No. 17

SEPARATE MINUTES of the Executive Board meeting on 15 October 2001

Present: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
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Sven Hulterström, Chairman of the General Council
Johan Gernandt, Vice Chairman of the General Council § 1
–
Kerstin Alm
Claes Berg
Anders Borg
Jörgen Eklund
Björn Hasselgren
Leif Jacobsson
Hans Lindblad
Christina Lindenius
Tomas Lundberg
Javiera Ragnartz
Robert Sparve

§ 1. The current inflation assessment

It was noted that Anders Borg and Jörgen Eklund 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 10 October (section 1). The Inflation Report was then adopted (section 2).

1. New information about economic developments internationally and in Sweden

1.1 The international scene

The Board noted that the new statistics on the American economy since the cut-off date for the Inflation Report (15 October) point to a slowdown that matches the assessment in the Report. The twelve-month change in retail turnover dropped from 3.3 per cent in August to 0.1 per cent in September. As an indication of consumption in October, however, consumer confidence as measured by the University of Michigan rose to 83.4 from 81.8 in September.

The signals about Europe in the statistics published in the past week have been mixed. Unemployment in Germany rose marginally from August to September. Euro area GDP growth in Q2 from 2000 Q2 was 1.7 per cent, the same as the earlier preliminary figure; some downward revision of household consumption is offset by marginally stronger investment growth. Preliminary statistics on industrial output in August show some recovery of activity in Germany and Spain but a continued weakening in Italy.

The increased aversion to financial market risk that followed the terrorist attacks in the United States has abated in the last few days. Long-term interest rates have fallen marginally in general. Moreover, the interest spread for bonds with some element of credit risk, such as housing bonds, and currency swaps has narrowed. Stock markets in the United States as well as the euro area have recovered the greater part of the fall in the wake of the terrorist attacks. This tendency has also left its mark on currency markets. The dollar has recovered against the euro, the yen and the Swiss franc. The krona's TCW index has also become somewhat stronger recently. Pricing in the fixed-income market indicates that today's meeting is not expected to result in a repo rate adjustment.

1.2 Developments in Sweden

The consumer price index rose 0.8 per cent from August to September and 3.2 per cent from September last year. Underlying inflation, measured by UND1X, rose somewhat more: 1.1 per cent from August to September and 3.4 per cent in annual terms. Underlying domestic inflation in September was 0.2 per cent higher than in August and 4.6 per cent up on September last year.

The price changes in September are in line with the Riksbank's forecasts in the Inflation Report. The import price increase was somewhat greater than normal.

House prices fell 4 per cent from August to September according to Statistics Sweden's index. However, the price level for all houses sold in 2001 Q3 rose 7 per cent from the same quarter last year. The Q3 number of houses sold was somewhat higher this year than last but the total for the first three quarters is 3 per cent down.

2. Monetary policy report (Inflation Report 2001:3) to the Riksdag's Finance Committee

Deputy Governor Lars Heikensten presented a draft of the monetary policy report (Inflation Report 2001:3) to the Riksdag's Finance Committee (annex A to the minutes). The Inflation Report is based on the presentations and discussions at the Board meetings on 5 and 10 October.

The Executive Board decided to adopt the Inflation Report as presented and to have it published at 9 a.m. on 16 October.

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

The uncertainty about future inflation is greater than at the time of the May Inflation Report. This has to do with the combination of developments in the United States and a synchronous economic slowdown in the major economies. The ongoing adjustment of investment and saving in the United States in connection with less optimistic expectations of future profits and wages makes the situation difficult to assess. The uncertainty has been heightened by the terrorist attacks and security policy developments. It is also difficult to gauge how demand and prices will be affected by the fiscal and monetary policy realignment that had already begun in the United States and many other industrialised countries, including Sweden, before the terrorist attacks. In addition, the outlook for inflation in Sweden seems more uncertain after the surprisingly high inflation outcomes as well as because the krona has now been weak for a longer period.

In the Inflation Report's main scenario, based on an unchanged repo rate of 3.75 per cent, UND1X inflation one year ahead is 1.7 per cent and after two years 2.0 per cent, while the rates of CPI inflation are 1.5 and 2.1 per cent, respectively.

On a number of occasions since the May Report the Riksbank has stated that the risk of growth being weaker has grown. Economic prospects in Japan and the euro area worsened during the summer and even before the terrorist attacks the Riksbank had noted clear signs that the slowdown in the United States could become deeper. The Board observed that compared with the May Report, the downward revision of growth, in Sweden as well as the rest of the world, is marked but that the picture is now much the same as at the time of the monetary policy meeting in September.

