Minutes of the Executive Board's Monetary Policy Meeting, no. 1

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

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PRESENT: Stefan Ingves, Chairman
Lars Nyberg
Lars E.O. Svensson
Barbro Wickman-Parak
Svante Öberg

Leif Pagrotsky, Vice Chairman of the General Council

Sigvard Ahlzén
Carl-Johan Belfrage
Claes Berg
Ingela Bäckström (§1)
Hans Dillén
Eric Frieberg
Kerstin Hallsten
Jesper Hansson
Karolina Holmberg (§1)
Ann-Christine Högberg
Anna Lidberg (§1)
Tomas Lundberg
Pernilla Meyersson
Jonas Niemeyer (§1)
Marianne Nessén
Staffan Viotti
Anders Vredin

§ 1. Economic developments

It was noted that Carl-Johan Belfrage and Hans Dillén would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

Jonas Niemeyer, head of the Policy and Analysis Division in the Financial Stability Department, began by giving an account of recent developments regarding financial stability and the functioning of the financial markets. The so-called 3-month basis spreads, which are often used as a measure of the market's valuation of credit and liquidity risks, have recently fallen around the world, although they remain at a relatively high level. It is still difficult for companies to finance their activities in the capital market.

In Sweden financing is primarily through short-term loans but there is considerable demand for loans with longer maturities. Foreign banks have reportedly become less willing to lend to companies outside of their own borders. Swedish companies are therefore looking to Swedish banks, which may crowd out the access to loans for smaller companies. This development could explain why non-financial companies' borrowing from credit institutions in Sweden is relatively high, at the same time as many companies are experiencing increasing difficulties in obtaining loans. It is also clear that banks wish to improve their capital strength, which may also entail a tighter credit policy.

At the same time, it can be noted that the recent auctions held by the Riksbank have not been fully subscribed, which may be a sign that the banks can manage their short-time financing without the aid of the Riksbank. The fact that the short interbank markets are normalising is also a sign that the measures taken by the Riksbank have had the desired effect. There is reason to consider how the Riksbank's measures should be designed to improve the functioning of a greater part of the credit markets.

Anna Lidberg from the Monetary Policy Department reported on the developments in the financial markets since the previous Executive Board Meeting on 23 January. The krona weakened a couple of per cent after the monetary policy meeting in December, but has to some extent recovered recently. The trend of policy rate cuts abroad is continuing. Market participants are expecting the Riksbank to cut the repo rate by 0.5-1 percentage points in February. However, the longer international government bond rates have begun to rise. This may reflect a need in the future for increased financing of government budget deficits.

Anders Vredin, Head of the Monetary Policy Department, presented a base for the Executive Board's discussion in the form of a draft Monetary Policy Report. He observed that the conditions for the base, in the form of an international outlook, developments in the financial markets, the Riksbank's company survey and an account of new information on the Swedish economy had been presented by the Monetary Policy Department and discussed at a meeting with the Executive Board on 22 January. An account of the detailed forecasts and alternative scenarios was presented at a meeting on 23 January.

The revisions to the forecasts are roughly the same size as those made at the two most recent meetings. The forecast for international growth, in TCW-weighted terms, has been written down by 1.2 percentage points for 2009. The oil price is expected to be lower. The forecast for the krona is on average a couple of per cent weaker than the assessments made in December. The gloomy developments abroad hit the Swedish economy hard, which is visible in the large falls in exports of goods and in order intake. The manufacturing sector statistics published in the morning further contribute to the gloomy outlook. The forecast for GDP growth in 2009 has therefore been revised down by 1.1 percentage points. However, the downturn is not expected to be as deep as during the crisis at the beginning of the 1990s. CPI inflation is expected to fall to -0.5 per cent during 2009, but will rise to levels above 3 per cent towards the end of the forecast period. The large adjustments in the repo rate during the forecast period lie behind the large changes in CPI inflation. The forecast for CPIF inflation is between 1 and 2 per cent over the coming two years. The forecast for the repo rate involves it being cut immediately to 1 per cent and that there is some probability that it may need to be cut more further ahead before it begins to rise fairly rapidly at the end of 2010. These forecasts refer to the main scenario in the draft Monetary Policy Report. A number of alternative scenarios are also presented in the Report.

§ 2. Economic outlook abroad

Deputy Governor **Lars Nyberg** began the discussion by observing that the funding situation in the international markets appears to have eased somewhat in recent weeks. Non-financial companies, and also some financial companies, have been able to issue bonds on the European market and the US market for short-term loans has also remained open, although volumes have fluctuated. But this is roughly the extent of the positive news. There still appear to be substantial unreported losses in many of the world's bank systems and the investors' distrust of the banks remains. The rapid decline in economic activity adds bad credits to the banks' balance sheets and above all increases uncertainty. A number of countries have now launched new government support packages, but these have not succeeded in restoring confidence either. It is rather the case that they have created expectations of government takeovers, which has made the banks' share prices fall further. Sweden is an exception here. A number of countries, including Spain, Ireland and Greece, have seen the interest rate at which they can borrow in the market rise substantially. This is not entirely unnatural. When governments guarantee their bank systems, the risk is transferred from bank securities to government securities. But when this concerns governments with the power of taxation, which are moreover part of the European monetary union, the development is nevertheless remarkable.

The process of deglobalisation of the financial markets is continuing. When the banks are forced to make cuts in their balance sheets it is often the foreign borrowers who are affected first. Extensions are given on loans to domestic borrowers, as they are well known and operate under the same legislation as the banks themselves, while foreign customers are given notices of termination. In this way, we can see a clear deglobalisation of the banking system at the same time as many companies are finding it difficult to finance their activities. When large companies that normally borrow on the world market turn back to the national banks they push out the small and medium-sized companies that are always dependent on domestic banks. The increasing focus on home markets by the banks gives tendencies towards a credit crunch throughout Europe. The shortage of credit accentuates the economic downturn and the new support packages are therefore aimed at encouraging the banks to lend more. It is too early to say whether this will succeed.

