Separate minutes of the Executive Board meeting No 18

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TIME: Kl 9:00

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

Leif Pagrotsky, Vice Chairman of the General Council

Sigvard Ahlzén
Hanna Armelius
Claes Berg
Kerstin Hallsten
Per Håkansson
Ann-Christine Högberg
Anna Lidberg
Tomas Lundberg
Pernilla Meyersson
Marianne Nessén
Christina Nyman
Mattias Persson (§1)
Britta von Schoultz (§3-4)
Sara Tägtström
Anders Vredin

§ 1. Economic developments

It was noted that Hanna Armelius and Sara Tägtström would prepare draft minutes of paragraphs 1, 2 and 3 on the agenda for the meeting.

Mattias Persson, Head of the Financial Stability Department, began by reporting on the latest developments with regard to financial stability. It appears that the various rescue packages recently presented by several governments and the liquidity provided by the central banks has helped to restore a degree of confidence on the markets. Interbank rates have fallen somewhat, mainly in the USA but also in the euro area and Sweden. In the USA, the interbank rates for different maturities have fallen by between 38 and 72 basis points since Friday. In the euro area, the fall is 7 to 9 basis points and yesterday three-month interbank loans were listed at their lowest level since Lehman Brothers filed for bankruptcy on 15 September. However, although there has been a slight fall, the interbank rates are still at high levels in relation to the policy rates in the USA and the euro area.

Just over a week ago, the Federal Reserve announced that it will launch a programme to purchase commercial papers, the Commercial Paper Funding Facility (CPFF). Swedish banks that have subsidiaries in the USA will also be able to use this facility. As a complement to this programme, the Federal Reserve launched an additional programme yesterday, the Money Market Investor Funding Facility (MMIFF), which will buy assets directly from money market funds that are finding it difficult to deal with the major outflows from their investors. Non-asset-backed commercial papers, which to 75 per cent are issued by financial institutions, have fallen significantly in value since September. This indicates how difficult it is for the companies to access short-term financing.

In Sweden, the interbank rates have fallen by 9 to 12 basis points. The so-called tomorrow next rate (the forward rate for loans from tomorrow and one day ahead) had yesterday fallen to 12.5 basis points above the current level of the repo rate, which is the smallest difference since mid-May this year and only slightly above normal levels. At the same time, lower monetary policy expectations have led to an increase in the so-called basis spread.

In the case of credit risks, no direct improvement is yet apparent. The premiums in the CDS index in both North America and Europe have increased. There has, however, been a slight improvement in the case of the US banks, where the CDS spreads have fallen significantly as a result of the rescue packages.

The stability programme that the Swedish government presented on Monday has been received positively in Sweden and abroad. Both the stability fund and the proposed borrowing guarantee should help to restore confidence on the interbank market and facilitate the banks' financing at longer maturities. The market for commercial papers and corporate bonds is functioning very ineffectively and it is difficult for large Swedish companies to finance their operations on the market. This problem will not be solved, however, by the government's plan, even though it may ease the situation somewhat.

At the moment the Swedish financial market seems to be in a state of hiatus in which the players are holding back issues while waiting for the details in the government's stability programme and the proposed borrowing guarantee to become clear.

The spreads on the Swedish market for housing bonds, that is the interest rate differentials between housing and government bonds, have decreased but are still at high levels. This relates to small transactions, however, and the purchasers are largely absent. It is mainly the market makers that are active.

To sum up, uncertainty on the financial markets has eased somewhat recently, but there is still some way to go before we see any real improvement.

Anna Lidberg from the Monetary Policy Department reported on developments in the financial markets since the previous Executive Board Meeting on Friday 17 October. Interbank rates have fallen somewhat on the fixed income market but trading is relatively limited. This fall is partly due to the liquidity- and stability-promoting measures taken by central banks and governments. Government bond rates with short-term maturities have increased in Sweden and the USA. At the same time, government bond rates with long- and medium-term maturities have fallen in Europe, the USA and Sweden. In the USA, consumer confidence (the Michigan Index) is at its lowest level since measurements began in 1978. New statistics also show that housing starts and the number of building permits have fallen significantly since August.

On the foreign exchange market, the krona has weakened further against both the dollar and the euro. This weakening is partly explained by limited trading, but it also reflects the increased risk aversion that has led to a "flight to quality" and in this context major currencies are perceived to be more secure. No corresponding weakening of the krona against other minor currencies is apparent. The dollar has strengthened more than the euro recently because the market perceives the threat of a recession to be greater in Europe than in the USA. This in turn is expected to lead to larger interest rate cuts in Europe than in the USA.

The Stockholm Stock Exchange rallied on Friday and Monday but share prices fell again on Tuesday. There were also considerable falls on the Asian stock exchanges last night. The subdued stock exchange climate is partly due to the fact that the reporting period has now begun, with the risk that outcomes may be poorer than expected. It is primarily the stock exchange index for banks, commodities and the industrial sector that has fallen. The low market values also stem from the fact that there have been periods when the market has functioned ineffectively due to a shortage of liquidity. The volatility index (VIX) has, on the other hand, declined somewhat after having reached the highest level ever measured.

