No. 13

SEPARATE MINUTES of the Executive Board meeting on 15 August 2002

Present: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
–
Sven Hulterström, Chairman of the General Council
–
Kerstin Alm
Claes Berg
Mårten Blix
Hans Dellmo (§ 1)
Jörgen Eklund
Anders Eklöf
Kerstin Hallsten
Björn Hasselgren
Jyry Hokkanen (§ 1)
Leif Jacobsson
Petra Lennartsdotter (§ 1)
Hans Lindblad
Tomas Lundberg
Stefan Palmqvist (§ 1)
Åsa Sydén
Staffan Viotti
Anders Vredin

§ 1. Monetary policy discussion

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

The meeting began with a discussion of economic developments in Sweden and the rest of the world and their relevance 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 based on the technical assumption that the repo rate would remain unchanged at 4.25 per cent until the end of August 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 gradual 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.

At the monetary policy meeting in July the Board had found that incoming data suggested that, notwithstanding the financial market unrest, growth in the coming years will be relatively satisfactory.

The macroeconomic information that has become available since the July meeting essentially confirms the picture of a gradual global recovery. The Board noted, however, that the increasingly low share prices may have negative effects on the development of investment and consumption, above all in the United States, and are accordingly a source of uncertainty about the global recovery. Another element in the somewhat increased uncertainty is the weaker growth figures for the United States and Europe.

In the *United States*, the preliminary Q2 national accounts show that domestic demand approximately followed the path in the earlier assessment but that imports were unexpectedly strong. As a result, GDP growth was somewhat lower than had been forecast. Together with falling stock markets and declining consumer confidence, all this leads to the assessment that the prospects for consumption and investment in the United States are reduced somewhat compared to the previous assessment.

In the *euro area*, the weak stock markets and a stronger currency have affected indicators of industrial confidence, which has become more subdued in the past month. Moderate growth in retailing and a continued deterioration in the labour market support the earlier impression that consumption will continue to be relatively restrained for some further time. All in all, this motivates the forecast of somewhat weaker growth in the euro area.

A number of Board members pointed out that the media have presented an unduly negative picture of international economic activity. One explanation lies in the one-sided focus on the negative stock market trends. One of these Board members recalled and compared the developments during the summer with the concern about a weaker global economic trend that had prevailed in connection with the financial crisis in 1997–98 but which did not become as serious as had been feared. This member

[1] Nineteen of Sweden's main trading partners in the OECD area.

considered that while the ongoing correction of the imbalances in the United States does constitute a downside risk for global activity, this risk has not changed appreciably during the summer. The greater part, three quarters, of the share price fall had already occurred before the summer.

Another Board member pointed out, however, that the summer's stock market fall had started from a level that was already low. The former member rejoined that the economic situation has nevertheless continued to improve and has done so alongside the falling share prices. Moreover, the latter should be seen in the light of the very high stock market values that had been noted earlier.

A Board member noted that an adjustment of the imbalances in savings and the current account in the United States has already begun and has been facilitated by a weaker dollar. Neither has a massive flight from dollar investment been discernible in connection with the continued share price fall during the summer. The member had observed that foreign ownership of shares on American stock markets is comparatively small. There are grounds for not exaggerating the problems with economic adjustment in the United States. There is certainly concern that the adjustment could occur too rapidly but in this member's opinion the concern has decreased rather than increased.

Another Board member underscored that the foundation for financing the US current-account deficit has become increasingly fragile in recent years in that the capital flows now consist to a greater extent of more volatile portfolio investments rather than direct investments.

This member stressed that the stable housing market and a continued improvement of household income have so far provided good support for household consumption in the United States. Moreover, empirical analyses indicate that for household consumption, changes in these factors are considerably more important than the development of share prices. The member considered that the growth of new borrowing and the attendant increase in the debt burden of households constitute a risk. If new borrowing were to fall, for example because of a deteriorating labour market or higher risk premiums in the house mortgage market, consumption could become more subdued in the future. The Board emphasised the importance of continuing to follow this aspect and of deepening the analysis.

