Minutes of monetary policy meeting

DECEMBER 2013

Summary

At its monetary policy meeting on 16 December, the Executive Board of the Riksbank decided to cut the repo rate by 0.25 percentage points to 0.75 per cent and to lower the repo-rate path.

It was noted at the meeting that the Executive Board agrees on the picture of economic prospects and the inflation outlook described in the Monetary Policy Update. Economic developments in Sweden and abroad have been largely in line with the Riksbank's forecasts for some time now. However, inflation has been lower than expected. Over the coming year, the Swedish economy is expected to show a more tangible improvement. GDP is expected to accelerate and during the latter part of 2014 unemployment will fall faster. Despite the economic recovery, inflationary pressures are now expected to be much lower over the coming year than was forecast in October. The reasons for the lower inflationary pressures include the halt in the increase in service prices recently and the broad downturn in these prices. A more expansionary monetary policy and rising resource utilisation will mean that CPIF inflation increases to 2 per cent in 2015. Indebtedness among Swedish households will remain high, which makes the economy vulnerable to shocks.

Given the low inflationary pressures, all of the members agreed that it is appropriate to cut the repo rate by 0.25 percentage points to 0.75 per cent and to adjust the repo-rate path downwards. The repo rate path suggests a slightly greater likelihood of a further cut, rather than a raise, in February next year, although the most likely scenario is that the repo rate will remain at the same level of 0.75 per cent until the start of 2015, before slowly starting to rise again. In this way, monetary policy will contribute to CPIF inflation rising towards 2 per cent. Towards the end of 2016, the repo rate is expected to amount to 2.6 per cent.

Among other matters, the risks linked to household indebtedness were discussed at the meeting. The need to implement macroprudential policy measures was emphasised, as was the importance of several policy areas cooperating to reduce these risks. Moreover, there was discussion of the links between inflation in Sweden and inflation abroad, possible reasons for the low rate of increase of service prices, how monetary policy in other countries affects the conditions for monetary policy in Sweden and how inflation expectations develop in Sweden.

MINUTES OF MONETARY POLICY MEETING
Executive Board, No. 6

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DATE: 16 December 2013

TIME 09.00

PRESENT: Stefan Ingves, Chairman
Karolina Ekholm
Martin Flodén
Per Jansson
Kerstin af Jochnick
Cecilia Skingsley

Johan Gernandt, Chairman of the General Council

Carl-Johan Belfrage
Claes Berg
Fredrik Bonthron (§ 1)
Charlotta Edler
Eric Frieberg
Kerstin Hallsten
Ann-Christine Högberg
Martin W Johansson
Ann-Leena Mikiver
Marianne Nessén
Christina Nyman
Bengt Pettersson
Maria Sjödin (§ 3-4)
Marianne Sterner (§ 1-3)
Ulf Söderström
David Vestin
Anders Vredin
Fredrik Wallin (§ 1)

It was noted that Carl-Johan Belfrage and Bengt Pettersson would prepare draft minutes of § 3 and 4 of the Executive Board’s monetary policy meeting.

§1. Economic developments

Fredrik Wallin of the Monetary Policy Department began by presenting the latest developments on the financial markets. Since the Monetary Policy Report was published in October, developments on the financial markets have been marked by changes in expectations regarding monetary policy in the United States and the euro area. For instance, more market participants than before are now expecting the Federal Reserve to begin tapering its asset purchases as early as the last quarter of this year. This has caused government bond yields with longer maturities to rise. Stock markets have fallen since October. The Swedish krona has weakened in trade-weighted terms since October, when inflation turned out to be lower than expected and monetary policy expectations were adjusted downwards. An overwhelming majority of analysts believe the repo rate will be cut at today's meeting. These expectations can also be read from market pricing and survey responses, where the first increase is expected to take place at the end of next year.

Fredrik Bonthron from the Financial Stability Department gave an account of recent developments in Sweden and the euro area with regard to government bond yields, financing costs for European banks and the Swedish banks' funding situation.

Marianne Nessén of the Monetary Policy Department presented the draft Monetary Policy Update which, in the assessment of the Monetary Policy Department, will gain the support of the majority of members of the Executive Board. She began by noting that the forecasts in the Update had been discussed by the Executive Board at the meetings held on 9 and 10 December. The text of the draft Monetary Policy Update was discussed at a meeting of the Executive Board on 12 December.

Economic developments in Sweden and abroad have been largely in line with the Riksbank's forecasts. New statistics received since the previous monetary policy meeting support the picture of a continued gradual recovery in the global economy. In Sweden, market participants are now expecting a lower repo rate in the coming period than they were expecting in October, and the krona has depreciated. GDP growth in Sweden was lower than anticipated in the third quarter, but an upward revision of earlier quarters means that the level of GDP was roughly as expected. GDP growth is expected to pick up more speed next year as a result of improved economic activity abroad and stronger domestic demand. The signals from indicators are mixed. Stronger GDP growth is supported by the National Institute of Economic Research's Economic Tendency Survey and other confidence indicators, while hard data in the form of figures for industrial production in October has been weaker. The labour market has continued to improve, with a stronger development than expected in employment, while unemployment has been largely in line with the forecast in the October Monetary Policy Report.

The main surprise in Sweden and abroad has been the continued low inflation. In Sweden, it is mainly a broad downswing in the rate of increase in service prices that lies behind the recent low inflation outcomes. CPIF inflation for October and November was much lower than the forecast in the October Monetary Policy Report and inflationary pressures are now expected to be lower in the coming period than was expected in October. Cost pressures, in terms of unit labour costs, are higher than inflation on an annual rate and the difference is currently unusually large. This implies that companies are finding it difficult to pass on their cost increases to consumers. At the same time, optimism abroad is increasing and as global economic activity is expected to remain strong, GDP growth in Sweden is forecast to accelerate and companies are expected to have greater scope to raise their prices. This means that CPIF inflation will increase to 2 per cent in 2015. Swedish households continue to be highly indebted, both in an historical and an international perspective, which makes the economy vulnerable to shocks. Debts as a percentage of household incomes are expected to continue to rise in the coming period.