According to surveys, a majority of the market participants expect the repo rate to be reduced by 0.25 percentage points to 4.0 per cent at today's meeting. Pricing on the market, as expressed in the implied forward rates, also indicates a reduction. Four of the five major Swedish banks expect the repo rate to be reduced. Their expectations regarding the future repo rate path have also been revised downwards. The forward rates show that the repo rate is expected to reach its lowest level approximately one year from now. Forward rates have also fallen in the USA and the euro area, where expectations regarding the euro area's interest rate path are rather similar to those in Sweden for the year ahead.

In Sweden, both fixed and variable mortgage rates have fallen marginally. Interbank rates have also fallen. This indicates that the recent rescue packages have eased the situation on the markets somewhat. The differentials between interbank rates and policy rates have also decreased since the peak levels reached in early October. Interest rates for US government bonds are now slightly higher than the extremely low levels recorded a few weeks ago. The one-month rate has now reached 0.50 per cent, while the three-month rate is at 1.16 per cent. There are thus signs that the flight to highly-liquid government securities has diminished. There has also been a slight decline in the three-month basis spread, which is the difference between the interbank rate and the expected policy rate.

Anders Vredin, Head of the Monetary Policy Department, presented a basis for the Executive Board's discussion in the form of a draft Monetary Policy Report. He noted at the start that the basis for the draft in the form of an international outlook, forecasts and alternative scenarios had been presented by the Monetary Policy Department and discussed at the meetings on 29 September and 6 October. At the extra monetary policy meeting on 8 October, new outcomes and indicators had been presented. At this meeting, the repo rate was cut by 0.50 percentage points. Since then, the forecasts have been revised in the light of the new repo rate and the new macro economic outcomes that have become available. The revised forecasts were presented at the Executive Board meeting held on 17 October, at which date the revised forecasts and texts were tabled.

Since the Monetary Policy Update in September, the turbulence on the financial markets has developed into a financial crisis. This has led to unusually large changes in the forecasts over a short period of time. The dramatic development of the situation on the financial markets is, however a global phenomenon that has not arisen in Sweden but is now clearly affecting us too. One example of how the crisis has worsened since the meeting in September is that the TED spreads, that is the differences between interbank rates and government bond rates, have increased substantially in Sweden as well as in the USA and the euro area.

Compared to the assessment in September, the forecast for international growth in TCW-weighted terms has been revised downwards by almost one percentage point. The assessment now is that growth in 2009 will be zero or close to zero in the USA, the euro area and Sweden. The forecasts for the oil price and inflation have also been revised downwards significantly, at the same time as the krona is expected to weaken further. The latter is, however, probably a temporary effect of the financial crisis. Currently, in trade-weighted terms, the krona has weakened by 8 per cent since the beginning of September. The assessment for the annual average of the TCW index in 2009 is 3 per cent weaker than in the Monetary Policy Update.

Up until yesterday, the oil price has fallen by over 30 per cent since the beginning of September, and there has been a similar fall in the price of oil futures. The forecast in this Monetary Policy Report has, however, been calculated on the basis of a 15-day average for future prices, which results in somewhat less of a downward revision of the forecast than indicated by forward pricing over the last few days.

The main scenario in the Monetary Policy Report is that the most acute crisis will diminish at the beginning of 2009 and that there will be some recovery towards the end of next year. The extensive rescue packages launched throughout the world should contribute to this. Growth in Sweden and abroad will improve in 2009. Inflation in Sweden is expected to fall rapidly over the next twelve months and then increase somewhat to reach the target of 2 per cent in 2011. Resource utilisation is currently higher than normal, but is expected to fall rapidly next year and then be lower than normal for a time. It is expected that the repo rate will be lowered to 3.25 per cent by the middle of next year, which is 1 percentage point lower than the current level of the repo rate. The repo rate path implies a cut of 0.50 percentage points today and then an additional reduction of 0.50 percentage points over the next six months.

§ 2. Economic outlook abroad

Deputy Governor **Lars Nyberg** wished to begin by complementing the picture of the financial crisis presented in the Monetary Policy Report and the developments that have taken place since the previous ordinary monetary policy meeting. The picture of developments internationally is now much gloomier. This applies to both financial and real economic developments. On the financial side, we are now talking about a crisis rather than a period of unease or turbulence. The turn for the worse can clearly be dated to mid-September when Lehman Brothers was allowed to collapse. Many counterparties throughout the world had exposure to Lehman Brothers and lost money. They had not expected such a prominent bank to go bankrupt. When this nevertheless happened, fears grew that another major market participant could end up in the same situation. This meant that lending between the banks largely dried up and that many large institutional investors and companies outside the financial system hesitated to invest their liquid funds in the banks. The difficulties that the banks were already experiencing in finding financing at longer maturities were exacerbated.