The primary factor behind the slowdown is the synchronous slackening of activity in the industrialised countries. The slowdown began in the American information and communication technology sector (ICT) and spread from there via poorer profit expectations as well as lower investment and falling share prices. This has been accompanied by a worsening of prospects in Japan, the euro area and a number of other countries. In the longer run, reconstruction work in the United States and a

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[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.

more expansionary economic policy in most countries are expected to contribute to a recovery in global economic activity. All in all, growth in the OECD area is calculated to be 1.0 per cent this year, 1.5 per cent in 2002 and 2.6 per cent in 2003.

In the main scenario the economic policy realignment to a more expansionary stance in many countries leads to a successive recovery that leaves its mark on the Swedish economy. Moreover, the repo rate is 0.25 percentage points lower than at the time of the previous forecast. The development of market interest rates and inflation expectations has also contributed to somewhat lower real interest rates. The exchange rate's impact on demand is likewise more expansionary than was assumed in the earlier forecast. Furthermore, it seems that fiscal policy will be somewhat more expansionary than assumed earlier, though this is mainly a consequence, not of new decisions as of revisions to the basis for the calculations.

More subdued prospects for household consumption as well as gross fixed investment mean that compared with the assessment in the May Report, domestic demand is likely to be weaker during 2001 in particular but also in the coming two years. The unexpectedly slack export growth, despite the weak exchange rate, largely has to do with Swedish export's product mix and market conditions for certain key industries. Together with favourable relative prices, the prospect of a gradual improvement in export market growth in the forecast period points to stronger export growth in the coming years. Compared with the earlier forecast, the contribution to growth from net exports in the years ahead is now expected to be somewhat larger.

All in all, this year's GDP growth in the main scenario is judged to be 1.3 per cent or almost 1 percentage point less than forecast in May. Growth in 2002 and 2003 is expected to be 2.2 and 2.8 per cent, respectively, which in both years is marginally lower than in the previous forecast.

Resource utilisation is lower throughout the forecast period than foreseen in May and the rate of wage increases has therefore been revised downwards. But as productivity growth is also judged to be lower, the picture of unit labour costs is only marginally different from the earlier assessment.

Inflation is expected to be higher than assumed earlier in the short run. In the course of next spring domestic inflation should fall back again as the effects of the large price increases for food, electricity and telecom, for example, disappear and resource utilisation becomes somewhat lower. In the latter part of the forecast period inflation then moves up again as economic activity picks up and resource utilisation tends to rise. The weak exchange rate's impact on import prices is countered by a more subdued increase in international prices for manufactured exports and lower prices for raw materials, including oil. The overall assessment is that the rates of CPI and UND1X inflation will be 1.5 and 1.7 per cent, respectively, in September 2002 and 2.1 and 2.0 per cent in September 2003.

As at the time of the May Report, the spectrum of risks for inflation is considered to be balanced. The downside risk associated with a weaker international trend is offset by the risks of a weaker exchange rate and a less favourable relationship between growth and inflation. With the risk spectrum taken into account, the rates of UND1X inflation one and two years ahead are judged to be 1.7 and 2.0 per cent, respectively.

The Board unanimously considered that new information broadly confirms the picture of inflation's path that is presented in the Inflation Report. The monetary policy discussion could accordingly start from the Report's main scenario, taking the risk spectrum into account, as outlined in the Report.

2 The Board's assessment of the monetary policy situation

2.1 The monetary policy group's view

First Deputy Governor Lars Heikensten noted that as the monetary policy group's picture of inflation prospects had not differed appreciably from the assessment in the Inflation Report, the discussion had started from the latter.

The Report picks out a weaker tendency in the rest of the world as a downside risk for price developments. The policy group discussed whether there could also be a specifically Swedish downside risk that mainly has to do with consumption. If employment were to be weaker than expected and uncertainty about the future lasts for a longer period, the recovery in consumption of durable goods, for example, might be delayed. Certain tendencies in this direction may be discernible in the incoming statistics.

The policy group also noted that the terrorist attacks in the United States could be seen as a negative supply shock. And in view of the increased inflation, it is conceivable that the U.S. economy's sustainable growth rate has been overestimated. But it does not necessarily follow that such a reassessment would have appreciable consequences for inflation prospects in Sweden. Expectations of lower potential growth in the United States would contribute to decreased demand and probably also to a weakening of the dollar and that would tend to hold back inflation in Europe.

