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The Executive Board's consultation response on the report Review of the Riksbank's Monetary Policy 2010–2015 (2015/16:RFR7)

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The Executive Board of the Riksbank observes that the report contains generally positive comments regarding the Riksbank's work with monetary policy and financial stability. The Executive Board considers that several of the recommendations in the report should be taken into account in the coming commission of inquiry.

The Executive Board considers, as do Goodfriend and King, that it is important that the area of financial stability is revised in a coming review of the Sveriges Riksbank Act and that the Riksbank's role with regard to promoting financial stability is clarified. The Executive Board also considers that the role of the Riksbank in mitigating risks and vulnerabilities in the financial system, including macroprudential policy, needs to be strengthened. With regard to the current framework for macroprudential policy, the Executive Board agrees with the assessment in the report that this has shortcomings in important areas and should be revised. The Executive Board considers that the framework for macroprudential policy should be reviewed again in connection with the review of the Sveriges Riksbank Act. The Executive Board points out that the structure chosen must be characterized by good decision-making power and a clear allocation of responsibility. However, it will probably take several years before a commission of inquiry is complete and its proposals incorporated into Swedish law. At the same time, there is an urgent need to counteract Swedish households' high and growing indebtedness. The Executive Board also agrees, therefore, with the recommendation in the report that Finansinspektionen should, without further delay, be given the legal powers and tools to be able to counteract risks that have arisen.

The report highlights several monetary policy issues that deserve further analysis and discussion. One important question is how detailed the target for monetary policy should be stipulated in law. At present the Executive Board is not taking a stance on the proposal to change target variable, but observes that there are several advantages of changing the target variable from the CPI to the CPIF or HICP, and welcomes continued discussion of this question.

The Executive Board welcomes the report's contribution to the discussion on flexible inflation targeting. The Executive Board agrees that monetary policy shall as before focus on attaining the inflation target and in addition promoting sustainable growth and a high level of employment. This flexible inflation-targeting policy, in which development of the real economy and risks linked to the financial system can be



■ *considered in the monetary policy decisions, fits into the Riksbank's current mandate. The Board also agrees that a well-balanced monetary policy can in some situations mean that it is expected to take more than two years for inflation to return to the target. It is therefore important that monetary policy is clearly explained and justified, both to the Riksdag Committee on Finance and the general public. The Riksbank does this today and aims to continue to do so in an open and comprehensible manner, regardless of how long inflation is expected to deviate from the target.*

The Executive Board agrees it is important to explain basic assumptions regarding international developments so that that base for the Riksbank's forecasts is made clear.

The Executive Board also thinks it is natural to analyse the causes and implications of the differences between the repo-rate path and market expectations of the repo-rate path on certain occasions, but that this does not necessarily need to be done as a matter of course.

The Executive Board does not see a need to clarify the responsibility for foreign exchange policy. This responsibility is clearly stated in the Currency Rate Policy Act and the Sveriges Riksbank Act.

The Executive Board agrees that the aim should be for the minutes of the monetary policy meetings to describe the different points of view put forward at the meeting. This aim can be considered to be fulfilled now, as the minutes express in full what was said at the monetary policy meetings. The Executive Board is open to supplementing the minutes of monetary policy meetings with more information of the type requested by the authors, that is, information from the drafting meetings prior to the monetary policy meetings.

Introduction

The Riksbank is presenting two separate consultation responses to the report "Review of the Riksbank's monetary policy 2010-2015" (2015/16 RFR6). This consultation response concerns the questions within the Executive Board's area of responsibility, but does not claim to cover all of the conclusions and recommendations in the report. The General Council will at the same time issue a consultation response regarding the issues that belong to its sphere of activity.

The Executive Board's response begins with some general views. The two following sections present and justify the Executive Board's stance on the recommendations. The consultation response follows the report's division into recommendations with regard to monetary policy (section 2) and financial stability (section 3). As most of the recommendations contain several proposals, the layout is such that each of the recommendations is followed by several standpoints and the motives for these. In those cases where the arguments for the Executive Board's standpoints are the same for several different recommendations, the recommendations are discussed together. A fourth and concluding section contains some overall comments by the Executive Board on the aim of the coming review of the Sveriges Riksbank Act announced by the Riksdag Committee on Finance in connection with the publication of the evaluation.



1. General views

The Executive Board welcomes the fact that Goodfriend and King's overall assessment of the Riksbank's monetary policy in 2010-2015 is generally positive. The Executive Board shares the view in the report that the present inflation-targeting regime and the legal framework with an independent central bank has functioned well. This is an important starting point when it is time for a review of the Sveriges Riksbank Act. The General Council and Executive Board of the Riksbank decided as early as February 2010 to make a joint submission to the Riksdag (the Swedish parliament) on certain points that need revision¹. In some cases there have been commissions of inquiry, but several of their proposals have not been followed up with continued law-drafting proposals.

