No. 21

SEPARATE MINUTES of the Executive Board meeting on 6 December 2000

Present: Urban Bäckström, Chairman
Lars Heikensten
Eva Srejber
Villy Bergström
Kerstin Hessius
Lars Nyberg
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Kerstin Alm
Mikael Apel
Claes Berg
Leif Jacobson
Per Jansson
Hans Lindblad
Christina Lindenius
Magnus Lomakka (§ 1)
Tomas Lundberg (§ 3–4)
Pernilla Meyersson
Robert Sparve
Åsa Sydén
Magnus Westerlund (§ 3–4)
Staffan Viotti
Anders Vredin

§ 1. The current inflation assessment

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

The Board's discussion was initiated with accounts of the information that had been received since the previous meeting on 30 November and its significance for inflation prospects (section 1). The Inflation Report was then adopted (section 2).

1. New information about economic developments in Sweden and internationally

The new statistics since the December Inflation Report was compiled confirm the picture of an international slowdown in economic activity, above all in the United States. Households as well as firms have become less optimistic about the future in the United States and also in the euro area. During the past week international bond rates have continued to fall in connection with the weaker economic statistics and further stock market declines. There has also been some fall in the price of oil. At the same time, the euro has become appreciably stronger against the U.S. dollar. Since the Inflation Report was compiled, the Swedish krona has strengthened against virtually all currencies; the level of the TCW index is now around 127, an appreciation of about 2.5 per cent. The Swedish stock market is still volatile but the probability of a larger fall has diminished. Just prior to the Board's meeting, 11 out of 12 market agents expected the repo rate would be increased, most of them by 0.25 percentage points. Expectations of the repo rate two years ahead were set at 4.6 per cent, which is 0.25 percentage points below the level of expectations before the previous Board meeting.

Statistics Sweden's survey of Swedish households' purchasing plans in November shows that households are still very optimistic. Households' expectations of their own economic situation 12 months ahead have become somewhat more optimistic since October. As regards the Swedish economy, however, fewer households now count on an improvement in the coming year, both in general and in respect of unemployment. Car sales in November were 8.5 per cent lower than a year earlier. The purchasing managers index for November indicates a clear weakening of manufacturing activity but does point to continued growth.

Deputy Governor Lars Heikensten then presented the monetary policy group's[1] appraisal of the new information. Some members of the group had considered that the information that is too recent to be incorporated in the Inflation Report pointed to inflation being marginally below the forecast and to the risk spectrum being somewhat more evenly balanced. It had also been pointed out that one explanation for the krona's appreciation could be that recent pronouncements by Board members had created expectations that an interest rate increase is imminent. The policy group had concluded that monetary policy ought to be based on forecasts in the Inflation Report. There were, however, reasons for making it clear that a revised assessment is entirely feasible if the Executive Board wishes to modify the picture underlying its repo rate decision. That could be made clear in §1.2 of the minutes as well as in the press notice in which the repo rate decision is published.

One Board member considered that the new information did not essentially alter the basic picture. The information contained in single observations is often limited and exchange rates in particular tend to

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

fluctuate upwards and downwards in the short run. This member did find it probable even so that the new information would have occasioned certain changes in the nuances of formulations compared with the Inflation Report and might also have resulted in a marginally different risk spectrum.

Another Board member agreed that some new statistics did suggest a weaker international trend but noted that the signals about the Swedish economy imply a continuation of strong activity. This member cited Statistics Sweden's survey of households' purchasing plans and underscored that households' own-economy expectations, which have proved to be a good indicator of future household consumption, have strengthened. Moreover, the numbers of new and unfilled job vacancies are still high. This picture is confirmed by the weekly statistics from the National Labour Market Board. The member also considered that the recent signals from wage negotiations give cause for concern.

