No. 17

SEPARATE MINUTES of the Executive Board meeting on 16 October 2002

Present: Urban Bäckström, chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson

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Kerstin Alm
Claes Berg
Anders Eklöf
Jörgen Eklund
Per Håkansson
Björn Hasselgren
Leif Jacobsson
Hans Lindblad
Cecilia Roos-Isaksson
Staffan Viotti
Anders Vredin (§§ 1-3)

§ 1. The current inflation assessment

It was noted that Anders Eklöf and Cecilia Roos Isaksson would prepare draft minutes of §§ 1 – 4 on the agenda for the meeting.

The Board began its discussion in the light 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 in Sweden and abroad

According to new preliminary statistics, American households' confidence in the future decreased in October. Circumstances behind this include a further share price fall, rising oil prices and increased concern about political and military conflicts in the Middle East. Moreover, retail sales in September in the United States were lower than the month before. In the euro area, the Q2 GDP outcome confirms the weak tendency that is described in the Inflation Report. New statistics also show that inflation fell back in September in a number of countries in Europe, while in others it rose more than had been expected.

In Sweden, the August outcome for retail sales shows an unexpectedly weak development from the month before. As previously during the summer, the September rate of inflation was somewhat lower than had been foreseen in June, partly as a result of weak consumption, better productivity growth than expected and a short-run exchange rate tendency that was stronger than envisaged earlier.

In the financial markets, both the stock market and interest rates have risen during the past week. A number of somewhat more positive corporate quarterly reports contributed to this. The Swedish krona has appreciated to some extent against both the euro and the dollar, which may mirror the stock market tendency as well as speculation about Sweden's future full participation in the EMU. According to Reuters' survey, nine out of ten money market agents expect that at today's monetary policy meeting the repo rate will be held unchanged.

The Executive Board considered that the new information was in line with the picture in the Inflation Report.

2. Monetary policy report (Inflation Report 2002:3)
to the Riksdag's Finance Committee

First Deputy Governor Lars Heikensten presented a draft of Inflation Report 2002:3, which also constitute the Riksbank's monetary policy report 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 3 and 10 October.

The Executive Board decided

- to adopt the Inflation Report as presented

- to present the Report to the Riksdag's Finance Committee, and

- to publish it at 8 a.m. on 17 October.

This paragraph was confirmed immediately.

§2 Monetary policy discussion

The Board's monetary policy discussion started from the assessment in the Inflation Report (section 1). The Board's assessment of the monetary policy situation (section 2) was preceded by an account of the discussion in the monetary policy group.[1]

1. The Board's assessment of inflation prospects

The assessment in the Inflation Report is that inflation both one and two years ahead will be largely in line with the targeted rate, albeit somewhat on the low side. Inflation has fallen back more than was foreseen in the June Inflation Report and the UND1X rate in September was 1.9 per cent. It is domestic price pressure in particular that has been weaker than expected.

At the time of the publication of the June Report there were signs that a cyclical upswing was beginning in the United States and this was judged to stimulate a recovery in other parts of the world as well. Since then, the uncertainty about growth prospects has increased as a result of, for example, the continued stock market fall and heightened security policy risks. But there are also positive signals in the United States, such as comparatively favourable productivity growth and a continuation of the good increase in household disposable income. A delay is also foreseen in the recovery in the euro area. All in all, the new information points to the cyclical upswing being more protracted than was foreseen both in the June Report and at the time of the two subsequent monetary policy meetings.

On account of lower global growth, international producer and export prices have been weaker than assumed earlier. Meanwhile, the price of oil has risen since the publication of the June Report as a result of, for example, security policy concern about developments in the Middle East and a lower supply of oil than was foreseen at that time. The price of oil is expected to go on rising in the rest of this year, followed by a more subdued tendency in connection with an increased supply from non-OPEC countries. The weak international price tendency has a downward effect on Swedish import prices, though this is countered initially by the higher oil price. The assessment of the situation two years ahead is broadly the same as in the June Report.

Despite the somewhat more subdued developments abroad, demand in Sweden has been comparatively stable. The national accounts for the first half-year show that GDP growth was somewhat stronger than expected. However, recent statistics indicate some slowdown in industrial production and trade. The Riksbank now considers that growth in the coming years will be somewhat weaker than was assumed in the June Report. Fiscal policy is judged to be less expansionary, partly so as not to exceed the spending ceiling. Domestic demand will then be lower at the same time as net exports are now judged to be more subdued. GDP growth is assumed to be 1.7 per cent this year, 2.3 per cent in 2003 and 2.1 per cent in 2004. Even with the slowdown to date, resource utilisation is considered to be relatively high initially; but during the forecast period it will probably be somewhat lower than the earlier assessment suggested.

