Minutes of Monetary Policy Meeting

SEPTEMBER 2014

Summary

At the Monetary Policy Meeting on 3 September, the Executive Board of the Riksbank decided to leave the repo rate unchanged at 0.25 per cent.

It was noted at the meeting that the Executive Board agreed on the picture of economic prospects and the inflation outlook described in the draft Monetary Policy Update.

Growth in the world as a whole is expected to gradually increase in the years immediately ahead, although the recovery will proceed at different rates. The economic signals from the United States and the United Kingdom remain strong, but at the same time a somewhat more sluggish recovery is expected in the euro area, partly as a result of the ongoing conflict in Ukraine. This will also dampen GDP growth in Sweden somewhat compared to the forecast in the Monetary Policy Report published in July.

However, the development of the labour market over the summer has been slightly stronger than expected and unemployment has begun to fall. Inflation remains low, although it has been somewhat higher than expected in recent months. The inflation forecast has been revised upwards slightly in the near term due to a weaker krona and somewhat higher labour costs.

On the whole, the economic and inflation prospects for the Swedish economy are the same as in July. Inflation remains low and the Executive Board agreed that the repo rate needs to remain at 0.25 per cent for inflation to rise towards the target. The assessment of the Executive Board was that it will not be appropriate to raise the repo rate until late 2015. With the adopted monetary policy, CPIF inflation is expected to gradually rise and to reach 2 per cent in early 2016.

At the same time, several members of the Executive Board noted that the low interest rates mean that there are still risks associated with the high level of household indebtedness and that it is necessary that other policy areas take measures to manage these risks.

Several members discussed the role of the repo-rate path in slightly different ways in light of the unusually high degree of uncertainty that prevails concerning economic and monetary-policy developments abroad.

Some members also discussed how monetary policy should react to new information and concluded that monetary policy should react asymmetrically in the near term so that new information that indicates higher inflation than expected does not necessarily have to lead to a less expansionary monetary policy.

MINUTES OF MONETARY POLICY MEETING
Executive Board, No. 4

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DATE: 03/09/2014

TIME: 09.00

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

Meredith Beechey Österholm
Claes Berg
Carl-Johan Belfrage
Charlotta Edler
Heidi Elmér
Mattias Erlandsson
Eric Frieberg
Christoffer Grände (§§ 1-3)
Ann-Christine Högberg
Martin W Johansson
Henrik Lundvall
Ann-Leena Mikiver
Carl-Fredrik Pettersson (§§ 1-3)
Maria Sjödin
Ulf Söderström
Sara Tägtström
David Vestin

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

§1. Economic developments

Carl-Fredrik Pettersson of the Markets Department began by presenting the latest developments on the financial markets. Since the Monetary Policy Report was published in July, interest rate differentials have continued to widen between the United States and the United Kingdom on the one hand and the euro area on the other. The market has above all reacted to the fact that the President of the European Central Bank, Mario Draghi, when speaking at the Jackson Hole Symposium in the United States recently, signalled an increased readiness to take further action to counteract falling inflation expectations in the euro area. This is in contrast to the market's expectations of a gradual normalisation of monetary policy in the United States and the United Kingdom. Financial markets have been relatively stable with rising share prices despite a crisis-hit Portuguese bank, Argentina's suspension of payments and weaker growth prospects in the euro area. The krona has weakened by almost 1 per cent in trade-weighted terms in recent weeks following unexpectedly weak Swedish macro statistics. Analysts believe that the repo rate will be left unchanged at today's monetary policy meeting but that the Riksbank will continue to signal a marginal probability of a cut during the autumn. Expectations according to market pricing are that the time of the Riksbank's first repo-rate increase will be moved forward.

Ulf Söderström, Acting 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. He began by noting that the forecasts in the Update were discussed by the Executive Board at meetings held on 27 and 28 August. The draft Monetary Policy Update was tabled at a meeting of the Executive Board on 1 September.

Although there are differences in the rate of growth in different countries, growth in the world as a whole is expected to gradually increase in the years immediately ahead. Signals regarding economic activity from the United States and the United Kingdom are still strong. Unexpectedly weak GDP growth during the second quarter in the euro area, plus the anticipated negative effects of the conflict in Ukraine, have led to the forecast for GDP growth in the euro area being revised downwards for this year and next year. The forecast for international GDP growth is therefore somewhat lower than the assessment in the July Monetary Policy Report.

Lower growth in the euro area will dampen the already weak development in exports in Sweden. This contributes to the assumption that GDP growth will be somewhat lower compared with the assessment in July. At the same time, the household sector has developed strongly and consumption and housing investment are expected to continue to increase at a good pace. The labour market has surprised on the upside during the summer, and a continuing improvement is expected, with rising employment and falling unemployment.

Inflation remains low, but was slightly higher than expected in June and July. Compared to the Monetary Policy Report published in July this year, the forecast for inflation in the near term has been revised up marginally as a result of a weaker krona and slightly higher labour costs. CPIF inflation is expected to reach 2 per cent at the beginning of 2016, as was forecast in July.

The repo rate needs to remain low for a long period of time for inflation to rise towards the target. The forecasts in the draft Monetary Policy Update are conditional on the repo rate being left unchanged at 0.25 per cent at today's meeting and, as in the previous forecast, on repo-rate increases beginning no sooner than the end of 2015 when inflation is significantly higher.

§2. The economic situation and monetary policy

Deputy Governor **Karolina Ekholm** began by saying that she supported the view of economic prospects presented in the draft Monetary Policy Update and the proposed repo-rate path, which is the same as the one adopted by the Executive Board in July apart from a marginal downward revision towards the end of the forecast period.