The economic downturn we are seeing in the world is extremely rapid and it has accelerated since the monetary policy meeting in December. The Riksbank's assessment then was that global growth would be almost 2 per cent in 2009. This figure has now been revised down to half a percentage point. The downturn affects almost all countries and all hopes that Asia or South America would contribute purchasing power when this declined in other areas have now been dashed. Not even developing countries which have largely remained outside the financial crisis have escaped the effects of the fall in world trade. In Western Europe and the United States GDP is falling by between one and two per cent, according to Consensus' forecasts. In the United States there is nothing to indicate that the property market is about to recover, which is the sign everyone is waiting for that the economic slump is over. However, a turnaround will come sooner or later and when it comes it may happen quickly.

At the same time, inflation is falling sharply, partly as a result of falling oil and commodity prices. Not much remains of the inflation and inflation expectations that gave us so much cause for concern only six months ago.

First Deputy Governor **Svante Öberg** agreed with the description of international developments in the Monetary Policy report and explained that he only had two comments.

Firstly, he considered that the Report makes perfectly clear the dramatic changes that have occurred since September last year. International prospects have deteriorated significantly and the crisis has spread to both Europe and the emerging economies. Mr Öberg noted that the Riksbank was assuming as recently as in September that GDP growth in the United States would be 1.6 per cent this year and that GDP growth in the world would be 3.8 per cent. Now the forecasts for the United States have been revised down to minus 2 per cent and for the world to almost zero. Growth in 2010 is also forecast to be modest. This means that the conditions for monetary policy are quite different now than in the autumn.

Secondly, Mr Öberg's assessment is that the downside risks are still greater, despite the large downward revision of the international economic outlook. The revised forecast is reasonable as a main scenario. The forecast assumes that the financial crisis will become milder in 2009 and that growth in the United States and Europe and as well as in the world economy will pick up in 2010. The main factor in favour of the main scenario is the forcefulness shown by central banks and governments during the crisis. This has enabled us to avoid a collapse in the financial system.

The main factor in favour of a more negative outlook is that the financial crisis is so potent and on a global scale. The traditional forecasting methods are not sufficient in such a comprehensive financial crisis. They are based on a combination of partial models and assessments and they have some forecasting ability up to one year, but the uncertainty is considerable, even one year ahead. This is indicated not least by the revisions to the forecasts for this year. The more extensive econometric models often do not have any developed financial sector and are therefore unable to capture the mechanisms of a financial crisis.

It is thus necessary to take into account experiences of earlier financial crises. These show that widespread financial crises are usually followed by a prolonged period of low growth and falling employment, falling asset prices and a substantial deterioration in public finances. The fact that there is a global downturn in the world economy makes it difficult for individual countries to bring about an export-driven recovery. Rising unemployment and poorer public finances have a restraining effect on private and public consumption. The need in the financial system to reduce balance sheets has a restraining effect on the banks' lending and on corporate investment. This indicates that there is a substantial risk that the economic downturn will be more prolonged than in the main scenario and that 2010 will also be a year of weak growth in the world economy.

Governor **Stefan Ingves** noted that, both in the Monetary Policy Report and elsewhere, large downward revisions are being made to the international economic outlook, concerning both the depth and length of the downturn, as well as its dispersion. Earlier hopes that parts of the world economy could develop relatively well, known as decoupling, have come to nought and the economic downturn is now a reality throughout the world economy. As everyone around the world is now talking about a fall in exports, this means a fall in global demand. The conclusion is that the Swedish economy will receive little or no help from abroad and that inflationary pressures are erased.

Excessively high risk-taking and new complex financial instruments created chaos in the financial sector, particularly in countries where this sector is large and advanced. However, some countries, such as Sweden, have escaped relatively lightly. We are now entering a widespread international economic downturn where the credit cycle is being tangibly affected and we can thus also expect more traditional credit problems in an already weakened financial sector. Mr Ingves shared Mr Nyberg’s assessment that we are now moving from global liquidity management to more domestic management. This can be regarded as an introduction of trade barriers for capital flows and thus entails an unforeseen reverse in the process of globalisation. A large part of the financial system's borrowing must now be managed in the domestic market, which entails a further strain, given the prevailing economic climate.

One consequence of all this is that the velocity of money falls and that large increases in central bank reserves are required to facilitate liquidity management and to avoid falling loan stocks. Low nominal interest rates contribute to low real interest rates, which are also important to maintain demand in the prevailing economic situation.

Continued liquidity support is reasonable, but this is only a first measure. New measures are required to meet the bank problems, similar to those experienced by Sweden in the 1990s. However, different countries are facing different problems. The willingness and ability to solve the problems can also vary. One thus cannot expect that all countries will resolve their bank problems at the same time or in the same way. Bank problems and budget deficits lead to problems in government finances, which in turn can have very different consequences from one country to another. The larger the public debt and the larger the distrust of economic policy, the greater the problems in financing deficits and the accompanying macroeconomic difficulties.

For Sweden, developments in the Baltic countries are a source of uncertainty. In terms of business cycle impact, the Baltic countries have a minor effect on the Swedish economy, but there is an indirect effect that arises from the Swedish financial sector’s exposure to the Baltic countries leading to increased risks and capital requirements, which in turn has repercussions for the banks’ ability to act in Sweden.

All in all, we see that falling global demand and various financing problems abroad lead to falling exports, increased demands for domestic financing and increased demands on the banks' capital adequacy.