2. Recommendations on monetary policy

2.1 Monetary policy target

Recommendation 1

The report recommends that the Riksdag, on a recommendation by the Finance Minister, should specify the inflation target, in terms both of its definition and its numerical value, and should delegate that objective to the Board of the Riksbank to achieve. At present, a target of 2% a year as measured by CPIF is recommended. The target should be reviewed every ten years unless the Riksdag legislates to change the target earlier than the next due review date.

The Executive Board does not take a stance on the recommendation that the Riksdag should define, quantify and regularly review the inflation target, but notes a couple of aspects of this that might be relevant to the Committee on Finance's processing.

The main reason why our politicians have chosen to delegate the responsibility for the formulation of monetary policy to an independent Riksbank with a clearly stated price stability target is to give monetary policy a long-term perspective that creates the right conditions for the target to be credible. To achieve this, the Riksbank has been given an institutional independence that means no one can give instructions to the Riksbank on monetary policy issues, other than through the formulation of the statutory objective of monetary policy.

It is not self-evident how detailed the formulation of the target for monetary policy should be stipulated in law and this question was discussed in the commissions of inquiry leading up to the amendment in the Sveriges Riksbank Act 1999 when the current monetary policy objective of price stability was confirmed by law. The conclusion in Government Bill 1997/98:40, The position of the Riksbank, was that there was no reason to specify the target in too much detail as specifying, for instance, the level of the permitted rate of price increase or the size of a potential tolerance interval could be too inflexible and would not allow the Riksbank sufficient scope to adapt the target to new circumstances.

¹ "Report on certain areas that require investigation as a result of the financial crisis", 2009/10:RB4.

■ There are examples of countries where the inflation target is specified by the central bank's principal. However, comparisons between countries are made more difficult by differences in the institutional conditions with regard to the position of the central bank. One must take into account the fact that Sweden does not have a formal exemption from the Treaty on the Functioning of the European Union (TFEU) and the regulations on central bank independence included there.

At present the Executive Board is not taking a stance on the proposal to change target variable, but observes that there are several advantages of changing the target variable from the CPI to the CPIF or HICP, and welcomes continued discussion of this question.

There are discussions in Sweden and abroad regarding the level of the inflation target, in which arguments are put forward in favour of both a higher and a lower target. In the light of this debate, the Executive Board notes that the report does not recommend changing the level of the inflation target, but considers it should remain at 2 per cent. On the other hand, the report takes an explicit stand against some other proposals regarding changes in inflation-targeting that also arise in the debate. Goodfriend and King do not consider it sensible, for instance, that the central bank's target be extended to include numerical targets for employment and output and they do not recommend that the monetary policy objective be established in terms of nominal GDP. The Executive Board agrees with this.

On the other hand, the authors do recommend changing the price index by which the inflation target is expressed, from CPI to CPIF. The Executive Board notes that the question of changing the target variable has been discussed for some time now. For instance, this question was raised in the two previous external evaluations of monetary policy.² The recommendation in the first evaluation was that the target should be defined in terms of a price index that is not directly affected by the cost of housing. The following evaluation recommended that the target index should not be changed.

The authors' main argument for changing target variable to CPIF is that the CPIF was in practice used consistently instead of the CPI in the Executive Board's monetary policy deliberations during the period evaluated. As the Executive Board pointed out in the Monetary Policy Reports published during this period, measures of inflation that do not include the direct effects of changes in interest rates, such as the CPIF or the HICP, provide a better picture of inflationary pressures in periods with considerable fluctuations in interest rates.

The direct effect on CPI inflation of changes in interest rates is one aspect that has complicated the communication of monetary policy ever since the introduction of the inflation target. However, the question of what should affect the choice of target variable is a larger one that has been discussed at length in academic circles and by central banks. The conclusion is that there is no obvious answer. A review of the arguments for and against the various potential measures of inflation, seen from both theoretical and empirical perspectives, is given in an Economic Commentary published in connection with this consultation response.³

² Giavazzi, F. and Mishkin, F. (2006), "An evaluation of Swedish monetary policy between 1995 and 2005", 2006/07:RFR1 and Goodhart, C. and Rochet, J-C. (2011), "Evaluation of the Riksbank's monetary policy and work with financial stability 2005–2010", 2010/11:RFR5.

³ Apel, M., Armelius, H. and Claussen, C-A. (2016), "Price index for the inflation target", *Economic Commentaries* no. 2, Sveriges Riksbank.

Recommendation 2

The report recommends that the mandate given by the Riksdag to the Riksbank should state that the monetary policy objective of the Riksbank shall be to maintain price stability, as defined by the inflation target, with regard to the long run sustainability of the path for the level and composition of output and its implications for inflation. Where, in the opinion of the Executive Board, it is appropriate to deviate for a while from targeting inflation some two years ahead, the Riksbank shall explain its reasons and defend them in front of the Finance Committee of the Riksdag.

The Executive Board largely agrees with the recommendation that monetary policy should continue to focus on attaining the inflation target and in addition give consideration to developments in the real economy.

