Minutes of the Executive Board's Monetary Policy Meeting, No 2

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

DATE: 19 April 2010

TIME: 09.00 a.m.

PRESENT: Svante Öberg, Chairman
Karolina Ekholm
Lars Nyberg
Lars E.O. Svensson
Barbro Wickman-Parak

Sigvard Ahlzén
Kai Barvèll
Claes Berg
Heidi Elmér
Johanna Fager
Eric Frieberg
Jesper Hansson
Ann-Christine Högberg
Per Jansson
Johanna Jeansson
Andreas Johnson
Anna Lidberg (§1)
Marianne Nessén
Christina Nyman
Britta von Schoultz
Lena Strömberg (§1)
David Vestin
Staffan Viotti

§ 1. Economic developments

It was noted that Johanna Jeansson and Andreas Johnson would prepare draft minutes of § 1, 2 and 3 on the agenda for the meeting.

It was further noted that the traffic problems in Europe following the volcanic eruption in Iceland meant that Governor Stefan Ingves was unable to take part in the monetary policy meeting, and that in his absence First Deputy Governor Svante Öberg functions as chairman. In addition, it was noted that Mr Ingves will provide his views on the economic situation in a separate comment to be published at the same time as the minutes of the monetary policy meeting, on 3 May.

Lena Strömberg from the Financial Stability Department began by describing recent developments in the financial markets with a focus on the problems linked to Greece's weak public finances.

The focus in the financial markets has recently been primarily on developments in Greece. The difference between 10-year government bond rates in Greece and those in Germany remains substantial, while the corresponding interest rate differences for other euro countries with weak public finances have remained relatively stable in recent times. However, the CDS premiums, which are a measure of how credit risk is priced, have risen for these countries, too. This development has not had any major impact on the Riksbank's international stress index, which is an aggregate measure of stress in the money, bond and stock markets. The stress index is at relatively low levels, but still higher than the historical average.

A joint aid package for Greece of EUR 45 billion from the euro countries and the IMF has been announced. This package had a temporarily soothing effect on the financial markets. However, there are uncertainties over how a possible launch of the package will work, as it may require a parliamentary majority in some of the euro countries. Moreover, market participants appear to be focussing more on Greece's solidity than on the short-term liquidity problems that the package is meant to counteract. Greece's total refinancing requirement in 2010 is estimated at EUR 55 billion, of which around EUR 10 billion is to be refinanced in April and May. Greece has not yet presented any formal application to activate the aid package.

Anna Lidberg of the Monetary Policy Department reported on developments in the financial markets since the Executive Board Meeting on 8 April. Monetary policy expectations have shifted downwards in the longer term, compared with the situation in February. According to market participants this is explained by the Riksbank's adjustment to the repo rate path in February, by weak statistics in the euro area and by Statistics Sweden's upward revision to the percentage of variable-rate mortgages. On an international level, too, expectations of monetary policy have been lowered slightly.

Analysts are expecting the repo rate and the repo rate path to remain unchanged at today's meeting. However, market participants differ in their views of whether the first interest rate increase will come in July or September. There does appear to be a slight majority for a first increase in July. Over the coming year market participants are expecting the repo rate to be increased at roughly the same rate as the repo rate path from February implies. After that, however, the increases are expected to be made at a slower rate than is implied by the repo rate path.

Since the Executive Board meeting on 8 April the euro has weakened slightly against the dollar, despite the aid package for Greece. The krona remains largely unchanged when measured according to the TCW index. Rates on government securities have fallen internationally. In the United States a lower CPI outcome than expected for March as well as higher demand for securities have contributed to a decline in interest rates. Swedish government securities rates have only changed marginally. Stock market developments have been marked by broad upturns, both in Sweden and abroad. So far the financial markets do not appear to have been tangibly affected by the volcanic eruption in Iceland, although it is as yet too early to say what consequences it might have.

Per Jansson of the Monetary Policy Department presented a summary of the background material for the Executive Board's discussion. This material had been discussed at a meeting with the Executive Board on 13 April and prior to that it had been presented at a meeting on 8 April. He observed that the recovery in the world economy is continuing but that there are large regional differences. Growth in Asia and also in the United States is continuing to improve, while developments in the euro area are more sluggish. This affects the prospects for Swedish exports, as more than 40 per cent of Swedish exports of goods go to the euro area. However, it is reasonable to assume that Swedish exports will gradually benefit from the increase in world trade.

The GDP forecast for Sweden in 2010 has been revised down slightly, compared with the assessment made in February, given that growth was weaker than expected in the fourth quarter of 2009. Both weaker consumption and investment explain the forecasting error. At the same time, the labour market has continued to develop better than forecast, which makes it more difficult to interpret the analysis of resource utilisation. When the number of hours worked is increasing at the same time as GDP is falling, productivity is under pressure from two different directions and all in all at the same time the forecast for productivity growth has been lowered slightly. However, it is reasonable to assume that GDP growth will pick up and that productivity growth will improve during the forecast period. The Swedish krona has strengthened more than expected and during the forecast period some further strengthening is anticipated. Taken together, this leads to small changes in the inflation prospects with regard to CPIF inflation. The forecast for CPI inflation is lower than the February assessment, but this is explained by a technical effect due to new weightings for mortgage rates. It is suggested in the main scenario of the draft Monetary Policy Update that the repo rate should remain at 0.25 per cent and later be raised to more normal levels, starting in the summer or early autumn. This is the same assessment as was made in February.

§ 2. Economic outlook abroad

Deputy Governor **Lars E.O. Svensson** began the discussion by saying that he shares the view of developments abroad contained in the draft Monetary Policy Update. However, he wished to emphasise that even though the recovery of the global economy is continuing and the situation on the financial markets is normalising, there is still a need for an expansionary monetary policy in Europe and the United States. The recovery is from a very low level and could very well be fairly slow. Resource utilisation in Europe and the United States is still very low and inflation is low. The risks associated with breaking off the expansionary monetary policy too early are still much greater than the risks of continuing to pursue it for too long. The Federal Reserve's monetary policy committee has in line with this stated on 16 March that the situation justifies "exceptionally low levels of the federal funds rate for an extended period".