A third Board member considered there were still major global imbalances but that as an adjustment had already begun, the risk of a marked slowdown has not increased since the Board's discussion of the draft Inflation Report. The dollar's decline eases the situation for countries whose currencies are linked, explicitly or otherwise, to the dollar. The tendencies to a slowdown in the United States, together with a continuation of modest price increases, reduce the need to raise the interest rate there, which is also positive for Latin America. The stronger euro dampens inflationary pressure in the euro area, which lessens the need for interest rate hikes. This, in turn, is good for growth. There is accordingly somewhat less risk of countries landing in the monetary policy dilemma of a marked slowdown coinciding with rising prices. As for the oil price, the short-run outlook is uncertain but the member saw no reason to adjust the path in the main scenario. This member shared the previous member's view of economic activity in Sweden and added that credit is still rising rapidly and although registered growth of the money supply had slowed during the autumn, this was probably because the statistics had not been adjusted for the millennium effect. The member also noted that even if export market growth and manufacturing activity do slacken, the services sector is becoming increasingly important for growth. Domestic demand, including persistently strong consumption, is keeping growth up. Moreover, the somewhat more subdued development of consumption has occurred from growth rates that were very high. In addition, tax cuts next year will contribute to increased scope for household consumption. All in all, this member found no need to alter the picture in the Inflation Report.

Another member considered that the new information about both Swedish and international activity pointed to the downside risks being larger than foreseen in the Inflation Report. The recent statistics show weaker tendencies in the United States as well as the euro area. There are clear signs that activity in Sweden is slowing. As examples, the member cited the Q4 business tendency survey for the engineering industry and a fall-off in

the inflow of export orders. Other signs of a more marked slowdown are falling car sales and a continued stock market decline.

A majority of the Executive Board stated that the new information about Swedish and international economic developments largely confirms the picture of inflation's path that is presented in the Inflation Report and does not call for any appreciable revision of the assessment. The monetary policy discussion should accordingly start from the main scenario in the Inflation Report, including the risk spectrum as outlined in the Report.

In the main scenario it is judged that, given an unchanged repo rate of 3.75 per cent, the rate of inflation excluding transitory effects from indirect taxes, subsidies and house mortgage interest expenditure (UND1X) will be 1.8 per cent one year ahead and 1.9 per cent after two years. The adjustments compared with the October Report are limited. Activity is judged to move along a more subdued path, with GDP growth rates in 2001 and 2002 that are somewhat lower than this year. The inflation forecast in the main scenario represents the development the Riksbank considers most probable; the underlying assumptions include gradually falling oil prices and an appreciating exchange rate. The inflation forecast is uncertain, which means that the risk spectrum is also relevant for the formation of monetary policy.

The oil price and the exchange rate both constitute clear upside risks for inflation in the coming years and these risks are judged to be greater than allowed for in the October Report. In keeping with that Report, the wage trend is another factor that might lead to inflation being higher than in the main scenario. An increasingly strong labour market, with rising employment, lower unemployment and growing labour shortages, implies a greater risk of wage drift. These upside risks are only partially countered by the downside risks in the risk spectrum: that international economic activity may be weaker than assumed in the main scenario and that the relationship between growth and inflation may be somewhat more favourable than predicted. All in all, the balance of risks is judged to be somewhat on the upside one year ahead and more substantially so after two years. When the risk spectrum is taken into account, the rate of UND1X inflation is judged to be 2 per cent one year ahead and 2.3 per cent after two years. The corresponding assessment of CPI inflation gives rates of 2.0 and 2.3 per cent, respectively.

2 Inflation Report 2000:4 adopted

Deputy Governor Lars Heikensten presented the draft of Inflation Report 2000:4 (Annex A to the minutes). The draft started from the presentations and discussions at the Board meetings on 23 and 30 November 2000.

The Board decided to adopt the Inflation Report as drafted and that it shall be published at 9 a.m. on 7 December 2000.

Reservation

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

With the risk spectrum taken into account, in the Inflation Report it is judged that the rate of inflation at the end of the forecast period will be 2.3 per cent. This is based on risk assessments that result in the balance of risks being on the upside. The main upside risks lie in higher oil prices, faster wage increases and a weaker exchange rate trend. Factors favouring lower inflation are weaker international economic activity and the possibility that the relationship between growth and inflation will turn out to be more favourable than assumed in the main scenario. I support the main scenario as described in the Inflation Report but not the skewed risk spectrum. In my view, the risk spectrum is symmetric. New information supports this opinion. The main scenario's forecast can accordingly constitute the foundation for the monetary policy decision.

