Minutes of the Executive Board's monetary policy meeting, no. 6

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TIME: 09.00

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

Johan Gernandt, Chairman of the General Council

Sigvard Ahlzén
Claes Berg
Carl Andreas Claussen
Charlotta Edler
Heidi Elmér
Eric Frieberg
Mattias Hector (§ 1)
Ann-Christine Högberg
Per Jansson
Martin W Johansson (§1)
Anna Lidberg (§1)
Tomas Lundberg
Pernilla Meyersson
Marianne Nessén
Christina Nyman
Bengt Petterson
Maria Sandström (§ 1)
Marianne Sterner
Ulf Söderström
David Vestin
Staffan Viotti

It was noted that Carl Andreas Claussen and Bengt Pettersson would prepare draft minutes of § 1, 2 and 3 of the Executive Board's monetary policy meeting.

§1. Economic developments

Anna Lidberg of the Monetary Policy Department began by presenting the latest developments on the financial markets. Expectations of monetary policy have shifted downwards in relation to the Monetary Policy Report in October. This applies in terms of both implied forward rates and surveys. Forward rates have shifted down by around 0.75 percentage points at most during the forecast period and Prospera's survey on money market participants shows a fall of a good 0.5 percentage points. However, market analysts do not agree on whether, and how much, the Riksbank will cut the policy rate at the monetary policy meeting. Most believe in a cut of 0.25 percentage points, but some believe in a cut of 0.5 percentage points. Earlier published forecasts from the four major banks did not imply a cut in December. But after Norges Bank (the central bank of Norway) cut its policy rate by 50 basis points, the banks began to imply in their newsletters and similar that they now believed there might also be a cut in Sweden in December.

Expectations of monetary policy abroad have also declined. In terms of implied forward rates, the decline is at most 0.5 percentage points for the euro area and the United States.

The average interest rate paid by households and companies on new loans has fallen slightly compared with the situation in October. This means that the difference towards the repo rate has also fallen slightly. Lending to households and companies is continuing to increase, albeit at a lower rate for households. In November, lending to both households and companies increased by just over 5 per cent compared with the same month last year.

Maria Sandström from the Financial Stability Department gave an account of recent developments regarding financial stability, with a focus on the results of the European Council meeting on 8-9 December. With regard to additional loans to the International Monetary Fund, IMF, to stabilise the situation in the euro area, a number of countries have shown willingness to contribute. This also includes countries outside the euro area and the EU. Government bond yields in the euro countries have fallen in recent weeks, and several countries have issued bonds over the past week. Moody's has downgraded Belgium's credit rating in two stages to AA-.

On 8 December the European Banking Authority (EBA) published its definitive capital adequacy requirements for European banks, and this shows that Swedish banks do not need to increase their capital base to attain the new requirements for European banks, namely to hold Core Equity Tier 1 Capital of 9 per cent.

Marianne Nessén, acting Head of the Monetary Policy Department, presented the draft Monetary Policy Update which, in the assessment of the Monetary Policy Department, should gain the support of the majority of the Executive Board members. She began by noting that the forecasts in the Update had been discussed by the Executive Board at the meetings held on 13 and 15 December. The text was tabled at the Executive Board's meeting on 15 December.

Since the October Monetary Policy Report was published, concerns over the problems with public finances in the euro area have continued. The yields on government bonds in France and Germany have risen since then. However, growth prospects in the United States appear to have improved somewhat. In Sweden, GDP increased in the third quarter by 4.6 per cent, compared with the same quarter in the previous year. GDP growth was much stronger than was expected in the October Monetary Policy Report. Unemployment amounted to 7.4 per cent in November, which is slightly higher than was expected in the Monetary Policy Report in October. However, employment has been in line with the forecast made in October. The difference is due to the labour supply increasing more than expected. Inflation has fallen faster than was expected in October. CPI inflation was 2.8 per cent in November and CPIF inflation, that is, the CPI excluding the direct effect of households' mortgage rates, was 1.1 per cent. The confidence indicators for the Swedish economy are still weak and indicate a slowdown in the economy. So-called hard data also point to a slowdown. Exports in goods are falling, as are imports. At the same time, developments in the retail trade, industry and the production of services were weak.

The forecasts for GDP, inflation and policy rates abroad are somewhat lower than those presented in the Monetary Policy Report in October. Short-term indicators for the euro area point to weaker developments than expected, and concern over sovereign debt problems has increased. The problems in the euro area are expected to have further negative effects on the Swedish economy, and given the recent clear signs of a slowdown in Sweden, too, the forecast for Swedish GDP growth has been revised down. The forecast for unemployment has been revised up, and the forecast for inflation has been revised down, partly due to unexpectedly low inflation.

According to the current forecast, the repo rate will be cut by 0.25 percentage points at this meeting and the repo-rate path will be lowered. Compared with the October Monetary Policy Report, the forecast for the repo rate is now around at most 0.65 percentage points lower during the forecast horizon. At the end of 2014 it is around 0.3 percentage points lower, and is then 3.2 per cent. Behind this forecast are the assumptions that sufficient fiscal policy measures will be taken in the euro area to limit the acute problems and that households' and companies' confidence will gradually return.

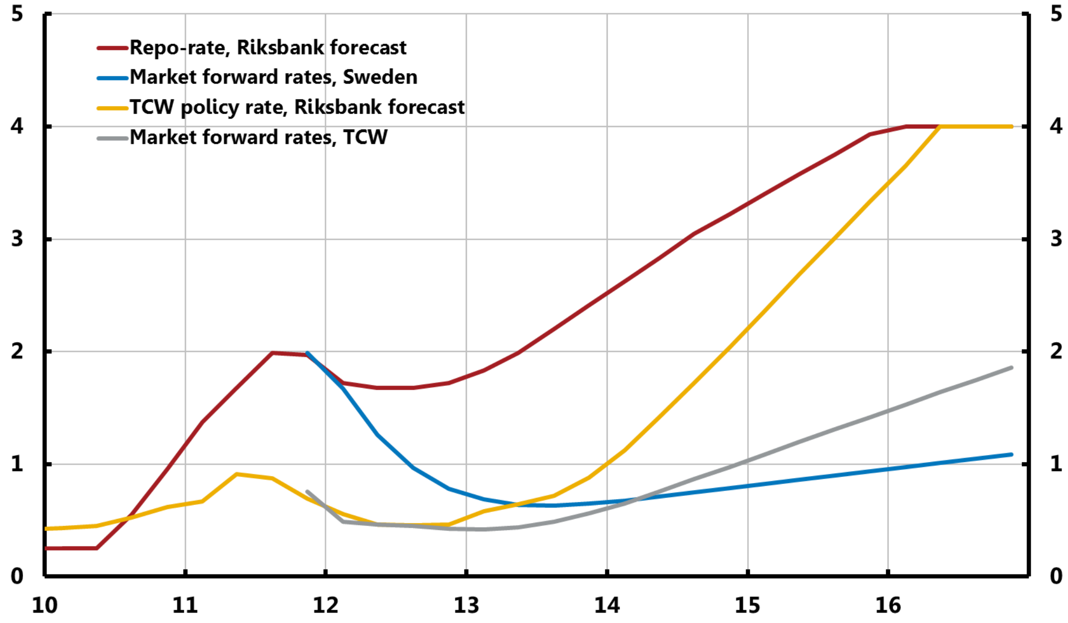
§2. Economic outlook abroad

Deputy Governor **Lars E.O. Svensson** began by saying that he was more pessimistic about developments in the real economy abroad than the forecast presented in the draft

Monetary Policy Update. Mr Svensson feared that it was less likely that the debt crisis in Europe would be resolved in a relatively good way. The effects on the real economy of this and of fiscal policy tightening would then be more negative. As before, he also saw a problem with regard to the Riksbank's 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 Swedish 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 referred to Figure 1 among the figures he had handed out. In this, the yellow line shows the current forecast for TCW-weighted policy rates abroad, which he himself had extended beyond the 3-year horizon with an even increase up to 4 per cent. The grey line shows TCW-weighted implied forward rates, adjusted according to a rule of thumb with a forward premium of 1 basis point per month. Further ahead, the forecast is very high above the implied forward rates and, all else being equal, gives rise to a substantial upward shift in the Riksbank's repo-rate path. There is no discussion in the draft Monetary Policy Update of these important circumstances, and there is no justification as to why one thinks that the central banks in the euro area, the United States and the United Kingdom should conduct a monetary policy that entails TCW-weighted policy rates beginning to rise after one year and then rising at a fairly rapid rate after two years. This is despite the fact that this has substantial consequences for the Riksbank's repo-rate path.