Given the lower inflationary pressures, monetary policy needs to become even more expansionary for CPIF inflation to rise to 2 per cent, according to the draft Monetary Policy Update. The repo rate is cut by 0.25 percentage points to 0.75 per cent, and the repo-rate path includes a slightly larger probability of a further cut than an increase in February next year. As economic activity picks up speed and inflation rises, the repo rate is expected to be increased at the beginning of 2015 and to reach 2.6 per cent at the end of 2016.

§2. The economic situation and monetary policy

Deputy Governor **Karolina Ekholm** began by saying that the most important thing that has happened since the previous monetary policy decision is that inflation in Sweden has become much lower than was forecast in October and that the downturn is relatively broad and not something that can be attributed to any individual component. Inflation has also fallen in other parts of the world, including the euro area, which led to the ECB cutting its policy rate in November. The problem in Sweden is that inflation was already low before the most recent outcomes were published, far below the target of 2 per cent. In this respect, developments in Sweden differ from those in other countries with a more or less explicit inflation target, as they are on the whole much closer to their targets.

Developments in the real economy have remained fairly weak in Sweden, although employment has continued to increase and many forward-looking indicators have developed strongly. There is thus relatively ample spare capacity in the economy, which contributes to low inflationary pressures.

Ms Ekholm's interpretation of the development of inflation in Sweden is that it is largely due to monetary policy failing to focus sufficiently on bringing inflation back to the target. In her view, an important condition for retaining firmly-anchored inflation expectations and maintaining confidence in the inflation target is to show by one's actions that the inflation target is the focus of the monetary policy decisions. This has been one important reason why she has advocated cutting the repo rate for a long time now. She admitted that this interpretation of what lies behind the unexpectedly low inflation rate could be wrong, but said that this would be revealed by future analyses.

Given this, Ms Ekholm welcomed the proposal for a lower repo rate in the repo-rate path presented in the draft Monetary Policy Update. As before, she considered that there could in principle be justification for a larger cut than the 0.25 percentage points proposed to bring up inflation even faster. But as the economic prospects in the forecast nevertheless show a stronger growth in GDP and increased resource utilisation in the coming period, a large cut would go against earlier patterns and risk creating confusion. However, she thought it was good that the repo-rate path was drawn to indicate a greater probability of a cut than an increase in the near term.

Ms Ekholm also welcomed the proposal for a clear downward revision of the end point of the repo-rate path. The basis for the downward revision is the assessment that inflationary pressures are lower than was previously assumed. With this downward revision the interest rate differential in relation to other countries is smaller towards the end of the forecast period than what it was with the previous repo-rate path and it is more in line with market expectations, at least based on what can be inferred from market pricing. It is still the case that the forecast interest rate differential increases more than is expected on the market, which means that the krona should strengthen when the Swedish interest rate begins to rise more quickly than the market has priced. On the other hand, the forecast now includes a gradual appreciation of the krona. Exactly how large the exchange rate changes are likely to be, and how much they may affect inflation, is not entirely clear to Ms Ekholm at present. However, she felt that this could be analysed in greater detail prior to the Monetary Policy Report published in February. Her assessment is that the end point for the repo-rate path is on the high side – that is, it can imply a krona appreciation that brings down inflation somewhat more than in the forecast – but the difference is too small for her to enter a reservation in preference of a different repo-rate path.

All in all, Ms Ekholm thus supported the proposed repo-rate path in its entirety. She went on to clarify her views of the trade-off mentioned in the draft Monetary Policy Update between a more expansionary monetary policy to bring up inflation towards the target sooner and a less expansionary monetary policy to reduce the risks linked to household indebtedness. She does not believe that a repo rate that is 0.25 percentage points lower has sufficiently large effects on indebtedness to significantly affect the risks that indebtedness will cause problems for macroeconomic developments further ahead. Finansinspektionen (the Swedish financial supervisory authority) has taken a number of measures and communicated that they are considering further measures to influence developments regarding mortgages. It is difficult to say how effective these measures are likely to be in reducing the risks linked to household indebtedness, but they are in any case measures that can be expected to have greater precision than a slightly higher repo rate, said Ms Ekholm. Moreover, she believed that there are substantial real economic costs and risks linked to allowing inflation to remain below the target for a long period of time. One risk is that inflation expectations will be less anchored around the inflation target, which makes it more difficult to bring up inflation. Another risk is that a negative shock that further reduces inflationary pressures could lead the economy into deflation and monetary policy into a situation where the policy rate hits the zero lower bound and cannot be cut any further. Given this, she sees a substantial need to make monetary policy more expansionary to bring up inflation towards the target sooner and she is therefore positive to the proposed downward revision to the repo-rate path.

Deputy Governor **Martin Flodén** began by explaining that he supports both the repo-rate path and the forecasts presented in the draft Monetary Policy Update. The major change since the previous monetary policy meeting is that inflation in October and November has been much lower than was forecast then. The new inflation outcomes are expected to primarily push down inflation over the coming year, but to some extent also in the longer run. GDP growth and industrial production have been somewhat lower than expected, but forward-looking indicators from surveys are strong.

The changes in the prospects for economic developments abroad have been relatively minor. The risk of extensive political problems in connection with US fiscal policy has declined, but it is still uncertain how tapering the monetary policy stimulus will affect the markets and economic developments outside of the United States. In the euro area, there are still problems with weak public finances and uncertainty over the quality of the banks' assets. However, the preparations for a review of the banks' balance sheets and for a banking union probably mean that the problems will not be revealed in the near term.

The low inflation in Sweden means that the deviation from the inflation target becomes clearer and that it becomes increasingly important to ensure that inflation does not approach the target too slowly. Mr Flodén therefore argued that it is important that monetary policy is made more expansionary by cutting the repo rate at today's meeting.

Mr Flodén pointed out that he has said at earlier monetary policy meetings that there is in principle justification for cutting the repo rate by more than 25 basis points precisely to ensure that inflation approaches two per cent at a faster rate, even if the economy were to suffer negative surprises. Now that inflation has been lower than expected, the reasons for cutting the repo rate by 50 basis points are somewhat stronger, but not sufficiently strong for him to advocate this alternative.

