No. 22:2

SEPARATE MINUTES of the Executive Board meeting on 4 December 2001

<u>Present</u>: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
–
Sven Hulterström, Chairman of the General Council
–
Kerstin Alm
Claes Berg
Anders Borg
Jörgen Eklund
Björn Hasselgren
Hans Lindblad
Christina Lindenius (§ 1)
Tomas Lundberg
Pernilla Meyersson
Javiera Ragnartz (§ 1)
Robert Sparve

§ 1. The current inflation assessment

It was noted that Anders Borg 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 29 November (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 statistics on economic developments in the rest of the world that have become available since the Board meeting on 29 November are in line with the picture in the Inflation Report. Due to the development of stocks and exports, the downward revision of Q3 GDP growth in the United States is somewhat greater than expected. There are, however, certain indications that Q4 household consumption will be somewhat above the forecast; retail turnover, for example, has been strong recently, largely but not solely on account of increased car sales. Neither do the statistics on Europe prompt a revision of the forecast.

Financial markets continue to undergo a normalisation after the events on 11 September. Recent developments, for instance the renewed unrest in Argentina and an American energy company's bankruptcy petition, have not affected credit spreads (the interest rate difference between treasury bonds and other fixed-income assets). This can be taken to indicate that financial market players see a limited risk of contagious effects in the rest of the financial system. Stock markets have also continued to normalise after the terrorist attacks. The euro has recently become marginally stronger, while the yen has weakened. The Swedish krona has been unchanged against the dollar and the euro.

Pricing in the fixed-income market as well as survey data indicate that most agents do not count on the Riksbank adjusting the repo rate at today's meeting.

1.2 Developments in Sweden

Neither do the statistics published recently on economic developments in Sweden deviate appreciably from the picture in the Inflation Report.

Households' expectations of inflation twelve months ahead, as measured in Statistics Sweden's survey of purchasing plans, have fallen from 2.3 per cent in October to about 2.0 per cent in November.

Industrial confidence in the future, as measured by the purchasing managers index, has stabilised; the total index rose from 44.1 in October to 45.6 in November. Despite this improvement, the survey shows that industrial activity is still very weak, as was already evident from earlier statistics on industrial output and orders.

The picture of household consumption is not uniform. Retail turnover in October was lower than a year earlier, according to the Wholesale & Retail Research Institute; the fall was most marked for infrequent purchases. Households' purchasing plans, on the other hand, showed signs of stabilising in November and there was some improvement in their expectations of both their own and the national economy; the appraisal of labour market prospects, however, continued to move in a somewhat more pessimistic direction.

Wage developments in September were in line with the Riksbank's expectations. In the first eight months of 2001, wages in the total economy rose an average of 3.6 per cent.

2. Inflation Report 2001:4 adopted

Deputy Governor Lars Heikensten presented a draft of Inflation Report 2001:4 (annex A to the minutes). The Inflation Report is based on the presentations and discussions at the Board meetings on 22 and 29 November.

The Executive Board decided to adopt the Inflation Report as presented and to have it published at 9 a.m. on 5 December.

Reservation

Deputy Governor Christina Persson entered a reservation against the decision to adopt the Inflation Report and made the following statement:

The international economic trend will remain weak during 2002, which should lead to export and import prices being somewhat lower than outlined in the Inflation Report. Moreover, Swedish exports up to the end of next year will probably be more subdued than forecast in the Report. A number of indicators show that demand in Sweden is growing more slowly than potential production capacity, so that resources are now being rapidly released. The poorer labour market prospects dampen the rate of wage increases and reduce the risk of inflation.

Unutilised resources may continue to exist throughout the forecast period even in the Report's main scenario. The price rise during the spring for certain goods and services has been described by the Riksbank as transitory and nothing has happened to alter that assessment. To the extent that the price increases in the spring stemmed from the high capacity utilisation in 1999 and 2000, it is reasonable to suppose that resource utilisation's rapid fall at present will have a corresponding downward effect on prices. The high inflation expectations that have been reported in certain surveys recently should not be over-interpreted. It seems that to a considerable extent, measurements of this type mirror current rather than future inflation.