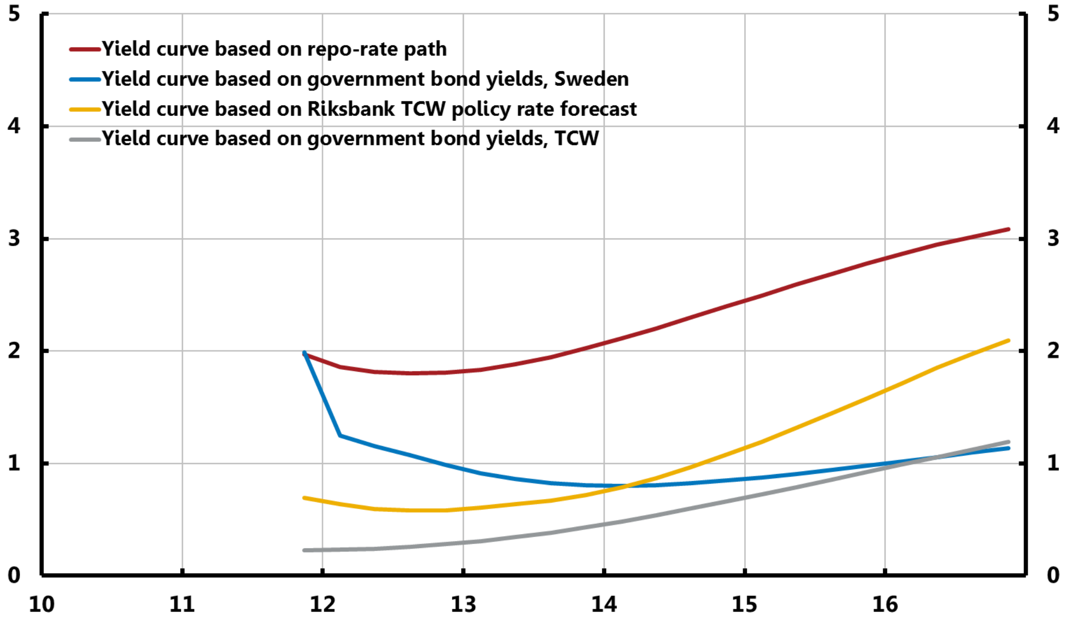
Figure 1. Repo-rate path, forward rates and forecast for TCW-weighted policy rate, December 2011
Per cent. Forward rates from 8 December



Note: The implied forward rates are adjusted for credit risk and maturity premiums using a rule of thumb of 1 basis point a month. The curves are extrapolated with an unchanged slope for the quarters beyond the forecast horizon (2014, Q4) and not based on actual market pricing.
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. The yellow curve shows the yield curve abroad that is compatible with the Riksbank's forecast for policy rates abroad. To make the interest rates more comparable, forward premiums have been added following the rule of thumb. 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. One can 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, December 2011
Per cent. Government bond rates from 8 December



Note: The blue and grey curves are based on market pricing. The red and yellow curves are based on the red and yellow curves in Figure 1. For better comparison with the market-based curves a term premium according to the rule of thumb has been added.
Sources: National sources, Reuters EcoWin, the Riksbank and own calculations

Mr Svensson recalled that Norges Bank made a different assessment, according to its most recent monetary policy report (prior to the meeting on 19 October). In this, Norges Bank 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. Norges Bank's forecast for policy rates abroad thus agrees with forward rates.

To sum up, Mr Svensson's opinion was thus that the forecast for interest rates abroad was too high and that this contributes to the repo-rate path in Sweden being too high. It would be better to let the forecast 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. He emphasised that, as before, it is unsatisfactory that this important question is not taken seriously. Any deviations from implied forward rates should be properly justified and carefully discussed, and should not just slink in, as they have a considerable effect on the Riksbank's repo-rate path.

Deputy Governor **Barbro Wickman-Parak** said that it was clear as early as the monetary policy meeting in October that the acute risks for the international economy were more centred on the euro area than the United States. These tendencies have since strengthened.

The growth forecast for the euro area has been revised down for good reasons. The cautious recovery expected in the second half of next year is based on an assumption that the acute debt crisis can be managed so that the situation on the financial markets stabilises. It is still difficult to assess whether the measures taken or announced will have this effect. There are some signs of a credit crunch in the euro area, although the situation cannot be compared to the period 2008-2009. A clear deterioration in the situation could entail a greater setback for GDP growth than was assumed in the draft Monetary Policy Update.

During the summer and at the beginning of the autumn the risk of recession in the United States was a topic of lively discussion. This topic has gradually waned in interest, however, and more positive signs can now be distinguished. Private sector consumption, for instance, has been surprisingly high and households' confidence has not continued to decline, but instead risen slightly, albeit from a very low level. Employment is continuing to increase, although at a moderate pace, and the revisions to statistics show that developments since the summer have not been as weak as earlier figures implied. It can also be mentioned that the purchasing managers' index for the manufacturing industry, both with regard to orders and production, has risen constantly since August and is now well above the 50 mark that denotes growth.

It is also difficult to assess the political process in the United States and what it will entail for the public sector budget and thus the real economy. The congressional committee appointed to resolve the long-term budget consolidation work did not achieve a result, which means that automatic tightening will begin in 2013. This was something that was also assumed in the forecast in October. The forecast in the Monetary Policy Update also contains an assumption that both the temporarily-expanded unemployment benefit and the payroll tax cuts, which both affect households' disposable incomes, will be withdrawn after this year. Over the past weekend, it was agreed in the senate to let the measures remain in place a couple of months into next year, while they try to negotiate on a decision for the rest of the year. The house of representatives has not yet made a decision on this issue. Positive surprises on the political level could lead to slightly better developments in the real economy.

Ms Wickman-Parak's assessment was that there is no reason to expect any exceptional recovery in the US economy, but nor are there any grounds for a very pessimistic forecast as yet.

Ms Wickman-Parak summarised by saying that growth prospects abroad are not uniformly bleak. Moreover, the fall shown by indicators for the euro area is slowing down. Emerging economies are slowing down, but so far they are nevertheless showing reasonable growth. Her assessment was that the international forecast is reasonable. Well aware of all of the risks looming on the horizon, she felt that one should take one meeting at a time and constantly adapt the forecasts to what the new information indicates.

Deputy Governor **Karolina Ekholm** considered that the forecast for developments abroad in the draft Monetary Policy Update is reasonable, given the information currently available. This time a fairly substantial downward revision has been made to the growth forecast abroad for 2012 and 2013, which is reasonable in the light of the debt crisis in the euro area still not having any credible solution and it is now clear that the poorer growth prospects in Europe also have negative effects on other parts of the world, so that growth in Asia and Latin American is also subdued.

The forecast in the Monetary Policy Update also assumes an even more severe fiscal policy tightening in the euro area than was included in the previous forecast, as further tightening has been announced in Italy, France and Ireland. Moreover, some credit tightening can be expected in the euro area as many banks have problems with their capital adequacy and market funding. The euro area is encumbered with an unfortunate link between weak public finances and problems in the banking sector. It is mainly local banks that hold government securities. When the value of these falls, it has a negative effect on the banks' balance sheets, which further aggravates the problems as the banks' lending capacity declines.

Ms Ekholm went on to say that on this occasion the forecast implies a regular recession in the euro area. Not a deep recession, but a couple of quarters of negative growth. At the same time, it is assumed that the rest of the world will continue to grow at a reasonable rate, so the main forecast is not for large parts of the global economy to fall into a recession. Moreover, the decline in the euro area is assumed to be relatively short-lived and a recovery is expected to start in the second half of 2012.

Ms Ekholm supported this, but like Lars E.O. Svensson she had some objections to the forecast for policy rates abroad. As before, these deviate from implied forward rates as they are higher. Although on this occasion the difference is less pronounced, as Ms Nessén pointed out in her presentation of the draft Monetary Policy Update, the forecast has been revised down substantially, which Ms Ekholm considered to be a positive sign. But she emphasised that she still feels that it is difficult to justify why one should expect policy rates abroad to begin rising at the beginning of 2013, given the assumptions that can be made regarding the need for fiscal policy tightening during 2013 and 2014. There may be good arguments for this, but if so they have not been made sufficiently clear yet.

Deputy Governor **Lars Nyberg** began by commenting on the political process of rectifying the public finance problems in Europe. The previous monetary policy meeting took place around the same time as the presentation of the so-called October package, where the aim was to convince the markets that politicians in Europe, and particularly the euro area, were now to put their words into actions with regard to turning around the financial crisis. The markets were not convinced, probably because the package proved to be fairly empty. Above all, there were no new commitments from the euro area countries to contribute capital. There were new demands regarding risk capital in the banks, but very little about where this capital would come from if the private market was unwilling to cooperate. There was a programme for further write-downs of Greek government bonds held by the private sector (not the public sector), now with a total of 50 per cent, without Greece defaulting on payments.

The purpose of getting the private sector to bear its share of the burden (known as Private Sector Involvement, or PSI) is of course a good one. It would be offensive if private investors, often European banks, were to have a high return on bonds that are essentially guaranteed by tax-payers. On the other hand, it is probable that PIS has strongly contributed to the Greek crisis spreading to other parts of Europe, first and foremost to Italy and Spain, but also to Belgium and France. The interest rates these countries have to pay when they are to refinance loans that fall due have risen substantially during the autumn. Mr Nyberg said that he did not believe that this was due to the market believing that France or Italy would default, even if the rising interest rates are often interpreted as an increasing risk that countries will suspend payments. They are rather due to the market seeing some probability that politicians in Italy will act in the same way as they have in Greece, namely force the private sector to take part in the debt write-down, even if the country does not suspend payments. And this is enough to push up interest rates to levels that are not sustainable – which in turn increases concern on the market that politicians will demand new contributions from investors.

Mr Nyberg noted that Italy and Spain in particular have had to pay a fairly high price in the form of rising loan costs for the requirement to allow private investors in Greek government securities to help pay the Greek bill – however reasonable this requirement may seem. Now that European banks are being forced to write down other countries' government bonds (to the extent that the rising interest rates are interpreted as a risk of a suspension of payments), it is also very likely that some governments will have to inject capital into their banking systems. The cost of the crisis will then rise even further. Now that the debt crisis has also clearly spread to the real economy and reduced growth prospects, this will also have to be paid for. And here Sweden, as a European neighbour, also has to pay as the falling GDP growth affects our export markets.

Mr Nyberg said that with hindsight one could say that PSI was perhaps not such a good idea. Using this as a means to combat "moral hazard", that is, the banks exposing themselves to large high risks as they assume that they will not have to bear losses as the government will support them if problems arise, appears very costly. It must be possible to find cheaper solutions. The politicians have now assured that PSI will not be applied in any other European countries. But the markets believe what politicians do and not what they say, so they have something of an uphill climb to attain credibility.

