Separate Minutes
Executive Board, No. 17

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

DATE: 3 July 2003

TIME: 1 p.m.

PRESENT:

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

—

Johan Gernandt, Vice Chairman of the General Council

—

Kerstin Alm
Claes Berg
Hans Dellmo
Jörgen Eklund
Kerstin Hallsten
Jan Hansen (§1)
Björn Hasselgren
Leif Jacobsson
Per Jansson
Stefan Laséen (§1)
Petra Lennartsdotter
Åsa Sydén
Anders Vredin
Christina Wejshammar
Martin Ådahl

§ 1. Monetary policy discussion

It was noted that Petra Lennartsdotter and Martin Ådahl would prepare draft minutes of paragraphs 1 and 2 on the agenda for the meeting.

The discussions were based on analyses and assessments compiled by the Monetary Policy Department. These analyses and assessments were based in turn on the technical assumption that the Riksbank's repo rate would remain unchanged at 3.00 per cent up to and including Q2 2005.

1. Economic developments and inflation prospects

The Executive Board concluded that economic developments in Sweden and abroad were largely in line with the assessment of the June Inflation Report. Over the past year, economic activity in Sweden and abroad has gradually deteriorated and the expected recovery has therefore been delayed.

By and large, developments in the financial markets have also followed the assessment made in the June Report. Since then, share prices on Stockholmsbörsen and all major equity markets have risen. Long-term interest rates in both Sweden and abroad have been marked by the uncertainty surrounding the economic recovery but are today somewhat higher than at the time of the June Inflation Report. The krona/euro exchange rate is roughly on a par with that at the beginning of June, while the dollar has strengthened somewhat against both the krona and euro.

In the June Inflation Report, it was assessed that a revival in the world economy had been delayed somewhat, due in part to the financial and geopolitical concerns in previous months. However, it was judged that economic activity would strengthen at the end of the current year, underpinned by expansionary monetary policy and less uncertainty.

The international economic climate has been characterised by continued weakness in both the industrial sector and employment growth. Several central banks have cut their key interest rates since the June Inflation Report. The ECB lowered its refi rate by 0.5 percentage points to 2 per cent, and the US Federal Reserve cut its Fed funds rate by 0.25 percentage points to 1 per cent. This was expected and has not given rise to any revisions in the assessments of international growth prospects.

In the United States, a new fiscal package has been adopted involving tax cuts for households and firms, a reduction in taxes on capital income and an increase in transfers to the state governments. This is expected to have a positive impact on household consumption in particular at the end of this year and during 2004. Despite the size of the package, it is anticipated that the effects on GDP will be relatively small, partly because households are expected to save a large part of their additional income from the cuts and long-term interest rates are expected to rise. Nevertheless, the fiscal package gives reason to expect somewhat stronger growth in the United States in both 2003 and 2004 compared with the forecast in the June Inflation Report. In the euro area, the recovery has been delayed further, as indicated by the National Accounts for Q1 and various confidence indicators for households and firms. Due to the combination of stronger US developments and a weaker European trend, the Executive Board's assessment of world market growth and international export prices has not changed since the June Report.

In the June Inflation Report, Swedish GDP was forecast to grow by 1.2 per cent this year and 2.4 per cent in both 2004 and 2005. This forecast was based in part on the weak international development and a delayed increase in investment. Furthermore, resource utilisation was anticipated to be relatively low over the entire forecast period.

The most significant change since the June Report has been the Riksbank's repo rate cut of 0.5 percentage points. In addition, the National Accounts for Q1 have affected the forecast for supply and demand in the Swedish economy. GDP growth in Q1 this year was unexpectedly high, coming to 2.2 per cent according to the National Accounts. This was largely due to somewhat stronger public consumption and inventory investment, as well as slightly weaker imports of services, than previously expected. Meanwhile, business tendency data has pointed to continued sluggishness in manufacturing activity. Households appear recently to have become more optimistic about the future, however. All in all, it is anticipated that GDP growth and resource utilisation will be marginally higher in coming years than was assumed in the June Inflation Report.

In the June Report, it was assessed that wage developments would be more subdued during the current year compared with 2002. The continued deterioration in the labour market, including a rise in the number of discharge notices, a reduction in the number of job vacancies and the wage outcomes in March, has lent support to this assessment. Since the June Inflation Report, the Municipal Workers' Union (MWU) has signed a new, two-year wage agreement with the Swedish Association of Local Authorities and the Swedish Federation of County Councils. While the outcome of the agreement proved somewhat lower than expected, the current assessment of the rate of wage increases is based on somewhat higher resource utilisation, which has the opposite effect.

