No. 5

SEPARATE
MINUTES of the Executive Board meeting on 22 March 2000

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

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Kerstin Alm
Claes Berg
Hans Dellmo
Anders Eklöf
Björn Hasselgren
Per Jansson
Hans Lindblad (§1)
Christina Lindenius
Fredrika Lindsjö
Robert Sparve
Åsa Sydén
Staffan Viotti
Michael Wallin

§1. The current inflation assessment

It was noted that Hans Dellmo, Anders Eklöf and Fredrika Lindsjö would draft the minutes of §§1, 2 and 3 on the agenda.

The Board's discussion began with accounts of the information about economic developments in Sweden and the rest of the world that had been received since the previous Board meeting (section 1). The account of monetary policy (the Inflation Report) that would be presented to the Riksdag's Standing Committee on Finance was then adopted (section 2).

1. Economic developments in Sweden and elsewhere

1.1 International activity and inflation

The 1999 Q4 GDP statistics for Japan supported the picture of a persistently weak economic trend there. However, the figures for January and February reveal some signs, albeit uncertain, that growth may tend to improve in Q1 this year, primarily due to increases in private consumption and investment. In the United States, the consumer price rise in February was somewhat above expectations, while the underlying rate of inflation remained moderate. There are still no signs of a slowdown in retail trade but the growth of U.S. manufacturing output in February was somewhat weaker than expected. In the euro area, the rate of HICP inflation moved up 0.1 percentage point in February to 2.0 per cent, while the rate excluding energy was unchanged at 1.0 per cent. At the same time, expectations indicators, such as the IFO index in Germany, confirm the impression that economic activity in the euro area is becoming increasingly strong. The Board found that the recent international statistics did not alter the assessment that lay behind the draft version of the Inflation Report.

1.1 Developments in Sweden

The statistics that have just been published on money supply growth and lending to Swedish households support the view that the future growth of private consumption will be strong. Further confirmation of this is provided by the February increase in retail turnover as reported by the Wholesale & Retail Research Institute. The Board noted that a proposal for wage increases for 200,000 teachers has been presented. The new Swedish statistics were not considered to call for any changes in the forecast for the Swedish economy in the draft version of the Inflation Report.

1.3 Financial markets

The Board noted that bond rates in the United States and the euro area have recently fallen. According to a number of observers, one factor behind the downward tendency in the United States is that the favourable development of federal finances has prompted the U.S. Treasury to announce the redemption of federal bonds. Long-term interest rates in the euro area have followed the American tendency but have fallen somewhat less.

In Sweden, bonds rates have declined somewhat more than in the euro area. One factor behind this development may be that the recently announced sale of Telia is expected to lead to a decreased supply of Swedish T-bonds. Earlier in March, the interest rate differential with Germany amounted to only 0.1 percentage point but it has subsequently widened to about 0.15 percentage points.

The U.S. Federal Reserve and the European Central Bank have both recently increased their instrumental rates by 0.25 percentage points, to 6.0 and 3.5 per cent, respectively. Market pricing indicates expectations of further increases in the instrumental rates of these two central banks. A majority of money market observers predict that at today's meeting the Executive Board will decide to raise the Riksbank's repo rate by 0.25 percentage points. In the light of speeches by two members of the Board, however, the expectations of an interest rate increase have tended to falter recently.

In stock markets in Sweden and abroad, the duality that characterised the early months of 2000 — with rising share prices in the IT and telecom sector and a downward trend in more traditional sectors — has tended to become less pronounced.

The Board noted that stock markets have continued to be relatively volatile, which implies a general uncertainty about the prevailing level of share prices.

2. Account of monetary policy (Inflation Report 2000:1) to the Riksdag's Standing Committee on Finance

First Deputy Governor Lars Heikensten submitted a proposed account of monetary policy (Inflation Report 2000:1) to present 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 9 and 16 March 2000.

The Board decided to adopt the Inflation Report as submitted and also that it be made public at 8 a.m. on 23 March 2000.

Reservation

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

My opinion of Swedish inflation prospects differs to some extent from the picture in the Inflation Report. I consider that the path of inflation will be stronger than in the Report's main scenario. The main explanation for this is an inflation propensity in the Swedish economy that is higher than foreseen in the Inflation Report. I attribute this both to a competitive situation in Swedish markets for goods and services that is weaker than envisaged in the Report and to a less flexible labour market.

