Separate minutes of the Executive Board meeting, no.24

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DATE: 3 December 2008

TIME: 9 a.m.

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 (by telephone §2-3)

Sigvard Ahlzén
Hanna Armelius
Claes Berg
Kurt Gustavsson
Kerstin Hallsten
Jesper Hansson
Ann-Christine Högberg
Anna Lidberg
Tomas Lundberg
Pernilla Meyersson
Marianne Nessén
Christina Nyman
Mattias Persson
Maria Sjödin
Åsa Sydén
Staffan Viotti
Anders Vredin

§ 1. Economic developments

It was noted that Hanna Armelius and Kurt Gustavsson would prepare draft minutes of § 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. The banks are still experiencing difficulties with funding in the international capital markets, although there are signs that the commercial paper market in the United States is slowly coming to life again.

Anna Lidberg from the Monetary Policy Department reported on developments in the financial markets since the previous Executive Board Meeting on Thursday 27 November.

The krona has weakened substantially in recent months and this weakening has persisted. The oil price has continued to fall and is now at the lowest level for 3½ years. Interest rates have fallen in Sweden, the euro area, the United Kingdom and the United States. In Sweden it is mainly the interest rate five years ahead that has fallen.

Anders Vredin, Head of the Monetary Policy Department, presented a base for the Executive Board's discussion in the form of a draft Monetary Policy Update. He began by noting that the conditions for the base, in the form of an international outlook, developments in the financial markets and a comparison of earlier alternative scenarios for international growth, a lower oil price and weaker exchange rate had been presented by the Monetary Policy Department and discussed at a meeting with the Executive Board on 27 November. At a meeting on 1 December, an account was provided of new information on the Swedish economy (including the National Accounts figures for the third quarter), with more detailed forecasts and alternative scenarios.

The revisions to the forecasts have been around the same size on this occasion as prior to the monetary policy meeting in October. The forecast for GDP growth abroad (in TCW-weighted terms) has now been revised down, as it was then, by 0.9 percentage points. The forecasts for the oil price, the CPI and the exchange rate have been revised by roughly the same amount on this occasion as prior to the previous meeting. These revisions also lead to a correspondingly large downward revision in the repo rate in the forecast.

The large downward revisions are mainly due to the indicators for the fourth quarters, in the form of industrial production, consumption and various confidence indicators, being very weak. GDP outcomes abroad have been roughly as expected. However, oil and commodity prices have been lower than forecast. At the same time, interest rate expectations in, for instance, the United States and the euro area have fallen. The most recent National Accounts statistics also indicate lower growth than expected in Sweden during the third quarter. There have been many redundancy notices given in the labour market and households' and companies' expectations have deteriorated rapidly. The oil price has also fallen drastically since the most recent monetary policy meeting. However, the krona has weakened more than expected, which dampens the decline in growth at the same time as it has the effect of pushing up inflation.

The purchasing managers' index for the manufacturing industry has fallen substantially in Sweden, the United Sates and the euro area since September. Consumer confidence is also weak but the fall since September has not been as dramatic.

According to the main scenario of the Monetary Policy Update, inflation will undershoot the target in 2009 and 2010. Resource utilisation will fall rapidly and will be lower than normal over the coming two years. Growth in Sweden and abroad will rise at the end of 2009, and the labour market will turn around a little later. The forecasts for inflation, growth and employment are lower than in the forecasts presented in October.

§ 2. Economic outlook abroad

Deputy Governor **Svante Öberg** began the discussion by noting that international economic developments are still weakening. International organisations such as the IMF, the OECD and the UN are now rapidly revising down their forecasts for world growth. Mr Öberg considered that the mood at the international meetings he had attended has been very pessimistic. We must now expect negative GDP growth in both the United States and the euro area next year. Developing countries and emerging markets have also begun to feel the effects of the financial crisis and the weaker developments in developed countries.

We can also note that world inflation has begun to fall. In the United States the inflation rate has declined three months in a row, to 3.7 per cent in October. In the euro area it has declined four months in a row and particularly sharply in November, when it fell to 2.1 per cent. Crude oil prices and other commodity prices have fallen from the earlier high levels. In addition, developments in the real economy are very weak. It is therefore likely that inflation will fall fairly rapidly over the coming year.