Although these assessments differ only marginally from the analysis in the Inflation Report, I have chosen to enter a reservation because the deviations play a part in my position on monetary policy. In the current economic situation, however, even the inflation forecast in the Report could serve as a ground for lowering the repo rate.

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

[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.

The Board noted first that inflation is currently just under three per cent. As the effects of last spring's price increases for certain goods and services fade away, accompanied by a damping of import prices, in the course of 2002 inflation will again be more in line with the Riksbank's target. With weaker demand and more unutilised resources, domestic inflation will also remain subdued towards the end of the forecast period. During 2003, however, rising commodity prices lead to a renewed increase in import prices. The spectrum of risks is judged to be balanced. The overall assessment is that in December 2002 both CPI and UND1X inflation will be 2.0 per cent, followed by rates of 2.1 and 1.9 per cent, respectively, in December 2003.

The international economic slowdown has become increasingly synchronous. Since the October Inflation Report there has been some downward revision of growth prospects in the rest of the world. Recent statistics largely confirm the picture, though it is difficult to tell to what extent this is due to transitory effects of the terrorist attacks in the United States. However, the major realignment of economic policy, above all in the United States but also in other industrialised countries, together with the completion of stock adjustments and gradually rising demand, does speak in favour of a recovery in the forecast period.

In the euro area, unlike the United States, the exchange rate helps to counter effects of the economic slowdown. Monetary policy's impact on demand is likewise expansionary in Europe, while fiscal policy has not been changed in a stimulatory direction to the same extent as in the United States. All in all, GDP growth in the OECD area is judged to be 1.0 per cent this year, 0.8 per cent in 2002 and 2.8 per cent in 2003.

The Board noted that a somewhat weaker level of international economic activity and lower commodity prices contribute to a more subdued development of international export prices. The Swedish krona is still weak but its path has been stronger than was foreseen in the October Inflation Report, partly as a result of less international uncertainty. Fundamental factors, such as the current-account surplus and relative growth, point to a continued appreciation of the krona in the forecast period. However, imported inflation will be somewhat higher towards the end of the forecast period, mainly due to gradually rising oil prices.

In Sweden, an initial phase of somewhat weaker growth is followed by a recovery. An important factor here is the expansionary economic policy. Tax cuts and increased transfers lead to a strong development of household disposable income. A stabilisation of household wealth is also foreseen. Moreover, the impact of real interest rates on domestic demand is expansionary. On top of this, a persistently weak exchange rate contributes to a recovery of exports in the forecast period. All in all, economic policy appears to be expansionary both in relation to earlier periods in Sweden and compared with other countries. In the main scenario, GDP growth has been revised downwards to 1.2 per cent this year, 1.8 per cent in 2002 and 2.4 per cent in 2003.

Notwithstanding the economic slowdown, employment has been rising strongly this year. The weaker growth is assumed to affect employment next year and lead to somewhat higher total unemployment. Lower aggregate demand entails a downward revision of resource utilisation. As economic growth is judged to be below the increase in potential output this year and in most of 2002, capacity utilisation falls. Towards the end of the forecast period the unutilised resources diminish again and the economy moves towards full capacity utilisation.

Wage increases have been revised marginally downwards compared with the forecast in the October Report. The extent to which the rate is compatible with stable, low inflation depends in part on productivity. This year's weak productivity growth is considered to be temporary and a successive return towards the trend is foreseen. Unit labour costs are judged to rise 3.3 per cent this year and 1.8 per cent in both 2002 and 2003.

With the lower resource utilisation both this year and next, inflation generated in Sweden is expected to be more subdued than was foreseen in the October Report. Together with the path for imported inflation, this means that in the main scenario CPI inflation one year ahead is judged to be 2.0 per cent and after two years 2.1 per cent, while the corresponding forecast for UND1X inflation is 2.0 and 1.9 per cent, respectively.

The uncertainty in the risk spectrum has decreased since the October Report but is still considered to be greater than normal. There is a risk of lower inflation than in the main scenario on account of a weaker economic development in the rest of the world as well as in Sweden. The adjustment of saving and investment in the United States could be more protracted. Swedish exports may also recover more slowly and the labour market be more unfavourable. Then there is an upside risk in the picture of inflation in Sweden. Inflation this year has been unexpectedly high and that has raised the question of, for example, the relationship between the rate of price increases and resource utilisation in a wide sense. There are also risks connected with the exchange rate and inflation expectations, risks that would be accentuated if the high rate of price increases became entrenched. As before, the spectrum of risks is considered to be balanced. With the risk spectrum taken into account, inflation two years ahead is judged to be in line with the target.