She said that the information on the development of the real economy in Sweden and abroad published since the Monetary Policy meeting in July has been something of a disappointment. The euro area, which is so important to the Swedish economy, had almost zero growth in the second quarter of this year. In Sweden, GDP growth was a moderate one percent in the same period in annualised terms, with exports and corporate investment being the main contributors to this subdued development. Ms Ekholm emphasised that this information is based on flash estimates and that it may be revised going forward. Labour market surveys suggest that the labour market has developed somewhat more strongly than the Riksbank expected in July, which is positive and indicates that a more distinct fall in unemployment is perhaps in the pipeline. Confidence indicators provide no clear picture of developments ahead and are most likely affected to some extent by the uncertainty concerning the situation in the euro area, where weak growth, low inflation and high levels of debt in some areas constitute a mix that makes it difficult to bring about a development that is sustainable in the long run. The situation in Ukraine and the possibility of further trade sanctions against Russia are factors that are contributing to uncertainty about developments in Europe at the moment. However, these are factors over and above more fundamental problems about which there is uncertainty concerning how they should be resolved.

A positive factor from the Riksbank's point of view is that Swedish inflation outcomes have surprised on the upside compared to the July forecast. Inflation figures are still well below the inflation target of 2 per cent. Nevertheless, Ms Ekholm saw this as a glimpse of light at the end of the tunnel, not least because it breaks the tendency towards systematic overestimates of inflation that has marked the Riksbank's forecast for some time. This tendency has led to a distorted picture of the costs and benefits associated with different monetary policy alternatives. It has seemed as though the costs for conducting a less expansionary monetary policy have been limited as, according to the forecasts, inflation would approach the target of 2 per cent quite rapidly. In reality the costs of an inflation rate that has remained below the target for a considerable time have been rather high, at least in her view.

In July, the Executive Board decided to attach more weight to models than to judgement-based assessments in the inflation forecast, as it has become apparent that the models provide relatively good forecasts according to forecast evaluations carried out at the Monetary Policy Department. This change may have eliminated the tendency towards systematic overestimations of future inflation that the forecasts have shown for a time. Ms Ekholm believed that it was an important task for the Riksbank to analyse what can be done to reduce the risk of such systematic forecast errors in the future. In any case, she viewed it as a positive development that the latest forecast errors have entailed an underestimation rather than yet another overestimation. It is of course important that the Riksbank bases its decisions on forecasts that are relatively accurate. However, Ms Ekholm said that it was even more important that the decisions are based on forecasts that do not exhibit bias in the sense that the forecasting errors tend to have the same sign all the time. This is because biased forecasts provide an incorrect picture of the trade-offs facing the decision-makers.

Ms Ekholm said that, all-in-all, developments since the July meeting do not justify any significant revision of the prospects for economic activity and inflation. There is thus no reason to change the stance of monetary policy. As inflation is so low and there are a number of risks on the downside, her view was that there are still reasons for attaching a higher probability to a repo-rate cut than a repo-rate increase in the near term.

The repo-rate path indicates a first repo-rate increase towards the end of 2015. According to market pricing, it is expected that both the Federal Reserve and the Bank of England will already have increased their policy rates by then, while the European Central Bank is expected to continue to hold its most important policy rate close to zero for some time to come.

A critical question that must be addressed with regard to the repo-rate path is how probable it is that the Swedish repo rate will be able to deviate by up to two percentage points from the European Central Bank's policy rate, as is now assumed in the forecast.

It is assumed that a rather substantial increase in the interest differential is compatible with an exchange-rate forecast in KIX terms that entails a strengthening of the krona, but not by so much that it pushes inflation down below the target. Personally, Ms Ekholm was, as on previous occasions, somewhat sceptical about whether the repo rate can deviate significantly from policy rates abroad without this affecting the exchange rate in a way that is incompatible with the inflation forecast. However, if the policy rates in the United States and the United Kingdom have risen somewhat at the same time as the Swedish economy exhibits strong growth, markedly lower unemployment and an inflation rate close to 2 per cent, which is the current forecast for the situation at the end of 2015, it is at the same time difficult to believe that the repo rate would then remain at today's low level.

Ms Ekholm therefore supported the forecast with an increase in the repo rate from the end of 2015 and a level of just over 2 per cent at the end of the forecast period. The level of the repo rate at the end of the period has been revised downwards slightly compared to the forecast in July given that the recovery in the euro area appears to be progressing more sluggishly than expected and that the European Central Bank's monetary policy can thus be expected to remain expansionary for a longer period. If the forecast for inflation in the euro area is revised downwards or the forecast for the value of the krona in KIX terms is revised upwards, this in itself will be an argument for an even lower repo rate at the end of the forecast period, according to Ms Ekholm. At the same time, she emphasised that there are many factors that may lead to future revisions of the repo-rate path, both upwards and downwards.

She continued by stressing that she views the monetary policy conducted abroad as an absolutely central precondition for monetary policy in Sweden. Some of the analysts who were surprised by the repo-rate cut of 0.5 percentage points in July seem in her opinion to have ignored the impact of events abroad and only focused on the fact that the development of the real economy in Sweden is, despite everything, not so bad and should eventually lead to rising inflation. However, Sweden cannot have significantly higher policy rates than the United States and the euro area without risking the krona strengthening in a way that is incompatible with getting inflation to rise to the target of 2 per cent. At the same time, bringing inflation up to the target is necessary in a situation where it has undershot the target for a long time, as long-lasting deviations threaten the credibility of the inflation target and risk reducing its value as a nominal anchor in the economy. It is the Swedish economy's strong international dependence that explains why the Riksbank's forecast is a repo rate of just over 2 per cent at the end of the forecast period despite the fact that growth is then expected to be around 3 per cent, unemployment around 6.5 per cent and CPIF inflation around 2 per cent. The Executive Board thus expects a repo rate that is well below what can be regarded as a long-run normal level at the same time as the macroeconomy is more or less in balance.[1] The

[1] See the article "What is a normal repo rate?", Monetary Policy Report February 2010, for a discussion of the level of a long-run normal repo rate.

reason for this is that this is what is required if the Swedish economy is to be able to achieve macroeconomic balance when policy rates abroad are expected to be so low. As Ms Ekholm suggested earlier, it may turn out that the repo rate needs to be even lower than this if monetary policy in the euro area remains extremely expansionary for a long time.

