No. 21

SEPARATE
MINUTES of the Executive Board meeting on 5 October 1999

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

Sven Hulterström, Chairman of the Governing Council
Johan Gernandt, Vice Chairman of the Governing Council

Kerstin Alm
Claes Berg (§§1–3)
Anders Eklöf (§2.1)
Björn Hasselgren
Per Jansson (§2.1)
Hans Lindberg (§§1–3)
Hans Lindblad (§2.1)
Christina Lindenius(§§1–3)
Fredrika Lindsjö
Robert Sparve
Michael Wallin
Staffan Viotti

§1. Account of monetary policy/Inflation Report 1999:3 to the Riksdag's Standing Committee on Finance

It was noted that Christina Lindenius and Hans Lindberg would draft the minutes of §§1, 2 and 3 on the agenda.

Lars Heikensten presented a proposed account of monetary policy/Inflation Report 1999:3 to the Riksdag's Standing Committee on Finance, Annex A to the minutes. The

Inflation Report is based on the presentations and discussions of inflation prospects at the Executive Board meetings on 16 September and 1 October 1999.

The Board decided to adopt the Inflation Report in accordance with the proposal and that the Report be made public at 8 a.m. on 6 October 1999.

Reservation

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

My view of Swedish inflation prospects differs from the picture in the Inflation Report. In my opinion, with an unchanged repo rate the path of inflation will be stronger than in the Report's main scenario.

International economic growth will probably be somewhat stronger than in the Report's main scenario and also probably more synchronised than in recent years. The economic recovery in Japan to date this year has exceeded most observers' expectations. A continued recovery in Japan would support the upturn in the rest of Asia and also tend to even out the existing imbalances in world trade. The situation is vulnerable but confidence in the Japanese economy does seem to be returning, partly now that more convincing steps are being taken to restructure the banking and corporate sectors. Most things therefore suggest that economic growth in Japan will be higher than in the main scenario.

Growth in the US economy has also been higher than expected and the slowdown there will presumably be more drawn-out than in the Report's main scenario. But I do share the Report's assessment of the risks associated with the internal and external imbalances in the US economy. Germany and Italy have been lagging behind the upturn in Europe but both these economies now show signs that they are also well into the recovery. In France and in some of the smaller European countries in particular, growth remains strong and inflation has already risen somewhat. The European economies will therefore probably grow faster than foreseen in the main scenario.

Economic activity also seems to be rising in other parts of the world. A large part of the restructuring of the former crisis economies in Asia remains to be done, but there are grounds for an appraisal that is more optimistic than in the main scenario. The slowdown in Latin America is milder than had been feared and should there be a setback in that region, the knock-on effects would be smaller now that developments in the rest of the world are more stable.

Stronger international growth stimulates Swedish exports and export-related sectors of the economy. GDP growth in Sweden may therefore be somewhat higher than foreseen in the Inflation Report's main scenario. The resources in the Swedish economy that are unutilised at present would then be brought into production more quickly and that in turn may generate inflationary pressure that is stronger than in the main scenario.

Moreover, global growth that is stronger and also synchronised probably entails somewhat higher international inflationary pressure, for example from higher commodity prices. The international economic upturn to date and the recovery in Asia, for instance, have in fact been accompanied recently by rising prices for commodities and intermediate goods. In the case of oil, the prise rise has been accentuated by cuts in supply.

The main scenario in the Inflation Report assumes that the barrel price of crude oil falls back from the current level to just over USD17 at the end of the forecast period. In my opinion, the improved international economic prospects, together with certain supply factors, suggest that during the forecast period the oil price may fluctuate instead around USD20. This may result in the rate of UND1X inflation one to two years ahead being about 0.1–0.2 percentage points higher than in the main scenario.

The relationship between growth and inflation in Sweden is decisive for the extent to which the growing demand in the Swedish economy results in rising inflation. I adhere to the assessment of the link between growth and inflation that was made in connection with the Inflation Report from June 1999. The weaker link that is presupposed in the new Report's main scenario cannot yet be born out with reference to such factors as the improved confidence in monetary and fiscal policy, deregulations, and increased international competition. Insufficient competition in a number of sectors in Sweden—the construction and food sectors, for instance—is a contrary factor here. Moreover, bottlenecks have already shown up in certain parts of the economy—residential construction, for example—with price increases as a consequence.