In the June Inflation Report, CPI and UND1X inflation were expected to show a year-on-year increase in May of 2.1 and 2.3 per cent, respectively. However, recent inflation has been somewhat lower than expected, reaching 1.9 and 2.0 per cent respectively in May according to CPI and UND1X. This was partly attributable to unexpectedly low fruit and vegetable prices as well as lower-than-expected imported inflation. The price of crude oil, however, has risen more than anticipated and is expected to remain at a higher level over the coming months as well. The effect of this on the general price level will be counteracted by the somewhat stronger krona in 2003. The long-term assessment of the price of crude oil is unchanged, however. All in all, there may be reason to expect somewhat lower imported inflation over the coming year.

Compared with the assessment in the June Inflation Report, CPI and UND1X inflation are expected to be marginally higher at the end of the forecast period as a result of the slightly stronger development in demand. Electricity prices, which had a considerable impact on inflation during the spring, are still expected to fall gradually over the summer and have a dampening effect on inflation in the year ahead.

Like the assessment in the June Inflation Report, the Executive Board concluded that there is still an overall downside risk from the international economy, while the main risks of higher inflation still stem from developments in electricity prices and wage costs.

All in all, the Executive Board concluded that the outlook for international economic activity has remained largely unchanged since the June Inflation Report. In Sweden, the June rate cut has contributed to somewhat better prospects for the real economy. Resource utilisation is therefore expected to be slightly higher in coming years, as is inflation two years ahead. However, there is still anticipated to be unutilised resources during the forecast period. UND1X inflation is expected to fall short of the Riksbank's target both one and two years ahead. This is also the case when excluding energy prices.

1.1 The Executive Board discussion

All members highlighted the fact that very little new information has been received since the June Inflation Report and that the main difference has been the Riksbank's own rate cut of 0.5 percentage points.

One member said that the most significant development, besides the repo rate cut in Sweden, was a generally more negative view of the international economy among many analysts. This had also left its mark on the actions of several other central banks. In particular, the outlook for the euro area had become gloomier, not just in Germany but also in other large euro area economies such as France.

A second member was of the opinion that there had been a further shift in global growth, with more sluggish development in the euro area and a somewhat stronger trend in the United States and other parts of the world. Meanwhile, the member noted that there had been a continued normalisation of the financial markets, characterised by higher share prices and narrowing credit spreads, the latter applying in particular to firms and countries with lower credit ratings. This improvement in the financial markets could be an indication of future developments in the real economy. Levels of borrowing are now higher due to the lower interest rates, in particular among firms with lower credit ratings. Companies have advanced further and further in the consolidation of their balance sheets, which no longer constitute the same obstacle to employment and investment.

A third member pointed to a number of bright spots in an otherwise weak economic climate: there are some indications of a revival in Japan, consumption has continued to rise quickly in the United States and the financial markets appear to have recovered somewhat. An upswing could be on the way in the United States, although the question is whether it could be sustained without any support from Europe. The member was pessimistic about the rate and strength of a rise in European activity and thereby also about the prospects for a recovery in the world economy on the whole. This would require substantial policy measures and a contracyclical policy in the major European economies, which does not appear likely at present. As long as the

investment recovery is delayed and the labour market continues to deteriorate, the outlook is highly uncertain. The threat of overly sluggish price rises, and even of recession, thus remains and exceeds that of rising inflation. The depreciation of the dollar may gather pace once again and constitutes a risk to the European recovery.

Another member raised the question of why the inflation rate during spring had been overestimated in earlier forecasts. One explanation often given is that electricity prices over the past six months fell back quicker than many had expected. However, the member did not believe that electricity prices gave a sufficient explanation and wondered whether the dynamics of growth and inflation could perhaps have been misjudged slightly. According to the member, it was important to monitor and assess inflation outcomes on a regular basis. A broad, unexpected rise or fall in prices could, even if not particularly large, be an indication that inflationary pressures had not been assessed correctly. It is another matter if the cause of the misjudgement was related to only one or two groups of goods and services. Changes in administrative prices have usually even less significance as indicators of the demand climate. With regard to these issues, the member called for a more in-depth analysis at the next meeting, particularly in the event of slight, unexpected falls in inflation in the future.

Several members commented on the discussion of productivity and GDP figures that had arisen recently, partly as a result of an article in Swedish daily Dagens Nyheter. The essence of the article was that Swedish GDP growth had been considerably overestimated in a number of recent years, mainly due to an overestimation of price declines in the IT and telecom sectors.

One member pointed out that GDP is not calculated from the production side only, which is the part of the calculations that had been criticised, but also from the demand and income sides. Had the calculations been as grossly incorrect as claimed, the discrepancy between these two calculation methods would have been so great that the figures should have been revised far earlier.

