No. 17:2 (2)

SEPARATE
MINUTES of the Executive Board meeting on 12 August 1999

Present Urban Bäckström, chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Kerstin Hessius
Lars Nyberg

Sven Hulterström, Chairman of the Governing Council

Kerstin Alm
Claes Berg
Mårten Blix (§1.1)
Hans Dillén (§1.1)
Kurt Gustavsson (§1.1)
Björn Hasselgren
Olle Holmberg (§1.1)
Per Jansson (§1.1)
Hans Lindberg
Christina Lindenius
Birgitta Lundin Östblom
Robert Sparve
Per Walter (§1.1)
Staffan Viotti

§1. Monetary policy discussion

It was noted that Christina Lindenius and Hans Lindberg would prepare draft minutes of items §§1 and 2 on the agenda for the meeting.

The meeting began with discussions of the factors in economic developments in Sweden and the rest of the world that are of importance for inflation prospects and the formation of monetary policy (section 1 below). The discussion of each aspect was preceded by presentations by Bank staff from the Economics Department and the Monetary & Exchange Rate Policy Department. The presentations were based on the technical assumption that the Riksbank's repo rate would be unchanged at 2.90 per cent up to the end of 2001 Q2. Thereafter the Executive Board discussed its assessment of inflation prospects (section 2) and on this basis drew its conclusions about the monetary policy situation (section 3).

1. Economic developments in Sweden and elsewhere

1.1 International activity and inflation

In the Inflation Report that was published on 3 June it was judged that in the period 1999–2001 the annual rate of GDP growth in the OECD area would be around 2 per cent. Annual inflation in the OECD area was expected to average 1.4 per cent in 1999, 1.6 per cent in 2000 and rise to 1.9 per cent in 2001 as a consequence of recoveries in Europe and Asia.

The Executive Board considered that, compared with when the Inflation Report was published, there were now grounds for expecting higher global growth. Economic activity in the OECD area has developed favourably during the summer. Real economic data in recent months and many indicators point to further strong growth in the United States, stronger activity in the euro area and a cautious turnaround in Japan. At the same time, price tendencies continue to be subdued. Notwithstanding rising prices for oil and other commodities, the outturn for prices in many countries has been lower than had been expected in the Inflation Report. The Board noted the central importance of trying to assess how inflation will develop as the global economy moves into an increasingly strong and more and more synchronised cyclical phase.

Economic growth in the United States in 1999 looks like being somewhat stronger than was expected in the Inflation Report. GDP growth in Q2 was admittedly weaker than in Q1, but leading indicators point to persistently stable growth in the near future and consumer confidence is high, even though there has been some decline in the wake of the recent rise in interest rates. Moreover, the more positive global growth prospects should lead to a stronger trend for US exports. But there is still the risk of the highly valued US stock markets undergoing an abrupt correction. In this context, however, the Board noted that US fiscal policy would be in a position to counter the effects of a more dramatic stock market fall. As regards price pressure in the US economy, the Board noted that the labour market seemed to be becoming increasingly tight and this had contributed to increased wage costs. At the same time, however, consumer price movements point to the continuation of a fairly weak tendency.

Economic activity in the euro area is gradually strengthening. It now looks as though growth in 2000 and 2001 will be somewhat stronger than was foreseen in the Inflation Report. Activity is still low in Italy and Germany in particular, but there are several indications of an improvement even there. Survey data suggest that firms are somewhat more positive about the future and expect production and exports to rise on account of a weaker currency and a recovery in global demand. Private consumption in the euro area is still rising and consumer confidence is high, even though there has recently been some fall. HICP inflation has tended to decrease in recent months from levels that were already low. But although the inflation rate has been lower than expected, the increased activity in the euro area means that inflation prospects are broadly unchanged from the Inflation Report.

Prospects for the Japanese economy are still somewhat difficult to assess. Very strong GDP growth in Q1 has been followed by mixed signals. There are signs of some recovery in manufacturing output and confidence is improving but consumption is weak and unemployment has risen to new record levels. In view of the strong Q1 growth, the annual rate for 1999 is now judged to be higher than expected earlier. But the path of the economy in the longer run is still highly uncertain.

1.2 Financial markets

The Board noted that since the publication of the Inflation Report, short-term and, above all, long-term interest rates in the rest of the world have risen. This has occurred in the context of increasingly strong global economic activity together with expectations of somewhat higher inflationary pressure and a tighter monetary stance in certain countries. Many market players now consider that a further increase in the US instrumental rate is imminent. The upward movement of interest rates has been particularly marked in the euro area, above all as a consequence of increasingly clear signs that economic activity there is improving.

