No. 5

SEPARATE MINUTES of the Executive Board meeting on 4 July 2002

<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
Malin Andersson (§ 1)
Claes Berg
Anders Borg
Jörgen Eklund
Anders Eklöf (§ 1)
Kerstin Hallsten
Björn Hasselgren
Karin Jabet (§ 1)
Leif Jacobsson
Stefan Laséen (§ 1)
Mikael Nilsson (§ 1)
Cecilia Roos-Isaksson (§ 1)
Robert Sparve
Staffan Viotti
Martin Ådahl

§ 1. Monetary policy discussion

It was noted that Jörgen Eklund and Martin Ådahl would prepare draft minutes of §§ 1–2 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 relevant 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 July 2004. 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 internationally and in Sweden

1.1 The international scene

The main scenario in the June Inflation Report envisaged a tentative recovery of world market growth during the year and subdued price pressure from goods in international trade. GDP growth in the OECD 19 area[1] was judged to average 1.4 per cent this year, followed by 2.6 per cent in 2003 and 2.7 per cent in 2004. The average weighted rate of CPI inflation was calculated to be 1.4 per cent this year, 1.7 per cent in 2003 and 1.9 per cent in 2004.

The Board noted that incoming data continue to suggest that notwithstanding the financial market unrest, growth in the coming years will be relatively satisfactory. New statistics from the United States confirm the June Report's picture of more subdued consumption growth but also of recoveries in manufacturing output, the labour market and investment. In the euro area, unexpectedly subdued domestic demand points to growth this year being somewhat weaker even though the export-led recovery is continuing. In Japan it looks as though GDP is not declining as much as expected. All in all, the main features of the forecasts for world market growth and international export prices hold good.

A number of Board members considered that the recent financial market unrest does not gainsay a continued recovery.

A member reminded the Board of the initial position: major imbalances in the United States and a strong increase in the dollar and stock markets in the 1990s, together with concern about how these imbalances would develop. It now looks as though a correction of these imbalances is on the way – an orderly retreat, according to this member, who underscored that this is not always the picture conveyed by financial market representatives and the newspapers.

Another Board member considered that the basic question is whether the financial market developments represent a continued adjustment to excessively high share values as opposed to being a sign of growing doubts as to whether economic activity is really turning upwards. It is not possible to tell just how much of the unrest stems from the former or the latter but this member considered that the first explanation carries more weight.

A Board member agreed that developments in the rest of the world are largely compatible with a normal economic upswing but found that three factors constitute departures from the normal pattern and give some cause for concern. One is stock markets: in the present cyclical phase they ought to reflect expectations of rising profits rather than continued uncertainty. Another is the high real estate prices, which at least in the United States have probably helped to sustain household demand more than usual but are simultaneously a source of uncertainty. Thirdly there is the

[1] Nineteen countries among Sweden's trading partners in the OECD area.

relatively high resource utilisation in Europe and Sweden, with tendencies to wage increases and inflation already showing up at the beginning of the upswing.

A Board member pointed to the historical experience of earlier cyclical fluctuations and referred to studies presented in the April issue of the IMF's *World Economic Outlook*, showing that a synchronisation of different countries' cyclical swings is the normal thing, particularly as regards investment. Moreover, a steep drop in manufacturing investment is normally a feature of downturns, while a characteristic of recoveries is that they are driven by consumption and stockbuilding, with investment lagging behind. The report also indicates that stock markets usually peak a year or so before the slowdown in growth. So what we are seeing now is broadly in line with the normal course.

This member's opinion, reiterated from the previous meeting, was that, compared with the main scenario in the June Report, developments in the rest of the world may be somewhat stronger. Although falling share prices and bond rates do normally signal a slackening of activity, real economic statistics and various indicators are pointing upwards. The economic situation in the United States does not seem to be particularly shaky. The property market trend remains strong, which favours the wealth position of households and to some extent balances the falling value of their share portfolios. Manufacturing is recovering well and in recent months the labour market has stabilised. As core inflation is being damped and inflationary pressure is easing, the Federal Reserve need not be in a hurry to tighten monetary policy. All this is accompanied by rising world trade and increased industrial output in many countries.