Deputy Governor **Karolina Ekholm** declared that she too shared the view of the international economic outlook in the draft Monetary Policy Update. The picture is roughly the same as at the monetary policy meeting in February. The recovery is continuing, but it looks different in different parts of the world. The region that appears to be recovering the most slowly is Europe, which is the area that Sweden is most dependent on regarding export demand. Furthermore, Ms Ekholm said that the national debt developments were the major cause for concern in Europe. A further element of uncertainty that has arisen now is the effects of the volcanic eruption on Iceland. She did not see any reasons why the disruptions in air traffic so far caused by the eruption would have any effects on economic activity, but if the eruption continues for a long time it may lead to production bottlenecks.

Deputy Governor **Lars Nyberg** also supported the assessment in the draft Monetary Policy Update where the recovery in the world economy is expected to continue roughly as anticipated. While the emerging economies in Asia are continuing to show stronger growth and the labour market in the United States appears to be improving slightly earlier than anticipated, developments in Europe are lagging behind. Mr Nyberg went on to say that the focus of the financial markets in recent months has increasingly been on the large government budget deficits and borrowing requirements that these will lead to over the coming years.

Mr Nyberg said that there were two different problems here, which one might call the US problem and the Greek problem. The US problem, which is also shared by the UK and a number of other industrial nations, concerns interest rates tending to rise when the demand for capital increases. This makes it more expensive to fund both budget deficits and private sector activities and it leads to a discussion of how growth will be affected if government borrowing squeezes out private investment. In March, uncertainty over the size of government borrowing and how it is distributed over time was one factor that led to ten year government bonds in the United States trading at a higher rate than the corresponding swap rate, which is unusual if not unique. This has led to a discussion of what one might regard in the future as a "risk-free interest rate". Mr Nyberg thought that this is a discussion that will continue, although no one is expecting the United States to default on payments.

The Greek problem, which is also to a large degree shared by a number of countries in southern Europe, is different. Here there is an uncertainty over whether the countries can manage the situation at all or whether they will be forced at some stage to suspend payments. Within the euro area it is also a question of whether countries should be saved through various aid packages, and if so, when and by whom. Mr Nyberg said that the uncertainty will probably remain for some time, as it is not politically possible to provide financial assistance just like that, even if the cost of helping, for instance, Greece is low in relation to the euro countries' total GDP. If money is handed out too easily, this will also mean a risk that the recipient country can avoid implementing necessary reforms to achieve a long-term balance. This is a question of moral hazard on a national scale. The point is that we could live with the uncertainty for a good while to come and that this will be reflected in the market rates. However, the risk that the market turbulence will spread to other countries gives the euro countries a strong incentive to manage the Greek problem.

Mr Nyberg went on to compare the Greek situation with the situation in Latvia. In both cases they have chosen a fixed exchange rate and have therefore been forced into an internal devaluation, that is, to reduce the domestic cost situation so that inhabitants must lower their standards of living for a while. According to Mr Nyberg, Latvia appears to have succeeded with this so far, and the risks have declined since last year.

Another uncertainty factor that is disturbing the markets and which will probably continue to do so over a long period of time is the uncertainty over the future regulation of the financial sector. How much will the new liquidity regulations cost the banks, and how much capital will be needed? Will there be any Tobin tax? The quicker the regulation agenda is cleared up, the sooner the uncertainty in the market will decline and the more capital governments and companies will be able to borrow at reasonable interest rates.

Mr Nyberg summarised his contribution to the debate by noting that the functioning of the financial markets has nevertheless gradually continued to improve. The turbulence and uncertainty currently prevailing in the markets would have given rise to substantial negative effects only one year ago. Now it has been possible to handle this without serious disruptions in the credit markets.

Deputy Governor **Barbro Wickman-Parak** began by saying that she shared Mr Nyberg's view that the focus of the financial markets is now on government budget deficits and credit ratings. These concerns have a different nature than the earlier problems related to the financial crisis, which are now beginning to wane. But this is nevertheless something that could have implications for economic activity through higher long-term interest rates. Ms Wickman-Parak reminded the meeting that until February she had had a more positive view of international growth prospects than was reflected in the forecasts made then. In February her view was in line with that presented in the Monetary Policy Report, and this is also the case now. The concern she has and has had regarding international economic activity applies from next year and onwards, when fiscal policy tightening begins in earnest.

Ms Wickman-Parak went on to say that it is gratifying that employment in the United States now appears to be turning around. Sales on the housing market have been somewhat lower, but at the same time the stock of unsold housing has been gradually reduced and there are signs that construction is recovering. If employment is now increasing, this will support the housing market through higher household income. It will also help public finances. Nevertheless, the United States still has a lot of work to do to correct its public finances. Ms Wickman-Parak noted that the problems in the euro area had already been mentioned by her colleagues on the Executive Board. However, she observed that it was good that the downturn in indicators for the euro area visible at the beginning of the year has turned around.

First Deputy Governor **Svante Öberg** agreed with the picture of international developments presented in the draft Monetary Policy Update. Developments in the world as a whole will be good, according to the forecasts, but GDP growth in the countries that are most important for our exports will be relatively weak, less than 2 per cent a year on average during the forecast period. Inflation in these countries will on average be only 1.5 per cent a year. The changes in the forecast relative to the February Monetary Policy Report are very minor.

Mr Öberg observed that one reason why developments are expected to be so weak is the consequences of the financial crisis. Financial crises are normally followed by periods of weak growth and weaker public finances as governments and banks, other companies and households all endeavour to reduce their balance sheets, which holds down demand and production.

Mr Öberg pointed out that the deficit in public finances in the OECD area has increased from around 1 per cent of GDP in 2007 to around 8 per cent of GDP in 2009. Only half of the deterioration can be explained by the downturn in economic activity, according to the OECD. The rising deficit has in turn led to a substantial increase in public-sector indebtedness. Mr Öberg thought that this deterioration in public finances will hold back GDP growth and inflation over a longer period of time, as it will result in higher interest rates and enforce fiscal policy tightening.

Mr Öberg went on to say that the problem was largely the same for all the established industrial nations. But there are major differences. Developments may be more dramatic for some countries that have particularly strained public finances. Greece is the country that has recently been the primary object of speculation regarding the sustainability of its public finances, which has resulted in large interest rate increases. The aid measures promised so far have not succeeded in reassuring the markets, according to Mr Öberg. Nor is Greece alone in experiencing problems. Other euro countries with problems are Portugal, Italy, Ireland and Spain. The deficits in the United States and the United Kingdom are also substantial.

