

SEPARATE MINUTES of the Executive Board meeting on 17 September 2001

Present: Urban Bäckström, Chairman

Lars Heikensten

Eva Srejber

Villy Bergström

Lars Nyberg

Kristina Persson

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Johan Gernandt, Vice Chairman of the General Council

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Kerstin Alm

Claes Berg

Anders Borg

Jörgen Eklund

Mats Galvenius

Björn Hasselgren

Leif Jacobsson

Hans Lindblad

Tomas Lundberg

Javiera Ragnartz

Robert Sparve

**§ 1. Monetary policy discussion**

It was noted that Claes Berg and Hans Lindblad would prepare draft minutes of §§ 1 and 2 on the agenda for the meeting.

It was also noted that the meeting had been convened by the Chairman after a discussion between members of the Board. The background was the tragic events last week in the United States and today's interest rate cuts by the US Federal Reserve and the European Central Bank.

The meeting began with a discussion of the economic picture abroad. The prospects for growth and inflation in Sweden were then discussed on the basis of the technical assumption that the Riksbank's repo rate is held unchanged at 4.25 per cent; the discussion started from analyses and assessments compiled by the Monetary Policy Department. In conclusion, the members of the Executive Board summarised their views of inflation prospects and presented their conclusions about the monetary policy situation (section 2).

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

## 1.1 Economic activity and inflation in the rest of the world

The Board noted that since the May Inflation Report, the economic slowdown in the major OECD countries has become more pronounced. In Europe, Japan and many emerging markets, the impact of the US downturn has been greater than expected. This has also been reflected in financial market price-setting and contributed to falling share prices and interest rates. At the monetary policy meetings in July as well as August the Board had judged that the slowdown in the rest of the world would be somewhat more pronounced than had been assumed in May.

Before the terrorist attacks in the United States on 11 September, new statistics on real economic activity had indicated that the global economic decline could reach a low in the closing months of 2001. In the United States, the inflow of manufacturing orders showed some improvement, accompanied by continued stock reductions and a stabilisation of confidence indicators. But the picture was not clear-cut. A more protracted decline was indicated by, for example, a further fall in consumer confidence since August and an unexpectedly sharp increase in applications for unemployment benefits. As a result of the terrorist attacks in the United States, the uncertainty about the timing of a recovery has become even greater. Private consumption is of decisive importance for growth in the American economy. There is a risk of activity being subdued as a result of declining consumer confidence in connection with rising unemployment and a weak stock market trend. The events on 11 September have accentuated this risk. Private saving, which is still low, may rise more quickly than expected earlier. Investment activity may also be hit by decreased confidence in the future, lower share prices and rising risk premiums. In addition, there are negative effects for certain sectors of the world economy, such as insurance, aviation, tourism, etc.

These effects are countered by today's cut of 0.5 percentage points in the Federal Reserve's instrumental rate, to 3.0 per cent. That has been followed by equally large cuts by the European Central Bank and the central banks of Canada and Switzerland. Moreover, the reconstruction of infrastructure will increase US demand for goods and services. Increased public spending on defence and security, for instance, should also help to stabilise economic activity.

All in all, the Board considered that the uncertainty stemming from the terrorist attacks is liable to act as a further damper on demand in the rest of the world, mainly through effects on business and household confidence in the future. Somewhat lower growth in the OECD area is probable and thereby somewhat lower world market growth and a somewhat weaker trend for international export prices. The Board also perceived an increased risk of a considerably poorer development of the US economy, mainly as a result of a marked slackening of private consumption.

## 1.1 Price tendencies in Sweden

The Board noted that in August the 12-month rate of both CPI and UNDIIX inflation was 3.1 per cent, which is 0.4 percentage points above the assessment in the May

Inflation Report. However, the outcomes are broadly in line with the Board's predictions in August. The deviation from the forecast in the Inflation Report came in the first place from a higher rate of domestic price increases that was only partly countered by imported inflation being lower than expected.

Underlying domestic inflation (UNDINHX) in August was 4.5 per cent, which is 0.9 percentage points above the forecast in the May Inflation Report. The outcome exceeded expectations, mainly due to rising prices for electricity and food, for example.

## 1.2 Financial markets

The Board noted that since the monetary policy meeting on 23 August, short-term interest rates have fallen in Sweden as well as in the United States and Europe. The attacks in the United States were followed by a further fall in the short market rates. Long-term interest rates have been broadly unchanged in Sweden and the rest of Europe, accompanied by some fall in the United States.

The events in the United States led to increased expectations of monetary easing. Today's cut of 50 basis points in the Federal Reserve's instrumental rate is in line with market expectations. Although some observers had also counted on an interest rate cut in the euro area, the ECB's announcement was still a surprise. Further interest rate cuts in Europe as well as the United States have been incorporated in market prices. Monetary policy expectations have also changed in Sweden; market prices imply expectations of an interest rate cut three months ahead but not of the same magnitude as in the United States and the euro area. But market prices in Sweden do not indicate an imminent interest rate reduction.