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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.

The spectrum of risks is also relevant for the formation of monetary policy. The greatest uncertainty in the assessment of inflation prospects concerns the effects of financial market developments. The adjustment has been orderly to date but it is conceivable that the stock market's effects will be larger than the main scenario assumes or that the fall continues. This downside risk is partly countered by a domestic upside risk, though this has decreased in that inflation as well as inflation expectations have fallen back to levels in line with the inflation target. But risks still exist, associated in the first place with wage formation and other factors to do with domestic resource utilisation. All in all, the balance of risks for inflation one and two years ahead is judged to be on the downside.

The overall assessment, with the risk spectrum taken into account, is that the 12-month changes in the CPI will be 2.0 per cent one year ahead and 2.2 per cent after two years. The corresponding forecasts for UND1X inflation are 1.7 and 1.8 per cent.

In connection with every monetary policy meeting since 1999 the Riksbank has chosen to clarify the measure of inflation that has guided monetary policy. As has been normal in recent years, on this occasion monetary policy is being formulated in the light of the assessment of inflation as measured by UND1X.

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 about the Inflation Report. A strict interpretation of the rule of action used by the Riksbank would warrant a reduction of the repo rate. At the same time, the most probable development in the coming years is a cyclical recovery. This kind of situation, with activity pointing in one direction and the assessment of inflation in another, always entails a difficult balancing act and also normally arouses a discussion. A feature of the current situation is that the downside risks mainly have to do with the development of turbulent and volatile financial markets. This makes the situation difficult to assess and liable to change at short notice. Moreover, the risks are of a type that is very much related to international developments, so that there is little the Riksbank can do to influence them.

The key question in the present situation is whether the Riksbank ought to lower the interest rate now and thereby perhaps have occasion to raise it again relatively soon if the financial markets stabilise, or whether it would be wiser to wait for a time. Opinions about this in the policy group differed but the decision was nevertheless to recommend an unchanged repo rate.

2.2 The Board's discussion

A majority of the Board members shared the opinion of the policy group that the repo rate should be left unchanged. All but one of the members pointed out that the assessment in the Inflation Report could also warrant a reduction. One of these members did, however, attach somewhat greater weight to the downside risks in the Inflation Report and stated that the repo rate should be lowered 0.25 percentage points.

A Board member stated that there were grounds for biding one's time in monetary policy and waiting for more information about the spectrum of risks. There are factors connected with costs that could work against lower inflation in the future. The security policy uncertainty may contribute to high and volatile oil prices for some time to come. This member also saw risks of rising electricity prices in Sweden after the dry summer and a supply of nuclear power that is not as extensive as previously. Moreover, wage increases have been high in recent years and there is a risk of demands for compensation if, for instance, local government employees were to call for the re-negotiation of their wage agreement. A considerably weaker economic development is also conceivable. In the event of a war, there could be appreciable negative effects whereby the conditions for a recovery may be upset for a longer period.

Another Board member underscored that the economic situation in Sweden has deteriorated since August. As at that time, expectations among households and firms are weak and the financial markets are volatile but now the real economic situation has worsened, as can be seen, for example, from the figures on industrial production. Corporate borrowing from banks and the market has virtually come to a standstill, giving cause for concern about the future development of investment. This member also noted that the inflation risks from the labour market have presumably decreased since the spring when the Riksbank, unlike the European Central Bank, raised its instrumental rate. All in all, this member considered that the weaker international economic tendency and the less strained situation in the domestic labour market could motivate a reduction of the repo rate.

Another member advocated a repo rate reduction and saw no reason why the repo rate should be one percentage point higher than the European Central Bank's instrumental rate. This member noted that both inflation and inflation expectations have fallen back since the spring and are below inflation in the euro area. The fears that inflation would become entrenched at a high level had been exaggerated and in this member's opinion the risk of increased inflationary pressure from wage increases has decreased. Moreover, the weak demand situation means that there is little risk of soon needing to reverse a repo rate cut. The member also mentioned the risk of a war between the United States and Iraq, with the possibility of further terrorist attacks and disturbances to oil production that could contribute to a deeper global recession than the Report's risk spectrum allows for.