This paragraph was immediately confirmed.

§ 2. Monetary policy discussion

The Board's monetary policy discussion was preceded by an account of the discussion in the Bank's monetary policy group (section 1). The Board members then presented their assessments of the monetary policy situation (section 2).

1 The monetary policy group's view of the monetary policy situation

The policy group had discussed the appropriate formulation of monetary policy on the basis of the assessment in the Inflation Report. The discussion had dealt with three closely related aspects.

The first and crucial aspect had been what the repo rate ought to be in order to ensure a rate of inflation in line with the target two years ahead. It had been judged that an increase of between 0.25 and 0.5 percentage points was needed in order to press inflation back from the forecast rate of 2.3 per cent to 2 per cent at the end of current two-year horizon. At the same time it had been noted that inflation is predicted to be below the target for a considerable part of the coming two years. It had been considered that the uncertainty in the assessment was greater than is normally the case, which might speak for acting cautiously.

The second aspect that had been discussed was how the financial markets could be expected to receive various conceivable repo rate decisions. After

the speeches that had been held, expectations had focussed on an increase of 0.25 percentage points. Presumably, then, an unchanged repo rate would elicit some discussion. The policy group had concluded that an increase of 0.25 percentage points would get a good reception.

Finally, various alternative repo rates had been discussed in relation both to monetary policy's intellectual framework and to earlier decisions and analyses. The policy group had noted that grounds had existed for advocating a minor repo rate increase earlier in the year. That could have been done in the light of forecasts indicating that inflation two years ahead would be approaching 2 per cent, accompanied by strong economic activity and a likelihood of growing price pressure beyond the two-year horizon. The inflation forecast plays a decisive part in the decisions that are made but it cannot be used mechanically. The exact timing of an interest rate adjustment is thus in many respects a matter of striking a balance between different risks. In this context it had also been mentioned that small changes in the current picture normally speak in favour of small repo rate adjustments. Finally it had been noted that an increase would probably give rise to a lively public discussion. Criticism would be likely to come from two quarters, from those who consider the Riksbank is acting too late and from those who would prefer an interest rate increase to be deferred.

Against this background the monetary policy group had recommended a repo rate increase of 0.25 percentage points.

2 The Board's assessment of the monetary policy situation

Five Board members agreed with the policy group's opinion that the repo rate ought to be raised. The sixth member considered that the repo rate ought to be left unchanged, arguing that the risk spectrum is probably considerably more balanced than is apparent from the Inflation Report and that risk-adjusted inflation is therefore overestimated.

In the opinion of one Board member, the risk spectrum in the Inflation Report is well motivated and new information does not alter this picture. The member stated that under these circumstances there are therefore no grounds for either referring specifically to a reassessment occasioned by new information or sending signals for other reasons in addition to what is presented in the Inflation Report. Other members agreed with this. The former member also stated that, as the picture of inflation prospects is comparatively difficult to interpret, there are reasons for proceeding relatively cautiously. Against this background the member advocated an increase of 0.25 percentage points.

The member who had considered that the repo rate should be left unchanged, noted that market expectations were now set on an interest rate increase. This member voiced doubts about the risk spectrum as presented in the Inflation Report. Concerning the exchange rate, the

member saw no strong reasons for departing from earlier assessments of the risks associated with the krona's appreciation. Economic fundamentals — the large trade and budget surpluses, for example, as well as the rapid repayment of government debt — continue to point to a stronger exchange rate. The member had difficulty in finding any appreciable risk of the krona's path being so weak that import prices would rise more rapidly than in the main scenario. Neither did the member concur with the assessment of risks to do with the oil price, arguing instead that as oil reserves are now larger than ever before and global economic activity is expected to be weaker, the risk of an unfavourable oil price trend is not as great as assumed in the Inflation Report. Against this there are political risks with instability in the Middle East, which could lead to high oil prices, but the member considered the probability of this was hardly greater than previously.