One line of monetary policy reasoning in this situation is to start from the Report's forecast that inflation one year ahead will be below 2 per cent and then in line with the target after two years. This is accompanied by an appreciable risk of economic activity continuing to weaken. In such a situation there may be arguments for using the scope for action to stabilise growth. That would favour a repo rate cut at present, with a high state of readiness to raise the rate again later on. Such an active monetary policy is gainsaid, however, by the weak exchange rate — not least together with the high rate of price increases at present — being liable to influence inflation expectations.

The policy group judged that, even with the risk spectrum taken into account, the prospects for inflation two years ahead are in line with the targeted rate. Against this background, the policy group had seen no strong reasons for altering the repo rate at today's meeting. Moreover, this opinion tallied with market assessments.

2.2 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 unanimously shared the policy group's opinion that in the light of the current inflation forecast, the repo rate ought to be left unchanged.

The discussion began with the observation that the outlook in the forecast period is hard to assess. Determining when a cyclical turning point will occur is always difficult and this problem is compounded by the uncertain situation in the United States and the question of how the low household saving and current-account deficits may be corrected. On top of this, the terrorist attacks on 11 September and developments in the field of security policy have added to the uncertainty and made it even harder to interpret the cyclical situation.

A Board member stated that the Riksbank's assessment rests on uncertain foundations and is liable to be upset by a number of factors; new attacks, for example, could dampen activity still more and postpone a recovery.

Another member agreed about the difficulty in determining the future course of events but considered that the risk spectrum together with the uncertainty render the basis for a decision comparatively uncomplicated.

A third member pointed out that provided there are no further attacks, the economic picture may suddenly appear more favourable, with a quicker recovery. Confidence among households and firms seems to have picked up well since the attacks, a tendency that is mirrored in stock markets.

A fourth member noted that while weaker demand in Sweden is, of course, fully conceivable if economic activity abroad were to take a turn for the worse or if household and business confidence were to remain weak, it is also the case that the effects of the expansionary fiscal and monetary policies would be considerable if confidence in the future were to recover somewhat faster than expected.

Another member, on the other hand, perceived a risk of growth being worse, particularly next year, than the Riksbank counted on. It was currently hard to believe in a quick recovery of household and business confidence.

Yet another member noted the existence of a number of stimulatory forces at work in the Swedish economy. Even from a historical perspective, the krona's weakening must be deemed considerable; similar depreciations in the past acted as an appreciable stimulus to production for export. Moreover, real interest rates are low; a repo rate of 3.75 per cent and expectations of inflation around 2 to 2.5 per cent one year from now imply low real short-term rates. Fiscal policy is another expansionary force. Inflation expectations in a wider sense have also moved upwards; this, too, is a future force in that the current development of prices and expectations tends to affect future price developments. All this makes the situation unusually uncertain.

This member also noted that on top of the normal cyclical pattern there is the problem of saving imbalances. It could be the case that the terrorist attacks have triggered a larger adjustment of household and corporate expectations about future incomes and profits. In such a situation it is reasonable to count on economic activity being considerably weaker. It follows that the interest rate may currently be too high or too low. Faced with these two extremes, the risk scenarios are central.

The Board noted that economic policy in the United States is very expansionary at present. A member argued that the large stock-market fall is a restraining factor; a stock-market recovery would eliminate this effect, in which case the expansionary economic policy could have a major impact on demand in the United States, with consequences for global economic activity. According to this member, there therefore needs to be a readiness to act quickly to prevent an upturn from becoming unduly strong.

Other members agreed on the importance of readiness in the event of a rapid upturn in the United States. A member mentioned that many institutional investors' portfolios contain a comparatively large proportion of liquid assets; when cyclical activity does turn upwards, this could lead to a not inconsiderable strengthening of both stock markets and the Swedish krona.

A member did not share the policy group's opinion that another downside risk may reside in the outlook for employment. The substantial structural changes in manufacturing in recent years speak against any sizeable need to cut work forces. Moreover, in that it ought to lead to improvements in profit margins as well as volume growth, the weak exchange rate reduces the risk of redundancies in export production. Neither did this member consider there would be further cuts in public sector employment. The combination of a relatively buoyant labour market, the wage settlements, increased transfers and tax cuts accordingly points to a strong development of household disposable income. Another member supported this view.

Another member did, however, agree with the policy group's assessment that employment could be weaker and is accordingly a downside risk for domestic demand and cyclical activity.

Another member again considered that the risk of an excessively strong upswing in the future should not prevent economic policy decision-makers in both the United States and Europe from taking measures to ensure a recovery. The major threat to global economic stability lies at present in the downside risks. The future problems that could attend an unduly stimulatory policy will have to be handled later on. A readiness to act is therefore needed but the time for action lies further ahead.