There is also a risk of a more dramatic development than the one the Riksbank is forecasting. What we call sovereign risk has recently become the main risk to the financial system. When risk premiums for countries rise, the banks in these countries may also experience problems with losses and higher funding costs, and these problems can spread to banks in other countries. This could mean that international growth is even weaker than forecast. However, Mr Öberg stressed that so far this is only a risk, and he supported the essential outlook in the draft Monetary Policy Update.

Mr Öberg concluded by summarising the discussion of the international outlook. He observed that all of the members of the Executive Board largely supported the international outlook described in the draft Monetary Policy Update. The recovery in the world economy is continuing, but it is a relatively slow recovery from a low level, and with developments differing considerably from region to region. The financial markets have gradually stabilised. The changes in the forecasts relative to the February Monetary Policy Report are very minor.

The main uncertainties that were discussed were the consequences of the worsening of public finances abroad and the future regulation of the financial markets, and to some extent the effects of a long-lasting volcanic eruption in Iceland.

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

Deputy Governor **Lars E.O. Svensson** declared that he shared the view of economic developments in Sweden contained in the draft Monetary Policy Update. However, Mr Svensson emphasised that he advocates a different repo rate path than that in the main scenario, either a lower repo rate path over four quarters or a path where the repo rate is held unchanged at 0.25 per cent until the end of the fourth quarter of 2010. These alternatives had been presented by the Monetary Policy Department in connection with the preparation of the material presented at the monetary policy meeting.

These two alternatives lead to a much better outcome for inflation and resource utilisation than the repo rate path in the main scenario. Interestingly, they also give very similar forecasts for inflation and resource utilisation, so it does not matter very much which one chooses. But it is possible that other members of the Executive Board would for some reason prefer an unchanged repo rate over a longer period of time rather than an interest rate cut now.

Mr Svensson went on to point out that the Sveriges Riksbank Act and its preparatory work specify that monetary policy should be directed towards stabilising inflation around the inflation target and resource utilisation around a normal level. It is thus a question of choosing a repo rate path that best fulfils these objectives at each monetary policy meeting.

Stabilising inflation around the inflation target stems from the objective of price stability in the Sveriges Riksbank Act. Stabilising resource utilisation stems from the emphasis in the preparatory works for the Sveriges Riksbank Act, that the Riksbank, without prejudice to the price stability target, should support the goals of general economic policy with a view to maintaining sustainable growth and a high rate of employment. It is important that resource utilisation is stabilised around a normal level to avoid prejudicing the price stability target and to avoid average inflation being too high. If one instead uses monetary policy to try to stabilise resource utilisation around a higher level than the normal one, the result will be that average inflation overshoots the target, without gaining a better outcome for the real economy.

However, the repo rate path chosen should not threaten financial stability. This could mean that in a situation where financial stability is fragile, one may wish to avoid very high repo rates. It is also possible that in certain situations it can be argued that very low repo rates should be avoided. But, as long as financial stability is not threatened he sees no reason to rule out any repo-rate path.

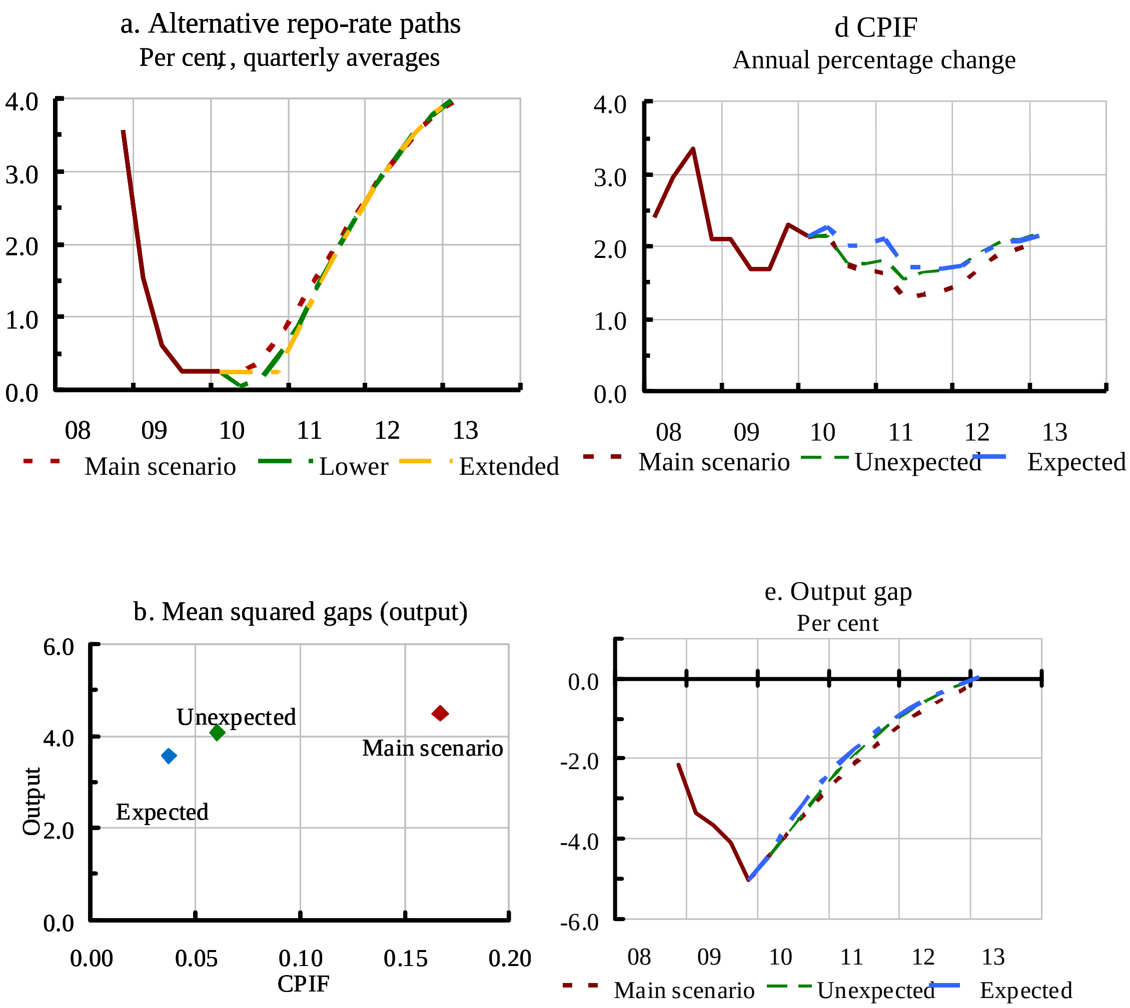
Mr Svensson further said that monetary policy should not set aside price stability and the stability of resource utilisation so as to "normalise" the repo rate and the repo-rate path in order, for example, to get away from a "crisis rate". Nor should monetary policy set aside price stability and the stability of resource utilisation in an attempt to influence the provision of credit or house prices, or because the economy has bottomed out and economic activity has begun to improve. The focus of monetary policy should always be on achieving the best stabilisation of both inflation and resource utilisation.