The Riksbank's strategy is, and has been for a long time, to conduct flexible inflation targeting, which means that monetary policy is aimed at attaining the inflation target at the same time as it supports the objectives of general economic policy for the purpose of attaining sustainable growth and a high level of employment. This is achieved through the Riksbank, in addition to stabilising inflation around the inflation target, also endeavouring to stabilise production and employment around paths that are sustainable in the long term. It does not mean that the Riksbank neglects the fact that the inflation target is the overriding objective.

Goodfriend and King recommend that monetary policy shall take into account the long-run sustainability of the path for the level and composition of output, and its implications for inflation. As mentioned earlier, however, they do not recommend that the objective for the central bank shall include numerical targets for output, for instance. The Executive Board agrees with this recommendation.

The flexibility of monetary policy essentially concerns the central bank's assessment of how soon it is appropriate to aim to return inflation to the target. How quickly the central bank aims to return inflation to the target can and should include giving consideration to imbalances – financial and others – that may cause major swings in output and employment later on, according to the report. The Executive Board agrees with this.

The Riksbank occasionally used the flexibility of its monetary policy during the period evaluated to counteract to some extent the risks linked to household indebtedness. This took the form, for instance, of cutting the repo rate at a slightly slower pace than would otherwise have been the case. This in turn meant that, according to the forecasts, inflation would return to the target at a somewhat slower pace than otherwise. The fact that the Riksbank used the flexibility of its monetary policy in this way has been debated, with one question being whether such flexibility is actually included in the Riksbank's mandate. The Executive Board considers, like the authors of the report, that it is, and welcomes the authors' contribution to this discussion.

However, the Executive Board wishes to emphasise that the possibility to use this flexibility assumes that the credibility of the inflation target is not jeopardised. The Riksbank used this flexibility during a certain period of time. But then circumstances changed – the period during which inflation undershot the target became more prolonged and inflation expectations fell further below the target, at the same time as monetary policy abroad became increasingly expansionary. It therefore became necessary for the Riksbank to safeguard confidence in the inflation target. This is the



■ reason why monetary policy has recently focused more clearly on inflation and the inflation target.

The Executive Board agrees that a well-balanced monetary policy can in some situations mean that the Riksbank assesses that it will take more than two years for inflation to return to the target.

The Executive Board notes that in principle there is nothing in the Riksbank's current strategy that prevents monetary policy from being such that it can take more than two years for inflation to return to the target according to the Riksbank's forecast. However, it is worth noting that there must be special circumstances for inflation not to return to the target within the Riksbank's forecast period, given that monetary policy is not restricted by other factors. Examples of such circumstances include major disruptions that affect the economy over a long period of time or changes in relationships within the economy that are assessed to affect the impact of monetary policy over a longer period of time.

The Riksbank's assessment of what is a well-balanced monetary policy and how long inflation is expected to deviate from the target depends, for instance, on how far inflation has deviated from the target and how the real economy is affected. But, as emphasised above, another important condition is that confidence in the inflation target is not threatened. There is thus no general answer to the question of how quickly the Riksbank aims to bring the inflation rate back to 2 per cent if it deviates from the target. The ambition has generally been to adjust the repo rate and the repo-rate path so that inflation is expected to be fairly close to the target in two years' time.

The Executive Board agrees that it is important that monetary policy is clearly explained and justified, both to the Riksdag Committee on Finance and the general public. The Riksbank's aim is to do this in an open and comprehensible manner, regardless of how long inflation is expected to deviate from the target.

The Riksbank endeavours to be open and clear in its communication. This aim is regardless of the current economic situation. If the Riksbank were to assess that a well-balanced monetary policy is such that the inflation target will not be attained during the forecast period, the circumstances and motives for this will be explained carefully and described in the usual discussions with the Riksdag Committee on Finance. How the Riksbank communicates in such a situation will thus not differ from the communication in normal times.

2.2 The Riksbank's forecasts

Recommendation 3

The report recommends that the Riksbank should re-examine its methods for producing forecasts for both the world economy and overseas interest rates to help the Executive Board focus on the big issues surrounding the outlook. The Monetary Policy Report should explain in more detail the basis for the assumptions about overseas growth and interest rates.

The Executive Board maintains that the re-examination recommended in the report is already done regularly as part of the forecasting work. The Riksbank regularly evaluates its forecasts and constantly re-examines its forecasting methods, including the methods for producing forecasts for the world economy and overseas interest rates.



- The recommendation is based on the main problems with the Riksbank's international forecasts identified by the authors in the period 2011–2013. They conclude that too much weight was given to unjustifiably optimistic forecasts made by international organisations and that the forecasts for overseas interest rate were above the path for interest rates implied by financial futures contracts.