At the same time, large institutional investors began to leave a number of US money market funds that invest in the short-term borrowing instruments with maturities of normally 30 to 90 days that are referred to as commercial papers. These borrowing instruments are used by companies both within and outside the financial sector. When the funds were affected by withdrawals, which also reflected fears that there would be additional suspensions of payments in financial companies, they could not buy new papers when the old papers fell due. The companies thus received no money. Industrial companies that had issued commercial papers then tried to use the promised loan facilities at their banks, but the banks were also unable to borrow on the market. This resulted in a gridlock in the credit system that significantly reduced access to loans and that risked – and still risks – having serious effects on growth and employment in the economy.

The distrust spread from the USA to Europe as investors within and outside the financial sector suspected that many European banks also had substantial credit losses on their balance sheets, and no one wanted to invest money in a bank that could end up in the same situation as Lehman Brothers. Consequently, the European credit system also largely ceased to function.

In this situation, the authorities had no choice but to intervene - and intervene decisively. This is also what the authorities have done in both the USA and Europe. It was important to restore confidence within the banking system and between the banking system and its customers. Essentially, the authorities have done three different things, even though they may differ a little in form and structure in different countries. They have offered the bank's risk capital or other guarantees so that the banks can survive the crisis. Investors and other counterparties must be able to be certain that the banks they lend money to will still exist when the time comes to repay the loans. This is the most important thing. Bankruptcies like that of Lehman Brothers should not need to happen – at least not when the financial sector is in such bad shape as it is at present. The authorities have also offered various systems to buy bad assets from the banks in order to clear and reduce the banks' balance sheets to some extent. Finally, the central banks have continued to supply the banks with the medium-term borrowing that the banks have been unable to get from the market.

Is this enough? Nyberg believed that these measures provide a good basis for restoring confidence in and within the financial system. Developments over the last few days indicate this, even though it is of course too early to come to any certain conclusions. The return to normal conditions will also take time. The balance sheets of many financial institutions are still too large in relation to their equity and the risks must continue to decrease. This process must be allowed to run its course before it can be said that the crisis is over. And the crisis may be worsened by a prolonged economic downturn in which new credit losses appear.

There is now also no doubt that the financial crisis has had far-reaching effects on the real economy. This is evident in the USA and Europe, but also to an increasing extent in the emerging economies. Almost everywhere, the difficulties that the banks are experiencing in finding funding have led to a situation in which they have been forced to become very restrictive in their lending. The world has been hit by a wave of credit rationing of almost unprecedented proportions. Hopefully, this may ease somewhat over the weeks ahead as a result of the extensive rescue packages that are now being implemented.

Anxiety and fears about the approaching economic downturn have also caused stock markets to fall dramatically around the world. The rescue packages for the financial sector have not led to any stable increases on the world's stock markets, which indicates that concern about the economic cycle is the predominant factor. As a result of all this, the propensity of households to consume is decreasing and saving is increasing. In the USA, there are as yet no signs that the property market has bottomed out. Growth is expected to be low over the next few years, in both the USA and Europe. Nyberg concluded by saying that in all essentials he shared the view of the development of the international economy described in the Monetary Policy Report.

Deputy Governor **Svante Öberg** supported the analyses and forecasts in the Monetary Policy Report and agreed with Nyberg's description of developments on the financial markets. Despite the measures that have been taken to handle the financial crisis, the latest developments indicate that the forecast for international GDP growth should be revised downwards.

Öberg believed that the picture of international developments presented in the Report is reasonable as a main scenario. The forecasts are based on the assumption that the most acute financial crisis will diminish at the beginning of 2009 and that there will be some recovery towards the end of next year. However, there is a risk that the economic downturn will be both deeper and longer when the repercussions of the financial crisis work their way through the economies. The present crisis is unusually strong and extensive. Experience of previous financial crises in industrial countries in recent decades indicates that they are accompanied by a prolonged period of weak growth. The most serious crises have, on average, been accompanied by three years of negative growth.

Öberg also noted that the decline in growth has reduced the risk of ongoing high inflation in the world. Inflation is still at a high level in the USA and Europe, but the most probable assessment is that it has peaked and that it will fall rather rapidly in the year ahead. The price of oil and the prices of other commodities have already fallen on the world market. In both the USA and the euro area, the rate of inflation has now decreased for two consecutive months as a result of lower rates of increase in energy and food prices. But underlying inflation has not fallen. In the USA, inflation excluding energy and food has increased somewhat during the year and in the euro area it has remained relatively stable at slightly less than 2 per cent. In the developing and emerging countries, inflation is a greater problem. Altogether, they now have a rate of inflation of over 8 per cent. Underlying inflation has also increased in these countries and it now averages approximately 5 per cent.

First Deputy Governor **Irma Rosenberg** also agreed with Nyberg's description of developments on the financial markets. She believed that it was important to highlight the fact that the extensive measures taken by the authorities in many countries over the last few weeks to help restore confidence on the markets now appear to be having some effects on interest rates and the functioning of the markets. Over the last few days, rates on the interbank markets have fallen somewhat. But there is still a long way to go before conditions return to normal and there are still major disruptions on the credit markets. In all likelihood, this will in turn have clear consequences for growth and employment in many countries. It has also become increasingly clear that even emerging countries have been tangibly affected by the financial crisis.

