No. 10

SEPARATE
MINUTES of the Executive Board meeting on 7 June 2000

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

——

Sven Hulterström, Chairman of the General Council

——

Kerstin Alm
Malin Andersson (§1)
Claes Berg
Anders Eklöf
Björn Hasselgren
Leif Jacobsson
Per Jansson
Hans Lindblad
Peter Lundkvist
Robert Sparve
Annica Svensson
Anders Vredin

**§1. The current inflation assessment**

It was noted that Anders Eklöf and Peter Lundkvist would prepare draft minutes of §§1, 2 and 3 on the agenda for the meeting.

The discussion began with accounts of the information about economic developments in Sweden and the rest of the world that had become available since the preceding Board meeting on 31 May 2000 (section 1 below). The assessment in the Inflation Report was then adopted (section 2).

## 1. Economic developments in Sweden and elsewhere

### 1.1 Financial markets

The Board noted that the downward international bond rate tendency has continued in early June. According to market observers, certain signs that activity in the U.S. economy was beginning to slacken have contributed to the lower interest rates there. Long-term interest rates in Sweden have broadly followed the international pattern and fallen about 0.2 percentage points in early June. A long-term interest rate differential of about –0.1 percentage point has been noted with Germany.

In the currency market the euro has appreciated about 4 per cent against the U.S. dollar. Market observers consider that improved growth prospects for the euro area relative to the United States have contributed to the euro's recovery. The Swedish krona has appreciated about 4 per cent against the dollar and about 1 per cent against the euro.

Pricing in interest rate markets indicates expectations of further increases in the instrumental rate of both the Federal Reserve and the European Central Bank. In the case of the Federal Reserve, however, the expectations have decreased somewhat after signs that economic activity may have begun to slacken. Survey data point to the ECB raising its instrumental rate about 1 percentage point in the coming year. A majority of money market assessments count on the Riksbank leaving the repo rate unchanged at today's meeting; one year ahead the repo rate is expected to have been raised about 1 percentage point to 4.8 per cent.

Share prices in Sweden and other countries have continued to fluctuate relatively widely. Option pricing indicates expectations of further large movements in the short run, particularly on the Nasdaq exchange.

### 1.2 Economic activity and inflation

There are certain signs of a quicker recovery in the Japanese economy, in that private consumption and unemployment have developed somewhat more favourably than expected earlier. The main cause for concern about import prices is the price of oil. The Board noted that the somewhat higher oil price has contributed to a continued increase in the price of petrol. This means that in the short run inflation may be somewhat higher than assumed in the current Inflation Report.

As regards information about domestic activity and price tendencies, it can be noted that to date this year the number of new passenger car registrations has been somewhat higher than expected but that household purchasing plans point to fewer car purchases in the near future. Households continue to be very optimistic about the economic future and manufacturing growth remains strong. Households' expectations of inflation one year ahead moved up 0.3 percentage points from April to May; compared with March, however, the expectations in May were 0.2 percentage points lower.

2. Adoption of the Inflation Report 2000:2

Deputy Governor Lars Heikensten presented the draft of Inflation Report 2000:2 (Annex A to the minutes). The draft started from the presentations and discussions of inflation prospects at the Board meeting on 31 May 2000. The Board found that there was no new information about Swedish and international economic developments that occasioned any sizeable change in the assessment at that time.

The Board accordingly decided to adopt the Inflation Report as drafted and that it shall be published at 9 a.m. on 8 June 2000.

This paragraph was immediately confirmed.

## §2. Monetary policy discussion

The Board's assessment of the monetary policy situation (section 2) was preceded by a summary of inflation prospects (section 1).

1. The Board's assessment of inflation prospects

The picture of inflation prospects in the Inflation Report is broadly the same as the assessment in the March Report. In the main scenario, the successively rising activity is expected to cause price pressure, measured as UNDINHX, to grow comparatively rapidly in the forecast period. Compared with the earlier forecast, however, the acceleration is now judged to be somewhat slower, particularly if the new proposal for a maximum day nursery charge is implemented. In the March Report it was assumed that the maximum charge would have a downward CPI effect of 0.1 percentage point in both 2001 and 2002. With the new proposal, presented in the Government's Spring Bill, it is now foreseen instead that the maximum charge will hold back inflation by 0.3 percentage points in 2002. Another factor behind lower UND1X inflation is a somewhat more subdued import price tendency. All in all, in the main scenario the rate of UND1X inflation is judged to be 1.5 per cent one year ahead and 1.9 per cent after two years.