Economic policy has reacted strongly to the new situation in many countries. Monetary policy, which can change rapidly, has become more expansionary. Interest rates have been cut substantially in many countries and there are expectations of further interest rate cuts. With regard to fiscal policy, it is reasonable to assume there will be strongly stimulative fiscal policy in the United States and also some fiscal policy stimulation in the EU. This could reduce the depth of the economic decline.

But there is a risk that an economic slowdown will be both deeper and more prolonged than we are assuming. Our experiences of earlier financial crises indicate that they are followed by longer periods of weak growth and the current financial crisis is unusually severe and covers large parts of the world. A decisive factor in ensuring that this does not happen is that the financial markets begin to function normally again to avoid having a long period of funding difficulties for companies and households.

Deputy Governor **Lars Nyberg** considered that financial developments abroad had not improved, quite the reverse. Despite the increasingly large rescue packages in the United States and Europe, the financial "circulatory system" has not begun to flow as hoped. Some markets have slowly opened, for instance the market for commercial paper in the United States, but then this is largely due to support from the authorities. The markets for medium and long-term borrowing are still closed to most companies, both those within and those outside of the financial sector. The picture is still dominated by a strong will from most of the worlds' financial institutions to reduce their risk exposure and their balance sheets. During November many financial assets traded internationally have fallen in value. In many countries this has led to a serious credit crunch. It is difficult to see signs that confidence is being restored on a broad front.

The financial crisis has continued to strengthen the economic downturn, which in its turn aggravates the financial crisis. The growth figures have been adjusted downwards substantially around the world, orders to industry are falling, construction activity is declining, house prices are stagnating or falling and confidence indicators are pointing sharply downwards. This now applies not only to industrial nations, but also to most developing countries. A number of central banks have cut their policy rates. In our immediate surroundings, the Baltic countries have been hard hit. Mr Nyberg could not remember any previous economic downturn coming with such speed and such force.

Governor **Stefan Ingves** agreed with Mr Öberg's and Mr Nyberg's descriptions. There has previously been a long period with cheap liquidity, rising asset prices and financial innovation. This has fuelled demand. Savings have been low in the United States, but high in Asia. All of the factors that were earlier promoting the expansion are now pulling in the opposite direction. Everyone is demanding liquidity and fewer are demanding goods, which leads to growth being much lower than was anticipated earlier. What we are now seeing is the most rapid change in economic activity since the beginning of the 1990s. We were nevertheless about to experience a slowdown, but the sequence of events is now being speeded up by the fact that we also have a financial crisis. This means that the central banks must stabilise the economy at the same time as they must ensure that the transmission mechanism is restored. Without an efficient transmission mechanism, monetary policy will lose impact. Both of these factors contribute to lower interest rates.

First Deputy Governor **Irma Rosenberg** considered it difficult to find any equivalent during the years since she began working with forecasts to the rapid deterioration in economic activity now occurring with all of the economic indicators pointing downwards for such large parts of the world economy. The international financial markets are still functioning ineffectively. It is difficult for banks and companies to fund themselves in the market. There are also indicators both in the United States and the euro area that point to the banks' loan terms for companies becoming even more restrictive. The consequences of this are now also evident in the fall in orders of investment goods in, for example, the United States and Germany. The longer it takes until confidence in the international financial markets is restored, the greater the risk that the lack of financing will lead to serious problems in the business sector on a broad scale.

GDP fell during the third quarter, both in the United States and the euro area, in line with the forecast made in October. But various economic indicators point to economic activity now weakening rapidly and to it being much weaker than expected during the coming period. In the United States, the financial crisis is still strongly influencing economic developments. Lending to households has been subdued. The housing market does not yet appear to have hit bottom and the labour market is still weakening. This indicates that households will continue to hold back their consumption expenditure. In the euro area, too, new information provides a very gloomy picture. Confidence indicators such as the EU survey, as well as the purchasing managers' index, have fallen heavily and are now at record-low levels.

Many developing countries were previously partly spared the effects of the financial crisis. But after the Lehman bankruptcy, many more countries are now affected. The difficulties in obtaining funding will probably also further dampen growth in these countries.

Deputy Governor **Barbro Wickman-Parak** said it was good that the monetary policy meeting had been brought forward. In October there was some confidence that the measures taken abroad and in Sweden would soon lead to a stabilisation becoming apparent. However, this has not been the case. As Mr Nyberg said in his speech, the situation in the financial area has hardly improved; what we instead need is continued intervention from the central banks so that the financial markets will function.