2 The Board's assessment of the monetary policy situation

2.1 The monetary policy group's view

First Deputy Governor Lars Heikensten presented the monetary policy group's discussion concerning the Inflation Report. The members of the group were broadly agreed about the assessment. Some arguments were, however, put forward for the possibility of lower inflation. With as good an economic development as in the main scenario, the krona may be stronger than envisaged there. And once the recovery is under way around mid 2002, productivity growth could no doubt be better, not just in line with the trend in recent years. Arguments for the opposite case — higher inflation — included the dynamic aspect. Inflation is now clearly above the targeted rate initially and it may be asked how quickly it will fall back to or below 2 per cent and whether this will actually occur before activity picks up again. In other words, will those who are expected to implement smaller price increases next year do so in practice if they perceive clear signs of stronger activity?

Monetary policy has been formulated in recent years on the basis of UND1X because the CPI has been affected by factors whose impact on inflation is not judged to be permanent. The policy group had found no reason to propose a change in this respect. It had noted that on this occasion the assumed development of oil prices has a clear effect on inflation's forecast path. In practice it is not possible to determine whether the price of oil is being driven by supply or demand factors, which makes it reasonable at present to use UND1X as the basis for monetary policy.

The group had then discussed monetary policy. An unchanged repo rate was indicated by the fact that in the time perspective that is most relevant for monetary policy, inflation is calculated to be approximately two per cent. This view is particularly valid because although uncertainty has diminished, it is still relatively high. But a repo rate cut could also be motivated. Resource utilisation is now falling and it is conceivable that unutilised resources will be available throughout the forecast period. In this situation, the risks of weaker economic activity and thereby of lower growth and employment, for example, could weigh more heavily when the decision is made. However, a majority of the policy group's members had recommended an unchanged repo rate.

An important aspect in this context is the high inflation initially, about three per cent. The substantial downward adjustment of the rate of price increases the main scenario presupposes has only just begun. Another assumption is that the krona continues to appreciate. In addition, there is some anxiety about future inflation. Judging from financial market prices and survey data, various economic agents seem on the whole to count on inflation being in line with the target. But certain measurements show an upward shift in expected inflation and there are also statements to that effect from labour market organisations. In the light of an economic policy that is expansionary, both historically and compared with other countries, these factors now speak in favour of leaving the repo rate unchanged.

The policy group also saw no grounds at present for any signals about future monetary policy. There was a general awareness that in February, information could already be available that might lead to a repo rate decision that differs from today's. New information about inflation in Sweden being in line with the assessment, for instance, could reduce the uncertainty about the path of domestic inflation and lessen the risk of inflation expectations creeping upwards. In the same way, future decisions could be affected by new information about economic activity.

2.2 The Board's discussion

The Board members, with one exception, shared the policy group's opinion that the repo rate ought to be left unchanged. These members also considered that monetary policy's future direction could be left open. The Board unanimously shared the policy's group's view that monetary policy should be based on an assessment of UND1X inflation.

The high inflation initially and some upward tendency in inflation expectations, coupled with a persistently weak exchange rate and an expansionary economic policy, were seen as arguments for an unchanged repo rate. It was considered that the future direction could be left entirely open.

One Board member stated that both an unchanged and a lower repo rate were conceivable. The arguments for a reduction included the labour market situation, with rising unemployment and decreased labour shortages. Against this there are the high inflation initially, rising inflation expectations that are difficult to interpret correctly, an expansionary economic policy and a weak exchange rate. If consumer prices in the coming months were to confirm the picture of inflation moving back towards the target, the uncertainty would be reduced and a downward adjustment of the interest rate would then seem more reasonable. Both monetary and fiscal policy are currently expansionary and the effects of this are difficult to gauge for certain. Moreover, the krona remains very weak. The low real interest rates are mirrored, for example, in the development of house prices and household borrowing. A further reason for deferring an interest rate cut, according to this member, was the indications that the Swedish economy is now approaching the cyclical low; stock adjustments, for example, seem to be coming to an end in a number of industries.