The Riksbank's forecasts for overseas interest rates are based on information from market rates, communication by central banks in other countries and the results of various models. They are also affected by judgements made by both Riksbank employees and the Executive Board. Over the past year, this has resulted in the forecasts for overseas interest rates being relatively close to the development of market rates indicated by market pricing. However, for most of the evaluation period, the Riksbank's forecasts were higher than the path for interest rates indicated by market pricing, particularly in the long run. It is not unusual that the forecasts in the longer run can differ, partly because there is considerable uncertainty over economic prospects in the distant future.

The authors claim that central banks tend to put too much weight in their international forecasts on forecasts made by counterparts in other countries and by international organisations. With hindsight, one can note that these forecasters have generally overestimated developments in global economic activity following the financial crisis. But this also applies to other forecasters. Forecast evaluations show that central banks and international organisations did not necessarily have a systematically more optimistic view of economic prospects than other economic analysts.⁴

The Executive Board agrees it is important to explain basic assumptions regarding international developments so that that base for the Riksbank's forecasts is made clear.

Recommendation 4

The authors recommend that the Riksbank should conduct and publish (i) a review of its experience with the announcement of a future path for the repo rate, and (ii) a post-mortem on the substantial deviation of market expectations from its published forecasts during the period covered by this Review.

The Executive Board agrees with this recommendation.

After almost 10 years of publishing a repo-rate path, it may be appropriate to evaluate the experiences. There is also international research in this field on which such an evaluation can be based.

The authors of the report focus on the repo-rate path as a tool for influencing market rates and draw the conclusion that the experiences have not been entirely positive in this respect. However, the Riksbank has all along made it clear that this is not the only reason, and perhaps not even the main one, for publishing its own repo-rate path. One important reason was the disadvantages of the assumptions regarding the development of the repo rate that the Riksbank used previously. The assumption that

⁴ See, for instance, Independent Evaluation Office (2014), "IMF Forecasts. Process, Quality, and Country Perspectives", IMF; Alessi, L. et al (2014), "Central Bank Macroeconomic Forecasting During the Global Financial Crisis: The European Central Bank and Federal Reserve Bank of New York Experiences", *Journal of Business & Economic Statistics*, 32:4, pp.483-500, and Sveriges Riksbank (2015), *Account of Monetary Policy in 2015*.

the repo rate would remain constant during the forecast period was mostly an unrealistic assumption that made it difficult to make good forecasts. The assumption that the repo rate would follow the path indicated by market pricing was more realistic, but did not necessarily reflect the deliberations that formed a base for monetary policy. Using a repo-rate forecast of its own makes it easier for the Riksbank to explain the reasoning behind the monetary policy decisions. One important reason for publishing a repo-rate path was the Riksbank's ambition to be open and transparent, which makes it easier to evaluate and discuss monetary policy.

The discussion of the development of monetary policy in the medium and longer run is made easier with a repo-rate path, as one can then communicate the Riksbank's view of future developments and describe how the economy is currently reacting to what can be regarded as normal. The Riksbank has found the repo-rate path very useful in this way. However, the Executive Board agrees with the authors that a published repo-rate path is not entirely without problems and that it is important to avoid the risks identified in the report. Nevertheless, the authors do not recommend that the Riksbank should abandon the repo-rate path. The Executive Board also notes that many of those the authors have spoken to have been positive to the repo-rate path, even those who were critical of the monetary policy conducted.

When it comes to analysing the reasons for, and implications of, the differences between the Riksbank's and the market's repo-rate paths, there are a number of problems that should be noted. One basic problem is that there is no unambiguous way of measuring market expectations of the repo rate. Another problem is that it is difficult to know why pricing, which implicitly indicates market expectations, changes over time. This in turn makes it difficult to link expectations of the repo rate to the market forecast for economic developments.

Recommendation 5

The report recommends that, as a matter of course the Riksbank should publish in its Monetary Policy Reports an analysis of why in its view there is a divergence between its published repo rate path and market expectations of the repo rate path, and what implications it believes any such divergence has for the setting of monetary policy.

The Executive Board thinks it is natural to analyse the causes and implications of the differences between the repo-rate path and market expectations of the repo-rate path on certain occasions, but that this does not necessarily need to be done as a matter of course.

The authors of the report identify the occasionally large difference between the Riksbank's repo-rate path and the path indicated by prices on the financial markets as a serious problem during the evaluation period. One conclusion they draw is that neither forecasts nor policy should be based solely on forecasts from a model that assumes full credibility in the stated policy path and they think there must be room for judgements about the credibility of the repo-rate path and the inflation target.

The Executive Board agrees with this and wishes to emphasise that the credibility of the inflation target is very important to the monetary policy deliberations. But this is no new insight. One should not interpret the fact that during the evaluation period the Monetary Policy Reports presented some results from economic models based on the inflation target being credible as meaning that its credibility was taken for granted in the monetary policy deliberations.