This affects the Swedish economy. Aggregate demand is falling dramatically and inflation will undershoot the target. There are several similarities to the crisis of the 1990s but also important differences. The problems this time come from abroad. Sweden has had a persistent current account surplus, the national debt is low and public finances are good at the same time as the repo rate has fallen rapidly. A number of measures have been taken to maintain the functioning of the financial sector. We are in no way unaffected by what is happening abroad, but compared with many others we have a fairly good point of departure. However, as pointed out in the Monetary Policy Report, one cannot expect it to be possible for an open economy like the Swedish one to use domestic demand to fully compensate for the fall in demand from abroad.

Deputy Governor **Barbro Wickman-Parak** noted, like Mr Nyberg and Mr Ingves that the deterioration in the world economy had come exceptionally fast and that it had been necessary to repeatedly revise down the international growth forecasts. The GDP of our main trading partners is expected to fall by almost two per cent this year which entails a total downward revision of a good three percentage points over the three rounds of forecasts since September. Now that the emerging markets are also slowing down, world growth this year is expected to be around half a per cent, compared with around 3.5 per cent last year. No corner of the world appears to be immune to the global crisis. The International Monetary Fund, IMF, recently published a new forecast that incidentally largely agrees with our own. The IMF's calculations show that the accumulated fall in production in relation to potential growth this year and next year is comparable to the downturns in the mid-1970s and early 1980s.

The outcomes reported since December have been poorer than expected and illustrate the depth of the current downturn. For example, the figures up to the end of November, and in some cases up to the end of December, show that industrial production in countries such as the United States, Germany, the United Kingdom and Japan fell by 10 per cent or more on an annual basis. The fact that orders and exports are plummeting simultaneously in most countries indicates that the fall in production is continuing. It is clear that 2009 will be a year of negative growth among our main trading partners. The question is whether the fall in growth may even be greater than is predicted in the forecast in the Monetary Policy Report, where international economic activity bottoms out this year and growth slowly begins to rise next year. It is expected to be a very bloodless economic upturn for our main trading partners, with growth in 2010 at around half a per cent. A fundamental condition for economic recovery is that the crisis in the financial system wanes, and does not worsen. But even if we are now past the worst, the large slowdown means that the banks' loan losses will increase as companies' and households' ability to pay deteriorates.

The growth forecast for 2010 and onwards is genuinely uncertain and depends to a great extent on whether the economy in the United States will begin a turnaround as predicted. However, Ms Wickman-Parak wished to emphasise that the main scenario in the Monetary Policy Report is far from optimistic. The six quarters of falling growth that are forecast entail a longer period than in earlier recessions since the Second World War. Furthermore, as illustrated in the Monetary Policy Report, the subsequent recovery is expected to be much more modest and much slower in relation to the aftermath of earlier post-war recessions.

Ms Wickman-Parak considers two key areas to observe in order to detect signs of whether the expected recovery in the United States is really on its way. One is the birthplace of the crisis, namely the housing market. House prices are falling by two-digit figures and there is no sign of a turnaround. As the supply of new housing has fallen so substantially, interest rates are so low and the access to credit should gradually normalise, however, it should be possible to see some gradual stabilisation. As yet, there is no sign, or at best only a very slight one.

The other key area is the labour market. Employment in the United States began to decline at the beginning of last year and up to the end of January this year it had fallen by around two and a half per cent, which means that around 3.5 million jobs have disappeared. This is a very rapid adjustment in the labour force; during the downturn immediately following the turn of the millennium, employment declined by two per cent, but this was a protracted process taking around two and a half years. Nor is it possible to expect any rapid turnaround, which makes the fall in private consumption that we saw during the second half of 2008 likely to continue and the forecast is for a decline in consumption for the year 2009 as a whole.

With this gloomy outlook, it is perhaps easy to think that the main forecast is not sufficiently pessimistic after all. An alternative scenario outlines a more negative development, which is based on the financial crisis having more prolonged and profound effects. Ms Wickman-Parak stressed the correctness of Mr Öberg's remark that experience shows that recessions rooted in financial crises can be drawn out. She also explained that she nevertheless supports the forecast in the main scenario of the Monetary Policy Report and that she does not wish to rank the different alternative scenarios. However, she did want to point out that the alternative scenario involving a quicker recovery nevertheless exists. The financial system is undergoing a massive confidence crisis which has quickly made a lasting impression in the real economy, and experience shows that a recovery may come quickly once confidence finally returns. It is easy to forget this when all figures point downwards. It is always difficult to predict turning points in the economy, and it is easy to underestimate the force of both upturns and downturns. It is not made any easier now, when we have a financial crisis the effects and length of which are difficult to assess. At the same time, it is not easy to assess the effects of the countermeasures launched in the form of stimulus packages and policy rate cuts. There is thus a possibility that the recovery will be quicker than assumed in the main scenario of the Monetary Policy Report.

Deputy Governor **Lars E.O. Svensson** explained that he agreed with the international analysis as discussed now and as presented in the Monetary Policy Report. The forecasts for the real economy and inflation in the world as a whole have been revised down substantially since the previous monetary policy meeting in December. This will affect Sweden and have consequences for the monetary policy decision.

Stefan Ingves noted that the members of the Executive Board share the international economic outlook expressed in the draft Monetary Policy Report.

§ 3. Economic developments in Sweden and the monetary policy discussion

Deputy Governor **Lars E.O. Svensson** began the discussion with a reminder that the forecasts for international developments have been revised down and noted that the forecasts for the real economy and inflation in Sweden have also been revised down substantially. As usual, the issue is to determine which new repo rate path is appropriate and makes the forecast for inflation and the real economy look as good as possible in relation to the inflation target and normal resource utilisation. One means of justifying the new repo rate path is to ask oneself how the forecast for inflation and the real economy looks with an unchanged repo rate path, that is, the old repo rate path from December, but with the revisions to the forecast motivated by the new information received since then. One can then compare this with the forecast for inflation and the real economy obtained from the new repo rate path and determine whether the forecast look better, that is, whether monetary policy is better balanced, with the new repo rate path.