In the USA, the repercussions of the financial crisis are particularly clear. Industrial production is falling. There are a number of indicators of a further deterioration in the housing market. The labour market is weakening and retail sales are falling. To a large extent, this reflects a deterioration that began already before Lehman Brothers went bankrupt. In the USA, the economic downturn will of course also be aggravated even more by the fact that the functioning of the financial markets is being so seriously disrupted.

In the euro area too there are signs that growth in production is slowing down. It is highly likely that growth will also be weaker in the rest of the world. In contrast to the USA, where a downturn in economic activity had already begun, the downturn in other parts of the world is more directly linked to the problems on the credit markets. The forecasts for international GDP growth have been revised downwards by almost one percentage point for 2009 and by slightly less for 2010. Uncertainty is of course especially great when the global economy is hit by a crisis of confidence such as we are seeing now. Given that the measures that are now being taken have the intended effect, Rosenberg believed that the forecasts for international growth in the Report's main scenario appeared to be reasonable. However, like Öberg, she also saw a clear risk that the repercussions of the crisis will be more prolonged and that it will be a long time before growth takes off again.

Rosenberg pointed out that at the time of the previous ordinary monetary policy meeting in September her assessment was that the probability of a slowdown in the development of energy and commodity prices had increased. In her view, it is difficult to determine exactly what has driven the rapid fall in prices since the summer. The oil price and the prices of most other commodities are now lower than they were a year ago. The decline in demand associated with the downturn in economic activity is probably the main explanation of this. However, there is also a possibility that financial investments in commodities have contributed to reinforcing both the previous increase and the sharp fall in prices since the summer. The fact that oil and food commodity prices have fallen again means that the downward pressure on the purchasing power of the households has slackened and this is subduing the slowdown in economic activity to some extent. It is above all energy and food prices that have pushed up inflation in both the USA and the euro area. The fact that these prices have now fallen also means that concern about inflation is diminishing. This makes it easier for the central banks to employ monetary policy to counteract the effects of the financial crisis on the real economy. Looking ahead, however, Rosenberg also sees a period of very weak growth in many of the industrial countries and a slowdown in the emerging countries too. This will affect the Swedish economy.

Deputy Governor **Barbro Wickman-Parak** wished to refer back to Rosenberg's view of developments in the US economy. Already at the monetary policy meeting in September, Wickman-Parak expressed concern about the risk that the downturn in the US economy would intensify and be more prolonged than was predicted at that time. The forecast for next year has now been revised downwards significantly and GDP growth is expected to be just over zero per cent. Wickman-Parak supported this forecast and referred to the well-founded grounds for this forecast that are presented in the Monetary Policy Report. She nevertheless wished to highlight the fact that an important factor is, as Nyberg also pointed out in his remarks, that the financial crisis has worsened since the previous meeting. For example, the Riksbank has previously stated that, over the last 12 months, the financial crisis has led to a tightening of credit conditions. Now, the aggravation of the crisis has led to a situation in which the possibility to get loans at all has been severely restricted.

We have already been able to note that the euro countries have been affected by the downturn in the USA and there have been no signs of decoupling. The GDP forecast for the euro area has also been further reduced this time to almost zero growth next year. The countries are being affected by the slowdown in the US economy and by the fact that the financial crisis is now also having a very concrete impact on the European banking system.

The emerging countries in Asia have already been mentioned. Up until recently, it appeared they would be relatively unaffected by developments in the rest of the world and that they would be able to continue growing at almost the same rate. Here too, however, it seems that it was too early to speak about decoupling. There are now signs that growth in these countries is shifting down a gear. Their stock markets were also more resilient for some time, but that time is now over and there have been major falls recently. In some countries, the financial markets in general have been affected and this has led the central banks to take measures. South Korea is an example of this.

Wickman-Parak concluded by pointing out that oil and commodity prices have continued to fall since September, which has made it easier for the central banks to deal with the effects of the financial crisis on the real economy. It was possible for several central banks, including the Riksbank, to implement the recent joint interest rate cut in a climate where the inflation prospects did not constitute anything like the same constraints as previously.

She also pointed out that the main scenario's forecasts for international growth may of course worsen if the financial crisis does not abate as expected. The downturn may then be both deeper and more prolonged. Such a scenario is also outlined in the Monetary Policy Report. However, even though there is a risk of such a scenario becoming a reality, the main scenario appears to be the most likely. The reason for this is that such extensive measures are now being taken in the international arena. Various packages to support and recapitalise banks may resolve the problems on the financial markets so that credit spreads diminish and access to credit is normalised. This also means that policy rate cuts will have a more normal impact on interest rates for households and companies. In addition, fiscal policy stimulation measures are under discussion in several countries, for example the UK, the USA and Germany.

Governor **Stefan Ingves** declared that he shared the view of international developments presented in the Monetary Policy Report. He pointed out that even in previous assessments that which was then referred to as the financial turmoil was expected to have a negative impact on growth, above all in countries with large financial markets like those in the USA and Europe. The effects on global economic activity were then expected to be moderate. Now the situation has deteriorated considerably and we have moved from a state of financial turmoil in the world to a financial crisis. This means that problems in the wake of the crisis are now appearing in other parts of the world, for example in Eastern Europe and Asia. Latin America will probably also be affected soon. Mexico, with its proximity to the US market and a foreign-owned banking sector, has already been affected negatively.