Another member agreed with this but stressed nevertheless that incorrect calculations from the production side could have affected the outcome, albeit to a much smaller extent than indicated in the article. According to the member, an in-depth discussion and greater transparency were desirable with regard to these issues.

A third member concluded that this was not a new problem and that the issue of how to measure prices and volumes correctly in the National Accounts had been under discussion for a long time. According to the member, it is not certain that the method used in other European countries is more correct. It is likely that the deflators for the production of telecommunications equipment in Sweden and other European countries are different, as different kinds of telecoms equipment are produced in different countries. The contention that Swedish growth was actually as weak as that of Germany in recent years has been contradicted by a number of other indicators such as redundancies, employment growth and the public finances.

One member raised the question of the MWU wage agreement, which was settled at the time of the June forecast. The member shared the basic view that an upward revision in growth would imply a stronger wage development. However, the member pointed out that the MWU agreement entailed a lower initial level than many had expected, in particular for next year. This had reduced the risk of high compensation demands and could also have some influence on the outcome of the autumn wage bargaining round, which therefore might not be as high.

Another member commented on the risk spectrum, referring in particular to the financial position of firms and households in Sweden, Europe and the United States. According to the member, it appeared that the financial imbalances for firms were being corrected, while the imbalances for households were, if anything, being reinforced. Despite an increase in households' savings, the ratio of debt to disposable income is rising, which is giving rise to risks.

The member wondered whether there was an element of "money illusion" in household behaviour. In theory, the willingness of households to incur debt should be determined by the real interest rate, which hasn't changed appreciably, and not by nominal rates, which have fallen sharply. In practice, however, it appears that households have been willing to increase their borrowing as long as declining nominal interest rates have entailed a largely unchanged nominal interest burden, in spite of the fact that their actual debt has increased significantly. For households with variable-interest loans, this could prove significant when rates rise once again. According to the member, an increase in interest rates might reflect positive factors such as lower unemployment and higher growth. But if interest rates are raised from a low level, when household debt is high, the effect on households' interest burden will be more dramatic than if the same rate rise had occurred from a higher level of interest rates and a lower level of debt.

According to the member, the expansionary monetary policy being pursued in the United States is fuelling household indebtedness there, and no clear drop in the high indebtedness has been perceived in the euro area either, despite the economic decline. When the US Federal Reserve emphasises that interest rates will remain low for a long time into the future, this reinforces households' borrowing behaviour. While this is not of great significance for monetary policy at present, it could be in the future if the ratio of debt to income continues to grow. The member pointed out, however, that from a historical perspective financial crises have always been the result of excessive borrowing by firms, and not households.

Another member observed that there was no obvious conclusion for monetary policy from this line of reasoning. If all were to go well, the consequences may be limited to monetary policy having a greater impact and interest rates not needing to be raised quite as much once economy activity eventually rebounds. However, it is of course important to monitor this trend carefully. In the event of a build-up of imbalances, the Riksbank should air its concerns clearly.

A third member said that the situation was different for firms and households. Monetary policy is currently having a greater impact on household demand, as interest relief affects consumption, while firms have continued to consolidate their weak balance sheets and are delaying investment.

A fourth member observed that monetary policy was having an effect on both households and firms. For companies, the low interest rates had led to balance sheet adjustments progressing so far that conditions were now in place for an increase in investment.

Yet another member pointed out that new, transitory factors have continuously been put forward to explain why a recovery in the world economy has been delayed, but that the fundamental reason has been that the recent economic cycle has been atypical for the post-war era. Previously, economic booms have been broken by rises in inflation and interest rates but this time the boom was broken when the over-optimism in investment activity and on the stock market came to an end. According to the member, monetary policy alone is not capable of turning around this kind of expectation-based decline; rather, other supporting factors are needed in order to reverse the pessimism of economic players.

Other members recalled that this economic decline has also been different in the sense that it has been both more protracted and less severe than previous declines, partly as a result of the expansionary economic policy.

One member added that we may not have seen the end of the downturn and that we may well have several years of more subdued growth ahead. An unusually long boom, such as that during the 1990s, could be followed by a long decline.

Another member pointed out that the present downturn in the United States had been less severe than earlier ones because household demand now, as opposed to what is usually the case, had remained buoyant. There is a threat of poorer development in the future, however, should the expansionary economic policy prove insufficient for households to continue to consume until investment gathers momentum once again. The severe decline in the euro area has further increased this risk.

2. The Executive Board's assessment of the monetary policy situation

2.1 Account of the monetary policy group's view of the monetary policy situation[1]

[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.

Deputy Governor Irma Rosenberg presented the monetary policy group's view of the inflationary trend and the monetary policy situation.

