No. 20

SEPARATE MINUTES of the Executive Board meeting on 4 December 2002

<u>Present</u>: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
–
Jan Bergqvist, Chairman of the General Council
Johan Gernandt, Vice Chairman of the General Council
–
Kerstin Alm
Malin Andersson (§ 1)
Claes Berg
Jörgen Eklund
Björn Hasselgren
Per Håkansson
Hans Lindblad
Tomas Lundberg
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Jörgen Eklund and Sara Tägtström would prepare draft minutes of §§ 1 – 3 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 28 November (section 1) and its significance for inflation prospects. The Inflation Report was then adopted (section 2).

1. New information about economic developments in Sweden and internationally

1.1 Financial markets

Developments in financial market since the previous meeting have been characterised by an increased propensity to take risks. The decreased volatility in equity markets and narrower credit spreads are illustrations of this. The upward tendency in equity markets since 9 October has ceased during the past week. Bond market tendencies have varied. Interest rates have moved up in the United States and the United Kingdom, while there has been some fall in Sweden and Germany. The Swedish krona has weakened against the euro but strengthened against the dollar. All in all, the krona's TCW exchange rate has been unchanged since the cut-off date for the December Inflation Report. According to Reuters' survey of money marker players, seven out of eleven expect that the repo rate will be left unchanged at today's meeting.

1.1 The international scene

Positive figures have come in from the United States. The purchasing managers index points to some improvement in manufacturing activity. The revised Q3 statistics show that GDP growth was marginally stronger than expected earlier. According to the Conference Board's index and measurements of consumer sentiment by the University of Michigan, household confidence rose in November.

The statistics from the euro area have been somewhat gloomier. Consumer confidence here fell back in November. The IFO picture of the business climate in Germany, the euro area's largest economy, shows some deterioration in November, though this was less marked than observers had expected. Unemployment in the euro area moved up to 8.4 per cent in October. According to new preliminary statistics for the harmonised consumer price index, HICP, the 12-month rate of price increases in the euro area in November was 2.2. per cent.

1.2 Developments in Sweden

According to the November business tendency survey from the National Institute of Economic Research, new orders have been unchanged in recent months and the order situation is weak. The purchasing managers index rose in November and its picture of manufacturing activity is somewhat more positive than the Institute's business tendency data. However, the impressions conveyed by components of the index are not uniform; the sub-index for orders shows no improvement, while there has been some positive shift in the sub-index for production plans.

The National Institute's November survey of households' purchasing plans indicates that households have not changed their relatively optimistic view of the Swedish economy and more households now believe that unemployment will fall.

Wage developments in September were in line with the Riksbank's expectations. At total level, wage increases in the first nine months of this year from the same period a year earlier averaged 3.7 per cent. The Municipal Workers' Union has presented wage demands for the 12 months from April 2003 to March 2004; they include a drive for low-paid groups and amount to a local increment of 5.5 per cent.

The Board noted that the new statistics since its meeting on 28 November are in line with the picture in the Inflation Report.

2. Inflation Report 2002:4 adopted

First Deputy Governor Lars Heikensten presented a draft of Inflation Report 2002:4 (annex A to the minutes). The Inflation Report is based on the presentations and discussions at the Board meetings on 20 and 28 November.

The Executive Board decided to adopt the Inflation Report as presented and to have it published at 9.30 a.m. on 5 December.

Reservation

Second Deputy Governor Eva Srejber entered a reservation against the decision to adopt the Inflation Report and made the following statement:

I broadly agree with the main scenario in the Inflation Report, where it is considered that future growth in Sweden will be in line with the long-term trend and the path of inflation will be close to the Riksbank's target. I also largely concur with the picture of risks, with a downside international risk connected with a more abrupt course of the remaining adjustments to balance sheets and current-account balances and an upside domestic risk as regards the labour market and wage formation, but attach somewhat more weight to the latter than the majority. In addition to these risks, moreover, I perceive an upside risk of growth abroad being higher as risk propensities strengthen at the same time as economic policy in most countries is expansionary and balance-sheet adjustments in this risk scenario are expected to remain orderly. Consequently I do not share the majority view that the downside risks predominate over the upside risks. In my opinion the spectrum of risks is balanced.

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 monetary policy (section 2) was preceded by an account 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.

In the time perspective on which monetary policy normally focuses, inflation is judged to be somewhat below the Riksbank's target. Inflation has followed the path that was foreseen in the October Report. The 12-month rates of UND1X and CPI inflation in October were 2.4 and 2.5 per cent, respectively.

Real economic activity is still weak. Manufacturing activity has worsened abroad as well as in Sweden. The conditions for a domestically driven recovery in the United States are judged – for much the same reasons as earlier this autumn – to be relatively favourable but prospects for the euro area now seem to be somewhat worse. Growth in many euro countries has been weaker than expected. The uncertainty in financial markets has decreased to some extent, though it is still too early to conclude that the stabilisation will last. The GDP forecast for the euro area has been revised downwards for this year and 2003. Overall growth in the OECD is judged to be 1.4 per cent this year, 2.2 per cent in 2003 and 2.7 per cent in 2004.