This can be seen in the current Monetary Policy Report in the higher repo rate scenario described in Chapter Two. The repo rate path for what is called the higher repo rate scenario is roughly the same repo rate path as that adopted in December. This repo rate path is the blue curve in Figure 36 on page 23. The red curve is the new bathtub-shaped repo rate path. Figure 38 on page 24 shows the forecasts for CPI inflation associated with the two repo rate paths. Figures 39 and 40 show the forecast for resource utilisation, represented by the production gap in Figure 39 and by the labour market gap in Figure 40.

With the old repo rate path one sees that CPI inflation is low in relation to the inflation target throughout the forecast period, and resource utilisation is also low throughout the forecast period. With the new repo rate path, CPI inflation is low to begin with but then increases and eventually overshoots the inflation target. Resource utilisation remains low with the new repo rate path but is much higher than with the old repo rate path. The deviations of CPI inflation from the target level are lower throughout the forecast period with the new repo rate path than with the old one. There is also less deviation of resource utilisation from normal with the new repo rate path. It is therefore clear that the new repo rate path is better at stabilising inflation around the inflation target and resource utilisation around the normal level. The new repo rate path is clearly preferable to the old.

Although the new repo rate path is better, it is not entirely clear that the new repo rate path is optimal, in the sense of providing the best possible stabilisation of both inflation and resource utilisation. Resource utilisation is still fairly low throughout the entire forecast period. Inflation overshoots the target towards the end of the forecast period. Mr Svensson pointed out that it is a question of weighing the cost of overshooting the inflation target towards the end of the forecast period against the cost of low resource utilisation. One might perhaps need to see forecasts for a longer period of time to be able to assess this better, but at the same time one can ask what forecasts at longer horizons are worth, especially in this unusual and difficult to assess situation.

If one looks at Figure 35, page 21, which shows the forecast for the CPIF, that is, CPI inflation with a fixed mortgage interest rate, one can see that with the new repo rate path CPIF inflation does not overshoot the target, but instead approaches two per cent from below at the end of the forecast period. The fact that CPI inflation overshoots the inflation target is thus due to the repo rate increasing rapidly during the latter part of the forecast period and is an unavoidable consequence of this. Given this, one can expect that CPI inflation will fall back towards the inflation target beyond the current forecast horizon when the repo rate has stabilised.

As CPI inflation will fluctuate around CPIF inflation when the repo rate varies and CPIF inflation will not overshoot the inflation target while resource utilisation remains low, one may wonder whether an optimal repo rate path would be even lower than the present one. However, in terms of real rates the new repo rate path is very expansionary. Figure 33 on page 20 shows the real repo rate measured as a real four-quarter repo rate, that is, the average repo rate over the next four quarters less the inflation forecast for the next four quarters. This is a better and more accurate measure of the real repo rate than that used in earlier Monetary Policy Reports. We see that the real repo rate measured in this way falls as far as minus two per cent before it begins to rise, and it remains negative throughout the forecast period. The new real repo rate path is also far below the old real repo rate path from December.

All in all, Mr Svensson's view was that the new repo rate path corresponds to a very expansionary policy that can also be described as well-balanced. He explained that he supports an immediate cut of the repo rate by 100 basis points and the new repo rate path, as well as the forecasts in the main scenario as a whole and the analysis in the Monetary Policy Report.

First Deputy Governor **Svante Öberg** explained that he also agrees with the picture of economic developments in Sweden presented in the Monetary Policy Report and that he supports the proposal to cut the repo rate by 1 percentage point. Inflation does not at present put any restriction on the possibilities to cut the repo rate. At the same time, developments in the real economy are so weak that they motivate an even more expansionary monetary policy.

Mr Öberg also maintained that he finds it reasonable to have a repo rate path that indicates an intention to retain a low repo rate over an extended period of time and that the repo rate may possibly need to be cut further if the economy deteriorates more than in the current forecast. However, it is also important to be aware that interest rates will not remain this low in the long term. This is underscored by the repo rate path curving upwards during the latter part of the forecast period.

Mr Öberg explained that he primarily wanted to raise three questions. These concern the differences between different measures of inflation, inflation expectations and other monetary policy tools than the repo rate. With regard to the differences between different measures of inflation, he pointed out that the target for monetary policy is expressed as CPI inflation being at 2 per cent. At the same time, the repo rate decision and the repo rate path that form the basis for the current forecast are not expected to provide a CPI inflation rate that is close to 2 per cent towards the end of the forecast period, but one that is just over 3 per cent. This may appear to be a breach of the Riksbank's explicit monetary policy strategy, which entails monetary policy normally being aimed at attaining the inflation target within two years. But the current situation is not normal.

Mr Öberg considered that in the current situation it is more reasonable to aim for inflation measured in terms of the CPIF, which excludes mortgage interest rate changes, being close to 2 per cent towards the end of the forecast period, which it will be according to the current forecast. CPI inflation varies substantially over time, partly as a result of the actual policy rate decisions. The substantial fall in inflation this year is primarily due to repo rate cuts and falling energy prices. Inflation measured in terms of the CPIF is more stable and provides a better picture of the underlying inflation trend. The difference between the CPI and the CPIF is on this occasion unusually large during the forecast period.

With regard to inflation expectations, Mr Öberg pointed out that monetary policy is not merely a question of determining the repo rate; it also involves affecting expectations about the future. The question of the importance of inflation expectations has become more prominent as discussions of deflation have intensified. In the United States, where the policy rate is close to zero, the proposal has once again been put forward, for instance by Professor Mishkin who took part in the assessment of Swedish monetary policy, that the Federal Reserve ought to introduce a quantified inflation target like in Sweden in order to contribute to stabilising inflation expectations around the implicit target that the Federal Reserve is nevertheless considered to have. This could contribute to ensuring that expectations of deflation do not take hold.