Ms Wickman-Parak also pointed out that the forecast for international growth had been revised down substantially before the monetary policy meeting in October. This time the downward adjustment was equally large. The economic downturn has intensified more and been more rapid than we expected and even fairly recent forecasts have become obsolete. As Mr Ingves pointed out, the financial crisis is very important in this context. Over the past two months important economic indicators have equalled or been lower than the earlier lowest record levels. For instance, the purchasing managers' index for industry in the United States has continued to fall dramatically. It measured 50 in September, which is the breakpoint between expansion and contraction. In November the figure was below 40 and beginning to approach the lowest levels from the recessions at the beginning and end of the 1970s. Consumer confidence in the United States is now at one of the lowest levels ever measured since the surveys began in the mid-1960s. The heavy fall in confidence has made a lasting impression; private sector consumption fell in the third quarter by 3.7 per cent calculated on an annual rate and the fall in the retail trade figures for October points to a very weak start to the current quarter. It is very unusual to have an actual fall in consumption, even in a single quarter. The last time this happened was at the beginning of the 1990s in the wake of the savings and loan crisis.

In the euro area, growth was negative in both the second and third quarters and indicators for households and companies are also at historically low levels. The latter also applies to the United Kingdom. In Japan, too, the two most recent quarters have shown falling growth and economic indicators are pointing sharply downwards.

The new forecasts mean that GDP in the United States, Japan and the euro area is expected to fall next year. The GDP figures for our largest trade partners (TCW-weighted GDP) are expected to fall by around half a percentage point next year and this is a downward revision by almost one percentage point since October. The forecast is in line with the alternative scenario with aggravated effects of the financial crisis that was presented in the October Monetary Policy Report.

The economic downturn has had a broad geographical spread; for the industrial nations it is expressed in falling GDP, while emerging markets are now also significantly affected and seeing a slowdown in growth.

In the wake of falling energy and other commodity prices, the inflation outlook has also changed quite radically. The average inflation rate among Sweden's trading partners is expected to be around 1.5 per cent next year. This is a downward revision from 2 per cent in October and in the summer the forecast was 2.5 per cent. During the summer stagflation, that is, the combination of weak or falling growth and high inflation, was a theme in the international debate. This debate has quickly been replaced by a discussion on the theme of deflation; will the vicious circle of the 1930s be repeated? Around the world, central banks and governments are now intervening to support the financial system and stimulation packages have been agreed on or are being prepared. This is one of several differences from the situation in the 1930s. Our forecasts assume that all measures will contribute to growth recovering and once again being positive in 2010. If it were the case that the economies reach such a deadlock that the measures have no effect on demand, then deflation may become more than just a theme for discussion, although this is not our main scenario.

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, international developments in the Monetary Policy Update.

Stefan Ingves summarised the discussion and concluded that there is an unambiguous outlook regarding developments abroad. Growth prospects have been revised down, the problems in the financial markets remain and inflationary pressures are quickly waning. All of this affects developments in Sweden.

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

Lars E. O. Svensson began by pointing out that the rapid and broad deterioration in prospects for the real economy have justified bringing the monetary policy meeting forward. In this situation it is also an advantage that the Riksbank can provide information on monetary policy at an earlier stage. As several other members have already noted, the continuing financial crisis, the rapidly-deteriorating situation and prospects for the real economy constitute a very abnormal situation. The financial crisis means that the actual transmission mechanism for monetary policy is not functioning well There is reason to believe that the interest rate cuts and shifts in the interest rate path will have less effect than usual on the real economy and on inflation, but at the same time there is also greater uncertainty regarding this effect.

It is thus a very abnormal situation, but it is still necessary to conduct a normal monetary policy as far as possible. By this Mr Svensson means that it is still necessary to conduct a flexible inflation-targeting policy in the sense of setting the interest rate and choosing an interest rate path so that inflation is stabilised around the target and resource utilisation is stabilised around its normal level in the best possible way. It is thus a question of conducting a normal monetary policy in a very abnormal situation, where it is more difficult than usual to assess how the interest rate path should be chosen so that the forecast for inflation and resource utilisation looks as good as possible. In this difficult situation our staff members have done excellent work under great time pressure and provided the best possible basis for decision-making in this situation.