The difficulty faced by the Riksbank, and all central banks with an inflation target in a similar situation, is how to include risks linked to credibility in the monetary policy deliberations and to communicate these without having an impact on expectations and further undermining confidence. However, as also exemplified by the Riksbank, one can reach a limit where it is quite simply necessary to explicitly discuss credibility in order to justify the monetary policy conducted. The falling long-term inflation expectations were given increasing weight in the monetary policy deliberations from autumn 2013 and the risks linked to a loss of credibility were discussed in an article published in the July 2015 Monetary Policy Report. The February 2016 report contained scenarios in which confidence in the inflation target declines.

2.3 Responsibility for foreign exchange policy

Recommendation 6

The report recommends that the Sveriges Riksbank Act should be amended to make clear that the choice of exchange rate regime is a matter for government, and that the mandate to meet the inflation target is subject to the Government deciding that the exchange rate should float freely.

The Executive Board does not see a need to clarify the responsibility for foreign exchange policy in this respect in the way proposed in the report. It is already stated in the Currency Rate Policy Act and the Sveriges Riksbank Act.

Pursuant to Section 2 of the Currency Rate Policy Act (1998:1404), the Government shall decide on the system that is to apply for establishing the value of the Swedish krona in relation to other currencies (the exchange rate system). Pursuant to the Sveriges Riksbank Act, Chapter 7, Section 1, the Riksbank shall decide on the application of the exchange rate system decided by the Government.

Sections 3 and 4 of the Currency Rate Policy Act also state that the Riksbank may request that the Government and Riksdag shall decide on the exchange rate system and that such a request shall be dealt with promptly. The Government shall, before deciding on the exchange rate system, also consult with the Riksbank.

2.4 Minutes of monetary policy meetings

Recommendation 12

The report recommends that the minutes should attempt to record the differing points made at the meeting and not a sequence of individual formal presentations. Longer analyses by particular members should be made available publicly in speeches.

The Executive Board agrees that the aim should be for the minutes of the monetary policy meetings to describe the different points of view put forward at the meeting. This aim can be considered to be fulfilled now, as the minutes express in full what was said at the monetary policy meetings. This is important to enable scrutiny of the Executive Board's work.

The authors of the report note that for a large part of the evaluation period the minutes of the monetary policy meetings were very long and mainly dealt with the individual viewpoints of members with an opinion differing from the majority, while the majority viewpoint was described in the Monetary Policy Reports. They also conclude that the minutes no longer represented a to-and-fro between different viewpoints and did not reflect the balance of discussion.

- The Executive Board takes note of this criticism and agrees that the length of the minutes should normally be limited to make them more readable. According to the Riksbank's communication policy, the members of the Executive Board should express themselves briefly, clearly and with a focus on their own analyses at the monetary policy meetings. The minutes are currently shorter than they were during the period that was analysed in the report.

However, the length and content of the minutes is not governed solely by readability requirements. The way the minutes look is the result of the consideration given to all the various requirements made of them. The minutes are an important tool for requiring accountability of the members of the Executive Board, which makes it inappropriate to limit their input in advance to the monetary policy stance taken and to set rules limiting the contents and length of the minutes.

Moreover, the minutes play an important role for giving the members an opportunity to agree on policy rate decisions and Monetary Policy Reports. It is possible to create majorities and to avoid dissension as possible differences in nuance in the views of monetary policy and the forecasts can be communicated in the minutes. In the cases where members nevertheless enter reservations against a decision, it is natural that their motives for doing so are given relatively large space in the minutes, given that the Monetary Policy Report reflects the majority view.

The report says that the minutes should record the differing points made at the meeting. The Executive Board wishes to clarify here that the minutes of the Riksbank's monetary policy meetings express in full what was said at the meetings. It is also worth mentioning that the minutes of the monetary policy meetings are special in an international perspective, as they are published shortly after the monetary policy meeting and they contain a detailed account of the stances taken by each individual member, clearly identified, as well as the motives given for their stance and the arguments put forward at the meeting.

Recommendation 13

The report recommends that the Riksbank should augment the current minutes with minutes of the meetings where the Main Scenario is decided – at the First or Second Large Monetary Policy Group Meetings and also the Executive Board Forecast Meeting. Those minutes could then be released to the public together with the current minutes two weeks after the Monetary Policy Meeting

The Executive Board is open to the idea of supplementing the minutes of the monetary policy meetings with further information of the type that the authors wish to see. However, the Executive Board does not agree that the current minutes should be supplemented with minutes of earlier meetings at which the Executive Board members discuss the forecasts.

The monetary policy meeting is the final point in a forecasting and decision-making process in which the stances of the individual members of the Executive Board develop gradually as the background information and data on which the decision is based are built up and supplemented with forecasts and analyses.

During this process there are preparatory meetings at which members of the Board discuss various analyses with employees in the Monetary Policy Department and with one another. These meetings are necessary to enable the members to form an opinion of what constitutes a well-balanced monetary policy. It does not mean that the decisions on monetary policy are in practice taken at these preparatory meetings. All of



- the forecasts, including the repo-rate path, can be changed by the Executive Board right up to, and primarily at, the monetary policy meeting, which is the meeting where the formal decisions on the forecast and the description in the Monetary Policy Report, the "main scenario" are made.