It is important for monetary policy that inflation expectations in the longer term are anchored firmly around the inflation target. Previously, when the inflation rate was higher than two per cent it was important that they did not rise too far above two per cent. Now that inflation is lower than two per cent and the forecasts point towards CPI inflation being negative later this year, it is important that they do not fall too far below two per cent and in particular that expectations of deflation do not arise.

Mr Öberg also considered that although one should not attach too much importance to measurements of inflation expectations, as they have their limitations, they are nevertheless interesting as a further piece in the puzzle that constitute the analytical material for monetary policy. He claimed that it is possible to draw four conclusions from Prospera's most recent surveys.

Firstly, inflation expectations five years ahead have declined from 2.6 per cent in October to 2.3 per cent in January, which is good as they were too high in October.

Secondly, inflation expectations in the longer term have not been pushed up by the repo rate being cut rapidly and forcefully, but have instead fallen.

Thirdly, there are no widespread expectations of deflation in the longer term. Inflation expectations five years ahead are close to 2 per cent. The normal relationship between actual inflation and inflation expectations five years ahead also indicates that they will remain close to 2 per cent even if the CPI falls in 2009 in line with the forecast.

Fourthly, inflation expectations two years ahead have fallen from 2.8 per cent in October to 1.5 per cent in January, which is slightly more worrying as it is a larger fall than the normal relationship between actual inflation and inflation expectations two years ahead would indicate. The fact that they are far below 2 per cent also indicates that the repo rate should remain low for a prolonged period of time.

Inflation expectations one year ahead are not as interesting in this perspective as they do not say as much about the credibility of monetary policy.

With regard to monetary policy with other tools, Mr Öberg began by noting that the Riksbank normally conducts monetary policy by affecting the shortest interest rate. When the repo rate is cut, it becomes cheaper to borrow for consumption and investment, households' disposable incomes increase and the krona weakens, which supports exports and subdues imports.

But during the autumn the transmission mechanism has not functioned in this normal manner. The interest rates that are normally close to the repo rate have at times deviated substantially from the repo rate and in parts of the financial markets interest rates have been at very high levels.

The measures taken by the Riksbank during the autumn, for instance, the increased lending in SEK and USD to the banks, has been aimed at preserving financial stability. But they have also affected other interest rates than the interest rate at which the banks can borrow from the Riksbank, for instance, the interbank rate and mortgage rates.

Given the risk that the current economic downturn will be both profound and prolonged, at the same time as inflationary pressures are low, Mr Öberg considered that the Riksbank should continue to take this kind of unconventional measure. During the introductory presentation a number of suitable measures were mentioned.

Deputy Governor **Lars Nyberg** pointed out that the Swedish financial sector is far from as adversely affected as those in the United States and the rest of Europe. The financing difficulties that arose after the Lehman Brothers bankruptcy were not a result of the Swedish banks investing in bad assets, but were caused by the international markets for bank borrowing drying up. The measures taken by the Riksbank and the Government during the autumn and winter have been aimed at solving this problem. However, the financing conditions have eased slightly since December. Interest rate spreads in the market have largely returned to the levels prevailing prior to Lehman Brothers filing for bankruptcy. Three of the banks have also recently succeeded in acquiring new equity capital from the market without any form of government support, the fourth could do so if this was considered necessary. This is a sign of strength of the Swedish banks, as such acquisition of risk capital has been difficult or even impossible for banks in many other countries. Moreover, during the entire crisis the Swedish banks have continued to lend to one another on the short interbank market. In both the euro area and the United Kingdom the interbank markets have in practice been taken over by the central bank.

Although the Swedish banks have managed much better than many foreign competitors, they are still dependent on being able to borrow on the international capital markets. This is necessary not least to be able to finance the Swedish housing stock. Here, as Mr Ingves pointed out, the situation in the Baltic countries gives cause for concern.

In an economic downturn demand for credit usually declines, at the same time as the risks increase and the banks then naturally increase their collateral requirements. This does not necessarily mean a shortage of credit, as this only arises if borrowers with adequate collateral are rejected by the banks because the latter do not have sufficient capital to lend. In an economic downturn companies are denied credit because their business concepts or collateral are assessed as too risky. Some companies refrain from borrowing as they consider the interest rates charged by the banks to be too high. None of this indicates a shortage of credit, even if it is sometimes called that.

In Sweden bank lending has not yet declined as much as might be expected in this phase of the business cycle. On the contrary, it has continued to grow. Nevertheless, there are many stories of companies being denied credit. The new trend of deglobalisation of banking activities has to some extent probably affected us too. When GE bank closed in Sweden, for instance, all of their customers were forced to make new bank contacts. This is not easy in the current financial climate.

The Swedish economic outlook is still as gloomy as the international one. However, compared with many other countries the stable public finances have given us a good starting situation. The forecast in the Report for GDP growth for this year has been adjusted down from -0.5 per cent in December to -1.6 per cent. Exports are falling substantially as a result of the fall in demand. Many export companies, which at the beginning of last summer still had a good inflow of orders, have during the autumn seen not merely the reduction expected in a normal economic downturn, but more or less a complete stop. Today's figures on manufacturing sector orders underline this. Households still have good finances, but demand from households can never compensate for a fall in demand from exports. In addition, households' purchasing power falls as unemployment gradually increases.

In December, the repo rate was cut by 1.75 percentage points, a uniquely large cut justified by a uniquely rapid economic downturn. Since then the downturn has continued at an even more rapid pace than expected, which calls for further large downward adjustments to the growth forecasts. It is obvious that the repo rate needs to be cut even further. Given the prevailing uncertainty a large cut of 1 percentage point down to 1 per cent is motivated. Inflation is currently no restriction when one disregards the direct interest cost effects that changes in the repo rate have on inflation.