Neither could this member support the perception that the risk of somewhat higher wage increases had grown compared with the assessment in the October Inflation Report. The level of wage demands is in line with earlier Riksbank forecasts that had been judged to be compatible with the inflation target. Moreover, they are still only demands, not negotiated outcomes. In all probability, agreements will be concluded at a lower level, even though there is then wage drift to consider. The outcome of the negotiations will be known in a couple of months and provide a better basis for deciding whether or not the development of wages poses a threat to the inflation target. At present, in this member's opinion, the material for such an assessment is insufficient.

Furthermore, this member considered that the downside risks as described in the Inflation Report should carry more weight, not least in view of the indications from recent statistics that tendencies in the United States are weaker than the Riksbank counted on earlier. Prospects in the European Union, Germany in particular, also look somewhat worse than before. The Swedish economy already seems to be experiencing some slowdown. Retail trade is more subdued, car sales are falling and so, with certain exceptions, are the orders reported by many export firms. Share prices have dropped appreciably and the rapid increase in real estate prices has been broken. All this is admittedly taken into account in the main forecast, but the risk of appreciably weakened activity is probably underestimated. At the same time, the member underscored in this context that there is hardly a risk of a recession; it is rather that a slowing of growth towards levels that are more sustainable in the longer run can occur comparatively abruptly.

This member considered, moreover, that some downside risk also exists in the possibility that unutilised labour resources are larger than expected. Total registered unemployment is not quite 7 per cent, which is considerably above the level that was considered to represent full employment in the four decades before the crisis in the 1990s. Even though the remaining usable amount of unutilised resources is highly uncertain, it is approximately true to say that total unemployment is about two

percentage points higher than the earlier conception of full employment. Together with newcomers to the labour market and persons temporarily engaged in educational programmes, there should be more than 200,000 persons to employ before one can talk of full employment in the sense that was customary earlier. In addition, this member observed, labour market developments suggest that the growth of employment stems from a combination of higher demand and an increased supply; since 1998 employment has risen by 250,000 persons, while labour supply has move up 140,000 persons. This is a sign of good flexibility and reduces the risk of inflationary impulses from large wage increases.

Another downside risk may exist in an underestimation of the structural improvements in productivity and their tendency to subdue inflation. In the opinion of this member, IT penetration of the 'old economy' is now proceeding rapidly and the upward effect of this on trend productivity may exceed expectations. That would confer either a greater tolerance of high wage increases or lower inflation at a given wage trend. The member considered that too little consideration had been paid to the comparatively high productivity growth that is reported in the revised national accounts.

All in all, against the above background, this member judged that the risk spectrum is broadly symmetric. The basis for a decision would then be a rate of UND1X inflation two years ahead of 1.9 per cent. The member did not feel able — except for political or tactical, and thereby, in the member's opinion, irrelevant reasons — to support an interest rate increase at present. There might be grounds for raising the interest rate in a couple of months from now, for instance if wage formation turns out to result in unduly high settlements or if the exchange rate trend remains weak even after the portfolio adjustments connected with the pension system have been completed. In this uncertain situation the member considered the Riksbank should wait for information and defer an interest rate increase for the time being. In conclusion, the member acknowledged that an increase of 0.25 percentage points is not dramatic but considered that an increase ought to have a better motivation.

A third member noted that the present situation is somewhat unusual in that forecast inflation two years ahead in the main scenario is marginally below 2 per cent, while the risk-adjusted forecast is above 2 per cent because the upside risks predominate. Moreover, the uncertainty in the present assessment is higher than normal. Against this background, the member considered that much is required of how the monetary policy deliberations are motivated and communicated. The member considered the risk assessment was reasonable and advocated a repo rate increase. In the member's opinion, it is not self-evident whether the increase should be made now or somewhat later. But an early monetary policy adjustment in the present situation no doubt entails less risk of larger increases later on. The member therefore advocated an increase of 0.25 percentage points.