In the United States, economic growth has been very high for a number of years without generating markedly increased upward price pressure. The weak consumer price trend can probably be explained by strong competition in the domestic markets, a flexible labour market and an appreciating dollar. Besides these factors, an efficient capital market, rising investment and strong productivity growth have probably contributed to improvements in supply. But the United States is the only industrialised economy to have achieved this at such a late stage in the business cycle. The picture is different in other countries, such as the United Kingdom and Finland, that are also cyclically ahead of Sweden. Domestic inflation is accelerating in the United Kingdom, where it is mainly the strength of sterling that is countering generally higher inflation. In the Finnish economy, which resembles the Swedish in many respects with, for example, high IT penetration, inflation has moved up recently despite large reserves of unutilised labour.

In the light of this, it is noteworthy that the domestic markets in Sweden still show no appreciable signs of such strong competition as American markets. Swedish markets are less marked by firms being obliged to accept prices, as is evident, for instance, from the high level of prices relative to other countries. Labour market flexibility in Sweden is relatively low, as can be seen, for example, from low geographical mobility and problems with matching. Under these circumstances, compared with the assessment in the Inflation Report I am less optimistic about how firms and employees will react when, for the first time in many years, the Swedish economy has no unutilised resources on which to draw.

All in all, I conclude that, given an unchanged repo rate, towards the end of the forecast period UND1X inflation will exceed the forecast in the Inflation Report by a couple of tenths of a percentage point.

This minute was immediately confirmed.

§2. Monetary policy discussion

The Executive Board opened the monetary policy discussion by presenting its assessment of inflation prospects (section 1). The Board's assessment of the monetary policy situation (section 2) was preceded by an account of the corresponding discussion in the Bank's monetary policy group.[1]

1. The Board's assessment of inflation prospects

The Board concluded that the new information about economic developments in Sweden and internationally did not call for any change in the appraisal of inflation prospects in Sweden that the Board expresses in the draft version of the Inflation Report. That appraisal was accordingly the relevant starting point for the discussion of monetary policy. One Board member, however, held a different opinion and considered that inflation would be somewhat higher than foreseen in the Inflation Report.

In the main scenario of the Inflation Report it is considered that changes in indirect taxes, subsidies and house mortgage interest expenditure will have a downward CPI effect one year ahead of 0.1 percentage point. In two years' time, however, these factors are judged to raise CPI inflation by 0.2 percentage points. The Board considered that in the current situation it would be reasonable, in the ensuing discussion of conditions for the formation of monetary policy, to disregard the calculated effects from indirect taxes, subsidies and interest expenditure because these factors are not judged to exert a permanent effect on either inflation or inflation expectations.

During the discussion of transitory effects, the Board also considered the outlook for oil prices. The Board noted that the oil price rise had been a major factor behind the path of consumer prices in recent months. But it is not self-evident that the development of oil prices affects inflation permanently. An oil price movement that stems from a supply shock may have effects on inflation that are mainly transitory and to that extent it should be regarded as of secondary importance in the formation of

[1] The group is made up of Riksbank staff and is headed by one of the deputy governors. The main features of the group's discussion are presented at the Board meeting. The opinions expressed and recorded in the minutes are not necessarily shared by all the members of the group, including the chairperson.

monetary policy. The oil price rise in the past year is, in fact, mainly attributable to restricted supply but for some time now it has also been influenced by rising international demand. Moreover, the higher crude oil prices are expected to spread to later stages of processing. For these reasons the Board considered that at present the different aspects of the oil price rise could not be separated satisfactorily. Against this background the Board found it most appropriate to base monetary policy at present on a forecast of UND1X inflation.

In the Inflation Report's main scenario, assuming an unchanged repo rate of 3.75 per cent, the 12-month change in UND1X is judged to be 1.6 per cent one year ahead and 2.1 per cent after two years. This is accompanied by the prospect of a balanced risk spectrum, which means that the probability of inflation being higher than in the main scenario is much the same as the probability of a lower rate. The inflation forecast in the main scenario accordingly agrees with the forecast that takes the risk spectrum into account. The main downside risks in inflation prospects are a weaker international economic trend, mainly in connection with falling share prices and increased saving in the United States, and larger price effects than expected from deregulations. The main upside risks are that activity in the Swedish economy will be stronger than assumed in the main scenario, above all towards the end of the forecast period, and that the price fall for oil and other commodities may be smaller than expected.

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

2.1 The view of the monetary policy group

The Board's discussion of the monetary policy situation was preceded by a presentation of a corresponding discussion in the Bank's monetary policy group.