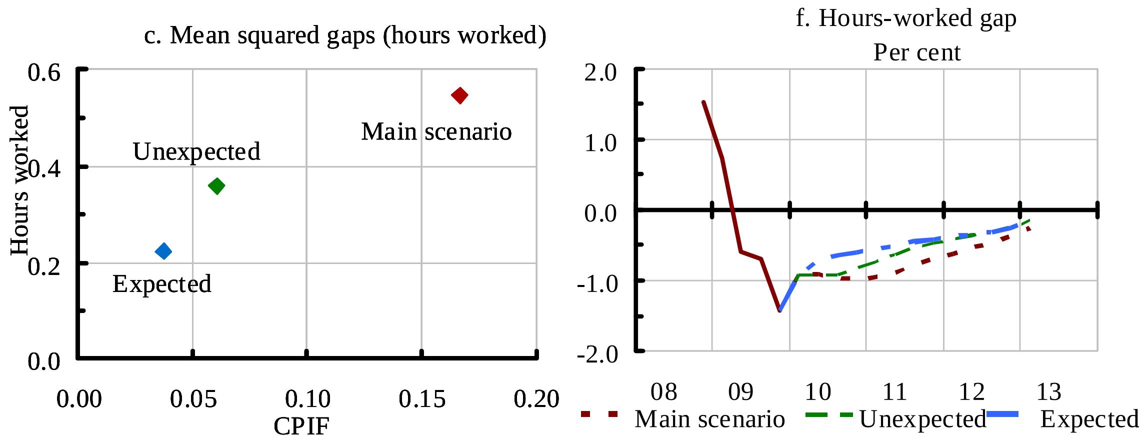
The repo rate and the repo rate path are not target variables in themselves. "A normal repo rate" is not a target for monetary policy. There is no support in the provisions or the preparatory work of the Sveriges Riksbank Act for using a high or low repo rate as a reason to set aside price stability or the stability of resource utilisation.

In Mr Svensson's view, various monetary policy alternatives and their consequences for inflation and the real economy must be discussed and assessed before any monetary policy decision can be clearly justified. A specific decision can best be justified by comparing it to the alternatives. It is thus a question of clarifying the reasonable and possible alternative repo rate paths that exist and what consequences they have on the forecast for inflation and resource utilisation.

For the past couple of years the Monetary Policy Reports have contained alternative repo rate paths (interest rate scenarios) with the corresponding alternative forecasts for inflation and the real economy. So far the Monetary Policy Update has only contained one repo rate path and corresponding forecasts for inflation and the real economy. Mr Svensson thought that without alternatives in the published update, it was not possible for outsiders to assess whether the Executive Board was making the right decision. Mr Svensson therefore believed that alternative repo rate paths and corresponding forecasts should also be presented in the Monetary Policy Updates. As he believes that alternative repo rate paths are necessary to be able to make a correct assessment of whether monetary policy is well balanced, Mr Svensson wished to include, as he did at the December meeting, graphs that present monetary alternatives in the minutes (Figure 1).

Figure 1. Monetary policy alternatives





Source: Statistics Sweden and the Riksbank

Panel a in the figure shows three different repo rate paths. These are the repo rate path of the main scenario; a repo rate path termed "Lower" which is below the repo rate path of the main scenario for four quarters and then returns to the path in the main scenario; and a repo rate path termed "Extended", where the repo rate remains at 0.25 per cent until the end of the fourth quarter of 2010 and then returns to the path of the main scenario.

Both of the alternative repo rate paths entail a more expansionary monetary policy than the main scenario. The interesting thing is that the alternative paths have very similar effects on the forecasts for inflation and resource utilisation. In panels d, e and f in the right-hand column the curves marked "Unexpected" show the forecasts under the assumption of a repo rate cut and an extension of an unchanged repo rate coming as a surprise to the market. The curves marked "Expected" show the effects under the assumption that an alternative repo rate path is announced now, gains credibility and is thus built into market expectations. The effect of expected changes in the repo rate is greater than the effect of unexpected changes, which is also shown in the graphs. As Mr Svensson has discussed at earlier monetary policy meetings, one might have different opinions on which of the outcomes is more realistic, "Expected" or "Unexpected". This may also vary, depending on the circumstances. With a transparent and properly-motivated monetary policy, he considered that the outcomes marked "Expected" would often be more realistic than those marked "Unexpected". Mr Svensson pointed out that these issues and the size of the effects were discussed in more detail in the speech he held at Umeå University on 24 February.

Panel d shows that both alternative repo rate paths give a forecast for CPIF inflation that is closer to the target and thus stabilises CPIF inflation better around the target.

In panels e and f one can see that both alternative repo rate paths give rise to a forecast for the output gap and the hours gap that entails higher resource utilisation. Resource utilisation is thus better stabilised around a normal level.

In panels b and c this is confirmed by the mean squared gap, which is closer to the origin than the main scenario, and closer to expected than unexpected changes in the repo rate. The closer to zero the mean squared gap for inflation is, the better the inflation target is attained. The closer to zero the mean squared gap for the output gap or the hours gap, the better the stabilisation of resource utilisation.

According to Mr Svensson, it is thus clear that both of the alternative repo rate paths better attain both price stability and stability in resource utilisation. If in this situation he instead were to choose the repo rate path of the main scenario, he would perceive this to be setting aside price stability and stability of resource utilisation.