The Board members underscored that the risk spectrum is a central feature of the basis for the monetary policy decision and is well integrated in the forecasting work. The combination of a main scenario and alternative risk scenarios is a structure that clarifies the choices open to the Riksbank. The members pointed out that, by structuring the discussion around the risks with the aid of, among other things, a probability distribution, the Riksbank has paved the way for a better internal discussion of different risks in the picture of inflation, as well as for a better external dialogue. Even so, they saw reasons in particular for deepening the Board's discussions of different risks. According to one member, it is not always clear whether the best way of handling a particular aspect is to include it in the main scenario rather than the risk spectrum. To take the exchange rate, for example, which is often influenced by short-run and rather unintelligible factors, there may be educational reasons for taking it into account mainly in the risk spectrum.

Referring to the discussion of the risk spectrum in the Inflation Report, a fourth member considered that the outlined upside risk from wage formation was well founded. One reason is that, while total wage increases to date this year are admittedly in line with last year's level, this is mainly because public sector wage increases have been lower than in 1999, which is due in turn to agreements for certain groups not being completed, so that retroactive wages have still to be paid out. It is, moreover, mainly in these segments of the labour market that shortages are high and demands for relative wage adjustments have built up. This member also referred to the pressure on profit margins in parts of the economy and saw, through price increases, a possible risk of profit margins rising in the future instead of stabilising as foreseen in the Inflation Report. Against this background, the member considered that the Report's risk spectrum, with a predominance of upside risks in the inflation forecast, must be seen as reasonable even if, for example, the krona's appreciation around the turn of November were to be an indication that the upside risks from a weaker exchange rate are smaller than foreseen. The member also noted that to date there are few signs that the rapid growth of domestic demand will slacken appreciably at the same time as certain markets of importance for Swedish exports, mainly in the Nordic area, are expected to be strong. All in all, this member was essentially able to support the forecast but expressed concern that the realignment to a less expansionary monetary stance may have been postponed for too long. An alternative might therefore be to make a larger increase and then await developments. But the member found no strong reasons for opposing the increase of 0.25 percentage point that most of the members advocated.

A fifth member opened with a reminder that Sweden has a very low instrumental rate. In the member's opinion, this indicates that if the rate is increased, the move would hardly be as dramatic as the public discussion sometimes suggests. The member also considered that inflationary pressure in the economy is probably affected not just by the levels of employment and output but also by the rates at which these variables change. There are

many indications that a more subdued development is preferable and that even real parameters stand to benefit in the longer run from a path that is slower but more sustainable. The member pointed out that an interest rate increase is not to be interpreted as the Riksbank becoming involved in the round of wage negotiations; it is simply an endeavour to set conditions for the negotiations by fulfilling the inflation target as well as possible, thereby providing a clear benchmark. In this member's opinion, waiting for the outcome of the negotiations could be risky in that inflation expectations could move up if an interest rate increase is deferred and the wage outcome turns out to be too high. If the outcome instead were to be unexpectedly low, there is nothing to prevent the interest rate being lowered again. The same applies if, for example, international economic activity becomes appreciably weaker than expected. At present, however, there are no grounds for a different assessment to the one presented in the Inflation Report. Against this background, the member advocated a repo rate increase of 0.25 percentage points.

The sixth member commented first on the earlier discussion, in particular the arguments put forward by the advocate of an unchanged repo rate. This member noted that while the reserve of unutilised labour can be said to be substantial, it is important to bear in mind that the forecast already assumes that employment rises by over 100,000 persons. A repo rate increase of 0.25 percentage points represents just a marginal damper in this respect. A need to fill so many new job vacancies at a time when the labour reserve is shrinking should surely imply certain risks of inflation. When discussing the interpretation of new information, moreover, the member underscored that a slowdown is included in the forecast. The new figures largely confirm this assessment. Furthermore, allowance has been made for the possibility that IT investments, for example, may lead to higher productivity and ultimately to higher potential growth. This, the member pointed out, is something that the risk assessment in the Report highlights as a factor that could lead to lower inflation than in the main scenario.