This member went on to note that while an expansionary fiscal policy has supported household consumption in the last two years, the effect is now judged to become less expansionary, partly as a result of increased local government taxes. Moreover, the public sector was not judged to be in a financial position to absorb redundant labour from the corporate sector to the same extent as before. The member also considered that the stock market fall's contractive effect on the Swedish economy in general could trigger a downturn in real estate prices, above all in the metropolitan regions. The member therefore proposed a repo rate reduction.

Another member voiced a brighter picture of future prospects. Last year's slowdown in Sweden, as well as in other countries, had involved a sharp fall in manufacturing but domestic demand had remained favourable. Like the slowdown, the recovery in manufacturing has been synchronous. Growth in the first half of 2002 was unexpectedly positive in many parts of the world as well as in Sweden. Growth was stronger than expected in the United States and most other countries of significance for Swedish exports. Some important countries in the euro area are an exception but the member judged that the turnaround in Europe has followed the normal pattern for these countries, beginning with a recovery in exports, followed by increased investment and rising consumption. The financial market unrest and concern about the security policy situation have admittedly slowed the recovery but there are good grounds for seeing a continued upswing as the main scenario. All in all, the member considered that the basic conditions for a recovery are in place, for instance in the form of low interest rates and a robust financial system. On balance, the member was accordingly optimistic.

As regards the path of inflation in Sweden, this member noted that, in keeping with an earlier speaker, inflation and inflation expectations have recently fallen back. In view of the financial market uncertainty and the deteriorating security policy situation, combined with a less expansionary fiscal policy and local government tax increases, the member foresaw lower inflation, in line with the assessment in the Inflation Report. The concern about stock market developments and war is generating a wait-and-see attitude among firms and households. Summing up, the member said that while the balance of risks is somewhat on the downside, upside risks do exist. In this member's opinion, the scenario mentioned by another member, with a war between the United States and Iraq, with attendant terrorist attacks, and thereby a deeper global recession, would have to be taken into account in monetary policy when such a situation has arisen.

This member also expressed some concern about upside risks for inflation in Sweden in connection with the level of potential output and how the labour market functions. All else equal, the high absence due to illness, possible reductions in working hours and early retirement tend to restrict potential production. Lower potential output means that there is less room before rising demand leads to resource utilisation becoming strained and generating inflationary pressure. Moreover, although the shortages in manufacturing are small, the public sector has a large personnel requirement that will have to be met despite the need for fiscal restraint. A rate of wage increases that is relatively higher than in other sectors may be needed to attract labour to the care sector, for example. That in turn may lead to demands for compensation that are liable to push the overall rate of wage increases up.

Another Board member considered that on the one hand a rather mechanical approach to monetary policy in the light of the inflation assessment favoured a repo rate reduction; on the other hand, there were grounds for awaiting the outcome of any re-negotiation of wage settlements and whether or not fiscal policy will become tighter. This member underscored, however, that a more central issue for today's meeting is the development of financial markets. Stock markets have admittedly risen in the last few days but it is too early to say whether or not financial markets have started to stabilise. In this member's opinion, stock markets may develop favourably but markedly poorer financial market developments cannot be ruled out, with consequences for the real economy. Such an outcome could warrant one or more interest rate cuts. However, the member would prefer to avoid making a choice at today's meeting and wanted to wait for more information. Against this background, the member proposed an extraordinary meeting in November for a new assessment of the situation.

All the Board members were in favour of an extraordinary meeting in November.

One member pointed to the uncertainty the members had expressed about developments in Sweden and considered that the situation was a hard one, with a weaker tendency in manufacturing and fiscal tightening. There may also be a need for cuts in the public sector in order to provide the wage increases that are necessary in order to overcome labour shortages. This comes up against the promised efforts for residential construction and infrastructure.

The member who had spoken earlier raised the question of how the market would react if the repo rate were to be lowered 0.25 percentage points at today's meeting and the stock market were subsequently to go on rising. In such a situation the Riksbank might be perceived as acting pro-cyclically.

Another member considered that an extraordinary meeting could give markets and the general public confidence. It would then be possible to await developments while making it clear that the Riksbank is closely following the course of events and is prepared to act if that is required.

This member also commented on an earlier opinion about the difference from the European Central Bank's instrumental rate. The situation has changed a good deal since the spring, when a positive interest rate differential with the European Central Bank's rate was motivated by Sweden's more expansionary fiscal policy, a weak exchange rate and uncertainty about the path of domestic inflation. But the situation has not changed in every respect and some differential may still be warranted in that the Swedish krona remains weak. In a European perspective, moreover, fiscal policy continues to be more expansionary. This member also agreed with an earlier speaker that in spite of the uncertainty, there are positive signals, particularly abroad, that could lead to an upswing that is quicker and stronger than expected. Although the principal risks are on the downside, a quick upturn is not impossible. Against this background, a meeting in November would also be appropriate in the present situation.