Mr Nyberg went on to point out that the most recent summit meeting was supposed to restore market confidence once again, but that investors are hard to persuade. Although they agreed on a first step to limit future build-up of debt in the euro area, this does not resolve the current crisis. Moreover, the picture of an increasingly fragmented Europe is emerging. As the market sees it, the most credible would be for Europe to lend euro to the IMF, which would then lend them back to Europe. China and other countries would also have the opportunity to contribute. The credibility lies in the IMF having an apparatus for making demands when lending money and following up these demands. Europe does not have this type of institution. But of course it seems absurd that the euro area, which can create an unlimited amount of euro, should need to lend them to the IMF for the IMF to manage the lending to European countries in need. Other ways of circumventing the ban on monetary funding, that is the ECB creating money, should have been possible. And of course it seems strange that wealthy Europe should require financial aid from emerging economies because it cannot manage its own internal problems. What will posterity have to say about this? And what do they think about it in Asia?

Mr Nyberg concluded his contribution to the discussion by saying that Sweden cannot expect much benefit from Europe during the coming period. Perhaps one can nevertheless hope that developments in the United States will turn around. Company profits are good and consumer confidence has improved. There are also a number of other signs of this, as noted in the Monetary Policy Update.

First Deputy Governor **Svante Öberg** began by saying that he felt the picture of developments abroad presented in the draft Monetary Policy Update is reasonable.

Developments in Europe are still troublesome. Forward-looking indicators appear slightly more negative than in October, the stress levels on the financial markets are now as high as they were in the United States following the Lehman bankruptcy in autumn 2008, and the forecast for the euro area has been revised down to largely zero growth in 2012.

Mr Öberg said that there are primarily two things that need to be done to calm the markets and get the recovery in the economy moving. Countries with large budget deficits must get their public finances onto sustainable development paths and the stability of the banking sector must be strengthened. The public finance deficits must be eliminated and debt ratios must begin to fall. During the autumn a further number of decisions have been reached on budget consolidation and there is discussion of an international agreement on stricter budget regulations.

Decisions have also been reached on strengthening the capital base in the European banks that had poor results in the European Banking Authority's (EBA) stress tests and on expanding the capacity of the European funds (EFSF and ESM) and the International Monetary Fund (IMF) for strengthening financial stability. It is essential, from Sweden's point of view, that the Riksbank should also participate in the strengthening of the IMF's resources through bilateral loans, assuming that there is a reasonable allocation of the burdens and that loans to European countries can be granted on strict conditions.

Mr Öberg said that it is easy to become frustrated over the time it takes to reach clear decisions in the EU. But if one looks at things in a longer perspective, a lot has happened since the financial crisis hit Europe with full force in autumn 2008. Budget consolidation is under way in several countries, three European financial supervisory authorities and a systemic risk board have been established, the regulatory framework for the financial markets is being tightened, and so on. Mr Öberg’s assessment is that it will be possible to manage the problems in the euro area, although it may take some time before a clear improvement is visible. The experience of Sweden's crisis in the 1990s was that it took several years to establish confidence on the markets.

Inflation in the euro area was unusually high in November, 3 per cent. Underlying inflation has increased over the year, despite a negative production gap. But the assumption both in the Monetary Policy Update and made by most other analysts, is that inflation will fall back to below 2 per cent next year. Given the falling inflation rate and the weak real economy, it is natural that the ECB has cut its policy rate twice during the autumn. It also makes it slightly easier for the Riksbank to cut its repo rate without causing any problems in the financial markets. The ECB has also reduced its minimum reserve requirements and improved the banks’ possibilities to borrow both euro and dollars from the ECB.

Developments in the United States are better than in Europe. New statistics have been slightly better than expected and the forecast for GDP growth has been revised up slightly to almost 2 per cent in 2012. But there is also in the United States a major problem with public finances. The budget deficit is actually larger in the United States (10 per cent of GDP in 2011) than in the euro area (4 per cent of GDP in 2011). Fiscal policy will therefore need to be tighter in the coming years, which in itself will hold back growth. However, monetary policy is expansionary. This on the whole supports the picture of continuing but slow recovery in the United States.

Mr Öberg underlined that other parts of the global economy had on the other hand showed much better development. The IMF is assuming in its most recent forecast from October that GDP growth in emerging and developing economies will be around 6 per cent in 2012 and in the Monetary Policy Update the forecast for global GDP growth for next year has only been revised down by a tenth of a percentage point. Despite the problems in Europe, the situation abroad is thus less dramatic than in 2009. The forecast in the Monetary Policy Update thus entails GDP growth of 3.7 for 2012, while global GDP fell by 0.7 per cent in 2009. We thus do not have the same reasons as in 2008-2009 to make drastic changes in monetary policy in Sweden.

Mr Öberg said that in the slightly longer run, when the crisis in the United States and Europe is over, there is a risk that the high growth in the world with an ensuing higher demand for energy and commodities and a slow adjustment of the supply in these markets will result in rising inflation as it did prior to the financial crisis breaking out. But if and when this occurs, monetary policy will be adjusted accordingly.

Governor **Stefan Ingves** said that he shared the view of international developments described in the draft Monetary Policy Update. All in all, poorer growth prospects are noted abroad. However, the picture is mixed. The European debt crisis is now more clearly subduing prospects in Europe for next year. There are signs in some emerging economies that the good recovery from the financial crisis in 2008-2009 is slowing down somewhat. But the forecast for GDP growth in the United States, where the financial crisis originated, has been revised up slightly. It is now many years since the property crisis detonated in the United States. Mr Ingves said that one receives the impression that the economy is turning around all on its own in a situation where a number of fundamental problems still remain.

He therefore felt that, despite the considerable political uncertainty in Europe, the picture of global developments was not entirely bleak and he did not see any reason to dramatically revise this picture. The euro area is currently characterised by the debt crisis and a decline in confidence. Some countries have decided on further fiscal policy tightening, but it is difficult as yet to see what will happen. There are also signs of tighter credit according to the European Central Bank's (ECB) "Bank Lending Survey". Underlying inflation has risen as a result of higher prices on food and services, despite the spare capacity in the economy. However, these effects are judged to be short-lived and the assessment in the Monetary Policy Update is that inflation will slow down going forward. Monetary policy has also been made more expansionary. The ECB has also introduced an opportunity for the banks to borrow at a three-year maturity. Mr Ingves's impression was that the extraordinary measures are actually more important than the interest rate-setting, as the transmission mechanism for monetary policy has been more or less put out of action. It is difficult to decipher what a European interest rate is at present.

Mr Ingves went on to say that the forecast for GDP growth for the euro area in the Monetary Policy Update shows a growth of only 0.2 per cent before the economy then recovers. The weak developments in the euro area dampen Swedish exports. Sweden also exports less to the crisis countries in southern Europe than to the countries in northern Europe. More than half of Swedish exports to the euro area are to Germany, Finland and the Netherlands. This is significant, as these countries will probably manage to achieve a recovery quicker than southern Europe.

However, according to Mr Ingves there are still considerable risks as the euro area has been affected by a substantial crisis of confidence. The introduction of a stronger fiscal policy framework in the EU also has a clearer place on the political agenda. However, it is difficult at present to say to what extent new fiscal policy regulations will be applied in individual countries. There also appears to be a divide between long-term commitments and what needs to be done now. The uncertainty over the management of the crisis in Europe is thus not over yet. A deeper crisis in the euro area would have very negative consequences for a small, trade-dependent country like Sweden. It is in Sweden's interests to lend money to the IMF, which can in turn lend them to the euro countries in crisis with the requirement of binding commitment to strengthening public finances, financial systems and competitiveness. Mr Ingves's assessment was that the IMF can make clearer conditional demands than the countries themselves, or than the various European institutions.

Mr Ingves concluded his contribution to the discussion by taking up an entirely different issue. The TCW index used by the Riksbank to describe international influences on the Swedish economy via our most important trading partners through the forecasts made for international GDP growth, inflation, policy rates and the Swedish exchange rate, was created in 1992. Quite a lot has happened since then, and it is now time, according to Mr Ingves, to modernise the TCW so that the prevailing trade flows are better captured.

Deputy Governor **Lars E.O. Svensson** agreed with Mr Ingves that the TCW weights need to be revised and emphasises the need to change over to the so-called KIX index as a starting point for assessments of how international developments affect the conditions for Swedish exports. He also agreed that it may be useful to disaggregate exports to the euro area if the markets for Swedish exports in different euro area countries develop in different ways. The current TCW weights for the euro area, the United States and the United Kingdom add up to around 79 per cent. It is clear that the Swedish economy is very dependent on developments in this area and these countries, which are all in a state of serious crisis.

Deputy Governor **Karolina Ekholm** commented on Mr Svensson's contribution regarding Swedish trade patterns, saying that a rule of thumb for the export pattern could be provided by a gravity model, where the size of Swedish exports is determined by the recipient country's geographical proximity and economic size. China has recently become Sweden's tenth most important export country, which is connected to the Chinese economy's increased share of the global economy. Unfortunately, this is not captured by the TCW index.

First Deputy Governor **Svante Öberg** thought it is important not only to look at the first recipient country for Swedish exports, but also to analyse where the goods and services go in the next stage. It would be useful if the calculations of the KIX index and export market growth could also take into account the final destination of exports, for instance, through input-output tables. Some of the exports to Germany, Holland and Belgium then go further to China and other emerging economies.

Deputy Governor **Barbro Wickman-Parak** reminded the meeting that the forecast for export market growth is based on our 15 largest trading partners and that, for instance, some emerging markets are actually included.

Governor **Stefan Ingves** then summed up the discussion of the international economic outlook by saying that there is a fair amount of agreement between the members of the Executive Board regarding economic developments abroad and the sources of uncertainty regarding these developments. There are, on the other hand, some differences of opinion regarding the development of policy rates in the large currency areas.

