Minutes of the Executive Board's monetary policy meeting

SEPTEMBER 2012

Summary

The Executive Board of the Riksbank decided at its monetary policy meeting on 5 September to cut the repo rate by 0.25 percentage points, to 1.25 per cent, and to adjust the repo-rate path downwards.

The Executive Board has long been in agreement that inflationary pressures are low and that the repo rate needs to be low to boost economic activity and for inflation to attain the target of 2 per cent. This is why the repo rate and the repo-rate path have been lowered over the last 12 months. However, there have been differences in the view of how expansionary monetary policy should be.

At the meeting on 5 September the assessment was that cost pressures will now be lower and lead to lower inflation than in the assessment in July. The Executive Board was unanimous that the repo rate thus needs to be cut further to counteract the low inflation and support economic activity. However, this time too there are differences in opinion with regard to how expansionary monetary policy should be.

Five Board members considered it appropriate to cut the repo rate by 0.25 percentage points, to 1.25 per cent. One member wanted to cut the repo rate by 0.5 percentage points. All of the members considered it appropriate to adjust the repo-rate path downward. A majority, four of the members, considered a small downward adjustment to be appropriate. They considered that CPIF inflation would thus reach 2 per cent within 2 years and resource utilisation would normalise. However, two members considered that there was scope for an even lower repo-rate path and assessed that this would lead to an inflation rate closer to 2 per cent and unemployment closer to a long-run sustainable level.

One issue facing the members of the Executive Board was, as in July, how to balance the weak and above all uncertain development of the euro area against the relatively strong development of the Swedish economy. All of the members believed that the situation in the euro area is still uncertain and that the downturn there will be prolonged.

The members agreed that the growth of Swedish GDP is now slowing down following strong growth so far this year and that the strong outcome is not expected to be inflationary. There was also agreement that actual unemployment is currently higher than the long-run sustainable unemployment rate, although there were different assessments of what this rate is. There were also different assessments of what monetary policy can achieve at present with regard to developments in unemployment.

Several members touched on recent developments of the krona and noted that the appreciation that was forecast earlier had come sooner than expected. Some members also discussed households' high debt ratios and the vulnerability this can create for the economy, something that these members thought would continue to require considerable attention.

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DATE: 5 September 2012

TIME: 9:00

PRESENT: Stefan Ingves, Chairman
Karolina Ekholm
Per Jansson
Kerstin af Jochnick
Barbro Wickman-Parak
Lars E.O. Svensson

Johan Gernandt, Chairman of the General Council
Sven-Erik Österberg, Vice Chairman of the General Council

Sigvard Ahlzén
Björn Andersson
Meredith Beechey Österholm
Claes Berg
Hans Dillén
Charlotta Edler
Eric Frieberg
Johannes Forss Sandahl (§1)
Kerstin Hallsten
Mia Holmfeldt (§1)
Ann-Christine Högberg
Jesper Johansson
Anna Lidberg (§1)
Pernilla Meyersson
Marianne Nessén
Christina Nyman
Mattias Persson (§1)
Lena Strömberg
Ulf Söderström
David Vestin
Staffan Viotti
Anders Vredin

It was noted that Björn Andersson and Hans Dillén would prepare draft minutes of § 1, 2 and 3 of the Executive Board's monetary policy meeting.

§1. Economic developments

Johan Forss Sandahl of the Financial Stability Department began by presenting recent developments regarding the banking sector and the public finances situation in the euro area countries.

Anna Lidberg of the Monetary Policy Department presented recent developments on the financial markets. Since the monetary policy meeting at the beginning of July, the krona has appreciated in trade-weighted terms – at its peak the appreciation has been around 5 per cent. Over the past week the krona has depreciated somewhat in line with the publication of weaker indicators for the Swedish macro economy. The krona is currently around 3 per cent stronger than it was at the beginning of July. According to market pricing, expectations of a repo rate cut at today's meeting have increased over the past week, to almost 50 per cent. According to the Prospera survey, monetary policy expectations are roughly in line with the proposed repo-rate path in the draft Monetary Policy Update. Monetary policy expectations abroad reflect the weaker economic prospects, particularly in Europe, and the belief that increases in policy rates will begin later than previously anticipated.

Christina Nyman, Deputy 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 draft report were discussed by the Executive Board at meetings held on 21, 28, 29 and 31 August.

As at the previous monetary policy meeting, the situation in the euro area is still fragile, and indicators point to economic activity remaining weak and GDP falling this year. Growth in the world economy as a whole looks to be reasonable in the coming period. The Swedish krona has appreciated unexpectedly rapidly since the beginning of July. The krona exchange rate has weakened over the past few days, but is in line with the forecast in the draft Monetary Policy Update. The Swedish GDP outcome for the second quarter was much stronger than expected. However, indicators, particularly for the manufacturing industry, point to a slowdown in the third quarter. Despite the Swedish economy showing good resilience to the weakening in economic activity in the euro area so far, Swedish GDP growth is now expected to slow down and the labour market to deteriorate somewhat. Productivity has been surprisingly strong, which together with the rapid strengthening of the krona, means that inflationary pressures are now expected to be lower than was forecast in July. A weak development of the economy in the coming year and lower inflationary pressures justify a lower repo-rate path.

§2. Discussion of economic developments

Deputy Governor **Lars E.O. Svensson** began by noting that the situation in the euro area, the United Kingdom and the United States is still relatively gloomy. The negative effects on growth of the fiscal policy tightening in the euro area have been greater than was first anticipated. Mr Svensson said that the possibilities for resolving the euro crisis in a satisfactory manner still seemed remote. His own forecast for activity abroad and Swedish exports is more pessimistic than that in the draft Monetary Policy Update. This also applies if one does not include scenarios with a catastrophic outcome in the forecast.

Mr Svensson said that the risk of catastrophic outcomes was, however, a separate argument in itself for even more expansionary monetary policy in this initial situation of imbalance. What he means by imbalance here is that inflation is too low and unemployment is too high. A particularly expansionary monetary policy would bring the economy back in balance more quickly, with inflation close to the target and unemployment close to a long-run sustainable level. If the economy is in balance, it has greater resilience to shocks than in its current, weaker state.

As at earlier meetings, Mr Svensson was also of the opinion that the forecast for policy rates abroad in the draft Monetary Policy Update is too high (see Figure 1). The yellow curve shows the forecast for policy rates abroad extended five years ahead. The broken upward bend on the curve shows the technical assumption used in the Ramses model regarding how the interest rate develops beyond the forecast horizon. The grey curve shows forward rates – with a broken line beyond the three-year horizon to mark that the estimate is more uncertain there. Further ahead the forecast (the yellow curve) is much higher than the forward rates (the grey curve), particularly when the technical assumption is added. This contributes, all else equal, to a higher repo-rate path. As Mr Svensson has emphasised at earlier monetary policy meetings, he sees no good reason for this.

Furthermore, Mr Svensson claimed that the repo-rate path in the main scenario is not perceived as credible by market participants (compare the red and the blue curve in Figure 1). Swedish forward rates (the blue curve) are much lower than the repo-rate path (the red curve). The large difference cannot be explained by risk premiums, according to Mr Svensson. The low forward rates mean that the actual financial conditions are much more expansionary than the Riksbank's repo-rate path indicates. Mr Svensson considered this to be good, as the economy requires more stimulus in this situation. He added that Sweden's experiences of publishing a repo-rate path and the varying credibility of this path are discussed at length in a paper by Michael Woodford presented at this year's Jackson Hole meeting.[1]

[1] Woodford, Michael (2012), Methods of Policy Accommodation at the Interest-Rate Lower Bound. Available at http://www.kansascityfed.org/publicat/sympos/2012/mw.pdf?sm=jh083112-4

Mr Svensson went on to discuss the yield curves (see Figure 2). The blue curve shows the yield curve for Swedish government securities with maturities up to 5 years. The grey curve shows the yield curve for TCW-weighted foreign government securities. The distance between the blue and the grey curves shows the interest rate differential between Sweden and foreign government bond yields for different maturities. A comparison shows that the shortest Swedish rate is 1.5 per cent, while the shortest foreign rate is around 0.25 per cent. The difference is thus around 1.25 percentage points. For longer maturities the interest rate differential is slightly smaller, but it is still large, around 0.75 percentage points a couple of years ahead.

Mr Svensson stated that the interest differential makes it attractive for foreign investors to invest in kronor, what is known as carry trade, where one borrows in foreign currency and invests in Swedish currency and makes money on the interest rate difference. This leads to a capital inflow and a tendency for the krona to appreciate. If the krona appreciates, one earns even more. The large interest rate differential compared with other countries means it is natural for the krona to follow a stronger path. Mr Svensson noted that this is exactly what has happened recently. The krona should gradually strengthen so much that it is expected to depreciate at a pace roughly equivalent to the interest rate differential. A stronger krona reduces inflation and hampers exports. It is not surprising that this has happened, according to Mr Svensson. What is surprising is that it has not happened earlier, as the Swedish repo rate has been much higher than policy rates abroad since autumn 2010. It is the usual exchange rate channel in the transmission mechanism that is now in action.