Given the rapidly-declining situation and prospects for the real economy and resource utilisation, and given the sharp fall in inflation and lower inflation forecast, there is justification for making a large cut in the interest rate and a large downward adjustment to the interest rate path to stimulate the real economy in the best way possible and to prevent resource utilisation and inflation being too low during the forecast period. Mr Svensson considered that the interest rate path and the forecast for the real economy and inflation presented in the Monetary Policy Update are as reasonable and judicious as is possible in this abnormal situation. He therefore supported cutting the repo rate by 175 basis points, lowering the repo rate path and expressed support for the analysis and forecasts presented in the Update.

The new repo rate path and the new forecasts for the real economy and inflation are as usual mean forecasts, forecasts of the expected value of future realisations of the repo rate, resource utilisation and inflation. Further ahead the real economy and inflation may develop more strongly or more weakly than our mean forecast. If the situation and prospects are weaker than our forecast, it may be necessary to further lower the repo rate path at the next monetary policy meeting. However, if the situation and prospects turn out better than expected, it may be necessary to raise the repo rate path again.

The krona has weakened substantially. This has led to a debate on whether it is a disadvantage in this situation to have an own currency instead of being part of the euro area. Mr Svensson said that he himself considered it an advantage in this situation to have an own currency and a floating exchange rate. The weaker krona does actually entail a desirable and well-needed stimulation for exporting and import-competing firms and industries, parallel to the stimulation brought about by a lower repo rate path. In a situation where the usual interest rate channel of the transmission mechanism may be weakened as a result of the financial markets not functioning properly, it may be particularly useful to have the exchange rate channel.

Svante Öberg agreed with Mr Svensson that the background material prepared for today's meeting is good. It provides a detailed description of what has happened recently as well as reasonable forecasts for the future. He therefore preferred to limit his comments to some broader issues.

Economic developments are very weak, even in Sweden. GDP has largely stagnated three quarters in a row and we have revised down our forecasts for growth. Employment will decline and unemployment will increase substantially over the coming two years. As for the rest of the world, there is also a risk that the economic slowdown in Sweden will be both deeper and more prolonged than we are now assuming. Sweden is a small country and we are highly dependent on events in the rest of the world.

It is also reasonable to assume that inflation will fall quickly over the coming year. It has already fallen from the top level of 4.4 per cent in September to 4.0 per cent in October, and we are now expecting that it will have fallen to 2.5 per cent in November. Crude oil prices and other commodity prices have fallen on the world market and real economic developments are very weak.

Mr Öberg's assessment is that with the current forecast the repo rate should be cut to 2 per cent or lower within the coming six months if the situation worsens more than anticipated. This gives an underlying inflation rate of around 2 per cent during the forecast period and a real repo rate close to zero, which may be reasonable when we want to support the development of production and employment. The question then is how much the repo rate should be cut.

One cause for concern in this context is that the krona has weakened by more than ten per cent since last summer. This weakening is probably linked to the financial market turbulence, and we are expecting the krona to strengthen again as the financial crisis wanes. But if it does not then it will boost exports and dampen imports, but it will also entail a considerable inflationary impulse in the Swedish economy. Nor can the possibility of a further weakening of the krona be ruled out, particularly if developments in the Baltic countries deteriorate.

As usual, it is a question of weighing different factors against one another. The falling inflation rate and the weaker developments in production and employment point to substantial and rapid interest rate cuts. An interest rate cut would also facilitate the stabilising of the financial sector. However, the weak krona points towards a more gradual reduction. In the current situation, the first argument carries greatest weight. Mr Öberg therefore supported the proposal for cutting the repo rate by 1.75 percentage points.

Barbro Wickman-Parak wanted to draw attention to household consumption, which declined somewhat during the third quarter, compared with the same quarter last year. It was much weaker than expected and the retail trade sales for October imply a very weak start to the fourth quarter. Households' views of the labour market situation in the coming period have continued to deteriorate substantially. In September a majority of 50 per cent of households had a negative view, in November the majority was 80 per cent. Although employment is still being held up, households have clearly been affected by the large wave of redundancy notices in October and November. Increased redundancy notices, fewer job vacancies and, according the National Institute of Economic Research's (NIER) Economic Tendency Survey, the large downward revision to companies' employment plans are some of the indicators pointing to the labour market cooling down. The employment forecast has also been revised down. A poorer labour market, falling stock market and cooling down of the housing market have made households cautious, quite regardless of their incomes having shown good growth so far.