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

Deputy Governor **Lars E.O. Svensson** explained that he thinks it a good idea to cut the repo rate and lower the repo-rate path at this time. However, the main scenario's forecast for CPIF inflation is still too low in relation to the inflation target of 2 per cent and the forecast for unemployment is still too high in relation to a sustainable unemployment rate. An even lower repo-rate path would mean that CPIF inflation came closer to the target and unemployment would come closer to the sustainable rate. Mr Svensson wished that the Riksbank would now demonstrate the same ability to take action as during the autumn, winter and spring 2008-2009, when the bank cut the repo rate substantially on several occasions when this was needed to stabilise inflation and resource utilisation.

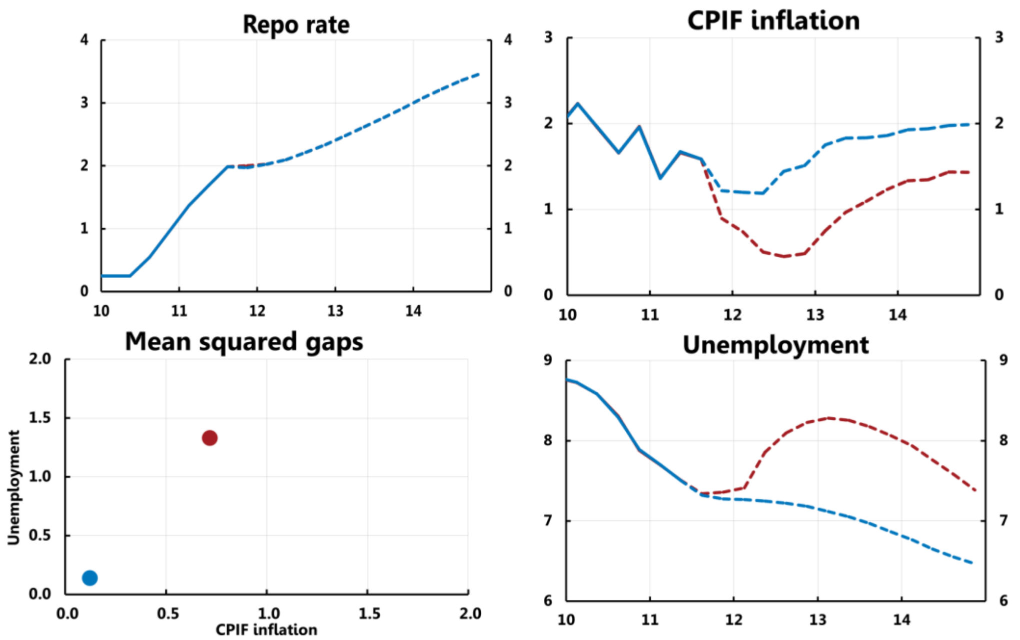
Mr Svensson entered reservations against parts of the draft Monetary Policy Update. He preferred that the repo rate be cut by 50 basis points to 1.5 per cent at this meeting and a lower repo-rate path which is at 1.25 per cent from the second quarter of 2012 and until the end of the third quarter of 2013, and which then rises at an even pace to slightly below 3 per cent at the end of the forecast period.

The repo-rate path in the main scenario is too high for three reasons. Firstly, as he has already mentioned, 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. Moreover, the Riksbank's analysis and measure of resource utilisation are unclear and the ideas are very confused. One must distinguish between measures of resource utilisation as a target variable and as an indicator of inflation pressure. These are different things, but the Riksbank's analysis mixes them together. It says in the draft Monetary Policy Update that "there is no simple way of measuring resource utilisation". It is no wonder that this conclusion is reached when one confuses the various purposes of the measures. However, there are strong reasons why the gap between the unemployment rate and the sustainable unemployment rate is the most appropriate target variable.

Thirdly, one can demonstrate that a lower repo-rate path better stabilises CPIF inflation around the target of 2 per cent and unemployment around a rate of 6.5 per cent, even if one accepts the high forecast for policy rates abroad and the high estimate of 6.5 per cent for the sustainable unemployment rate. Regardless of how one views it, the main scenario thus represents a monetary policy that is not well balanced.

Mr Svensson then emphasised that the outlook for inflation and unemployment was much poorer now than at the meeting in October. To illustrate how the situation has changed, he wished to present a preliminary attempt to show how much new information and new assessments had shifted the forecast for CPIF inflation and unemployment compared with the October forecast, under the assumption of an unchanged repo-rate path. Holding the repo-rate path unchanged makes the comparison between October and December fairer, as one can then isolate the effects on inflation and unemployment of the new information and the new assessments. If the repo-rate path is not held unchanged, the comparison becomes more difficult, as the effects of the changed repo-rate path are added.

Figure 3. Comparison of the forecast for the CPIF and unemployment, October and December 2011, with an unchanged repo-rate path from October



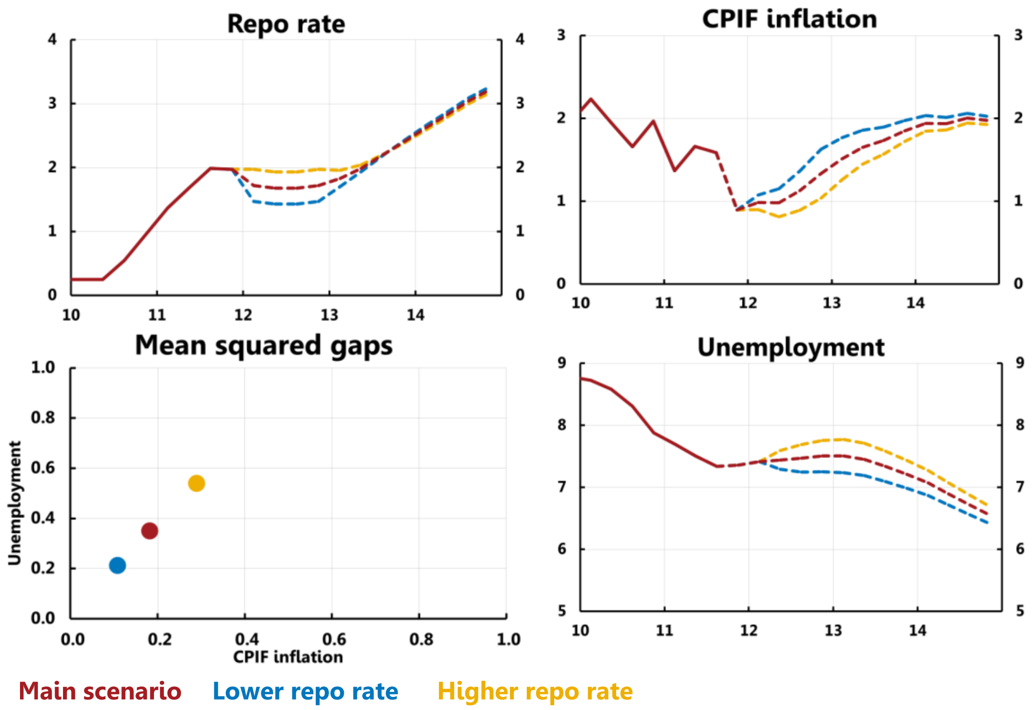
Note: The blue line and dots show the forecast in the October Monetary Policy Report. The red line and dots show the forecast in December. This has been calculated with an unchanged repo-rate path from October, using the Riksbank's Ramses model.
Sources: Statistics Sweden and the Riksbank

Figure 3 shows the forecasts for CPIF inflation and unemployment in October (blue curves) and December (red curves) with an unchanged repo-rate path from October. The December forecast for CPIF inflation with an unchanged repo-rate path is roughly a whole percentage point lower just over one year ahead. The December forecast for unemployment is roughly 1.2 percentage points higher one to two years ahead. The calculations behind the December forecast are complicated, and the results are preliminary and of course dependent on a number of details as to how the calculations are made. However, it is clear that there is a considerable shift in the forecasts and that the situation looks much worse than in October. This justifies a substantial shift in the repo rate and the repo-rate path. It would be interesting to compare how much the situation deteriorated according to this measure during late autumn 2008 and spring 2009, when the repo rate and repo-rate path were shifted down substantially. However, there has not been time to do this now. Mr Svensson considered it desirable that this way of measuring the effects of new information and new assessments with an unchanged repo-rate path should be further developed and become a standard element in the future monetary policy-making process.

Mr Svensson continued onto his third reason why the repo-rate is too high, namely that a lower repo-rate path than the one in the main scenario better stabilises CPIF inflation and unemployment, even if one accepts the assumption in the main scenario with a high forecast for policy rates abroad and a high sustainable unemployment rate of 6.5 per cent. Figure 4 shows the forecasts for CPIF inflation and unemployment for different repo-rate paths under this assumption. In the upper left 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 panel also shows that the mean squared gap is lower for both inflation and unemployment with the lower repo-rate path.

Figure 4. Monetary policy alternatives, December 2011

Policy rates abroad according to the Riksbank's forecast; sustainable employment rate of 6.5 per cent; Lower repo-rate path: -50 basis points in December and -25 points in January



Sources: Statistics Sweden and the Riksbank

As illustrated in Figure 3, the forecast for inflation and resource utilisation with an unchanged repo-rate path has shifted down substantially from October to December. The repo-rate path in the main scenario in Figure 4 has been lowered in relation to October, 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. According to Figure 4, lowering the repo-rate path further improves target fulfilment for both CPIF inflation and unemployment. Monetary policy is therefore not well balanced in the main scenario, said

Mr Svensson. This should be obvious to everyone and one does not need to be an expert on monetary policy to realise it, he pointed out.

So why isn't the repo-rate path being lowered further? The only argument Mr Svensson had heard in the discussions prior to this meeting was that one should not shift the repo-rate path too far. This type of argument means that the repo rate has become an explicit or implicit target variable, in addition to inflation and resource utilisation, where small shifts are regarded as better than large shifts. This is not right, he said. The repo rate should solely be used as an instrument to stabilise the correct target variables, inflation and resource utilisation.