Strong confidence in monetary policy is essential for price-setting and wage-formation in the economy to be compatible with the inflation target. By cutting the repo rate, the Riksbank is sending a signal that it will ensure the inflation target is met by monetary policy reacting to new information and new developments in the economy. On the basis of this perspective, Mr Flodén thinks the most important thing is that the repo rate is cut, rather than the size of the cut. He is not convinced that an unexpectedly large cut of the repo rate would strengthen confidence in monetary policy more than a cut of 25 basis points.

Moreover, according to Mr Flodén, there are signs that it is a little too late now to make monetary policy a lot more expansionary. Monetary policy has its greatest impact on inflation with some time lag. Although the inflation outcomes in recent months strengthen the picture of underlying inflation being and remaining low despite employment rising, it is nevertheless over the coming year that inflation is expected to be really low. In addition, the forward-looking economic indicators have strengthened considerably in the recent period. If economic developments strengthen in line with the indicators, the greatest effects of current monetary policy could coincide with a rapid upswing in economic activity that also entails rising inflation.

Mr Flodén's assessment is that it is appropriate to cut the repo rate by 25 basis points at today's meeting. But as there are also reasons for a larger cut, not much new negative information is needed for him to advocate a further repo-rate cut at the next monetary policy meeting. He therefore considers it good that the repo-rate path in the draft Monetary Policy Update shows a greater probability of a cut than an increase at the next monetary policy meeting in February. There will probably not be much new information on how inflation in Sweden is developing then. A new repo-rate cut may instead be justified if economic activity does not pick up speed, particularly if the confidence indicators weaken or if the tapering of the expansionary monetary policy in the United States has a significantly negative impact on international economic prospects.

In the longer run, Mr Flodén considers, as is described in the draft Monetary Policy Update, that the uncertainty linked to economic prospects and the inflation outlook is more balanced. According to the forecast in the draft Monetary Policy Update, the repo rate will remain at around 0.75 per cent for roughly one year and then be increased at the beginning of 2015. An earlier increase could be justified if the strong economic indicators result in rapid growth that also gives an upturn in inflation sooner than forecast. A later increase could be justified if CPIF inflation is still far below two per cent at the beginning of 2015.

Deputy Governor **Per Jansson** began by saying that this was probably the most difficult repo-rate decision he had been involved in during his time as a member of the Riksbank's Executive Board.

With regard to economic prospects and the risks associated with household debt, little has happened since the most recent monetary policy meeting on 23 October. This suggests that one should hold onto the monetary policy plan from October and thus leave the repo rate unchanged at today's meeting.

But at the same time, inflation has been much lower than expected for two months in a row, compared with the forecast in October. Of course, individual outcomes should not overthrow a monetary policy plan spanning over several years. But in the present situation, where inflation has already been below the target for around two years and is not expected to reach the target until autumn 2015, the level of tolerance for further negative inflation surprises is very limited.

Given this, Mr Jansson said that in principle he was approaching the question whether monetary policy should react to the negative inflation surprises with a tendency to rather do too much than too little. He felt that it is important to emphasise that this does not mean that the risks linked to households' high and growing indebtedness have disappeared, or are a factor that monetary policy no longer needs to take into account. But in terms of the trade-off that he has so often mentioned – namely that one in setting the interest rate must reach a compromise between on the one hand a shorter-term need to stimulate economic activity and contribute to inflation rising and on the other hand a longer-run need to take into account the risks of households' high indebtedness – it is simply the case that there has been a shift in the form of a higher price tag on taking into account the risks linked to household debt.

One circumstance that increases concern over the unexpectedly low inflation is that the main cause of the forecasting error is a weak development in prices of services. This is worrying for several reasons. Firstly, developments in prices of services should have a stronger link to the domestic economic situation than developments in prices of goods. An unexpectedly weak development in prices of services can thus indicate that companies are finding it even more difficult to pass on domestic cost increases to prices than the Riksbank is assuming. It should be noted in this context that difficulties in passing on cost increases to prices were an important reason for revising down the inflation forecast as early as April this year. Secondly, with this, total inflation is more dependent on developments in prices of goods. However these have shown a tendency towards a weak trend over a longer period of time, which makes it less probable that they can compensate for a continuing weak development in prices of services. Mr Jansson said that all of this indicates there is a risk of the unexpectedly low inflation in recent months becoming entrenched and worryingly delaying the expected rise in inflation towards the target.

Against this background, Mr Jansson went on to say that it is now particularly important to thoroughly analyse the reasons why prices of services have shown such a weak development. This will be a very important task for the Riksbank's Monetary Policy Department in the coming months.

Mr Jansson explained that, in order to counteract such a troublesome delay in the adjustment of inflation, he had come to the conclusion that taking fairly decisive action to combat the unexpectedly low rate of inflation was now justified. He thus supported both the macro forecast and the monetary policy presented in the draft Monetary Policy Report.

This rather significant change of the repo-rate path of course raises questions about what will happen with the high and growing level of household debt. There is no doubt that an even lower repo rate over an even longer period of time increases the risk of excessive debt in the household sector. As households already expect variable mortgage rates to be very low in the long term it will now be very important to monitor how these expectations are affected by the new repo-rate path. All else being equal, the Riksbank's need to now prioritise short-term stimulus measures to a greater extent makes it more urgent to tighten macroprudential policy.

Mr Jansson wished to make it clear that he personally continues to view the risks associated with household debt as a factor to take into account in monetary policy. Swedish household indebtedness is currently high in both historical and international terms. This creates risks, especially for households with small liquidity reserves. A particularly serious problem would arise if the debt ratio were to once again begin rising steeply. This would make the economy more vulnerable as liquidity reserves would shrink further. Sooner or later, we would reach a point where even fairly small shocks to, for example, income, asset prices or interest rates, could trigger adjustments that have fairly substantial effects on the macroeconomy.

The fact that this is not fiction but a real risk is illustrated not least by developments in Denmark and the Netherlands, where debt ratios were allowed to rise far too much before the danger was recognised. Avoiding such a situation is of course not easy in a country where the debt ratio has risen more or less continuously over the last 15 years. Mr Jansson found it difficult to see how it will be possible to meet this formidable challenge without cooperation between several policy areas, including of course both macroprudential policy and monetary policy.[1]

Mr Jansson wished to conclude by explaining how his previously somewhat more optimistic view of the development of the economy, which he had expressed at every monetary policy meeting since July, fitted with what he was now saying and with the repo-rate decision he was now advocating.