Another member expressed concern about the persistently high inflation and the Swedish economy being in a situation with strained resources at the beginning of the year after a considerable period of growth above the potential level. That inflation rises in such a situation is not surprising. Inflation normally moves up late in the business cycle. This was compounded by a number of special factors such as mad cow disease and rising electricity prices. Growth has slackened during the year and oil prices have fallen. According to this member, Sweden differs from many other countries is that the lower demand has not resulted in inflation falling back as decidedly. On the contrary, price increases a little on the high side seem to have spread to additional items. Underlying inflation is around three per cent and domestic inflation has been stubbornly high. The member saw a number of factors that might explain this. It could be a matter of transitory factors generating contagious effects. Firms in sectors where competition is weak take the opportunity to raise prices. The higher price increases in Sweden could also be an effect of the weak exchange rate or of firms aiming to maintain profit margins at a time when productivity growth is slackening. Another explanation could be that resources are perhaps more strained than the preliminary statistics suggest. If demand is weak, the resistance to price increases ought to be stronger. Neither does the growth of credit and the money supply indicate that economic activity is particularly low. The member also expressed concern about rising inflation expectations.

The member went on to caution against an over-interpretation of the weak Q3 statistics. The effects of the expansionary economic policy have not yet shown up. The member also recalled that the interest rate was recently lowered one half of a percentage point and the main effect of this will not appear until late next year and some way into 2003, when growth may have turned upwards.

A Board member recommended lowering the repo rate 25 basis points and referred both to a forecast of inflation being marginally lower than outlined in the main scenario and to unutilised resources becoming more plentiful and continuing to be available throughout the forecast period. The member pointed out that the slowdown in the Swedish labour market has only just begun. Employment has weakened markedly in the past three months. The number of redundancy notices in November is the highest since 1993 and a further increase is foreseen in the coming months. Resources are now becoming inactive at a rapid pace and the poorer labour market situation acts as a damper on the rate of wage increases and eases upward price pressure. It is virtually only the chemicals industry (pharmaceuticals) and retail trade that are making a positive contribution to employment. The positive trend in construction has now turned downwards, too; the business tendency survey from the National Institute of Economic Research shows that 40 per cent of firms expect activity to decline in the coming year.

This member pointed in particular to the weak international picture. The Riksbank has underestimated the effects of the simultaneous slowdown in the European Union, the United States and Japan. New statistics, not least from the large European countries, suggest that the decline in Europe will be deeper than foreseen earlier. Moreover, fiscal policy is not particularly stimulatory compared with the United States, neither is it likely to become so because many countries still have large budget deficits. The weaker tendency in Europe may delay the upturn in Sweden. In the United States there is still a risk of activity being even weaker than envisaged in the Inflation Report. It is conceivable that, in the light of the weak labour market, consumers choose to adjust the large saving imbalances more quickly, which could postpone the upswing to late in 2002.

This member went on to observe that in the Inflation Reports, this year's high inflation has been described as transitory and nothing has happened to alter that assessment. Neither should the upward shift in inflation expectations be interpreted as a forecast of future inflation because, as also pointed out in the Inflation Report, it is primarily a reflection of high current inflation. The member considered that it was now that a somewhat more expansionary monetary policy would be most beneficial as a stimulus to economic activity and employment.

Another Board member agreed that prospects in Europe, Germany in particular, are troublesome. As regards the United States, however, there were now a number of positive aspects that pointed to the slowdown being mild and there were actually some faint signs of a recovery. Activity in the construction and services sectors still seems to be relatively good. The strong productivity also favours good growth in the future. But there are major risks in connection with the labour market. If unemployment rises even more and influences consumption, the consequences could be considerable. This member also noted that in view of the official announcement that the recession began last March, American monetary policy has been proactive. The average duration of recessions in America is about 11 months, so if the upturn does not occur until Q3 next year, the current slowdown will have been the longest in the post-war era. On the other hand, there are indications that slowdowns occasioned by over-investment tend to be both longer and deeper than normal. This member felt, however, that there has been a change of mood, an impression that is supported by rising prices for some commodities, some recovery from the stock-market low and an upward tendency in interest rates. Together with the major fiscal and monetary stimuli, this gives grounds for optimism. As regards Japan, the member noted that prospects are becoming worse and worse, though in the rest of Asia it does look as though a low is approaching. World market growth below three per cent implies a weak external pull.