The weaker demand trend implies subdued international price pressure. The oil price has fallen since the time of the October Inflation Report and although there has been an upward tendency recently, the future path is judged to be somewhat weaker than foreseen in October. The Swedish krona is expected to appreciate during the forecast period. Compared with the assessment in October, all this will tend to dampen the development of prices for imported products in Sweden.

The weaker manufacturing activity in a number of Sweden's major trading partners has worsened the prospects for the Swedish economy. Exports have slackened, manufacturing output has continued to fall and new orders are weak. It is foreseen, as in the October Report, that fiscal policy will be less expansionary. This is accompanied by only a moderate increase in household income – after a number of years of rapid growth – and lower demand will hold investment back. Even so, a recovery in domestic demand is foreseen in the forecast period. The GDP growth rates in the main scenario are 1.5 per cent this year, 2.1 per cent in 2003 and 2.3 per cent in 2004, which is somewhat lower than expected earlier. Resource utilisation in the forecast period is judged to be comparatively high but lower than in the previous assessment.

With the somewhat weaker demand situation in the main scenario, higher wages in the local government sector – as a result of the cancellation of the third year of the Municipal Workers' Union's wage agreements – are not expected to spread at all markedly to the private sector. But with higher corporate costs, due to increased negotiated contributions to pension funds, unit labour costs in the corporate sector in 2003 are now judged to be higher than foreseen in the October Report. This background adds to the uncertainty about the outcome of the 2004 round of wage negotiations.

The risk spectrum is relevant for the formation of monetary policy. Although there has been some stabilisation, the international economic outlook still represents a downside risk. This risk is not fully balanced by the upside risk for inflation that has to do with domestic inflationary pressure and wage formation. All in all, the balance of risks for inflation one to two years ahead is judged to be somewhat on the downside.

The overall assessment, with the risk spectrum taken into account, is that the 12-month change in UND1X is expected to be 1.9 per cent one year ahead and 1.8 per cent after two years. The corresponding CPI figures are 2.2 and 2.1 per cent.

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 and noted that opinions had differed in the group.

The case for lowering the repo rate lies in the Riksbank's forecast in the Inflation Report, where the main scenario and the risk spectrum point to inflation being somewhat below the Riksbank's 2 per cent target. The case against this is the fact that the Riksbank lowered the repo rate at the previous meeting and not much has happened in the meantime. The circumstance that the present forecast motivates a further cut of 0.25 percentage points indicates that the rate could have been lowered 0.5 percentage points on the previous occasion. Market expectations are mixed, with a majority believing that the Executive Board will leave the repo rate unchanged. The policy group had also noted that prior to the monetary policy meeting there had been no clear signals of a lowering.

2.2 The Board's discussion

The formation of monetary policy in recent years has been based on UND1X because the CPI is affected by factors whose impact on inflation or the inflation process is not judged to be permanent. The Board found no cause to alter the construction of policy in this respect. Monetary policy is accordingly based on an assessment of UND1X inflation.

In the course of the meeting it emerged to begin with that three Board members considered that the repo rate ought to be lowered but that the decision was not self-evident. Another two members, however, were more inclined to defer a cut and instead leave the repo rate unchanged; at the same time they underscored that the issue was not self-evident. These two members were influenced by the discussion and declared at the end of the meeting that they accepted that the repo rate could be lowered. The sixth Board member judged inflation prospects somewhat differently and considered on this basis that the repo rate should be left unchanged.

One of the first three Board members pointed out that it could go either way. On the one hand the inflation forecast favours a repo rate cut; on the other a cut is not expected by the market. Regardless of the figures, one can argue for no change or a reduction; but given the forecast it is difficult in this situation to make a case for not following the rule of action. For many years now monetary policy's strength has lain in using the inflation assessments as the foundation for repo rate decisions. This member recalled the situation in the early summer, when most people had concluded that the upward adjustment of the interest rate would continue and be fairly marked as international activity improved. However, the Riksbank's forecast in the June Inflation Report pointed to inflation being in line with the target at the forecast horizon, so that starting from the rule of action it was natural to leave the repo rate unchanged. The member argued that refraining from a cut when inflation, both in the main scenario and including the risk spectrum, was below the Riksbank's target would raise the question of why the Executive Board had chosen to depart from the rule of action. Given the inflation assessment, this member therefore felt inclined to lower the repo rate, though the member was also prepared to change this view if there were strong grounds for a different decision.

Another of the first trio pointed out that a cut was favoured by a number of arguments: forecast inflation is below the target; the Swedish repo rate exceeds the instrumental rate in the euro area to an unmotivated extent; and the next monetary policy meeting is not due until February. This Board member added, however, that the arguments for lowering the repo rate are not as strong as they were earlier in the autumn. The economic situation now looks more favourable but the danger of a poorer development is not over. As the upswing will probably be protracted and the risks are still there, reasons may arise for a further lowering of the repo rate. The security policy situation continues to constitute a risk of a weaker economic trend that may lead to further cuts. This member considered, however, that signals at present about the future direction of policy should be neutral.