It is at present even more difficult than usual to have a definite opinion about the future repo rate path, and a path that remains around one per cent over the coming year does not appear unreasonable. It is too early to say whether the economic trough will be more prolonged or whether the economy will recover more quickly. Much of this is connected with confidence and the mood on the financial markets, and here things can change very quickly.

Governor **Stefan Ingves** made the assessment that the economic situation at present is very worrying but that the starting point is nevertheless better than during the crisis years at the beginning of the 1990s. Mr Ingves supports the analyses in the draft Monetary Policy Report and the proposal for a repo rate path, but could also consider a slightly lower repo rate path over the coming period if there is general support for such a downward adjustment among the members of the Executive Board. On the other hand, at the current repo rate other measures play an increasingly large role in ensuring that monetary policy and the financial sector will function.

Thus far, it is good that inflation expectations in the slightly longer term continue to remain close to the inflation target. Under the prevailing circumstances the real repo rate is perhaps particularly important. With an already low nominal repo rate this means that monetary policy should in one way or another ensure that inflation expectations are kept around the inflation target of 2 per cent. However, this will require further measures to reinforce the functioning of the financial sector. There is reason to return to these measures, such as increased lending to the banks in one form or another, fairly soon. In addition, the dynamics of current events and the changed functioning of the financial markets will require that various measures are taken along the way, partly as it is not entirely possible to assess the effects of the different measures.

Under normal circumstances monetary policy is formulated under the assumption of a fairly constant transmission mechanism. This does not apply at present. It is therefore important for this reason, too, that normal monetary policy is supported by other measures. The article in the Monetary Policy Report on monetary policy with a zero policy rate provides a good picture of which alternative tools are available. In this context, government measures to strengthen the banks' capital base are also an important complement to the Riksbank's measures.

This far in the business cycle there are no conflicts between policy objectives. A repo rate cut supports both the inflation target and economic developments in general. However, one risk that cannot entirely be disregarded is the development of productivity. A continued low productivity could lead to increased cost pressures, despite the economic downturn. A conflict between policy objectives would then arise between the inflation target and economic activity. The scenario with low productivity and a weaker krona exchange rate described in the second chapter of the Monetary Policy Report is not particularly likely, but nevertheless describes risks that must be closely monitored.

To summarise, Sweden cannot avoid a global economic downturn, but the effects can be alleviated by both fiscal and monetary policy. Under the prevailing circumstances a repo rate cut supports both attaining our inflation target in the long term and maintaining demand. If developments were to be even worse than we anticipate now, we should be prepared to take further measures in addition to traditional monetary policy. If this were to happen, the measures would also need to be related to what happens in the public sector as a whole to support the financial system. For instance, government guarantees and capital injections act as a complement to increased lending from the Riksbank.

Deputy Governor **Barbro Wickman-Parak** pointed out that exports of goods fell by more than 10 per cent in volume during the final quarter of the year and export orders fell even further. These outcomes are very concrete examples of how the increasingly weakened international economic activity is affecting Sweden and the forecast for exports has been revised down substantially since December. A slow strengthening of exports is expected next year, but this in turn depends on international economic activity recovering as anticipated.

In Sweden industrial production fell by two-digit figures at the end of the year and capacity utilisation has plummeted. The percentage of companies in the services sector with full utilisation of the company’s resources has also fallen. In this situation it is natural that investment plans are reduced and the forecasts for investment have therefore been revised down since December. It would be strange in this environment if the demand for credit did not decline, which Mr Nyberg has already mentioned. There is a lot of discussion that the banks are not lending enough, but in practice it is difficult to distinguish what is due to a decline in demand for credit and what is due to limits in the supply.

Ms Wickman-Parak then brought up some questions regarding households. Their expectations are currently at a low level, although they have recovered somewhat in recent months. It is primarily the view of their own finances, both with regard to the current situation and expectations of the future, that has contributed to the improvement. All those who are employed have reason to be optimistic, as real disposable incomes are expected to increase by a good three per cent this year. Households’ attitudes to buying capital goods have become much more positive in recent months. This may be an indication that the repo rate cuts have begun to have an effect. There are also some signals that the housing market may be about to recover, which is also largely due to lower interest rates.

However, households’ views of the labour market remain as gloomy as before, with 85 per cent of households believing that unemployment will increase over the coming year. On this point households have the same view as expressed in the Monetary Policy Report's forecast. Employment has started to fall and all indicators point to continued rapid deterioration. The forecasts for employment have been revised down both for this year and next year and unemployment is expected to peak at 9 per cent in autumn 2010. Employment is not expected to begin rising until 2011. This is one of the more worrying elements of the macroeconomic forecast presented in the Monetary Policy Report. With these gloomy future prospects it is natural that households should be cautious and save more. The forecast decline in private consumption of around 0.5 per cent this year appears reasonable. The downward revision now being made to Swedish growth this year and next year, for the third time in a row, is justified.

Given the gloomy economic prospects a substantial cut in the repo rate is necessary. Resource utilisation will fall at a rapid rate and thus inflationary pressures will also fall. There is nothing to prevent monetary policy from being used forcefully to alleviate the fall in production and to avoid an even worse development in the labour market. There is nothing to lose. On the contrary, a repo rate cut is needed to attain the inflation target in the long term. As Mr Ingves pointed out, there are no conflicting policy objectives at present.

Ms Wickman-Parak supported the proposal to cut the repo rate by one percentage point and the forecast indicated in the repo rate path. There is some probability that the repo rate may need to be cut further. When economic activity then recovers, it will also be reasonable to begin adjusting the repo rate upwards from an exceptionally low level.

Ms Wickman-Parak is not worried that monetary policy has reacted too much by cutting the repo rate to one per cent. If the upturn was to prove stronger and inflationary pressures were to begin to rise, it is possible to quickly restore the repo rate to more normal levels. This flexibility exists and then the repo rate can, if necessary, be raised in larger stages than the 0.25 percentage points that have been the "normal" size for repo rate adjustments. If developments are worse than expected, further repo rate cuts may be necessary.

