Minutes of the Executive Board's monetary policy meeting, No. 5

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TIME: 09.00

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

Sven-Erik Österberg, Vice Chairman of the General Council

Sigvard Ahlzén
Carl-Johan Belfrage
Claes Berg
Charlotta Edler
Heidi Elmér
Eric Frieberg
Johannes Forss Sandahl (§ 1)
Ann-Christine Högberg
Per Jansson
Hanna Larsson (§ 1)
Pernilla Meyersson
Marianne Nessén
Christina Nyman
Mattias Persson (§ 1)
Ulf Söderström
David Vestin
Staffan Viotti
Magnus Wiberg

It was noted that Carl-Johan Belfrage and Magnus Wiberg would prepare draft minutes of § 1, 2 and 3 of the Executive Board's monetary policy meeting.

§ 1. Economic developments

Hanna Larsson of the Monetary Policy Department began by presenting the most recent developments on the financial markets. Market developments in October have been characterised by somewhat less turmoil and volatility than in September. Developments on the stock markets have been calmer and somewhat stronger in October, when many

Swedish companies presented relatively good interim reports, although there have been warnings that effects in the form of lower demand may be felt further ahead. Since September the index for shares in the financial sector has developed roughly the same as the broader index. After weakening during the more turbulent month of September, the krona has strengthened slightly in October. Monetary policy expectations according to both survey responses and forward pricing have shifted down slightly in the short term since the monetary policy meeting in September. The pricing reflects an expected repo rate level of 1.75 per cent at the end of the year, that is, in total a cut of 25 basis points across the year's remaining monetary policy meetings, including this one.

Johan Forss Sandahl of the Financial Stability Department began by presenting recent developments regarding financial stability with a focus on the turbulence regarding public finances in Europe. It is expected that a rescue package from the EU and IMF will be paid to Greece at the beginning of November. Risk premiums – measured as the difference between the three-month interbank rate and the expected overnight rate – in the United States, the euro area, the United Kingdom and Sweden are still at high levels. A decomposition of the recent risk premium for the euro system shows that credit risk exceeds liquidity risk, unlike the situation during the financial crisis in 2008-2009.

The sovereign debt problems in the euro area have led to the situation in parts of the European banking sector becoming increasingly strained. For example, some banks there have experienced difficulties in borrowing money. The uncertainty has led to credit rating agencies downgrading the ratings for a number of Italian and Spanish banks. Moody's has downgraded Spain's credit rating by two notches and also said that France's credit rating may be threatened.

Per Jansson, Head of the Monetary Policy Department, presented the draft Monetary Policy Report which, in the assessment of the Monetary Policy Department, will gain the support of the majority of the members of the Executive Board. He began by noting that the forecasts in the draft were discussed by the Executive Board at meetings held on 10, 11 and 17 October. The text was tabled at a meeting of the Executive Board on 20 October. Since the Monetary Policy Update was published in September, new statistics have been received for among other things GDP, unemployment and inflation.

GDP for the second quarter of this year was revised down slightly. Unemployment was 7.2 per cent in September, which was slightly lower than forecast in the September Monetary Policy Update. The lower growth abroad in the coming period is expected to have a negative effect on Swedish export market growth and thereby Swedish GDP. The improvement in the labour market is therefore slowing down now. Resource utilisation is currently slightly lower than normal, but will normalise during the latter part of the forecast period as growth increases. CPI inflation was 3.2 per cent and CPIF inflation 1.5 per cent, calculated as an annual percentage change, in September, which was in line with the forecast. CPIF inflation will rise gradually and be close to 2 per cent towards the end of the forecast period. CPI inflation, which is affected by the Riksbank's repo rate increases, is still higher and will amount to 2.6 per cent in 2014. According to the forecast, the repo rate will gradually be increased to 3.5 per cent at the end of 2014.

Confidence indicators continued to fall up to the end of September. The purchasing managers' index is now below the levels connected to growth in the manufacturing industry in both Sweden and abroad, while the National Institute of Economic Research's Economy Tendency Survey indicates a slowdown in growth.

Compared with the Monetary Policy Update published in September, the forecast for growth, inflation and policy rates in some parts of the world is now lower. This is due to intensified concern over sovereign debt problems in the euro area, which has meant that greater emphasis is placed on the downside risk that was included in the September Monetary Policy Update. Unemployment in Sweden is revised up for 2013 and parts of 2014. Inflation has been revised down slightly during the forecast period, despite an increase in the cost of labour. This is due to lower energy prices and weaker economic developments abroad. According to the current forecast, the repo rate is expected to be increased at a slightly slower pace. Compared with the Monetary Policy Update in September, the forecast for the repo rate is now 0.3 percentage points lower for the end of 2012 and 2013. The reasons for this forecast are the assumptions that sufficient fiscal policy measures will be taken in the euro area and that households' and companies' confidence will gradually return.

§ 2. Economic outlook abroad

Deputy Governor **Karolina Ekholm** began by stating that she largely shares the view of developments abroad presented in the draft Monetary Policy Report. The report entails a further downward revision to the growth outlook, although it is a smaller revision than that made prior to the monetary policy meeting in September. The downward revision is mainly because it appears increasingly unlikely that the problems connected to weak public finances in the euro area will be quickly and painlessly resolved. The main scenario is still based on the assumption that the acute problems are successfully dealt with, and that an out and out bank crisis can be avoided, which is reasonable. But, as emphasised in the draft Monetary Policy Report, there are fundamental structural problems that cannot be resolved so quickly. Countries like Greece, Portugal and Spain have seen their competitiveness decline over a number of years through higher increases in wages and prices than the average for the euro area. As in the Baltic countries, they have tended to see high increases in wages and prices as a natural part of a convergence process in which these countries will become more like countries such as Germany. But they have not had a growth in productivity that would justify such a convergence with regard to wages and prices. Like the Baltic countries, the countries in southern Europe need to implement some form of internal devaluation to restore their competitiveness. This is not easy, although not impossible, which is illustrated by the example of the Baltic countries. However, it will take time and it will be unpopular.

She pointed out that the assumption that the most acute problems will be managed successfully would have been easier to justify if the results of this evening's meeting of the EU heads of state and heads of government were known. Now we do not know whether this meeting will result in decisions that reduce or increase the market turbulence that has been observed recently. Although she did not think that one should attach too much importance to what can be achieved at a single summit meeting, she believed that this meeting could nevertheless prove critical for the situation in parts of the financial market in the euro area. Without clear information on how banks lacking sufficient capital will be managed, she felt that it is difficult to believe that severe disruptions to the financial markets can be avoided.

Ms Ekholm explained further that, as at earlier meetings, she has a different opinion with regard to the forecast for policy rates abroad. The forecast is once again much higher than market expectations based on implied forward rates at slightly longer horizons. Ms Ekholm considers it unclear on what grounds one might expect them to rise much more quickly than market pricing would indicate. One might possibly claim that market pricing indicates that market participants expect a much weaker development abroad than is forecast in the draft Monetary Policy Report. A path based on market pricing is not entirely different from the TCW rate in the scenario with a prolonged public finance crisis, although it rises slightly more steeply. However, it is still the case that the strained public finances in the United States and large parts of Europe indicate that monetary policy will need to be more expansionary than is normal in a given phase of the economic cycle to compensate for fiscal policy tightening. Given this, Ms Ekholm explained that she once again enters a reservation against this particular component of the international forecast.

First Deputy Governor **Svante Öberg** felt that developments in Europe are currently worrying. As Ms Ekholm said, the EU heads of state and heads of government are meeting today to discuss, and hopefully to reach, a decision on measures to begin to rectify the excessive deficits in public finances and to stabilise developments on the financial markets. However, it is unclear how this will go and it is even less clear how the markets will react after the meetings. This indicates that we should not rock the boat with regard to monetary policy. We will be able to see in the coming weeks whether the measures succeed in turning the tide in a more positive direction, or whether the crisis deepens.

Developments in the United States are also troublesome. Public finances are actually an even greater problem in the United States than in the euro area as a whole. The deficit is much larger and a decision has been made about expenditure-increasing reforms. What is more, experiences of previous financial crises also point to production and employment being weaker than normal over a long period of time. This makes it even more difficult to manage the deficit in public finances and to bring down the high unemployment.

However, Mr Öberg nevertheless thought that the picture of international economic developments painted in the Monetary Policy Report is reasonable. The main scenario entails growth in both the United States and the euro area next year, although only weak growth. In addition, it is slightly weaker than was forecast at the most recent monetary policy meeting in early September. The forecasts for GDP growth in the United States and the euro area for next year have been revised down by 2 and 4 tenths of a percentage point respectively.