As the Executive Board understands the recommendation, its purpose is to make further information available on how individual members have reached their stances regarding appropriate monetary policy. The authors' conclusion is that the minutes currently do not serve well their purpose of providing individual accountability for each Board member's contribution to the policy deliberations.

Although the Executive Board does not share this conclusion, the Board is open to publishing more information of the type requested by the authors that is, information from the drafting meetings prior to the monetary policy meetings. Doing this by taking minutes of drafting and forecasting meetings would entail considerable problems, however, and make the forecasting process unnecessarily formal. However, the Executive Board shall review whether, and if so how, the contents of the minutes of the monetary policy meetings could be supplemented with information from the discussions held by the Executive Board earlier in the forecasting process.

2.5 Other conclusions in the Review

One of the conclusions in the report, based on the discussions held during parts of the evaluation period, is that there was heavy reliance in the Executive Board on forecasts produced by models developed by Riksbank staff. On this point it would appear that the authors have not really gained a fair picture of the forecasting process. Then as now, the model forecasts are only used as a base for discussion; the final forecasts are largely based on judgements by both the Executive Board and the Riksbank staff. The Executive Board is very familiar with the assumptions and limitations of the models and takes this into account when producing its final forecasts.

The Executive Board also notes the authors' criticism of the discussion climate within the Executive Board during parts of the evaluation period. It is of course important that the discussions are always conducted in a reasonable tone and that potential differences of opinion are respected. The Executive Board wishes to point out that the current discussion climate is entirely in keeping with this. In recent years, the discussions have been rewarding and the discussion climate has been good, despite differences of opinion that have sometimes resulted in reservations being entered against the decisions made.

3. Recommendations on financial stability

3.1 The Riksbank's role in promoting financial stability

Recommendation 9

The report recommends that the Sveriges Riksbank Act should be amended to clarify the role of the Riksbank in financial stability. The report states that the mandate of the Riksbank should include financial stability, and that the Riksbank must have some formal powers to enable it to achieve its objective.

- **The Executive Board agrees with the recommendation in the report. The Riksbank has also previously pointed out, for instance, in a submission to the Riksdag in 2010, the need for clarification in this area. Further, the Executive Board considers that the role of the Riksbank in preventing and mitigating risks and vulnerabilities in the financial system, including macroprudential policy, needs to be strengthened.**

According to the Sveriges Riksbank Act, the Riksbank "shall promote a safe and efficient payments system". However, it is not stated clearly within the Act or the preliminary works for the Act what this task includes. A safe and efficient payment system requires a stable financial system so that payments and the supply of credit, amongst other things, can function smoothly. The Riksbank, like other central banks, must be able to manage financial crises and other serious disruptions in the financial system to ensure the payment system is safe and efficient. The concept of "promoting a safe and efficient payments system" thus has a broad meaning and, in practice, involves a responsibility for promoting the stability of the financial system.

One important reason why promoting financial stability is a central task for the Riksbank is the central banks' unique possibility to provide the financial system with liquidity and if necessary to support the functioning of financial markets.

The Riksbank functions as the banks' bank when payments are made in Swedish krona, in the same way as other central banks in other countries. The Riksbank's system for payments between banks and a number of other financial institutions, the RIX system, is the hub of the Swedish payment system. It is also through this system that monetary policy is implemented in practice. Furthermore, the Riksbank can, by formulating the terms and conditions for the different liquidity facilities provided by the Riksbank, influence risk-taking and liquidity buffers in financial institutions.

An important aspect of the Riksbank's task as liquidity provider is the responsibility to act as lender of last resort in a financial crisis, that is, to give loans, if necessary, to institutions which are viable in the long term, but experiencing liquidity problems. In this way, the Riksbank can avert or at least alleviate the effects of a crisis by ensuring there is sufficient liquidity when no one else can or is willing to provide loans.

To carry out its assignment, the Riksbank must constantly have a good overview of the banks and other financial institutions, as well as insight into the functioning of the financial markets. The Riksbank therefore regularly analyses the financial system, with a focus on identifying vulnerabilities and risks, as well as their causes. This analysis, combined with the Riksbank's analysis of macroeconomic developments and models to assess it, creates good conditions for the Riksbank to identify appropriate measures for dealing with vulnerabilities and risks in the financial system.

Like other central banks, the Riksbank communicates its risk assessments and recommendations on measures. For instance, the Riksbank has been issuing its Financial Stability Report twice a year for almost 20 years now. The information and knowledge that the Riksbank gathers during its day-to-day work with financial stability also entails increased efficiency and reduced financial risks to the state when the central bank acts as lender of last resort. The Riksbank shares the work on preventing financial crises with the Government and other authorities, in particular Finansinspektionen and the Swedish National Debt Office. The Riksbank also cooperates with other authorities in Sweden and internationally to try to influence the formulation of financial regulatory frameworks so that they will contribute to a stable and efficient financial system.