The same member also expressed concern about the valuation of the krona and wondered when it could become more equitable. The causes of the recent depreciation could lie to some extent in the krona's difficulty in holding its own in a stock-market downturn and portfolio adjustments, for example in the wake of new investment rules for the national pension funds. At a deeper level the valuation may have to do with other explanations of a more structural nature: for example market memories of Sweden's history of devaluations, difficulties in attracting capital to Sweden, the krona's comparative insignificance and the fact that Sweden is not participating fully in EMU. Even when the economic situation has improved and portfolio adjustments have been completed, these causes will still apply. At the same time, there is so much psychology in market flows that once they have turned, the krona may appreciate strongly.

The member went on to underscore that monetary policy is not in a position to manage structural problems and the Riksbank faces a dilemma in that the undervalued exchange rate represents a risk for inflation at a time when demand is unduly weak. When resource utilisation is declining the Riksbank ought to be cautious about adjusting the interest rate upwards and wait for clear signs of rising inflation expectations and a more general price rise.

Two members rejoined that there is a danger in deferring monetary policy action until such time as the currency depreciation has led to a general price rise and affected inflation expectations. Once a higher level of inflation expectations has been established, a longer period of weak demand and less-than-potential growth may be needed to bring the rate of price increases back to the Riksbank's inflation target.

Another member considered that a number of colleagues have gone too far in their interpretation of how interest rates and the exchange rate have developed. It is actually only eighteen months since the krona was being traded with the euro at levels that were considerably stronger than at present and well on a par with what could conceivably be motivated by long-term fundamentals.

The Board was unanimously concerned about the increase in inflation. One member was troubled by the high domestic inflation and saw a problem in the tendency for the media and people in general to focus so much on current inflation rather than on the prospects for future inflation.

Another member agreed that inflation being currently above the target gives cause for concern and considered that the increased rate is partly attributable to transient factors but also to resource utilisation being somewhat higher than had been believed earlier, so that the economy has been running above its potential rate. This member also saw the exchange rate as a contributory factor and cited fruit, vegetables and clothing as examples of items that have been affected. Regardless of the underlying factors, the price increases are a sign of high demand. They may also signal insufficient competition because otherwise the increased costs could not have been passed on to consumers.

The same member underscored the importance of not allowing inflation expectations in a wide sense to take off. That could lead to effects on wage formation, for example, as well as on other aspects that have not yet been affected. The cyclical slowdown is tending to cool activity but it may be asked whether this will suffice. If the main scenario materialises, the economy will return to something approaching full capacity utilisation comparatively soon. In view of the risks surrounding the main assessment, however, demand could be weaker than forecast. But neither can a quicker restoration of confidence be ruled out.

The member went on to note that for some months inflation has been higher than expected but stressed the importance of looking ahead to a future slackening of price increases that expectations are concentrating on. Judging from inflation expectations in general, a slowing of price increases does seem probable. Lower demand as well as purely statistical effects are grounds for lower inflation next year but it is troublesome that the expectations contained in the exchange rate, long-term interest rates and the development of unit labour costs do not signal a quick fall-off in inflation. The combination of lower inflation and high resource utilisation does not invariably point to a permanently lower trade-off between growth and inflation because pricing behaviour implicitly includes an expectation that the central bank will act to secure price stability.

The same member considered that in the absence of any significant new information, it is too early to adjust the interest rate and reminded the Board that the confidence-enhancing cut of 0.5 percentage points on 17 September had been ample.

Another Board member observed that shocks which affect inflation sometimes occur without requiring a monetary policy reaction. This was one of the grounds for the Riksbank's decision to define the inflation target as the mid-point in a broad tolerance interval. A shift in inflation outside the tolerance interval does not necessarily have dramatic implications. Last spring's temporary increase in inflation will be present in the price statistics for a year, that is, until next spring.

A Board member pointed out that while the current situation can certainly be analysed in terms of potential growth proving to be lower than expected on account of an unfavourable supply shock, the attendant risks should not be exaggerated. In the 1970s economic policy decision-makers misjudged the current situation and chose to counter negative supply shocks by stimulating demand, which then resulted in imbalances. Now that there is an awareness of the problem, there should be less risk of similar mistakes today.

§ 3 Monetary policy decision

The Chairman summarised the monetary policy discussion under § 2 and found there was a proposal to leave the repo rate as well as the deposit and lending rates unchanged. The Executive Board decided to leave the instrumental rates unchanged and to announce the decision at 9.00 a.m. on 16 October 2001 with the motivation and wording contained in Press Release no. 66 2001 (annex B to the minutes).

This paragraph was immediately confirmed.