The Board observed that during the summer, interest rates in Sweden had followed the European tendency but that recently the long-term interest rate differential against Germany had widened to around 0.75 percentage points, having previously fluctuated in the interval 0.5–0.6 percentage points. In this context the Board discussed the increased unrest recently in both Swedish and external interest rate markets. In the opinion of the Board, the wider differential between Swedish and German rates had to do with the general interest rate turbulence and could hardly be interpreted as an expression of decreased confidence in monetary policy's commitment to price stability.

The Board also discussed the rapid widening of swap spreads in Sweden during the recent interest rate unrest. The widening of these spreads seems to have been initiated by a corresponding tendency in the United States, where a number of factors probably contributed. The Board noted, for example, that in the United States demand for corporate credit seems to have increased temporarily in connection with the turn of the millennium. Moreover, expectations of rising interest rates and greater uncertainty in the interest rate market provide motives for using interest swaps to convert short-term borrowing into fixed interest rates. Furthermore, it is conceivable that in the aftermath of the financial turbulence in the autumn of 1998 there are now fewer players who are willing to accept risks and that this has contributed to less liquid swap markets during periods of unrest. But compared with the situation during the last autumn's financial turbulence, the current widening of swap spreads does not seem to be an expression of concern about increased credit risks in general.

The Board noted that the krona strengthened against the euro at the beginning of the summer, above all in response to signals of stronger activity in Sweden compared with the euro area, and has since then traded in the interval SEK 8.70–8.80 per euro. Attention was also drawn to the US dollar's general weakening in the latter part of the summer. Since the publication of the Inflation Report on 3 June, the krona has appreciated almost 5 per cent against the dollar. In effective terms, in this period the krona has become almost 2.5 per cent stronger. The krona's effective exchange rate is accordingly in line with the level that was expected in the Inflation Report. Finally, the Board noted that, in contrast to a common pattern earlier in the 1990s, the recent interest rate unrest and widening long-term interest rate differential with Germany have not been accompanied by a weakening of the krona.

1.3 Demand and supply

In the Inflation Report, the GDP growth rate for Sweden was judged to be 2.5 per cent in 1999 and 3 per cent in both 2000 and 2001. The Board noted that the preliminary national accounts for the first six months show a GDP growth rate of 3.7 per cent, which means that growth to date in 1999 has been higher than expected. The high rate for the first half-year means that even with no growth at all in the second half, the annual growth rate for 1999 will reach 3 per cent. Employment has also risen strongly, by more than 100,000 persons in the first half of 1999. Moreover, export growth has exceeded expectations. The improved international economic prospects, data on domestic orders and business tendency data all support the picture of stronger manufacturing activity in Sweden. Retail turnover, car sales and money and credit aggregates show, in turn, that household consumption is still rising strongly.

Against this background, the Board concluded that GDP growth in 1999 will be stronger than earlier expected and amount to about 3.5 per cent. There are also grounds for an upward revision of the growth assessments for 2000 and 2001, even though the prospects for those two years are more uncertain. If it were to last, the recent rapid upward shift in market interest rates, in Sweden as well as abroad, can act as a damper.

The Board also discussed the development of productivity and noted that the weak increase to date this year must be seen in part in the light of the large increase in employment in the services sector. Moreover, as the national accounts for 1999 Q2 are only preliminary, it is too early to draw any definite conclusions. The Board underscored the importance of analysing the development of productivity more closely.

Economic growth in Sweden has recently exceeded what is judged to be the long-term potential rate. The Board concluded, however, that unutilised resources still exist in the economy. The improved prospects suggest that in the coming two years these resources will be utilised more quickly than was expected earlier. In this context it was noted that the Riksbank's econometric estimates point to an output gap that is now comparatively small. But according to business tendency data and indicators of labour market shortages, the economy has more unutilised resources than the econometric estimates show. There are no signs, for example, of widespread shortages in the labour markets, even if the first tendencies of shortages in some areas of the labour market are discernible. So far, the matching of job-seekers and vacancies seems to be working comparatively smoothly and shortages of skilled labour in manufacturing have risen only slightly from a low level.