■ Another important reason why promoting financial stability is a central task for the Riksbank is the close relationship and interdependence between financial stability and monetary policy. Under certain conditions the inflation-targeting policy can help facilitate the work on maintaining financial stability. Correspondingly, financial stability is a prerequisite for being able to pursue monetary policy in a meaningful way, as monetary policy affects the real economy and inflation via the financial system.

The relationship between financial stability and monetary policy is also highlighted by Goodfriend and King. They point out that there will be times when it may be appropriate, for financial stability reasons, for the Riksbank to allow monetary policy to deviate from the normal focus of meeting the inflation target two years ahead (see also the discussion on the flexibility of monetary policy in section 2.1). They emphasise that this is an important reason why the Riksbank should play an active role in discussions of policy towards financial stability. The Executive Board shares the assessment in the report that this type of deliberation may need to be made in monetary policy, and that the Riksbank, for this reason too, must regularly analyse the stability of the financial system.

To summarise, the Executive Board considers, like Goodfriend and King, that it would be appropriate to clarify the Sveriges Riksbank Act so that the Riksbank's responsibility for financial stability is explicitly stated.

When reviewing and clarifying the Riksbank's responsibility with regard to financial stability, it is also important to review the role of the Riksbank in this area, as there should be a balance between responsibility and powers. The report is less clear in its recommendation on this point, merely pointing out that the Riksbank must have "some formal powers to enable it to achieve its objective".

As already described, the Riksbank has some powers relating to financial stability, in a crisis situation as well as through the formulation of conditions for providing liquidity. However, the Executive Board considers that the role of the Riksbank in the work on mitigating risks and vulnerabilities in the financial system, including macroprudential policy, needs to be strengthened to attain a better balance between responsibility and powers. How this could be done is discussed in section 3.2.3 below.

From a socioeconomic efficiency perspective, it would also be appropriate to use the expertise on systemic risk in Sweden as efficiently as possible. The Riksbank's knowledge, experience and resources in this area can be used in a better way than is currently the case. As described above, identifying systemic risks is nothing new for the Riksbank, but a central part of the analyses made by the Riksbank and other central banks, and closely linked to liquidity provision, which is the central banks' responsibility. Tools to counteract an overly rapid growth of credit in the economy were also being used by the central banks prior to the large wave of deregulations in the 1980s.



■ 3.2 A Prudential Policy Committee consisting of the Riksbank and Finansinspektionen – and a review of this structure in 2020

Recommendation 8

The report recommends that a joint Prudential Policy Committee (PPC) of the Riksbank and Finansinspektionen be established to meet quarterly to discuss the setting of the main macroprudential policy instruments. The PPC should have the right to make recommendations to the Riksdag on whether the set of instruments delegated to Finansinspektionen should be expanded or contracted. The PPC is also proposed to be the primary source of reports on financial stability and should appear before the Finance Committee at least once a year.

Recommendation 10

The report also recommends that the allocation of responsibility for macroprudential policy between Finansinspektionen and the Riksbank be reviewed by a small group of experts in 2020.

The Executive Board shares the assessment that the current Swedish framework for macroprudential policy has shortcomings in important areas and needs to be revised.⁵ The Executive Board therefore considers that the framework for macroprudential policy should be reviewed again in connection with the review of the Sveriges Riksbank Act. There are several possible ways of organising macroprudential policy. The Executive Board points out that most importantly the structure chosen should be characterized by good decision-making power and a clear allocation of responsibility.

3.2.1 Important aspects to be taken into account when formulating a framework for macroprudential policy

The Executive Board emphasises the importance of the macroprudential framework being characterised by good decision-making power and a clear allocation of responsibility. The Executive Board also wishes to highlight a number of aspects of principle that should be taken into account when choosing the organisational structure in order for macroprudential policy to work well. These are the same as the Riksbank mentioned in 2013 in its consultation response to the Financial Crisis Commission's proposal on how to organize macroprudential policy in Sweden⁶. The most important aspects are that the macroprudential authority should have i) a good and lasting capacity to analyse risks to the financial system as a whole, ii) the conditions to conduct the work in a resource-efficient manner, and iii) the possibility to interact with adjacent policy areas, such as monetary policy and microprudential supervision, both in Sweden and abroad.

The Executive Board also wishes to emphasise the importance of Sweden being able to participate effectively in the international cooperation in the macroprudential policy area. In this perspective, it is important to consider how this work is organised in other

⁵ For a review of Goodfriend and King's criticism, see pages 101-103 in the Review.