From a central bank perspective, it can be said that what has happened recently is that the velocity of circulation of money has decreased. Everyone wants to hold on to their money. Another way of describing this is to say that the transmission mechanism for monetary policy has been affected. This makes it more difficult to determine the form and structure of monetary policy in all countries. The financial crisis is also leading to an increase in tightening effects over and above those stemming from monetary policy. We are seeing a temporary credit crunch due to the fact that a number of markets in a number of countries have stopped functioning. Shadow interest rates are therefore significantly higher than the observed rates at the moment. This has a negative impact on aggregate demand. This is why the forecasts for international growth are being revised downwards.

Ingves also pointed out that several countries have taken similar measures to come to terms with the financial crisis. This is necessary because the financial crisis has negative external effects across international borders. The measures that have been taken comprise standard tools for handling such crises and will probably help the world to eventually emerge from the crisis. Experience shows that measures of this type are effective. The unusual thing is that many countries are now taking these measures at the same time. However, although many countries are taking similar action, the effects of the crisis on growth will probably still take different forms in different countries as the preconditions in the various countries differ. Saving in the industrialised countries needs to increase for example, not least in the USA.

Deputy Governor **Lars E. O. Svensson** had nothing to add to the points made by the previous speakers and supported the analysis of, and the forecast for, the international developments presented in the Monetary Policy Report.

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

Deputy Governor **Barbro Wickman-Parak** began by noting that already at the meeting in September it was possible to see that the downturn in the Swedish economy was taking place more quickly and more forcefully than expected. All of the statistics that have been presented since then clearly indicate that the economy will continue to weaken. This applies both to the outcome data and to the indicators for households and companies, which are presented in detail in the Monetary Policy Report.

In the new forecast, the downward revisions for next year are considerable. This applies to GDP and to practically all of the demand components. Export growth is expected to decline when GDP growth among Sweden's most important trading partners barely climbs above zero. Households have also become much more cautious as a result of the financial crisis. Share prices have fallen and loan costs have increased. The financial crisis has led to high risk premiums and market rates, including short-term mortgage rates, have consequently lost their normal relation to the repo rate. There are also now clear signs that the housing market is cooling down and the prices of tenant-owned apartments have already been pushed down. But perhaps the most important restraining factor is the weakening of the labour market. Statistics show that employment began to decrease in the third quarter, which was in line with previous household expectations.

This can all be summed up by saying that an economy that was already in decline has been given a further push downwards by the international slump in economic activity. At the same time, the financial crisis has taken a firmer hold in the Swedish financial system.

The repo rate was reduced earlier in October and a further reduction is now needed to try to mitigate the effects on the real economy as much as possible. Wickman-Parak therefore supported a reduction of the repo rate by 0.50 percentage points and also supported the repo rate path in the Monetary Policy Report which entails further reductions of the repo rate by approximately the same amount within the fairly near future.

These interest rate cuts can, according to Wickman-Parak, be implemented without threatening the inflation target. Resource utilisation is falling rapidly and cost pressures will ease considerably in the period ahead. The inflation forecast has been revised downward for the entire forecast period and it is even estimated that by the end of next year inflation will fall below 2 per cent. A return to sharply rising commodity prices and/or a long-term weakening of the krona could be risk factors, but such a development is not very likely. In the case of the weakening of the krona, it is rather the case that at the moment it is providing well-needed support to the scope for Swedish exports on a shrinking market. The krona is a small currency and as such suffers in periods of crisis. This is a fate it shares with other small currencies. The most probable scenario is that the krona will recover when the crisis wanes. If this does not happen it may entail a problem for inflation, but monetary policy will then have to be adapted accordingly.

In conclusion, Wickman-Parak noted that there is a possibility that the financial crisis will not wane in the way predicted in the main scenario of the Monetary Policy Report. Although there are signs that conditions on the financial markets have begun to improve somewhat, primarily in the USA, it is still too early to draw far-reaching conclusions. The road back to normal conditions may be a more difficult and longer one. Growth next year may be weaker and recovery slower than predicted. Such an alternative scenario is presented in the Report. If it becomes a reality, it may be necessary to reduce the interest rate more to prevent the economy falling into a situation with very low resource utilisation and a rate of inflation far below the target. Wickman-Parak believed that, at present, such a scenario was the least likely. Any reconsideration will have to wait until the effects of all the measures taken nationally and internationally, or the absence of such effects, can be more clearly noted.

Deputy Governor **Lars E.O. Svensson** emphasized that with flexible inflation targeting the task for the Executive Board is, as usual, to determine a repo rate path so that monetary policy is well balanced. A well-balanced policy means that the forecast for inflation and resource utilisation looks good in the sense that it indicates that inflation is approaching the target and resource utilisation is approaching a normal level at an appropriate pace. Although the principles behind flexible inflation targeting are relatively simple, it is in practice usually rather difficult to make forecasts for inflation and resource utilisation and to decide which interest rate path makes the forecast for inflation and resource utilisation look good. This time it is particularly difficult as, since the monetary policy meeting in September, the financial system in Sweden has been hit hard by the international financial crisis.