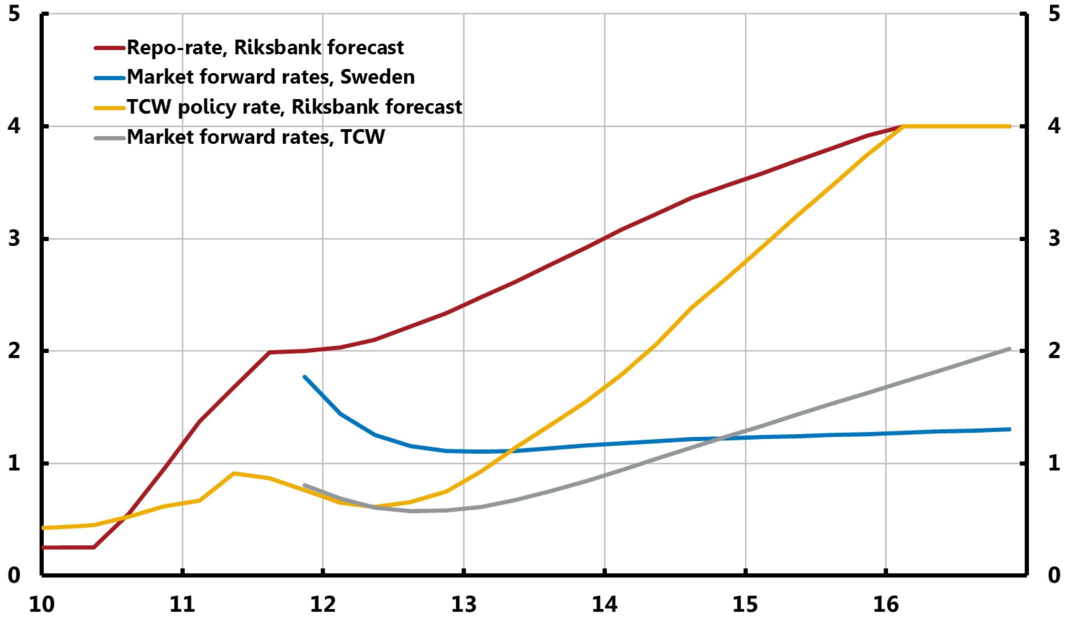
However, the picture is not as gloomy for the world as a whole. The downward revision to GDP growth next year is only one tenth of a percentage point and the forecast still entails relatively high GDP growth of 3.8 per cent. This is of course because emerging and developing economies are faring better. Together, they account for almost half of the global GDP. The IMF is expecting in its latest World Economic Outlook a GDP growth of just over 6 per cent in these countries in 2012. China, for examples, is expected to grow by 9 per cent and India by 7.5 per cent.

There is also a substantial difference between the forecasts for 2012 and the way things looked in 2009. The current forecast thus entails global GDP growth of 3.8 for 2012, while GDP fell by 0.7 per cent in 2009. This may of course be too optimistic, which was the case in October 2008, when the forecast entailed a global GDP growth rate of 2.9 per cent in 2009. If the calculations are as wrong this time, monetary policy will need to be adjusted accordingly.

Deputy Governor **Lars E.O. Svensson** pointed out that he has a more pessimistic view of the real economy than the one presented in the draft Monetary Policy Report with regard to inflation and GDP abroad. He fears that it is less likely that the debt crisis in Europe will be resolved in a good way and that the effects on the real economy and fiscal policy tightening will thus be more negative. As he has pointed out earlier, and as Ms Ekholm has stressed, there are problems with the assumptions regarding interest rates abroad and the forecast for policy rates abroad. As he had demonstrated with the aid of a figure at the monetary policy meeting in July, the forecast for policy rates abroad has systematically been too high for several years, with the outcome systematically lower than the forecast. A too high forecast for policy rates abroad leads to a bias towards a too high repo-rate path, all else being equal. A higher interest rate path abroad will, all else being equal, lead to a smaller difference between Swedish interest rates and those abroad, and to a weaker krona. The Swedish repo-rate path must then be higher to counteract this.

Mr Svensson then showed some figures to illustrate his reasoning. The figures contain forecasts and assessments beyond the normal forecast horizon that Mr Svensson has made himself. In Figure 1 the yellow line shows the current forecast for TCW-weighted interest rates abroad. The grey line shows TCW-weighted implied forward rates, adjusted by normal forward premiums, that is, 1 basis point per month. The forecast is very high above the implied forward rates and gives rise to a substantial upward shift in the Riksbank's repo-rate path. There is no discussion of these important circumstances in the draft Monetary Policy Report and there is no explanation of this high forecast, despite the fact that it has major consequences for the repo-rate path.

Figure 1. Repo-rate path, forward rates and policy-rate forecasts, October 2011
Per cent. Forward rates from 19 October 2011

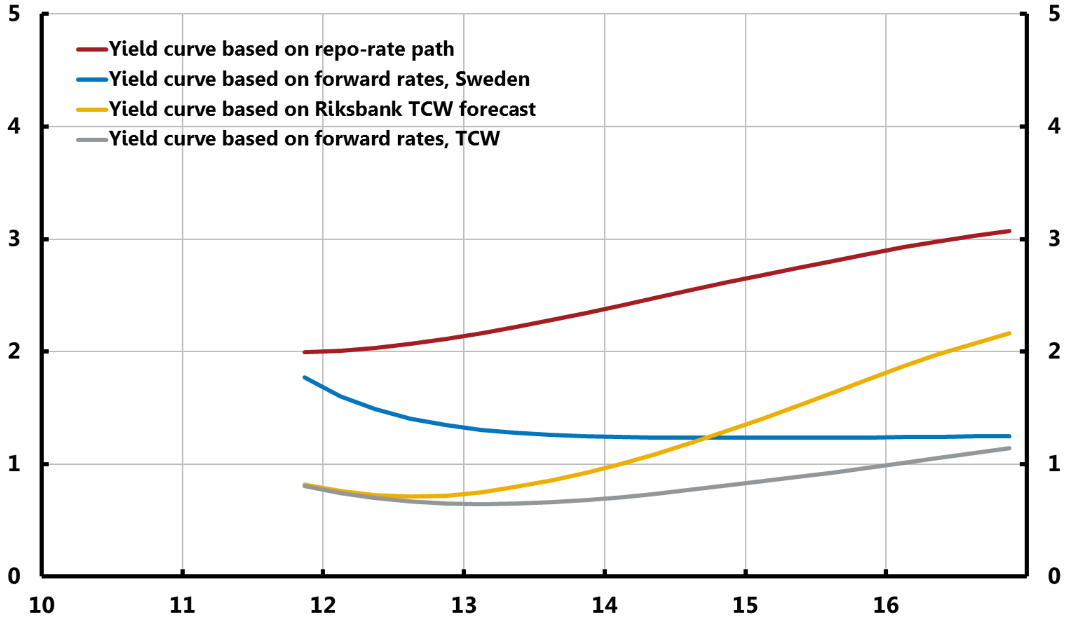


Sources: National sources, Reuters EcoWin, the Riksbank and own calculations

The forecast for interest rates abroad can also be perceived as an assumption on and a forecast for yield curves abroad, that is, interest rates abroad for different maturities. In Figure 2 the grey curve shows the actual TCW-weighted yield curve abroad, more specifically that which is compatible with the extended forward rate curve in Figure 1, while the yellow curve shows the yield curve abroad that is compatible with the Riksbank's forecast for policy rates abroad. A TCW-weighted five-year market rate is roughly 110 basis points. The Riksbank's high forecast for policy rates abroad corresponds to a five-year rate that is 100 basis points higher. Mr Svensson pointed out that one could simplify by saying that the Riksbank's analysis is based on the five-year rates abroad being 100 basis points higher than they actually are.

Figure 2. Yield curves, October 2011

Per cent. Forward rates from 19 October 2011



Sources: National sources, Reuters EcoWin, the Riksbank and own calculations

Mr Svensson pointed out that in this context it may be interesting to see what Norges Bank had forecast for forward rates abroad in its most recent Monetary Policy Report at its meeting on 19 October. They stated that there were no strong reasons for assuming that interest rates abroad would normalise more quickly than is indicated by market rates, that is, by forward rates. They also emphasised that the Federal Reserve had signalled that its policy rate will remain low for a long time. Norges Bank's forecast for policy rates abroad thus agrees with forward rates.

To sum up, Mr Svensson claimed that the forecast for policy rates abroad is much too high and that this contributes to the repo-rate path being too high. It would be better to let the forecast to be based on forward rates abroad and then adjust it on the basis of an assessment of monetary policy in the euro area, the United Kingdom and the United States. Mr Svensson claimed that he had pointed out on several earlier occasions that it is important to monitor this issue, and that potential deviations from implied forward rates should be justified and carefully discussed, as they have a major effect on the domestic interest-rate path.

Deputy Governor **Barbro Wickman-Parak** said that the starting point for this monetary policy decision is the same as at the monetary policy meeting in September, in that there are no existing agreements on solutions to the acute problems in the euro area. The different elements of a solution would appear evident, but the technical construction is complicated and politically difficult to manage, when it is ultimately a question of what demands can be made of the countries with problems and where the money will come from. This is a political crisis, and we can only wait and see what the solution will be. Hopefully, it will be resolved soon.

With regard to international growth, the risks in the euro area are also more acute now than they are, for example, in the United States. Earlier forecasts have been for modest growth in the euro area next year. In the summer GDP was expected to increase by just over one and half per cent, but with the downward revisions in September and in the current draft Monetary Policy Report, it is expected to increase by only half a per cent. This is a fairly large write-down in a short time. Assuming that the crisis does not lead to a drastic credit crunch, the growth forecast should not be unreasonable.

The forecast for growth in the United States has been adjusted down gradually since last spring. This time it is only a question of a reduction by a couple of tenths of a percentage point for next year so that the growth rate will be just below 2 per cent. That is roughly the same growth rate as this year. In both cases, growth is approximately one percentage point lower than in the forecasts made last spring.

The United States has its own political problems to manage, even if these have been overshadowed in the media by the euro crisis. As pointed out in the draft Monetary Policy Report, severe tightening is necessary and the dissension in Congress creates uncertainty over how this can be achieved. Although well aware of the continued problems in the housing market and the weak labour market, Ms Wickman-Parak nevertheless wanted to note, as at the previous monetary policy meeting, that the outlook is not entirely bleak. Companies have earned plenty of money and the current report period has not yet shown evidence of any major disappointments. The economic statistics received in the recent period have in several cases been slightly better than expected, and do not imply a much poorer outlook than indicated in the main scenario. The real economic collapse that came in the wake of the financial crisis in 2008-2009 is still fresh in our minds and it is easy to draw too many parallels. There are similarities, but also differences between the situation then and now. These are described in a special article in the draft Monetary Policy Report.