In addition, shortage situations in the labour market that are more pronounced than foreseen in the main scenario cannot be ruled out. The matching of job-seekers and vacancies does seem to have been working comparatively smoothly to date and as yet there are no signs of widespread shortages in the labour market. But in certain parts of the labour market there are incipient shortage situations and productivity growth to date this year has been disconcertingly low. And despite the high unemployment, in recent years the wage level in Sweden has risen faster than in the main competitor countries. Wage drift, moreover, is comparatively high in the labour market segments where demand is already strong. In the wage negotiations that are scheduled for the coming two years, certain occupational groups will probably aim for comparatively high wage increases, for example to improve their relative wage levels. Especially in a strong upward phase, however, high wage trends in particular settlements can spread to other parts of the labour market, for instance through parity clauses. In this context it can also be noted that the latest rounds of wage agreements have resulted in a rate of wage increases that is relatively similar in different sectors of the economy.

All in all, I conclude that, given an unchanged repo rate, the rate of UND1X inflation will probably be 2.1 per cent in one year's time and 2.6 per cent two years ahead. The inflation assessment in the Inflation Report shows an upside risk. Important factors behind my assessment of inflation's most probable path are stronger international growth, a higher oil price and a higher trade-off between growth and inflation, all compared with the Report's main scenario. Thus, these circumstances are incorporated in my main scenario and are therefore not a part of the risk spectrum. My risk spectrum is accordingly symmetrical.

This minute was immediately confirmed.

§2. Monetary policy discussion

The monetary policy discussion began with accounts of the information about economic developments in Sweden and the rest of the world that had become available since the Board's preceding meeting (section 1). This was followed by a discussion of whether and to what extent the new information affected the assessment of inflation prospects that the Board had expressed in the Inflation Report (section 2). The Board's assessment of the monetary policy situation (section 3) was preceded by an account of a corresponding discussion in the Bank's monetary policy group.

1. Economic developments in Sweden and elsewhere

1.1 International activity and inflation

The Board briefly discussed the development of international economic activity and inflation. It was noted that the recent statistics did not alter the earlier assessment, expressed in the Inflation Report.

The latest statistics confirm the picture of economic stabilisation in Japan; in the coming years a cautious increase in growth is probable, but Japan is still the main source of uncertainty about the Asian economies. In the United States, a persistently strong economy is indicated by the purchasing managers index; the price component of the index has climbed to the highest level since the spring of 1995 but considering the sharp price rise for oil, this is not remarkable. In the euro area, the latest statistics point to an increasingly rapid expansion of manufacturing, not least in the major economies: Germany, France and Italy.

1.2 The situation in Sweden

The new statistics on household purchasing plans support the Inflation Report's assessment that consumption will be rising strongly in the coming years. The purchasing managers index for September 1999 likewise supports the Report's assessment of persistently strong manufacturing activity. The Board noted, however, that the oil price has gone on rising and is now above the level that the Report assumed would apply in 1999. If the oil price were to remain at this level for the rest of the year, a higher petrol price could cause the consumer price rise towards the end of 1999 to be over 0.1 per cent stronger than expected.

1.3 Financial markets

The Board noted that the interest rate unrest during the late summer had gradually subsided and that the interest rate markets are now less volatile. After the strong increase during the summer, the long-term interest rates in the United States and the euro area have recently been relatively stable. The long-term rates in Sweden have broadly followed the international pattern. The ten-year differential with the euro area has narrowed again since the period of unrest at the beginning of August and is now around 0.6 percentage points. Another indication of decreased unrest in interest rate markets is some fall-back in the swap spread from high levels earlier.

The Board found that price setting in interest markets indicates expectations of future increases in instrumental rates in the United States, the euro area and the United Kingdom but that market players are counting on unchanged instrumental rates in the short term. In Sweden, financial market pricing points to fairly sizeable interest rate increases by the Riksbank in the coming six months. However, the Board observed a considerable discrepancy between repo rate expectations derived from market pricing and the expectations expressed in surveys and market letters; the expectations of future repo rate increases are more limited in the latter. The Board found this discrepancy natural in that the risk premium in market prices does not feature in survey data.