The Board discussed the weakening of the Swedish krona against both the euro and the US dollar since the previous monetary policy meeting on 24 August. The weakening is probably due above all to growing concern about economic activity abroad and in Sweden and the continued stock market fall. The increased unrest in the global financial markets, not least after the terrorist attack, has probably also tended to weaken the krona and some other smaller currencies; there has been a flight to larger and more liquid currencies and to currencies that have coped well in earlier periods of unrest.

Economic fundamentals still speak in favour of a future appreciation of the krona. In view of the recent unrest, however, it is now reasonable to count on the appreciation occurring later than the Board had foreseen in August. Financial unrest in connection with the events in the United States can have a negative impact on the Swedish krona, above all in the short run. That at least is what the historical pattern shows.

Finally, the Board noted that in the past week the financial markets have functioned well under the prevailing circumstances. European stock markets have recovered a part of the initial fall in connection with the terrorist attacks. Currency and the money markets have both been relatively calm during the day, although the opening of the American bourses was preceded by some unrest. The first trading day for US stock markets after the terrorist attacks seems to have been relatively calm and the

downward shift has been smaller than certain observers had feared. It was emphasised, however, that it is too early to draw clear conclusions from this, even about the near future.

#### 1.4 Demand and supply in Sweden

The Board noted that new statistics largely confirm the picture in August of a slowdown in the Swedish economy. The inflow of export orders dropped 8.6 per cent from Q1 to Q2 and the domestic order inflow declined 0.6 per cent. This was accompanied by a 2.3 per cent fall in seasonally-adjusted manufacturing output. The balance of trade (defined as nominal exports of goods less nominal imports) showed a surplus of just under SEK 7 billion in July, which was below market expectations. Even though the exchange rate has been weaker than expected, the damper on international demand, partly as a consequence of the events in the United States, is judged to result in lower export growth than foreseen in August.

Furthermore, Statistics Sweden's survey of household purchasing plans shows that households count on just a marginal worsening of their own economy in the coming year. On the other hand, the proportion of households expecting increased unemployment in the coming year has risen markedly. Moreover, households' expectations of the national economy have worsened appreciably. Calendar-corrected and seasonally-adjusted figures from Statistics Sweden show an 0.8 per cent increase in retail turnover from June to July but growth measured as a three-month moving average is still slowing.

The path of employment to date in 2001 is in line with the assessment in the May Inflation Report. At the same time, the number of persons affected by discharge notices rose in August; more than half of the notices came from manufacturing.

The Board observed that the new statistics pertaining to private consumption are largely in line with the assessment in August. A factor that could lead to a weaker development of consumption is the possibility of declining household confidence on account of the global fall-off in demand after the terrorist attacks in the United States and decreased wealth as a result of the continued fall in share prices.

All in all, the Board judged that, compared with the August assessment, GDP growth will presumably be somewhat weaker this year and next. Moreover, there is an increased risk of growth being appreciably poorer if confidence falters, above all in the United States.

#### 1.5 Price effects of deregulations, trade liberalisation, political decisions and interest expenditure in Sweden

The Board noted that increased subscription charges announced by Telia from 1 October will have upward effects of about 0.15 percentage points on the CPI and UNDIX and about 0.25 percentage points on UNDINH as of October. Moreover, the decision to cut property tax on apartment buildings retroactively as of this year

means that the measure has been brought forward in relation to what was known in August; the Board judged that as the rent negotiations for 2001 have already been completed, this will not affect rents before 2002. Other tax adjustments that have been announced, with effects on the CPI from the turn of this year, are increased taxes on energy and carbon dioxide and lower VAT on books. The net effect of these changes on the CPI is judged to be just under 0.1 percentage point.

## 1.6 Inflation expectations in Sweden

The Board noted that, according to the survey of purchasing plans (HIP), from July to August households' expectations of inflation fell 0.3 percentage points to 1.8 per cent.

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

The Board's assessment of the monetary policy situation was preceded by an account of a corresponding discussion in the Bank's monetary policy group.<sup>1</sup>

### 2.1 The monetary policy group's appraisal

The Board's discussion began with an account by First Deputy Governor Lars Heikensten of the policy group's view of inflation prospects and monetary policy.

At an extraordinary meeting on 13 September the policy group had discussed economic developments in the light of the events in the United States and the consequences of any interest rate cuts in other countries.

Prior to the tragic events in the United States there had been no strong grounds for changing the economic appraisal in August. There was possibly some reason to count on somewhat weaker activity but at the same time, domestic price pressure was somewhat higher than expected. After the terror attacks, the situation was now even more difficult to assess. But it is reasonable to assume that what has happened in the United States has heightened the risk of the slowdown in the global economy being deeper and possibly also more protracted. This in turn means that the risk of inflation one to two years ahead being below the Riksbank's target is greater than before.

The course of events will depend in large measure on how economic policy is conducted. Central banks have a considerable responsibility here.

Against this background the policy group found it reasonable to lower the repo rate 0.5 percentage points, though there were differences of opinion in the group. This matches the reductions the aforementioned central banks have made. The current risk spectrum suggests that this is a natural step.

