2001 with the motivation and wording contained in Press Release no. 50 2001.

This paragraph was immediately confirmed.