The group concluded that recent developments have reinforced the assessment presented in the June Inflation Report. However, inflation two years ahead is expected to be slightly higher than forecast in the June Inflation Report, although still marginally below the Riksbank's target. This applies to inflation both including and excluding energy prices. Adjusted for the risk spectrum, inflation is expected to fall somewhat short of the target two years ahead.

The members of the monetary policy group agreed that there was scope for a repo rate cut given the assessment of inflation. However, there was slight disagreement as to whether the rate should be lowered at the present time or whether, in light of the repo rate cut of 0.5 percentage points in June, a slower approach should be adopted with a view to obtaining further information. The group decided, however, to recommend an additional repo rate cut of 0.25 percentage points.

2.2 The Executive Board discussion

All members pointed out that the forecasts of inflation one to two years ahead are below the target, which according to the Riksbank's policy rule normally advocates a repo rate cut. The arguments in favour of following the policy rule in the current situation outweighed the arguments against, according to the members, although there were slight differences in their assessment of the balance of these arguments.

A number of members stressed in particular the fact that new information had not provided any clear indications of an upswing and that there were therefore no immediate inflationary threats.

One member observed that the repo rate could have been lowered by an additional 0.25 percentage points at the previous monetary policy meeting in June. The fact that this did not happen should be seen in the light of the relatively sudden change in the view of inflation which had occurred since the preceding meeting in April. The member mentioned a number of factors which had been re-assessed during the spring: the upswing in international economic activity had been delayed, particularly in the euro area. In Sweden, inflation had fallen quicker than expected. The low outcome in the MWU wage agreement had reduced the risk of wage inflation. The rate cut implemented in June was also relatively substantial. According to the member, it was presently difficult to see any reasons for delaying a repo rate cut. While the Riksbank and the majority of other analysts expected an upturn in international economic activity over the year ahead, there were no clear signs to this effect as yet. In spite of this, the member wanted to emphasise some arguments in favour of continued vigilance over inflationary risks: there have been rapid interest rate cuts abroad, where fiscal policy is also fairly expansionary. Even if the upturn has been delayed, it should gather pace in time, and it can't be fully ruled out that it will be a rather sharp turnaround once it happens.

Another member agreed that the repo rate could be lowered given that the inflation forecast was slightly below the Riksbank's target over the forecast period, thus enabling the bank to both fulfil the legal requirement of maintaining price stability and to promote a balanced development of economic activities. However, the member mentioned factors that advocated a different approach. A short period of time has elapsed since the last interest rate change, and new statistics has not altered the picture. Swedish growth has been reasonable, and there has been neither particularly high nor particularly low pressure on available resources. Neither is the future scenario especially negative, with resource utilisation, and thereby inflationary pressures, expected to increase in the time ahead.

Another member agreed that there was scope for an interest rate cut but also that certain factors opposed such a move. Firstly, there may be reason to wait for signs of the effects of the Riksbank's rate cut in June before lowering the repo rate further. Moreover, a rate cut could contribute to a deterioration in households' balance sheets in a way that could give rise to problems once interest rates rebound.

One member summarised the arguments in favour of a repo rate cut now as opposed to awaiting new information. On the whole, the same assessment of international developments as in the June Inflation Report still applies. However, demand in the Swedish economy, and thereby also inflationary pressure, are expected to be somewhat stronger as a result of the repo rate cut in June. Nevertheless, the forecast provides leeway for lowering the repo rate slightly more. While a substantial cut has recently been implemented, the information that has been received since then does not include any evidence of a turnaround in economic activity but rather to a marginally poorer development. All in all, this advocates lowering the repo rate now by 0.25 percentage points. Following such a cut, there is no need at present to provide any indications of the future stance of monetary policy. This will depend on new information about economic developments in Sweden and abroad and the effects these may have on inflation prospects in Sweden.

§ 2. Monetary policy decision

The Chairman summarised the monetary policy discussion under § 1 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 2.75 per cent and that this decision would apply from Wednesday, 9 July 2003,
- to lower the *lending rate* by 0.25 percentage points to 3.50 per cent and to lower the *deposit rate* by 0.25 percentage points to 2.00 per cent with effect from Wednesday, 9 July 2003,
- to announce the decision at 9.30 a.m. on 4 July 2003 with the motivation and wording contained in Press Release no. 47 (Annex to the minutes), and
- to publish the minutes of today's meeting on Thursday, 17 July 2003.

This paragraph was confirmed immediately.

Minutes by:
Kerstin Alm

Checked by:
Lars Heikensten
Eva Srejber
Villy Bergström
Lars Nyberg
Kristina Persson
Irma Rosenberg