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[1] For a more detailed argument on this topic, see Per Jansson (2013), "How do we stop the trend in household debt? Work on several fronts", speech at SvD Bank Summit, Stockholm.

He emphasised once again that the economic outlook is not a reason for cutting the repo rate or having a more expansionary repo-rate path. It is true that data about the future course of the economy point in slightly different directions. But some indicators, such as the purchasing managers' index and the survey of the National Institute of Economic Research, are now at rather high levels. While it has been argued that survey-based indicators of this type are not working at present as well as they have done in the past, we cannot deny that they herald a clear and substantial strengthening of economic activity. Another important factor in this context is the ongoing improvement in the economic situation abroad. As a result, Mr Jansson still saw reasons for remaining open to the possibility that economic developments will be stronger than predicted in the forecast.

When Mr Jansson argued in favour of a somewhat brighter forecast of economic developments at previous monetary policy meetings he emphasised that this did not necessarily have to have consequences for the decision on the repo rate at the time or the repo-rate path in the future. This is still his assessment. The background to this assessment was that inflation was well below the target and that the risks of overheating were limited. This remains the case today, according to Mr Jansson. In such a situation, the forecast for the development of the economy can tolerate a certain upward revision without this needing to affect the stance of monetary policy.

Mr Jansson also pointed out that, at the earlier meetings, he had made clear that the assertion that monetary policy need not be affected by a brighter forecast for economic developments, rests on the assumption that the risks linked to high household indebtedness, which can ultimately pose a serious threat to macroeconomic stability, do not increase and can be managed. This assessment, as well, applies in the same way today. And given the rather substantial policy easing that the new repo-rate path entails he felt that it was particularly important to underline that this is still the case.

Deputy Governor **Cecilia Skingsley** believed that the proposed repo rate, the revised repo-rate path and the other forecast assumptions will perform the task of gradually returning inflation to 2 per cent during the course of 2015. She therefore supported the repo-rate path and the forecast presented in the Monetary Policy Update.

Since the previous monetary policy meeting in October, the picture of a global recovery has continued to be confirmed. This is still a question of a gradual recovery supported by the continuation of expansionary monetary policy and the reduction of fiscal-policy tightening.

However, it is clear that rates of inflation abroad are low and are actually showing a downward trend in the United States and the euro area. In part this relates to lower energy prices, but even adjusted for this the rate of inflation has fallen in several of

Sweden's important trading partners. It is therefore natural that the draft Monetary Policy Update contains some downward revisions of inflation rates abroad in the years ahead.

When one analyses the recent low inflation outcomes in Sweden it is important to bear this international factor in mind. However, lower-than-expected inflation abroad is not a sufficient explanation of the development of inflation in Sweden in recent months.

Cost pressures in Sweden, measured as the annual percentage change in unit labour costs, have been around 2 per cent in recent years. At the same time, CPIF inflation has been around or below 1 per cent.

It thus appears that businesses have not increased their prices at the same rate as the increase in costs. The fact that businesses see little chance of being able to raise their prices in the near term is indicated, for example, in the Riksbank's latest Business Survey. It is expected that businesses will be more able to increase prices as economic activity recovers, but in the near term it appears that the ability to raise prices is weak.

Ms Skingsley said that there are also good reasons for carefully monitoring price movements in individual sectors, especially considering that the development of service prices has been weak across the board recently. It is traditionally assumed that there is a strong correlation between service prices and labour costs, that the development of productivity in the service sector is weaker than in the manufacturing sector and that the competitive situation is determined by more domestic factors. Put simply, Swedish service prices should be less sensitive to international factors than goods prices, all else being equal.

Several months of data are required to definitely determine whether the weaker price trend relates to temporary factors. However, given the relatively high level of domestic demand in Sweden there is reason to wonder whether the supply of services has become more elastic and whether this explains the weaker price trend in the service sector. Perhaps international influence over price setting is also increasing in the service sector.

International dependence is not only one of the determinants of inflation, it also affects the scope for pursuing an independent monetary policy. During the years with an international financial crisis, a number of central banks have increased their stimulative measures several times and postponed what they judge to be an appropriate time at which to begin a return to more economically-neutral policy-rate conditions. In theory, a floating exchange rate provides a rather high degree of freedom. However, in a relatively synchronised global situation, the degree of freedom is not so high for an economy that is dependent on foreign trade, as is the Swedish economy.

The established historical pattern, in which the krona exchange rate weakened in phases when international demand declined, does not seem to apply as distinctly in this phase of the economic cycle. One way of trying to increase inflation could be to use monetary policy to try to weaken the exchange rate. This would probably require a stronger policy stimulus than that implemented by several of our trading partners, many of whom at present have policy rates close to zero as well as other stimulative measures. However, such a Swedish monetary policy could lead to growing domestic imbalances, not least with regard to indebtedness. This applies in particular as interest rates are already low and have been low for several years.

Ms Skingsley said that recent inflation outcomes, and the composition of inflation in particular, nevertheless indicate a need to add stimulus to the monetary policy conducted. She therefore believed that it is reasonable to cut the repo rate to ensure target attainment within a reasonable period of time, but also to adjust the repo-rate path as there would otherwise be an increasing risk of inflation remaining low for a considerable time.

However, she also said that it will remain important to monitor how the monetary policy conducted in Sweden contributes to the build-up of risks that would mean growth is no longer sustainable in the long term. Ms Skingsley pointed out that at previous meetings she had welcomed the measures taken in the field of macroprudential policy. An ongoing analysis of events and developments is required and it is important that the necessary measures are implemented in order to come to terms with the high level of household indebtedness.

Considering the Swedish mortgage market's relatively high dependence on international capital to fund the expansion of credit, it is important to maintain international confidence in the Swedish economy. Swedish housing prices and the behaviour of the households on the housing market are thus not only of concern to us here in Sweden but also to a range of financial players at home and abroad.