With regard to choosing between the lower repo rate path or the extended one, Mr Svensson thought that it would be more credible and affect market expectations more to cut the repo rate now than to announce that the repo rate would remain at the same level for a longer period of time. This would indicate that the effects of the lower repo rate path would be reflected better by the curves marked "Expected", while the effects of the extended repo rate path would perhaps be better reflected by the curves marked "Unexpected". But announcing an extended repo rate path could also be credible, as it can so clearly be justified in that it provides a better outcome for inflation and resource utilisation.

Mr Svensson wondered whether it might be easier for his colleagues on the Executive Board to accept an extended repo rate path instead of a lower repo rate path? To enable a compromise and perhaps achieve unity on the repo rate path he therefore wished to first and foremost advocate the extended repo rate path and he hoped that his colleagues on the Executive Board would also prefer this. Mr Svensson maintained that he thus supported the proposal for an unchanged repo rate of 0.25 per cent, but that he preferred a repo rate path where the repo rate remained at this level until the end of the fourth quarter of 2010.

Deputy Governor **Karolina Ekholm** supported the proposal to hold the repo rate unchanged at 0.25 per cent. As inflationary pressures are apparently declining and resource utilisation is still low, Ms Ekholm said there is no reason to increase the repo rate now. Ms Ekholm also supported the proposal for an unchanged repo rate path in the draft Monetary Policy Update. However, she considered that it was more difficult to take a stance on the repo rate path than on the appropriate current level for the repo rate.

According to Ms Ekholm there are two different stances to take with regard to the repo rate path. The first is that the repo rate path, just like the repo rate, is a decision variable, where all members of the Executive Board may have an own optimal path they vote for. This could result in six different repo rate paths and a very difficult decision-making situation. It could also mean that the chairman's repo rate path is most often the one voted through, as it would be the chairman who decides how the different proposals are put against one another. The other stance, according to Ms Ekholm, is to view the repo rate path as the best forecast for the Executive Board's future collective decisions. In this case it comprises much more than how a future repo rate level might affect inflation and resource utilisation. It also involves how the Executive Board members interact to create a majority for various paths.

If the Executive Board could use a mechanical rule to determine which repo rate path provides the best outcome on each given occasion when a decision is to be made, both of the stances would result in one and the same repo rate path. But the majority of the Executive Board members appear to consider that there is no such mechanical rule, and they therefore have slightly different opinions as to which repo rate they would prefer to have. Ms Ekholm summarised by saying that her outlook was that the Executive Board members try to find a path that is sufficiently close to the paths that most of the Board members want to be able to achieve a majority decision. This should mean that this repo rate path is also a good forecast as to how the actual repo rate will develop.

With regard to the current decision on the repo rate path, Ms Ekholm said she considered that if anything the probability of a first repo rate increase in September rather than July had increased. She gave a number of reasons for this. Resource utilisation is still low and is expected to be below normal throughout the whole forecast period, in principle. Moreover, inflationary pressures also look to be low in the future. The low wage increases in the central agreements that have been reached so far contribute to this, as do a stronger krona and an expected increase in labour productivity. It also looks as though expectations are that several other central banks, such as the Federal Reserve, the ECB and the Bank of England will begin raising their policy rates at a later date than was assumed at the time of the previous meeting. Given the stable public finances in Sweden and the fact that household credits are showing relatively high growth here, it is not unreasonable that interest rate raises will come slightly sooner in Sweden than in the United States, the United Kingdom and the euro area. But at the same time Ms Ekholm considered that the situation did not look so much better in Sweden that it would justify much earlier increases, which might result in the krona strengthening more than was forecast. A possible introduction of an upper borrowing limit for new mortgages could also have some restraining effect. This could happen in the summer, according to Finansinspektionen (the Swedish financial supervisory authority). A final reason is the maturing of the Riksbank's three fixed-rate loans with long maturities. Although there is nothing in the expectations outlook to imply that this would lead to higher market rates, as these are large amounts that need to be refunded, Ms Ekholm did not wish to rule out the possibility of higher interest rates in connection with the maturities.

All in all, Ms Ekholm said that there are a number of reasons for raising the repo rate later rather than sooner, but that it is nevertheless a case of such minor differences that it does not justify a different assessment of the repo rate path than that presented in the draft Monetary Policy Update. According to Ms Ekholm, this repo rate path is a good assessment of which repo rate one can expect, given that the economy develops according to the forecast and given the information available regarding the other Executive Board members' views regarding the repo rate.

In conclusion, Ms Ekholm stated two reasons why she is against Mr Svensson's proposal to choose a repo rate path with a lower repo rate or an extended period at a level of 0.25 per cent. One reason is that she considers the rapid growth in household credit to create some risks and it is important to avoid households taking on too much credit so they will experience difficulty in meeting interest and amortisation payments in the future. To avoid this from happening, as it would make it more difficult to attain price stability and stability in resource utilisation, the interest rate needs to be increased in the relatively near future. The other reason is that there is a discrepancy between market pricing and the Riksbank's repo rate path, which actually entails a more expansionary monetary policy than the forecast. With a more expansionary repo rate path this discrepancy can be expected to remain or even to worsen. Ms Ekholm claimed that this could lead to an actual monetary policy that was clearly more expansionary and thus less well-balanced than that proposed in the draft Monetary Policy Update.

Deputy Governor **Barbro Wickman-Parak** agreed with Ms Ekholm that there is no mechanical rule for monetary policy. If there were such a rule it would not be necessary to have six Executive Board members. Ms Wickman-Parak went on to ask the question of where to draw the line between when a member of the Executive Board finds it necessary to point out that they do not agree with an assessment and when it is necessary to enter a reservation. She observed that she supported the proposal to hold the repo rate unchanged and nor did she wish to enter a reservation against the repo rate path, but she would like to send a signal that the normalisation of the repo rate could begin in July.

Ms Wickman-Parak went on to comment that the surprisingly weak GDP figure for the fourth quarter of 2009 was now history, and that history may well be rewritten. However, industrial output, where outcomes are available up to the end of February, was also weaker than expected. Strong indicators for the manufacturing industry have thus not yet made any great impact on the outcome data. Ms Wickman-Parak said that this could either be interpreted to mean that companies have been, and are, too optimistic, which would imply that the indicators will gradually begin to show a downturn, or else the indicators will soon also make their mark in the outcome statistics. Ms Wickman-Parak maintained that she believes in the latter. Both orders and export figures point to this.