The risk spectrum, which is also relevant for the formation of monetary policy, is considered, however, to point to somewhat higher inflation at the end of the forecast period. An important factor in this assessment is that domestic demand may be stronger than allowed for in the main scenario. It is evident from the Government's Spring Bill that a more expansionary direction of fiscal policy cannot be ruled out, although the major part of the inflationary effect would probably not occur until after the current forecast period. Another risk for inflation is wage formation. The current wage forecast contains both upside and downside risks. Still, the perception of a small risk of an essentially higher wage outcome but no equivalent risk of an essentially lower outcome does mean that the overall wage tendency must be said to constitute an upside inflation risk. Furthermore, the synergistic effects of a simultaneous international upswing may have been underestimated. One downside inflation risk lies in an abrupt adjustment of activity in the United States as a consequence of the imbalances that have accumulated in the form of low household saving, large current-account deficits and high stock market prices. Another downside risk stems from the possibility that the relationship between growth and inflation may again prove to be somewhat more favourable. All in all, the risk spectrum is judged to be balanced one year ahead, while some upside risk is seen after two years, above all in the form of the greater probability of stronger demand.

The conclusion from the Board's assessments as presented in the Inflation Report is that, taking the risk spectrum into account and excluding transitory effects from indirect taxes, subsidies and house mortgage interest expenditure, with an unchanged repo rate the rate of inflation will be below 2 per cent one year ahead and on the target after two years.

A matter that has to be considered in the formation of monetary policy is how the expected effects of a maximum day nursery charge are to be handled. Excluding measures of this type in the formation of monetary policy would be tantamount to disregarding an important element in the inflation process in recent years, in the same way as excluding the inflationary effects of growing public intervention would have been in the 1970s and '80s. At the same time, the maximum charge clearly does not alter underlying, more cyclical inflationary pressure, at least not directly, and it is this conjunctural inflation that monetary policy can primarily influence. So the appropriate treatment of the maximum charge is not self-evident. The Board decided that monetary policy is to be based at present on an assessment of UND1X inflation.

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

### 2.1 The monetary policy group's appraisal

The Board's discussion of the monetary policy situation was preceded by a presentation of a corresponding discussion on 5 June 2000 in the Bank's monetary policy group.[1]

The policy group's discussion had started from the Board's assessment of inflation prospects at its meeting on 31 May 2000.

The discussion began with some topical monetary policy issues, such as the appropriate time perspective for monetary policy when activity is rising strongly. It was noted that inflation's domestic, more cyclical component (UNDINHX) was judged to rise faster than UND1X inflation, mainly due to effects from the exchange rate and oil prices, and that the tendency for these effects to restrain inflation can be expected to diminish beyond the two-year horizon. There is also an upward inflation risk from fiscal policy. The effects of this on inflation are likewise expected to act mainly after the current two-year period. The same goes for effects from introducing the maximum charge in 2002. Moreover, these effects are uncertain in that the proposed maximum day nursery charge has not yet been approved by the Riksdag (Sweden's parliament).

[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 in the minutes are not necessarily shared by all the members of the group, including the chairperson.

The policy group pointed out that the interest rate decision is not self-evident at a time when forecast inflation one to two years ahead is below the target at the same time as inflationary pressure beyond the two-year horizon can be expected to exceed 2 per cent. An early repo rate adjustment could possibly mean that larger changes in the instrumental rate can be avoided at a later stage. This is particularly the case in that inflation's more cyclical elements are rising continuously and UND1X inflation is being held back in the forecast period by a number of factors that cannot be expected to act as strongly in the longer run. At the same time it must be recognised that a forecast of the longer run is normally more uncertain. The assessment of the longer term is heavily dependent on how resource utilisation in the economy relates to inflation. The Riksbank has had to reassess this relationship on a number of occasions.

At present there is widespread agreement among market players and analysts that the repo rate will not be changed. To some extent this presumably reflects a weakness in the Riksbank's communications. It seems that the Riksbank's rule for monetary policy action is interpreted unduly narrowly. There is therefore a need to fill in the picture of the Riksbank's policy and bring out the fact that there may be reasons for monetary policy also to consider inflation in the coming year and beyond the two-year horizon.

All in all, the monetary policy group's assessment was that the repo rate should be left unchanged for some further time.

## 2.2 The Board's discussion

A majority of the Board's members considered that the current inflation forecast speaks in favour of an unchanged repo rate. One member, however, advocated an immediate repo rate increase.

A number of those in favour of an unchanged repo rate underscored that the strong economic trend in Sweden means that a repo rate increase will probably be called for in the future. Two of these members added that the forecast could support raising the repo rate now as well as leaving it unchanged.

One Board member noted that even when the risk spectrum is taken into account, UND1X inflation one to two years ahead is on average below 2 per cent. The member pointed out that with a strict interpretation of the Riksbank's simple rule of thumb, this could even warrant an interest rate cut. In view of the present cyclical situation, however, the member advocated an unchanged repo rate. Domestic inflation's underlying tendency has been weak, partly on account of weak prices for electricity and telecom products. But there is a clear trend, with increasingly strong activity and rising inflation, and the interest rate may need to be increased in the future.