Deputy Governor **Martin Flodén** began by saying that he supported the proposed repo-rate decision, repo-rate path and the forecasts presented in the draft Monetary Policy Update.

Economic developments in Sweden and abroad have largely been in line with the forecasts in the Monetary Policy Report published in July. The repo-rate cut of 0.50 percentage points in July has also had more or less the expected effects on market rates and exchange rates. Mr Flodén's assessment was therefore that it was appropriate at today's meeting to continue to follow the direction for monetary policy adopted at the previous meeting and that there were good prospects that this expansionary monetary policy would contribute to inflation approaching the target within the year ahead. But it is important for monetary policy to maintain its focus on the development of inflation and to continue to react to developments that may otherwise counteract inflation rising quickly enough.

The most important deviations from the forecasts in the Monetary Policy Report published in July are weaker economic developments in the euro area and somewhat higher inflation in Sweden. The weaker economic climate in Europe will contribute to a weakening of Swedish exports and consequently to somewhat lower inflationary pressures in Sweden at the end of the forecast period. The forecast for the repo-rate path in the draft Monetary Policy Update has therefore been revised downwards slightly from mid-2016 and onwards.

The somewhat higher inflation outcomes for June and July, in combination with a forecast of a slightly weaker krona exchange rate in the near term, have led to an upward revision of the inflation forecasts for the coming quarters. But this upward revision has not led to any adjustment of the forecast for monetary policy in the near term.

Mr Flodén noted that the forecast changes he had just mentioned are small and may seem not worth commenting on. Nevertheless, they illustrate the situation that Swedish monetary policy now finds itself in, where the focus on attaining the inflation target is of utmost importance at the same time as the repo rate is close to its lower limit. In this situation he believed that monetary policy in the near term should react asymmetrically to new information on the development of inflation. It may be necessary to make monetary policy more expansionary, by cutting the repo rate or postponing the first increase, if new information is received that leads to a lower forecast for inflation in the short and medium term. If new information is received that leads to a higher inflation forecast at the same time horizons, it is on the other hand not so evident that monetary policy should be made less expansionary.

Mr Flodén went on to explain why he believes it is appropriate to react asymmetrically in this situation. As we all know, inflation has been too low for several years. As he has said at previous monetary policy meetings, the scope for surprises on the downside of inflation is now limited. The short and medium-term development of inflation must now be prioritised in order to maintain confidence in monetary policy and the inflation target. Monetary policy must ensure that inflation moves towards the inflation target reasonably quickly even if inflationary pressures prove to be surprisingly low going forward. In principle, this statement could justify an even lower repo rate than 0.25 per cent today. It would then be possible to present an inflation forecast that in a main scenario clearly overshoots the target of 2 per cent and where inflation would attain the target even if it surprises on the downside. As the repo rate is close to its lower bound, such a monetary policy strategy may be difficult to formulate in practice. However, one step in that direction is to adopt a wait-and-see attitude to new information that indicates higher inflation in the short and medium term.

Another reason for letting monetary policy react asymmetrically in this situation is more directly linked to the fact that the repo rate is close to its lower bound. As the repo rate cannot be cut much more because of the lower bound, it is appropriate to wait for a substantial amount of new information before beginning to raise the repo rate. Otherwise, expectations that the repo rate can now only move in one direction may generate an unwarranted increase in medium-term market rates.

A natural follow-up question is what economic development is required to raise the repo rate. Mr Flodén pointed out that the forecasts in the draft Monetary Policy Update are that the repo rate will remain at 0.25 per cent at the same time as inflation will rise rapidly towards the target, growth will be good and unemployment will fall. He wanted to particularly highlight that, according to the forecasts, the repo rate will be raised at the end of next year and that CPIF inflation will then have been above 1.5 per cent for more than six months, at the same time as underlying inflation measured in terms of the CPIF excluding energy will have been close to 2 per cent.

Mr Flodén did not wish to commit himself to saying that this exact scenario must materialise before the repo rate can be raised. Decisive factors for his decision on this issue will be what the inflation forecast looks like and the assessment of how certain it is that inflation is and will remain at a level that preserves confidence in the inflation target. As at the monetary policy meeting in July, he believed that a repo-rate increase may be considered when CPIF inflation and other measures of underlying inflation have approached 2 per cent at the same time as various measures of inflation expectations have increased.

Deputy Governor **Per Jansson** began by saying that he also supported both the macro forecast and the monetary policy presented in the draft Monetary Policy Update. Despite a slight downward revision of the growth prospects in Sweden and abroad, the new information in this forecast is mainly positive. This is because it strengthens the arguments for inflation increasing in the period ahead. There are above all two circumstances in the forecast that lead to this conclusion.

First, the inflation outcomes have for once been a surprise on the upside for a couple of months now. It may seem a little strange to interpret a forecasting error as something positive. But given that inflation has been below target for a long time this is actually something to be pleased about. It is after all, argued Mr Jansson, more important that the Riksbank attains the inflation target than that the forecasts are perfectly accurate.