Ms Wickman-Parak said that when companies were surprised by an extremely large fall in demand, they cut down production and inventory in all channels. This process was now drawing to an end. According to Ms Wickman-Parak, anecdotal information implied that some companies found it difficult to quickly meet an increase in order intake with an increase in production, as companies in earlier production channels did not have inventory at their disposal, but were forced to wait for deliveries of input goods. Even if this was sporadic information it might explain why the increase in production is weaker than would be implied by orders and various other indicators.

Ms Wickman-Parak pointed out that the fall in GDP that was larger than expected could indicate that resource utilisation is lower than it was at the time of the monetary policy meeting in February. At the same time, employment has been stronger. Capacity utilisation in industry has moved upwards, according to both Statistics Sweden and the Swedish National Institute of Economic Research, albeit from a low level. In the draft Monetary Policy Update the conclusion is drawn that resource utilisation is probably higher than it was at the time of the February assessment and Ms Wickman-Parak shared this view. At the same time, she noted that all of the calculations of resource utilisation are always uncertain and particularly now when it is difficult to know what effects the crisis has had on potential production. The output gap the Riksbank calculates does not contain any information on how resource utilisation looks in different sectors. As we know, developments in production in the manufacturing and services sectors differ substantially and this also means that the degree of spare capacity in the two sectors differs. Ms Wickman-Parak considered this to be of interest when making monetary policy considerations.

The inflation outcome for the first quarter has been a little higher than the Riksbank estimated, but the forecast in the draft Monetary Policy Update shows a declining inflation rate in the future. This is partly due to falling unit labour costs, but also to a stronger krona. As economic activity strengthens, the inflation rate is expected to rise again. Ms Wickman-Parak said that there is no immediate inflation risk at present. However, monetary policy must look ahead and ensure that we can prevent domestic inflationary pressures generated in the services sector from building up, even if inflation is temporarily held down by a stronger krona. Ms Wickman-Parak pointed out that it is important for monetary policy to analyse the driving forces behind inflation.

Ms Wickman-Parak went on to say that the current extremely low interest rate was set during a crisis situation. It has been valuable in contributing as far as possible to keeping down the number of company bankruptcies. It has also contributed to households borrowing, consuming and buying houses and apartments. This in turn has benefitted the domestic economy when export demand declined substantially.

But now the acute stage is over, said Ms Wickman-Parak. International demand is beginning to return and it is an open question to what extent Swedish companies will need to make changes to be able to fully benefit from this. Incidentally, it can be noted that a stronger exchange rate could enforce such a change process.

It will take some time before companies' increased demand has an impact in the form of increased investment in the business sector. The current low interest rate cannot change this. This is also why bank lending to companies is continuing to fall. However, household borrowing is increasing at a rapid rate and households' debt ratios are continuing to rise from an already high level. This is a development that is not sustainable in the long term, and when an adjustment comes it may affect economic activity further ahead. Ms Wickman-Parak pointed out that several members of the Executive Board have mentioned this problem on various occasions. The interest rate has an effect, but in a way that is worrying in the long run. The fact that the regulations for leverage and amortisation with regard to mortgages are to be tightened is one thing, but the price of money still plays an important role in the expansion of lending.

Ms Wickman-Parak reminded that a majority of the Executive Board agreed in February that the repo rate should be raised fairly soon; in the summer or early autumn. But there were nuances, where she personally leaned more towards an increase in the summer, although she did not consider the difference between an increase in July versus an increase in September to justify entering a reservation. A further period of time has now passed, with continued improvements in the financial markets, almost unchanged growth and inflation forecasts, a labour market that has developed more strongly and a continued high level of household borrowing. Ms Wickman-Parak therefore repeated that she supported holding the repo rate unchanged this time, but that she is if anything more convinced now that a suitable time to begin normalisation is in the summer.

Deputy Governor **Lars Nyberg** said that developments in Sweden are largely following expectations. The recovery is on increasingly firm ground. Employment has shown an upturn sooner and more clearly than expected, if one makes a comparison with previous economic cycles. In July last year the Riksbank was expecting unemployment to peak at 11 per cent in 2010. Now the forecast is for 9 per cent. This is despite expected GDP growth only having been adjusted upwards from 1.1 to 1.8 per cent. This is a positive but surprising development, which we must try to understand and explain better in our analysis.

The division in the economy has been further accentuated, with a comparatively strong services sector and a manufacturing sector that is lagging behind. Mr Nyberg considered this to be a problem for monetary policy, which risks over-stimulating the domestic economy while investment in industry is not forthcoming while waiting for clearer signals regarding the rise in export demand. The help that export companies receive from a low interest rate is more about continuing to conduct their operations throughout the recession without liquidity being threatened by high costs for existing loans. The banks' loan losses from Swedish companies have also been surprisingly small, which is a different aspect of the same thing.

Now, however, it is possible to perceive a clear increase in the demand for exports. An important question here is how quickly the export industry can adjust to new trade patterns. Sweden has traditionally based its exports on investment goods rather than on consumption goods, and sold them to Europe and the United States rather than to Asia and Latin America. How much does the composition of Swedish exports need to change to fit the new markets, and are the sales channels sufficiently developed? But one of the strong sides of the Swedish manufacturing industry over the past fifty years has been its ability to make such adjustments. Otherwise, Sweden would still be dependent on the steel and shipping industries.

Mr Nyberg emphasised that the division in the economy has not led to any negative surprises in the wage bargaining rounds, which was viewed as a risk at the February meeting. On the contrary, the agreements appear to have landed at a reasonable level, even in sectors were the demand situation has been good. There are thus few inflation impulses from the labour market.

A reflection of the weak development in the manufacturing industry and the strong development in the service sectors is that lending to companies is continuing to fall, while lending to households is instead increasing rapidly. Mr Nyberg repeated his stance from earlier meetings that this sequence of events in the long run risks building up imbalances in the household sector in the same way that happened in a number of countries prior to the financial crisis. This should be avoided. Continued rising house prices in the middle of a recession are a worrying sign, even if house prices in themselves do not entail any target for monetary policy. If Finansinspektionen sets a ceiling for leverage, this will be a step in the right direction. It is also a clear signal of rising concern.