Another of these Board members expressed certain fears that higher inflationary pressure may be in the process of becoming established in that, for example, the price of oil remains high and surveys indicate that manufacturers intend to increase their prices. The member considered that a relatively high wage outcome would be needed for an appreciable acceleration of inflation. All in all, the member considered that the current inflation forecast did not warrant a repo rate increase at today's meeting. But if economic activity continues to follow the path in the main scenario, it is not unreasonable that in time this will give rise to an assessment of inflation two years ahead that is above the target. Consequently there are good reasons for maintaining a high state of readiness for interest rate increases and closely following the development of, for example, capacity utilisation and the labour market with a view to detecting any shortages at an early stage.

A third Board member considered that the strong economic trend and the risk of increased inflationary pressure beyond the two-year horizon could justify an immediate repo rate increase. Such a measure would not jeopardise the upswing in business activity. At the same time, the Riksbank's assessment clearly implies that for the greater part of the period, with which monetary policy is mainly concerned, inflation will be below 2 per cent. Neither is a repo rate increase at today's meeting expected in the financial markets. But it is natural to envisage an increased rate immediately after the summer if there is no new information that changes the picture.

A fourth Board member pointed out that the inflation forecast with the risk spectrum taken into account could speak in favour of an immediate repo rate increase as well as an unchanged rate. The member noted that both the money supply and lending to the Swedish household sector are continuing to rise rapidly and wondered whether this was commensurate with the inflation target in the longer run. The strong confidence in the future that is mirrored in rising asset prices, as well as in an expected increase in households' lifetime income, may have become increasingly important for demand. The member also observed that share prices in American stock markets have tended to rise as a reaction to monetary tightening, thereby partly countering the monetary policy's intended restrictive effect. For these and other reasons the member saw grounds for a further analysis of how inflation prospects are influenced by effects from asset prices and debt accumulation in the economy and of how this should condition the formation of monetary policy. Another Board member was of the same opinion and pointed out that there are reasons for continuing to discuss whether the Riksbank's intellectual framework allows in full for the development of asset prices and debt accumulation.

One Board member advocated an immediate repo rate increase. This member attached great importance to the degree of resource utilisation in the economy. In view of the revised assessment of unutilised resources during 1999, the member was not surprised that inflation to date this year has been somewhat lower than foreseen in the March Report. In the coming years, on the other hand, the member judged that the shortage of unutilised resources will probably lead to a rate of inflation that is somewhat higher than in the main scenario. These effects were, however, incorporated in the Report's risk spectrum. The member drew attention to the tendency, in economies where price stability has been established, for prices to display both upward and downward rigidity, with the prospect of price increases relatively late in an upward phase. It may therefore be risky to wait too long before raising interest rates. The same applies with regard to transitory effects of administrative prices that are tending to curb UND1X inflation two years ahead. The member noted, moreover, that the monetary stance is still expansionary and it cannot be assumed that fiscal policy will at least become less expansionary. A monetary stance that remains expansionary would be liable to build up real and financial imbalances that in time may jeopardise the price stability target and lead to fluctuating growth. Average growth would then be likely to be lower than otherwise. The member cited Japan in the 1980s, Southeast Asia and South Korea in the early '90s and the United States in the late '90s as examples of an accumulation of both real and financial imbalances despite low inflation, sound government finances, high investment, a good productivity trend and strong economic growth. It is therefore important that monetary policy is formed on the basis of an overall economic assessment that includes the financial components and on how the economy is expected to develop beyond the two-year horizon.

A sixth Board member underscored that it is forecast inflation one to two years ahead that should guide the interest rate decision and that the current forecast is somewhat below the target. It is certainly important that monetary policy reacts at an early stage so as to avoid a need of stronger restrictions later on but it must not react too early. Monetary policy is to be conducted symmetrically in relation to the inflation target. The member nevertheless considered two conceivable situations that could favour an immediate repo rate increase. One involves clear signs of an increasingly rapid acceleration of economic activity at the same time as other factors with downward effects on inflation are more uncertain. In such a situation one could choose to attach greater importance to the level of activity and raise the interest rate early on. The member judged, however, that this argument is not yet applicable. The other situation concerns a threat to financial stability. This has not been observed, either, in that the growth of total lending to the non-bank sector seems to have levelled out and the strong asset price trend has tended to slacken recently. The member accordingly concluded that at today's meeting the repo rate should remain unchanged.

## §3. The monetary policy decision

The Chairman summarised the discussion under §2 and noted that there were proposals for an unchanged repo rate and a repo rate increase, respectively.

The matter was put to the vote and the Executive Board decided that the rate repo is to be held unchanged at 3.75 per cent and that this decision shall apply from Wednesday, June 14th, 2000 and be announced at 9 a.m. on June 8th, 2000 with the motivation and wording contained in the Press Release no. 36 2000 (Annex B to the minutes).

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

This paragraph was immediately confirmed.