No. 17

SEPARATE MINUTES of the Executive Board meeting on 9 October 2000

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
Sophie Degenne (§§ 2-3)
Jörgen Eklund
Anders Eklöf
Björn Hasselgren
Leif Jacobsson
Per Jansson
Hans Lindblad
Christina Lindenius (§2)
Fredrika Lindsjö
Tomas Lundberg
Pernilla Meyersson
Håkan Nyholm (§1)
Staffan Viotti
Anders Vredin

§1. The current inflation assessment

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

The Executive Board opened the discussion with accounts of the information that had been received since the October Inflation Report was compiled (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 new statistics since the Inflation Report was compiled confirm the picture of a strong economic trend in the euro area. Unemployment in Germany continued to fall in September. However, forward indicators, such as the purchasing managers index for manufacturing, as well as survey data from the EU Commission point to future tendencies that are somewhat weaker in both manufacturing and the household sector. The picture of a slowdown in the United States is supported by, for example, forward indicators such as the purchasing managers index. But unemployment did turn down again in September and shows that the growth of employment remains strong in services industries and construction.

1.2 Developments in Sweden

New statistics show that the total wage level in July 2000 was 3.1 per cent higher than a year earlier. The average preliminary rate of wage increases in the first seven months of this year was 3.3 per cent. The most recent statistics broadly support the picture conveyed by the Inflation Report's main scenario.

1.3 Financial markets

At the latest meeting the European Central Bank raised its instrumental rate 0.25 percentage points to 4.75 per cent. Market pricing indicates expectations of yet another interest rate hike by the ECB in the coming months, accompanied by no change by the Federal Reserve for the time being. Survey data show a relatively balanced spread between observers who count on the repo rate in Sweden being raised 0.25 percentage points at today's meeting and those who expect an unchanged rate; looking six and twelve months ahead, the data show expectations of repo rate increases to about 4.3 per cent and about 4.7 per cent, respectively.

The Swedish krona has continued to weaken recently and at present the TCW index is around 128. Market comments attribute the recent depreciation to such factors as a wider difference between the instrumental rates in Sweden and the euro area and capital outflows to mutual funds abroad. One Board member pointed out, however, that the krona is not among the currencies that have weakened most this year. The depreciation has been more marked in, for instance, Australia and New Zealand; a conceivable explanation for that is those countries' large current-account deficits. The member considered that the krona's recent depreciation might possibly have to do with the relatively weak share price trend in the information technology and telecom sectors, which weigh heavily on the Stockholm Stock Exchange. Another Board member pointed out that arguments about exchange rate effects from portfolio flows, for example in the wake of the pension reform, should be taken with a pinch of salt. Tentative studies of such effects that have been made at the Riksbank show no distinct pattern. It should also be borne in mind that households in Sweden have already diversified their share holdings to a greater extent than in most other countries in Europe; increased diversification is also to be expected there as a part of the general process of internationalisation. Against this background and if one does believe that portfolio flows of this kind do affect exchange rates, there is rather reason to be optimistic about the path of the Swedish krona.

Stock markets in Sweden and elsewhere have been characterised recently by falling share prices and a nervous mood as the next round of reports approaches. Prices have fallen most in the IT and telecom sectors, where a number of major American corporations have issued profit warnings.

2. Account of monetary policy (Inflation Report 2000:3) to the Riksdag's Standing Committee on Finance

First Deputy Governor Lars Heikensten submitted a proposed account of monetary policy (Inflation Report 2000:3) 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 at the Executive Board meetings on 28 September and 4 October 2000.

The Board decided to adopt the Inflation Report as submitted and also that it be made public at 8 a.m. on 10 October 2000.

§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

New information about economic developments in Sweden and internationally confirms the picture of future inflation that is presented in the Inflation Report and does not call for changes in the assessment. The monetary policy discussion accordingly started from the Report's main scenario, taking into account the risk spectrum as outlined in the Report.