The discussion in the monetary policy group had started from the Board's assessment of inflation prospects at the meetings on 9 and 16 March 2000 in connection with the production of the Inflation Report.

The monetary policy group essentially shared the assessment of inflation that is expressed in the Inflation Report and considered that, given an unchanged repo rate and excluding transitory effects from indirect taxes, subsidies and interest rates, the rate of inflation will move up in the coming years but remain below the target in the greater part of the forecast period. In the light of this assessment, the group considered that the repo rate should be left unchanged at today's meeting. However, economic activity in Sweden will become increasingly strong and inflationary pressure will grow successively. Although the risk spectrum is balanced at present, the stronger activity combined with the successive forward shift in monetary policy's perspective imply that the repo rate may need to be increased in the future. This means that the present proposal to leave the repo rate unchanged on this occasion is not entirely self-evident. Still, it is new information and its significance for the overall assessment of inflation that should determine the pace and size of repo rate adjustments.

In the discussion of the monetary policy situation, the policy group also considered current market expectations. The group noted that most players and analysts foresee a repo rate increase at today's Board meeting. One reason for this was considered to be that observers had heeded statements by Board members to the effect that at present the repo rate is probably below what might be regarded as a long-term neutral level.

Against this background the group found it important to clarify that it is the forecast of inflation one to two years ahead that normally determines the path of the repo rate. There is, of course, a connection between the long-term neutral level of the repo rate and the assessment of inflation. If the repo rate is below its neutral level and output is liable to exceed its potential level, in time this should normally be reflected in a forecast rate of inflation that is above the target. That in turn means that monetary policy may need to adjusted in a less expansionary direction. Having said this, there are also considerable difficulties in determining what can be regarded as a neutral repo rate.

It is important, moreover, not to interpret the intellectual framework too mechanically. The forecast rate of inflation in both the short run and beyond the two-year horizon should also play some part in the decision. There may be grounds for taking other aspects into account, too, in which case they should be clarified as far as possible.

2.2 The Board's discussion

A majority of the Board's members considered that the present inflation forecast speaks in favour of an unchanged repo rate. A number of these members pointed out, however, that the strong economic trend in Sweden may call for a future increase in the repo rate. The appropriate pace and size of this increase should be considered in the light of new statistics. One member considered that the forecast can support leaving the repo rate unchanged as well as an increase right away. Another member advocated an immediate increase in the repo rate.

The Board referred to the monetary policy group's discussion about communicating monetary policy to the outside world and the Riksbank's intellectual framework for the formation of policy. The Board's unanimous opinion was that while the intellectual framework for monetary policy and thereby the formation of policy normally rests on an assessment of inflationary pressure in the Swedish economy one to two years ahead, it should be emphasised that there are reasons for not interpreting this framework too mechanically. Moreover, there may be special circumstances that make it inappropriate to base the monetary policy decision on the assessment of inflation. One such circumstance would be if financial stability is threatened. There might also be grounds for countering a risk of shocks to the real economy, for instance in connection with financial imbalances. In such situations the Riksbank should be explicit about this.

One of the members who favoured an unchanged repo rate underscored that the repo rate increase in February has had certain consequences for the current assessment of inflation. Taking that increase into account, it was judged that inflation would be in line with the target and this was communicated when the decision was announced. Another influence on the current forecast came from the revised forecasts for wages and productivity. Leaving the repo rate unchanged on this occasion would clarify that the Riksbank is adhering to its intellectual framework and using the new assessment to guide monetary policy. This member also indicated, however, that the upward economic trend in Sweden made it probable that the repo rate will need to be increased in the future as the perspective is shifted further ahead. Considering that inflation is clearly on its way up above 2 per cent, the present interest rate decision is not entirely self-evident. The member underscored that the upward revision of productivity in the Inflation Report represents a return to more normal growth rates, motivated by new statistics for 1999, rather than a clear change of opinion about how the economy is functioning.

Another member considered that high GDP growth, rapidly rising consumption (partly in connection with rising asset prices), a high rate of increase in monetary aggregates and increased investment are signs that speak in favour of an interest rate increase. While increased investment will indeed lead to additional capacity, the member pointed out that these effects are likely to be lagged, so that the impact on demand will probably dominate initially. At the same time, however, the picture is not clear-cut; employment is not rising as markedly as the good growth might suggest and there are signs that wage increases may be lower than the Riksbank assumed earlier. In the opinion of this member, the signs that could be discerned in the teachers' wage negotiations suggest that the risk of future wage-wage spirals has now decreased. The recent stock market fluctuations are possibly an indication that share prices will not rise so rapidly in the future, in which case the influence of asset prices on private consumption may be smaller than is assumed in the Inflation Report. All in all, inflation one to two years ahead is expected to be subdued, notwithstanding the strong economic activity in Sweden. The member therefore found no grounds for drawing any other conclusion than that the repo rate should remain unchanged at present.