Ms Wickman-Parak summarised her view of developments abroad by saying that growth in the United States and the euro area over the coming year would not be anything to get excited about, but nevertheless positive, while it will remain high in the emerging economies, although it will slow down slightly. She then explained that she supports the international forecast as presented in the draft Monetary Policy Report.

Ms Wickman-Parak noted in conclusion that the international growth forecasts, which had been gradually adjusted downwards, also mean that the conditions for Swedish exports are expected to deteriorate. Last year the market for Swedish exports increased by more than 9 per cent, this year it is expected to be 5.5 per cent and over the coming two years to fall below 5 per cent.

Deputy Governor **Lars Nyberg** pointed out that since the previous monetary policy meeting the situation in Europe has deteriorated, not improved. Concern has increased as to how a political solution to the public finance problems in Greece, and also other countries, can be found. In addition, there is a realisation that many European banks lack sufficient capital to manage a write-down of Greek, and possibly other, government bonds. A new rescue package has been discussed at length in recent weeks, and will apparently be discussed at this evening's EU summit.

However, Mr Nyberg does not believe that one should expect a new package to solve all problems, even if the market reacts positively to the rumours circulating. During the week there have been discussions with the banks on a voluntary write-down of at least 50 per cent of their Greek assets. It is good that they have come this far, but it is not likely that even this will be enough to provide the Greeks with a lasting stable sovereign debt. Now the troika consisting of the EU, the ECB and the IMF has evidently approved a payment of EUR 8 billion in November, but it would appear that in addition to this, new programmes, that have not been planned, are needed from Europe and the IMF to manage future problems. Strikes and an inability to implement the promised measures have also undermined confidence in Greece's ability to manage the situation. Given this, it is difficult to see how the investors' concerns regarding further Greek write-downs can be allayed. And as long as these concerns remain, the investors will still be dubious about, for instance, Italian government securities. Although Greece is increasingly appearing to be unique, the Greek problem must be resolved in a credible manner if the European crisis is to be resolved. As Mr Nyberg sees it, there is no way around this.

With regard to the banks in Europe, the assessment made in connection with the stress tests during the summer was that they needed a capital injection of around EUR 2.5 billion. Since then the French-Belgian bank Dexia, which was far above the critical levels in the stress test, has been entirely taken over by its state owners. Now, according to the newspapers, the European Banking Authority assesses that almost EUR 110 billion is needed to attain a satisfactory capital adequacy level, at least temporarily, given that the banks' entire holdings of European government bonds are to be market valued. Mr Nyberg believes that the market has overacted in beginning to doubt that Italy and Spain are able to pay their debts, but this nevertheless illustrates how little confidence market participants have in the political process for crisis management in Europe.

It is far from clear how the banks' capital needs will be met. Agreeing on a capital adequacy requirement of 9 per cent, a figure that has appeared in the media reporting, is one thing, agreeing on who will pay is another thing. Only a few of the banks are likely to be able to acquire capital on the private market. The rest will probably need to receive capital injections from the tax-payers in their respective countries, where possible – or from a joint European fund, if it is possible to agree on its establishment. And this applies only to the need for risk capital. In addition to risk capital, the banks need to borrow much larger amounts if they are not to be forced to quickly strangle their lending, which would of course be very unfortunate when growth in the real economy is already weak for other reasons. The tax-payers will probably have to provide guarantees here, just as they did during the crisis in 2008. Not in all countries, but in many of them.

Mr Nyberg felt that the sum total of this was that things would probably get worse before they get better. However, he emphasised that he of course hopes that he is wrong. However, the political will to solve the European problems does not appear to have been mobilised. Crisis awareness and support in the opinion polls are weak, and there are conflicts of opinion on both major and minor issues. And for each press conference that contains more rhetoric than substance, confidence in the euro and also the EU declines. Moreover, there appears to be a split between the euro area countries and the other EU countries, which also makes it more difficult to find a solution. Although the market now and then appears to glimpse a ray of hope, the crisis will probably persist for many more months. Mr Nyberg assesses that the "muddling through", which is the Riksbank's main scenario for Europe, will take time. He also assesses that there is a considerable risk of difficult complications arising, for instance, in the form of the Greek crisis deteriorating, or in failures with regard to the internal devaluations that a number of euro countries need to implement.

At the same time, one must remember that growth in most of the rest of the world – and this also applies to parts of Europe – is fairly high. Although it has slowed down, it is still surprisingly strong in comparison with the expectations reflected in consumer and purchasing manager surveys. Companies in many parts of the world are making good profits and their order books are nowhere near the catastrophic situation at the end of 2008. Mr Nyberg concluded by noting that all of this is described clearly in the draft Monetary Policy Report and that he supports the analysis presented there.

Governor **Stefan Ingves** said that he shares the view of international developments presented in the draft Monetary Policy Update. There is great uncertainty as a result of the strained public finance situation abroad. The recovery will be more prolonged than in the previous assessment. This is largely due to the political difficulties in resolving the public finance problems in the United States and the euro area.

The forecast for the United States has been revised down somewhat. Households' and companies' confidence in the future has declined, and unemployment is still high. At the same time, there may be reason to remember the conclusions of Rogoff and Reinhart, based on a large sample of earlier financial crises in many countries. One conclusion is that economic recessions in connection with crises often last a long time. But one eventually reaches a situation where the economy finally turns around. On average, unemployment usually remains at high levels for several years – almost five – before turning around. And house prices may be depressed even longer, around six years. But then things improve. The crisis in the United States has now been going on for around four and a half years, and the outlook is not entirely bleak. Corporate profits are high and households are consolidating their debts. This indicates a recovery in the United States during the forecast period, on condition that confidence in the future is not undermined by too weak public finances.

Growth will be weak in many European countries over the coming year. But there are major differences between southern and northern Europe. Developments in Sweden and some of our neighbouring countries, with the exception of Denmark, are fairly good, as well as in Germany.

In the emerging economies, for example China and India, growth is still rapid and inflation is high, although we can begin to note signs of some slowdown. Together with developments in northern Europe, this will contribute to relatively good global GDP growth, despite the weaker developments in some areas.

Developments in the euro area will be affected in particular by the following three issues: the banks' funding, the banks' needs for new capital and the countries' public finances. With regard to the banks' funding in a liquidity crisis, the ECB has both the regulations and tools necessary. The ECB is now better-equipped to deal with liquidity problems than when the financial crisis broke out, so it is difficult to see why a liquidity crisis might arise.

The main issue to be clarified in the euro area concerns the institutional regulations for capital injections to banks and the sovereign debt problems. The management of one area affects the management of the other. The need to capitalise banks affects public finances in the countries whose banks have exposures to the crisis countries. The public finances in their turn affect the extent to which it is possible to capitalise the banks. When the dust has settled, it would not surprise me if the European banking sector needs both to be restructured and to shrink. The main scenario is based on measures being taken to resolve the most acute problems. But it would appear to be a more drawn out process to introduce a more comprehensive regulatory framework. This also means that there are both good and bad scenarios in the coming period for developments in the euro area. The outcome will probably affect Swedish monetary policy further ahead.

Mr Ingves then summarised the discussion on economic prospects abroad by saying that the members of the Executive Board have chosen to highlight different parts of the assessment presented in the draft Monetary Policy Report. There are some variations in the degree of pessimism regarding global developments. However, the assessments differ only with regard to policy rates abroad, which two members estimate will rise at a slower pace than is assumed in the main scenario.

Deputy Governor **Lars Nyberg** commented on Mr Ingves's observation that a few years after the property crisis the United States has come quite a long way in managing the "balance sheet recession" that hit households in particular. In this type of recession monetary policy is not very effective, as households want to pay off their debts and tidy their balance sheets before increasing their consumption again. Many European countries, on the other hand, are just at the beginning of this process and in addition, companies and banks also have large debts. This indicates that the adjustment will take some time.

Mr Nyberg also agreed with Mr Ingves that the central banks are well-equipped to deal with a crisis and that the banks should not need to suffer any acute liquidity shortage in the event of a crisis. However, the banks need to be able to find long-term funding outside of the central banks, otherwise the supply of credit will not function any way. It is therefore necessary to strengthen confidence in the banking system in Europe, and this can best be done by injecting fresh capital.

With regard to the use of implied forward rates as a measure of market expectations, Mr Nyberg said that he does not believe that the forward rate curves contain the information they did a few years ago. It is thus not possible to rely on them in the same way as before when determining monetary policy. Mr Nyberg does not believe that he is the only central bank representative in the world to feel this uncertainty. He then referred to what he had said at earlier meetings for more detailed reasoning in support of this view.

Christina Nyman from the Monetary Policy Department reported on the recently-received trade statistics for September, which pointed to stronger exports and slightly weaker important than had been forecast. This entails slightly better net trade figures than expected, which points to slightly higher GDP. At the same time as strong exports provide a positive picture of the demand from abroad, weak imports indicate weak domestic demand. The preliminary assessment is that the outcome can be said to be neutral for the outlook for GDP.