Mr Svensson also took up what would happen if the repo-rate path were to become credible, that is, if market expectations shifted upwards and came in line with the repo-rate path. Then the actual yield curve (the blue curve) would shift upwards to the repo-rate path (the red curve). This means that a five-year Swedish government bond yield would increase by around 1.8 percentage points. Mr Svensson said that this would be a very large negative shock to the Swedish economy. He claimed that this hypothetical case could also be said to illustrate how unrealistic the Riksbank's high repo-rate path is.

Mr Svensson then went on to say that the starting point for the Swedish economy in general is not good, with low inflation below the target and high unemployment far above a reasonable estimate of long-run sustainable unemployment. Inflation is around 1 percentage point below the target. Unemployment is around 7.5 per cent. With a long-run sustainable unemployment rate of 5.5 per cent, the unemployment gap is thus 2 percentage points. With a labour force that currently stands at about 5 million, this corresponds to about 100,000 unemployed people.

Mr Svensson said that one might ask why he assumes a long-run sustainable rate of unemployment of 5.5 per cent. He referred to an appendix to the minutes of the monetary policy meeting in July, where he put forward reasons why the Riksbank's new estimate of the interval for the long-run sustainable unemployment has a midpoint, 6.25 per cent, which is 0.75 percentage points too high. According to Mr Svensson, the reason is that average inflation has been below the target, while average inflation expectations have been anchored on the target during the past 15 years.

Mr Svensson commented that the situation ahead rather looked worse than in the draft Monetary Policy Update and referred to the National Institute of Economic Research's most recent version of their report on the Swedish economy (August 2012). Although the NIER assumes a much lower repo-rate path than that in the Monetary Policy Update, its forecast for the CPIF is much lower than the inflation target in the coming years and it forecasts that unemployment will rise to 8 per cent towards the end of 2013.

Mr Svensson then said that there has recently been much discussion of how much too high average unemployment has been during the past 15 years as a result of CPI inflation being a good 0.6 percentage points below the target during the same period. According to Mr Svensson's preliminary estimates, which are described in a paper, average unemployment has been around 0.8 percentage points too high.[2] The average number of people in the labour force over the past 15 years has been around 4.7 million. 0.8 per cent of 4.7 million is around 38,000. This is undeniably a large figure, said Mr Svensson, but he also pointed out that these are preliminary and approximate estimates, which he is doing further work on and may revise somewhat further ahead.

Mr Svensson emphasised the importance of realising that the consequences of the too low inflation, namely the unnecessarily high unemployment, are the same regardless of the reasons why inflation has been too low. The possible reasons for the deviation from the target mentioned, for instance, in the IMF's Article IV report, include that the Riksbank may in practice have had an asymmetrical target and for instance regarded the inflation target as a ceiling rather than a midpoint and/or that the Riksbank may have systematically overestimated inflationary pressures.[3] Mr Svensson felt that the latter could be because the Riksbank has overestimated the long-run sustainable unemployment rate (a kind of reverse Orphanides argument), that the Riksbank may have missed a negative trend in mortgage rates, that the Riksbank has underestimated productivity growth, or that the Riksbank has overestimated imported inflation.[4] But, regardless of the reasons, the fact still remains that if average inflation has undershot the target, then average

[2] Svensson, Lars E.O. (2012), The Possible Unemployment Cost of Average Inflation below a Credible Target. *Working paper*, available at www.larseosvensson.net.

[3] IMF (2012), Sweden: Selected Issues, section III.D, Country Report No. 12/155. Available at www.imf.org.

[4] Athanasios Orphanides claimed in an article that inflation in the 1970s was too high in the United States because the Federal Reserve underestimated the long-run sustainable unemployment rate. See Orphanides, Athanasios (2003), The quest for prosperity without inflation. *Journal of Monetary Economics* 50, pp. 633-663.

unemployment has been higher, compared with if the average inflation rate with a more expansionary monetary policy had attained the target.

Deputy Governor **Barbro Wickman-Parak** began by noting that it is interesting and important to discuss target fulfilment, but that the important thing here and now is today’s repo-rate decision.

With regard to the international outlook, Ms Wickman-Parak said there was not much to say as no major change had taken place since July. The US economy is developing in line with the Riksbank’s earlier forecast. However, she felt that there was considerable uncertainty linked to the risk of large fiscal tightening automatically being triggered at the turn of the year unless agreement was reached regarding the budget policy. Ms Wickman-Parak commented that this could become a major theme during the autumn. The emerging economies are still growing at a good pace, although the pace has slowed down, as expected. Nor have there been any decisive changes in Europe. The uncertainty over the results of various on-going political processes still remains, and there has been no reason to change the forecasts since July.

Ms Wickman-Parak felt that it might be worth mentioning the recent weak statistics from Germany, which could have a particular bearing on the Swedish economy. Sweden’s largest trading partner has so far managed relatively well, but recent indicators point to the country risking a more pronounced slowdown.

Once again, the figure for Swedish GDP was higher than expected, this time for the second quarter of the year. Ms Wickman-Parak noted that the Executive Board appears to be facing the same considerations as in July; strong developments in Sweden balanced against weak developments in Europe. But, she said, it is not so simple when one analyses the GDP figure more closely and adds to this the indicators received since July. It is worth noting that the preliminary growth figure for the second quarter is a flash estimate that is based on more incomplete data than usual. But as usual one has to use these preliminary figures as a base and try to examine the different components more closely to see what guidance they can give with regard to coming quarters.

Ms Wickman-Parak said that what one can then see is that there has been a build-up of inventories that is greater than expected. There is every reason to believe that this will not continue over the coming quarters, which is also reflected in the forecast in the Monetary Policy Update; the inventories provide a negative contribution to growth in the second half of the year. The second component that was higher than expected was exports, but here the indicators unanimously point towards a weak development ahead. With regard to confidence indicators in general, it is significant that it is in the manufacturing industry, which is more export-dependent, that confidence has declined compared to other industries. The only outcome for the third quarter that has been published is foreign trade for August, which shows that exports of goods have fallen somewhat. Ms Wickman-

Parak considered that the weaker indicators for Germany also played a role for the weaker export prospects in the coming period. Of course, the stronger krona also plays a role in this context.

The labour market has largely developed in line with the forecasts in July. Now, as before, the Riksbank is expecting some increase in unemployment in the coming quarters. The inflation figures have so far been in line with the forecast in July. The stronger krona, but also the lower increase in unit labour costs, contributes to the forecast for inflation being adjusted down in relation to the July forecast. Ms Wickman-Parak intended to return to this when monetary policy was discussed. With regard to the Monetary Policy Update as a whole, she supported it and the forecasts presented in it.

Deputy Governor **Karolina Ekholm** began by noting that she, like Ms Wickman-Parak, does not consider the prospects for the international economy to have changed significantly since the meeting in July. The situation abroad still looks problematic. The euro area is still struggling with both acute problems regarding funding budget deficits at reasonable interest rates and dealing with banks that are not viable, as well as more structural problems with competitiveness and generally weak public finances. Despite a number of initiatives during the summer, there has still been no clear message from politicians as to how they intend to resolve these problems, but nor was this really expected, said Ms Ekholm. This is in line with the outlook at the previous meeting.

In the United States the recovery remains sluggish, although there are some positive signs with regard to the housing market. Growth in several large emerging economies, such as China, India and Brazil, is slowing down, although it is still at a reasonable level, and even at an enviably high level in some countries.

With regard to domestic developments, the strong GDP figure for the second quarter came as a surprise, of course, and Ms Ekholm felt that this figure was not so easy to relate to. The starting point for the forecast in the draft Monetary Policy Update is that the Swedish economy is also slowing down and that the high growth in the second quarter does not entail higher resource utilisation than the Riksbank was expecting, and thus it does not mean higher inflationary pressures. These assumptions appear reasonable and Ms Ekholm supported them.

Another factor that affects inflationary pressures is the development of the krona. Here there has been an unexpectedly rapid appreciation since July. As the Riksbank earlier expected that the krona would strengthen in the long run, it is reasonable to assume that the appreciation is not merely transitory, but that the krona will remain at roughly this level during the forecast period. Ms Ekholm pointed out that this of course does not prevent the krona from fluctuating both upwards and downwards in the coming period, as the exchange rate normally shows a high degree of variability. However, the rapid krona appreciation contributes to holding back inflationary pressures.

With these assumptions regarding what have been crucial issues on this occasion, the forecast projects that inflationary pressures will remain low and the labour market will remain relatively weak. Ms Ekholm said that she supports this forecast with regard to its starting points, although she has some objections to the repo-rate path on which the forecast is based.