First Deputy Governor **Kerstin af Jochnick** began by saying that she shared the assessment of developments in Sweden and abroad presented in the draft Monetary Policy Update. The data that has become available since the monetary policy meeting in October has largely been in line with the forecast presented at that time. However, there is one exception: inflation in Sweden and abroad has been lower than previously assessed.

Given the fact that inflation has been low, Ms af Jochnick said that it was now reasonable to cut the repo rate by 0.25 percentage points to 0.75 per cent in order to stimulate the Swedish economy and to bring CPIF inflation back to 2 per cent in 2015. She also supported the proposed repo-rate path.

Ms af Jochnick also said that supporting a repo-rate cut to 0.75 per cent had not been an easy decision to make as there is a risk that even lower interest rates will lead to a further increase in household indebtedness. However, she believed that the current proposal represented a reasonable balance as inflation has been significantly lower than forecast in October and is now expected to be lower in the year immediately ahead.

The analysis of the reasons for the low inflation figures makes it clear that service prices, in particular, have increased more slowly than expected during the autumn. Ms af Jochnick said that it is difficult to assess the reasons for the lower rate of inflation but noted that it is obviously difficult for businesses to pass on cost increases to their customers. One reason may be that demand continues to be weak. It may also be the case that the slow recovery in both Sweden and abroad is creating uncertainty so that businesses are refraining from increasing their prices.

Ms af Jochnick agreed with several other members of the Executive Board that there is a need for further analysis in this area in order to better understand the background to the development of service prices and how this development should influence the view of inflation in the period ahead. She also noted that the labour market is continuing to develop relatively well. The number of redundancy notices is lower than it was a year ago and employment has increased somewhat more than forecast in October.

Ms af Jochnick said that she is still concerned about the development of household debt and the problems this may lead to in the long term for the Swedish macroeconomy and financial stability. The low interest rates may reinforce the trend of rising prices for different types of asset. If household indebtedness continue to rise and financial imbalances continue to increase, this will place even higher demands on other policy areas to take action to limit the risks associated with household indebtedness.

The Riksbank's latest Financial Stability Report makes it clear how interconnected the Swedish financial system is with financial systems abroad. Swedish banks are dependent on maintaining a high level of confidence, not least among foreign financiers, in order to fund the households' debts. Ms af Jochnick said that it was important to set up the organisation of macroprudential policy in Sweden and for Finansinspektionen to actively contribute to analyses and proposals concerning macroprudential-policy measures. To date, Finansinspektionen has announced that it intends to raise risk weights for mortgages and that this could reduce household indebtedness. Ms af Jochnick welcomed this stance but said that until the decision is made, and as long as it is unclear when a decision on higher risk weights can come into force, it is highly uncertain what effect Finansinspektionen's declaration of intent will have on the behaviour of the banks and the households.

In the case of macroeconomic developments abroad there have not been any major surprises, with the exception of the lower inflation figures, since the previous monetary policy meeting. However, it is positive for the global economy that significant progress has been made on a budget agreement in the United States following the compromise in the House of Representatives.

In the case of the financial markets, there is still reason to closely monitor the actions taken by the Federal Reserve and any decisions on the tapering of asset purchases. Ms af Jochnick pointed out that market expectations of a decision on the tapering of asset purchases in the summer of 2013 led to a general increase in long-term interest rates. European and Swedish long-term rates also increased. This time, expectations of a more imminent tapering process have given rise to a significantly milder reaction than in the summer.

As she had said at previous monetary policy meetings, she believes that there are good reasons for considering further measures to limit the risk associated with household indebtedness. A major risk when indebtedness is high is that a potential fall in housing prices may lead to a substantial fall in private consumption with negative effects on unemployment and growth.

Monetary policy will continue to take indebtedness in the household sector into account as long as the risks remain high. However, the Riksbank's possibility to influence household indebtedness with monetary policy measures is limited. Nevertheless, it is important in our communication to be clear about the risks that have been identified and that may eventually lead to such problems in the financial system that it becomes difficult to implement monetary policy. If other policy areas fail to take action it will become more difficult for the Riksbank to attain the inflation target, safeguard financial stability and avoid serious repercussions on the real economy in the longer term.

Ms af Jochnick summed up by saying that distinct measures are necessary in the field of macroprudential policy considering the low interest-rate environment in Sweden. Moreover, the European Commission has pointed out that housing production is being hampered by inflexible planning regulations, weak competition in the construction sector and rental regulations. Tax deductions for interest-rate payments have also helped to push up housing prices and household debts. In addition to clear decisions in the field of macroprudential policy, measures are therefore needed to build more housing and to review rental regulations and the taxes and regulations that create the wrong incentives on the housing market.

Governor **Stefan Ingves** began be saying that he shared the description of international developments and the Swedish economy in the draft Monetary Policy Update and that he supported the proposal to lower the repo rate and the repo-rate path that forms the basis of the forecast.

Mr Ingves pointed out that the real economy in both Sweden and abroad is developing in line with the assessment at the previous monetary policy meeting. World trade is growing and global economic activity is improving, but at the same time inflation is generally lower than expected.

The recovery is supported by an increase in various confidence indicators and by a fairly stable situation on the financial markets. However, it is still the case that the recovery is much stronger in some parts of the world than in others. In the euro area the recovery is making only slow progress due to the ongoing debt-consolidation process in the private and public sectors, and inflationary pressures are low. There are brighter signs with regard to credit conditions and the interest rates charged to households and companies. However, there is still a great need to scrutinise and straighten things out in the banking sector, which is hampering the recovery. The situation in the United States continues to improve. Household consumption is increasing and there are signs of a brighter situation on the labour and housing markets. Developments on the other important Swedish export markets have been more or less as expected.

In Sweden, several confidence indicators are higher than their historical averages. Employment has developed somewhat more strongly than expected. The number of redundancy notices is lower than it was a year ago and is now at a low level close to its historical average. The companies have a brighter view of the future. However, some of the hard data that has become available recently is weaker, which makes the picture disjointed.

Last year, goods prices fell fairly substantially while service prices rose by approximately 2 per cent. In recent months, service prices have increased more slowly than expected, while on the other hand, goods prices have not fallen as much.