Currency markets have focused in recent weeks on the yen’s marked appreciation against the US dollar and the euro. The stronger yen has mainly had to do with signals of higher growth in Japan, capital flows to the Japanese stock market and the growing current-account and trade deficits in the United States. The euro has had some support from expectations of increasingly buoyant activity in the euro area but has recently been relatively unchanged against the dollar. The Swedish krona has continued to appreciate against the euro, accompanied by relatively little change against the dollar.

The Board found that the krona’s recent appreciation against the euro appears to have been a combined effect of several factors: signals of increasingly strong activity in Sweden, the combination of expectations of a more expansionary fiscal policy and a relatively tighter monetary policy, and a number of positive analyses from Swedish and foreign banks that point to a further appreciation of the krona. The Board noted that the market expectations of a continued appreciation of the krona are well in line with the exchange rate assumptions in the Inflation Report.

The Board also considered stock market tendencies and noted that US share prices had decreased almost 10 per cent in recent weeks, while the financial imbalances in the United States are attracting growing attention.

2. The Board's assessment of inflation prospects

The Board concluded that the new information about Swedish and international developments did not call for any change in the appraisal of Swedish inflation prospects compared with the assessment the Board had expressed in the Inflation Report. The Board accordingly noted that the Report's assessment of inflation prospects was the relevant starting point for the monetary policy discussion. One

Board member differed, however, and considered that inflation would be higher than envisaged in the Inflation Report. The member pointed out that this assessment of higher inflationary pressure determined the associated assessment of the current situation for monetary policy.

In the Report's main scenario it is considered that changes in indirect taxes, subsidies and house mortgage interest expenditure will exert a downward effect on CPI inflation of 0.5 percentage points twelve months ahead but that in twenty-four months' time the effect will be upwards and amount to 0.1 percentage point. The Board considered that in the present situation the Riksbank would disregard these transitory factors in the formulation of monetary policy because they are not expected to have a permanent effect on either inflation or inflation expectations. In practice, therefore, the conduct of monetary policy is currently based on an assessment of inflation as measured by UND1X.

In the Inflation Report's main scenario it is judged that, given an unchanged repo rate of 2.90 per cent, the rate of UND1X inflation will be 1.8 per cent in one year's time and 2.1 per cent two years ahead. Moreover, the risks in inflation prospects are considered to predominate on the upside. The reasons for this are that wage developments may be stronger than expected and that inflation may react sooner and more distinctly to the marked economic improvement. Thus, higher inflation than in the main scenario was judged to be more probable than a lower rate. The mean and the median of the inflation assessment are accordingly approximately 0.1 percentage point above the main scenario's forecast.

All in all, given an unchanged repo rate, inflation was judged to become somewhat higher in the coming years and be marginally above the Riksbank's target in two years' time. In this context it was noted that the assessment in the Inflation Report is based on the technical assumption that the Riksbank's repo rate is kept unchanged at 2.90 per cent up to the end of 2001 Q3.

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

3.1 The monetary policy group's appraisal

The Board meeting had been preceded by a discussion in the Bank's monetary policy group.[1] The main conclusions from the group's meeting were presented to the Executive Board.

The discussion in the policy group had started from the Board's assessment of inflation prospects at its meetings on 16 September and 1 October 1999 prior to the presentation of the Inflation Report.

The policy group essentially agreed with the inflation assessment as expressed in the Inflation Report and considered that, excluding transitory effects of indirect taxes, subsidies and interest expenditure, inflation will tend to rise in the coming years and,

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

given an unchanged repo rate, will be marginally above the Riksbank's target in two years' time. The assessment of price tendencies in the Inflation Report could actually motivate both continuing to keep the repo rate unchanged for a time and an immediate increase. The prevailing opinion in the group was, however, that in the present situation the repo rate should be kept unchanged. Several arguments favoured this.

For one thing, it was noted that confidence is established in economic policy's commitment to price stability and that expectations of inflation in the longer run are anchored around 2 per cent. Consequently there are no arguments from credibility in favour of an immediate repo rate increase.

For another, the importance of the Riksbank acting symmetrically was emphasised, so that both the timing and the magnitude of repo rate adjustments are the same regardless of whether inflation prospects are above or below the target. The deviation from the target two years ahead was considered to be too small to motivate an immediate increase in the repo rate.