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

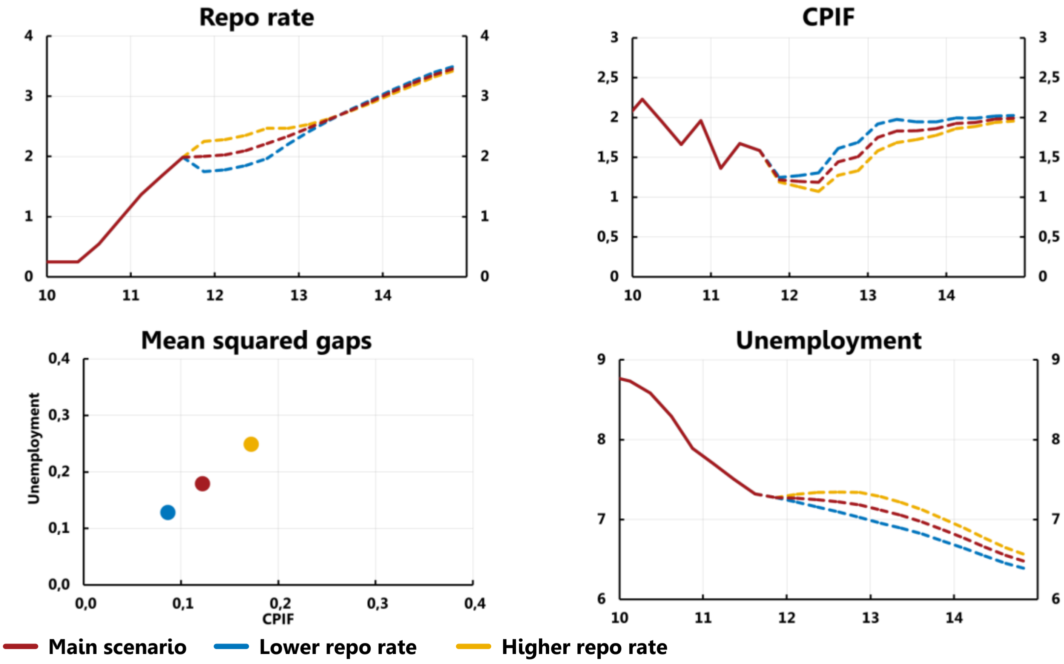
Deputy Governor **Lars E.O. Svensson** stated that he enters a reservation against parts of the draft Monetary Policy Report. Mr Svensson prefers that the repo rate is cut by 25 basis points to 1.75 per cent at this meeting and then a lower repo-rate path which is at 1.5 per cent from the first quarter of 2012 and until the end of the first quarter of 2013, and which then rises at an even pace to slightly above 3 per cent at the end of the forecast period.

He feels that the repo-rate path in the main scenario is too high for three reasons. Firstly, as he has said, an unjustified high forecast for policy rates abroad gives a bias towards a too high repo-rate path. Secondly, there is a bias towards overestimating resource utilisation. Thirdly, even if one accepts the high forecast for policy rates abroad and the high estimate of resource utilisation and the sustainable unemployment rate of 6.5 per cent, one can still show that a lower repo-rate path stabilises CPIF inflation better around 2 per cent and unemployment better around a level of 6.5 per cent. Regardless of how one views it, the main scenario thus entails monetary policy that is not well balanced.

Mr Svensson began with the third reason, which is illustrated in Figure 3. The figure extends the analysis of alternative repo-rate paths made at the end of Chapter 2 in the draft Monetary Policy Report. The figure shows the forecasts for CPIF inflation and unemployment for different repo-rate paths under the assumption in the main scenario of a high forecast for policy rates abroad and a high sustainable level of unemployment of 6.5 per cent. In the upper left-hand panel the red path represents the repo-rate path in the main scenario, and the blue path is a lower repo-rate path. The right-hand panels show that the lower repo-rate path gives a forecast for CPIF inflation that is better stabilised around 2 per cent and a forecast for unemployment that is better stabilised around 6.5 per cent. One can thus directly see that a lower repo-rate path leads to better target fulfilment for both inflation and unemployment. The lower left-hand panel also shows that the mean squared gap is lower for both inflation and unemployment with the lower repo-rate path.

Figure 3. Monetary policy alternatives, October 2011

Foreign interest rates according to Riksbank forecasts; sustainable unemployment rate 6.5 %



Sources: Statistics Sweden and the Riksbank

Mr Svensson said that he actually thinks that this is fairly self-evident. Since the meeting in September the situation for the Swedish economy has deteriorated. The forecasts for inflation and resource utilisation have been adjusted downwards for an unchanged repo-rate path. The repo-rate path in the main scenario has been lowered in relation to September, but not far enough. With the new repo-rate path the forecast for CPIF inflation is still too low and the forecast for unemployment is still too high. Lowering the repo-rate path further would improve target fulfilment for both inflation and unemployment. This should be obvious to everyone. Mr Svensson felt that one doesn't need to be an expert on monetary policy to understand it.

So why isn't the repo-rate path being lowered further? Mr Svensson went on to say that a few muddled reasons are given at the end of Chapter 2. It is claimed that economic activity will fall because companies and households will postpone consumption and investment due to the uncertainty over future developments. In such a situation, it is doubtful whether monetary policy will have the same immediate effect as indicated by the historically-estimated links. It would require a more uneven repo-rate path to stimulate the economy.

This appears to be speculation and has no foundation. The arguments are not convincing and raise several questions. Why is it increased uncertainty and not lower expectations of future income and demand that will make households and companies reduce their consumption and investment? And if it is increased uncertainty, why should this mean that monetary policy has less impact? And why should a specially-uneven repo-rate path be necessary in this situation? Why wouldn't a lower, relatively smooth repo-rate path provide a better and acceptable outcome? And how can one discuss these issues without showing how the various repo-rate paths would look? Where is the analysis that supports these claims? As far as Mr Svensson could see there was no such analysis. It all gives an impression of excuses added on afterwards.

If, in this situation, the repo rate were really to have less effect on inflation and resource utilisation than usual, it would be a reason to cut the repo rate *further*, not less, to have the same effect. In autumn 2008 and later, following Lehman, in a situation with maximum uncertainty and minimum confidence among economic agents, it was by acting forcefully and making large interest-rate cuts that enabled central banks around the world to contribute to ensuring that the crisis did not develop into the Great Depression II.

If one takes the increased uncertainty seriously, it must be so that the increased uncertainty means a greater probability that the situation may deteriorate so much that the zero lower bound may bind the policy rate in the future. In this case, academic research results unequivocally say that there is justification for lowering the policy rate further and more quickly than is justified by the forecasts for inflation and resource utilisation. This also reduces the risk of being caught in the future in a situation with a binding lower bound for the policy rate.

Moreover, it is stated in the draft Monetary Policy Report that a lower repo-rate path would entail a risk that housing prices and household indebtedness once again began to develop in a way that would lead to imbalances in the economy in the longer run. Mr Svensson wondered what has happened to the conclusions from the Riksbank's large inquiry into risks in the housing market. This stated that the policy rate is a blunt instrument, not suitable for influencing housing prices and indebtedness as it can have very negative consequences for the real economy, and that there are other instruments, such as the mortgage ceiling and so on, that are much more effective. And what kind of imprecise and indeterminate imbalances are we talking about? The results of the Riksbank's inquiry show that there are no signs that houses are over-valued, but that housing prices are quite compatible with the fundamentals, mainly a large demand and small supply. This means that housing prices are sustainable. And there is no analysis that points to household indebtedness not being sustainable. With a high nominal mortgage rate after tax of 5 per cent and a moderate growth in disposable incomes of 4 per cent, a net debt payment of only 1 per cent of the mortgage is required to stabilise the debt ratio. With a debt ratio as high as 200 per cent of disposable income, the net debt payment is thus only 2 per cent of the disposable income. Those who have mortgages and own their homes also do not need to pay rent for a rented home, a rent which can on average be around 20 per cent of disposable income, and may instead pay condominium fees for maintenance, heating, garbage disposal and so on, which is less expensive than rent.

Furthermore, households' assets excluding pension claims have long been stable at around 3 times the size of their debts, so households' net wealth has been stable at around 2/3 of their assets and thus double the size of their debts. This entails low leverage and very strong balance sheets.

Moreover, growth in lending to households has fallen recently and is now lower than it has been for a long time, at around 6 per cent, which is not far from the level compatible with steady state and a constant debt ratio. Housing prices have also stabilised and even fallen slightly.

Moreover, this talk of unspecified imbalances in the longer run appears to mean that all of the work on financial stability is repudiated. The Financial Stability Report closely monitors threats to financial stability and risks due to high leverage and low liquidity are managed much better with capital adequacy and liquidity requirements than with the repo rate.

So, why should housing prices and household borrowing be promoted to target variables that justify inflation being too low and unemployment being too high? Monetary policy should not be the first, but the *last* line of defence with regard to financial stability, to be used only in cases where the normal financial stability tools do not work or are insufficient. There is now an abundance of instruments for managing financial stability.

Nor should the repo rate be an explicit or implicit target variable. It should solely be used as a means to stabilise the correct target variables, inflation and resource utilisation.

Mr Svensson went on to the other reason why the repo-rate path is too high and the claim that the Riksbank over-estimates resource utilisation. He referred to the previous monetary policy meeting, when he pointed out that the assessments of potential GDP made by the National Institute of Economic Research and the Ministry of Finance are higher than that of the Riksbank and that their assessment of the GDP gap thus is lower. This is still the case at this meeting. Mr Svensson also criticised that the Riksbank's assumptions and assessments of potential GDP shifted down considerably after the crisis, despite the crisis being, from a macroeconomic and monetary policy perspective, largely a purely negative shock to aggregate demand, a fall in export demand, which does not have any major effect on potential GDP according to normal monetary policy analysis. Moreover, potential GDP shifts considerably in earlier years according to the Riksbank's estimate, in stark contrast to the estimates of potential GDP in the United States made by the Congressional Budget Office.