1.4 Prices

The Board noted that the rate of CPI inflation in July 1999 was 0.1 per cent, which is 0.1 percentage point higher than in the Inflation Report's main scenario. The deviation comes from house mortgage interest expenditure which, due to the increase in market interest rates during the summer, declined somewhat less than had been calculated. Inflation's underlying rate, measured by UND1X, in July 1999 was 1.2 per cent, which is less than one tenth of a percentage point higher than in the Report's main scenario. On the other hand, underlying domestic inflation, measured by UNDINHX, was 1.3 per cent in July and thus 0.2 percentage points lower than assumed in the main scenario. The unexpectedly strong GDP growth to date this year has accordingly not yet had any impact on underlying inflation. The Board concluded by noting that in the period May–July consumer prices have broadly followed the path in the Inflation Report's main scenario.

Price pressure at the producer level is rising but is still generally low. The barrel price of oil has moved up during the summer to over USD 19 but the tendency for other import prices has been weak and in line with the Riksbank's assessment. In the main scenario for the Inflation Report, the barrel price of oil was expected to rise to USD 14.5 at the end of 1999 and to USD 16.5 in two years time. In July 1999, rising petrol prices contributed to a CPI increase that exceeded expectations by 0.05 percentage points. If the world market price of oil were to stabilise at the current level, this could mean that, via increased petrol prices, the levels of the CPI and UND1X during 1999 are 0.2–0.3 per cent higher than in the Report's main scenario. The Board noted that during 2000 and 2001, on the other hand, the consumer price tendency may be weaker than expected if the oil price rise—which came earlier and was stronger than expected in the Inflation Report—is followed by unchanged or falling oil prices in the coming years.

1.5 Price effects of deregulation, political decisions, interest expenditure, etc.

The Board found no reason to revise the Inflation Report's assessments concerning price effects from Agenda 2000 and the deregulation of the Swedish markets for telecommunications and electricity.

In the June Inflation Report it was judged that changes in indirect taxes and subsidies, together with lower interest expenditure, would tend to hold back consumer prices by a total of 0.8 percentage points in one year and by 0.3 percentage points after two years.

The Board noted that since the publication of the Inflation Report, there have been no new proposals to alter indirect taxes and subsidies. However, government borrowing rates have risen considerably and as the spread between government bond and housing bond rates has widened, the interest rates that households are offered have risen even more. But as it is mainly the longer interest rates that have moved up, the effects on household interest expenditure—and thereby the direct impact on the CPI—are not yet as great. However, the effects may already be considerable by the turn of 1999 and then be in the region of 0.4–0.5 percentage points in 2000 and 2001.

1.6 Inflation expectations

The business tendency survey from the National Institute of Economic Research shows that manufacturing firms' expectations of CPI inflation in the year ahead moved up from 0.6 per cent in March to 1.0 per cent in June 1999. In the services sectors, inflation expectations rose by 0.1–0.5 percentage points to between 0.7 and 1.4 per cent. Households' inflation expectations, as measured by Statistics Sweden's HIP survey, show a similar increase, to 1.1 per cent in July 1999.

The Board noted that, according to survey data, inflation in the coming twelve months is expected to be below 2 per cent. For the longer run, however, the surveys show inflation expectations that are in line with the Riksbank's inflation target.

2. The Board's assessment of inflation prospects

The Board noted that in the Inflation Report's main scenario, the 12-month change figure for the CPI was judged to be 1.0 per cent in June 2000 and 1.6 per cent in June 2001. The corresponding assessments of underlying inflation, measured by UND1X, were 1.9 and 2.0 per cent, respectively. Moreover, the risk spectrum was symmetric around the main scenario.

2.1 The monetary policy group's[1] appraisal of inflation prospects

The Board's discussion of inflation prospects was preceded by an account of a corresponding discussion in the Riksbank's monetary policy group.

The policy group had judged that, given an unchanged repo rate, inflation excluding transitory effects from changes in indirect taxes, subsidies and interest rates (UND1X) would be broadly in line with the target in one to two years time. In view of the rising interest expenditure that may result from the recent increase in market interest rates, this in turn means that at this time horizon, CPI inflation may be above 2 per cent.

The policy group had also considered the risks in the inflation assessment. Just as in the Inflation Report, the risk spectrum was judged to be symmetric around the main scenario. The main threat to growth in the world economy is still the financial imbalances in the United States. At the same time, a stronger recovery in Europe and Japan is conceivable, partly as a consequence of expansionary monetary stances. In Sweden, the future formulation of fiscal policy, which may include tax reductions already during 2000, and the economy's potential growth rate, which may be higher than assumed in the main scenario, are two forces that are still working in contrary directions as regards the risk spectrum for inflation in the longer run. All in all, however, the uncertainty in the assessment has diminished since the Inflation Report, mainly because new statistics indicate that the international economic situation is now more stable.