In a situation that is difficult to assess, where a turnaround can occur, it is particularly important to monitor all of the various forward-looking economic indicators. For example, one can note, without appearing overly optimistic, that the purchasing managers' index for January took a slight turn upwards in almost all countries. All analysts know that an individual monthly figure should not be taken too seriously. But it may nevertheless be worth mentioning this as, according to experience, it is easy to be blinded by the current conditions and particularly now when these are pitch-dark.

As Mr Öberg has mentioned, during the forecast period there are substantial differences between the CPI and the CPI excluding the effects of interest rate changes. This is because of the Riksbank's repo rate cuts. It is therefore good that the Report on this occasion highlights the CPI excluding the effects of changes in interest rates, that is, the CPIF. It has a much smoother course and explains monetary policy in a better way. Nor does it ever go below zero, which may also be a good thing to point out in times when deflation is being discussed, as Mr Öberg also mentioned.

Finally, Ms Wickman-Parak agreed with her colleagues who emphasised that it is important that the Riksbank continues to implement measures aimed at improving the functioning of the financial markets and that the Riksbank is prepared to take whatever measures are necessary.

Lars E.O. Svensson referred to Mr Öberg's and Mr Ingves' comments on unconventional monetary policy and said that as both Japan and the United States now in practice have policy interest rates at zero and several countries are cutting their rates to close to zero, it is natural that monetary policy with a policy rate at zero should be discussed and debated even more. The Monetary Policy Report indeed also contains an alternative scenario in

Chapter Two assuming weaker developments in the real economy and a repo rate path at zero during part of the forecast period. The Report also contains an article on monetary policy with a zero policy rate. Although it is not very probable that a situation with a binding zero lower bound for the policy rate will arise, it is wise to consider what measures would be appropriate if this were to happen.

A binding zero lower bound on the interest rate means that the real interest rate is still too high for sufficient stimulation of the real economy, despite the policy rate being cut to zero. It is the real market rate that is important to the real economy, and it equals the policy rate plus a spread that reflects various risk and liquidity premia, minus expected inflation. Although the policy rate is zero, nominal market rates are positive as a result of the spread. The various measures taken by the Riksbank and other public authorities during the financial crisis to ensure that the financial markets function better and that the spreads decline would thus still play an important role, even if the repo rate were zero. They could actually be seen as even more important in such a situation. But the main means of preventing the real market rate from becoming too high and preferably making it sufficiently low lies in affecting inflation expectations; counteracting expectations of falling inflation and preferably creating expectations of higher inflation. In this type of situation it may be desirable to create expectations that even exceed the inflation target to obtain a sufficiently low real market rate.

It is in any case important to monitor inflation expectations and Mr Svensson thus found Mr Öberg's comments on Prospera's most recent survey to be of interest. According to this survey, inflation expectations one and two years ahead have fallen more than implied by the estimated normal relationship between inflation expectations and actual inflation. This could perhaps be regarded as indications that these inflation expectations are becoming worryingly low. On the other hand, inflation expectations five years ahead do not appear to have fallen unusually much, but are anchored close to the target.

A credible inflation target and a convincing inflation forecast, where inflation approaches the target or even exceeds the inflation target during this period is probably sufficient to create and preserve such inflation expectations. If, contrary to expectations, this was not sufficient, one might consider a temporary price level target, for instance, in the form of an average inflation target so that inflation over the coming five years should on average be two per cent. If inflation then falls below two per cent during a period of time, it must be kept above two per cent during a period of time to ensure the average will be two per cent.

If this does not suffice either, Mr Svensson pointed out that there is more powerful ammunition that can be used, and mentioned his proposal for a foolproof way of escaping a liquidity trap, which consists of first announcing a price level target, then depreciating the krona and holding it at a temporary exchange rate target in order to achieve this price level target. Mr Svensson does not believe that it will be necessary to use this method, but considers it good that it is available.

Svante Öberg interposed that the question taken up by Mr Svensson regarding a price level target was taken up and rejected by the Riksbank in connection with the assessment of Swedish monetary policy by Professors Giavazzi and Mishkin. The question still lacks topicality as there is so much invested in the credibility of the current inflation target, which has functioned very well. In the longer term, inflation expectations are firmly anchored close to 2 per cent. Temporarily replacing the inflation target with a price level target could jeopardise the credibility of our monetary policy.

Nor is a policy aimed at depreciating the krona something the Riksbank should devote itself to, in Mr Öberg's opinion. When the repo rate is cut, this also means in theory that the krona weakens, but the relationship is not a stable one. The current weakening of the krona began in August before the repo rate cuts were made and it ought to be mainly due to the financial crisis. The problem is now that there is a global economic downturn and all countries cannot simultaneously depreciate their currencies to stimulate production.

With regard to Mr Ingves' proposal for a lower repo rate path during the coming period, Mr Öberg pointed out that he considered it important that the repo rate path marks a willingness to hold the repo rate at a low level over a long period of time and at the same time to be prepared to lower it further. It would probably be possible to lower it a little further to denote a greater probability of a cut, but preferably not as far as 0.5 per cent. Then Mr Öberg would prefer to cut the repo rate more now.

Stefan Ingves put forward the view that in the current situation the time was not right to change the inflation target and nor were various forms of exchange rate intervention appropriate.

Lars Nyberg considered that while it was interesting to discuss these principles, the situation was not one where this was appropriate and it was not likely that such a situation would arise. With regard to a policy of exchange rate interventions, experiences show that these are not very simple in practice. Mr Nyberg also pointed out that inflation expectations need hardly become a problem. Oil and commodity prices, as well as nominal interest rates, are now so low that inflation and ultimately inflation expectations will gradually begin to rise. Furthermore, Mr Nyberg considered that the repo rate path in the main scenario of the Monetary Policy Report is reasonable and pointed out that in its current form it already implies some probability of further repo rate cuts ahead.