As is the case abroad, the economic indicators in Sweden are disheartening. Confidence indicators for companies have plummeted, according to the NIER's survey. The November survey, which was published recently, shows that all sectors included in the measurements have weakened substantially. The purchasing managers' index has also fallen sharply to historically low levels.

GDP has fallen slightly during the second and third quarters of this year, measured consecutively. The growth forecast for next year has been adjusted down to roughly the same extent as in October and GDP next year is now expected to fall by half a per cent.

The decision-making situation is simple, in a way. There is no doubt that interest rates must be cut substantially and that inflation prospects do not place any restriction on our actions. On the contrary, a lower interest rate is needed so that it is possible to obtain the inflation target within the forecast horizon.

Ms Wickman-Parak therefore supported the proposal to cut the repo rate by 1.75 percentage points. This is an exceptionally large cut and a departure from the way the Riksbank normally conducts monetary policy, which is characterised by gradual changes in the repo rate. However, the situation is exceptional. The problems in the financial markets have not been resolved despite large efforts and economic activity is falling heavily. A substantial interest rate cut is necessary to alleviate the fall in production and employment and to reduce the risk of the economy entering a deflationary spiral. The risk of this should not be exaggerated. The Swedish economy has a good starting point and there is scope for stimulation through fiscal policy. We also assume in our forecast that this will be used. But one should also be aware that if a deflationary spiral arises, it is a situation that is difficult to escape from. Monetary policy should manage risks and in the current situation it is better to risk acting too strongly rather than too weakly. Moreover, as a result of the high risk premiums in the wake of the financial crisis, there is a risk of the interest rate cuts having less impact.

Of course, one can discuss the size of the cut. It is not possible to determine with any exactness, but a repo rate of 2 per cent appears reasonable. Given this, one can also discuss whether the interest rate cuts should be divided up into several stages, but there is no advantage with this. The interest rate cut is needed now and an actual delivery ought to have a quicker effect than if some of it comes now and the rest is described in an interest rate path, which is a forecast and not a promise.

To summarise, Ms Wickman-Parak advocated an interest rate cut of 1.75 percentage points and supported the interest rate path presented in the Monetary Policy Update. This shows the repo rate remaining at 2 per cent in 2009 with a slight probability of a further cut being necessary. Wickman-Parak stated that she had so far touched on the problems with economic activity in a near-term perspective. It is difficult to talk about 2010, but the forecast presented appears reasonable if all that is done abroad and here at home with regard to fiscal policy, monetary policy and the work on resolving the problems in the financial markets provides results.

With regard to the severe weakening of the krona, Ms Wickman-Parak shared Mr Svensson's opinion that in the short term it would provide well-needed assistance to Swedish exports, which were fighting for a shrinking market. As the crisis wanes, the krona will probably strengthen. A more prolonged weakening of the krona could create problems with inflation further ahead, but monetary policy never takes time-out; it is always vigilant and ready to take action when problems arise.

Stefan Ingves observed that the problems in the financial sector remain. The international economic outlook is weak and Sweden is affected to a large degree. Some of the weakening can already be observed in the statistics and the remainder is not yet visible. In particular, the statistics regarding loan volumes lag behind. At the same time, everyone is aware that there are things happening that give cause for concern, which can be noted not least in the large-scale lending the Riksbank has been forced to provide. Inflation is also falling rapidly and expected to undershoot the target for a period of time. It is therefore reasonable to cut the repo rate. One alternative is to maintain the strategy the Riksbank has traditionally employed, with small changes. However, it is better to act so forcefully that the Riksbank makes it clear that this is a new situation. There would not be any advantage in having a more prolonged procedure. We will attain the inflation target with a lower interest rate.

The transmission mechanism is functioning less efficiently than usual. The neutral equilibrium policy rate should therefore be lower than otherwise, as the interest rates in the credit market will nevertheless be relatively high. The rapidly falling inflation rate also means that if we give consideration to the real interest rate, we must make a rapid cut in the repo rate. Mr Ingves therefore supported the proposal to cut the repo rate by 1.75 percentage points.