[1] The group is made up of Riksbank staff and is headed by one of the Deputy Governors.

2.2 The Board's discussion

The Board noted initially that in its discussion of inflation prospects and the formulation of monetary policy, in the present situation it was reasonable to disregard the effects of changes in indirect taxes, subsidies and interest rates because these factors were not judged to have a permanent effect on either inflation or inflation expectations. The subsequent discussion accordingly focused on inflation as measured by UND1X.

The Board considered there had been a further improvement in economic prospects, internationally as well as in Sweden. Stronger economic growth in Sweden and increased resource utilisation were indicative of growing pressure on prices. The Board found, however, that in this situation it was not in total agreement about inflation prospects. Two members considered that the high growth rate can be expected to generate higher inflationary pressure than the policy group had suggested. In the opinion of the other members, higher growth did suggest that price pressure would in time rise faster than assumed in the Inflation Report's main scenario but that there were no signs that called for a sizeable upward revision, partly because, despite higher growth, price increases to date had not exceeded earlier estimates. The Board unanimously underscored that the link between growth and inflation is uncertain and that earlier relationships must be tested continuously in the light of new information.

3. The Board's assessment of the monetary policy situation

3.1 The monetary policy group's appraisal of the situation for monetary policy

Considering the improved prospects for economic growth in Sweden and a gradual increase in resource utilisation, the policy group had concluded that monetary policy may need to have a less expansionary direction in the future. But the group was of the opinion that the inflation prospects did not call for an immediate adjustment of the repo rate. Neither has an increase been signalled. It was considered that further analyses of how inflationary pressure is affected by the present cyclical upswing are highly important, along with investigations of whether earlier relationships between inflation and growth have changed. The policy group considered that, all in all, for the time being the repo rate should be kept unchanged at 2.90 per cent.

3.2 The Board's discussion

One member considered there are factors that call for a repo rate increase but that there is also a great deal in favour of leaving the repo rate unchanged. The former factors are the strong upswing in GDP, the weaker increase in productivity, the increasingly synchronised global cyclical situation, with the continuation of a strong trend in the United States and successively rising activity in the euro area, the observed price increases for oil and other commodities, and the beginning of an increase in inflation expectations, albeit from relatively low levels. Arguments against a repo rate increase are that even with increasingly strong growth, inflation in Sweden has been weak to date, particularly as regards the domestic production of goods and services. Moreover, the krona has appreciated and long-term interest rates have risen sharply, with the restrictive effect that this entails. Furthermore, the impact of the oil price rise on inflation is probably a one-off phenomenon. As regards the labour market, the member emphasised that the increase in employment is being accompanied by a rising labour supply, which could indicate that the labour market is functioning somewhat better than historical patterns suggest. The labour market's future response to the stronger growth is an essential consideration; for the assessment of inflation it will be important to study whether relative wage adjustments can be achieved without a general increase in wage levels. In conclusion, the member considered that the forecast for UND1X is in line with the target and in the present situation there is no case for raising the interest rate. An immediate repo rate increase would mean that the Riksbank acts asymmetrically in relation to its target. The member added that there are grounds, nevertheless, for being particularly alert to the future development of price pressure and for being prepared to conduct monetary policy in a less expansionary direction.

Two members were of the opinion that the repo rate should to be increased.
One of these members saw a risk of inflationary pressure being underestimated in the present situation, in that the effects of the Asian crisis on international growth and prices had still not ceased entirely. This member argued that the current low level of the repo rate is not in keeping with Sweden's improved economic prospects at the same time as commodity and import prices are rising on account of the international recovery. When the forecast period is shifted one quarter into the future in connection with the next Inflation Report, the rate of inflation in one to two years time will probably be above the Riksbank's target. Rather than signalling a future tightening, the member advocated an immediate interest rate increase because financial market expectations already seem to be set on an increase as a consequence of rising inflationary pressure. The member noted, however, that the inflation prospects do not appear to warrant any considerable interest rate increases, particularly if the Riksbank chooses to act at an early stage. The member also mentioned that on account of the turn of the millennium, it would be unwise to raise the repo rate unduly late in the autumn.