Mr Ingves pointed out that it is not easy to explain the low rate of inflation. The inflation forecast was revised downwards already in the spring as it was assessed that, given the weak state of the economy, it would be more difficult for the companies to pass on increasing costs to consumer prices. This seems to be an important factor now too. One reason may be that weak demand abroad together with stiff global competition are factors that have limited the margins of the Swedish companies. Another reason may be that domestic demand has been held back by general uncertainty about the future, despite a highly-expansionary monetary policy. The development of prices for goods and services needs to be investigated and analysed further.

Turning to monetary policy, Mr Ingves said that it is important to note that the interest rates charged to Swedish households and companies do not differ significantly from interest rates in other countries where the economies are working relatively well. In his view, the interest rates that are ultimately charged to households and companies are much more important to the impact of monetary policy than implied forward rates.

At the same time as inflation is lower than expected, housing prices and household indebtedness continue to rise. For example, lending for the purchase of tenant-owned apartments increased by approximately 8 per cent in October, and other measures of lending also seem to be increasing. This is helping to make household indebtedness a significant and growing risk. It is true that a number of measures have been announced in the field of macroprudential policy, but the effect of these measures is uncertain.

According to Mr Ingves it is not possible to put a figure on the overall effect of various macroprudential policy instruments, but his assessment is that they are not adequate at present. Macroprudential policy measures aim to dampen the financial cycle, which is much longer than the traditional business cycle. Monetary policy can play its part, regardless of the fact that the traditional analysis model is ill-adjusted to financial stability issues. Several different policy areas need to cooperate to manage financial imbalances. A low level of housing construction, tax deductions and rigidities of various kinds have led to higher housing prices and increased household indebtedness.

As a lot of work remains to be done in the field of macroprudential policy and other areas, monetary policy faces a genuine dilemma. It has become more difficult to achieve the right balance between attaining the inflation target and safeguarding financial stability. It is a difficult task to find a level of the repo rate that makes it possible to manage inflation, support general economic policy and safeguard financial stability. In the present situation it is not possible to fine tune the development of inflation and of financial variables such as lending or the debt ratio. The Swedish economy has become increasingly divided in this respect. Nevertheless, it is of course the case that a repo-rate decision must be made as usual.

In light of the low inflation and the prediction of lower inflationary pressures ahead, the forecast in the draft Monetary Policy Update is based on cutting the repo rate to 0.75 per cent, at which level it is anticipated to remain for about one year. The forecast for the repo rate is lower than in October. Monetary policy is thereby deemed to contribute to CPIF inflation rising towards 2 per cent. At the same time, households' high indebtedness is continuing to form a risk for the economy, making it difficult to find a balance between attaining the inflation target and taking more long-term risks linked to the debt situation into account. However, Mr Ingves' overall assessment led him to support the proposal to cut the repo rate to 0.75 per cent and the proposed repo-rate path.

§3. Discussion

Deputy Governor **Cecilia Skingsley** began the discussion by noting that, due to the recent years' financial crisis, the framework for central banks is being discussed in many countries and in several arenas, for example the academic and the political. Here in Sweden, the discussion has focused on the fact that inflation, measured in terms of the CPIF, has been more or less below the target of two percent since the start of 2011.

One of the points made in the criticism of the Riksbank, or at least of a part of the Executive Board, is that the assignment given to it by the legislators has been misinterpreted. It has been claimed that major differences in how this assignment is seen lie behind the relatively minor differences of opinion on the repo rate.

Ms Skingsley explained that, instead of being ascribed opinions by others, she would prefer to take the opportunity to express how she herself sees the assignment of Executive Board members. Her opinion is that the members of the Executive Board are agreed that their assignment consists of supplying price stability, specified as inflation of 2 per cent.

According to Ms Skingsley, the differences of opinion seem instead to concern how rapidly inflation should be brought back to two per cent. The underlying issues are both in which situations it is acceptable to deviate from the target, and how long the 2-per cent target can be deviated from before the assignment itself can be said to have been neglected.

As part of the description of her view of the assignment, Ms Skingsley wished to remind the Board of what was said in the preliminary work for the Sveriges Riksbank Act at the end of the 1990s. This preliminary work specifies that, as monetary policy has price stability as a goal, the Riksbank ought not to have any explicit subordinate goals. But it also stipulates that the Riksbank, without forgoing price stability, should be able to support the general targets of economic policy. Monetary policy is thus considered able to contribute to the targets of sustainable growth and high employment.

High employment over time assumes long-term sustainable growth, but implementing an economic policy that contributes to sustainable growth is complicated. For Ms Skingsley, it is obvious that the concept of sustainable growth includes avoiding economic policy decisions that increase the risk of shocks and their undesirable effects. For her, it is also therefore reasonable to consider continued rising debt ratios when these decrease households' resilience and thus become a threat against sustainable growth and high employment.

The preliminary work ahead of the Sveriges Riksbank Act also includes descriptions of exceptional circumstances in which the price stability target must reasonably give way to an immediate need to dampen the shock and prevent it from having permanent effects through the use of an active monetary policy. Examples of such exceptional circumstances cited by the preliminary work include war, natural disasters or very severe supply shocks. These are situations in which other adjustment mechanisms do not work.

The text of the bill concludes that no attempt should be made to stipulate in advance the conditions under which price stability must give way. This is because it is difficult to predict all conceivable situations of this kind. Neither were any rules established for how rapidly inflation should be brought back on target. Considering this, Ms Skingsley concluded that the legislators have placed their confidence in the Executive Board of the Riksbank, a confidence she considers that it is capable of living up to.

She went on to argue that, within this mandate, there is room for several views of what is the most appropriate monetary policy and said that she hopes for a more nuanced debate of whether monetary policy lives up to the mandate from the Riksbank's principal.

The inflation-targeting regime largely functions well, but implementing an appropriate monetary policy can occasionally be difficult as it is strongly dependent on forecasts. Ms Skingsley went on to say that forecasting models producing decision-making material that indicates what makes a well-balanced monetary policy have their advantages, but she pointed out that the recurring crises on the financial markets illustrate that the forecasting models are not capable of capturing the stability risks that exist.