The member went on to note that the exact timing of a measure is always a difficult question; in the member's opinion, the repo rate could have been raised earlier in the year, above all in June when many economic indicators were disturbingly strong. As things now stand, however, it seems the Riksbank was wise to proceed cautiously with increases in the past year and a half. To date it is on the downside, if anything, that the path of inflation has been unexpected. The member stated that in reality the development of inflation cannot be explained for certain. Even if many of the factors, such as deregulations, for instance, that have tended to subdue inflation recently can be expected to go on doing so, it is probably wise not to count on as many positive surprises in the future. The member also underscored the earlier view that waiting for the outcome of the wage negotiations would be risky. In the member's opinion, acting clearly at an early stage in the negotiations is the best contribution the Riksbank can make to good conditions for wage formation. The member found it important to stress that reversing an interest rate increase is comparatively easy if there are

grounds for this, for instance because the wage forecast has been adjusted downwards, whereas it is difficult at a late stage to mitigate the national economic costs of unduly high wage increases, possibly fixed by agreements for several years to come. Against this background, the member advocated a repo rate increase of 0.25 percentage points.

Two Board members had a discussion about the forecasting methods, particularly with reference to the exchange rate. The assumption of a constant repo rate was seen as a potential source of problems in that in practice it can be difficult to determine the extent to which an expected appreciation presupposes that the repo rate is increased. This was considered to be an important issue, not least because the forecast envisages that a successive increase in the predicted pressure from domestic demand is countered by an appreciating krona contributing to a subdued import price trend. One member pointed out that while the technical assumption of a constant repo rate is not without problems, the present forecasting method means that the Board attempts to construct as consistent a picture as possible of all the variables of importance for inflation, given an unchanged repo rate. The Riksbank's exchange rate assessment is integrated in the scenario as presented and it is hard to find alternatives to or evident improvements in the present methodology. However, the fact that the krona's exchange rate fluctuates a great deal — for reasons that are not always easy to understand even in retrospect — does suggest that it is reasonable to allow for considerable risks of the krona not following the path that is assumed in the main scenario.

§ 3. The monetary policy decision

The Chairman summarised the monetary policy discussion under § 2 and noted that there were proposals for, respectively, an unchanged repo rate and a repo rate increase of 0.25 percentage points. A vote was taken and the Executive Board decided that the repo rate is to be increased by 0.25 percentage points to 4.0 per cent, with effect from Wednesday, 13 December 2000, and that the decision is to be announced at 9 a.m. on 7 December 2000 with the motivation and wording contained in Press Release no. 78 2000 (Annex B to the minutes).

Deputy Governor Villy Bergström entered a reservation against the decision and stated that the repo rate should be left unchanged at 3.75 per cent.

This paragraph was immediately confirmed.

§ 4. Adjustment of the lending and deposit rates

Magnus Vesterlund, Market Operations Department, presented a memorandum (Annex C to the minutes) containing a proposal whereby

the Riksbank's deposit and lending rates would cease to constitute an instrument for signalling monetary policy.

The Executive Board decided to:

- terminate the monetary policy signalling function of the deposit and lending rates in accordance with the proposal in the appended memorandum, which means that until further notice, whenever the repo rate is adjusted, the deposit and lending rates are altered so that the repo rate continues to lie in the middle of the interest rate corridor
- set the width of the interest rate corridor until further notice at 150 basis points,
- raise the lending rate 0.50 percentage points, from 4.25 to 4.75 per cent, and the deposit rate 0.50 percentage points, from 2.75 to 3.25 per cent, as of Wednesday 13 December 2000
- issue a statute in the Riksbank's statute book in accordance with Annex D to the minutes
- publish the decision at 9 a.m. on 7 December 2000
- publish the termination of the monetary policy signalling function of the deposit and lending rates, Press Release no. 79 (Annex E to the minutes).

This paragraph was immediately confirmed.