The Riksbank has taken a number of measures to improve liquidity in the Swedish financial system. The aim of these measures has been to strengthen financial stability and to help the Swedish financial system to function as effectively as possible. Svensson pointed out that it is important to distinguish the measures that have been taken to support liquidity and preserve the market from normal monetary policy, the aim of which is to stabilise inflation around the target and resource utilisation around a normal level.

How then should monetary policy be conducted in a financial crisis? As usual, it is important to make as reliable a forecast for inflation and for resource utilisation as possible with regard to the effects of the financial crisis and to choose a repo rate path so that these forecasts look good. The principles are still the same and as simple, which is testimony to how flexible our system for monetary policy is. It is basically a question of taking a new major shock into account. It can be very difficult, however, to determine how the financial crisis affects the forecast for inflation and resource utilisation. It is also very possible that the transmission mechanism is working less effectively, which means that the forecast's dependence on the repo rate path is different than usual. The effects of shifts in the repo rate path on the forecast will probably be smaller than usual.

As Nyberg has already mentioned and as is evident in the Monetary Policy Report, the financial crisis has manifested itself in the form of a greater risk aversion, higher interest rate premia, larger interest rate spreads, more difficult and more expensive financing for banks, firms and households, falling asset prices and wealth, a weaker krona and increased pessimism about the future development of the real economy. With an unchanged repo rate path this would all mean weaker aggregate demand, lower resource utilisation and lower inflation in the period ahead. Lower aggregate demand internationally also leads to lower demand for Swedish exports. Falling commodity and food prices also contribute to lower inflation. The krona has weakened, which is not unusual for a small currency in troubled times. The weakening of the krona may, if it lasts and depending on the impact of the exchange rate, in itself improve the situation for exporting and import-competing industries. But it will also increase inflation. The net effect of the financial crisis is, according to Svensson, definitely a weaker development of the real economy and probably a lower development of inflation.

All other things being equal, Svensson believed that a more expansionary monetary policy and thus a lower repo rate path are therefore justified due to the financial crisis. But how much more expansionary and for how long? How long will the financial crisis last and how will the government's measures be received by the market? How soon will conditions in the economy return to normal again? These questions reflect the fact that the degree of uncertainty is unusually high. One of the reasons for this is of course that the situation with a financial crisis is so new that as yet we do not have any extensive experience of monetary policy during a financial crisis and of how great the effects of the financial crisis on the transmission mechanism, the real economy and inflation will be. Svensson's assessment is that the forecast for inflation and the real economy in the Monetary Policy Report looks as good as possible in this difficult and uncertain situation. Svensson therefore supported the repo rate path in the Monetary Policy Report and supported a reduction of the repo rate by 0.50 percentage points at today's meeting.

First Deputy Governor **Irma Rosenberg** began by noting that the new information that has become available since the Monetary Policy Meeting in September supports the view that the slowdown of growth in the Swedish economy that was already evident at that time now appears to be even more pronounced. All the indications also are that inflation will fall much more rapidly than previously expected.

One important reason why the outlook is so much gloomier now is that the financial crisis is now having a very tangible effect on economic development in Sweden too. Although the Swedish banks have not been forced to record major write-downs for losses in the same way as many banks in the USA and the rest of Europe, it has become much more difficult for them to acquire financing at anything other than very short maturities. As Nyberg pointed out earlier, this is mainly because the problems on the international financial, markets are now having a more tangible impact on the Swedish economy. The measures that the Riksbank, the National Debt Office and the government have taken to improve the functioning of the market and to restore market confidence appear to have had a certain positive effect recently. But the financial markets are still functioning ineffectively. One consequence of this is that interest rates for loans to both households and companies have risen to levels that are significantly higher than those motivated by monetary policy. It has also become much more difficult to get credit. This means that the risks associated with longer financial commitments have increased. We must therefore expect a sharp downturn in demand in the economy. This applies to both corporate investments and household consumption.

The revised figures for growth confirm that growth in the Swedish economy was close to zero in the second quarter. Practically all of the indicators that have become available since then point to a continuing slowdown in the economy. This will in all likelihood have a dampening effect on domestic price pressures.

Another important reason for the changed outlook on inflation prospects is also the fall in the prices of oil and food commodities. In Sweden too, it is mainly the price increases for oil and food that have driven up inflation to a level far above the target. The fall in prices on the world market has as yet not had a significant impact on Swedish consumer prices. It can be assumed, however, that the rate of inflation will fall rapidly during the first six months of next year. It is probable that the rate of inflation will be significantly lower already during the last quarter of this year. This is because it was during this period last year that energy and food prices began to increase. Unless the price increases are as high during the corresponding months this year, inflation will fall mechanically in October, November and December. This is also taken into account in the forecast in the main scenario in the Report.

One question is of course how the significant weakening of the krona affects the inflation prospects. But Rosenberg was not too worried about this. Experience gained in recent years indicates that changes in the exchange rate do not have a major impact on inflation if they are regarded as temporary. Most indications are that the krona will strengthen again when the worst anxiety on the financial markets eases.