Mr Ingves pointed out that it is common for small currencies to depreciate more than larger currencies in times of international turbulence. This could entail a risk of greater inflationary impulses. But nor can one entirely rule out the possibility that the economic downturn will be even more lengthy, which points in the opposite direction. Mr Ingves therefore considered that the proposed interest rate path provided a good balance and the best possible assessment in the current situation.

Lars Nyberg thought that we in Sweden have a good starting point, with stable public finances and a number of years with a current account surplus behind us. The Swedish financial system has also coped better than many others so far, although the difficulty experienced by the banks since mid-September in borrowing internationally has required support measures from the Swedish authorities. Without the measures taken by the authorities the financial system would hardly have been able to function, either in Sweden or in other countries. The strained situation has led to the repo rate losing some of its ability to affect other short-term interest rates and thereby the real economy. But the Swedish policy rate nevertheless functions better as a monetary policy instrument than the policy rates in many other industrial nations. Economic activity in Sweden is nevertheless falling at the same rapid rate as that in other countries. The Economic Tendency Survey has fallen to its lowest level since 1993. Many large companies have experienced a large reduction in orders and redundancy notices are pouring into the labour market. Household wealth is declining as a result of the stock market fall and of declining property prices and private consumption is also falling. The downward adjustments in the growth forecasts for this year and next year appear to be well-motivated.

Inflation is falling much more quickly than we could have imagined, as are inflation expectations. The krona has depreciated substantially, but this also applies to other currencies in small countries with floating exchange rates. It is probably primarily linked to the financial crisis and reflects a flight to currencies that are considered safer in times of unease. It is therefore likely that there will be an adjustment as the crisis gradually wanes. The unease in the Baltic countries may delay this process, but inflationary impulses from a krona with a low value do not currently appear to be a major problem. In these circumstances there are good opportunities to make use of monetary policy to counteract the economic downturn without this needing to jeopardise the inflation target.

In a situation where the economy is almost in free fall and there is considerable uncertainty regarding the future, it is necessary to cut the repo rate substantially. It seems meaningless to fine tune the interest rate path when there is such considerable uncertainty. According to Mr Nyberg, it is also better to overdo it than to be too restrictive when cutting the interest rate. It is now that the stimulation from a lower interest rate is needed. Mr Nyberg therefore considered that the proposal to cut the repo rate to two per cent was a good one.

Irma Rosenberg said that it had been essential to bring forward the monetary policy meeting. The reason is that all of the information that has been received clearly indicates that a large interest rate cut is necessary. Nor is there any reason to wait to implement this. Another advantage is that the interest rate decision does not come so close to the Christmas and New Year holidays.

The fact that there is a very clear and rapid slowdown in economic activity abroad also affects the Swedish economy. Various economic indicators also point clearly towards an even more sudden slowdown in economic activity in the Swedish economy than we had earlier assumed. It is difficult to find any positive elements in the information flow regarding the real economy since the previous monetary policy meeting. GDP growth for the third quarter was much weaker than expected. Compared with one year ago, GDP was largely unchanged, and compared with the second quarter of this year there was even a slight decline. It is then necessary to be aware that this slowdown in growth largely took place before the financial crisis accelerated in mid-September. The financial markets are still functioning poorly and there is reason to believe that this will have a negative effect on growth over the coming quarters, just as reflected in the forecast in the main scenario.

Exports, investments and private consumption all slowed down in the third quarter. The developments in household consumption were particularly remarkable. Although we expected at our meeting in October that the rate of increase in consumption would slow down somewhat, there has been a sharp braking. Consumption fell slightly compared with the corresponding quarter last year. The slowdown was broad, covering many categories of goods, but the expenditure on purchasing and running vehicles was particularly weak. The retail trade figures for October indicate that households are being even more restrictive during the fourth quarter and the Consumer Tendency Survey also points to this. The labour market indicators also imply that there is now a rapid cooling in the labour market and this will gradually have an effect on households' incomes. Developments in stock markets and the housing market will probably also contribute to households being more restrictive in the coming period, and the forecast in the Update that private sector consumption will fall next year therefore appears reasonable.