Mr Svensson also said that the unemployment gap between unemployment and an estimate of the sustainable unemployment rate is the most relevant, reliable and transparent indicator of resource utilisation as a target variable. Unemployment is more relevant because it is more closely related to welfare. After all, one of the worst things that can happen to a household is that one of its members loses their job. The unemployment gap is more reliable because unemployment subject to fewer revisions and has smaller measurement errors. Although it is not easy to estimate sustainable employment, it is much easier than to estimate potential GDP.

The Riksbank uses more measures of resource utilisation than the unemployment gap, namely the employment gap, the hours worked gap and the GDP gap. There are significant weaknesses in these measures. The employment gap consists of the unemployment gap with the reverse sign and the labour force gap, actual labour force minus potential labour force. As the current estimate and forecast for the labour force gap are approximately zero, there is now no difference between the employment gap and the unemployment gap as a measure of resource utilisation.

The hours worked gap consists of the employment gap and the average working hours gap, actual average working hours minus potential average working hours. The forecast for the hours worked gap is higher than the employment gap because the forecast for average working hours is higher than normal. The average working hours depend on sick leave, overtime and the share of part-time. The welfare effects of average working hours are probably less relevant than those of the employment gap and the unemployment gap, except with regard to involuntary part-time. With regard to involuntary part-time, one can claim that potential average working hours should be higher and should include desirable share of full-time. In this case the average working hours gap would be lower and more negative, and the current measure over-estimates resource utilisation as a target variable.

The GDP gap consists of the hours worked gap and the labour productivity gap, actual labour productivity minus potential labour productivity. The forecast for the GDP gap is higher than for the hours worked gap, as productivity is expected to be higher than normal, so the labour productivity gap is positive. Mr Svensson noted that if one wishes to stabilise the GDP gap, one should reduce employment when productivity is higher than normal. This does not appear reasonable and is contrary to what is generally regarded as efficient, namely to work more during periods when productivity is high.

Mr Svensson pointed out a further reason why the Riksbank's GDP gap under-estimates resource utilisation. This is because potential GDP is calculated using the actual capital stock when it should be the sustainable capital stock, the capital stock in steady state, that is used. Potential GDP should be sustainable GDP. The sustainable capital stock is larger than the current capital stock, as investment has been low for several years. Potential GDP then becomes higher and the GDP gap correspondingly lower and more negative.

Mr Svensson summarised his reasoning by saying that more terms are added the further one goes down this list of measures of resource utilisation, which results in more potential sources of error and less reliability. At the same time, the relevance for welfare declines.

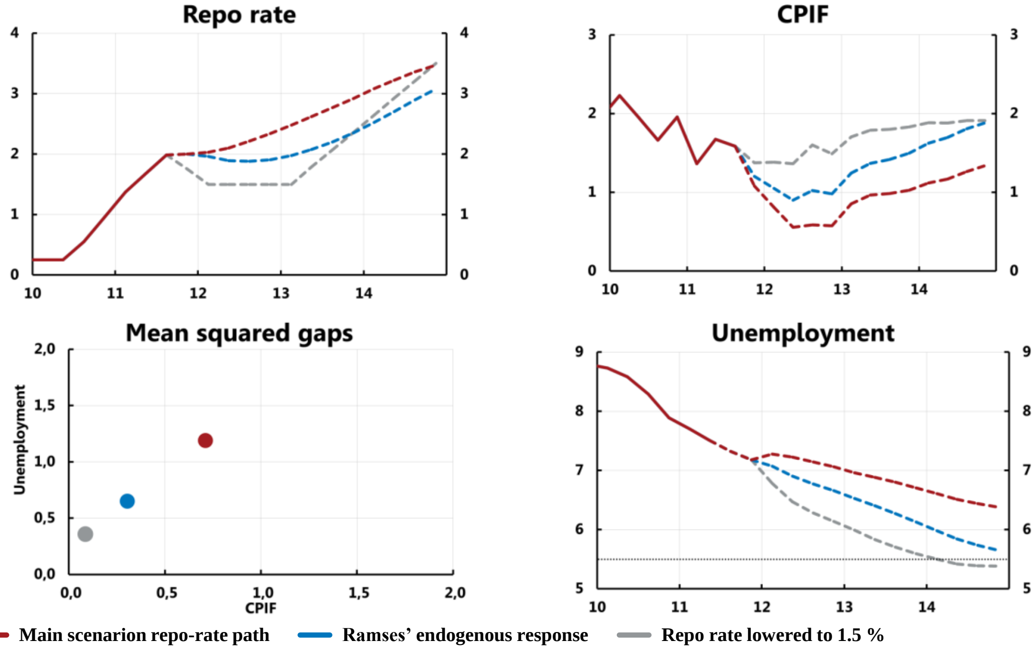
When several measures of resource utilisation are used and point in different directions, it is important to discuss both how reliable and how relevant the measures are as target variables. Mr Svensson pointed out that this is the type of discussion he has tried to initiate here.

One important question is, as we all know, the sustainable level of unemployment. In a thorough survey of the effects of demography, structural reforms and unemployment insurance – using the existing theoretical and empirical research results and in collaboration with some of Sweden's leading labour market economists and macro economists – the Ministry of Finance has reached the conclusion that the sustainable unemployment rate has fallen substantially, to around 5 per cent. Mr Svensson's own assessment of the sustainable unemployment rate is, as previously discussed, at present 5.5 per cent, which is roughly midway between the National Institute of Economic Research's assessment of just over 5 per cent and the Ministry's assessment. The Riksbank assumes a level of 6.5 per cent. He emphasised that it is high time that the Riksbank deals with this issue and takes a stance on the above effects on sustainable unemployment.

Finally, Mr Svensson wished to explain why he prefers such a low repo-rate path. This is shown in Figure 4. The figure presents this repo-rate path in grey and the repo-rate path of the main scenario in red, with the corresponding forecasts for the CPIF and unemployment, under the assumption of interest rates abroad in accordance with forward rates, and Mr Svensson's own assessment of the sustainable unemployment rate of 5.5 per cent.

Figure 4. Monetary policy alternatives, October 2011

Foreign interest rates according to implied forward rates; sustainable unemployment rate 5.5 %



Sources: Statistics Sweden, the Riksbank and own calculations

It is clear that the repo-rate path in the main scenario gives a CPIF forecast well under 2 per cent. A lower interest-rate path abroad, together with the repo-rate path in the main scenario, gives a greater interest rate differential and a stronger krona that brings down inflation. The lower repo-rate path gives higher CPIF inflation closer to the target and a much lower forecast for unemployment closer to 5.5 per cent. Target fulfilment for both inflation and unemployment will be much better with the lower repo-rate path.

Note that this result is not sensitive to the assumption of a sustainable unemployment rate of 5.5 per cent. The lower interest-rate path also gives better target fulfilment if the sustainable unemployment rate is assumed to be 6 or 6.5 per cent.

According to this analysis, target fulfilment could be even better if the repo-rate path was lowered further. However, as Mr Svensson mentioned at the previous meeting, it requires considerable resources and there are a number of technical difficulties that have not yet been resolved when it comes to making forecast calculations for repo-rate paths that are far from the main scenario and then determining which path is best. This repo-rate path does, however, entail a much improved target fulfilment relative to the main scenario, so it will have to suffice on this occasion.

First Deputy Governor **Svante Öberg** said that he considers the view of economic developments in Sweden presented in the draft Monetary Policy Report to be reasonable. This entails a fairly weak performance next year, with GDP growth of 1.5 per cent, unemployment that levels off in seasonally-adjusted terms at the current level of 7.2 per cent and an underlying inflation rate just below 2 per cent. The forecasts for growth, employment and inflation have been revised down slightly since the Monetary Policy Update published in early September.

The great uncertainty over what will happen in Europe and the slightly weaker forecasts for the Swedish economy point to holding the repo rate unchanged for some time to come. Mr Öberg therefore supports the proposal to hold the repo rate unchanged today and to postpone future increases in the way indicated in the proposed repo-rate path.

As the impact of monetary policy comes with a time lag, it is necessary to base the decision on forecasts of economic developments. However, forecasts are always uncertain, and become increasingly uncertain the longer the forecast horizon extends. This time it is unusually difficult to have a clear opinion on developments in the economy in the longer run. Mr Öberg said that one could probably regard the reported forecast as one of several reasonable scenarios and that he therefore wished to concentrate on this occasion on the starting position.

CPI inflation was 3.2 per cent in September. This was way above the target of 2 per cent, but largely in line with the forecast made at the previous meeting. Various measures of underlying inflation, on the other hand, were lower. They were between 1 and 2 per cent, with a concentration around 1.5-1.6 per cent. According to Prospera, inflation expectations five years ahead have increased slightly over the past year, from 2.2 to 2.4 per cent. But they have increased less than one might expect, given the CPI inflation rate. And they are, despite the increase, fairly close to the inflation target. This indicates on the whole that inflation will in the long run stabilise close to the inflation target.

Mr Öberg assesses that resource utilisation is largely normal at present. Measures that are based on economic tendency data and HP filters indicate that it is slightly higher than normal, while measures based on the production function approach indicate that it is slightly lower than normal. In both cases, the deviations are very small. Unemployment, on the other hand, is higher than normal. But it is uncertain what this currently says about resource utilisation. Resource utilisation has a fairly strong link to future inflation. The fact that resource utilisation is currently normal thus also indicates that inflation will stabilise close to the target in the long run.