A Board member who had previously thought of recommending an interest rate reduction considered that an extraordinary meeting was a good idea. Although there was much in the Inflation Report that supported a cut, the recent stock market recovery had raised some faint hopes. If the stock market were to go on rising, households and firms may become more confident again in the near future, so that the negative effects on demand from the stock market fall are restricted. The member was concerned, however, about how markets will be affected by developments among insurance companies in Sweden and the rest of Europe. Large investments in shares have been converted into holdings of bonds. Even if stock markets do begin to recover, life assurance companies will probably be cautious about share investments for some time to come.

Another member pointed out that the life assurance companies' flight to bonds is liable to lead to market losses if interest rates began to rise. The member who spoke earlier added that life assurance companies might be forced to take additional measures to strengthen their solvency and concluded that the uncertainty about the future flow of capital to stock markets has now grown.

A Board member returned to the case for lowering the repo rate in this situation. If the economic situation continues to give cause for concern, further cuts may be called for. An extraordinary meeting is therefore a good idea. This member also noted that while the public sector does have labour shortages that could contribute to demands for a re-negotiation of wage settlements in the local government sector, in the light of the weak demand situation there seems to be little danger of this having consequences elsewhere that affect inflation in the forecast period. The member went on to argue against another member's earlier statement about the case for a positive interest rate differential with the European Central Bank: the upside risks associated with the weak krona – in the form of imported inflation and increased export demand – should be small in that the krona is expected to appreciate and demand abroad, especially in the euro area, is slack.

In the opinion of another Board member, since a large part of the necessary stock-market adjustment has already occurred and currencies are beginning to adjust, it is reasonable to suppose that the risk of an abrupt adjustment simultaneously in a number of financial markets is now smaller than it was two and a half years ago, when the stock market bubble was largest. Considering the major adjustments that have occurred in the course of the thirty months of share price adjustments, accompanied by the other shocks to which financial systems have been exposed, such as the terrorist attacks in the United States last year, it can be said that the financial system has been resilient and markets have functioned efficiently. Although the world still has imbalances in saving and thereby in exchange rates and there are also questions about the real estate markets in a number of countries and the ability of some institutions to absorb losses, the system as a whole has been robust, which is essential for a recovery. This member accordingly disagreed with the previous speaker's pessimistic assessment. There are, moreover, a number of bright spots abroad, in Europe as well as Asia and the Anglo-Saxon countries, including the American economy. A favourable trend for corporate earnings and strong household purchasing power – partly as a result of converting house mortgage loans to lower rates and a good development of disposable income – provide the foundation for a recovery in the United States.

The earlier speaker argued, however, that as long as household and business confidence in the United States is weak, it will take time for consumption and investment to pick up. In view of the uncertain situation, American consumers with heavy debts will probably choose to save more, which gainsays the earlier speaker's optimism. The improved profit margins to date have come mainly from cost-cutting and rationalisation; with weak demand, firms have little possibility of raising prices.

§3. Decision on an extraordinary monetary policy meeting

In that the prospects for inflation are difficult to assess, particularly on account of the uncertainty in the assessment of developments in the financial markets, the future course of events calls for heightened attention.

The Executive Board decided to hold an extraordinary monetary policy meeting at 1 p.m. on 14 November, when a new appraisal of the situation will be made.

§ 4. Monetary policy decision[2]

The Chairman summarised the monetary policy discussion under § 2 and found there were proposals for, respectively, an unchanged repo rate and a repo rate reduction of 0.25 percentage points.

A vote was taken and the Executive Board decided

- to hold the repo rate unchanged at 4.25 per cent as of 23 October 2002
- to accordingly hold the deposit and lending rates unchanged
- to announce the decision at 8 a.m. on 17 October 2002 with the motivation and wording contained in Press Release no. 61 (Annex B to the minutes), and
- to publish the minutes of today's meeting on Wednesday 30 October 2002.

Deputy Governor Kristina Persson entered a reservation against the decision to keep the repo rate unchanged and stated that the repo rate should be lowered 0.25 percentage points with the motivation that the picture presented in the Inflation Report provides a good foundation for an interest rate cut. Moreover, there are large risks of developments being even worse, both in Sweden and in the rest of the world, on account of the security policy situation in the Middle East, continued financial market unrest, weaker domestic demand and decreased fiscal stimulation.

This paragraph was immediately confirmed.

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