The statistics on Europe show a more sluggish development. Moreover, Europe tends to be behind the United States in the business cycle and since potential growth is lower in Europe, it would not be reasonable to suppose that Europe can replace the United States as the driving force behind international growth. Developments in the Asian economies continue to be favourable, leading to a successive upward revision of GDP forecasts. In Latin America, however, activity is considerably slacker; with political unrest in a number of countries and weak government finances, the prospects for the near future are not particularly bright. Summing up, this Board member pointed out that, as the financial uncertainty that became increasingly pronounced during the spring seems to be balanced by rising real estate prices and increased real household income in a number of countries, it looks as though the real economic impact of the uncertainty will not be so great. The member cited the Asian crisis in 1997 and the financial turbulence during 1998 as examples of financial unrest that did not have as large an effect on real economic activity in the industrial countries as had been feared, partly because economic policy was more expansionary. Neither have more recent crises, for example in Argentina and Turkey, left any deep marks on other countries. Finally, the member raised the question of what has actually happened since the June meeting. The Board has expressed concern earlier about excessively high stock market prices and an unduly strong dollar. Some Board members are now even more concerned even though a large part of the stock market adjustment has already occurred, so that the remaining risk should have decreased.

Two members were somewhat more pessimistic.

One of them considered that the uncertainty about the recovery has grown recently. In the wake of terrorist threats, corporate scandals and the turbulent mood in stock markets, the risk of a double dip in the United States has increased. The negative stock market trend is liable to postpone investment and subdue consumption. In both monetary and fiscal policy there is limited scope for responding to further negative signals from financial markets or security policy developments. As the Federal Reserve's instrumental rate is already low, a new downturn might have more extensive consequences because the interest rate could not provide an equally strong positive cyclical injection. This is a problem particularly because no other region in the world seems to be capable of shouldering the function of the United States as an economic locomotive. Europe lacks the internal dynamics that could offset falling demand in the United States. Dependence on exports is pronounced, particularly in Germany, where the problems with a recovery are liable to be accentuated when the dollar weakens. Provided there are no further negative events, conditions still exist for a development in line with the Riksbank's main scenario but the risk spectrum has recently become more disadvantageous.

The other of the somewhat more pessimistic Board members warned against taking the risks with the stock market unrest too lightly. The figures that point to a gradual, broad recovery have been accompanied by financial market signals of a weakening of the economy. This member pointed out that we are seeing the worst stock market development since the 1930s. Moreover, a fall-off some way into an upswing is a common occurrence. Furthermore, parts of the American, the British and even the Swedish real estate market may constitute a bubble that is liable to burst and thereby cause a setback in private consumption. This member added that a weakening of the dollar may lead to a J-shaped development of the US balance on current account; this is because imports become more expensive without their volume being affected in the short run, while it often takes time for a currency depreciation and improved competitive conditions to show up in exports. Another factor, according to this member, is that a number of countries in Europe have missed the chance of consolidating their government finances during the years of high economic growth; they accordingly now risk having to conduct a procyclical policy and thereby accentuate cyclical fluctuations. The member considered that the EU's Stability & Growth Pact, which limits government financial deficits to 3 per cent of GDP under normal cyclical conditions, is liable to exacerbate the situation even more.

A number of Board members expressed concern about the property market in the United States being over-valued.

One of them pointed out that new financial instruments have given American households the possibility of extracting even more than before of the additional value represented by rising property prices. This naturally increases the risk of a property price fall having negative consequences for household demand. This member added, however, that initiated American observers do not see any major risk of a marked adjustment of property prices.

Another Board member considered that the concern about the American real estate market is exaggerated and noted that a young population represents a stable base for new housing demand in the United States. House mortgage rates in the United States are governed by the long interest rate, the background being that house mortgage loans have long maturities at fixed rates at the same time as households are free to rearrange the loans, which they often do when interest rates fall. The long interest rates are affected by inflation prospects. Consequently, a monetary tightening in the United States need not necessarily have a negative effect on the property market insofar as long-term inflation expectations are dampened and push long interest rates down. If house mortgage rates were to rise, households would simply hold on to loans at the lower rate negotiated earlier. Thus, higher house mortgage rates would only affect first-time buyers.

The Board's overall assessment was that recent developments in the rest of the world have broadly agreed with the outlook in the June Report. At that time it had been foreseen that an international recovery would be dampened by stock market corrections and the necessary adjustment of the low saving in the United States. Three Board members subscribed to this view, while two saw an increased risk of developments being somewhat weaker. The sixth Board member considered that global activity will achieve a somewhat stronger recovery than allowed for in the June Report's main scenario.