The Taylor rule based on a long-run normal repo rate of 4 per cent, the current CPIF inflation rate and various measures of current resource utilisation presently point to a repo rate of 2.8-3.5 per cent. This would indicate that the repo rate is currently too low. In the forecasts it remains unchanged for a while, and then rises to 3.5 per cent towards the end of the forecast period. This also seems reasonable, said Mr Öberg, who said that on the basis of his overall assessment he supported the proposed direction for monetary policy.

Deputy Governor **Barbro Wickman-Parak** pointed out that the Riksbank's forecasts have on the last few occasions pointed to a slowdown in growth during the second half of this year and some way into next year. These tendencies had been reinforced in September, which led to a downward adjustment in the growth forecast, particularly for 2012. This time the growth forecast for next year has been revised down only marginally, and this is mainly due to the lower growth forecast for the second half of this year.

As Ms Wickman-Parak has mentioned earlier, export market growth is in a slowdown phase and the forecast is that the increase in Swedish exports will stop at around 4 per cent this year, which is a downward adjustment in relation to the forecast in the September Monetary Policy Update, which entails a halving of the growth rate compared with the full year 2011. Foreign trade so far, July and August, points to exports having increased at a relatively good pace during the third quarter. As Christina Nyman said, the September figure for foreign trade has just been published and it confirms the strong performance. But the downward revision of the forecast is still reasonable, given the information that is currently available on actual export orders and export order indicators.

Ms Wickman-Parak pointed out that she has earlier expressed some doubts about the strength of private sector consumption. Although household consumption increased at a relatively good pace during the first half of the year, there are clear signs that households are more cautious. New car registrations have slowed down significantly and the retail trade turnover figures have been weak in recent months. Households are also less willing to take on loans. Falling stock markets and stagnating or slightly falling house prices have probably contributed to draining households' confidence, which continued to decline fairly dramatically in September and is now at a low level. This applies both to their view of their own personal finances and their view of the Swedish economy, as well as their view of the labour market. The downward revision to growth in household consumption made in the forecast is thus justified.

The National Institute of Economic Research’s Economic Tendency Survey also shows that households perceive an increased risk that they might suffer unemployment. So far, employment has increased in line with our forecasts. Even if the forecast entails a slowdown in employment growth, it still points to a continued increase. If a more tangible slowdown in employment were to be detected, this could have an even greater effect on households' consumption propensity. There are already fewer companies planning to increase their staff, according to the National Institute of Economic Research’s Economic Tendency Survey. It will be particularly important to monitor the various indicators for the labour market in the coming period.

Ms Wickman-Parak went on to talk about the general situation in the economy. As in September, one can note that the confidence indicators in the business sector continued to fall, while the monthly outcomes for production are still relatively good.

The results of the Riksbank’s own survey can be summarised as companies perceiving the economic situation to be good right now, but that there is great uncertainty over future developments. This describes the situation rather well. The economy is in a kind of period of waiting, where companies and households are waiting to see what happens and are very uncertain about the future. The longer this situation continues, the greater the impression it will have on the outcome figures, and growth risks being weaker than assumed in the main scenario.

If uncertainty abroad increases, and stock markets begin to rise, the situation may be different, even if it may be difficult to imagine this now. This is what we can expect further ahead, although it could happen sooner. Sentiment is something that can change quickly.

Although it is not difficult at present to imagine a more gloomy sequence of events than that painted in the Monetary Policy Report, Ms Wickman-Parak considered that the approach of gradually adjusting the forecasts in line with what is justified by the new information received is a wise attitude. Becoming too caught up in the prevailing sentiment and reacting quickly to fluctuations risks our forecasts becoming uneven and monetary policy lacking stability. Ms Wickman-Parak said that she supports the forecasts presented in the report, and feels personally that it is no difficult decision to hold the repo rate at 2 per cent and to postpone the increases in the rate as indicated by the repo-rate path. The expansionary monetary policy can be extended further ahead without jeopardising the inflation target. Monetary policy is now in a wait-and-see situation, but with a good preparedness to take action if reality proves different from the forecasts.

Deputy Governor **Karolina Ekholm** said that the first question she has considered is whether she thinks the repo rate should be held at its current level or whether it should be cut. At the previous monetary policy meeting she felt that in principle there was justification for cutting the repo rate, but that it was nevertheless better to hold it unchanged while awaiting further developments. Now a bit more than one and half months have passed and things should be somewhat clearer. As usual, however, incoming data point in different directions, so which direction the Swedish economy will take is far from clear. Nevertheless, her assessment is that the indications that demand in the Swedish economy will be subdued by the weaker developments abroad are stronger now than they were in September. Consequently, she feels that there is greater justification for a repo-rate cut now than there was before.

One potential objection to cutting the repo rate today is that it may be necessary to increase it again in December, if sentiments change suddenly, as Ms Wickman-Parak mentioned as a possibility. It may, of course, be the case that the EU's political leaders exceed expectations tomorrow by delivering a strong rescue package and that this will lead to investors, firms and households regaining confidence and to the economy returning to a strong recovery phase. There may be a risk of some damage to the Riksbank's reputation if we cut the repo rate due to an incorrect assessment of future developments. But in an uncertain world it is unavoidable that assessments are made that are afterwards proved to be incorrect, so this is a loss of face that Ms Ekholm is quite prepared to live with. She therefore advocates cutting the repo rate today by 25 basis points, to 1.75 per cent.

With regard to the actual repo-rate path, she advocates as at earlier meetings a path that is lower than the one in the main scenario. As before, she sees two main reasons for this.

One reason is her opinion that a more reasonable forecast for policy rates abroad would be one where they rise at a slower pace. This has implications for the view of the repo-rate path, as explained by Mr Svensson in his earlier remark. The proposed path in the draft Monetary Policy Report then leads to higher interest rate differentials towards other countries than is forecast in the main scenario, and thus a stronger exchange rate in the short run. The interest rate differential towards other countries is fairly substantial in the forecast in the main scenario, and would in itself justify a greater appreciation of the krona than is included in the forecast. But, based on the experience that periods of great uncertainty are periods with a relatively weak krona, the forecast has been adjusted towards a weaker krona, which Ms Ekholm considers entirely reasonable. However, all else being equal, large interest rate differentials imply a stronger krona in the short run, and a stronger krona reduces inflationary pressures and resource utilisation. In the current situation, this is undesireable as inflationary pressures are already low and resource utilisation is currently lower than normal, in Ms Ekholm's opinion.

The other reason is the same as one of the reasons given by Mr Svensson. Even if one accepts the forecast for policy rates abroad in the draft Monetary Policy Report, the proposed repo-rate path appears too high. Inflationary pressures will remain low during almost the whole forecast period and resource utilisation will be below normal for large parts of the forecast period based on some of the measures of resource utilisation, namely the unemployment gap and the hours worked gap. It is only on the basis of the forecasts for the GDP gap and the RU indicator that resource utilisation appears to normalise fairly early during the forecast period. But Ms Ekholm believes that the GDP gap may over-estimate resource utilisation. It is less negative than the hours worked gap at present, and is expected to change into a positive gap during the forecast period as a result of labour productivity growth being relatively high in the coming period. She meant that high growth in labour productivity is not a factor that is particularly relevant for assessing resource utilisation.

Ms Ekholm thus advocated a lower repo-rate path than the one assumed in the main scenario in the draft Monetary Policy Report and supported the path advocated by Mr Svensson. Ms Ekholm thus advocated a path where the repo rate is cut by a total of 50 basis points this year, then remains at 1.5 per cent until the end of the first quarter of 2013, to be gradually increased thereafter to just over 3 per cent at the end of the forecast period.

According to model simulations, such a path gives a well-balanced monetary policy, under the assumption that policy rates abroad develop in accordance with market expectations as these can be interpreted from implied forward rates. But of course model simulations do not reveal the entire truth. There may be considerations that are not captured in the models and which would call for a higher repo-rate path. As Mr Svensson has pointed out, this is discussed in the draft Monetary Policy Report and a number of arguments are put forward against choosing a lower repo-rate path. Ms Ekholm judged that she has greater sympathy for these arguments than Mr Svensson, although she also reaches the conclusion in her assessment that a lower repo-rate path is preferable. As she has already mentioned, she does not see the risk of monetary policy being perceived as uneven if the repo rate was increased at one meeting and then cut at the next meeting as a major problem. It is rather a natural consequence of making decisions under uncertainty and thus sometimes basing decisions on assessments that are later proved to be wrong. With regard to developments in the housing market, her assessment is similar to those made by Mr Svensson and possibly Ms Wickman-Parak on the basis of her earlier remark, namely that there is at present no great risk of a build-up of imbalances as prices have stagnated and in some areas would appear to be falling if anything, at the same time as the growth in household credit has fallen.

The argument that Ms Ekholm believes may be relevant is that households and companies may be relatively insensitive to interest rate cuts now, because they take a cautious stance when they are pessimistic about the future. The argument in the draft Monetary Policy Report is in principle that there are very minor advantages in choosing a lower repo-rate path as a result of this insensitivity, at the same time as there may be considerable costs, as it risks leading to uneven monetary policy and a build-up of imbalances in the housing market. Ms Ekholm thus also believes that the advantages may be minor, but at the same time doubts that there are any substantial costs linked to a lower repo-rate path. And the fact that advantages may be minor because households and companies do not react to interest rate cuts need not prevent us from trying to make them react. If it does have an effect, then it should in any case be in the right direction.