All in all, this indicates that inflation will fall more rapidly than previously forecasted. As economic growth is also expected to be weak, Rosenberg advocated a lowering of the repo rate by 0.50 percentage points at today's meeting. Subsequent interests rate cuts will probably be required in the near future to prevent inflation from falling too much. Rosenberg therefore supported the interest rate path that forms the basis of the assessment in the main scenario.

Finally, she added that the Riksbank has two different assignments: price stability and financial stability. These are clearly interlinked in the sense that a precondition for the Riksbank being able to conduct monetary policy is that the financial system functions effectively. Now the financial markets are seriously disrupted. The Riksbank is therefore taking a number of measures to improve the functioning of the financial markets.

Deputy Governor **Svante Öberg** began by expressing his support for the analysis and the forecasts in the Monetary Policy Report even with regard to the Swedish economy. He believed that the forecasts presented in the Report were reasonable as a main scenario, although there is of course a risk that the downturn will be both deeper and more prolonged in Sweden too. Sweden is a small country and as such is highly dependent on events in the rest of the world.

Inflation is still high in Sweden and no dampening of the rate of inflation can be seen so far. The rate of food price increases in September was 8 percent measured as an annual percentage change and this has still not fallen, unlike the case in the euro area where this rate has fallen to just over 5 per cent. Wage costs per produced unit increased by over 4 per cent last year and will increase by approximately the same amount this year, mainly due to decreasing productivity, which will contribute to higher cost pressures. According to the Prospera survey conducted in October, inflation expectations for two and five years ahead are still above the inflation target of two per cent, although they have fallen somewhat for two years ahead.

Another worrying factor is that the krona has weakened substantially since September. This is probably linked to the turbulence on the financial markets. The most probable development is therefore that the krona will strengthen again when the financial crisis abates. If it does not then it will boost exports and dampen imports, but it will also represent a strong inflationary impulse in the Swedish economy. Such an alternative scenario is presented in chapter two of the report.

However, the most likely scenario is, according to Öberg, that inflation in Sweden has now peaked and that it will fall rapidly over the next 12 months. The price of crude oil and the prices of other commodities have fallen on the world market and the forecasts for GDP growth in both Sweden and abroad have been revised downwards significantly.

He therefore supported the proposal to reduce the repo rate by 0.50 percentage points and also supported the revised repo rate path. He also expressed the belief that the interest rate can be cut in the current situation without setting aside the price stability target. Although it is unclear exactly how the transmission mechanism is functioning at present, it is nevertheless probable that a reduction of the repo rate will dampen the slowdown in the economy and facilitate the stabilisation of the financial sector. The downward shift in monetary policy expectations in the USA and the euro area also makes it easier for the Riksbank to reduce the interest rate without this giving rise to a further weakening of the krona.

Governor **Stefan Ingves** began by noting that Sweden is in a new economic situation primarily as a result of major changes in the world around us. The financial crisis makes it more difficult to assess the effects of monetary policy and uncertainty is greater than usual. The interest rate path that forms the basis of the forecasts in the Report represents a good balance between price stability and the development of the real economy. Ingves said that it was important to point out that it is now possible to redirect monetary policy in a more expansionary direction because the inflation target has been taken seriously in the measures implemented previously.

He also said that it was worth noting that the distinction between monetary policy and financial stability becomes diffuse when a financial crisis breaks out. Experience shows that if measures are not taken to combat a financial crisis it will eventually hit growth and the downturn in the real economy may be both deep and prolonged. Monetary policy can not, however, solve the problems of the financial market. This requires complementary measures of the type that have been taken around the world.

As several Board members have already mentioned, the krona has weakened. It is not unusual for a small currency like the krona to weaken in periods of financial unrest; we have seen similar developments in other countries with small currencies. The situation should correct itself when the financial crisis abates. If the effects on the exchange rate for the krona should increase or become more permanent this could be a factor that drives up inflation, which is one of the alternative scenarios in chapter two. In this case, there would have to be monetary policy consequences.

The repo rate path presented in the Report means that the real interest rate is still positive. This is good as otherwise monetary policy would be too expansionary and could give rise to problems further ahead. Given the risks that exist both downwards, in terms of ongoing financial unrest or even lower growth than expected, and upwards, in terms of a further weakening of the krona, Ingves expressed the belief that the repo rate path illustrated a well-balanced monetary policy. He therefore supported a reduction of the repo rate by 0.50 percentage points at today's meeting and the interest rate path presented in the Report.

Deputy Governor **Lars Nyberg** noted that the Swedish economy has now also been clearly affected by the financial crisis. The downturn has come more quickly and more forcefully than we expected in September. Market capitalisation has fallen by almost 50 per cent over the course of a year and the households have seen their financial wealth and their pension funds shrink rapidly. The bank's lending to households is still high measured as a rolling yearly average, but is expected to decrease considerably. The property market has quickly entered a phase in which it has become increasingly difficult to sell houses and apartments, which is usually an indication that prices will begin to fall. This applies especially to tenant-owned apartments in the big cities. Housing construction is expected to decline considerably over the next few years. Although many companies are still experiencing high demand and resource utilisation is high, the turnaround is clear and expectations are negative. On the labour market, there has been a rapid increase in the number of redundancy notices. Given this background, it is reasonable to expect a significant cut-back in household consumption.