The outcome for CPIF inflation in July was just over 0.6 per cent. This was almost 0.3 percentage points higher than expected. Inflation was somewhat above the forecast in the Monetary Policy Report already in June, but the outcome for July reinforced this tendency. One should of course not exaggerate the positive in such a short-term development. But after several months of systematic overpredictions of inflation it is naturally something of a relief, said Mr Jansson. All else being equal, these positive inflation surprises mean that it has now become a little more likely that the forecast of a more lasting upturn in inflation will de facto happen.

Second, the assessment of some of inflation's more fundamental driving forces has been adjusted upwards. According to the forecast in the draft Monetary Policy Update, unit labour costs will now grow significantly faster in the coming years than was previously assumed. In 2014 and 2015, they will increase by 2.3 per cent and 2.2 per cent respectively, which is over 0.5 percentage points higher on average than the forecast in July.

Moreover, the prospects for the development of the Swedish krona have become more favourable, at least in the near term. In effective terms, based on the so-called KIX weights, the forecast for the krona's exchange rate is revised upwards by almost 2 per cent for the fourth quarter of this year and by over 1 per cent on average for next year. This weakening is largely due to the fact that the US dollar is expected to become somewhat more expensive than was previously assumed. From this perspective, there is potential for a further weakening of the krona in trade weighted terms if, for example, the euro, for various reasons, becomes more expensive than now assumed in the draft Monetary Policy Update. Also these changes of course mean that, all else being equal, it is more likely that the more lasting upturn in inflation will actually take place.

However, despite the bright spots he had just mentioned, Mr Jansson said that it becomes clear when looking at the overall picture for inflation that there is no reason as yet to jump for joy, or at least not too high. Inflation is still well below the target and it is too early to conclude that it is exhibiting an increasing trend. Current developments can be expected to reduce the risk of further falls in more long-term inflation expectations, but a continued rise in inflation is required over a longer period of time before we can begin to regard the situation as being more normal.

In order to generate the greatest possible credibility concerning his ambition to really achieve such a situation, Mr Jansson has promised not to vote for a repo-rate increase before inflation picks up and exceeds 1.5 per cent. He intends to continue to stick to this promise. The forecast in the draft Monetary Policy Update entails the Riksbank observing outcomes for CPIF inflation exceeding 1.5 per cent for just over six months before initiating cautious increases in the repo rate. This is roughly the course of development that Mr Jansson perceives to be compatible with his promise and he emphasised that this promise is unconditional, that is it applies irrespective of the development of other variables that under normal circumstances may matter for monetary policy.

So, under what conditions could a further easing of monetary policy be considered? And how would this be done now that the repo rate is already so low? In both the Monetary Policy Report published in July and in the draft Monetary Policy Update, the Executive Board has made it clear that any further easing of monetary policy will in the first instance be undertaken by continuing to cut the repo rate and by postponing the date of a first increase. If this proves to be insufficient there are further measures to make monetary policy more expansionary. In this way, said Mr Jansson, the Riksbank is fully prepared to act should the need arise.

With regard to circumstances that could lead to the need to make monetary policy more expansionary, Mr Jansson said that it is self-evident that a new deterioration in the prospects for inflation comes first. The upturn in inflation that has now taken place has improved the situation somewhat, but in his view the scope for inflation surprises on the downside remains very limited.

In conclusion, Mr Jansson wished once again to underline that the Riksbank's strong focus on now achieving rising inflation does not mean that the risks associated with household debt have suddenly disappeared. On the contrary, these risks remain highly tangible and it is probable that they will increase in the period ahead. The rapid increase in housing prices is a contributory factor in this context. At present, however, the Riksbank has no scope to help out in this area, at least not by adjusting the repo rate. As pointed out in the draft Monetary Policy Update, other policy areas must therefore bear a greater burden. And measures must now be taken urgently, both in the field of macroprudential policy to dampen the households' demand for loans and in the field of housing policy to achieve a larger and more varied supply of housing.[2]

First Deputy Governor **Kerstin af Jochnick** began by saying that on the whole she shared the assessment of developments in Sweden and abroad presented in the draft Monetary Policy Update. She supported the proposal to hold the repo rate at 0.25 per cent.

She also supported the forecast that the recovery abroad will continue, even though the figure for growth in the euro area has been revised downwards as a result of weaker outcomes and the impact of the conflict between Russia and Ukraine. At the same time, the economic signals from the United States and the United Kingdom have continued to be strong and are bright spots.

As several members of the Executive Board have already mentioned, the GDP forecast for Sweden has been revised downwards somewhat due to weaker outcomes and the slackening of exports due to the slowdown in the euro area. Inflation in Sweden is still low but is expected to rise towards the target at the end of the forecast period as a result of an expansionary monetary policy and rising resource utilisation, which will make it easier for the companies to increase their prices.

However, in the case of the repo-rate path Ms af Jochnick thought that the situation was difficult to assess at present.

She did not intent to enter a reservation against the proposed repo-rate path but wished to highlight several difficulties associated with making a repo-rate forecast for as long a period as three years in the current situation. The repo-rate path is the Riksbank's way of showing the interest rates that have been used in the forecasts in the material on which the monetary-policy decisions are based. Under more normal conditions, Ms af Jochnick believes that the repo-rate path fulfils an important purpose by openly and transparently communicating the Riksbank's assessment of the repo rate in the period ahead to the market. Given that she sees several considerable uncertainties at present, she wanted to be a little more cautious about putting too much focus on the repo-rate path going forward.