Deputy Governor **Lars Nyberg** said that Sweden is at present privileged to have strong public finances and a stable banking system. On the whole, the banks have succeeded well in their funding and a couple of them have recently, despite the situation in Europe, been able to take loans in the market in senior unsecured bonds. They should also be able to manage the increased capital adequacy requirement that may come in connection with having to restore confidence in the European banking system as a whole. With a bit of luck, Sweden should be spared the financial part of the European crisis.

But a decline in growth in Europe will sooner or later affect our exports. As in other countries, however, the expectations of harder times point much more steeply downwards than the actual outcomes. The uncertainty is making Swedish households more cautious in their consumption, however. At the same time, inflationary pressures have declined, at least temporarily. All in all, it therefore appears reasonable to hold the repo rate unchanged at 2 per cent at today's meeting and to adjust the repo-rate path downwards as proposed. This means that no more repo-rate increases are expected this year, and some way into next year, which Mr Nyberg said is in line with his views. In the main scenario the world gradually recovers, despite the difficulties in Europe, and then there will be reason to begin increasing the repo rate again.

One might of course imagine cutting the repo-rate path further, given the increased uncertainty in Europe and particularly what Mr Nyberg considers to be the growing likelihood of a more uncontrolled sequence of events. An entirely unbiased repo-rate path might require this. But including some form of political collapse in the Riksbank's forecasts and assessing the consequences of such an event is hazardous. Monetary policy must deal with catastrophes if and when they arise, not in advance. The Riksbank has better opportunities than many other central banks to do this, given an already implemented "exit" from the earlier crisis and a number of increases in the repo rate. There is scope to cut the repo rate if necessary, and this scope is something many other countries lack.

Are there any domestic risks? The labour market and housing market have often been discussed at earlier meetings. With regard to the labour market, it is difficult to imagine that the coming wage bargaining rounds would, in the present very uncertain economic climate, lead to results that contribute to increased unemployment and rising inflation. The wage demands reflect to some extent the very favourable economic outlook that prevailed before the summer.

With regard to the housing market, one can now see a clearer slowdown, which has led to the banks' lending to households increasing at a more reasonable pace than before. Mr Nyberg does not feel that developments in either of these two areas currently require particular attention from a monetary policy point of view. However, it is important to continue to closely follow growth in credit in the private sector. Experiences from the United States and Europe illustrate how low interest rates over a long period of time may contribute to building up imbalances that later become very costly for society to deal with. Perhaps there will be better tools and a better framework for managing such problems in the future. But as a central bank one can never waive the responsibility for excessive credit growth, according to Mr Nyberg. And even with other tools, monetary policy must always be the final line of defence.

Mr Nyberg concluded with a few words on the value of the krona. Its value has fallen as the European crisis has worsened; which is in line with earlier periods of uncertainty on the financial markets. The krona is a small currency, and small currencies are normally avoided in times of turbulence. But the krona would probably have fallen much more if Sweden had not increasingly appeared a good country for investment, with good public finances and well-capitalised banks. There is a distinct difference from developments in autumn 2008. However, there is reason to expect continuing large fluctuations in the value of the krona as the mood of the financial markets swings.

Governor **Stefan Ingves** said that he agrees with the assessment of the Swedish economy in the draft Monetary Policy Report and supports the proposal to hold the repo rate unchanged at this meeting and to adopt the repo-rate path described.

Mr Ingves considered that Ms Wickman-Parak expressed things well when she said that the international conditions at present were similar to those prevailing at the time of the monetary policy meeting in September. Developments abroad have contributed to a decline in optimism among Swedish households and companies. Moreover, share prices have fallen quite substantially in Sweden. But, compared with many other countries, the conditions for managing a slowdown abroad are better. At present there is no need for consolidation of public finances in Sweden. The housing market also appears to be calming down in an orderly manner. The rate of lending to households has slowed down. The banks’ losses have also so far been lower during this crisis than the Riksbank had calculated and it is a strength that they have managed their market funding during the recent international turmoil.

But as a result of the slowdown abroad, economic growth in Sweden has decelerated and is now expected to be lower than normal over the coming year. Resource utilisation is currently slightly lower than normal. As growth abroad is expected to better in 2013 and 2014, resource utilisation in Sweden should rise towards a normal level at the end of the forecast period. This also means that CPIF inflation will increase and approach 2 per cent. However, CPI inflation will be higher than CPIF inflation as a result of mortgage rates rising, partly because the repo-rate path shows future interest-rate increases and partly because the margins on mortgages have increased. All in all, this means that the repo-rate path in the main scenario of the draft Monetary Policy Report is slightly lower now than the assessment in the September Monetary Policy Update. The repo-rate path in the main scenario, for which Mr Ingves expressed his support, entails the repo rate being held unchanged at 2 per cent and waiting until next year to make further increases.

The forecast is now, as always, the best assessment we can make when events in the world around us are difficult to assess and dependent on others' ability to manage a number of European problems. This means that the Executive Board of the Riksbank is in a form of monetary policy state of suspension. It is not appropriate for any large monetary policy manoeuvring now when CPI inflation is still fairly high and CPIF inflation is below 2 per cent. In this year's forecasts the Riksbank can also be said to have begun to allow scope for different developments in 2012 earlier than other analysts. The Riksbank began to revise down the assessment of GDP growth in Sweden in 2012 as early as April this year. Since the Monetary Policy Report that was published in February, GDP growth in Sweden in 2012 has been revised down from 2.4 per cent to 1.5 per cent.

As always, there are risks surrounding the main scenario. The fiscal problems in several countries may worsen and delay the international recovery. The downside risk is mainly linked to the difficulty in making decisions in the political systems to consolidate public finances. The consequences of such a scenario for inflation and resource utilisation in Sweden must be managed if the scenario is realised. But it is also possible that there will be a faster normalisation abroad. The ability to take action may also prove a positive surprise, particularly in acute crisis situations. Even in this type of scenario, the consequences for inflation and resource utilisation must be taken into account if and when the scenario is realised. There is great uncertainty over future developments and new shocks that are difficult to foresee could occur.

All in all, this means that at present we need to exercise great vigilance with regard to economic policy in Sweden. This applies to monetary policy, fiscal policy and the collective wage bargaining rounds. When it is difficult to assess events abroad because of turbulence in certain central countries, it is important that policymakers do not rock the boat with regard to monetary policy and create imbalances in their own economy. This requires a measure of caution in monetary policy. Monetary policy should be adapted gradually and should not react in advance on the assumption of either negative or positive events. One should not contribute to greater uncertainty by advocating interest rate paths with an overly volatile interest-rate adjustment. In the assessment there is also still reason to take indebtedness into account. The models are too myopic in this respect. International experiences point to the fact that if the government or the private sector borrows too much, and particularly when this is done through borrowing abroad, there is a risk of a financial crisis.

Deputy Governor **Lars E.O. Svensson** said that he reacted when Mr Öberg said it was unclear what the high unemployment entails for resource utilisation, immediately after Mr Svensson had said that the unemployment gap was the most relevant and reliable measure of resource utilisation as a target variable. Here it is important to distinguish between measures of resource utilisation as a target variable and measures of resource utilisation as indicators of inflationary pressures. They are not the same thing. This is something that has been discussed several times at earlier meetings, said Mr Svensson.

Mr Svensson said that Mr Öberg was probably referring to the measures of resource utilisation as indicators of inflationary pressures. Such measures enter monetary policy and influence the repo-rate path solely through their effect on the inflation forecast. They are merely indicators, not target variables. Measures of resource utilisation as a target variable are a different thing. The unemployment gap between actual unemployment and the sustainable unemployment rate is a target variable. All else being equal, it is desirable to stabilise unemployment around the sustainable level. This unemployment gap is not necessarily the best indicator of inflationary pressures.

With reference to Ms Ekholm's contribution to the discussion on the risk of the Riksbank causing damage to its reputation if it first cuts the repo rate and then needs to increase it again, Mr Svensson felt that it was quite possibly this type of consideration regarding loss of face that lay behind the discussion of an uneven repo-rate path in the Monetary Policy Report. However, it entails a greater risk of damage to its reputation for the Riksbank to deliberately choose an interest-rate path that does not entail a well-balanced monetary policy with regard to inflation and resource utilisation. At each monetary policy meeting one should draw up a repo-rate path that best stabilises both inflation and resource utilisation in an unbiased sense. This ought to be what is best for the Riksbank's reputation in the long run. The probability should then normally, specifically using symmetrical probability distributions, be roughly the same for later needing to raise or lower the repo-rate path. These changes in the path need not in themselves lead to any damage to the Riksbank's reputation, according to Mr Svensson.

With regard to Mr Nyberg's discussion of the krona, one can look at Figure 2, where the grey curve shows the TCW-weighted foreign yield curve, and the blue curve shows the Swedish yield curve, to be precise, expressed as a function of the maturity date. There is not such a large difference between Swedish interest rates and interest rates abroad at longer maturities. On the far right we can see that the Swedish five-year rate is roughly the same as the five-year rate abroad. On the basis of standard uncovered interest-rate parity, this means that the krona is expected to remain roughly unchanged in a five-year horizon. Given this, it is perhaps not so surprising that the krona has been fairly stable.

The red curve in Figure 2 shows how the Swedish yield curve would look if the repo-rate path in the main scenario gained full credibility and forward premiums are normal. It is then clear that a five-year rate would be roughly 190 basis points higher than now. This would not be good for the Swedish economy. It gives reason to really hope that the market continues to set the current low market rates, emphasised Mr Svensson.