The forecast for policy rates abroad is important to the repo-rate path, as the Executive Board has discussed at a number of monetary policy meetings and as Mr Svensson has also mentioned. As shown in his figure (see Figure 1), the Riksbank's forecast is close to market expectations measured as implied forward rates for most of the forecast period, but then, as noted at the previous meetings, diverges towards the end of the forecast period by being much higher. As before, Ms Ekholm was sceptical about this deviation, but she did not consider that this in itself justified entering a reservation with regard to the forecast as a whole. Ms Ekholm felt, however, that this has some significance for her stance with regard to what she considers a suitable repo-rate path, which she will return to later.

First Deputy Governor **Kerstin af Jochnick** noted that she largely agrees with the assessment of economic developments abroad and in Sweden as described in the draft Monetary Policy Update. Over the past month it has become increasingly clear that developments in Europe, and in particular the euro area, have considerable significance for global developments and growth in Sweden. Although growth in Sweden was unexpectedly strong during the first half of the year, Ms af Jochnick believed that developments would now be poorer for a period of time. Many of the indicators the Riksbank follows are currently mostly moving sideways. Apart from a prolonged unease over continuing weak growth in the euro area, it is clear that developments in Europe will have a negative effect on growth in the rest of the world.

With regard to developments in the euro area, Ms af Jochnick said that a lot is at stake during the autumn. In general, there is still uncertainty over how to rectify the high public debt, the problems in the banking sector and the weak competitiveness. A number of concrete issues are waiting to be resolved. Examples of these are the public finance problems in Spain and the size of the capital injections to the Spanish banks, the design of the European banking supervision that is required for loans to be paid directly to the Spanish banks, and Greece's ability to implement its adjustment programme. Ms af Jochnick felt that all of these questions would be resolved, but it remains to be seen how and when. Confidence in the euro area must be built up again step by step. It is also necessary to anchor in a democratic manner the implementation of far-reaching proposals. At present it is difficult to see when the euro zone has stabilised and when the surrounding world can breathe easily again.

Developments in the Swedish economy will be weak for the remainder of 2012. The uncertainty abroad means that households and companies will continue to be cautious with regard to consumption and investment. Cost pressures are subdued as a result of unexpectedly high productivity growth in Sweden and the relatively strong krona. So the low inflation will remain for a while.

However, Ms af Jochnick said it is difficult to know how the krona will develop. There are probably several different explanations for the krona appreciation over the summer. The real economy in Sweden has proved stronger than those in many other countries. Another factor is the strong public finances, which have contributed to Sweden being regarded as something of a safe haven for international investors. However, this does not rule out the possibility that the krona may be weaker or stronger than forecast in the Monetary Policy Update. But the development of the krona is just one of several factors that affect inflation and resource utilisation and thereby the direction for monetary policy in Sweden.

Ms af Jochnick also wanted to briefly comment on Mr Svensson's contribution to the discussion on the forecast for policy rates abroad and the discussion at Jackson Hole. She noted that the experiences of using forward rates as a forecast of policy rates abroad are not clear-cut. Ms af Jochnick said that implied forward rates are, for various reasons, depressed in many countries at the same time as they have proved to be fairly volatile. She noted that the Executive Board has discussed on repeated occasions the Riksbank's method for forecasting policy rates abroad and has assessed that the current method works satisfactorily.

Deputy Governor **Per Jansson** began by noting that the picture of economic developments in Sweden and abroad presented in the July Monetary Policy Report still applies to a great extent. This means that the revisions to the forecasts in this Monetary Policy Update are in general fairly small and that the fundamental direction for monetary policy remains the same.

The two slightly larger forecast revisions made in this Monetary Policy Update concern Swedish growth and the Swedish krona exchange rate. These variables are also the ones that have played the largest role in Mr Jansson's stance on this occasion, and he said that he would therefore focus on them in his contribution to the discussion. Mr Jansson did not intend to comment especially on international developments, but he noted that this does not mean they are less important than before. What is happening at an international level will continue to determine the basic direction for the economy.

Mr Jansson's intention was to begin his contribution by attempting to answer the question of whether it is appropriate to hold onto the repo-rate path that formed the base for the forecast in July. Mr Jansson said that he would hopefully be able to make it clear that this is not appropriate, but conclude instead that there is justification for a slightly more expansionary monetary policy now than in July. He intended to return in greater detail to explain how he considers monetary policy should be made more expansionary in the monetary policy discussion.

Mr Jansson said that it is not easy to find a country in the western world that experienced faster growth than Sweden during the second quarter of 2012; he himself had at least not succeeded in doing so. The seasonally-adjusted increase from the first quarter was a good 1.4 per cent, according to Statistics Sweden. The Riksbank's forecast assumed a growth rate of 0.2 per cent, and other forecasters had on average roughly the same forecast as the Riksbank. Naturally, the very high growth in the second quarter makes it necessary to revise the growth forecast for the whole of 2012 substantially, from 0.6 per cent to 1.5 per cent.

Mr Jansson noted that the circumstance that Sweden's growth in 2012 will probably be faster than was anticipated is of course essentially pleasing and in line with the assessment that Sweden's resilience is surprisingly good. But he felt that behind the good annual figure there was a growth path that was not as favourable and actually more dramatic than in the earlier forecasts. The main cause of the unexpectedly high growth during the second quarter was that exports and investments in inventories developed better than expected. But as a result of the weak developments on several of Sweden's most important export markets, many factors, if not all, suggest that both of these components will provide a much smaller contribution to GDP during the third quarter. This is underlined by the outcome for the purchasing managers' index in August, for instance, which showed the third largest fall since 1994. The Riksbank now assesses that growth during the third quarter will amount to -0.2 per cent, compared with 0.2 per cent in the earlier forecast. After the third quarter the growth path will be roughly the same as in July.

Mr Jansson said that the weak growth path during the rest of 2012 makes it very unlikely that the surprise growth during the second quarter will have any consequences for inflation. This assessment is also supported by the high growth going hand in hand with an unexpectedly strong increase in productivity. The latter means at the same time that the effects on resource utilisation will probably also be limited.

Mr Jansson then went on to discuss the other variable that has shown a surprising result since July, namely the krona exchange rate. Although the krona has weakened somewhat during the past few days, developments since the Monetary Policy Report was published in July have been much stronger than expected. The earlier forecast for the krona included an overall appreciation of the size that has now taken place during the summer. The faster appreciation is probably due to a combination of positive economic surprises in Sweden, and negative surprises abroad, particularly in the euro area.

For his part, Mr Jansson thought that the fluctuations in the krona exchange rate were related to a much greater degree to different exchange rate premiums than to actual or expected interest rate differentials. To the extent that the euro has been affected by premiums relating to the crisis in the euro area, there should be scope for the krona to weaken against the euro again, as progress is made in the management of the European crisis. But, on average against several currencies, it is reasonable to assume that the krona is now close to its long-run level.

Mr Jansson's conclusion from the staff's different analyses is that if the interest rate and the interest-rate path are now held unchanged compared with July, then CPIF inflation will be far below the inflation target throughout the forecast period. This would be a completely different inflation forecast than the one in July, and Mr Jansson felt that this almost makes it obvious that monetary policy now needs to be adjusted in a more expansionary direction.

He wondered whether there was not a risk that monetary policy might soon need to be tightened again, for instance, if the krona were to weaken in the near future. Mr Jansson thought that while it was of course impossible to rule out this possibility, the current inflation prospects suggest that a lot needs to happen before this situation arises. Inflation is low to begin with, and it will take some time before it is in line with the target. He noted that another important factor in this context was that the risk of other types of imbalance, such as an overly rapid development of the real economy or problems relating to the housing market, was currently small. Mr Jansson said that he would return in greater detail to explain how he considers monetary policy should be more expansionary in the monetary policy discussion.

As Mr Svensson had taken up the question of the Riksbank's fulfilment of the inflation target, Mr Jansson wished to conclude with a few comments on the current debate. Mr Jansson said that, unfortunately, some factual errors seemed to have taken root in the general debate, a debate that is often marked by oversimplification and lacks nuance. This is the case despite several representatives of the Riksbank having discussed these issues in various contexts. As examples, Mr Jansson mentioned a debate article in the newspaper Dagens Nyheter in May 2011, which he wrote himself and he also pointed out that he has discussed these questions regularly at the monetary policy meetings over the year.[5]

Therefore, he thought it was good that the Riksbank will now publish an Economic Commentary which, in a commendable way, explains the facts regarding, among other things, how well the Riksbank has succeeded in attaining the inflation target since its

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[5] Jansson, Per (2011), Riksbanken har ingen hemlig agenda. (The Riksbank does not have a secret agenda) DN debate 9 May 2011. Available (in Swedish) at http://www.dn.se/debatt/riksbanken-har-ingen-hemlig-agenda.

introduction.[6] It is also good that the commentary will clarify that it is not the case that the Riksbank has been particularly unsuccessful in attaining the inflation target compared with other countries. Mr Jansson hoped that this Economic Commentary will be widely read.

