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SEPARATE MINUTES
Executive Board, No. 6

DATE: 17 March 2003

TIME: 1 p.m.

PRESENT: Lars Heikensten, Chairman
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg

Jan Bergqvist, Chairman of the General Council

Kerstin Alm
Claes Berg
Jörgen Eklund
Anders Eklöf (§ 1)
Kerstin Hallsten
Björn Hasselgren
Per Håkansson
Leif Jacobsson
Hans Lindblad
Annika Svensson
Sara Tägtström
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

It was noted that Annika Svensson and Sara Tägtström would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

New information

The meeting began with an account of the new information received in addition to the Inflation Report that was established on 12 March. Employment in the United States had fallen in February compared with the previous month. Retail trade figures in the USA were also weak for the beginning of the year, while housing investment increased in January.

Developments in the financial markets are marked by uncertainty over the Iraq conflict. This is expressed in, for instance, a continued high level of risk aversion among investors and a high level of volatility, particularly on the international bond markets. Long-term bond yields and share prices have risen over the past few days as a result of expectations that the war may be short-lived and that geopolitical unease will thus be more rapidly dispersed. On the foreign exchange market, this has resulted in a general appreciation of the US dollar and thereby some weakening of the krona against the dollar. All in all, the krona's TCW exchange rate has remained largely unchanged over the past week. All of the analysts of financial markets who have been asked their opinion expected a lowering of the repo rate by 0.25 percentage points and these expectations were also mirrored in market prices.

Inflation in Sweden rose in February and the increase in UND1X inflation amounted to 3.3 per cent. This was mainly due to higher energy prices. The rate of UND1X, excluding energy amounted to 1.9 per cent in February. Statistics received over the past week were largely in line with the picture painted in the Inflation Report. The outcome for inflation does not change the assessment in the Inflation Report that the energy price increase essentially entails temporary effects on price levels and that inflation will probably fall again during the spring as electricity and oil prices decline.

Inflation Report

Deputy Governor Irma Rosenberg presented a draft of Inflation Report 2003:1, which also comprises the Riksbank's account to the Riksdag Committee on Finance (*Annex A to the minutes*). The Inflation Report is based on the presentations and discussions at the Board meetings on 6 and 12 March.

The Inflation Report shows that economic growth in both Sweden and abroad recovered somewhat last year. However, the prolonged uncertainty connected to falling share prices and a risk of war in Iraq have meant that international economic prospects have deteriorated somewhat since December. Developments in the large euro countries have been surprisingly weak and the prospects of a clear recovery appear gloomier now. The picture of a gradual recovery painted by the Riksbank in December – and in connection with the monetary policy decision in February – still largely holds, but the upturn is expected to be slower. This means that resource utilisation will remain relatively modest during the forecast period, which will contribute to a more subdued development in international prices.

The lower level of international demand will lead to Swedish exports developing at a slightly slower rate than in the Riksbank's earlier assessments. There is as yet no clear sign of an upswing in manufacturing activity. During the present year households' purchasing power is expected to be subdued by increases in municipal and county council taxes, higher energy prices and rising unemployment. This, together with continued unease over the Iraq conflict, is expected to entail a rather more subdued growth in consumption. The Swedish National Accounts have been revised and an analysis of these and other economic indicators implies that there are more unutilised resources than was previously anticipated. All in all, this means that resource utilisation is also expected to be slightly less strained in Sweden during the forecast period.

The forecasts in the main scenario of the Inflation Report indicate a rate of increase in CPI one year ahead (March 2004) of 1.0 per cent and in UND1X of 0.8 per cent. The corresponding figures two years ahead (March 2005) are 1.9 per cent and 1.7 per cent respectively. The average inflation rate up to the end of March 2004, both CPI and UND1X, is expected to be 2.0 per cent. From April 2004 to the end of March 2005 the average rates are expected to be 1.7 per cent for CPI and 1.4 per cent for UND1X.