Mr Nyberg further observed that Sweden has strong public finances and appears to be a good example, compared with many other countries in the world. One only needs to look back at the years following the 1990s crisis to realise what strength lies in this. But the strong public finances have also contributed to the krona strengthening more than expected, which has attained some economic restraint. There will also be some restraining effect in the summer and autumn when the Riksbank's three fixed-rate loans mature without being replaced. But as this is expected by the market, it should not give rise to any interest rate movements worth mentioning. The most significant aspect of this is that the Riksbank will return the overnight market to the banks after having managed it in practice since the crisis started. This is an indication that the banks can now cope on their own and thus a healthy sign.

Mr Nyberg summarised by saying that he supported the proposal to hold the repo rate and the repo rate path unchanged. Although the new information received since February has been largely positive, it has not been so different from expectations that it justifies changing the repo rate path. The inflation forecast for 2011 in the draft Monetary Policy Update has been marginally revised down. However, at some point in the summer or early autumn it will be time to leave the crisis interest rate of 0.25 per cent behind us and to begin to view the situation as a more normal economic downturn. It is important to emphasise to households that the time of low interest rates will not last for ever. Mr Nyberg concluded by saying that he, like Ms Wickman-Parak, considered July to be a more natural starting point for the interest rate increases than September.

First Deputy Governor **Svante Öberg** also agreed with the picture of economic developments in Sweden presented in the draft Monetary Policy Update. He merely wished to add a brief comment on the spring wage bargaining rounds. The wage agreements signed so far have had roughly the outcomes expected. However, the Industrial Agreement has not had quite the normative function as before; the length of the agreement periods has varied more between the different sectors and there would appear to be more notices and conflicts than during the most recent wage bargaining rounds. This could ultimately lead in the worst case to wage formation not functioning as smoothly in the future as it has done over the past fifteen years.

Mr Öberg also supported the proposal to hold both the repo rate and the proposed repo rate path unchanged. The repo rate is currently exceptionally low. It is much lower than would be implied by a standard rule like the Taylor rule. In real terms it is around -1 per cent. This is a crisis interest rate. The repo rate path that is proposed entails the repo rate being gradually raised to a more normal level of around 4 per cent and the real interest rate being raised gradually to around 2 per cent. This is expected to lead to underlying inflation being 2 per cent and to resource utilisation being roughly normal at the end of the forecast period. The changes in the forecasts relative to the February Monetary Policy Report are very minor. Mr Öberg said that as far as he could see, it is still reasonable to begin raising the repo rate in the summer or early autumn.

Furthermore, Mr Öberg said that with regard to the monetary policy stance, it is necessary to take into consideration the fact that phasing out the three large fixed-rate loans will to some extent push up short-term interest rates. The effective policy rate is now 0.15 per cent, in that the bank system has too much liquidity through the fixed-rate loans, but when the loans mature it will return to 0.25 per cent or whatever level the repo rate may be at then. Slightly longer market rates are probably also being held down by the fixed-rate loans. If no new fixed-rate loans are offered, and it does not seem likely at present, then the maturities of these loans will entail some monetary policy tightening.

Other measures may also lead to some tightening. The limitation in the size of loans relative to the value of the home, which Finansinspektionen has recently proposed, is one such measure. On the whole, stricter regulation of the financial markets will probably lead in the long run to rising interest rates for borrowers.

Deputy Governor **Lars E.O. Svensson** replied that on this occasion one can regard the choice of different repo rate paths as a question of at what point in time a return to a normal interest rate level should begin, July, September or, as he personally advocates, December. What criteria should be used when choosing an alternative? Mr Svensson said that one should look at the forecasts for inflation and resource utilisation for each interest rate alternative and then choose the alternative in which the forecast for inflation and resource utilisation best stabilises inflation and resource utilisation. According to Mr Svensson, December is then preferable.

Mr Svensson went on to respond to Ms Ekholm's argument that household indebtedness could entail future risks. Mr Nyberg had also taken up household indebtedness and rising house prices and warned of future imbalances. Mr Svensson's firm opinion was that if one believes that indebtedness and house prices are important, one should make a thorough analysis of the potential effects on future inflation and resource utilisation. If indebtedness and house prices prove to have an effect one can then include this in the forecasts for inflation and resource utilisation.

Further, Mr Svensson referred to Ms Ekholm's reasoning that an unchanged repo rate up to the end of the fourth quarter could have drastic effects on market expectations and lead to monetary policy becoming too expansionary. If one believes this, then a thorough analysis of its effects should be made. Mr Svensson did not understand why this should be the case, but said that if one believes that an unchanged repo rate up to December, but not up to September, would have such drastic effects perhaps it would be possible to compromise on October?

Mr Svensson then responded to Ms Wickman-Parak's argument that the measures of resource utilisation are uncertain. This is true, but there is no doubt that resource utilisation now and in the coming years will be very low, however it is measured. Mr Svensson pointed out that he had considered including a figure from the speech he held at Umeå University on 24 February with forecasts for resource utilisation from different forecasters. There one can see that most forecasters are more pessimistic and have lower forecasts for resource utilisation than the Riksbank's.

Mr Svensson then commented on Ms Wickman-Parak's discussion of the division in the economy and the fact that inflation in different sectors can differ. He considered that monetary policy cannot do anything about the allocation of resource utilisation between different sectors and the rate of inflation of different components of the CPI. The best thing is for monetary policy to focus on average resource and average CPI inflation, or as is now more appropriate, CPIF inflation.

Further, Mr Svensson referred to Mr Nyberg's reasoning that a largely unchanged outlook for the economy compared with February justified an unchanged repo rate path compared with February. This assumes that the repo rate path in February was well-balanced, which Mr Svensson did not consider that it was. He considered that each repo rate path at each monetary policy meeting should be able to stand alone and be motivated as the path that best stabilises inflation and resource utilisation.

Deputy Governor **Lars Nyberg** responded to Mr Svensson's contribution by saying that even if all of the Executive Board members agree that monetary policy should focus on the inflation target, giving consideration to the real economy, one can nevertheless make different assessments of what constitutes a well-balanced monetary policy. He pointed out that he, like Ms Wickman-Parak, had earlier viewed the Riksbank's forecasts for the real economy as overly cautious – a view that has proved to be correct.