Governor **Stefan Ingves** said that he shares the view of international developments and the Swedish economy presented in the draft Monetary Policy Update. There have not been any major changes in the international outlook since the previous meeting and there is still considerable uncertainty over developments in the euro area. There are major differences between countries in Europe: a deep recession in southern Europe, better resilience in Germany and good growth in Norway.

Adjustment processes are under way in the crisis countries. In some countries, such as Ireland and Spain, for instance, the current account has improved. There has also been some progress in the consolidation of public finances in some countries, and competitiveness has improved, but these things take time. High interest rates show that several crisis countries have not succeeded in restoring lenders' confidence. This makes the monetary policy stance in the EMU more difficult.

It is therefore important to establish long-run sustainable solutions for financial systems, public finances and competitiveness in the crisis countries. The uncertainty is expected to remain until credible measures are implemented. This is the assumption in the main scenario. If this does not happen, there is a risk of a very unfavourable scenario, with negative effects for the Swedish economy.

The US economy has developed in line with the previous forecast and the recovery is continuing, albeit sluggishly. The situation on the housing market has improved and thereby the conditions for increased domestic demand. However, the uncertainty over future fiscal policy will persist for some time. There are some signs of a slowdown in the emerging economies, which in several cases is met by more stimulating economic policy. All in all, the world economy is expected to grow by around 4 per cent a year, which will benefit Sweden substantially, given the structural problems faced by several European countries.

At the same time as developments abroad have been roughly in line with the forecasts made in July, GDP growth in Sweden has been stronger than the Riksbank was expecting. This leads to a higher level of GDP, but does not significantly change growth prospects for the coming period. This view is also supported by macro indicators. The stronger GDP growth is not due to Swedes having worked more hours than before. Instead, productivity

[6] Andersson, Björn, Palmqvist, Stefan and Österholm, Pär (2012), The Riksbank's attainment of its inflation target over a longer period of time. *Economic Commentary* no. 4, 2012, Sveriges Riksbank.

has risen unexpectedly. If the measurement is correct, it means that the stronger productivity growth will not increase inflationary pressures. It will rather reduce them.

The krona has strengthened more than the Riksbank was expecting at the meeting in July. One reason may be that Sweden's GDP growth in relation to the rest of the world has been higher than expected. This could reflect the fact that demand for Swedish goods has increased in relation to goods from other countries, which in turn has also increased the demand for Swedish kronor in relation to other currencies. Another reason could be that good public finances and low inflation have reinforced the view of Sweden as a safe haven in a troubled world. Sweden is one of the few countries that still have the highest credit rating, with stable prospects, from all of the three major credit rating institutions.

However, it is difficult to know what might be a reasonable level for the krona. Calculations of equilibrium exchange rates are genuinely uncertain. The persistent and substantial current account surplus could justify the krona remaining relatively strong. On the other hand, one cannot know how persistent the increase in productivity will be. In addition, the krona usually weakens in times of uncertainty. There are different factors all pointing in different directions. It would therefore be a good idea for the Riksbank to make a more in-depth analysis of the real equilibrium exchange rate and its determinants. Empirical research points to there not being a simple relationship between interest rate differentials and the exchange rate. All in all, given the other assumptions regarding economic developments, Mr Ingves assessed that the forecast for the krona is reasonable.

Another variable that is difficult to assess is the level of long-run unemployment. The Riksbank forecasts that unemployment will increase somewhat over the coming year, before declining again as a result of the gradual improvement in economic activity. But, Mr Ingves wondered, how low can unemployment fall without inflation accelerating? The structural problems with regard to matching and wage formation still remain. Mr Ingves believed that one must count on fairly broad intervals for long-run unemployment, as the Riksbank did in July when assessing the interval to be 5-7.5 per cent.

Inflation is expected to be lower in the coming period than the Riksbank had assessed in July. Cost pressures have become lower as a result of a higher productivity increase and of the krona strengthening. Furthermore, the wage bargaining rounds have resulted in moderate wage increases. All in all, the inflation target of two per cent and developments in the real economy justify a slightly more stimulating monetary policy, which Mr Ingves intended to return to later.

Deputy Governor **Lars E.O. Svensson** wished to explain why he had taken up the question of the higher average unemployment resulting from lower average inflation than the target. It is because it leads to an important conclusion for monetary policy at each meeting, namely that it is important to hold inflation on average around the target over a longer period of time. It is important to avoid average unemployment becoming unnecessarily high in the coming period, by ensuring that average inflation is close to the target over a longer period of time. This means that one should not be afraid of overshooting the inflation target. If the average inflation rate is to attain the target, then inflation must in principle overshoot the target as often and by as much as it undershoots the target.

Mr Svensson then commented on Mr Jansson's claim that the debate has been characterised by factual errors and oversimplification. Mr Svensson wished to explain in this context where the data on inflation being 0.6 percentage points too low the last 15 years comes from. According to real-time data, average CPI inflation has been 1.5 per cent for 1995-2011, 1.4 per cent for 1996-2011 and 1.4 per cent for 1997-2011. Mr Svensson said that in his paper he has chosen to focus on the period 1997-2011, for several reasons. Inflation expectations had then had time to stabilise around 2 per cent, so the regime had become credible. The Riksbank had had a couple of years from the inflation target beginning to apply in 1995 to learn to conduct a policy of inflation targeting. The repo rate had fallen to a normal level. The regime had had time to become reasonably established.

If the Riksbank has on average deviated from the target, this is in itself an important issue, and the target attainment should not be made light of. However, it is even more important that the deviation from the target appears to have had consequences for unemployment. That is why it is so important to keep average inflation on target in the coming period. This is not impossible. Experiences from the countries that have had a fixed inflation target as long as Sweden show this. Australia, Canada and the United Kingdom have succeeded (in the UK's case during the period up to and including 2007) in holding average inflation on or very close to the target.

Deputy Governor **Karolina Ekholm** criticised that so much time at this meeting was spent discussing whether or not earlier Executive Boards long ago had succeeded in attaining the inflation target. She said that the important thing for the Executive Board to discuss at today's meeting was the monetary policy stance in the coming period. As inflation is expected to be below 2 per cent for some time to come, according to the inflation forecast, the gap between the inflation target and the long-run average inflation rate, however large it is now, ought to increase in the coming period. According to Ms Ekholm, this means that it is important that the Riksbank focuses on how to maintain confidence in the inflation target.

Deputy Governor **Per Jansson** interjected that he agreed with Ms Ekholm that the Executive Board should spend its time on discussing current monetary policy issues. This was why he considered the coming Economic Commentary to be so good. It clarifies the facts in an orderly and transparent manner and it will hopefully mean that the Executive

Board needs to spend less time in the future discussing what has actually happened in the past. This should give the Board greater scope to instead discuss current monetary policy issues.

Governor **Stefan Ingves** agreed with this view and proposed that one could thus put an end to the discussion on average inflation on this occasion.

§3. Monetary policy discussion

Deputy Governor **Barbro Wickman-Parak** began my noting that the Executive Board in July had to weigh a strong Swedish economy against a weak and uncertain European outlook. The latter situation remains largely the same. However, the analysis of GDP figures and the new indicators that Ms Wickman-Parak described in her earlier contribution led her to the conclusion that one can now see more clearly that economic activity in Sweden will weaken in the coming period. This is also reflected in the weaker growth sequence in relation to the forecast made in July. Ms Wickman-Parak said that this was a piece of the puzzle in the thought process that led her to the decision that there is now reason not only to state that there is some probability of a lower repo rate in the autumn, as the Executive Board did in July, but to go a step further and cut the repo rate.

Inflation is currently low and the Riksbank has on several occasions explained the reasons for this in its reports, as it does now. Ms Wickman-Parak said that she had pointed out on several occasions that she considers the low inflation at present to have received too little attention at the cost of the forecast. Although the Riksbank's forecasts have earlier been for the krona rate to be roughly at its current level, the appreciation has come sooner than expected. The forecast now is that the krona will remain at roughly the current levels for the remainder of the year. In addition, higher productivity growth has led to a downward revision of unit labour costs. This of course affects the inflation forecast, which is adjusted down for a large part of the forecast period.

It is thus several factors, that is, weaker growth prospects, a stronger krona and lower unit labour costs that have together led Ms Wickman-Parak to the conclusion that it is appropriate to cut the repo rate to 1.25 per cent and lower the repo-rate path in line with the assessment in the Monetary Policy Update. The krona exchange rate is notoriously difficult to predict and can move rapidly. Nor should one read too much into individual quarterly figures on productivity. According to the current forecasts, inflation will be below the target for some way into 2014. Even if, for example, the krona were to weaken more than the Riksbank is predicting, the inflation target need not be jeopardised. The risk that cutting the repo rate today would mean that the Riksbank rapidly needed to change its policy and begin raising the repo rate is almost non-existent, in Ms Wickman-Parak's view.

She also considered that one should not expect major effects on growth from the lower repo rate in a situation where economic agents take a wait-and-see stance because of uncertainty over developments abroad. Households with variable mortgage rates will have a better cash flow and this could contribute to somewhat higher consumption than would otherwise have been the case. An interest rate cut can also have some effect on the krona exchange rate and thus affect exports.