Mr Svensson then went on to the second reason why he thinks the repo-rate path is too high, namely that the Riksbank overestimates resource utilisation and that the analysis of resource utilisation is somewhat confused.

As before, Mr Svensson wants to advocate the gap between the unemployment rate and an estimate of the sustainable unemployment rate (the long-term equilibrium unemployment rate, the unemployment rate in steady state) as 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. 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 the unemployment rate is not revised as much and there are fewer measurement errors. Although it is not easy to estimate sustainable employment, it is much easier than estimating potential GDP. The unemployment gap is the most transparent, as the unemployment rate is most known and well-understood by both experts and the general public.

As before, Mr Svensson's assessment until further notice is that the sustainable unemployment rate is around 5.5 per cent, rather than the Riksbank's assessment of 6.5 per cent, and that the Riksbank is thus overestimating resource utilisation.

The Riksbank uses more measures of resource utilisation than the unemployment gap, namely the employment gap, the hours worked gap and the GDP gap. However, there are significant weaknesses in the hours worked gap and the GDP gap as target variables. They may be relevant as indicators of inflationary pressures, but it is important not to confuse them with resource utilisation as a target variable.

The hours worked gap consists of the employment gap and the average working hours gap (actual average working hours minus potential average working hours). If the average working hours gap increases, the hours worked gap increases. If one then wants to stabilise the hours worked gap, one should reduce employment and raise unemployment. This does not appear reasonable.

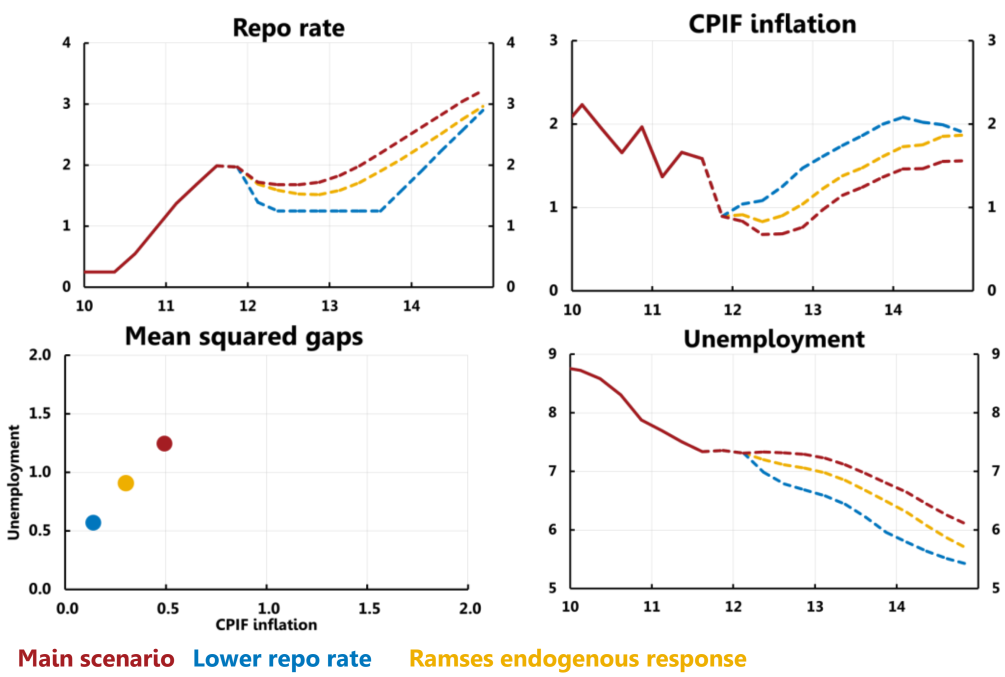
The GDP gap consists of the hours worked gap and the labour productivity gap (actual labour productivity minus potential labour productivity). If one wishes to stabilise the GDP gap, one should reduce employment when productivity is higher than normal. This does not appear reasonable and is contrary to what is generally regarded as efficient, namely to work more during period when productivity is high. In addition, potential labour productivity is calculated using actual capital stock when it is sustainable capital stock, the capital stock in steady state, that should be used.

More items are added the further one goes down this list, with more potential sources of error and less reliability. At the same time, the relevance for welfare declines. It is difficult to see that a high average working hours gap or a high labour productivity gap would, all else being equal, be a good reason for reducing employment and increasing unemployment.

Mr Svensson finally referred to Figure 5, to explain why he wants to have a lower repo rate path. The picture shows forecasts for CPIF inflation and unemployment under the assumption of policy rates abroad in accordance with forward rates, and Mr Svensson's assessment of the sustainable unemployment rate of 5.5 per cent. Blue curves show forecasts according to the repo-rate path preferred by Mr Svensson. Red curves show the forecasts with the repo-rate path in the main scenario.

Figure 5. Monetary policy alternatives, December 2011

Policy rates abroad according to implied forward rates; sustainable unemployment 5.5 per cent



Sources: Statistics Sweden and the Riksbank

The repo-rate path of the main scenario gives a forecast for CPIF inflation well below 2 per cent. With the repo-rate path in the main scenario, a lower interest-rate path abroad gives a greater interest rate differential and a stronger krona that reduces inflation and exports. The lower repo-rate path gives higher CPIF inflation closer to 2 per cent and a much lower forecast for unemployment closer to 5.5 per cent. Target fulfilment for both inflation and unemployment will thus be much better with the lower repo-rate path.

It is worth noting that this result is in the current situation not sensitive to the assumption of a sustainable unemployment rate of 5.5 per cent. The lower repo-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 monetary policy meeting in October, 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 thereby determining more precisely which path is best. Mr Svensson said, however, that his proposed repo-rate path entails much better target fulfilment compared to the path in the main scenario. This path will therefore have to do for now. Next time, however, a new analysis may very well conclude that target fulfilment would be better with a significantly lower path than this. A new analysis may also reach the conclusion that the repo-rate path should be lower at the end of the forecast period.

Deputy Governor **Karolina Ekholm** said that the crucial issue in the forecast is how much Sweden will be affected by the problems in the euro area. The Swedish economy is not burdened by the same problems as the euro area, particularly not with regard to public finances. One may perhaps think that Sweden should be able to remain fairly unaffected by the United States and several European countries being forced to implement fiscal tightening measures. It is, however, unavoidable that Sweden will be affected by lower demand for Swedish export products and that general pessimism about the future will also spread to Swedish households and companies. On the other hand, Sweden will probably not be hit as hard by the recent increased stress on the financial markets. This is because there is no obvious reason why Swedish banks should tighten their lending over and above what is justified by the economic situation per se. The Swedish banks are well capitalised and the value of Swedish government bonds has increased rather than fallen. The latter means that the link between public finances and the situation of the banks appears, if anything, to be to the advantage of the Swedish banks.

However, the draft Monetary Policy Update entails a significant deterioration in the growth prospects for Sweden. This is because it now forecasts a more severe slowdown in Europe. The forecast for inflation in Sweden has also been revised downwards, among other things because inflation has been lower than expected during the autumn. All in all, this argues for a more expansionary monetary policy than was predicted in October.

Ms Ekholm pointed out that already in October she advocated a repo-rate cut and a lower repo-rate path than the path in the main scenario of the Monetary Policy Report. Given this, she was obviously in favour of a repo-rate cut and a downward revision of the repo-rate path now. The question now was rather how large the downward revisions of the repo-rate and the repo-rate path should be. Had Ms Ekholm's stance prevailed in October, the repo rate would now be 1.75 per cent. From this starting point, the proposed cut of 25 basis points does not entail any additional monetary policy stimulation in the immediate future compared to what she wanted to see in October. The repo-rate path she advocated then went down to 1.5 per cent. The repo-rate path proposed in the draft Monetary Policy Update does not therefore constitute any further expansion, but rather the opposite. It follows from this, according to Ms Ekholm, that a larger downward revision of the repo-rate path than that proposed in the draft Monetary Policy Update is justified.

Ms Ekholm said that this time she had found it difficult to reach a decision about the level of the repo rate. During the drafting process, Ms Ekholm had implied that she could accept a cut of 25 basis points as this would entail a change in the right direction, and it would also probably mean the she would avoid having to once again enter a reservation against that part of the monetary policy decision. However, Ms Ekholm had now decided to advocate a cut of 50 basis points as she really believed that such a large cut was justified.

Ms Ekholm's reasons for wanting a lower repo-rate path than that proposed in the draft Monetary Policy Update were the same as at previous meetings. Mr Svensson had already given a detailed account of these reasons. In principle they are that a lower repo-rate path constitutes a better-balanced monetary policy given the forecast in the draft Monetary Policy Update, and that a forecast based on implied forward rates instead of on the current forecast for foreign policy rates imply forecasts for inflation and resource utilisation that are even further from what one should consider to be compatible with a well-balanced monetary policy.

To explain how large a downward revision of the repo-rate path she believed to be justified, Ms Ekholm referred to the analyses based on the Riksbank's analysis model Ramses that Mr Svensson had presented earlier. These analyses study a repo-rate path that falls to 1.25 per cent and remains at that level until the end of the third quarter 2013 and then gradually rises to just below 3 per cent. This path, which Ms Ekholm said she supported, provides better-balanced development with regard to underlying inflation and resource utilisation.

Ms Ekholm posed the question of whether it really makes much difference if one cuts the repo rate by 25 or 50 basis points, or if the repo-rate path bottoms out at just above 1.5 or 1.25 per cent. As the future course of development is so uncertain, one might think that one of the alternatives would probably work as well as the other. However, Ms Ekholm believed that which of these alternatives one chooses does really matter.