The Economic Tendency Survey and the purchasing managers' index have continued to fall to record-low levels and production and orders in industry are also falling. It is therefore necessary to assume a weak outcome for growth in the fourth quarter.

With regard to inflation prospects, there has been a total turnaround compared with last summer. Both companies' and households' inflation expectations are now close to the inflation target according to the Economic Tendency Survey. Inflation looks set to fall back both sooner and by much more than we anticipated in October. The fact that the dampening in demand will be stronger than expected indicates this, as does the fact that oil and other commodity prices in the world market have continued to fall. Inflation will therefore probably fall very quickly and undershoot the target next year.

All in all, this indicates that a substantial repo rate cut is needed to dampen the decline in economic activity and ensure that the inflation target can be attained within a reasonable time. In a more traditional economic slowdown there are good reasons to cut the repo rate gradually. But taking into account the financial crisis and the very dramatic deterioration that has occurred in various economic indicators at the same time as inflation appears to be falling very rapidly, it is very clear that the repo rate needs to be cut substantially. Ms Rosenberg did not see any reason to wait, but considered the repo rate should be cut to 2 per cent directly, that is, that it should be cut by 1.75 percentage points. It would then be down at a level where it could probably remain for a fairly long time.

Ms Rosenberg has not been particularly worried over the effects on inflation of the substantial weakening in the exchange rate in recent months. At present, a weaker krona helps to attain the inflation target, as inflation is now expected to fall rapidly and undershoot the target. In the long term, it is also possible that the krona will strengthen in connection with the effects of the financial crisis waning.

Svante Öberg wanted to return to the question of the development of the Swedish krona. We shall not determine today whether it is an advantage or disadvantage to have a floating exchange rate instead of being part of the euro area. But it may be worth commenting on this nevertheless. We are not talking about a normal economic slowdown, where it may be an advantage to have a currency that depreciates and strengthens the development of the real economy. This is a combination of a financial crisis and a floating exchange rate. Several countries in the EU, which remain outside the monetary union, have seen their currencies depreciate substantially. Examples of this are Hungary, Poland, the Czech Republic and Romania. In the case of Hungary it has resulted in the country being forced to seek support from the IMF and the EU as a result of difficulties in funding itself in the international financial markets. Slovenia, which has adopted the euro, and Slovakia, which will do so from the start of next year, have not experienced these problems. The Swedish and Norwegian krona have depreciated substantially and the Danish krona has also come under considerable pressure. Iceland has suffered a collapse. The Baltic countries, as Mr Nyberg pointed out, are experiencing considerable problems and the situation in Latvia is particularly worrisome. We cannot rule out the possibility of a deterioration in the Baltic countries leading to problems for the Swedish banks, too, and for Sweden as a nation in obtaining funding in the international financial markets. This is not the most likely sequence of events, but it is a risk we cannot ignore.

Lars E. O. Svensson further pointed out that the Riksbank and other central banks have traditionally carried out what is known as interest-rate smoothing. This involves changing the interest rate slowly and in small steps. Such behaviour is perhaps reasonable if the situation and the prospects for the real economy and inflation change slowly and the uncertainty about developments is substantial, but it is scarcely reasonable if the situation and prospects change rapidly and in a particular direction. It is interesting that several central banks appear to have abandoned this interest-rate smoothing during the financial crisis. The Federal Reserve, the Riksbank and the Bank of England have cut their policy rates in large steps. Today's cut is another example of this. It is very possible that, when the situation has normalised and the financial crisis is over, many central banks, including the Riksbank, will not in the future exercise as much interest-rate smoothing as they did before.

Mr Svensson also reminded that a forecast with a low interest rate path, inflation and resource utilisation may accentuate the risk of deflation, a zero interest rate and a liquidity trap. The repo rate cannot be cut lower than to zero. If at that stage there is still deflation and deflation expectations, the real interest rate may still be too high and provide insufficient stimulation to the real economy. This has been all central banks' nightmare. However, there is considerable research on, and experiences from, deflation and the liquidity trap in Japan, in particular regarding the mistakes made by policymakers then. This research and these experiences have given rise to a toolbox of unconventional tools that can be used if Sweden were to find itself in such a situation.