The third Board member emphasised that it is a hard decision but that the decisive point should be what the forecast points to, that is, a cut. A departure from the rule of action requires good arguments. Other aspects also favour a cut on this occasion. If the interest rate is lowered and economic activity then looks like being stronger, there will be a discussion as to whether it is time to raise the interest rate but that is likely to happen regardless of how the Riksbank acts today. But if the Riksbank defers a cut and economic statistics point to a deterioration, there will be a discussion about why we did not lower the interest rate even though our rule favoured this. That discussion could be more difficult to handle. This member also compared the instrumental rates in Sweden and the euro area and noted that while it had not been difficult last spring to motivate a higher rate in Sweden, today it is not as easy.

The two Board members who expressed doubts about lowering the repo rate agreed with the policy group's assessment that not much has happened since the previous monetary policy meeting. One of them pointed out, however, that manufacturing activity looks somewhat stronger in the United States and Southeast Asia but the picture of Germany is poorer. Manufacturing in Sweden has remained weak at the same time as economic policy has and is expected to become less expansionary as a result of a less stimulatory fiscal policy, increased local government taxes and the krona's appreciation. This member noted that the Municipal Workers' Union's demand for an average wage increase of 5.5 per cent in the 2003 settlement year does not call for more than a marginal revision of the wage forecast for the local government sector. This means that the interest rate decision is more a question of timing. Considering that economic activity is on the way up, the basic position should be to defer a cut. If the economy had been in a downward phase the inflation forecast would unquestionably have implied a cut but when activity is turning upwards, a case can be made for waiting and seeing.

The other of these two Board members shared the opinion that an upward phase points to leaving the repo rate unchanged at today's meeting. This member mentioned that it is not unusual for the strength of a recovery to be underestimated just during the turning phase. Once activity has turned upwards, the recovery may proceed rapidly, as happened in the United States in 1999, for example. The member therefore preferred to wait and see even though inflation was judged to be somewhat below the target.

The sixth Board member pointed out that growth abroad had been quite good and said that Board members must not become unduly gloomy. Monetary policy is already expansionary as regards interest rates and the exchange rate. Future growth, in Sweden as well as the euro area, is expected to be in line with what is sustainable in the longer run without generating higher inflation. The member also noted that in view of the level of potential growth, for example in the euro area, one should not expect growth to be all that high. All in all, this member considered that the interest rate should be left unchanged.

One of the Board members who preferred to wait with a cut pointed out that the rule of action is not to be interpreted too mechanically.

Another Board member rejoined that the rule of action is a support that has helped the Board on many occasions. This member agreed that the rule is not to be applied mechanically and there needs to be a coherent account that motivates the conclusion which is reached. The member felt that this was the case today. The situation is more or less the same as at the time of the October Report, when we pointed out that economic prospects abroad, above all in the euro area, had deteriorated.

Another Board member agreed and argued that those who wished to disregard the forecast and leave the interest rate unchanged should instead declare what they consider to be wrong with the basis for the decision and the forecasts.

A Board member raised the question of whether it is an advantage to start from a low interest rate when activity turns upwards.

Another Board member stated that although it is the level of the interest rate that is central for the assessment of inflation, the initial level never seems to be considered when interest rate increases are discussed. Once economic activity appears to be rising, many call for interest rate increases almost automatically. In that sense the level from which one starts does not matter all that much.

Another Board member took up what had been said earlier about the difference from the ECB's instrumental rate and argued both that the comparison should focus on the real instead of the nominal interest rate and that a positive difference can be motivated by the Swedish krona still being weak, even though there has been an appreciation, as well as by fiscal policy in Sweden being more expansionary than in the euro area. This member went on to say that besides analysing appropriate interest rate adjustments, one should make an overall assessment of the level of interest rates that is suitable for the economy, an assessment that should include a judgement of fiscal policy's effects.

One of the two Board members who had expressed a preference for deferring an interest rate cut said that the discussion had made an impression; as no decisive reasons had been put forward for departing from the present rule of action, this member was prepared to support a cut of 0.25 percentage points. If growth turns out to be stronger than expected, monetary policy can be realigned in a less expansionary direction in the future.

The Board member who had shared this member's earlier preference concurred with this view.

§ 3. 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.

The Executive Board decided

- to lower the repo rate 0.25 percentage points, to 3.75 per cent, as of Wednesday, 11 December, 2002

- to lower the lending rate 0.25 percentage points, to 4.5 per cent, and the deposit rate 0.25 percentage points, to 3.0 per cent, as of Wednesday, 11 December, 2002

- to announce the decision at 9.30 a.m. on 5 December 2002 with the motivation and wording contained in Press Release no. 82 (Annex B to the minutes), and

- to publish the minutes of today's meeting on Thursday, 19 December, 2002.

Second Deputy Governor Eva Srejber entered a reservation against the decision to lower the repo rate and stated, with reference to her reservation against the decision to adopt the Inflation Report under § 1 above, that the repo rate should be unchanged at 4.0 per cent.

This paragraph was confirmed immediately.

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