Like Ms Wickman-Parak, Mr Nyberg considered that the situation could look quite different when a turnaround in the world economy finally arrives. The recovery could then be relatively rapid.

Barbro Wickman-Parak considered that Mr Svensson's contribution reflects an interesting current discussion. However, she felt that a price level target could be considered in connection with choosing a monetary policy regime, but not now that our current inflation-targeting regime is well-establishing and working well. There is no reason to change this now, particularly in times of uncertainty when stable rules are required. Furthermore, Ms Wickman-Parak pointed out that the solution is elegant in theory but that many questions remain regarding how such a policy can be implemented in reality. It is not so easy to influence expectations in the way required for a price level target to function and be credible. Institutional conditions may also have an impact. One example: let us say that inflation has undershot the target a couple of years and one is committed to allowing inflation to be higher to return to the path. In connection with the wage negotiations for the period when the central bank aims for relatively high inflation, it will be difficult to explain that inflation needs to be higher because of undertakings to the price level target and to get the parties in the labour market to accept this. An adjustment of wage agreements to a temporarily higher inflation rate risks initiating an inflation process that could get out of control.

Ms Wickman-Parak also considered that a temporary transition to exchange rate targeting would be very problematic. In the current situation where many large countries are facing the same problems, it is not possible for everyone to choose to depreciate and thereby push up inflation expectations. It may be easier for a small country, but Sweden has chosen its regime and it is difficult to retain credibility if one switches between different regimes. The krona has depreciated in the wake of the crisis without monetary policy being aimed at influencing the exchange rate.

With regard to Mr Ingves' proposal for a lower repo rate path in the short term, Ms Wickman-Parak said that she had also considered this, but nevertheless decided to support the repo rate path described in the main scenario of the Monetary Policy Report. She pointed out that the Riksbank, including today's repo rate cut, has in total cut the repo rate by 3.75 percentage points in a short period of time and that there may be reason to first wait and see what effects this will have.

Lars E.O. Svensson clarified that he currently finds it less likely that anything other than the inflation target will be needed, but that he thinks it is good that alternatives are available and have been considered in the event that a situation should arise where they are needed. With regard to the credibility issues mentioned by Ms Wickman-Parak, there is a large literature dealing with the important question of which methods can best be used to establish credibility in a situation with a binding zero lower bound and which can best influence inflation expectations. However, it is beyond the scope of this forum to provide an account of these now. With regard to a depreciation of the krona, Mr Svensson pointed out that even a normal repo rate cut partly works through a weakening of the krona and that his proposal merely entails ensuring such a depreciation and conducting an expansionary monetary policy by other means than by cutting the policy rate when the policy rate is zero.

Mr Svensson further explained that he considered the repo rate path described in the draft Monetary Policy Report to be appropriate. It is compatible with the other forecasts and no new information has come to light over the past few days that dramatically changes the picture.

Stefan Ingves repeated his willingness to adjust the repo rate path downwards in the short term, but did not press for such a change, deciding instead to emphasise the downside risks that are outlined in the alternative scenario in the Monetary Policy Report describing worsened problems in the financial markets.

Stefan Ingves then summarised the monetary policy discussion. The downturn in the economy now looks as if it will be even worse than was thought in December. Exports and export orders have fallen dramatically and the number of redundancy notices remains high. The weaker economic activity has also led to the oil price falling further since December, which contributes to a lower inflation rate.

A lower repo rate and repo rate path are needed to counteract production and employment being too weak and inflation becoming too low. A lower repo rate path will dampen the fall in resource utilisation, which will rise again at the end of the forecast period. When the financial system begins to function better and the uncertainty declines, the demand from

Sweden and abroad will increase. The effects of the fiscal policy measures taken around the world will also contribute to the recovery. The weaker krona will also dampen the fall in growth and keep inflation in Sweden closer to the target of 2 per cent.

Inflation measured in terms of the CPI will fall very rapidly in 2009. This is largely due to the rapid repo rate cuts at the end of 2008 and the beginning of 2009. With effect from 2011, when the repo rate is expected to be raised again, CPI inflation will rise substantially. If the effects of unchanged mortgage rates are excluded, CPI inflation will develop in a more stable manner and be close to the target of 2 per cent at the end of the forecast period.

Economic prospects are unusually uncertain at the moment. For example, it may take longer time before the financial markets function as they should, but the effects of an expansionary economic policy may also come sooner and be stronger than in the main scenario. The future direction for monetary policy will depend, as usual, on how new information on economic developments abroad and in Sweden will affect the prospects for inflation and economic activity in Sweden.

§ 4. Monetary policy decision

The Chairman noted that the members of the Executive Board were unanimous in the decision to reduce the repo rate by 1.0 percentage points to 1.0 per cent.

The Executive Board decided unanimously

- to adopt the Monetary Policy Report according to the proposal, Annex A to the minutes.
- to publish the Monetary Policy Report on Wednesday 11 February at 9.30 a.m.,
- to cut the repo rate by 1.0 percentage point to 1.0 per cent and that this decision would apply from Wednesday 18 February 2009,
- to cut the lending rate to 1.75 per cent and the deposit rate to 0.25 per cent, with effect from Wednesday 18 February 2009,
- to announce the decision at 9.30 a.m. on Wednesday 11 February 2009 with the motivation and wording contained in Press Release no. 14 2009 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 9.30 a.m. on Wednesday, 25 February.

This paragraph was confirmed immediately.

Minutes by

Ann-Christine Högberg

Checked by:

Stefan Ingves, Lars Nyberg, Lars E.O. Svensson, Barbro Wickman-Parak, Svante Öberg