Thirdly, it is difficult to assess the economy's potential growth rate, the supply of unutilised resources and the level of structural unemployment. It is conceivable that the workings of the economy and the labour market have improved. An unduly early repo rate increase, based on historical relationships between growth and inflation, would risk holding back a new, higher potential growth rate and unnecessarily checking the growth of employment.

Deferring an increase of the repo rate provides additional time for the analysis of incoming statistics. In the light of the gradual increase in inflationary pressure, however, the group also emphasised the importance of signalling a higher future repo rate.

3.2 The Board's discussion

The Executive Board agreed that inflation prospects indicated a need for monetary policy to have a less expansionary direction in the future and that the present discussion mainly concerned the timing of an interest rate increase. Four members of the Board considered the repo rate should continue to be kept unchanged for a time, but that it is important to send clear signals of the need to raise the repo rate in a near future. Two Board members advocated an immediate repo rate increase.

One of the members in favour of an unchanged repo rate considered there were factors that speak for a repo rate increase but also factors that speak for continuing to keep the repo rate unchanged for a time. Factors pointing to a repo rate increase include the high economic activity and the broad price increase for all intermediate goods, even though rising prices for intermediate goods are natural in this phase of an upward trend.

Factors against an immediate repo rate increase are that both open and total unemployment are still comparatively high (approximately 5 and 8 per cent, respectively) and the uncertainty as to how inflationary pressure will develop now that the labour market situation is improving. Historically, open unemployment in Sweden has been lower than at present, even during low activity. The member pointed to the difficulty of assessing the level of unemployment that can be combined with good long-term growth and stable prices but emphasised the importance of not checking the current improvement in the labour market situation unduly early. The member considered there were some signs which could indicate that the labour market is functioning better than before. There are no widespread shortages in the labour market and matching seems to be working better. Neither has wage drift to date been particularly alarming.

The member also drew attention to the strong growth of investment and the ensuing increase in production capacity. If investment and thereby the expansion of production capacity keep pace with the growth of demand, the output gap will not close in terms of fixed capital; the economy will continue to have unutilised resources. The member also noted that, notwithstanding the strong activity, only half of the increased unemployment that occurred during the recession in the early 1990s has now been absorbed. Moreover, we are probably not in a ‘new economy’; in many respects it is rather a matter of a return to the ‘old economy’ that obtained before the years of high inflation in the 1970s and ’80s. In the 1950s and ’60s, growth rates of 3.5–4 per cent had been accompanied by inflation that was usually below 3 per cent.

Another Board member underscored that inflation will probably be clearly above the target one to two years ahead. Monetary policy is very expansionary at present and the fiscal stance will become more expansionary in the coming years. In order to achieve sustainable long-term growth and a stable expansion of employment over a longer period, monetary policy will have to be given a less expansionary direction. If resource utilisation has time to become unduly strong, the monetary tightening will need to be more pronounced that if the Riksbank ‘cautiously closes the throttle’ in time. The member therefore concluded that the repo rate ought to be increased immediately.

A third Board member began by considering the risk spectrum’s significance for the monetary policy decision. The member noted that the oil price is difficult to predict and it is conceivable that OPEC will manage to keep its cartel together and maintain prices at their current levels. In Sweden, fiscal policy has been given a more expansionary direction and asset prices are rising. On the other hand, an abrupt share price correction in the United States cannot be ruled out. American stock markets are probably driven by liquidity and consumption in the United States is financed with loans. In Asia the financial systems are still in a weak state and this may delay the economic recovery there. In addition, the member noted that wage drift in the Swedish economy is comparatively low and an increased labour supply in the years ahead seems reasonable. As to the link between growth and inflation, confidence in economic policy’s commitment to price stability will probably be a restraining factor in wage formation. In conclusion, the member considered that the inflation prospects suggest there is no urgent need to raise the repo rate. Still, the repo rate decision today is more difficult than the Board’s decision at the preceding monetary policy meeting. The time when the repo rate ought to be raised is approaching. For the time being, however, the repo rate should be left unchanged but the press notice should make it clear that an interest rate increase is to be expected if nothing unforeseen happens.