A number of Board members mentioned that for a recovery of investment it is important that confidence is restored in the accounting practices of American corporations. The introduction of new sanctions for accounting malpractices may have laid a foundation for this. Requiring company directors to certify the accuracy of their accounts may also help to reduce market uncertainty. A Board member considered that while the accounting scandals that have been disclosed are certainly serious, it does not follow that all accounting in the United States has been dishonest. According to another Board member, the Asian crisis has shown that once the appropriate measures have been taken, financial market confidence can soon be restored. Moreover, in contrast to Japan, there have been no general problems in the American banking sector.

Yet another Board member considered that it could take longer to restore confidence in stock markets and pointed to the risk of the disclosures to date being just a fraction of all that has been done to inflate profits and share prices. Moreover, the strength of domestic demand in Europe is questionable and economic growth in Japan is judged to remain weak. This means that the recovery will be more protracted and feeble than was assumed earlier. The question is no longer whether or not there will be a double dip but whether the upward tendency will weaken slightly or markedly. This member warned that there could be a risk of a deflationary scenario if the downturn were to extend to the property market. Stock market developments could also lead to falling real estate prices. The United States is heavily dependent on a large capital inflow and a failure in this respect could accentuate the dollar's depreciation and make it difficult to maintain low interest rates. The member was also somewhat worried about what might happen in the United States if investors were to choose to withdraw from the American securities market at the same time as the public borrowing requirement rises. All in all, this could imply that the downside risk for international economic activity is somewhat greater than before.

The Board's overall assessment was that incoming information broadly supports the Inflation Report's picture of a global economic upturn. But in view of the financial market uncertainty and somewhat weaker growth outcomes for the United States and the euro area, the global recovery is now expected to be somewhat more subdued than envisaged earlier. International prices and international export prices are accordingly judged to follow a somewhat more subdued path than was foreseen in the Inflation Report.

A Board member who had considered in June that the international trend would be somewhat stronger than the picture in the Inflation Report, shared the Board's opinion that international economic prospects have worsened to some extent. This member concluded, however, that since the fundamental factors behind the recovery are working in the same way as at the beginning of the summer, the path of international activity could be somewhat stronger than the other Board members foresee. The member considered that although the development of American stock markets is admittedly generating uncertainty, that is being countered by an expansionary fiscal policy, falling interest rates and the development of house prices. American corporate profits are rising and business confidence is at levels that indicate growth, albeit with some downward tendency recently that has led to increased uncertainty about investment prospects. In the euro area, the floods in Germany and other countries imply decreased activity in the short run but the extensive building repairs will be a positive factor for future construction. The member also noted that the tendency in Asia excluding Japan is strong and that the countries there do not just export goods to the United States but are also engaged in sizeable regional trade.

1.2 Financial markets

International stock markets and the Swedish stock exchange have gone on falling since the Board's monetary policy meeting in July and share prices have fluctuated widely. The Stockholm exchange's SAX index has declined another 12 per cent or so, giving a drop of about 35 per cent since the beginning of the year.

The weak stock markets, somewhat greater uncertainty about the strength of economic activity and declining inflation expectations have contributed to a downward shift in international and Swedish bond rates across the yield curve.

The Board noted that the risks of a weaker economic trend have been heeded by the US Federal Reserve as well as by other central banks, including the ECB and the Bank of England. Another illustration of this is that prices in, for example, the American money market now even point to a lower instrumental rate in the future.

Expectations in the Swedish money market have also shifted to the prospect of a lower repo rate than before. Pricing indicates an increase of about 0.25 percentage points in the coming year, to 4.5 per cent, while the picture of expectations in survey data implies an increase of 0.75 percentage points.

The US dollar has become somewhat more stable after the depreciation that began in the spring. The Board noted, however, that the Swedish krona has followed a somewhat weaker path than foreseen in the Inflation Report, partly in connection with the financial market unrest. Fluctuating expectations about Sweden's future participation in the euro area have probably also continued to affect the exchange rate.

A Board member considered that with the present adjustment of share prices and more reasonable P/E figures, there are some grounds for a more positive appraisal of stock market prospects. According to this member, a more stable financial environment, partly on account of credibly low inflation around the world, can motivate P/E figures somewhat above the historical average.