1.2 Financial markets

The Board noted that developments in the past month have been dominated by the weak stock market and a depreciating dollar. Global stock exchanges have been coloured by increased uncertainty about corporate profit accounts and conditions for growth. On the Stockholm Exchange, both the SAX and the OMX index have fallen about 15 per cent since the time of the June Report, accompanied by falls of much the same magnitude elsewhere in Europe and in the United States. The decline has come mainly from the IT and telecom sectors.

The international stock market fall has led to declining bond rates in Sweden as well as elsewhere. Since the June Report, moreover, the long-term interest rate differential with Germany has narrowed, which may be due in part to less concern about inflation in Sweden.

Money market prices indicate expectations that in the coming year the Riksbank will raise the repo rate 0.75 percentage points to 5.0 per cent, which tallies with the picture of expectations derived from survey data.

The US dollar has continued to weaken in June. Market observers attribute this to, among other things, new terrorist threats to the United States and questions about the resilience of the cyclical upturn. The Swedish krona has appreciated against the dollar in this period but weakened marginally against the euro. Shifting expectations about Sweden's future adoption of the euro have also affected the exchange rate and are expected to go on doing so.

A number of Board members considered that the adjustment of the dollar is a welcome development.

One of them pointed to the difficulty of determining what effect a weakening of the dollar will have on growth in the rest of the world. A weaker dollar's effects on export production and monetary policy in the euro area and the United States respectively could cancel each other out. But if a depreciating dollar reflects fundamental worries about the US economy, it could clearly go hand in hand with a poorer global trend, though in that case not on account of the dollar's decline but because of the change it reflects in the investment climate.

Another Board member observed that problems arise, not from a slow, orderly adjustment, but from a rapid correction that is not offset by an increase in global demand. The financial market unrest accentuates the uncertainty in a sensitive situation.

A Board member mentioned that experience of broad share ownership through institutions is still rather limited and wondered whether the consequences of the increased stock market volatility might be more negative today than when share ownership was less widespread.

Another Board member pointed out that the institutional ownership provides support for the stock market through the continuous inflow of capital from pension funds and other institutional investors. Moreover, despite the precarious state of stock markets, there have been a number of successful introductions and new share issues in recent months. But as one might expect in the current situation, investors are mainly interested in companies with a stable future rather than in untested commercial ideas with a high risk. Commenting on the recent accounting scandals that have lowered share prices, this member considered that while certain companies have unquestionably used criminal or otherwise unacceptable methods, suspicions are now also being voiced about other technical accounting principles that have been current and fully justified for a long time.

All in all, the Board considered that the recent financial market developments have been somewhat more turbulent than expected and will therefore also tend to subdue the future development of demand in Sweden to a somewhat greater extent than foreseen earlier.

1.3 Demand and supply

GDP growth in Sweden was judged in the June Report to be 1.6 per cent this year, 2.7 per cent in 2003 and 2.5 per cent in 2004. The background included an international recovery, a comparatively weak initial exchange rate, low real interest rates and an expansionary fiscal policy.

The Board noted that the June Report's main scenario, with a gradual recovery, still holds but there are now signs that activity may not strengthen quite as soon as had been expected.

The national accounts for 2002 Q1 show that private consumption, gross fixed investment and stockbuilding have been somewhat slacker than foreseen in the June

Report. A weaker stock market should tend to subdue consumption but the opposite is indicated by household optimism about the future, better real incomes and rising house prices. All in all, it looks as though the recovery of consumption will occur somewhat later than assumed in the June Report. On the other hand, net exports in the first five months of 2002 have been stronger than expected. Growth at somewhat above the potential rate is still foreseen in 2003 and 2004.

Wage outcomes in April were broadly as foreseen in the June Report. But with higher productivity growth, this year's development of unit labour costs has been somewhat more subdued than expected.

A Board member pointed out that a series of years with low unemployment seems to have led to an upward shift in the rate of wage increases to around 4 per cent.

Another Board member warned that wage developments may be a problem. A norm of around 4 per cent seems to have been established for wage increases. That is not compatible with the inflation target in the longer run and may result in higher price pressure when the currently high productivity falls back and a stronger exchange rate no longer generates a downward pressure on import prices.