A fourth Board member stated that inflation in the main scenario is judged to be above the target in two years' time and the assessment also shows an upside risk. In order to safeguard high and stable long-term growth it is therefore important to start giving monetary policy a less expansionary direction. The member noted the importance of conducting monetary policy symmetrically in relation to the inflation target and acting at an early stage regardless of whether inflation is expected to be above or below the target. If monetary policy is already made less expansionary at this juncture, that will also reduce the risk of financial assets being over-valued later on in the upward phase, which in time should contribute to increased stability in both the financial and the real economy. In the light of this, the member advocated an immediate repo rate increase.

A fifth Board member underscored that basically, the Board members' differences of opinion about the monetary policy situation are not particularly marked. The current monetary policy decision is not self-evident. The appraisal of price tendencies in the Inflation Report can warrant an unchanged as well as an increased repo rate. In the light of this, the member wondered whether it would not be possible for the Board to arrive at an agreed course of action. Two members advocated an immediate repo rate increase. The fifth member saw an increase later in the autumn as natural if new information did not clearly alter the picture. The member also emphasised the importance of the coming wage negotiations for inflation. The development of wages is crucial for inflation and also very difficult to predict. The member also expressed concern about the consequences of the rising asset prices and warned that a more expansionary fiscal policy can have negative effects on future inflation. At the same time, the member underscored that a small repo rate increase today does not necessarily mean that required increases in the future will be smaller or easier to put across, at least as long as confidence in the low inflation policy is good.

The sixth Board member noted that inflation in the main scenario is judged to be approximately in line with the target one to two years ahead. However, shortages in the labour market can be more pronounced than assumed in the main scenario and this can lead to wage increases and inflationary pressure that are higher than in the main scenario. This background provides arguments for an unchanged as well as an increased repo rate. The member considered there was some scope for deferring an interest rate increase and analysing incoming statistics. The situation to day is calmer than previously in the 1990s. In the early part of the decade economic policy was tightened too late, as a reaction to overheating and the financial bubbles that had become inflated. Growth fell dramatically. When the interest rate was raised during 1994, the strength of the upswing was substantial and the output gap was closing considerably faster than at present. Unlike the current situation, moreover, there were clear signs of rising inflation expectations and wages. The interest rate hike was necessary in order to adjust inflation expectations to the inflation target. We do now see rising inflationary pressure but inflation expectations are stable and the labour market shows signs of working better. It is now up to monetary policy to achieve some moderation of developments. The purpose of repo rate increases is accordingly not to prevent continued economic growth and increased employment; on the contrary, it is to extend the period of good growth. A small interest rate increase will probably be called for soon, but no evident risks are involved in deferring it for a time. It is now highly important that the Riksbank explains to the general public that a future interest rate increase does not aim to dampen the economic expansion; on the contrary, its purpose is to extent the period of high and stable growth in the Swedish economy.

Several members highlighted the importance of following the future development of asset prices and analysing their significance for the path of inflation and the formulation of monetary policy. One member also mentioned that financial market concern about the turn of the millennium appears to have moderated recently. The influence of the millennium changeover on the formulation of monetary policy can therefore be smaller than the member had previously assumed.

§3. The Board's decision

The Chairman summarised the monetary policy discussion under §2 and noted that a majority of the members of the Executive Board considered that the repo rate should be kept unchanged.

The Chairman then proposed that the Executive Board decides

– that the repo rate be kept unchanged and that this decision be effective from 13 October, and

– that the decision on an unchanged repo rate be announced at 8 a.m. on 6 October 1999 with the motivation and wording contained in the draft of Press Release no. 65 1999, Annex B to the minutes.

The Executive Board decided in accordance with the proposal.

Deputy Governors Kerstin Hessius and Eva Srejber entered reservations against the decision. They both stated that the repo rate ought to be raised 0.25 percentage points.

This minute was immediately confirmed.

§4. Address to the Riksdag's Standing Committee on Finance

Urban Bäckström presented a draft of his address to the Riksdag's Standing Committee on Finance on 6 October.

The Executive Board decided to adopt the address in accordance with Annex C to the minutes.

Eva Srejber entered a reservation against the decision with reference to minutes §§1–3 of today's meeting.

Kerstin Hessius entered a reservation against the decision with reference to minutes §§2–3 of today's meeting.

This minute was immediately confirmed.