When Ms Skingsley studies other central banks, it is clear to her that they are managing different kinds of challenge. The United States and the euro area, whose monetary policy some consider the Riksbank should adopt, focus on managing balance sheet adjustments and weak credit supply caused by current or previous bank problems, which requires a very stimulatory monetary policy. In countries that, like Sweden, would prefer to avoid triggering a crisis, for example Norway, Canada and New Zealand, central bank representatives fully accept that the occurrence of financial imbalances must also be taken into account in monetary policy decisions.

In Sweden, the focus is largely on households and their balance sheets, whether they include risks and whether any such risks are a matter for the Riksbank. Ms Skingsley explained that, just as was made clear by the Riksbank's conceptual framework for financial imbalances in the monetary policy assessment, she considers that the Riksbank must be vigilant regarding the way in which household interest-rate expectations deviate from the long-term equilibrium interest rate. This is because permanent shifts in interest-rate expectations have major effects on behaviour related to indebtedness.

In conclusion, Ms Skingsley noted that she considers that continually developing analyses is part of the mandate from the principal, i.e. the Riksdag. This does not mean being more or less committed to the inflation-targeting regime, but developing it.

Deputy Governor **Martin Flodén** noted that the low and falling level of international inflation had been mentioned several times during the meeting. International inflation is also occasionally taken up in discussions outside the Riksbank as an explanation for the low rate of inflation in Sweden. Mr Flodén pointed out that it sometimes sounds as if the Riksbank is unable to influence Swedish inflation as we are an internationally-dependent country and as low inflation is an international phenomenon that we are hardly able to do anything about.

It is true that international inflation and the rate of change of global export prices have been low for a time. But despite this downward trend, the average trade-weighted rate of international inflation is close to two per cent. And, if individual countries are examined, only a few have had lower inflation than Sweden during and after the financial crisis. This is even though many other countries have been affected by significantly deeper recessions. Of course, falling international inflation could have contributed towards decreasing inflationary pressures in Sweden, but it could hardly have been international inflation that has prevented Swedish inflation from being at around two per cent. In recent years, the Riksbank has made a trade-off between how strongly monetary policy should be used to counteract low inflation and the risks a more expansionary monetary policy would entail for the development of household risks. It seems reasonable to conclude that the consideration paid by monetary policy to household indebtedness, which has thereby held the repo rate higher than it would otherwise have been, has contributed to the low level of inflation.

Mr Flodén went on to refer to Ms Skingsley's observation that monetary policy in Canada, Norway and New Zealand has also considered financial risks, but that the central banks of these countries have not been questioned in the same way as the Riksbank has in Sweden. The explanation for this may be that these countries have not faced the same problematic choice between financial risks on one hand and low inflation and low resource utilisation on the other. In Canada and New Zealand in particular, inflation has been close to each country's inflation target in recent years.

Deputy Governor **Karolina Ekholm** commented on Ms Skingsley's reasoning in her first contribution on the ability of a country with an internationally-dependent economy to conduct an autonomous monetary policy that is not determined by monetary policy abroad. This reasoning is connected with a discussion brought up by a paper by Hélène Rey presented at this year's conference at Jackson Hole and which dealt with what is usually spoken of in terms of the financial trilemma.[2] This trilemma refers to the impossibility of simultaneously having internationally-integrated financial markets, monetary policy autonomy and a stable exchange rate. It is possible to have two of these three things, but all three cannot be attained simultaneously. What Rey points out is that it could be worse than this, namely that it is impossible to achieve monetary policy autonomy by allowing the exchange rate to move because capital movements on internationally-integrated financial markets mean that financial conditions are determined abroad. Ms Ekholm said that there was a lot to be said for this reasoning. In a small open economy like Sweden's, in which monetary policy is conducted on the basis of an inflation target, the monetary policy alternatives are limited by the monetary policies conducted in the large currency areas. They are limited because a domestic monetary policy that deviates greatly from the one conducted abroad has effects on the exchange rate that are not compatible with the chosen inflation target. This has been an important reason for her sustained advocacy of a repo-rate path that is more in line with the expected development of policy rates abroad.

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[2] Hélène Rey (2013), "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence", Federal Reserve Bank of Kansas City.

As regards Ms Skingsley's second contribution, Ms Ekholm agreed that monetary policy should, of course, as far as possible, support the general targets of economic policy and should thus be conducted so as to promote growth and employment. However, the economy is a complex system and there are many factors that influence growth, employment and inflation. This means that monetary policy cannot achieve everything that is desired. It requires a well-considered division of responsibility between different policy areas to attain an overall positive economic development. What is special about monetary policy is that it is the most efficient too for influencing inflation. It is thus important that monetary policy is actively used specifically to stabilise inflation around the target.

Finally, Ms Ekholm commented on what Mr Ingves had said about the interest rates ultimately faced by households and firms being most important for the impact of monetary policy. She agreed with this. But such interest rates with longer maturities are influenced by expectations of future short-term interest rates and thereby by expectations of future monetary policy. This is why it is important to her that the repo rate reflects what she deems is a reasonable forecast for an appropriate repo rate in the future, given the information on the economy available at present.

First Deputy Governor **Kerstin af Jochnick** agreed with Ms Skingsley's observation on the Riksbank's mandate and explained that, for her, it is self-evident that the applied policy is consistent with the mandate of maintaining price stability and promoting financial stability. However, it is very difficult to find a balance when setting the repo rate that allows the inflation target to be attained rapidly enough at the same time as the risks of households' increased indebtedness are considered. The inflation target has worked well and monetary policy is to contribute towards inflation reaching two per cent. At the same time, her assessment is that the low interest rate situation places high demands on several policy areas to identify potential risk accumulation and adopt appropriate risk-prevention measures to maintain financial stability.

Deputy Governor **Per Jansson** opened his contribution to the discussion by emphasising that he agreed with what Ms Skingsley and Ms af Jochnick had just said. This can also clearly be seen in the speech he held a few weeks ago at Svenska Dagbladet's Bank Summit conference.