The risk of deflation and a zero interest rate has sometimes been put forward as an argument in favour of central banks holding back, that is, not cutting the rate too quickly towards zero, but waiting and having more interest rate cuts in reserve. Mr Svensson does not share this view. Instead, he considers it better to act forcefully at an early stage rather than later on, also bearing in mind the long time lag between monetary policy measures and their effects on the real economy and inflation. An early interest rate cut may work longer than a late one.

Svante Öberg pointed out that it is important to differentiate between negative inflation and deflation. CPI inflation will be low during the coming period as a result of our own repo rate cuts and of falling oil prices. But according to the current forecasts, underlying inflation measured in terms of the CPI with a fixed interest rate (the CPIF) and excluding energy prices will be very close to 2 per cent during the whole forecast period. We have had negative inflation earlier, for instance, at the beginning of 2004, without this having been a problem; GDP growth was good then. This is quite different from the deflation experienced by Japan for many years.

Irma Rosenberg agreed with this. It is still now largely due to falling oil and other commodity prices that inflation is declining so quickly. The fact that oil prices are falling is not something that damages the Swedish economy. It is only if demand becomes so weak that inflation falls too low that the situation is serious.

Barbro Wickman-Parak agreed with Mr Svensson, Mr Öberg and Ms Rosenberg and clarified what she said in her earlier comments. It is deflationary tendencies provoked by a downward demand spiral that are a serious problem and it is therefore particularly important to dampen the fall in demand.

Lars E. O. Svensson agreed that what is important is to combat persistent deflation and avoid deflation expectations arising, as they did in Japan. In this case even a nominal rate that is at zero implies a positive and possibly excessively high real interest rate. On the other hand, negative inflation for a couple of quarters or so is not a problem. This happened, for example, in Sweden a few years ago. A good guarantee against persistent deflation expectations is to achieve a credible, positive inflation target.

Stefan Ingves considered it difficult to compare transmission mechanism effects in different countries, but agreed with Mr Nyberg that it had taken some time before Sweden was pulled into the crisis. He considered that as the Riksbank's balance sheet has expected very substantially, there is no shortage of short-term liquidity in Sweden, thanks to the measures taken. However, what remains is to restore the functioning of the financial markets in full, and if the negative developments continue it is up to the Riksbank to supply the necessary liquidity. We have this possibility and the measures taken so far have worked. There are further tools that can be used; the Riksbank has not come close to using its entire armoury.

Mr Ingves summarised the monetary policy discussion. There has been an unexpectedly rapid and clear deterioration in economic activity since October. Economic activity is also expected to continue to weaken over the coming period. Several economic indicators are at historically low levels. At the same time, the crisis in the financial markets is persisting, despite the forceful measures that have been taken around the world. The financial turbulence has made it both difficult and expensive for companies and households to borrow money. The weak developments in the global real economy have led the oil price and other commodity prices to continue to fall, which has led to lower cost pressures.

A much lower repo rate and repo rate path are needed to counteract economic developments being too weak and inflation being too low. The fact that the interest rate needs to be cut substantially is also due to monetary policy not having such a large impact recently as it normally does. It is therefore proposed that the Executive Board of the Riksbank today decides to cut the repo rate by 1.75 percentage points to 2 per cent. After this the repo rate may in principle remain unchanged over the coming year.

A lower repo rate path will dampen the fall in resource utilisation, which is expected to rise again at the end of the forecast period. Important components in the recovery include increased demand from abroad, improved functioning of the financial system and a general reduction in uncertainty. The weakening of the krona will also dampen the fall in growth. Inflation will fall rapidly next year and be below target over the coming two years. Inflation will then approach the target of 2 per cent a couple of years ahead.

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 1.75 percentage points to 2.0 per cent.

The Executive Board decided unanimously

to adopt the Monetary Policy Update according to the proposal, Annex A to the minutes,

to publish the Monetary Policy Update on Thursday 4 December at 09.30 a.m.,

to lower the repo rate by 1.75 percentage points to 2.0 per cent and that this decision would apply from Wednesday, 10 December 2008,

to lower the lending rate to 2.75 per cent and the deposit rate to 1.25 per cent, with effect from Wednesday 10 December 2008,

to announce the decision at 9.30 a.m. on Thursday 4 December 2008 with the motivation and wording contained in Press Release no. 67 2008 (Annex B to the minutes), and

to publish the minutes of today's meeting at 9.30 a.m. on Wednesday, 17 December at 9.30 a.m.

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