With regard to the risk spectrum, the possibility that the higher energy prices will have more prolonged effects on inflation cannot be ruled out. In addition, there is a risk that the outcome of the wage bargaining rounds in the autumn will be higher wage increases than in the main scenario of the Inflation Report. The primary downside risk for Swedish inflation is connected with the uncertainty over economic developments in the rest of the world. There is a risk that activity in the euro area will be weaker than anticipated. It is also significant that the geopolitical situation creates uncertainty and poses a threat to the global economy which is difficult to estimate but should be included in the information on which monetary policy decisions are based.

Decision

The Executive Board decided

- to adopt the Inflation Report as presented
- to present the report to the Riksdag Committee on Finance and
- to publish it on 18 March at 9.00 a.m.

This paragraph was confirmed immediately.

§ 2. Monetary policy discussion

Deputy Governor Irma Rosenberg began by presenting the monetary policy group's discussion of the Inflation Report[1]. She observed that there were differing opinions with regard to monetary policy at present, but that most of those participating in the discussion advocated a lowering of the repo rate. The Riksbank's forecast in the Inflation Report indicates a path for inflation that is clearly below 2 per cent one to two years ahead. This is largely because energy prices are expected to fall back from their present high levels. Such temporary changes in inflation do not need to influence monetary policy. In addition, resource utilisation in Sweden and abroad is assessed to be less strained than before. The total assessment of inflation in the report was assessed as providing scope for reducing the repo rate. Another important factor is that the unease and uncertainty in the global economy risks leading to a worse development in the short term than the report's main scenario.

The Executive Board observed that monetary policy had in general been based on forecasts of UND1X inflation in recent years. This index was chosen because it is less sensitive than CPI to temporary effects on inflation connected to changes in indirect taxes, subsidies and

[1] The monetary policy 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.

house mortgage interest expenditure. In addition, it is at present appropriate to take into account developments in electricity and oil prices. The upturn in prices on these products is assessed as essentially the result of temporary supply shocks and thereby not relevant to the shaping of monetary policy, in line with the Riksbank's clarification of monetary policy in 1999.

All of the members shared the monetary policy group's opinion that the repo rate should be lowered by 0.25 percentage points given the current inflation forecast and the total risk spectrum. One of the members felt, however, that there were also arguments in favour of leaving the repo rate unchanged, while another member did not want to rule out the possibility of lowering by more than 0.25 percentage points and that further reductions might be necessary in the future. Two members were doubtful about lowering the interest rate, but emphasised that it could quickly be raised again. Two other members made the assessment that the future direction of monetary policy was an open issue and that there was considerable uncertainty at present. The discussion largely focussed on the risk spectrum.

One member expressed support for the picture painted in the Inflation Report, but wished to modulate the risk spectrum somewhat. This member pointed to the considerable uncertainty in Europe, particularly in Germany, and felt that perhaps the picture painted in the Inflation Report was too bright, given recent developments. The member also saw a risk of a poorer development beyond the forecast horizon. At the same time, this board member saw a risk of stronger international economic activity and claimed that in the USA there had been a clear adjustment of companies' balance sheet imbalances, both with regard to assets and liabilities. This has been expressed, for instance, in an improvement in companies' liquidity and liabilities in relation to equity. This in turn has meant that economic activity and share prices can rise rapidly when the turning point comes. However, there may also be areas of the US economy where a negative development has been hidden behind the uncertainty afflicting the markets at present. This could be an explanation for the slightly more subdued recovery we have seen recently. The member weighed together the upside and downside risks from international economic activity and came to the conclusion that the downside factors are substantial at present. This, together with the fact that there are unutilised resources in the Swedish economy, was considered motivation for lowering the repo rate.