There are above all four factors that she believes may have a significant impact on future repo-rate decisions and that are particularly difficult to forecast at present. First, it is obvious that geopolitical tensions have increased, but it is very difficult to make more detailed forecasts of the effects of the conflict between Russia and Ukraine on Sweden. There are signs of how declining trade between Russia and countries close to Sweden are affecting growth. Economic development was already weak in Finland, but is now being affected even more negatively by the European Union's sanctions on Russia and Russia's

[2] Measures of this kind are also called for in the IMF's Article IV consultation for Sweden. See http://www.imf.org/external/pubs/ft/scr/2014/cr14261.pdf.

counter-sanctions. The Baltic countries and Germany are also being affected negatively. There is a risk that the Swedish economy will also be affected more than has been assumed in the forecasts as yet, due to Sweden's extensive trade with countries in Europe.

Second, it is difficult to assess developments in the euro area. According to Ms af Jochnick, downside risks had increased since July. Balance sheet adjustment in the private sector is proceeding much slower than in the United States. There is a risk of weak growth and low inflation for a longer period than in the Riksbank's scenario, even if one disregards geopolitical risks.

This risk is compounded by developments in the European banking system. At the moment an Asset Quality Review is in progress for the European banks. Stress tests of the banks are also underway. The results are not yet ready. But the problems in Portuguese, Bulgarian and Austrian banks that have been revealed during the summer show that there are still problems in the European banking system. The granting of credit from European banks to companies and households continues to fall albeit at a lower rate, although credit standards have been eased somewhat. An important issue that must be resolved is whether to capitalise or restructure European banks so that they can support the real economy.

The third area concerns foreign policy rates. According to assessments of the market, it seems likely that policy rates will be raised first in the United Kingdom, then in the United States and finally in the euro area. Major central banks are thus in different phases as regards the timing of the first increase of policy rates. But it is not possible to know with certainty when other central banks will raise their policy rates. However, for the Swedish economy, the krona's development will be an important factor affecting inflation. The krona exchange rate is therefore a central variable for monetary policy, according to Ms af Jochnick. For her, it is important that monetary policy does not contribute towards an even greater appreciation of the krona than is now assumed in the forecast. According to her, this suggests that the Riksbank may need to wait with any repo rate increases until the Executive Board knows more about what other central banks will decide on their policy rates and any further complementary monetary policy measures.

Fourthly, monetary policy over the years ahead must take a stance on both fiscal policy and macroprudential policy measures in Sweden. In both areas, it is possible that the effects on private consumption will be greater than assessed at present. If so, this may dampen demand in the Swedish economy and, ultimately, also inflation and thereby affect the assessment of the level of the repo rate in the long run. It is difficult to believe that increased amortisation requirements or reduced tax relief would not restrain consumption.

If the budget surplus target is to be achieved in 2018, fiscal policy will have to be tightened, regardless of the composition of the new government after the general election. This could be achieved by increasing public revenues or by reducing expenditure that undermines public commitments. This also entails the risk of a dampening of private consumption.

As well as these uncertainty factors, Ms af Jochnick also wished to mention sentiments among companies and households. The latest Economic Tendency Indicator from the National Institute of Economic Research notes that sentiment is currently dampened among Swedish households. This could be a temporary note, but it could also be an effect of discussions on measures to bring indebtedness down. It could also be an effect of the increased international unease and uncertainty over the political situation in Sweden during the autumn.

Of course, for several years, one reason for the slow recovery in Sweden has been companies' uncertainty over the outlook, which is holding investment back. There is an ongoing risk that this uncertainty will lead to more cautious households and companies. Lower growth in consumption and investment will lead to the weaker development of demand in the economy, which could also affect inflation.

Even if Ms af Jochnick largely agrees with the assessment of the draft Monetary Policy Update, she says that there are clear downside risks for the Swedish economy. One precondition for the Riksbank to be able to decide on an initial repo rate rise at the end of 2015, as indicated by the repo rate path, is for the Swedish economy to develop relatively well and for none of the downside risks she mentions to take root.

In her assessment, all in all, this entails a risk that monetary policy in Sweden may need to be expansionary for a longer time than the repo rate path in the draft Monetary Policy Update indicates if the inflation target of 2 per cent is to be attained.

The highly expansionary monetary policy places great demands on other policy areas to act promptly to dampen household indebtedness. Ms af Jochnick notes that the prevailing low interest rate situation is contributing towards higher prices on the housing market. Price increases for tenant-owned apartments are now at 14 per cent at an annual rate. This is also a very high rate of increase in real terms as consumer price inflation is so low. The high rate of price increases will also be accompanied, according to Ms af Jochnick, of increased indebtedness for households.

If households deem that the low interest rate situation will be prolonged, this will additionally create an incentive for them mainly to take loans with variable interest rates. About 80 per cent of new loans are now granted with variable interest rates and about 55 per cent of the mortgage stock is at variable interest rates. This means that household are becoming increasingly vulnerable. Ms af Jochnick shares the view expressed by the International Monetary Fund (IMF) in its latest Article IV report for Sweden, that households' high indebtedness is a potential source of problems for the Swedish economy. The Government and central government agencies therefore promptly need to adopt appropriate measures to dampen indebtedness according to Ms af Jochnick.

Deputy Governor **Cecilia Skingsley** began by saying that she supported the picture of economic developments and the monetary policy trade-offs described in the draft Monetary Policy Update.

The situation outlined in July of a successive global economic recovery still holds. However, the risk factors against the recovery have increased and changed character slightly since then. She therefore considers it reasonable for the Riksbank to revise its view of the rate of recovery in the euro area downwards.