In the Inflation Report's main scenario, the 12-month rate of UND1X inflation (CPI inflation excluding transitory effects from indirect taxes, subsidies and house mortgage interest rates) is judged to be 1.5 per cent one year ahead and 1.9 per cent after two years. The corresponding rates of CPI inflation are expected to be 1.4 and

[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.

2.0 per cent. The picture of a strong economic upswing in Sweden, with rising resource utilisation, still holds. The reason why inflation is not forecast to be higher, even though the upswing is continuing and the forecast horizon has shifted ahead, is partly that the amount of unutilised resources in the economy is now judged to be somewhat larger than assumed earlier. This is accompanied by the prospect of somewhat lower wage increases and somewhat more favourable productivity growth. GDP growth in the main scenario is judged to be 4 per cent this year, 3.7 per cent in 2001 and 3 per cent in 2002. Compared with the assessments in June, the new forecast represents marginal revisions to growth as well as inflation.

Notwithstanding the development of oil prices and the exchange rate in the summer and early autumn, the forecast counts on the krona appreciating successively and the oil price falling back gradually. There is, however, a large element of uncertainty. A higher oil price and a weaker exchange rate could lead to inflation rising more rapidly than assumed in the main scenario. The situation in the labour market and the forthcoming round of wage negotiations are also highly important for the formation of monetary policy. There is judged to be some, albeit relatively small, risk of wage increases being considerably stronger than allowed for in the main scenario, for example as a result of negotiators' demands for parity and compensation. When various alternative paths are incorporated in the assessment, the balance of risks in the inflation forecast is judged to be on the upside both one and two years ahead.[2]

The conclusion from the assessments in the Inflation Report is that, with the risk spectrum included and given an unchanged repo rate of 3.75 per cent, the 12-month rate of UND1X inflation will be 1.6 per cent one year ahead and 2.1 per cent after two years. The corresponding assessments of CPI inflation are 1.5 and 2.2 per cent. The differences between the paths of CPI and UND1X inflation in the coming two years are accordingly marginal.

During 2000 UND1X inflation has been affected to a high degree by the price of crude oil. In keeping with earlier inflation reports, the price of oil is judged to be dependent on aspects of supply and demand that cannot be distinguished simply or clearly. The appraisal of how oil price developments are to be taken into account in monetary policy is unchanged. Another matter to consider when discussing the inflation assessment's consequences for monetary policy is how the tax changes proposed in the Budget Bill are to be treated. In the calculation of underlying inflation as represented by UND1X, it is only the direct impact from indirect taxes that is excluded. It follows that the tax adjustments for owner-occupied houses do not show up in UND1X. The tax changes for apartment buildings, on the other hand, do have some impact on UND1X inflation during 2001.

The appropriateness or otherwise of disregarding one or the other of these effects in the formation of monetary policy cannot be argued from economic grounds. At the same time, there are educational reasons for not altering the indicator that guide monetary policy too frequently. Furthermore, alternative ways of classifying the proposed tax changes have effects on inflation one to two years ahead that amount to

---

[2] An upside risk means that when the risk spectrum is included, forecast inflation is above the assessment in the main scenario.

only some tenths of a percentage point. The Board therefore considered that monetary policy should be formulated at present in the light of an assessment of inflation as measured by UND1X.

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

2.1 The monetary policy group's appraisal

The policy group had unanimously considered that the interest rate should not be increased. This was because inflation is forecast to be below the target for virtually the whole of the period on which monetary policy focuses. Inflation is admittedly expected to move up beyond the forecast horizon but there no grounds at present for supposing that the tendency will be dramatic. So if economic activity and prices develop in line with the assessments, there will be time to secure inflation at the targeted rate by means of future repo rate adjustments. Moreover, the fact that forecast inflation in the short run is clearly below the target should also be taken into consideration and play some part in the decision. Neither does the Riksbank's responsibility for financial stability afford any grounds at present for raising the repo rate. The rates of increase shown by a number of indicators, such as growth of the money supply and credit aggregates, have slackened recently. Although stock market values are high, the recent tendency has been downward.