Monetary policy decisions are rarely simple and self-evident, and when one prepares to make a decision one must of course consider various different alternatives. Ms Wickman-Parak noted that given what she just said, one might perhaps get the impression that a larger repo rate cut would be worth considering. But she stated several reasons for why that was not the case.

Firstly, it is not the case as yet that new outcome statistics and new indicators point to any drastic slowdown in the economy. Secondly, private consumption is developing fairly well and household confidence is relatively strong. Thirdly, Ms Wickman-Parak's assessment is that the Swedish economy will have very good conditions next year to keep up if the euro crisis fades and demand from abroad picks up more. She could very well imagine that over the course of next year one might see stronger growth than is now being predicted.

Finally, Ms Wickman-Parak took up household borrowing. To begin with, she pointed out that the Riksbank does not have a target for either credit growth or house prices. But she said that both she and other members of the Executive Board welcome the slow-down in household borrowing. Her view was that higher interest rates had played a role here. Household borrowing does not present any immediate danger, but a substantial cut in the repo rate might mean that the build-up of debt accelerated again. This is not primarily a question of risks to financial stability, but of risks to growth, employment and inflation in the longer run – variables that are central to monetary policy.

Ms Wickman-Parak stated that she had on several occasions said that she considers gradual changes in the repo rate to be preferable in normal cases. However, there should be a readiness to reconsider repo-rate decisions when this is required. In some cases, even more radical steps in rate-setting may be justified, and yet relatively easy to decide. This was the case in the midst of the financial crisis, said Ms Wickman-Parak. But for the most part, the monetary policy decisions are preceded by much more delicate deliberations, at least in her case. These have led her to decide in favour of a repo-rate cut and lower repo-rate path on this occasion.

If economic activity abroad should worsen substantially, and this had a large effect on the Swedish economy, the situation would be different. Ms Wickman-Parak then said that she would take the liberty of repeating what she had said at the meeting in July, that in this case there might be reason to discuss the opportunities and efficiency of monetary policy versus other measures to stimulate the economy.

Deputy Governor **Lars E.O. Svensson** advocated a significantly lower repo-rate path than the one in the main scenario of the draft Monetary Policy Update. He considered that the forecasts for foreign policy rates and growth abroad were too high and that a lower repo-rate path would lead to a higher rate of CPIF inflation closer to the target and a lower rate of unemployment closer to a long-run sustainable rate and thus provide a better-balanced monetary policy.

Mr Svensson's interpretation of the Sveriges Riksbank Act and its preparatory works is that it is reasonable to have as a starting point that monetary policy has a mandate to maintain price stability and attain the highest sustainable rate of employment, where the latter is in practice the same thing as the lowest sustainable rate of unemployment. He said that in practice this entails choosing a repo-rate path that best stabilises CPIF inflation around the inflation target and unemployment around a long-run sustainable rate throughout the forecast period and not just at the end of the forecast period. According to Mr Svensson, the focus should thus be on employment and unemployment, not on resource utilisation in a more general and diffuse way as measured using a number of different, unreliable indicators.

He felt that even if one were to accept the assumptions in the draft Monetary Policy Update with regard to reasonable growth abroad and higher future policy rates abroad, a lower repo-rate path than that in the main scenario provides better target fulfilment for CPIF inflation and unemployment. This is illustrated clearly in Figure 3, which shows the main scenario and forecasts for alternative repo-rate paths with the aid of the Riksbank's Ramses model. Mr Svensson's conclusion was that this also applies if one assumes that inflation and unemployment react more slowly to interest rate changes than is the case in the Ramses model. If the reaction is slower, this is an argument in favour of a larger and earlier cut in the repo rate. This conclusion applies regardless of whether one measures the unemployment gap against 6.5 or 5.5 per cent long-run sustainable rate of unemployment.

A forecast for policy rates abroad in line with forward rates, which according to Mr Svensson would currently entail a more realistic forecast, argues in favour of a much lower repo-rate path. This is shown in Figure 4. Under the assumption of policy rates abroad following forward rates, the figure shows the forecasts for CPIF inflation and unemployment with the main scenario's repo-rate path and with a lower repo-rate path. The forecasts were made using Mr Svensson's assessment of long-run sustainable unemployment of 5.5 per cent. Lower policy rates abroad in accordance with forward rates (the grey curve instead of the yellow one in Figure 1), all else equal, give a larger interest rate differential between the repo-rate path and policy rates abroad and a stronger krona. This in turn leads to lower inflation, lower exports and higher unemployment, as shown in Figure 4.

Mr Svensson's conclusion was that the lower repo-rate path leads to much better target fulfilment. A less optimistic forecast for developments abroad gives further arguments in favour of a lower repo-rate path. Given this, Mr Svensson entered a reservation against the draft Monetary Policy Update and the repo-rate path and advocated that the repo rate should be cut by 0.5 percentage points to 1.0 per cent and then follow a repo rate path of 0.75 per cent from the beginning of the fourth quarter 2012 to the end of the fourth quarter 2013, followed by a gradual increase to 2 per cent at the end of the forecast period.

Deputy Governor **Karolina Ekholm** said that, as at the previous meeting, the current situation is one where inflation is far below the target and unemployment is clearly higher than what can be regarded as a sustainable long-run rate of unemployment. It is therefore necessary to find a monetary policy that contributes to pushing up inflation and pushing down unemployment. This has to be done in a situation where economic activity abroad is weak and thus does not provide much assistance. Moreover, the krona is relatively strong, which contributes further to dampening export demand.

Given this, Ms Ekholm, like Ms Wickman-Parak and Mr Svensson, felt that more monetary policy stimulation was needed. Ms Ekholm noted that at the previous meeting she advocated a repo-rate cut of 0.5 percentage points and a path that remained at 1 per cent until the end of the third quarter of 2013, then gradually rose to just over 2.5 per cent. As the conditions have not significantly changed, she did not really have any strong reasons to advocate anything else on this occasion. One difference from the previous meeting was that there is now a proposal to cut the repo rate by 0.25 percentage points. As Ms Ekholm believed it is more important to cut the repo rate than to cut it by exactly 0.5 percentage points now, she intended to support this proposal and thus support cutting the repo rate by 0.25 percentage points.

However, she did stand firm by her assessment from the previous meeting that the repo rate probably needs to be brought down to 1 per cent gradually and to remain there for some quarters. The repo-rate path in the draft Monetary Policy Update entails some downward revision in relation to the path decided on in July, but this is not enough, in Ms Ekholm's opinion. CPIF inflation is not expected to reach 2 per cent until early 2014. Unemployment will not fall to what is considered a sustainable long-run level until the very end of the forecast period. A lower repo-rate path would provide better target attainment in so far as the forecast shows inflation reaching the target of 2 per cent earlier and unemployment coming closer to its long-run sustainable level.

With regard to households' credit growth, Ms Ekholm said that it has shown a downward trend for a fairly long time and her assessment was that developments with regard to household indebtedness and the Swedish housing market did not justify holding the repo rate at a higher level than was strictly motivated by the inflation target. As the inflation target has recently been questioned by some, Ms Ekholm considered it important to focus on the inflation target. Otherwise there is a risk of losing the anchor for inflation expectations around the inflation target.

Ms Ekholm explained that the path she advocated at the previous meeting had an arbitrary element in that it was not based on a systematic analysis of which path provides the best possible target fulfilment with regard to inflation and resource utilisation. But it is still the case that a path that comes down to 1 per cent during the autumn and remains there until the end of the third quarter of 2013, to gradually rise to around 2.5 per cent at the end of the forecast period in model simulations gives a better target fulfilment than the path in the main scenario when policy rates abroad are forecast using implied forward rates.

Ms Ekholm said that her proposed path gives fairly good target fulfilment even when the TCW path for policy rates abroad is used instead of implied forward rates. What does not look so good in that case, is that inflation rises slightly over the target towards the end of the forecast period. Ms Ekholm noted that this is because the TCW path rises fairly steeply towards the end of the forecast period and that her repo-rate path therefore implies substantially reduced interest rate differentials towards other countries and thus a weaker krona, which pushes up inflation. If one does not believe in this steep rise for policy rates abroad towards the end of the forecast period – and as Ms Ekholm has mentioned earlier, she was sceptical towards it – or if one does not believe in the strong relationship between interest rate differentials and exchange rates that exists in the Riksbank's Ramses model, the path she advocated in July gives a better target attainment on this occasion, too. Ms Ekholm therefore stood firmly by her opinion that this is a better repo-rate path.

All in all, Ms Ekholm supported cutting the repo rate by 25 basis points and advocated a repo-rate path that falls to 1 per cent and remains there until the end of the third quarter of 2013, and then rises to around 2.5 per cent.