Another member saw greater risks of an even weaker global economy. This member leaned more towards a collective downside risk for Swedish inflation than the balanced risk spectrum depicted in the Inflation Report, but accepted the difficulties of estimating the effects of a serious war scenario. The member had a more pessimistic view of the course of the Iraq conflict. In addition to the risk of war and fear of terrorist actions, there are several other factors holding back an upturn in economic activity. The adjustment to companies' and households' balance sheets is still taking place, the current account and budget deficits in the USA are considerable and both companies and consumers have become more pessimistic about the future. The current account deficit could lead to a continued depreciation of the dollar. As neither the Chinese nor the Japanese currency will be allowed to appreciate in relation to the dollar, it is mainly Europe that will bear the adjustment, which will not contribute to its growth. This member also pointed out that the geopolitical concern arose in a situation with an already weakened global economy and warned that it could very well remain and worsen even if the Iraq conflict were to be resolved quickly.

A third member argued against the previous member's description of the underlying economic developments in the USA and instead pointed to the slightly more positive picture described in the main scenario of the Inflation Report, with rising profits and a continued high level of productivity. This member considered, like the first speaker, that the adjustment in balance sheets had made considerable progress. The slightly weaker development after the New Year could partly be attributed to seasonal conditions, according to the member. However, this member did not rule out the possibility of weaker economic developments in the USA, which is more heavily dependent on oil than Europe and where rising oil prices will not be subdued by a stronger currency. Summing up, this member felt that the USA was better equipped for growth than Europe. With regard to the ongoing reform work in Germany, the member considered it might have an effect on potential growth in the slightly longer term, but called for more discussion with regard to demand. A ray of hope in the world economy is in South East Asia and China, which are demonstrating strong growth rates and whose importance to world trade is increasing and may be underestimated. With regard to the conflict in Iraq, this member said there was potential for a much better development on the stock market and interest rate market when the uncertainty declines. The market has earlier reacted rapidly and positively to news indicating a reduction in uncertainty.

The same member emphasised that there is a risk of continued high electricity prices in Sweden, which could also have contagion effects. The greatest risk from the energy price rise was linked to wage formation, according to this member. The member also feared possible demands for compensation, not just because of the early termination of the Municipal Workers' Union's wage agreement, but also as a result of wages for white collar workers increasing more rapidly than those for blue collar workers, despite lower collective agreements. The member also feared that these tensions could obstruct coordination within the Trade Union Confederation in the coming wage bargaining rounds this autumn. It may also be difficult for the social partners to sign nominal wage agreements at non-inflationary levels, which according to the National Mediation Office are approximately 1.5 per cent at union level, given that inflation has been higher than the target level for some time now. The member brought up the property market as a further cause for concern, given a high burden of debt in certain regions and a low lending rate to begin with. Lowering the interest rate could in this situation put further upward pressure on property prices. This member agreed with considerable hesitation to the proposal to lower the interest rate and pointed out that the Executive Board should be prepared to quickly raise the rate again.

A fourth member agreed that there was a base for a continued economic upturn, but emphasised that the uncertainty connected with developments in Iraq made it difficult to interpret incoming economic statistics. This member wondered whether it was concern over a war or more underlying factors, such as continued adjustment of balance sheets and structural problems in Europe that lay behind the fact that the global economy has moved sideways since the New Year. Regardless of which explanation is correct, the truth will be revealed in the near future. If market participants wait to see the outcome of the Iraq conflict, the recovery may accelerate once again when the uncertainty disappears and the effects of the expansionary economic policy will have a full impact. If it is instead fundamental factors that lie behind the slowdown, this will also be clear when the war concerns have dissipated and economic statistics become easier to interpret.