For Sweden, this member judged that the slowdown could turn out to be mild and its harmful consequences relatively slight. The labour market seems to be holding up unexpectedly well. Unemployment is admittedly judged to become historically high but not in relation to the early 1990s. The wage trend is good and disposable income is developing strongly, which points to a favourable path for consumption. The member agreed that construction activity seems to be weakening but saw this as a healthy easing off in a sector where there have been certain signs of overheating. The member also pointed to the expansionary economic policy and the investments in infrastructure and the third generation of mobile telephony, which are now coming at an appropriate time.

This member went on to note that an average annual growth rate of 1.8 per cent in 2001–03 is not so bad historically. It should be possible for the Board to wait a couple of months until the next monetary policy meeting in order to evaluate whether the economy is on the right path. At the same time, the member underscored the existence of risks. If consumption in the United States were to go on weakening and this affects Swedish exports, the Riksbank may need to adjust the interest rate. But inflation in Sweden is still on the high side.

Another Board member considered that during the winter and spring there must be a readiness to adjust the interest rate upwards or downwards, depending on how the economy develops. It is still far too early to arrive at a well-founded opinion about this. Even if economic activity does strengthen as expected, the Riksbank may have cause to revise other components of the assessment, for example the inflation propensity or the exchange rate. This member also called for a cautious interpretation of the size of the output gap — this is very much a matter of uncertain estimations. The overall assessment points to unutilised resources being available throughout the forecast period. The member went on to underscore that inflation has moved up more than expected and is above the target; this probably has to do with transitory factors but we do not know for certain. A weighty reason for deferring interest rate adjustments is economic policy's expansionary direction both historically and compared with most other countries: it takes time for effects of the policy to materialise.

Yet another Board member observed that as inflation is forecast to be in line with the target, in this respect there are no grounds for adjusting the interest rate. On the other hand, economic prospects and the downside risks could lead to the conclusion that the repo rate should be lowered. So what are the arguments for not reducing the interest rate today? The first is the high inflation, which is a problem. Leading trade union representatives are signalling concern over inflation being higher than they had counted on. There are grounds for being cautious and waiting to see that inflation really does fall back. Another argument is the persistently weak exchange rate, which constitutes a risk for inflation. A further argument for waiting is the expansionary economic policy, with low interest rates and fiscal stimuli that generate a substantial increase in disposable income. The member agreed that a neutral position ought to be signalled.

A Board member pointed out that for the credibility of the inflation target it is important that the Riksbank acts symmetrically and noted that the Bank has been criticised earlier for a “bias” in monetary policy. This should be avoided and we should make a point of that in the Board’s decision. Other Board members commented on this. One of them agreed about the importance of the Riksbank acting symmetrically in relation to the targeted rate and considered that this was the case. When supply shocks and other transitory effects had led to a period of inflation below the target, the Riksbank had refrained from lowering the interest rate. The high inflation earlier this year could have motivated more marked interest rate increases during the summer had the Riksbank not considered that the price rise was partly due to identifiable supply shocks. Another member rejoined that the criticism about the Riksbank acting asymmetrically had been wrong. In this member’s opinion, establishing a credible inflation target in the 1990s represented a major socio-economic victory.

§ 3 Monetary policy decision

The Chairman summarised the monetary policy discussion under § 2 and found there were two proposals: one to leave the repo rate unchanged and another to lower the repo rate from 3.75 to 3.5 per cent. The Executive Board decided to leave the repo rate, and thereby the deposit and lending rates, unchanged and to announce the decision at 9.00 a.m. on Wednesday, 5 December 2001 with the motivation and wording contained in Press Release no. 79 2001 (annex B to the minutes).

Deputy Governor Christina Persson entered a reservation against leaving the repo rate unchanged and with reference to her reservation, under § 1 above, against the decision to adopt the Inflation Report, stated that the repo rate ought to be lowered 25 basis points.

This paragraph was immediately confirmed.