

unrest. During the summer of 1998 many investors closed their most risky equity positions, mainly in favour of interest-bearing securities. This caused a further drop in long-term interest rates, internationally as well as in Sweden.

The level of Swedish long bond rates is still historically low.

After the December Report, Swedish long bond rates went on falling. At times in the early part of 1999 the level was below 4 per cent. Recently, however, bond rates have been pushed up somewhat in Sweden as well as in the euro area. In Sweden, the upward tendency seems to be almost entirely a reaction to the rising rates in the United States, which seem to be occasioned in turn by signs of sustained economic strength. But the level of Swedish long bond rates is still historically low, around 4.5 per cent

(Annex: Fig. 10). As long rates in Germany have not risen as much as in Sweden, the long-term interest rate differential with Germany was widened somewhat to about 0.4 percentage points (Annex: Fig. 11).

During the autumn, a further decline in international economic activity and inflation prospects had weakened the outlook for economic activity and inflation in Sweden. The expectations this raised of further interest rate cuts were subsequently fulfilled when the monetary stance was adjusted in a more expansionary direction. In December 1998 and February 1999 the repo rate was lowered in two steps, totalling 0.45 percentage points, to 3.15 per cent.

5 World Bank (1999), *Global Commodity Markets*.

MONETARY POLICY'S ECONOMIC IMPACT

The repo rate—the short-term rate for the private banks' deposits in and borrowing from the Riksbank—is the Riksbank's main monetary policy instrument. Simplifying somewhat, the Riksbank influences other interest rates in Sweden by altering the repo rate. Via these market interest rates an influence is exerted in turn on economic activity, for example business investment and household consumption, and thereby ultimately on price formation. However, the effect of the Riksbank's actions is not the same for every type of interest rate. The rates with the shortest maturities are controlled by the repo rate more or less directly, while those with longer maturities are also strongly influenced by factors which the Riksbank does not control directly, for example the construction of fiscal policy, the development of international interest rates and the credibility of overall economic policy's commitment to price stability. It should also be noted here that households and most firms finance their procurements and consumption mainly at interest rates, that differ from the quoted mar-

ket rates. The loans are usually provided by banks and house mortgage institutions at rates that also reflect credit risks and competition between different institutions.

Monetary policy also influences the course of inflation via the exchange rate because exchange rate movements have effects on, for example, demand and investment in the internationally oriented sector of the economy. Under normal conditions a repo rate increase, or expectations of this, leads to a stronger exchange rate because the higher interest rates make Swedish assets more attractive than equivalent interest-bearing investments in other currencies; this draws foreign capital to Sweden, with an increased demand for Swedish kronor. All else equal, a permanent weakening or strengthening of the exchange rate will affect demand via shifts in relative prices between Swedish and foreign goods. This in turn affects inflation. Inflation is also influenced directly by exchange rate movements in that these alter import prices.