Finally, Mr Svensson commented on Mr Ingves's contribution to the discussion, which took up the question of excessive borrowing by households, companies, the government or the entire country. Mr Svensson said that his point is that one must first examine what can be deemed to be a sustainable debt level in the long run before one knows whether or not the actual borrowing is too high. Mr Svensson felt that this was what he had tried to do with his arguments regarding the net debt payment entailed in households' indebtedness. What can be considered a sustainable debt level depends partly on the net debt payment as a percentage of disposable income and partly on which assets are included on the asset side of the balance sheet and whether their size and value are sustainable in the long run. Without examining this, one cannot know what is sustainable and whether or not indebtedness is a problem.

Deputy Governor **Barbro Wickman-Parak** replied that of course one would like to have an analysis of what constitutes a sustainable development debt trajectory, but that it would nevertheless be difficult to know where the limits are. For example, Denmark has had a higher debt ratio than Sweden over a long period of time, as well as rising house prices, which worked well for quite a long time, but the situation is now different. Ms Wickman-Parak explained that the housing market and indebtedness have never been her main focus, but that like many others she has seen a more subdued development in indebtedness as a positive side-effect of the interest rate increases. Now that households are becoming more cautious and losing confidence, the fall in the value of assets is probably contributing to that. At the same time, households' debts are intact and the high debt ratio may also contribute to the greater caution that can be observed.

Furthermore, Ms Wickman-Parak wanted to emphasise the importance of resource utilisation in the material on which the monetary policy decision is based. The different measures have their shortcomings, which several members of the Board have pointed out over the years. She does not believe in relying entirely on the unemployment gap, which is what she understands to be Mr Svensson's current recommendation, as she thinks it will still be necessary to be guided by several different measures of resource utilisation.

Ms Wickman-Parak then sought a clarification from Mr Svensson as to why he now wanted interest rate cuts totalling 50 basis points over a relatively short period of time, yet argued in favour of an unchanged repo rate at the previous monetary policy meeting when the forecast for growth in Sweden had been revised down much more than is now the case.

Deputy Governor **Karolina Ekholm** observed that it is important to follow up the discussion on resource utilisation, as it is a recurring discussion at the monetary policy meetings, where different board members have different opinions as to what the resource utilisation is and which measures are most relevant to capture it. The follow-up should analyse the way that different measures relate to one another, including with the aid of decompositions into, for instance, productivity and number of hours worked as already mentioned, and what type of measure is most relevant from a welfare perspective.

Ms Ekholm also said that she agreed entirely with Ms Wickman-Parak that a positive side-effect of the increases in the repo rate since the summer was that lending to households has slowed down. However, she stated a couple of reasons for not believing that developments in the housing market point to a higher repo-rate path. For one thing, the housing market situation is currently quite different, with more subdued prices and household credit. For another thing, the discussion on the need for macroprudential supervision has led to other authorities becoming more aware of the risks on the housing market. In Ms Ekholm's opinion, the latter means that monetary policy has become more free to focus on attaining the normal monetary policy objectives, that is, to stabilise inflation around the target and resource utilisation around a sustainable level.

Deputy Governor **Lars E.O. Svensson** explained that he completely agrees with Ms Ekholm with regard to resource utilisation. In response to Ms Wickman-Parak's contribution to the discussion regarding housing prices and household borrowing, Mr Svensson said that what he objects to is that housing prices and household borrowing are made into separate target variables, which are allowed to justify choosing a monetary policy that gives poorer target fulfilment for inflation and resource utilisation.

His point with regard to resource utilisation is that when there are several measures of resource utilisation pointing in different directions, one must examine and discuss which measures are more relevant as target variables and which measures are more reliable, that is, have fewer measurement errors. Mr Svensson said that this was what he was trying to do in his earlier comments and accounts of why he has concluded that the unemployment gap is the most relevant and reliable measure.

Mr Svensson went on to explain why he advocates cutting the repo rate now but advocated an unchanged repo rate at the previous meeting. The prospects for the Swedish economy have deteriorated compared with the situation at the previous meeting. Moreover, it requires considerable resources and causes technical problems to fine tune an optimum repo-rate path that is far from the main scenario. According to Mr Svensson, the repo-rate path that he and Ms Ekholm advocated at the previous meeting was far below the path in the main scenario then, although it did not entail cutting the repo rate at that point. This time, the repo-rate path that Mr Svensson and Ms Ekholm prefer is also significantly lower than the path in the current main scenario. It is more important to take a good step in the right direction than to fine tune the path. Further fine tuning of the path will have to come later.

Deputy Governor **Barbro Wickman-Parak** sought clarification of whether Mr Svensson's opinion now differs from the one he held in September because he now has an even more pessimistic view of economic developments than in the main scenario, or whether it is the various technical limitations that are the deciding factor.

Deputy Governor **Lars E.O. Svensson** said that his current proposal for a repo-rate path is based partly on the outlook looking gloomier than it did in September and partly on a slightly more extensive analysis having been possible now than at the previous monetary policy meeting.

Deputy Governor **Lars Nyberg** claimed that the interest rate instrument cannot be separated from macroprudential supervision instruments, such as amortisation requirements or mortgage ceilings. However, macroprudential supervision instruments can probably, when the legislation has been developed to enable their systematic use, become a good complement to the repo rate with regard to managing an undesirable credit boom.

Governor **Stefan Ingves** agreed with Mr Nyberg that there are reasons to believe that macroprudential supervision in many ways coincides with monetary policy and will do so for some time to come.

Deputy Governor **Lars E.O. Svensson** commented on Mr Nyberg's discussion of macroprudential supervision, that is, financial stability policy, by emphasising that it is important to realise that policy for financial stability is not the same as monetary policy.

Fiscal policy is not considered to be monetary policy. Fiscal policy has its objectives, primarily efficiency, stability and an even income distribution, and its instruments, primarily taxation and spending. Monetary policy has its objectives, stable inflation and resource utilisation, and its instruments, primarily the policy rate and communication. Fiscal policy influences inflation and resource utilisation. This means that monetary policy must give consideration to the way that fiscal policy is conducted when setting the interest rate, but it does not mean that fiscal policy is monetary policy.

In the same way, the policy for financial stability and monetary policy are different policies. The policy for financial stability has its own objective, that is financial stability, and its own instruments, primarily regulation and supervision. The policy for financial stability affects financial markets, spreads between interest rates, the functioning of financial markets and the transmission mechanism. This means that monetary policy must give consideration to how the policy for financial stability is conducted when setting the interest rate to attain the monetary policy objectives. It also means that the policy for financial stability must take into account how monetary policy is conducted when supervision and regulation are used to attain and maintain financial stability. But it does not mean that monetary policy and the policy for financial stability are the same thing.

Deputy Governor **Lars Nyberg** said that it is an oversimplification to say that one no longer needs to worry about indebtedness when making monetary policy decisions, because it can be managed by other instruments. The Riksbank will always be held accountable if low interest rates over a long period of time have contributed to a credit bubble that bursts.

Deputy Governor **Karolina Ekholm** explained that she agrees with Mr Nyberg that monetary policy does affect indebtedness, but like Mr Svensson she believes that one can make a clear distinction between macroprudential supervision and monetary policy. The former concerns affecting relative interest rates in the economy, while the latter concerns affecting the overall level of the interest rates.

Deputy Governor **Lars E.O. Svensson** emphasised that monetary policy should be the *last* line of defence with regard to financial stability, not the first. That is, monetary policy only has a role when the policy for financial stability is not working, for instance because of a lack of suitable instruments. But now there are an increasing number of effective instruments to attain and maintain financial stability.

First Deputy Governor **Svante Öberg** explained that he considers it important for monetary policy to give more consideration in the future to developments of debt and asset prices. It has been a mistake made in many countries not to give sufficient consideration to the expansion in credit.

Deputy Governor **Barbro Wickman-Parak** said that she agrees with Mr Öberg on this point.

The Chairman, Governor **Stefan Ingves**, summarised the discussion by noting that on the whole all of the members of the Executive Board supported the forecasts for most variables in the draft Monetary Policy Report. However, there were fairly substantial nuances in the assessments of downside risks. Monetary policy in the main scenario is based on a recovery abroad coming sooner or later and on the Swedish economy normalising.

§ 4. Monetary policy decision

The Executive Board decided after voting

- to adopt the Monetary Policy Report according to the proposal, Annex A to the minutes,
- to publish the Monetary Policy Report on Thursday, 27 October 2011 at 9.30 a.m.,

- to hold the repo rate unchanged at 2.0 per cent and that this decision would apply from Wednesday, 2 November 2011,
- to publish the repo rate decision above at 9.30 a.m. on Thursday, 27 October 2011 with the motivation and wording contained in a press release, and
- to publish the minutes of today's meeting on Wednesday, 9 November 2011, at 9.30 a.m.

Deputy Governors Karolina Ekholm and Lars E.O. Svensson entered a reservation against the decision to hold the repo rate unchanged and against the repo-rate path in the Monetary Policy Report. They preferred to lower the repo rate to 1.75 per cent. They also preferred a lower repo-rate path that stays at 1.5 per cent from the first quarter of 2012 through the first quarter of 2013, and then rises to just above 3 per cent by the end of the forecast period. This was justified by their assessment that the Report's forecasts of foreign policy rates and Swedish resource utilisation were both too high. This repo-rate path then implies CPIF inflation closer to 2 per cent and a faster reduction of unemployment towards a longer-run sustainable rate.

This paragraph was verified immediately.

Minutes by

Ann-Christine Högberg

Verified by:

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