Forecasts are uncertain because we have so little information today that is relevant to an assessment of the state of the economy in two to three years' time. In principle we have no information that is relevant to what we should believe about the situation in three years' time, other than assessments of what are long-term, average values for various variables. It is in the nature of things that a medium-term forecast tends to end up in these long-term average values at the end of the forecast horizon as it is these values one can expect when conditions cannot be based on any more specific information.

However, according to Ms Ekholm, this cannot justify not fully taking account of how the forecast for inflation and resource utilisation looks throughout the entire forecast period when deciding on the repo-rate path. She said that the principle should be to choose the path associated with the most desirable forecast, even if one knows that it is extremely unlikely that this forecast will materialise exactly.

This is important, said Ms Ekholm, in enabling the repo-rate path to fully realise its potential role as a monetary policy instrument. The forecast that the Executive Board adopts today is conditioned on the information that is available today. This applies to all the variables, including the repo rate. Revealing the conditioned forecast for the repo rate gives external parties information on what the Executive Board believes to be an appropriate monetary policy given the information available and the assessments the Executive Board has made. Ideally, this should then affect expectations regarding short-term interest rates in the future and thereby affect the longer-term interest rates, which are the rates that in reality are significant to the subsequent development of the economy.

It is a problem that the repo-rate path has deviated significantly and in a systematic way from market expectations as expressed in implied forward rates for a long time now. To a certain extent, the very low Swedish forwards rates are an expression of factors other than purely monetary policy expectations. However, all the indications are that these expectations have nevertheless deviated significantly from the repo-rate path. As this has been the case for a long period of time, there is a risk that the value of the repo-rate path as a monetary policy instrument will decline because it has a weaker impact on market expectations. This would be unfortunate, concluded Ms Ekholm.

Deputy Governor **Barbro Wickman-Parak** began by commenting on Mr Svensson's contribution in which he expressed a desire to see the same forceful action on the part of the Riksbank as in 2008-2009. She said that "demonstrating the ability to take action" has no value in itself. What is important is to set the repo rate that the situation requires. She also noted that Mr Svensson actually thought that an even lower repo-rate path than the one he now proposed would probably be desirable. However, he believed that this was not possible on the grounds that it is technically difficult to calculate the effects of a repo-rate path that lies even further from the main scenario. Ms Wickman-Parak said that in this sense the majority's repo-rate path represented a restriction to Mr Svensson, and she wondered whether in such a situation he shouldn't anyway choose the repo-rate be believed to be reasonable and do this irrespective of what the models can or cannot do.

Ms Wickman-Parak went on to present her views on monetary policy. Forecasts of economic activity are always uncertain. The further ahead one looks, the more uncertain the forecasts are. The prospects for the period ahead are now largely dependent on the outcome of the ongoing political process to resolve the debt problems in Europe. The results of this process, and how it will affect the confidence of the participants on the financial markets and in the real economy, are genuinely difficult – if not to say completely impossible – to assess with any degree of certainty. This means that it is now particularly difficult to assess the outlook even for only a few quarters ahead.

That there would be a sharper slowdown in economic activity was clear already in September when the Riksbank made a fairly large downward adjustment of the growth forecast for the year ahead. A smaller downward adjustment followed in October. At that time, the outcomes for exports and production were still quite strong, but all of the indicators pointed downwards. Household confidence had already fallen, and figures for the retail trade and new car registrations indicated that weaker confidence was having an impact on consumption. The forecast for consumption was adjusted downwards. The repo-rate decisions in the autumn left the repo rate unchanged, but the repo-rate path was adjusted downwards.

Ms Wickman-Parak's assessment earlier in the autumn was that it was reasonable to put monetary policy into something of a wait-and-see mode. The downward revision of the forecast for GDP growth in the draft Monetary Policy Update is not particularly substantial but of about the same magnitude as the downward revision in October. This time, however, the Executive Board should take the step and lower the repo-rate and the repo-rate path as proposed in the draft Monetary Policy Update.

Ms Wickman-Parak then went on to explain why she now advocates a repo-rate cut. She highlighted the development of exports, private consumption and inflation.

The GDP figure for the third quarter was much higher than expected and confirmed that both exports and production were still exhibiting reasonable growth at the time of the monetary policy meeting in October. Although the third quarter is now history, it may be instructive to look a little more closely at the statistics and combine them with other information that has become available since the meeting in October. Export growth was still strong in the third quarter, but the monthly statistics for the export of goods show that there was a slowdown in the final month of the quarter. The slowdown continued in October, and monthly figures for export orders show a marked fall-off. The fact that several outcome figures are in line with the export order indicators means that we have a somewhat sounder basis on which to assess exports in the quarters immediately ahead. The weaker growth abroad has begun to have a greater impact on Swedish exports and will continue to do so going forward. The forecast for export growth next year is no more than just under 2 per cent.

Ms Wickman-Parak then reminded the meeting that as far as she is concerned the strength of household consumption began to look like a very uncertain factor in the assessment of economic activity already in the summer. She had already discussed the reasons for this at earlier monetary policy meetings. The Riksbank's forecasts for consumption have been revised downwards significantly during the autumn. The weak growth of consumption in the third quarter in the National Accounts had been heralded by weak figures for the retail sector and car purchases, but the level was actually much lower than predicted in the Riksbank's forecast in October. There was also a substantial contribution from investments in stock in the third quarter and it was above all stocks in the retail sector that increased. This can be interpreted as an involuntary build-up of stocks when household demand proved to be unexpectedly weak. New information that has become available since the meeting in October thus indicates that weak consumer confidence has had a sharper impact on actual consumption. The forecast for consumption has now been revised downwards even further compared to the forecast in October, and this is well grounded.

With weaker exports and weaker consumer demand it is natural that investments are postponed. The investment forecast in the draft Monetary Policy Update has been revised downwards. At the monetary policy meeting in October, Ms Wickman-Parak said that there was something of a wait-and-see situation in the economy where companies and households were cautious and highly uncertain. The longer this situation continued, the greater the impression it would have on the outcome figures, and growth would risk being weaker than predicted. This is the situation that Ms Wickman-Parak sees now. The improvement on the labour market is also slowing down.

The more evident slowdown of exports and domestic demand is one of the reasons why the repo rate should be cut and the repo-rate path revised downwards today. However, the fact that inflation has been unexpectedly low over the last two months is also important. This has not been due to a limited range of prices but to prices across the board. In the draft Monetary Policy Update, the inflation forecast has been adjusted downwards for the major part of the forecast period.

The repo-rate path in the draft Update indicates that there is a certain probability of a further cut in the repo rate. This was also about as far as Ms Wickman-Parak was prepared to go on the basis of the information available today. She expects the economy to gradually begin to strengthen once again towards the end of next year. This presupposes, however, that the acute economic problems abroad are resolved in a credible way so that confidence returns and international growth recovers. There is then every chance that the Swedish economy will also benefit from this through an increase in exports. It is also likely that household demand will increase, partly because household saving will be high initially. We can thus also expect household wealth to increase due to rising asset prices. If the weakening of demand proves to be transitory, then there will also be scope for an improvement in investment activity.

As a lot depends on whether a political crisis abroad can be resolved, it is impossible to assess what will happen next with any great degree of certainty. According to Ms Wickman-Parak, it is now a question of taking one monetary policy meeting at a time. If things turn out to be worse than predicted then it may of course be necessary to take bolder action. However, it may also be worth remembering that things can sometimes go better than we expect.

Governor **Stefan Ingves** said that he agreed with the assessment of the Swedish economy in the draft Monetary Policy Update and supported the proposal to cut the repo rate by 25 basis points to 1.75 per cent and to adopt the repo-rate path proposed.

In the draft Monetary Policy Update it is assumed that weaker economic activity abroad will contribute to a slowdown of the Swedish economy. Although there was good GDP growth in the third quarter, there has since been an abrupt slowdown in the trade in goods and in consumption. Unemployment has stopped falling and the demand for labour is levelling off. The unease abroad has also lowered various indicators that measure confidence in future conditions. All in all, there are clear signals that exports are slowing down and that GDP growth will be weak in the quarters ahead.

Weak demand from abroad contributes to weak GDP growth also in Sweden next year. The decline in confidence in the future conditions will lead to the postponement of some investments and consumption. However, the assessment is that postponed investments and consumption will materialise in 2013 and 2014 and push up GDP growth towards more normal levels again.

The slower rate of growth next year also means that the resource utilisation gap will close a little later than previously expected.

The krona has weakened somewhat, but has been more stable during the recent European crisis than during previous international crises. This should be seen as a healthy sign. Moderate volatility in the exchange rate is not a target in itself but it makes things easier for everyone involved in a period of great uncertainty about developments abroad.

Mr Ingves also said that the inflation forecast has been adjusted downwards due to the recent weak outcomes for inflation, the weaker economic activity abroad and the fall-off in domestic demand. Inflation expectations are also well-anchored around the inflation target.

According to Mr Ingves, there are no reasons for trying to use monetary policy to come to terms with the great political uncertainty that now prevails abroad. The Riksbank should not add uncertainty by implementing sudden and dramatic changes in monetary policy. It is reasonable to cut the repo rate by 25 basis points today and to have a somewhat lower repo-rate path for a while. It is also difficult to know how the crisis in the euro area will be resolved. It is difficult, not to say impossible, to capture political uncertainty in macroeconomic models.

It is also difficult to measure the impact of monetary policy under the present circumstances. This is even more the case in the euro area. The implied forward rates that emerge are not particularly useful. It is also difficult to take into account the interest rates that households have to pay in the models. The gap between mortgage rates and the repo rate has increased due to rising funding costs and increasing margins. Mr Ingves said that he would not be surprised to see higher margins for lending on the housing market. Nor is it self-evident that monetary policy should compensate for these higher margins. A slowdown in the rate of increase in household debt could help to reduce the risk of future crises. However, more analysis of how actual interest rates affect the economy is needed. When assessing actual interest rates, it is also important to analyse the interest rates that companies have to pay, which have not increased as much as mortgage rates. Useful measures of the interest rates that economic agents actually have to pay must be produced. Such an analysis can also provide clearer guidance on the balance between monetary policy and regulatory measures.