Governor **Stefan Ingves** stated that he supported the proposal to cut the repo rate by 0.25 percentage points to 1.25 per cent, and to adjust the repo-rate path down somewhat.

Cost pressures are expected to be weaker than in the previous forecast. The inflation target therefore justifies a slightly more stimulative monetary policy. Such a monetary policy also contributes to resource utilisation being at a normal level during the forecast period. Mr Ingves said that monetary policy does what it can to ensure the Swedish economy is as stable as possible, when economic activity abroad is unstable.

He noted further that developments in the financial sector and household borrowing were currently a little calmer, but still require considerable attention. Introduction of new regulations regarding capital adequacy, liquidity and risk weights are important measures. The discussion of amortisation requirements, reduced tax deductions for mortgages and an increased supply of housing is also important. Ensuring that indebtedness does not rise too far has long-term significance. Mr Ingves pointed out that when monetary policy is being considered, the Riksbank also needs to take into consideration what is being done in these other policy areas. The level of the repo rate is therefore, among other things, a function of how well the regulations for financial stability function with regard to counteracting new imbalances. He said that the less one does in other areas, the more responsibility falls to monetary policy.

Mr Ingves summarised by saying that many variables are moving "sideways" and that the changes are not so great in relation to the forecast made in July. Given developments in wages, productivity and the exchange rate, as well as a lower forecast for inflation, there is reason to cut the repo rate now. Another alternative, which over time gives roughly the same result, would have been to wait until October. Without any major surprises this should not change the outlook dramatically and thus one might just as well cut the repo rate now, according to Mr Ingves. If anything dramatic happens in Europe, the situation will be different and monetary policy will have to be adjusted to the new circumstances. If, on the other hand, growth is much higher than in the forecast over a long period of time, then an adjustment will be necessary as well.

Finally, Mr Ingves also said he would like to see more work in the future on the long-run equilibrium assumptions. He noted that the analysis apparatus for monetary policy had been established during the period known as the Great Moderation, that is, when the real economy in the world was developing well at the same time as inflation was low. Mr Ingves said that it is more difficult to make forecasts now, as developments over the past five years have been completely different. He wondered whether it was reasonable, for instance, to hold onto a long-run interest rate assumption of 4 per cent. Mr Ingves called for further analysis of this and other equilibrium assumptions made in the analysis work.

Deputy Governor **Per Jansson** referred to his earlier contribution, in which he had explained that changes now being made to the forecasts entail inflation being below the target throughout the forecast period, unless monetary policy is adjusted. The question is then exactly how monetary policy should be adapted. Mr Jansson said that he could see two possible ways of adjusting the repo-rate path. The first way entails the repo rate now being held unchanged, but the repo-rate path containing a sizeable probability of a cut in October. After that, the repo-rate path will remain at a lower level than in July. The other way is to immediately cut the repo rate and then apply a lower repo-rate path than in July from now onwards.

Mr Jansson noted that it is fairly evident that the two ways of adjusting monetary policy lead to roughly the same forecasts for economic developments. He said that this could lead to the conclusion that it does not matter very much whether one cuts the repo rate now or communicates a sizeable probability of a cut in October. Given that the lower cost pressures in the form of the faster productivity increase and the stronger krona are not a future risk, but instead a fact, Mr Jansson said it appears more natural to cut the repo rate now. He therefore supported the proposal in the draft Monetary Policy Update to cut the repo rate by 0.25 percentage points now and then to apply a repo-rate path that is on average around 0.2 percentage points lower than the repo-rate path in the July Monetary Policy Report. He also supported the forecasts for the Swedish and international economies described in the Update.

Mr Jansson concluded by commenting on how his monetary policy stance relates to his view of risks with regard to household indebtedness. It was important for Mr Jansson to explain this, as he had earlier said that household indebtedness had been a factor on the margin that weighed against cutting the repo rate.

Mr Jansson said that the answer to the question of why he now thinks the repo rate should be cut, but did not think so earlier is quite simply that some deviation from the inflation target can be tolerated, but that one cannot aim for a future inflation that never quite reaches the target over the coming three years. In Mr Jansson's view this could only be acceptable in very exceptional circumstances. And these circumstances did not exist now.

However, he noted at the same time that households' debt ratios had not declined; they remain at a very high level, both in historical and international terms. Although the risks in this area have scarcely increased since July, one cannot rule out the possibility that this will happen in the coming period, for one reason or another.

If this does happen, a situation could emerge where it is necessary for other Swedish authorities to take measures to gain control over the situation and to reduce the risks, according to Mr Jansson. This could concern measures aimed at the demand side of the credit market, for instance, amortisation requirements or more binding limitations to the lending allowed in relation to incomes. It could also involve measures on the supply side aimed at getting the banks to fund mortgages to a greater extent with equity rather than loans. Mr Jansson also took up another measure, which has already been discussed and to which there is reason to return, namely an increase in the risk weights used to calculate how much capital the Swedish banks must hold to lend to a customer. At present the Swedish risk weights are among the lowest in Europe and there is reason to question whether this correctly takes into account the rapid growth in housing prices and indebtedness observed over the past 15 years or so.

Mr Jansson emphasised that he believes that the Swedish authorities' preparedness to take measures in this field can be improved. He therefore considered that it is desirable that the authorities with responsibility in this context hold a more in-depth discussion of what can be considered appropriate measures to take if the risks relating to household indebtedness begin to increase again.

In conclusion, Mr Jansson wished to ask Mr Svensson a question. Given the way that Mr Svensson interprets the Riksbank's mandate and his analyses of inflation having become too low in an historical perspective, one may wonder why Mr Svensson does not advocate an even lower repo rate right now and an even lower repo-rate path in the coming period. Mr Jansson pointed out that with the monetary policy that Mr Svensson wished to conduct, CPIF inflation is below the target for the entire forecast period (see Figure 4). Mr Jansson emphasised that this is not the case in the Monetary Policy Update and with the monetary policy the majority wishes to conduct. Mr Jansson also noted that Mr Svensson's preferred monetary policy would lead to unemployment being higher than the level Mr Svensson assesses to be sustainable in the long run, with the possible exception of a few months or so in 2015.

First Deputy Governor **Kerstin af Jochnick** noted that she supports the proposal in the Monetary Policy Update to cut the repo rate by 0.25 percentage points to 1.25 per cent and to adjust the repo-rate path downwards. She said that the decisive factors that have affected her stance are the weak developments in the euro area and the lower cost pressures in Sweden. She also considered that there are signs that the euro area risks holding back growth in several other countries. While the situation on the housing market in the United States has improved somewhat, there is considerable uncertainty over future demand, partly because of the need for continued fiscal policy consolidation. There are also signs of a slowdown in several emerging economies, which may be related to the weaker demand from Europe. However, several of these countries have better possibilities to take expansionary measures than the industrial nations, which contributes to the forecast that the world economy as a whole will grow at a good pace.

Ms af Jochnick said that, in addition to developments abroad, her stance was also affected by the fact that inflationary pressures in Sweden are lower than the Riksbank had previously assumed. She also assessed the strong GDP growth during the second quarter to be temporary.

Ms af Jochnick considered that the Riksbank should cut the repo rate now in order to attain the inflation target of 2 per cent within the forecast period. The motives for cutting the repo rate have gradually increased during the summer, partly affected by the krona appreciation and partly by the improved productivity. Together, these factors contribute to cost pressures being weaker than in the assessment made in July. Even if the krona appreciation were to some extent to prove to be temporary, there are underlying fundamental factors that support the picture of weaker cost pressures. Ms af Jochnick therefore did not feel that there is reason to wait and see how the krona develops; there is sufficient reason to cut the repo rate by 0.25 percentage points now to 1.25 per cent. This leads to better target fulfilment within the forecast period with regard to inflation and also contributes to resource utilisation in the economy normalising during the forecast period.

Ms af Jochnick noted that she had earlier pointed to there being great uncertainty over future developments. It is crucial for the world economy and for Sweden that the euro area gets back on its feet. Her assessment is based on the turning point coming during the next six months. In the middle of next year it may then be time to begin raising the repo rate again. But there are, of course, risks. A much poorer outcome in the euro area is a downside risk for the Swedish economy. The Swedish economy could also continue to show greater resilience than expected, which would be an upside risk.

Finally, Ms af Jochnick wished to point out once again the importance of continuing the discussion of what incentives and imbalances the low interest rates might entail. The increase in lending to households is now down at a reasonable level. However, the build-up of debt could accelerate further ahead. Now that interest rates are becoming even lower, it is even more important that new loans to households keep to healthy loan ratios and that the Riksbank, in the discussion of financial stability and macro prudential supervision, considers whether other measures, like amortisation requirements or requirements that loans be set in relation to incomes, would be appropriate to limit households risk-taking.