The importance of the risk spectrum was explicitly discussed, with the focus on the paths of the oil price, the exchange rate and wages. In the opinion of the policy group, raising the interest rate today on account of higher oil prices would not be reasonable. A higher oil price neither can nor should be countered with interest rate increases if there is no risk of inflation being affected more permanently, for instance via effects on inflation expectations. There are still no signs of this. Concern about unduly high wage increases in the coming round of negotiations could be an argument for raising the interest rate already. The development of wages does present some upside risk, mainly because of the uncertainty as to how wage formation will function in a period when growth and resource utilisation are high. Finally, the policy group judged that the weaker exchange rate is mainly a consequence of how the euro/dollar rate has developed and therefore does not represent a direct loss of confidence in the krona. A repo rate increase could have desirable effects on the exchange rate.

2.2 The Board's discussion

Five Board members shared the policy group's opinion that the current inflation forecast favours leaving the repo rate unchanged. But all five underscored that the clear picture of a strong economic upswing implies that the unutilised resources will be brought into production successively and that a repo rate increase may be necessary in the future. The sixth Board member attached greater weight to the risk of rising inflation beyond the two-year period and the risk that a late curbing of such a tendency would entail a more marked downward effect on output. This member therefore advocated an immediate repo rate increase.

One of the members who favoured an unchanged repo rate agreed that in the current phase it is reasonable to attach somewhat greater importance to prospects beyond the forecast horizon. The effect on inflation of the strong development of activity will presumably become more marked in the future. Much of the weak price tendency in recent years can be explained by various structural changes and the downward price effects of these changes should become smaller in the years ahead.

Another member who likewise considered the repo rate should be left unchanged pointed out that such a development is not self-evident. The strong growth trend and signs of bottleneck problems do admittedly suggest that inflation may accelerate beyond the forecast horizon but in a market economy there are self-regulating forces that can subdue such a tendency. A more nuanced perception of the conditions for economic growth in Sweden would also have effects on asset prices. The over-confidence in the economic future that was apparent earlier this year, for example in share prices on the Stockholm Exchange, seems to have subsided to some extent. Real-estate prices are still rising but mainly in the metropolitan regions, where they seem to mirror a realistic balance between financing costs and direct returns rather than exaggerated expectations of future price increases. Household net wealth in particular is heavily dependent on property prices, not least in that the level of liabilities is comparatively high and still rising.

A third member pointed out that the recent difficulties in predicting inflation's future path have had to do with the uncertain relationship between growth and inflation rather than with growth prospects as such. There are many indications that one reason why the rapid growth has not generated the inflationary impulses where there had previously been grounds for expecting, is a somewhat larger amount of unutilised resources. The complexity of the analysis means, however, that other explanatory mechanisms must also be considered. One such is the possibility that potential growth has risen. Another is that there has been a further reduction of the economy's inflation propensity, that is, in how inflation reacts to a given output gap. This may have resulted from, for example, the labour market becoming more flexible. One indication in that direction is the growing prevalence of forms of employment where bonus systems are an important component. That creates better conditions for individual wage adjustments that do not entail general wage inflation.

The Board went on to discuss the uncertainty in the inflation assessment with reference to the oil price, the exchange rate and developments in the labour market. Two members pointed out that the path of the oil price is a minor risk as long as inflation expectations remain in line with the inflation target. Inflation can, indeed, be expected to be somewhat higher in the short run but this is countered by the tendency for higher oil prices to dampen household consumption. The combination of higher inflation and weaker demand could in fact constitute a dilemma for monetary policy. With reference to inflation, however, an exchange rate tendency that is weaker than in the main scenario would be more serious. This is because a weaker exchange rate tends to stimulate resource utilisation at the same time as higher import prices have a direct inflationary effect.

As regards the coming wage negotiations, a number of Board members considered there were still no strong grounds for concern but developments must be followed closely. In recent years, employees have increasingly recognised that with the price stability objective, firms can no longer pass higher wage costs on to consumers to the same extent as before. At the same time, new forms for wage agreements and a mediation institute have been introduced, as well as more decentralised wage formation that is linked to productivity at the local workplace. One member did, however, express some concern about the level of the wage settlements that have been proposed to date. If there were to be indications of wage increases that are higher than the present forecast assumes, a larger interest rate adjustment may be necessary towards the end of the year. For inflation forecasts, there is scarcely a single factor that is of greater importance than the development of wages.