A third Board member observed that the risk from wage drift is being reduced by the ongoing cuts in the private services sector, not least in the IT and telecom industries, which were involved to a high degree in the unduly rapid wage increases associated with the overheating in 1999–2000. There is in fact a risk of the upturn slackening, with a further postponement of investments. Firms have become more pessimistic, with increased redundancy notices above all in the Stockholm region, where cyclical turning points usually begin. This member expressed concern that the Riksbank may have been too hasty in signalling the timing of further interest rate increases. There was probably no need now to be concerned about underlying inflation on account of wage drift, partly because labour shortages are located mainly in the public sector and also because the labour market is not expected to be as tight as envisaged earlier. Moreover, this member cited trade union reports suggesting that other wage-earners are prepared to accept rising public sector wages; the risk of public sector wage increases leading to higher inflation may therefore not be all that great. This member also considered that the methods for detecting important structural changes in the economy need to be improved. In the long run, labour shortages are Sweden's major economic problem and constitute a restriction on potential growth further ahead.

A number of Board members opposed this description of the economic situation. One of them pointed out that firms may have become somewhat less optimistic but not more pessimistic. As regards redundancy notices in the Stockholm area, these stem above all from the telecom sector (Ericsson).

Another Board member argued against the reports of private sector acceptance of rising public sector wages and that this is a sufficient reason for cancelling the risks of unsustainable wage increases in the rest of the economy. Considering the likely development of labour supply and demand, there are grounds for being concerned about wage costs in the coming years.

A Board member observed that a recovery is evidently in progress in the Swedish economy but the stock market is weak and there seem to be signs that prices in parts of the real estate market could constitute a bubble. Moreover, the member was somewhat concerned about the falling rate of investment and saw a risk that this could weaken production capacity and ultimately productivity. The ongoing gross investments are sufficient to compensate for the depreciation of the capital stock but not for a rapid expansion of capacity. There is therefore a risk that growth of the capital stock slows, which may lower potential GDP growth. This member pointed out that the weak investment activity may be one factor behind the increased net exports in that imports of capital goods have fallen.

Another Board member underscored that while property prices have risen rapidly in the metropolitan regions, increases in the rest of the country have not been marked. The present situation differs essentially from the property boom in the late 1980s, when prices in large parts of the country mirrored unreasonable expectations of continued increases in value. Moreover, households' debt burden is smaller and interest expenditure is lower in relation to income.

Yet another Board member considered that new statistics confirm the earlier impression that expansionary monetary and fiscal policies are supporting a successively broader recovery. Household confidence in the future is improving more quickly than usual in such a phase. This member cited an earlier IMF study showing that only a minor proportion of the value of shares is taken as secure in households' behaviour; share price fluctuations affect household consumption considerably less than variations in property prices. This means that as house prices are still rising, it would be wrong to conclude that the stock market unrest will undermine consumption. The member expressed concern about labour supply, partly in view of a steep fall in average working time, and agreed with the member who was worried about wage formation. On the whole, there seemed to be no grounds for changing the member's assessment of the Swedish economy at the previous meeting, though stock market developments have made things somewhat more uncertain.

All in all, the Board considered that developments in the Swedish economy are in line with the assessment in the June Report, although the cyclical path has become somewhat more uncertain. An expansionary economic policy, with low real interest rates, lower taxes and increased demand, still favours a future recovery of demand and growth somewhat above the potential level in 2003 and 2004.

2. The Board's assessment of inflation prospects

The rate of CPI inflation in the main scenario in the June Report, with the risk spectrum taken into account, was judged to be 2.1 per cent in June 2003 and 2.4 per cent in June 2004. The corresponding rates of UND1X inflation were forecast to be 2.0 and 2.1 per cent.

The Board noted that, according to survey data, households' expectations of inflation one year ahead fell back in June to 2.2 per cent. Expectations derived from market prices (the difference between nominal and real bond rates) have also fallen back for inflation two years ahead.

Since the June Report, outcomes have been published for CPI and underlying inflation in May. The 12-month rate of underlying inflation (UND1X) declined to 2.2 per cent in May. Domestic inflation was somewhat lower than expected and imported inflation somewhat higher.

The Board noted that inflation has now fallen back as the Riksbank had envisaged a year ago and has reiterated there after. It had been foreseen that the effects of certain transitory price increases would disappear in the course of the year and this has now happened. Somewhat lower inflation is also foreseen in the coming year, in keeping with the earlier assessment.