Deputy Governor **Lars E.O. Svensson** interjected that he welcomed a discussion of household indebtedness, particularly if one discussed means that are better than the repo rate at managing potential problems, such as mortgage ceilings, regulations regarding tax deductions, risk weights and capital adequacy requirements. With regard to determining whether there are problems with financial stability in general and indebtedness in particular, it is necessary, in Mr Svensson's view, to discuss whether levels of debt ratios, leverage and other indicators are sustainable, that is, compatible with steady state, as well as to discuss whether borrowers and lenders have sufficient resilience to shocks. He said that there is insufficient scope to discuss this further here, and referred instead to a discussion of these questions in an article he has written in a new issue of the journal Ekonomisk Debatt.[7]

With regard to amortisation requirements as a means of affecting household indebtedness, there is one circumstance that sometimes appears to have been forgotten.

[7] Svensson, Lars E.O., "Utmaningar för Riksbanken – penningpolitik och finansiell stabilitet" (Challenges for the Riksbank – monetary policy and financial stability), Ekonomisk Debatt no. 5 2012, pp.17-29, available (in Swedish) at www2.ne.su.se/ed/pdf/40-5-leos.pdf.

A loan without amortisation remains unchanged in nominal terms. But the debt ratio, the loan in relation to disposable income, is not unchanged. It is reasonable to assume that nominal disposable incomes grow on average by 4 per cent a year, 2 per cent in real terms and 2 per cent inflation. The disposable incomes of many young households will probably rise even faster. But this means that the debt ratio for an interest-only loan falls and is halved in less than 18 years, and thus declines to a quarter of its original level in just under 36 years.[8] In relation to disposable income, an interest-only loan thus entails a fairly rapid amortisation. As nominal housing prices are likely to rise on average at least as quickly as disposable incomes, the loan-to-value ratio for an interest-only loan will decline at least as fast as the debt ratio.

Deputy Governor **Karolina Ekholm** said that she believes it is difficult to conduct a really good and clear discussion of different measures that could reduce the risks of increased indebtedness among households and rising house prices, as there is no adequate analytical base either inside or outside of the Riksbank. But she emphasised that it is important for the predictability of monetary policy to clarify how factors related to indebtedness and house prices affect the Executive Board's monetary policy stance.

First Deputy Governor **Kerstin af Jochnick** noted that as the forms for macro prudential policy have not been developed in Sweden it is reasonable for the Riksbank to discuss, for example, the effects on household indebtedness in view of the low interest rates. It is important that potential imbalances are identified at an early stage and that measures are taken, if possible, to limit the accumulation of risk.

Governor **Stefan Ingves** said that the risks of financial imbalances and their consequences for monetary policy are not a new issue but something that was discussed by the Executive Board long before the financial crisis escalated in 2008. He noted that the Executive Board agreed that these were important issues that the Riksbank would need to discuss further in the years ahead.

Deputy Governor **Lars E.O. Svensson** then responded to the question that Mr Jansson had asked about the repo-rate preferred by Mr Svensson (as represented in Figure 4). Mr Svensson said that it is correct that with this repo-rate path the forecasts for CPIF inflation are below the target and the forecast for unemployment is above the sustainable rate. He claimed therefore that it would be better with a repo-rate path that gives a forecast for CPIF inflation that overshoots the target in order to push down unemployment a little more.

[8] This follows on from $1/(1{,}04)^{18} = 0{,}49$.

Mr Svensson took up Qvigstad's rule, that is, the criterion for a good interest-rate path formulated by the Deputy Governor at Norges Bank Jan Qvigstad.[9] Adapted to inflation and unemployment, this says that for a good interest-rate path the inflation gap and the unemployment gap should normally have the same sign. Mr Svensson admitted that this is not achieved for his preferred repo-rate path (see Figure 4).

He said that the reason for this was that it is difficult and that there are unfortunately not sufficient resources at the Riksbank to perform a thorough analysis of repo-rate paths and forecasts that lie far away from the main scenario. Mr Svensson believed that his repo-rate path entailed a significant step in the right direction, but that it is not necessarily the best repo-rate path that could be found with a more thorough analysis and that it is quite possible that an even lower repo-rate path would be better. He said that his repo-rate path is an example of coarse tuning rather than fine tuning and he wished of course that the majority of the Executive Board would support his repo-rate path and that ahead of the next monetary policy meeting it would be possible to devote sufficient resources for finding an even better path that complies with Qvigstad's rule.

The Chairman, Governor **Stefan Ingves**, then summarised the monetary policy discussion. The Executive Board has long been in agreement that inflationary pressures are low and that the repo rate needs to be low to boost economic activity and for inflation to attain the target of 2 per cent. This is why the repo rate and the repo-rate path have been lowered over the last 12 months. However, there have been differences in the view of how expansionary monetary policy should be.

The assessment at today's meeting is that cost pressures will now be lower and lead to lower inflation than in the assessment in July. The Executive Board was unanimous that the repo rate thus needs to be cut further to counteract the low inflation and support economic activity. However, this time too there are differences in opinion with regard to how expansionary monetary policy should be.

Five Board members considered it appropriate to cut the repo rate by 0.25 percentage points, to 1.25 per cent. One member wanted to cut the repo rate by 0.5 percentage points. All of the members considered it appropriate to adjust the repo-rate path downward. A majority, four of the members, considered a small downward adjustment to be appropriate. They considered that CPIF inflation would thus reach 2 per cent within 2 years and resource utilisation would normalise. However, two members considered that there was scope for an even lower repo-rate path and assessed that this would lead to an inflation rate closer to 2 per cent and unemployment closer to a long-run sustainable level.

[9] See Qvigstad, Jan F. (2005), When does an interest rate path 'look good'? Criteria for an appropriate future interest rate path – A practician's approach. Staff Memo No. 2005/6, Norges Bank.

One issue facing the members of the Executive Board was, as in July, how to balance the weak and above all uncertain development of the euro area against the relatively strong development of the Swedish economy. All of the members believed that the situation in the euro area is still uncertain and that the downturn there will be prolonged.

The members agreed that the growth of Swedish GDP is now slowing down following strong growth so far this year and that the strong outcome is not expected to be inflationary. There was also agreement that actual unemployment is currently higher than the long-run sustainable unemployment rate, although there were different assessments of what this rate is. There were also different assessments of what monetary policy can achieve at present with regard to developments in unemployment.

Several members touched on recent developments of the krona and noted that the appreciation that was forecast earlier had come sooner than expected. Some members also discussed households' high debt ratios and the vulnerability this can create for the economy, something that these members thought would continue to require considerable attention.

§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 Thursday 6 September 2012 at 9.30,
- that the repo rate would be lowered to 1.25 per cent and that this decision would apply from Wednesday 12 September 2012,
- to publish the decision above on Thursday 6 September 2012 at 9.30 with the motivation and wording contained in a press release, and
- that the minutes of today's meeting would be published on Tuesday 18 September 2012 at 9.30.

Deputy Governor Lars E.O. Svensson entered reservations against the Monetary Policy Update and the decision about the repo rate and repo-rate path in the Monetary Policy Update. He advocated a lowering of the repo rate to 1.0 per cent and then a repo-rate path that stays at 0.75 per cent from the fourth quarter of 2012 through the fourth quarter of 2013, and then rises to 2 per cent by the end of the forecast period. This was justified by his assessment that the Update's forecasts of foreign policy rates further ahead and foreign growth are too high and that his repo-rate path is associated with a forecast of CPIF inflation that is closer to the inflation target and a forecast of unemployment that is closer to a long-run sustainable rate and therefore constitutes a better-balanced monetary policy.

Deputy Governor Karolina Ekholm entered a reservation against the repo-rate path in the Monetary Policy Update. She advocated a repo-rate path that is lowered to 1.0 per cent during the autumn, stays at this level through the third quarter of 2013 and then rises to about 2.5 per cent by the end of the forecast period. This was justified by her assessment that a repo-rate path that is associated with a higher forecast of CPIF inflation and a lower forecast of unemployment constitutes a better-balanced monetary policy.

This paragraph was verified immediately.