Another Board member considered that in the present situation, basing the formation of monetary policy primarily on prospects in the coming two years entails a comparatively large risk. There are now many signs that — disregarding the possibility of an abrupt adjustment to global imbalances — growth will be above the potential level for several years in succession. Due to various rigidities in the economy, there is a time lag before effects on prices show up and there is a considerable risk that, beyond the forecast horizon, inflation will exceed the target by a fairly wide margin.

This member also underscored the importance of bearing in mind that the present inflation assessment rests on a number of uncertain assumptions about oil, the exchange rate, the saving ratio, wages, profit margins and expectations. The effect on the inflation assessment of minor revisions in these respects can be quite appreciable, even for the coming two years. The continuation of a low saving ratio and an even smaller reduction of profit margins could well result if firms and households were to be more optimistic about expected future income flows. The analysis of the risk spectrum in the Inflation Report shows that an alternative picture of the oil price trend or the exchange rate can alter the forecast by several tenths of a percentage point. The wage assumption is also uncertain. While there is no general labour shortage, employment is distributed unevenly in terms of regions as well as competence; this places heavy demands on efficient matching in order to prevent shortage figures from rising more markedly. Moreover, small firms are experiencing greater labour shortages and many service industries continue to report shortages of competent labour. In addition, the rate of wage increases to date this year has been held back mainly by low increases in the public sector, particularly among the local authorities, where high shortages of various occupational categories are reported. The probability of matching problems and higher wage increases is not negligible.

Furthermore, the inflation assessment starts from inflation expectations that are low and presupposes that they remain relatively stable. This cannot be taken for granted. It is conceivable that, as a result of the strong activity or the high oil price, for example, expectations will change more quickly than assumed in the main scenario.

If inflation were to start rising more rapidly than is now foreseen in the main scenario, real income flows in the economy would also be affected, leading to a slower increase in real incomes. That could lead to problems if imbalances have accumulated and the consumption and investment decisions of households and firms have been based on a more optimistic future for real income. Having borrowed to invest and consume, they will have pledged too much to future growth. Household and corporate debt has grown; the level relative to GDP is high and for households it is rising, though the level in relation to disposable income is not yet alarming. But both the rate of lending to households and total corporate borrowing are still increasing comparatively strongly. The development of various asset prices, which is influenced to a high degree by expectations, would likewise probably be affected in such a scenario. Falling share and property prices might then accentuate the decline in demand and output.

The member's overall assessment was nonetheless that the picture in the Inflation Report represents the most probable development in the coming two years. But even with a path that follows the outlines in the Report, the member considered that if interest rates are left unchanged at present, most things suggest that beyond the forecast horizon inflation will rise comparatively rapidly. Allowance must be made for the risk that undue optimism, combined with factors that are temporarily holding inflation down, can lead to considerable imbalances in the future. Continuing to defer a monetary policy adjustment therefore entails a risk of high socio-economic costs in connection with lower growth. The member judged that the combined effect on demand from the real interest rate and exchange rate is still expansionary. To this should be added the prospect of a more expansionary fiscal policy. Prudence speaks in favour of making monetary policy less expansionary now. The member advocated a repo rate increase of 0.5 percentage points.

§3. The monetary policy decision

The Chairman summarised the monetary policy discussion under §2 and noted that there were proposals for a repo rate increase of 0.5 percentage points and an unchanged repo rate, respectively. The matter was put to the vote, whereupon the Executive Board decided that the repo rate is to be held unchanged at 3.75 per cent and that this decision shall apply from Wednesday, 11 October 2000, and that the decision be announced at 8.00 a.m. on 10 October, with the motivation and wording contained in Press Release no. 61 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 50 basis points.

This paragraph was immediately confirmed.