In July, however, an increase in UND1X inflation is expected, partly because last year's major bargain sales of clothes will probably not be repeated this year; some downward shift in inflation is then foreseen in August. The inflation assessment for the rest of the forecast period is largely unchanged. High resource utilisation and relatively high wage increases are expected to contribute to a renewed increase in domestic inflation one to two years ahead; this is countered, however, by subdued price increases for imports on account of the krona's expected appreciation and falling oil prices. All in all, in the main scenario with an unchanged repo rate, CPI inflation is judged to be 2.1 per cent one year ahead and 2.3 per cent after two years. The corresponding assessment of UND1X inflation is 2.0 per cent both one and two years ahead.

The Board also noted that the financial market uncertainty has made it somewhat more probable that inflation will be lower than this. At present there are no grounds for altering the assessment in the June Report; inflation is still calculated to be at the Riksbank's 2 per cent target one and two years ahead, which is the perspective that primarily guides monetary policy.

Neither did the member whose main scenario allowed for somewhat stronger growth, in the rest of the world as well as in Sweden, see any reason to modify the appraisal of future inflation and considered, with reference to earlier arguments, that inflation in Sweden would probably be a couple of tenths of a percentage point higher than the other Board members expected.

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

3.1 The monetary policy group's view[2]

First Deputy Governor Lars Heikensten presented the view of the monetary policy group regarding the path of inflation and the situation for monetary policy.

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[2] 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 policy group had noted that inflation had fallen back during the spring as expected. That confirms the assessment that the increase in inflation was mainly transitory. It also favours increased confidence in the Riksbank's assessment of domestic inflation.

The policy group had also found that new data do not alter the picture of economic activity. The main scenario, with rising resource utilisation in the coming years, accordingly holds and implies further interest rate increases.

Financial market developments have run counter to the real economy. Above all, stock markets have gone on falling. This presumably represents an adjustment to more reasonable long-term values but to some extent it probably also reflects concern about a weaker cyclical development or even a double dip. Continued stock market unrest could clearly affect economic activity and resource utilisation. There is also a risk, albeit small, of a deeper financial crisis.

So all in all, there have been no dramatic changes since June but the downside risk is marginally greater than at the time of the previous meeting. This favours waiting and seeing on this occasion instead of adjusting the instrumental rate. Still, the policy group saw no reason to change the basic assessment of the future development of policy. The Riksbank acted early on and raised the repo rate twice during the spring. That leaves room for waiting at present. But further increases will be called for if the economic picture of the coming years is correct.

3.2 The Board's discussion

The Board unanimously considered that monetary policy should be based on UND1X inflation. All the members also shared the policy group's opinion that the repo rate should be left unchanged.

Four Board members agreed with the policy group's conclusion that there is still expected to be a need for a future adjustment of monetary policy in a less expansionary direction as resource utilisation in the economy rises. But in the light of the current inflation forecast and the risks connected with the financial market unrest, there are no grounds for altering the repo rate on this occasion.

The Board member whose main scenario gave a somewhat higher inflation forecast compared with the others shared the opinion that on account of the prevailing financial market unrest, in Sweden as well as internationally, in the present situation it would not be appropriate to raise the interest rate. But this member considered that the interest rate ought to be raised very soon in order to safeguard price stability.

In the opinion of another Board member, the uncertainty about both the real and the financial economy favours a policy of awaiting future developments. The situation is characterised at present by genuine uncertainty. There is therefore no reason now to signal the direction in which monetary policy ought to be conducted in the near future.

The Board's assessment was that the repo rate should remain unchanged. The direction of monetary policy depends, as always, on the Riksbank's appraisal of inflation prospects. If demand continues to strengthen and resource utilisation rises, further steps towards a less expansionary monetary policy may be called for. The timing and pace of further interest rate adjustments will depend, as usual, on the information that becomes available and how it is interpreted.

§ 2 Monetary policy decision[3]

The Chairman summarised the monetary policy discussion under § 1 and found there was a proposal for an unchanged repo rate. A vote was taken and the Board unanimously decided to leave the repo rate unchanged at 4.25 per cent and to announce the decision at 9 a.m. on 5 July with the motivation and wording contained in Press Release no. 45 (annex to the minutes). The Board also decided that the minutes of today's meeting are to be published on 25 July 2002.

This paragraph was immediately confirmed.

[3] Board members who are present and do not enter a reservation have participated in and agreed to the Board's decision.