However, Mr Jansson wished to comment on another matter, namely the development of longer-term inflation expectations. These were not discussed so much at the day's meeting, but have been the subject of a great deal of recent debate and articles outside the Riksbank. Of course, this is an important variable to follow and requires monetary policy to be conducted in such a way as to ensure that long-term inflation expectations do not end up clearly below or above the inflation target. Put simply, the less these expectations vary around the target, the better.

Considering that some commentators had brought attention to the fact that longer-term inflation expectations fell in Prospera's latest survey, Mr Jansson said that there was reason to point out that overall, the expectations are actually very well anchored around the target.

Firstly, expectations only fell for two out of five groups, measured as mean values. For employee organisations, expectations even increased slightly, from 1.8 per cent to 1.9 per cent. This is actually quite interesting, considering that LO often rates highly in evaluations of accuracy of inflation forecasts.[3]

Secondly, measured as mean values and for all groups, expectations indeed fell from 1.9 per cent to 1.8 per cent. But if the figures are examined a little more closely, it can be discovered that more or less the entire difference is due to rounding-off effects. In the previous survey, during the second quarter, the more exact value amounted to 1.862 per cent. The corresponding figure in the latest survey is 1.844 per cent. In other words, the more exact decrease amounts to 0.018 percentage points. Making a big deal of this is "making a mountain out of a molehill", according to Mr Jansson.

Thirdly, the median value for all groups except purchasing managers in the manufacturing sector was exactly 2.0 per cent.[4] And these results for the median value in each group were unchanged from the previous survey during the second quarter.

Mr Jansson's conclusion from all of this was that it required a great deal of pessimism to find any present sign of credibility problems in these surveys of long-term inflation expectations. He emphasised that by no means did he wish to belittle the significance of long-term inflation expectations. The reason he addresses the issue in the first place is that he considers them to be highly significant. But it is important that a nuanced and fact-based debate takes place.

However, those determined to search high and low could possibly claim that the monthly Prospera survey shows certain signs of falling long-term inflation expectations. In this survey, money market participants' expectations fell from 2.0 per cent in November to 1.8 per cent in December. But even here, continued Mr Jansson, the view becomes somewhat more nuanced when the figures are examined more closely. Seen over the period July-December, the November figure appears relatively high, just as the December figure seems relatively low. Compared with the average long-term expected inflation over the period July-November, the decline in December is limited to 0.098 percentage points.

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[3] See Michael Andersson and Stefan Palmqvist (2013), "The Riksbank's forecasts hold up well", Economic Commentary no. 3, Sveriges Riksbank.

[4] Yash P. Mehra (2002), "Survey Measures of Expected Inflation: Revisiting the Issues of Predictive Content and Rationality", Federal Reserve Bank of Richmond Economic Quarterly, Volume 88/3, argues that the median value measures inflation expectations in a better way than the mean value in a study of household inflation expectations.

And neither is this a decrease that signals serious credibility problems. And just as in the quarterly surveys, the median value of the long-term inflation expectations in the monthly survey is throughout exactly 2.0 per cent, concluded Mr Jansson.

Governor **Stefan Ingves** noted that the low interest-rate environment following the financial crisis raises several difficult issues. These include the matter of how companies' allocation of capital will be affected by a long period of low interest rates. How is innovativeness affected by access to cheap funding? Does the risk of bad investments increase in a low-interest environment? Will structural change be hampered? How are financial imbalances included in the analysis? These are questions that have been discussed a great deal in other countries, for example Japan and the United Kingdom, and which may need to be raised in Sweden.

To this can be added that it now seems to be significantly more difficult to use models and data than it was before the financial crisis. How are potential GDP growth and the output gap affected if it takes time to move resources from old to new sectors? What is the neutral real repo rate after the crisis? Is the economy moving towards a new equilibrium?

In conclusion, Mr Ingves noted that, in the period ahead, there will be reason to work more on these important issues and others.

Governor **Stefan Ingves** then summarised the discussion. It was noted at the meeting that the Executive Board agrees on the picture of economic prospects and the inflation outlook described in the Monetary Policy Update.

Economic developments in Sweden and abroad have been largely in line with the Riksbank's forecasts for some time now. However, inflation has been lower than expected. Over the coming year, the Swedish economy is expected to show a more tangible improvement. GDP is expected to accelerate and during the latter part of 2014 unemployment will fall faster. Despite the economic recovery, inflationary pressures are now expected to be much lower over the coming year than was forecast in October. The reasons for the lower inflationary pressures include the halt in the increase in service prices recently and the broad downturn in these prices. A more expansionary monetary policy and rising resource utilisation will mean that CPIF inflation increases to 2 per cent in 2015. Indebtedness among Swedish households will remain high, which makes the economy vulnerable to shocks.

Given the low inflationary pressures, all of the members agreed that it is appropriate to cut the repo rate by 0.25 percentage points to 0.75 per cent and to adjust the repo-rate path downwards. The repo rate path suggests a slightly greater likelihood of a further cut, rather than a raise, in February next year, although the most likely scenario is that the repo rate will remain at the same level of 0.75 per cent until the start of 2015, before slowly starting to rise again. In this way, monetary policy will contribute to CPIF inflation rising towards 2 per cent. Towards the end of 2016, the repo rate is expected to amount to 2.6 per cent.

Among other matters, the risks linked to household indebtedness were discussed at the meeting. The need to implement macroprudential policy measures was emphasised, as was the importance of several policy areas cooperating to reduce these risks. Moreover, there was discussion of the links between inflation in Sweden and inflation abroad, possible reasons for the low rate of increase of service prices, how monetary policy in other countries affects the conditions for monetary policy in Sweden and how inflation expectations develop in Sweden.

§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 17 December 2013, at 9.30 a.m.,
- to lower the repo rate by 0.25 percentage points to 0.75 per cent and that this decision would apply from Wednesday 18 December 2013,
- to publish the decision above at 9.30 a.m. on Tuesday 17 December 2013 with the motivation and wording contained in a press release, and
- to publish the minutes of today's meeting on Wednesday 08 January 2014 at 9.30 a.m.

This paragraph was verified immediately.

Minutes by

Ann-Christine Högberg

Verified by:

Karolina Ekholm	Stefan Ingves	Per Jansson
Kerstin af Jochnick	Martin Flodén	Cecilia Skingsley

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