Mr Ingves said that all this means that after today's repo-rate cut the Executive Board will enter a sort of wait-and-see mode. It was extremely difficult to assess the probability of the main scenario now on the table, but he chose to vote for it while remaining well aware that new information can alter the preconditions governing future repo-rate decisions. It is reasonable to believe that the Swedish economy will grow in the period ahead at the same time as inflation is under control. Sweden is not in need of the same low interest rate as those countries or regions that are experiencing major problems. Nor, by the same token, does Sweden need to have a significantly higher policy rate, as is the case in a number of rapidly-growing economies.

First Deputy Governor **Svante Öberg** said that the picture of the development of the Swedish economy presented in the draft Monetary Policy Update was reasonable and that he supported the proposal to reduce the repo rate by 0.25 percentage points and to lower the repo rate path. He did not think, however, that it was time for the Riksbank to provide the banks with additional liquidity as it did during the crisis of 2008 – 2009. The

Swedish banks have access to short-term funding and relatively good access to long-term funding compared to banks in the rest of Europe.

There have not been any really substantial changes regarding economic developments in Sweden since October. It is true that GDP growth was much higher than expected in the third quarter, but a downward rebound is expected in the fourth quarter. Unemployment increased during the autumn and inflation was somewhat lower in November than forecast in October.

The business tendency survey for November indicates that growth in the Swedish economy is weaker than normal. However, the survey indicator fell by only 0.5 percentage points in November following much larger falls in the preceding months. In the business sector it was only the manufacturing industry that lowered the indicator. Other parts of the business sector instead pushed up the indicator. The households still have a largely negative view of the future. However, the confidence indicator for the households has increased marginally over the last 12 months and their view of their own financial situation has improved slightly.

So nothing has happened that radically changes the picture of the Swedish economy. Given this background, the forecasts for GDP and CPIF inflation in 2012 have been marginally revised downwards by two per cent and one tenth of a per cent respectively. In the new repo-rate path, the forecast for CPI inflation in 2012 is revised downwards by four tenths of a per cent.

The forecast for development in the year ahead nevertheless justifies the Riksbank now cutting the repo rate. The main reason is that inflationary pressures are low now and will remain low in the period immediately ahead. Various measures of underlying inflation are clearly below 2 per cent according to the latest outcomes and according to the forecasts for next year in the draft Monetary Policy Update. CPI inflation adjusted for the Riksbank's own repo-rate increases was 1.6 per cent in November and when also adjusted for the banks' increased funding costs and margins it was 1.1 per cent. Other measures of underlying inflation were in the range 0.8 to 1.4 per cent.

Inflation expectations five years ahead are on the other hand stable at just over 2 per cent according to the Prospera survey in December, which indicates that there is confidence in the ability of the Riksbank to keep inflation close to the inflation target in the long term.

The wage agreements that were reached recently in the manufacturing industry entail wage levels somewhat higher than the Riksbank expected in October, but the assessment is that these levels are nevertheless well in line with the inflation target of 2 per cent. Wage formation has now worked well for 15 years. It has been compatible with a low and stable rate of inflation and also with a relatively high rate of GDP growth and rising real wages. The agreements in the manufacturing industry indicate that wage formation will continue to work well. However, this of course depends on how normative the agreements now reached will be for the rest of the wage agreements on the labour market. However, the agreements in the manufacturing industry do not indicate that the long-term sustainable rate of unemployment has fallen compared to the years prior to the financial crisis.

Mr Öberg also said that various measures of resource utilisation do not give any indication that inflationary pressures will be high in the period ahead. Resource utilisation measured in terms of the GDP gap and the resource utilisation indicator (the RU indicator) was largely normal in the third quarter of 2011. However, with a weaker development of GDP in the fourth quarter of 2011 and in 2012, it appears that resource utilisation will be lower than normal again in 2012. Resource utilisation measured in terms of the hours worked gap and unemployment is already in the initial position lower than normal and is expected to remain so in 2012.

Give the current rate of inflation and level of resource utilisation, the Taylor rule would give a repo rate of 2.1 to 2.7 per cent. This also indicates a lower repo rate than in October. In addition, it indicates a somewhat lower repo rate in the period immediately ahead. Although the repo rate according to the Taylor rule should be somewhat higher than in the Riksbank's forecast, new information indicates that the repo rate should be cut. Mr Öberg's overall assessment was that the repo rate should be lowered by 0.25 percentage points.

Mr Öberg said that it was slightly more difficult to decide on the repo-rate path. As he said in a speech recently, the forecasting ability of the Riksbank is limited looking one year ahead and non-existent looking two to three years ahead. Nevertheless, he believed that it was reasonable to revise the repo-rate downwards approximately as proposed.

Credit expansion and asset prices do not appear to be causing any major problems at the moment. Lending to both households and companies is increasing by about 5 per cent per year. Lending rates are no longer at the extremely low levels they were at a couple of years ago, and the prices of houses and tenant-owner apartments have levelled off or are falling slightly.

Deputy Governor **Lars Nyberg** pointed out that there are now clear signs that growth is slowing down, and not just the expectations of households and purchasing managers declining and unease on the stock exchange increasing as was the case at the time of the monetary policy meeting in October. Exports are slowing down and new orders in the manufacturing industry are falling, although not dramatically. The situation is far from the situation that prevailed in Sweden in the autumn of 2008. At that time, the Swedish manufacturing industry had to face a sudden and dramatic halt on the export markets due to the financial crisis. Now the slowdown is more normal. However, companies are cautious about making new investments and the households are restricting their consumption. Although bank lending to companies and households is still increasing, it is doing so at a lower rate than previously. Mr Nyberg said that he shared the view expressed in the draft Monetary Policy Update that a significant slowdown can be expected in 2012.

It should also be said, as the situation in Europe is contagious, that Sweden has strong public finances, a competitive industrial sector and a stable and well-capitalised financial sector. Sweden is in a better position to cope with a slowdown than many other European countries – countries that lack all three of these preconditions. Nor is Sweden facing a period of credit tightening as the Swedish banks have good access to the international capital markets.

Against this background it appears reasonable to reduce the repo rate by a quarter of a per cent at today's meeting and to adjust the repo-rate curve so that it reflects the possibility that it may be necessary to cut the repo rate further at some time during the winter or spring. The fall-off in demand has also led to a fall in inflationary pressures, which makes it possible to cut the repo rate without taking the risk that inflation will exceed the target. And although the level of household debt is still increasing, household saving is increasing too. There is therefore no reasonable cause to worry about an excessive expansion of credit at present.

Mr Nyberg also said that it was unusually difficult to have a clear idea about what direction the repo rate will take after next summer. This depends on what happens in Europe. The Riksbank's main forecast is positive and predicts that the European crisis will eventually be resolved, even though a lot remains to be done before then. Crisis awareness must still increase in a number of countries and this must pave the way for measures that can increase international competitiveness in the long term. This will take time, as it will take time to pay off the debts. However, the market is not demanding success now; it simply wants to be convinced that success will definitely be achieved in the future. This has also proved to be difficult, but not impossible as can be seen if we look at developments in Ireland, Latvia and Iceland. It is not unreasonable to assume that this crisis, which to a great degree is a political crisis with severe economic consequences, may also be resolved relatively quickly.

But the process may also take time, quite simply because political processes take time. Sufficiently strong measures must be taken in a number of countries, not only in southern Europe but also in countries such as France and Belgium, to restore competitiveness. Significant changes have already been made in some countries. But Europe needs politicians who will do what Margaret Thatcher once did in the UK. And this of course is not a popular message.

Mr Nyberg therefore thought that uncertainty about the repo rate is greater than usual even in the relatively near future, that is during the course of next year. He agreed with Ms Ekholm that it is important that the Riksbank can produce a credible repo-rate path.

At the moment, however, it is more a question of political than economic forecasts, and this complicates every discussion of the form the repo-rate path should take. In Mr Nyberg's view, we must get a little closer to the end of the crisis before we will be able to calculate a repo-rate path that everyone can support.

Mr Nyberg concluded by saying that he will follow how the Executive Board handles this analysis next year with great interest.

Deputy Governor **Lars E.O. Svensson** then responded to Ms Wickman-Parak's comments on his contribution. He clarified that what he meant by the Riksbank "demonstrating the ability to take action" is that he sees no reason why the Executive Board should impose any restrictions on itself about not letting the repo-rate shift too much. Instead the Executive Board should on every occasion plot a repo-rate path that seems, according to the analysis, to best stabilise inflation and resource utilisation, irrespective of whether this entails a large or small shift in the repo-rate path.

Mr Svensson then referred to Ms Wickman-Parak's comment that she did not think Mr Svensson should accept the technical difficulties that it so far entails to study the consequences of repo-rate paths that lie far from the main scenario and, if he had understood her correctly, plot an entirely judgment-based lower repo-rate path without the help of technical analysis. Mr Svensson was, however, not prepared to entirely abandon the technical analysis at this point. He thought instead that it is a problem that should be solved that there are such limited resources for a more detailed analysis of monetary policy alternatives and that the decision-making process is so short that there is hardly time for a serious discussion of monetary policy alternatives.