The same member observed that a determining factor in the development of Swedish inflation is whether the lower level of resource utilisation would manage to hold back contagion effects from rising energy prices or whether inflation would become entrenched at a high rate. This comes after the inflation rate has exceeded the 2 per cent target for two years and Swedes begin to realise that they may have a third year with inflation above this level. According to surveys, inflation expectations in the longer term exceed 2 per cent and the member was concerned that participants in the economy would come to expect higher price rises. This, combined with a continued rise in prices for services and administration, is a cause for concern prior to the autumn's wage bargaining rounds. In addition, monetary policy is already expansionary, with very low real interest rates. Uncertainty over the future shaping of fiscal policy was put forward as a further complicating factor when assessing inflation. It is unclear whether the expenditure ceiling can be met through savings or in another way with other effects on demand. This member supported an interest rate reduction at the present time, but was agreed with the previous member that the Executive Board should be prepared to raise the rate again to avoid excessive monetary policy stimulation if the recovery accelerated in the near future. The member also reminded that the economy reached its lowest point in 2001 and that growth was surprisingly strong in 2002, despite terrorist threats and balance sheet adaptations. The member commented on an earlier member's concern for the current account deficit in the USA, saying that an imbalance in one region also implied imbalances, i.e. surpluses, in other parts of the world. A combination of exchange rate adaptations and growth changes is required to facilitate the adjustment process.

A fifth member considered that the situation was difficult to assess and agreed with the previous member that it is difficult to know whether the statistics received recently reflect fear of a war or whether more fundamental and underlying forces are curbing the recovery. Following a potential resolution of the conflict in Iraq, we can probably expect share prices and long-term interest rates to rise. However, this member pointed out the importance of not over-interpreting these movements on the markets. It is quite possible that the next stage in monetary policy will be to raise the rate, although one cannot say now whether this will be the case. However, before possibly raising the rate in the future, one should have received information regarding the real economy that indicated the recovery had really accelerated. This member found it difficult to see what information could come in the near future that would indicate a clear stabilisation of the global economy had taken place. The member considered that the downside risks, connected to the geopolitical uncertainty, will dominate the picture of the coming months, although the risk spectrum for inflation is balanced one to two years ahead. According to this member, the main reason for lowering the rate was that the total inflation forecast one to two years ahead provided scope for it.

A sixth member agreed on the whole with the previous speaker and pointed out that in the short term the international downside risks also motivate lowering the interest rate. The member was also concerned that the protracted insecurity had increased the risk of a much worse development in economic activity and agreed with a previous member that the geopolitical uncertainty was not limited to Iraq.

Two members envisaged risks of a stronger international economic climate and pointed out that it was a genuinely difficult situation for monetary policy, even if they decided to support a lowering of the repo rate. One of these members stressed that in the short term there could just as easily be a rapid reversal of sentiment that could push up consumption and investment. Another member agreed with this.

One member referred back to the earlier discussion on whether electricity prices would fall and expressed concern that certain electricity companies demand the same return on equity as other companies in the manufacturing sector. The member objected to this reasoning as electricity companies take a lower risk than manufacturing companies on average as they face a more stable demand. The member also played down the importance of households' burden of debt. If debts are put in relation to household wealth, the situation appears less problematic.

Another member pointed out, in contradiction to the member who saw a risk of wage inflation, that the demand situation and a deteriorating labour market would probably have a subduing effect on the rate of wage increase.

Two other members shared the opinion that no new upside risks had come from wage formation since December, with the exception of the increase in energy prices. On the contrary, the wages outcome has been slightly lower and the demand situation slightly weaker. It is not until the autumn, when the wage bargaining rounds start up, that new information will be received that might have a significant effect on this assessment.

§ 3. Monetary policy decision[2]

The Chairman summarised the monetary policy discussion under § 2 and found there was a proposal to lower the repo rate by 0.25 percentage points.

The Executive Board decided

- to lower the repo rate by 0.25 percentage points to 3.50 per cent and that this decision would apply from Wednesday, 19 March 2003,
- to lower the lending rate by 0.25 percentage points to 4.25 per cent and to lower the deposit rate by 0.25 percentage points to 2.75 per cent with effect from 19 March 2003,
- to announce the decision at 9.00 a.m. on 18 March 2003 with the motivation and wording contained in Press Release no. 19 *(Annex B to the minutes)* and
- to publish the minutes of today's meeting on Friday, 28 March 2003.

This paragraph was confirmed immediately.

Minutes by:

Kerstin Alm

Checked by:

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

Lars Heikensten	Eva Srejber	Villy Bergström
Lars Nyberg	Kristina Persson	Irma Rosenberg