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<sup>1</sup> 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.

## 2.2 The Board's discussion

In recent years the formation of monetary policy has been based on UNDEX 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 UNDEX inflation.

The Board shared the policy group's opinion that the repo rate ought to be lowered and that this could be done immediately. A Board member stated that joining the wave of interest cuts abroad was a natural and self-evident measure in the situation that had arisen. As to the size of the adjustment, the Board agreed with the policy group; there were no grounds for deviating from the changes that, for example, the Federal Reserve and the ECB had made earlier today.

A Board member underscored the importance of the Riksbank adhering to the usual process and acting in a predictable way. A decision today to lower the interest rate will surprise the market but this, the member said, must be weighed against the value of being able to act promptly under exceptional and special circumstances. That was the case today.

Two Board members reported the contacts that there have been with other central banks by telephone and at meetings in the G10, the EFC and the ECB. There have also been a number of bilateral contacts with the ECB and the Federal Reserve. The talks have been about the consequences of what has happened for the world economy and the financial markets. A formal coordination between the Riksbank and other central banks has not been discussed.

A Board member noted that the terrorist deeds in the United States will probably subdue economic activity there in the short run. Developments in the somewhat longer term will depend to a large extent on the construction of economic policy.

Two members noted that even before the terrorist attacks, economic prospects abroad were marginally worse than at the time of the August meeting. They considered that the events in the United States and the expected aftermath have above all created more uncertainty and less confidence in the future. This is liable to dampen the consumption and investment propensities of American firms and households, chiefly in the short run. In the opinion of another member, it is not certain that the events in the United States would tend to dampen activity further ahead; a decline will be countered by such factors as greater patriotism, additional construction activity and increased public expenditure. Moreover, the impact on the price of oil is uncertain in that OPEC has made certain undertakings to keep the price in the lower part of the interval that had been presented earlier.

Another member noted that economic policy in Sweden is expansionary at the same time as the exchange rate continues to be weak. The uncertainty generated by the events in the United States is liable to lead to a further weakening of the Swedish krona, with the attendant risk of higher inflation. However, the effects on future

confidence and hence on expected demand following from the terror attacks predominates. Accordingly the member found it reasonable to lower the interest rate.

Three other members agreed and observed that a marked interest rate cut is an insurance against a poorer development in the future. One of them pointed out that earlier increases had been motivated by a need to insure against higher inflation expectations, while it is now a question of insuring against a loss of confidence, weaker activity and the attendant risk of inflation being below the targeted rate. Another member pointed out that while the payment system and financial markets have admittedly functioned relatively well, trade has been limited and mainly focused on closing positions in view of the great uncertainty. The stability of the overnight market and currency trading had benefited from the injection of US dollars. There is a risk of the uncertainty and diminished confidence lasting for a good while yet. In such a situation it is up to central banks to provide reassurance and financial stability. That makes it important to act in accordance with other central banks. It is too early for pronouncements about real economic developments one to two years ahead, though it does seem likely that GDP growth in the second half of this year will be lower than would otherwise have been the case. It is important to bear in mind that Swedish economic policy is already very expansionary, with a low interest rate, a weak exchange rate and an expansionary fiscal policy. Against this background it is natural that the measures are withdrawn when confidence and expectations have stabilised.

A Board member objected that the financial markets in general had coped well, that price formation continues to function and that liquidity has been satisfactory under the circumstances. Central banks had contributed some liquidity to the short-term market. There had been no concern that a large number of market players would have difficulties in meeting their commitments, as had been the case during the crises with Russia's suspension of payments and LTCM in 1998. An interest rate cut, particularly in Sweden, should therefore be tied to a need to stimulate demand rather than to safeguarding the financial system's stability.

A majority of the Board members considered that today's decision is not to be taken as a signal about the future path of the interest rate; this will be determined by the ongoing course of events and their impact on inflation prospects in Sweden. At the same time, a Board member pointed out that in certain respects the problem of inflation in Sweden differs from that in the rest of the world, particularly in the United States and the United Kingdom. Inflation in Sweden, primarily its domestic component, has increased and there is uncertainty about the extent to which this upward shift consists of transient price increases that monetary policy ought to disregard. Moreover, the Swedish krona is very weak, though to date the effects of this on inflation have been limited. Moreover, two members pointed out that the risk of the krona remaining weak still applied. Two members noted that against this background it is not surprising that in the United States and the euro area, expectations of interest rate cuts are clearer than in Sweden.

## § 2 Monetary policy decision

The Chairman summarised the monetary policy discussion under § 1 and found there was a proposal to lower the repo rate 0.5 percentage points.

The Executive Board decided to lower the repo rate 0.5 percentage points, from 4.25 to 3.75 per cent, accompanied by cuts in the lending and deposit rates from 5.0 to 4.5 per cent and from 3.5 to 3.0 per cent, respectively. The decision applies from Wednesday 19 September 2001 and is to be announced on 17 September 2001 with the motivation and wording contained in Press Release no. 57 2001.

This paragraph was immediately confirmed.