Another Board member recalled that with the downward adjustment of share prices since 2000, levels on the Stockholm exchange have been on a par with those that prevailed in 1997 and at times in connection with the financial crisis in 1998.

All in all, the Board judged that the continued financial market turbulence can be expected to somewhat accentuate the downward effect on the future development of demand. This is at least partly countered by lower interest rates and stable real estate prices. The Swedish krona is judged to be marginally weaker in the short run but is still expected to return to approximately the same end level as was assumed in the June Inflation Report.

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.

Recent statistics suggest that the prospects for a recovery of economic activity in Sweden are still good. The July business tendency survey from the National Institute of

Economic Research indicates that industrial activity has strengthened. The inflow of both domestic and export orders rose in Q2. The situation does, however, vary considerably. Manufacturing output rose in Q2 in line with the earlier expectations of firms. The expectations for Q3 show that industrial firms are generally optimistic, though the expectations are somewhat lower than was the case for Q2. The purchasing managers index (ICI) for July was somewhat lower than for June but still points to growth in manufacturing.

In contrast to the bright picture for manufacturing, the business tendency data suggest that construction continued to weaken in Q2. Construction firms are also rather pessimistic about Q3 and the coming year. On the other hand, house prices are still rising.

Economic growth in Sweden picked up markedly in Q2. According to a flash estimate from the national accounts, the (day-adjusted) annual rate of GDP growth in Q2 was 2.1 per cent from the same quarter a year earlier and 0.6 per cent from Q1 this year. GDP in the first half of this year was 1.5 per cent up on the first half of 2001, while the number of hours worked fell 1.1 per cent. To date this year average labour productivity has accordingly risen about 2.6 per cent, which is considerably more than in 2001.

A Board member pointed out that the outcome for exports has been better than expected, partly on account of the weak exchange rate. Moreover, changes in wealth affect private consumption much less than changes in disposable income; according to this member, a 5 per cent increase in disposable income would more than make up for a stock market fall of 50 per cent. The member stressed that it is property prices that are important for households' perception of their own wealth; high real estate prices make it possible to borrow more, for example, although this facility has not been utilised as much as before. Another Board member noted, however, that there will be some time lag before the stock market fall affects the growth of consumption.

According to the June labour force survey, the number of persons in employment was 44,000 (1.0 per cent) higher than a year earlier. To date this year employment has developed somewhat more strongly than expected earlier.

The May wage outcome has become available since the monetary policy meeting in June and shows that to date this year the rate of wage increases in the total economy has been 3.6 per cent. Relatively high retroactive wage payments in the latter part of the year are expected to result in an appreciable upward revision of the outcome. Despite productivity's surprisingly favourable development to date, there seem to be no grounds at present for altering the assessment of unit labour costs.

A Board member underscored that a 4 per cent wage rise is not sustainable and must ultimately be seen as a risk for cost pressure in the economy.

A Board member pointed out that the better productivity performance is a positive feature of the picture and in line with what is normal in the present cyclical phase. There now seems to be somewhat less danger that last year's weaker development of productivity was due to structural factors.

A Board member noted that notwithstanding extensive redundancies and cutbacks, economic developments in Sweden have been fairly favourable. Labour demand and labour market flexibility seem to be sufficiently good to absorb the increase in unutilised manpower. Moreover, redundancy notices have not been implemented in full in a number of regions and cutbacks have been smaller than originally announced. At the same time, this member found it probable that the recent stock market fall will have negative effects on both consumption and investment.

A Board member stated that the growth of M0, M3 and household borrowing has slackened and the rate of increase in corporate borrowing from banks has become markedly lower, though this has been partly offset by a stronger increase in borrowing against certificates.

Almost all the Board members concluded that developments to date this year warrant only marginal adjustments to the forecast of growth, which compared with the assessment in the June Report is now judged to be somewhat stronger this year but somewhat weaker in 2003 and 2004. Even so, growth in the latter part of the forecast period may still exceed the sustainable long-term expansion of output.

One Board member referred to that member's earlier reasoning about a somewhat more favourable picture of international growth prospects, together with the fundamental factors that had been discussed concerning the Swedish economy, and considered that this could lead to growth in Sweden being somewhat stronger than the other Board members counted on.