The conflict in Ukraine and escalated trade restrictions between Russia and the European Union are a growing element of uncertainty for recovery of the euro area, which must still be described as fragile. Political developments concerning Ukraine are difficult to assess and so, therefore, are the economic consequences, but Ms Skingsley considers that downside risks dominate, particularly for important Swedish trading partners like Germany and Finland.

However, since the meeting in July, positive factors have also arisen for global economic prospects, noted Ms Skingsley. The development of the financial markets shows slightly rising volatility, but this is from low levels. According to her, the fact that neither a suspension of payments in Argentina nor a bank failure in Portugal – themselves serious developments – have had any more serious negative contagion effects is an encouraging sign.

Furthermore, uncertainty over the US economic recovery has decreased since it became clear that the first quarter's weak GDP outcome was related to weather and was temporary. Economic signals are strong and the forecast is for continued strong growth in the United States.

In the Swedish economy, the household sector continues to play an important role for demand. The downward revision of export growth and the consequent weak industrial activity in this forecast are linked to a slightly weaker assessment of the international recovery than at the July meeting. This is largely due to continued weak economic development, but also to structural shifts meaning that some production, and thus jobs, will not return in their previous form. Monetary policy can stimulate economic recovery. However, the consequences of various types of structural change in the industrial sector, as far as this is appropriate, are best dealt with by other policy areas.

The interest rate level in Sweden is expected to remain low for a long time. Combined with the highest house price expectations, as regards the net figures in SEB's Housing Price Indicator, among households since 2007, this suggests that indebtedness in relation to household income will continue to rise. A higher interest rate level could marginally slow this down, but it would also extend the time until the inflation target is fulfilled.

According to Ms Skingsley, to avoid the household sector becoming increasingly economically vulnerable it is important to adopt a mix of measures in which low interest rates are combined with measures to reduce households' willingness to take on further debt. Put simply, the recovery will be stronger if low interest rates are channelled, for example, to more investments and more consumption of goods and services instead of more mortgage deeds.

Anchored inflation expectations are a central part of price and wage formation in the economy. As inflation has been low on a broad front for some time, the Riksbank made a strong monetary policy signal at its July meeting to emphasise the importance of fulfilling inflation targeting within a reasonable time. Since then, the development of inflation has generally developed in line with the forecast, with forecast deviations being at a reasonable level.

Ms Skingsley concluded by saying that the proposed interest rate path entails an appropriate monetary policy consideration in which weaker international prospects are reflected by a slight downward adjustment of the repo rate at the end of the forecast period. As with her assessment from July, she considers that the current proposed forecasts and decisions entail sufficiently rapid target fulfilment.

If a situation were to arise in which monetary policy would need to become even more expansionary, it is her assessment that there is further marginal scope to cut the repo rate as well as the possibility of delaying and changing the timing of future repo rate increases. Reasons for further stimulation from monetary policy could, for example, be if long-term inflation expectations were to fall rapidly or be significantly below the 2-per cent level. Another reason for why she could support further stimulation would be if, for some reason, the Riksbank's forecast for a stronger krona over the longer term were to be realised sooner or with greater force than assumed.

Governor **Stefan Ingves** began by saying that he shared the view of developments abroad and the Swedish economy in the draft Monetary Policy Update. He also supported the proposal to allow the repo rate to remain unchanged at the day's meeting.

Mr Ingves went on to explain that he did not intend to enter a reservation against the proposed repo rate path but wanted to discuss a few fundamental difficulties in making a forecast for the repo rate over a longer horizon in this situation.

The forecast in the draft Monetary Policy Update is based on the assumption of a continued international recovery. However, growth in the euro area is somewhat more sluggish than anticipated in July. Balance sheet adjustments are proceeding altogether too slowly in the euro area, impeding a recovery. More probably needs to be done in terms of the banks and, until this happens, monetary policy will have less of an impact than otherwise. The increased geopolitical unease concerning Ukraine is also dampening growth somewhat in the euro area. In the United States and the United Kingdom, on the other hand, the economic situation is improving.

All in all, the forecast means that international demand is contributing to growth in the most important countries for Sweden of 2 per cent this year, gradually increasing to just under 3 per cent in 2016.

Inflation continues to be low internationally and the price of oil has become lower than in the July forecast, despite increased geopolitical unease. More expansionary monetary policies in several countries are deemed to be contributing to KIX-weighted inflation rising to just over 2 per cent at the end of the forecast period. Once again, we see a slow but gradual normalisation ahead of us.

In Sweden, GDP growth is deemed to be slightly weaker than in the July forecast. The weakening of the euro area is contributing towards exports growing slightly more slowly. Growth for this year has also been revised downwards due to a weaker GDP outcome for the second quarter than was assumed in July. However, the development of the labour market has been stronger than expected.

Inflation remains low in Sweden, but has been slightly higher than in the forecast from July. The krona has become slightly weaker than the Riksbank was expecting in July, which will contribute to marginally higher inflation in 2015. Inflation is expected to rise over the forecast period due to expansionary monetary policy and greater opportunities for companies to increase prices. The development of prices in the services sector seems to have stabilised at the same time as prices of goods are not falling as much as previously. By the end of 2014, the weak outcome during 2013 will no longer be affecting inflation. A fairly rapid rise of CPIF inflation is expected by this point. It would not be surprising if forecasts were wrong on a monthly basis here, even if inflation is developing in one direction only.

A large and unfortunately lasting concern is provided by the imbalances on the housing market in Sweden, which has contributed to increased indebtedness for households. Housing prices are expected to continue to increase over the forecast period. Furthermore, the forecast suggests that debts will increase faster than incomes. Household debt as a percentage of disposable income will therefore increase. If the debts of tenant-owner associations are added, the level of indebtedness will be even higher. This development is unsustainable and raises the risk level of the Swedish economy.