Minutes by

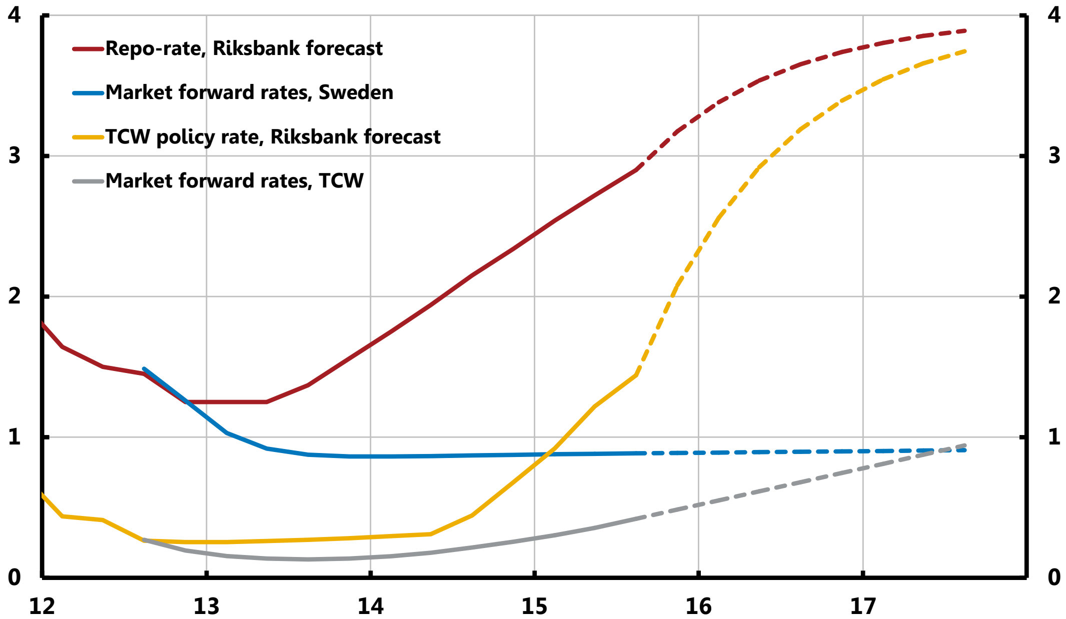
Ann-Christine Högberg

Verified by:

Karolina Ekholm	Stefan Ingves	Per Jansson
Kerstin af Jochnick	Lars E.O. Svensson	Barbro Wickman-Parak

Figure 1. Repo-rate path, forward rates and forecast for TCW-weighted policy rate, September 2012

Per cent. Forward rates from 31 August

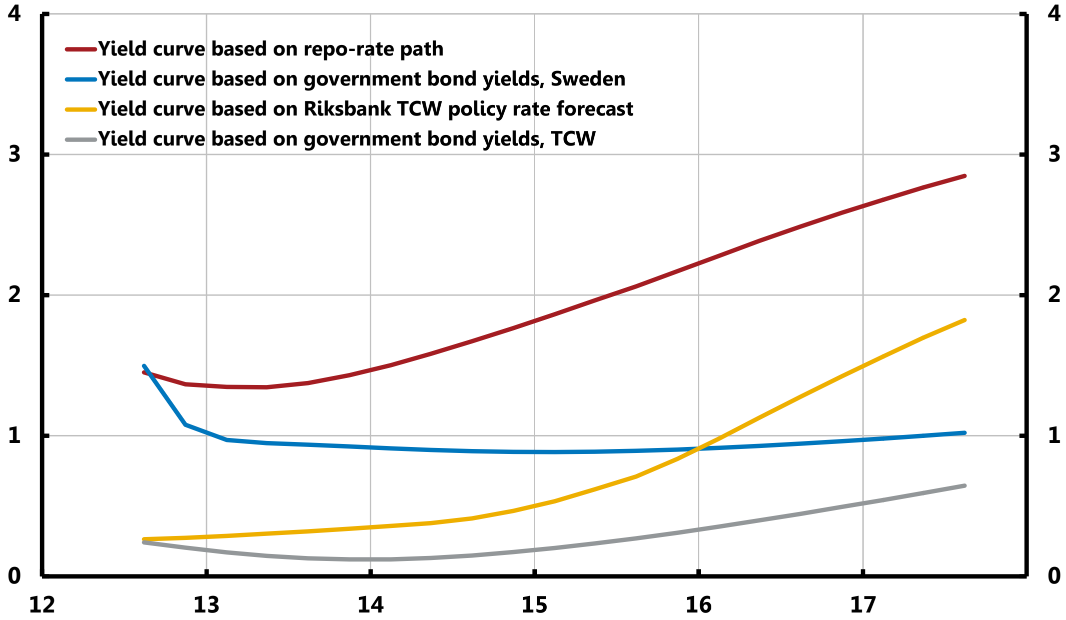


Note: The implied forward rates exclude credit risk and maturity premiums in accordance with a rule of thumb of 1 basis point per month. The curves are extrapolated with an unchanged curve for the quarters beyond the forecast horizon (2015, Q4) and not based on actual market pricing.

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

Figure 2. Yield curves, September 2012

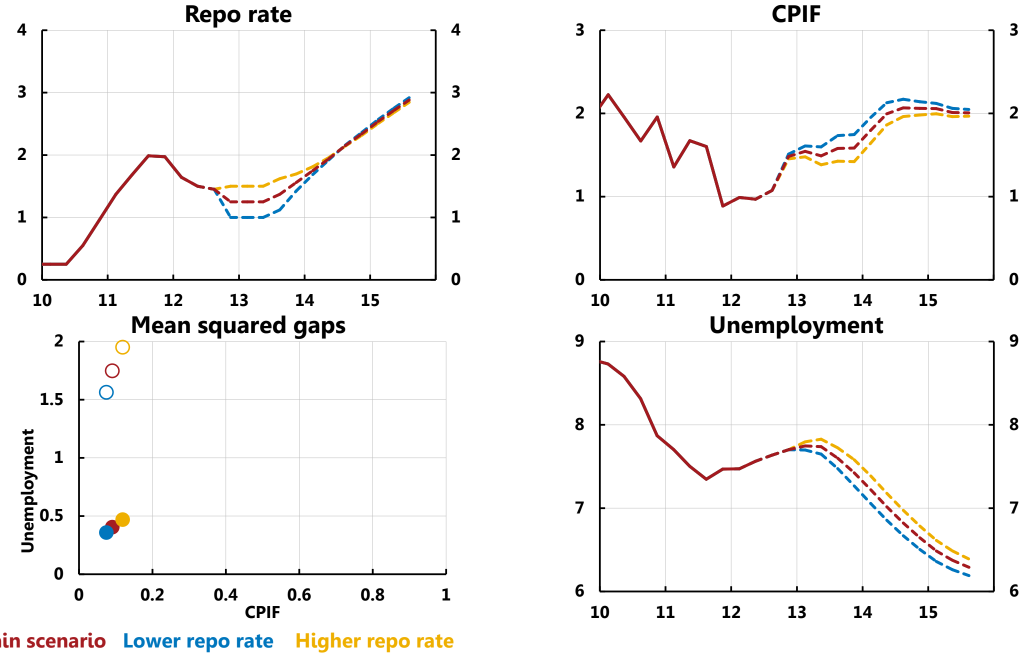
Per cent. Government bond yields from 27 August



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

Figure 3. Monetary policy alternatives, September 2012

Policy rates abroad according to the main scenario. Long-term sustainable unemployment rate 6.5 per cent. Deviations according to Ramses.

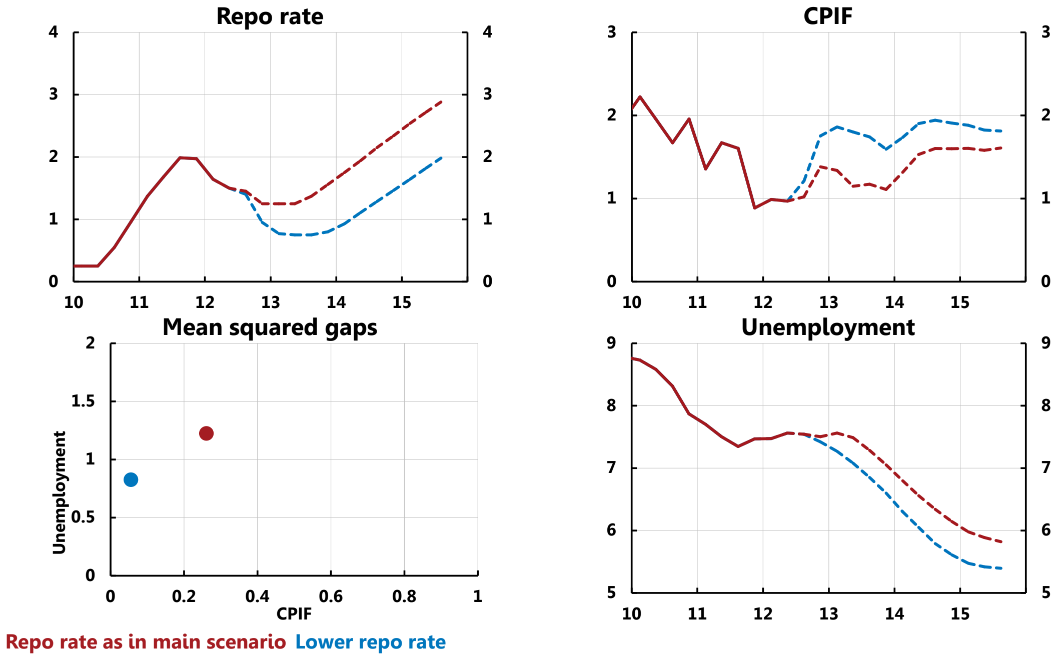


Sources: Statistics Sweden and the Riksbank

Figure 4. Monetary policy alternatives, September 2012

Policy rates abroad according to implied forward rates. Long-run sustainable unemployment rate 5.5 per cent

Per cent



Sources: Statistics Sweden and the Riksbank

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