The other member who advocated a repo rate increase considered that the prospects for higher growth, internationally as well as in Sweden, during 1999 and the coming years suggest that the Swedish economy will reach full resource utilisation more quickly than expected. This in turn suggests that underlying inflation, measured by UND1X, will be above 2 per cent in one to two years time. The first tendencies of shortages in some areas of the labour market are already discernible. Productivity's path is somewhat obscure but the weak outturn to date this year is still disturbing. Market prices are rising strongly as are money supply and credit. Expectations of inflation one year ahead have also risen. The member also considered that, particularly in view of the lack of competition in a number of sectors in Sweden, it is still too early to draw any conclusions as to whether the link between growth and inflation has changed. The member pointed out that with the repo rate at 2.9 per cent, the monetary stance is strongly expansionary. Against this background, the member concluded that it is time to make monetary policy less expansionary and that the repo rate should therefore be raised. Economic agents thereby receive a signal that the Riksbank is prepared to act on the increased inflationary impulses.

The other three members of the Board arrived, however, at largely the same assessment as the member who opened the discussion and considered that the repo rate should be kept unchanged for the time being. One of the three noted that the monetary stance is currently expansionary and the real interest rate is low, while growth is above the potential rate. This means that sooner or later the repo rate will have to be raised so that monetary policy's impact on the economy is neutral. If the Riksbank were to wait too long, the repo rate would ultimately have to be raised at such a pace and extent that its effect on the economy would be markedly restrictive. The timing of an interest rate increase is crucially dependent on in what ways and how quickly the economy's unutilised resources are taken up. The member saw the functioning of the labour market as the decisive factor in this respect. At present there are no signs of a shortage of skilled labour, which otherwise tends to play a central part in generating wage drift. Moreover, the matching of job-seekers and vacancies now seems to be tending to improve. In addition, labour force participation is still relatively low, which points to a future increase in labour supply. The member also underscored that confidence in monetary policy's commitment to price stability has been established for some time and noted that medium- and long-term inflation expectations continue to be stable and in line with the target. Monetary policy is accordingly in a situation where it does not need to be used to establish credibility and can be formulated entirely in relation to the cyclical position and its impact on inflation prospects.

Another of the members who advocated an unchanged repo rate added that the interest rate should not be raised solely on the basis of historical patterns between growth and inflation. It is highly important to obtain more knowledge of how the economy is now reacting in an upward phase. The member also agreed with the assessment that today there is no case for raising the interest rate for reasons of credibility. Confidence that monetary policy aims for price stability is already well established. This creates conditions for conducting a symmetrical policy. With this starting point, the magnitude and timing of interest rate adjustments should be determined in a uniform manner regardless of whether inflation prospects are above or below the Riksbank's target. Furthermore, an immediate repo rate increase that has not been signalled in speeches or the like might convey a picture of inflation prospects that is alarmist.

Another member underscored that it is not just a matter of maintaining the credibility of the Riksbank's policy in the financial markets. Confidence in the Riksbank's policy is to be nurtured throughout the economy and among all its players and groups. A repo rate increase in the present situation can convey the impression that the Riksbank acts asymmetrically in relation to the inflation target and thereby risk, contrary to intentions, weakening monetary policy's credibility, particularly among groups that have argued earlier that the Riksbank has used its instrumental rate too vigorously. Another of the members who advocated an unchanged repo rate considered that since confidence in monetary policy is established, the Riksbank does not need to react to the very first indications of increased inflationary pressure. The existing stock of confidence provides room for a continued analysis of inflation prospects. The link between growth and inflation is uncertain, for example, and earlier relationships must be tested in the light of new information.

§2. Monetary policy decision

The Chairman summarised the discussion under §1 and observed that a majority of the Board's members were of the opinion that the repo rate should be left unchanged.

The Chairman then proposed that the Executive Board decides

- to announce a fixed rate repo with a duration from the 18th to the 25th of August 1999 at an unchanged rate of 2.90 per cent and a fixed rate repo with a duration from the 25th of August to the 1st of September 1999 at an unchanged rate of 2.90 per cent, and
- to announce the decision to keep the repo rate unchanged with the motivation and wording contained in the draft before the meeting of Press Release no. 31 1999, Annex to the Minutes.

The Executive Board decided in accordance with the proposal.

Deputy Govenors Kerstin Hessius and Eva Srejber entered reservations against the decision. Ms. Hessius stated that the repo rate should be raised by 0.25 percentage points. Ms. Srejber stated that the repo rate should be raised by 0.10 percentage points.