Mr Ingves then explained that he wanted to say a few words on the challenges facing monetary policy. The proposed repo rate path is largely the same as in July. A marginal downward revision has been made at the end of the forecast period. However, Mr Ingves' opinion is that the future is far too uncertain for it to be possible to make a good forecast for monetary policy three years ahead. Consequently, too much faith should not be placed in the repo rate path too far in the future. One important source of uncertainty is how other central banks' monetary policies will be in the period ahead.

On one hand, inflation has been lower than expected in several parts of the world in recent years. Interest rates on long-term government bonds are low and have continued to decrease in several countries since July. Shorter-term interest rates, which reflect expectations of monetary policy, remain on a very low level in Europe and the United States. On the other hand, at the same time, an economic recovery is underway in the United States and the United Kingdom. There are market assessments indicating that the Federal Reserve and the Bank of England will start to raise their policy rates next year, while the ECB will wait longer before raising rates. But there is considerable uncertainty. When a recovery is not synchronised, Sweden must be positioned in relation to the rest of the world.

It is uncertain when other central banks will start to raise their policy rates and whether more complementary monetary policy measures will be introduced in the euro area. It is even more uncertain to what extent they will affect the effectiveness of monetary policy or otherwise change the playing field. However, it remains clear that international monetary policy will affect the exchange rate, resource utilisation and inflation in Sweden. The Riksbank's monetary policy should therefore be flexible in the sense that it takes account of changes in other countries' monetary policies when more is known about what measures will actually be adopted.

According to Mr Ingves, the type of flexibility he is thinking of is not fundamentally compatible with making repo rate forecasts over a longer horizon than six months to one year. When the international situation, like today, is unusually uncertain, it is difficult to use a conventional analytical tool for forecasts. To this can be added the entirely unique situation with continued low inflation in Sweden despite the fact that the recovery from the crisis has been better here than in many other countries in Europe.

For a small country with extensive foreign trade, this entails a sort of economic dilemma. It is difficult to combine domestic monetary policy and the free movement of capital, even with a variable exchange rate. The policy rate in major currency areas puts a limit on how independently monetary policy can be formulated in a small open economy like Sweden. Low policy rates and complementary measures in other countries risk leading to capital flows and exchange rate appreciation that will hold inflation in Sweden down longer than is desirable.

Mr Ingves' conclusion for monetary policy is that, at present, there is an unusually large amount of uncertainty over other central banks' future monetary policy and that, compared with earlier decisions, the repo rate path is even more of a forecast that can be changed than a promise. As inflation has been below target over a longer period, Mr

Ingves does not regard it as being particularly problematic if inflation is slightly above target for some time to come.

The prevailing situation has created a troublesome mix in which, on one hand, inflation needs to rise towards the target and, on the other, the increase in household debt is unsustainable. It is also unfortunate that monetary policy needs to be highly expansionary before the debt issue is resolved. This is a risk and it entails difficult trade-offs. The inflation-targeting policy must be complemented by meaningful macroprudential policy measures, as several international organisations have pointed out, most recently in the IMF's strongly-worded Article IV report on Sweden.[3] The low interest rate situation is increasing the risks linked to household indebtedness. The lack of a functioning housing market is contributing to major risks to the financial system. The need to manage households' high and rising indebtedness using other means than monetary policy is therefore pressing. If this does not happen and the increase in debt accelerates, the only remaining choice will be to raise the interest rate before the situation becomes unsustainable.

Mr Ingves concluded by commenting on geopolitical unease. The conflict in Ukraine has been considered in the assessment in the draft Monetary Policy Update as it is deemed to affect world trade and developments in Europe in particular. But it is genuinely difficult to make forecasts of 'binary' events that can suddenly take place and exacerbate the situation considerably. Should anything like that occur, a new and different assessment than that now being discussed would be needed.

§3. Discussion

Deputy Governor **Per Jansson** began the discussion with a comment on something taken up by Ms Ekholm. She said that the recent low inflation had created significant costs for the Swedish economy. And that, observed Mr Jansson, is an opinion that a number of other debaters and commentators have expressed too.

Mr Jansson said that he had to agree that the low rate of inflation has led some to call the inflation target's status into question. And this, indeed, probably was the most important reason for carrying out the major interest rate cut in July. The point in doing so was to send a strong signal that now there really was a need to push inflation up.

However, when the development of Sweden's real economy is considered, this claim becomes considerably more doubtful. Output and the labour market have after all developed quite well since the outbreak of the financial crisis, both over time and compared with other countries. Looking at the data there cannot really be any doubt about this, said Mr Jansson.

[3] See http://www.imf.org/external/np/sec/pr/2014/pr14407.htm.

Deputy Governor **Martin Flodén** referred to how several Members had indicated that the forecast for the repo rate path is highly uncertain. He said that he could agree with that description and probably also with the assessment that this uncertainty is unusually large at present, perhaps primarily due to developments in the euro area.

One can then ask what the value of such an uncertain forecast is. As Mr Flodén sees it, it is not the point estimate itself that is interesting. Ms af Jochnick mentioned that the repo rate path makes monetary policy more transparent as it shows which assumptions of future monetary policy have been used in the Riksbank's analysis. Additionally, and at least as importantly, the Riksbank's forecast for the repo rate contributes towards illustrating the monetary policy reaction function, which is to say how monetary policy can be expected to react to other economic developments.