The development of inflation, which caused a great deal of concern during the spring, appears to have become less of a problem. Inflation is still high, but the forecast in the Monetary Policy Report is that it will fall fairly rapidly towards the target of two per cent. The rapid downturn in the global economy has halted the price increases for food, oil and other commodities. This is of major importance to the development of inflation, but the gradual decline in resource utilisation in Sweden is also significant. The weakening of the krona of course represents an inflationary impulse but, as several board members have pointed out, this is due to the fact that the krona is a small currency in a troubled world and the weakening should therefore be transitory.

Over the last 12 months, as the banks' financing problems have increased, mortgage rates and interest rates for other bank loans have increased faster than the repo rate. During the weeks since mid-September, as the crisis has gradually worsened, mortgage rates have increased even more. But the situation is extreme. When the banks are able to borrow as normal again the difference between the repo rate and the mortgage rates should also return to more normal levels. The structure of the Swedish covered bonds is such that in credit terms they are close to government securities. The prices set for these bonds have been undeservedly low at a time when the desire to have liquid investments has led investors to ignore almost everything that has not been issued by the State. It is hardly likely however, that the interest rates will return to the levels that prevailed before the financial turbulence began in the summer of 2007 as the situation had then been extreme in the opposite direction for several years.

What then is the conclusion that can be drawn from all this? Nyberg considered that we should reduce the repo rate by 0.50 percentage points at today's meeting and he also supported the repo rate path presented in the Report. It is important to slow down the severe decline in domestic demand that we see ahead of us and he believed that this could be done without endangering the inflation target. Future developments are highly dependent on how successful the measures implemented by the governments in the USA and Europe (including Sweden) are in subduing the financial crisis. Nyberg pointed out that the chances that these measures will have a positive effect are good, but it is difficult to say how long this will take. Success may come quickly, and if so it may be possible to reduce the pace at which interest rate cuts are made. But it is also possible that the economic slowdown will be more prolonged than we expect today and thus justify an interest rate path that is somewhat lower than that presented in the main scenario. Hopefully, the picture will become clearer before the next monetary policy meeting in December.

Governor **Stefan Ingves** summarised the monetary policy discussion. Since mid-September the global financial crisis has worsened and it is now clearly affecting developments in Sweden. The crisis in the financial markets has led to higher loan costs for companies and households, lower capital wealth and increased uncertainty in general. Access to credit has declined. The assessment is that the financial crisis aggravates the ongoing economic downturn resulting in a weaker labour market and lower inflation.

To alleviate the effects of the financial crisis in the Swedish economy, the repo rate needs to be cut relatively substantially over a comparatively short period. In the last two weeks, the repo rate has been cut by 0.50 percentage points. The assessment is that it needs to be cut by a further 0.50 percentage points at today's meeting and that it subsequently needs to be reduced by a further 0.50 percentage points during the next six months. However, the effects of the lower repo rate will probably be less than usual. The reason is that the confidence crisis in the financial system has led to high risk premiums so that the normal link between short market rates and the repo rate has been broken. The Riksbank is regularly taking other measures to improve the functioning of the financial markets.

Resource utilisation is still slightly higher than normal, but will fall rapidly next year and then be slightly lower than normal. Inflation is high at present but expected to drop back quickly over the coming year. It will then increase slightly and be at the target level of 2 per cent in 2011.

The uncertainty in the assessments is unusually great this time. If the financial crisis intensifies, or if the effects on the real economy are more extensive, it may be necessary to cut the repo rate more than is assumed in the current assessment. However, if the exchange rate remains weak or if inflation remains high, a higher repo rate may be justified. The future direction for monetary policy will depend on how new information on economic developments abroad and in Sweden will affect the prospects for inflation and economic activity in Sweden.

§ 4. Monetary policy decision

The Chairman noted that the members of the Executive Board were unanimous in the decision to reduce the repo rate by 0.50 percentage points to 3.75 per cent.

The Executive Board decided unanimously

- to adopt the Monetary Policy Report according to the proposal, Annex A to the minutes,
- to publish the Monetary Policy Report at 09.30 on Thursday 23 October,
- to lower the repo rate by 0.50 percentage points to 3.75 per cent and that this decision would apply from Wednesday 29 October 2008,
- to lower the lending rate to 4.50 per cent and the deposit rate to 3.0 per cent, with effect from Wednesday 29 October 2008,
- to announce the decision at 09.30 on 23 October 2008 with the motivation and wording contained in Press Release no. 49 2008 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 09.30 on Wednesday 5 November.

This paragraph was confirmed immediately.

Minutes by:

Ann-Christine Högberg

Checked by:

Stefan Ingves, Chairman
Lars Nyberg
Irma Rosenberg
Lars E.O. Svensson
Barbro Wickman-Parak
Svante Öberg