Mr Svensson then referred to the comments of Ms Ekholm and others that one has less information on forecasts at longer horizons and that this means that forecasts at long horizons approach the unconditional mean and cannot be affected by current information. According to Mr Svensson, this means that one must look at the entire forecast path in order to distinguish different monetary policy alternatives. It becomes important to examine how the forecasts look within the time frame of one and two years, given that there is less information on the situation in three years' time. This also constitutes an argument for changing the repo rate and the repo-rate path more at the beginning of the path so that there is time to affect the forecasts at horizons of one and two years. This argument also gains strength if one believes that the economy reacts more slowly or more weakly to repo-rate changes than is the case in Ramses.

In Figure 2, the blue curve shows the yield curve for Swedish government bonds. This can be seen as representing the actual financial conditions. The red curve shows the financial conditions that would prevail if the repo-rate path were to acquire full credibility and forward premiums were to follow the rule of thumb. There is a big difference at the long end. At a maturity of 5 years the market rate is almost 200 basis points lower than the rate that is compatible with the repo-rate path. As things are now, it appears that the long rates in Sweden are going their own way, independent of the repo-rate path. Which is fortunate, added Mr Svensson, as this means that the actual financial conditions are much more expansionary than the financial conditions compatible with the repo rate and he believed this was good for the Swedish economy. It seems that long interest rates in Sweden are affected more by foreign rates than by the repo-rate path. It can be seen in Figure 2 that long Swedish interest rates are at approximately the same low level as long TCW rates. Swedish long rates cannot deviate too much from long rates abroad without this having major effects on the exchange rate. The short end of the yield curve is, however, affected by the repo rate. Right now, a too high repo rate is lifting up the short end of the yield curve. It would therefore be good to lower the repo rate and the short end of the repo rate path significantly in order to bring down the short end of the yield curve and thus create even more expansionary financial conditions.

Mr Svensson also referred to the fact that several members of the Executive Board had pointed out the high level of uncertainty and spoken of a "wait-and-see" situation, implying that monetary policy should not be changed very much until uncertainty recedes and the situation becomes clearer. The conclusion seems to be that monetary policy should be more cautious when uncertainty is high. This conclusion may seem intuitive, but it is not supported by research and practical experience. To explain why, one can think of a situation in which uncertainty increases at the same time as the mean forecast for inflation and resource utilisation is unchanged, an example of a so-called mean-preserving spread. How should monetary policy be conducted in such a situation? In a classic article published in 1967, William Brainard shows that if the uncertainty relates to the effect of the interest rate on aggregated demand then monetary policy should be conducted more cautiously. Another important article published by Ulf Söderström in 2002 shows that if the uncertainty instead relates to the persistency of inflation then monetary policy should be conducted more aggressively. Moreover, a closer study of Brainard's article shows that also in the cases he presents monetary policy should become more cautious or more aggressive depending on the precise nature and correlation of the uncertainty about different aspects of the transmission mechanism. In order to know whether monetary policy should be conducted more cautiously or more aggressively in the event of greater uncertainty, we thus need very precise information about the form of this uncertainty. Normally, such detailed information is not available. It is therefore best not to deviate from the usual unbiased forecast targeting where the expected-value forecasts for the target variables determine the appropriate repo-rate path. Deviating from this usual forecast targeting in the absence of sufficient information entails simply introducing random errors into monetary policy. If this happens, monetary policy will actually increase uncertainty. To prevent monetary policy from adding to uncertainty, it should be conducted in accordance with the usual, clear principles even when uncertainty increases. The idea of a "wait-and-see" approach and a more cautious policy in times of increased uncertainty are not supported by research, nor by practical experience.

Deputy Governor **Karolina Ekholm** commented that what has been said about how the forecast for Sweden has been revised this time perhaps gives a somewhat confusing impression, as some have claimed that the revisions are small while others have said that the revisions are large. The revisions presented in the draft Monetary Policy Update are fairly small, but it is important to clarify that these revisions assume a monetary policy response in terms of a repo-rate cut and a lower repo-rate path. Without such a response, the revisions would be significantly larger. It would be good if information on how the forecast for the Swedish economy has been revised given an unchanged monetary policy was regularly presented during the drafting process. This would make it clear how large the revisions concerned are. She referred to the fact that Mr Svensson's Figure 3 should provide this information, but said that the staff perhaps thinks there are better ways of performing this analysis.

Ms Ekholm also had a comment with regard to the discussion on the significance of increased uncertainty. She noted that Norges Bank justified its decision to cut its policy rate by 50 basis points at its most recent monetary policy meeting with reference to increased uncertainty. The Bank argues that in the event of greater uncertainty there may be reason to make a substantial cut to avoid a very poor outcome for the economy. Thus, there are evidently different ways of viewing the implications of increased uncertainty at the different central banks.

Deputy Governor **Barbro Wickman-Parak** referred to Mr Svensson's most recent contribution and said that she could not see a need for the same forceful intervention now as the Executive Board showed in 2008 and 2009. Further, she said that she did not, as Mr Svensson implied in his contribution, put any restrictions on how much the repo-rate path may shift. She now felt she was on firmer ground with regard to the assessment of the near future and therefore advocated a repo-rate cut. She considered the lower repo-rate path that she preferred was reasonable given the economic outlook that she supported. To her, the repo-rate path represented well-balanced monetary policy. But, as always, this applies given the information that is currently available. If developments were to deteriorate, there are no restrictions on cutting the repo rate and the repo-rate path further.

First Deputy Governor **Svante Öberg** said that he agrees with Ms Ekholm that the revisions to the forecasts for next year are in principle due to both new information on economic developments and new decisions on the repo rate. One problem with regard to estimating the latter effect is that Ramses is estimated during a period with a one-to-one relationship between the repo-rate path and the yield curve. There are problems when the model is used to estimate the effect in a future where there is no such one-to-one relationship. This means that the estimate probably exaggerates the effect of the change in the repo rate. If the decision on the repo-rate path affects the yield curve only slightly or not at all, monetary policy will have little or no effect, as it is the actual yield curve that is important to economic developments. Ramses therefore needs to be developed, if it is to make this type of calculation, to manage situations where our repo-rate path does not agree with the market's forward rate curve.

Deputy Governor **Lars E.O. Svensson** pointed out that the Executive Board discussed what is known as interest-rate smoothing in 2008-2009. The Executive Board then seemed to find that there was no value in interest-rate smoothing for its own sake. With regard to the comparison with how the Riksbank acted during the winter to early spring of 2008-2009, he felt it is interesting that the Executive Board at that time completely disregarded interest-rate smoothing and consistently tried to set the interest rate and plot the repo-rate path in the way that would best stabilise inflation and the real economy. He commented at the time that the Riksbank had abandoned interest-rate smoothing and asked whether interest-rate smoothing and a preference for small steps in setting the repo rate would return under more normal conditions.[1] This discussion is being continued now. Mr Svensson's opinion is that there was no reason to apply interest-rate smoothing then and there is no reason to do so now.

With regard to Ms Wickman-Parak's claim that the monetary policy in the main scenario is well balanced, this is contradicted by Figure 4. Here, the main scenario's forecasts for the repo-rate path, CPIF inflation and unemployment summarise all of the relevant information currently available and all of the relevant current assessments on the present situation and the forecasts. Given this information and these assessments, it is at the same time obvious that a lower repo-rate path would give a higher forecast for CPIF inflation and would thus better stabilise both CPIF inflation around the inflation target and unemployment around a sustainable rate. For this conclusion it is enough which direction the effect of the repo rate takes on inflation and unemployment. It does not matter whether the effects are slightly less or slightly greater or whether they come a little sooner or later. We do not need a model or any model experiments to reach this conclusion, merely the fact that a lower repo rate increases inflation and reduces unemployment. As target fulfilment can be increased for both CPIF inflation and unemployment with a different repo-rate path, there is no trade-off in the main scenario. Pure logic dictates that monetary policy is not balanced in the main scenario, if CPIF inflation and unemployment are the only target variables and the interest rate is not regarded as a separate target variable.

The Chairman, Governor **Stefan Ingves**, summarised the discussion and noted that all of the members of the Executive Board supported the conclusion that the Swedish economy is now slowing down more sharply than anticipated. He noted further that there were

[1] Minutes of the Executive Board's monetary policy meeting on 3 December 2008.

some minor differences of opinion with regard to inflation, which according to the forecast will approach the target two years ahead when the state of the Swedish economy normalises. However, there is disagreement on the forecasts for interest rates and the degree of uncertainty over developments abroad. The members reach different conclusions regarding what can be considered the appropriate monetary policy for Sweden in the current situation. Two members advocate cutting the repo rate by 50 basis points and having a lower repo-rate path than the one in the Monetary Policy Update. The majority support the proposed repo-rate path and the proposal to cut the repo rate by 0.25 percentage points, to 1.75 per cent.

§4. Monetary policy decision

The Executive Board decided after voting

- to adopt the Monetary Policy Update according to the proposal, Annex A to the minutes,
- to publish the Monetary Policy Update on Tuesday, 20 December 2011 at 9.30 a.m.,
- to cut the repo rate by 0.25 percentage points to 1.75 per cent and that this decision would apply from 21 December 2011,
- to publish the decision above at 9.30 a.m. on Tuesday 20 December 2011 with the motivation and wording contained in a press release, and
- to publish the minutes of today's meeting on Monday, 3 January 2012 at 9.30 a.m.

Deputy Governors Karolina Ekholm and Lars E.O. Svensson entered a reservation against the decision to cut the repo rate to 1.75 and against the repo-rate path in the Monetary Policy Update.

They preferred instead to lower the repo rate to 1.5 per cent. They also preferred a lower repo-rate path that stays at 1.25 per cent from the second quarter of 2012 through the third quarter of 2013, and then rises to just below 3 per cent at the end of the forecast period. This is justified by their assessment that the Monetary Policy Update's forecasts of foreign policy rates and Swedish resource utilisation are both too high. Their 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:

Stefan Ingves Karolina Ekholm Lars Nyberg

Lars E.O. Svensson Barbro Wickman-Parak Svante Öberg