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 since the latest monetary policy meeting, outcomes have been published for CPI and underlying inflation in June and July. The 12-month change in the CPI was 2.1 per cent in June and 2.2 per cent in July. Underlying inflation (UND1X) was 2.2 per cent in June and 2.4 per cent in July, which is somewhat lower than foreseen in the June Report. The transitory price increases that occurred in the spring of 2001 have dropped out of the 12-month change figures. At the same time, inflation expectations have fallen and are now down in line with the inflation target.

The Board considered that in the short run the higher oil price and the weaker exchange rate may contribute to imported inflation being somewhat higher this year. In 2003 and 2004, however, a somewhat stronger exchange rate accompanied by lower international export prices may lead to imported inflation being somewhat lower in the rest of the forecast period. All in all, it is expected that inflation one and two years ahead will continue to be in line with the inflation target, though marginally lower than envisaged earlier.

Neither has the picture of the various risks associated with future inflation changed significantly. However, a weaker international trend has become somewhat more probable, mainly because the effects of the global stock market fall may be greater than calculated. In Sweden there is still the risk of domestic inflation being higher. Resource utilisation is high, as is evident from the latest figures for employment and growth. The risk of wage increases being higher than expected also contributes to an upside risk for domestic inflation. At the same time, however, the uncertainty about the Swedish economy's inflation propensity has decreased to some extent in that inflation has been approximately in line with earlier assessments.

The Board member who considered that growth could be somewhat more marked than in the main scenario broadly shared the other Board members' view of future inflation but held that inflation in the latter part of the forecast period could be somewhat higher than the other members counted on, though with much the same risk spectrum.

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.

The greater part of the economic statistics that have become available during the summer continues to point to a gradual and broad but relatively tentative recovery in the global economy. The turbulence in stock markets around the world has, however, led to increased uncertainty about the strength of the recovery. The lower and lower share prices may have negative effects on investment and consumption. Weaker growth figures for both the United States and Europe have also contributed to the uncertainty. But all in all, there are still grounds for broadly adhering to the appraisal of the global economy that was presented in the June Report and which lay behind the monetary policy decision in July, even though prospects have worsened to some extent.

A continued economic recovery in Sweden seems likely in the coming years. There is reason to count on activity in Sweden being supported by the international trend as well as by a relatively rapid increase in disposable income. Although the stock market fall has tended to weaken household financial wealth, total household wealth has been sustained by the ongoing increase in real estate prices. All in all, there is therefore no reason at present to revise the assessment of economic growth in Sweden more than marginally.

[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.

Against this background the policy group had judged that the rate of price increases one and two years ahead will be in line with the Riksbank's inflation target and the repo rate should be left unchanged. That is also what market players expect to be the result of today's meeting. The future formation of monetary policy will have to be examined in the light of new information that is considered to be relevant for inflation prospects. It should, however, be evident from the Riksbank's communications that the risk spectrum has shifted to a certain extent since June. The probability of needing to raise the interest rate at the pace expected earlier has decreased.

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.

A Board member noted that forecast inflation one to two years ahead is in line with the target, which speaks in favour of leaving the interest rate unchanged. In this context the appraisal of the risk spectrum is important. In this member's opinion, the probable scenario is that there will be future interest rate increases but today there is no reason for the Riksbank to commit itself to when they may be needed. The future formation of monetary policy will depend on how the Riksbank evaluates new information about economic and financial developments that are judged to be relevant for inflation prospects. Another Board member considered that the Riksbank's position on interest rate increases is now somewhat less strong than before.

The Board's overall assessment was that the repo rate should be left unchanged. The Board member who had judged that both growth and inflation could be somewhat stronger than in the main scenario considered that grounds already existed for raising the interest rate. The argument against this has to do with the turbulent situation in financial markets. This member therefore adhered to the other members' conclusion that the repo rate should be unchanged.

§ 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 16 August with the motivation and wording contained in Press Release no. §§ (annex to the minutes). The Board also decided that the minutes of today's meeting are to be published on 29 August 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.