A third member pointed out that the dangers for monetary policy that the Board had highlighted earlier, for example the risks of shortages arising in various segments of the economy, have been analysed and incorporated in the current inflation forecast. This member considered that the forecast speaks in favour of leaving the repo rate unchanged. The future path of investment should help to expand capacity and thereby lead to a somewhat smaller risk of capacity restrictions. Moreover, the February increase in interest rates has contributed to a risk spectrum that is now more balanced. At the same time, the member emphasised that while the future trend is clear, the appropriate pace of future repo rate increases will be determined in the light of new information and its significance for forecast inflation, including the risk spectrum. The member considered that the Riksbank must continue to attach major importance to analysing the existence of market shortages.

A fourth member considered that the forecast in the new Inflation Report, with a rate below 2 per cent for the greater part of the coming two years, indicates that the repo rate should remain unchanged at present. The member underscored that in the present situation there may be certain grounds for a cautious interpretation of model relationships derived from historical data. Recent data show that the economy is developing somewhat differently from before. The path of employment is weaker than expected, inflation is still moderate even though activity is strong, and productivity is rising comparatively rapidly. In addition to this economic picture, it is possible that wage increases for teachers will be lower than foreseen earlier.

A fifth member pointed out that the Board's current inflation forecast can warrant leaving the repo rate unchanged as well as raising it 0.25 percentage points. The member considered that the clear trend is a reason for attaching greater weight at present to the latter part of the forecast period. That can motivate raising the repo rate in good time in order to avoid the necessity of larger repo rate adjustments later on. There are risks, according to this member, of demand rising more rapidly than supply. There are still no more general indications that the supply side is expanding at a rate that is markedly faster than in earlier upward phases. In the opinion of this member, the slight signs of a more efficient economy that have been discerned to date would probably have escaped attention if the performance of the U.S. economy had not served as a guide to where these signs might be found. No genuine bubble can yet be observed in Sweden's asset markets but the member noted that asset prices are rising and so is the degree of loan financing. For these reasons and the fact that forecast inflation two years ahead is above the target, the member advocated a repo rate increase of 0.25 percentage points but could accept a decision to leave the rate unchanged for a time.

The sixth member noted that the economy is expanding rapidly and judged that inflation two years ahead would exceed the target by a larger margin than is assumed in the Inflation Report. Against this background, the member advocated a repo rate increase. The member pointed out that the monetary stance is still expansionary, as the development of the money supply and credit aggregates, for example, confirms. Moreover, the downward movement of long-term interest rates has made the overall monetary conditions more expansionary. On the subject of the intellectual framework, the member underscored the balancing act involved in communicating an educational and simple framework without denying that monetary policy involves complex deliberations. In the present phase of successively rising inflation, the member found grounds for relating to a somewhat more distant forecast horizon than usual. The member pointed out that, with an established price stability regime, it is not surprising that it takes time before inflation picks up when demand is rising, particularly as this is now occurring after a series of years with a negative output gap. Inflation will accelerate, so there are grounds for acting comparatively vigorously and in good time in order to avoid the necessity of larger repo rate adjustments later on. Against this background, the member advocated a repo rate increase of 0.5 percentage points.

§3. Monetary policy 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 left unchanged.

The Chairman then proposed that the Executive Board decides

- that the repo rate be left unchanged at 3.75 per cent and that this decision be effective from Wednesday 29 March 2000, and

- that the decision be announced at 8 a.m. on 23 March 2000 with the motivation and wording contained in the draft of Press Release no. 16:2000, Annex B to the minutes.

The Executive Board decided in accordance with the proposal.

Deputy Governor Eva Srejber entered a reservation against the decision and stated that the repo rate ought to be raised 0.5 percentage points.

This minute was immediately confirmed.

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

Governor Urban Bäckström presented a draft of his speech to the Riksdag's Standing Committee on Finance on 23 March 2000.

The Executive Board decided to adopt the speech, Annex C to the minutes

Referring to §§1–3 of these minutes, Deputy Governor Eva Srejber entered a reservation against this decision.

This paragraph was immediately confirmed.