Consequently, the forecast for the repo rate cannot be detached from the forecast for other variables, such as future inflationary pressures, foreign policy rates and the exchange rate. And the forecast for these variables is also linked to substantial uncertainty a few years ahead. Mr Flodén pointed out that he had previously mentioned that the repo rate path indicates that an initial increase of the repo rate will take place at the end of next year when inflation will be tangibly higher than today and when underlying inflation will have been at about two per cent for the previous six months and economic development will be strong. If inflation should rise surprisingly slowly, foreign policy rates are not raised or the krona appreciates more strongly than forecast, this will naturally also have consequences for the Riksbank's view of an appropriate level for the repo rate.

Deputy Governor **Karolina Ekholm** first responded to Mr Jansson's comments on her claim that low inflation had led to significant costs. She clarified that she primarily meant that a prolonged period with below-target inflation damages the credibility of the inflation target and risks reducing its value as a nominal anchor. But, at the same time, she considered that it could be worth clarifying that the overestimation of forecast inflation means that the real interest rate appears lower than it will be in reality. It is the real interest rate that determines how much stimulus monetary policy brings. If monetary policy decision-makers believe that the real interest rate will be lower than actually turns out to be the case, they will hold the nominal policy rate above what is actually required for the intended stance of monetary policy. For this reason, the inflation forecast is of crucial importance for interest rate decisions to really bring about the monetary policy stimulus considered appropriate by decision-makers.

Furthermore, like Mr Flodén, she wished to comment on the role of the repo rate path. Ms Ekholm primarily sees the repo rate path as a tool to communicate the Executive Board's reaction function, which is to say how the Executive Board collectively reacts with its monetary policy when conditions abroad and in the Swedish economy change. Through the repo rate path, the Executive Board issues guidance over how changed circumstances can be expected to affect the monetary policy stance. As regards the end point three years ahead, there is not enough relevant information at present to be able to determine either the level of the repo rate or the level of other variables with any great accuracy. All that is available, in principle, is long-term averages for different variables. It is therefore natural for forecasts to exhibit a pattern where different variables always tend to move towards their long-term averages later on in the forecast period. However, according to Ms Ekholm, the present repo rate path gives more guidance than usual as it ends at a repo rate significantly below the long-term average even though other variables, such as inflation and unemployment, are reasonably close to their averages. This is a clear message that the repo rate will have to continue to be low even after the macroeconomy in general has returned to normal.

Ms Ekholm wished finally to comment on Mr Flodén's reasoning in his opening contribution that monetary policy may need to react asymmetrically in the present economic situation, with inflation below target and a policy rate close to its lower bound. She agrees with this reasoning. If inflation is surprisingly low or if the krona appreciates more than expected, monetary policy may need to be more expansionary. If inflation is instead surprisingly high or the krona depreciates more than anticipated, she sees no immediate need to change the monetary policy stance.

Governor **Stefan Ingves** explained that he wished to say a few more words on the impact of monetary policy.

Monetary policy is often described on the basis of the interest rate set by monetary policy and, to a lesser extent, in relation to the interest rates actually faced by households and companies when they borrow. If final interest rates are focused on, monetary policy in Sweden is currently very expansionary, with only German and US corporate rates being slightly lower. In the euro area as a whole, both corporate and household rates are higher than in Sweden. At the same time, Swedish mortgage rates are as low as Swedish corporate rates. In the United States, for example, mortgage rates are significantly higher than corporate rates. The structure of the Swedish financial market and the lack of powerful macroprudential policy measures have created a situation in which households borrow at the lowest interest rate. These structural circumstances are unfortunate as households are already borrowing too much, while companies could be borrowing more and investing more, according to Mr Ingves. In light of this, one way of achieving a better macroeconomic effect from monetary policy would be to make sure that households borrow at fixed rates for longer maturities, as the yield curve normally slopes upwards.

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

Growth in the world as a whole is expected to gradually increase in the years immediately ahead, although the recovery will proceed at different rates. The economic signals from the United States and the United Kingdom remain strong, but at the same time a somewhat more sluggish recovery is expected in the euro area, partly as a result of the ongoing conflict in Ukraine. This will also dampen GDP growth in Sweden somewhat compared to the forecast in the Monetary Policy Report published in July.

However, the development of the labour market over the summer has been slightly stronger than expected and unemployment has begun to fall. Inflation remains low, although it has been somewhat higher than expected in recent months. The inflation forecast has been revised upwards slightly in the near term due to a weaker krona and somewhat higher labour costs.

On the whole, the economic and inflation prospects for the Swedish economy are the same as in July. Inflation remains low and the Executive Board agreed that the repo rate needs to remain at 0.25 per cent for inflation to rise towards the target. The assessment of the Executive Board was that it will not be appropriate to raise the repo rate until late 2015. With the adopted monetary policy, CPIF inflation is expected to gradually rise and to reach 2 per cent in early 2016.

At the same time, several members of the Executive Board noted that the low interest rates mean that there are still risks associated with the high level of household indebtedness and that it is necessary that other policy areas take measures to manage these risks.

Several members discussed the role of the repo-rate path in slightly different ways in light of the unusually high degree of uncertainty that prevails concerning economic and monetary-policy developments abroad.

Some members also discussed how monetary policy should react to new information and concluded that monetary policy should react asymmetrically in the near term so that new information that indicates higher inflation than expected does not necessarily have to lead to a less expansionary monetary policy.

§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, 4 September 2014, at 9.30 a.m.,

• to hold the repo rate at 0.25 per cent and that this decision would apply from Wednesday, 10 September 2014,

• to publish the decision above at 9.30 a.m. on Thursday 4 September 2014 with the motivation and wording contained in a press release, and

• to publish the minutes of today's meeting on Wednesday 17 September 2014 at 9.30 a.m.

This paragraph was verified immediately.

Minutes by

Ann-Christine Högberg

Verified:

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