Mr Nyberg went on to express concern over the division in the economy. He considered that the economy is in a situation that it has never been in before, and where one cannot receive the same assistance from models based on historical relationship. There is also reason to give consideration to the fact that imbalances can be created, which can affect monetary policy at a later stage. The crisis has taught us not to dismiss these questions as only concerning financial stability. It is difficult to determine when serious imbalances arise, but the costs of ignoring them can be high.

Deputy Governor **Barbro Wickman-Parak** began by pointing out that all of the Executive Board members agreed that resource utilisation is low and that it is a strongly contributing factor to the assessment that monetary policy needs to be expansionary over a long period of time. But even if all measures of resource utilisation show that it is low, one may attain different results regarding the size of the gap, depending on whether one uses the output gap or the labour market gap or depending on the method used. She therefore considered that it is not possible to use a measure of the output gap or the labour market gap in the economy in the precise way that Mr Svensson describes. Ms Wickman-Parak instead called for a more cautious approach to the calculations.

Further, Ms Wickman-Parak said that it is not reasonable to hide behind an average when it comes to resource utilisation. To be prepared, it is necessary to analyse the driving forces behind data on, for instance, resource utilisation or inflation and also to try to ascertain what this may mean in the slightly longer term. The world does not end where the forecast horizon stops.

Deputy Governor **Karolina Ekholm** wanted to comment on two points that Mr Svensson had taken up in his contribution. One is the reasoning that if one is worried that credit growth and developments in the housing market are creating imbalances that affect demand in the economy further ahead; this should be incorporated into the forecast. Ms Ekholm agreed that this should be the Riksbank's aim. However, the question is what stance one should take regarding factors that one believes may have significance for the development of the economy, but which one has not succeeded in incorporating in a quantified forecast. Ms Ekholm pointed out that Mr Svensson does not consider that such factors should be taken into account in the monetary policy decisions. However, Ms Ekholm thought that it is the task of the Executive Board members to take into account factors that are expected to have significance for the way the economy develops, even if their significance cannot be specified in figures.

The second point Ms Ekholm wished to make was her own reasoning that monetary policy at present is actually more expansionary than is indicated in the forecast and that this discrepancy would risk remaining or even worsening if the Executive Board decided on a more expansionary monetary policy at today's meeting. Ms Ekholm pointed out that Mr Svensson has called for a thorough analysis of what the outcome would be for different decisions, given the way that interest rate expectations are affected. She agreed that such an analysis would be very useful. However, the Executive Board must make a decision on the repo rate path now, based on the material that is available now.

Deputy Governor **Lars E.O. Svensson** wanted to comment on the division in the economy that Mr Nyberg mentioned again. The problem in the real economy now is mainly that the export industry is finding it difficult to get going. Mr Svensson considered this to be an argument in favour of a more expansionary monetary policy, not tighter monetary policy. A repo rate path with an unchanged repo rate up to the end of the fourth quarter of 2010 would probably contribute to a weaker krona, and a weaker krona is the best help for the export industry at present.

Mr Svensson then turned to Ms Ekholm and argued that one does not know whether or not household indebtedness will affect future inflation and resource utilisation. He believed that one should not react to what one does not know. It would in this case involve a certain cost, in the form of poorer target achievement for inflation and poorer resource utilisation, to obtain an unknown and uncertain gain.

In addition, Mr Svensson considered that Ms Ekholm's comments on the difference between market expectations and the repo rate path, where market expectations further ahead were much lower than the Riksbank's repo rate path, were interesting. This means that the market is expecting much more expansionary monetary policy than the Riksbank has announced. Mr Svensson felt that this difference should be processed and discussed properly prior to the next monetary policy meeting. Mr Svensson emphasised that he is not usually one to say that the market is right and the Riksbank is wrong. But on this occasion he would not be surprised if a slower rise in the repo rate would prove to be more reasonable.

After this, First Deputy Governor **Svante Öberg** summarised the monetary policy discussion. All of the members of the Executive Board support the picture of developments in Sweden described in the draft Monetary Policy Update. The Swedish economy developed weakly last year, but in 2010 GDP growth is expected to be positive again. However, the recovery is from a low level and it will take time before the recent years' fall in GDP has been recovered. The labour market has nevertheless developed better than the Riksbank had earlier anticipated. Inflationary pressures are low and underlying inflation measured as the CPIF is calculated to fall this year, but is then expected to rise to around 2 per cent at the end of the forecast period.

The Executive Board agrees to hold the repo rate unchanged at today's meeting. There is also a majority in favour of the repo rate path described in the draft Monetary Policy Update, which means that the repo rate will probably begin to be raised with effect from the summer or early autumn. Four of the five Executive Board members present share this assessment. However, the members of the Executive Board differ slightly in their assessments of whether the repo rate should first be raised in July or September. Lars E.O. Svensson shares the view of economic developments but advocates a different repo rate path where the repo rate begins to be raised in December and is then raised at a slightly faster pace. Mr Öberg observed that four of the five Executive Board members present thus supported the Monetary Policy Update.

§ 4. Monetary policy decision

The Executive Board decided after voting

- to adopt the Monetary Policy Update according to the proposal, Annex A to the minutes,
- to hold the repo rate unchanged at 0.25 per cent and that this decision would apply with effect from 21 April 2010,
- to hold the lending rate unchanged at 0.75 per cent, and the deposit rate unchanged at -0.25 per cent, with effect from 21 April 2010,

- to publish the Monetary Policy Update and other decisions at 9.30 a.m. on 20 April 2010 with the motivation and wording contained in Press Release no. 19 2010 (Annex B to the minutes), and
- to publish the minutes of today's meeting at 9.30 a.m. on Monday, 3 May at 9.30 a.m.

Deputy Governor Lars E.O. Svensson entered a reservation against the repo rate path and advocated a repo rate path with a repo rate of 0.25 per cent through the fourth quarter of 2010, and then a gradual return to the repo rate path in the main scenario. Such a repo rate path results in about the same effects as the lower repo rate path that he has previously advocated, that is, a better outcome for both resource utilisation and inflation, with both higher resource utilisation and CPIF inflation closer to the target.

This paragraph was confirmed immediately.

Minutes by

Ann-Christine Högberg

Checked by:

Karolina Ekholm   Lars Nyberg   Lars E.O. Svensson

Barbro Wickman-Parak   Svante Öberg