⁶ The Riksbank's consultation response to the report Preventing and managing financial crises (SOU 2013:6). (Only available in Swedish)

countries, and particularly within the EU. Thirteen of the EU Member States have given the responsibility to the central bank, a similar number have given it to a separate council and two countries (Sweden and Finland) have given it to the supervisory authority.⁷ In addition, it is worth mentioning that the European Central Bank, the ECB, has received a mandate that in practice involves it sharing the responsibility for macroprudential policy with the national macroprudential authorities in those countries that participate in the Single Supervisory Mechanism, SSM. The ECB has the responsibility for a so-called "topping-up" of some of the macroprudential policy measures decided at national level, that is, to tighten the tools somewhat more if this is considered warranted.

Finally, the Executive Board considers it important to observe the balance between independence and democratic control. Both the Financial Crisis Commission and Goodfriend and King note that macroprudential policy measures may be unpopular with the general public. This is an element that macroprudential policy shares with monetary policy. There is thus a risk that measures that are good for a country's long-term economic development are not implemented because they are politically unpopular in a short-term perspective. This is because the costs arise in the short term, while the benefits, in the form of a reduced risk of a financial crisis, are long-term and difficult to measure. This is a reason often stated for giving macroprudential policy a high degree of independence.

3.2.2 Shortcomings in the Swedish framework for macroprudential policy

The Executive Board considers that the experiences of the Swedish framework for macroprudential policy so far show that there are clear shortcomings in the decision-making power. An obvious example is the protracted discussions on the introduction of a binding amortisation requirement. One cause of the problem is that the objective of macroprudential policy is unclear and too narrow. A clear and broad objective is also appropriate to bring Sweden's framework in line with European standards.⁸ Another cause is the lack of a clear and expeditious procedure for the assignment of new macroprudential tools. It is essential that such a procedure is introduced for the timely handling of risks. This is also recommended by the EU body for macroprudential policy, the European Systemic Risk Board (ESRB).⁹

The Executive Board considers that the Swedish framework also has shortcomings with regard to clarity in the allocation of responsibility for macroprudential policy. Finansinspektionen has been allocated the responsibility by the Government, through its Instruction, "for taking measures to counteract financial imbalances with a view to stabilising the credit market, but taking into consideration the effect of the measures on economic development".¹⁰ However, the allocation of responsibility is problematic, as illustrated by the decision-making process for the coming amortisation requirement. The Government has indeed tasked Finansinspektionen to produce regulations that more closely define the amortisation requirement but at the same time requires these

⁷ European Systemic Risk Board (ESRB) Recommendation on the macro-prudential mandate of national authorities (ESRB/2011/3): Follow-up Report – Overall assessment (published 25 June 2014).

⁸ Recommendation of the European Systemic Risk Board (ESRB) of 22 December 2011 on the macroprudential mandate of national authorities (ESRB/2011/3).

⁹ Ibid.

¹⁰ Ordinance (2013:1111) on amending Finansinspektionen's Instructions Ordinance (2009:93).

■ regulations to be approved by the Government before Finansinspektionen adopts them. This is not in line with the ESRB's recommendation that the macroprudential authority should as a minimum be operationally independent from political bodies.¹¹ The importance of independence when adopting macroprudential measures is also underscored by Goodfriend and King.

A further problem with the Swedish macroprudential framework is that it has not been established by law. Finansinspektionen's mandate in the macroprudential area is only a government ordinance and the Stability council is formally only a committee, appointed by the Government. This is unfortunate as macroprudential policy is an important policy area and it is vital that a long-term, sustainable structure is created for it, so that macroprudential analysis is not given lower priority when other tasks require resources and the experiences of the crisis are forgotten. Moreover, it is reasonable that the decision on the overall macroprudential mandate is made at the same level as the regulation of macroprudential tools, that is, in this case by law.

Given these experiences, the Executive Board considers that it would be appropriate to review the macroprudential framework once again. This could well be done in connection with the review of the Sveriges Riksbank Act that has been announced.

3.2.3 Different ways of organising macroprudential policy

Goodfriend and King consider that the functions of the current Financial Stability Council should be separated into those relevant to an immediate crisis and those applying under normal circumstances. The Ministry of Finance shall be involved in issues concerning crisis management, as public funds may need to be used. On the other hand, when there is no crisis, Goodfriend and King find it important that the decisions on macroprudential measures are "separated from day-to-day political pressures". They warn that present arrangements for macroprudential policy can lead to slow responses to future concerns about financial stability. Against this background, the authors of the report recommend that a Prudential Policy Committee should be established, consisting of the Riksbank and Finansinspektionen.

The Executive Board finds it difficult to comment on the recommended Prudential Policy Committee, as the description in the report leaves certain important questions unanswered. One important question is how the committee's responsibility would relate to the two authorities' respective areas of responsibility. This is important in light of the proposal that the committee should be given the right to make recommendations to the Riksdag regarding the design of the macroprudential toolbox and be the primary source of reports on financial stability. However, the Executive Board takes a favourable view of the authors' aim to separate the decisions on the toolbox, which should lie with politicians, from the decisions on concrete measures, which should lie with the authorities.

A possible alternative solution to the committee structure recommended in the report would be to give the Riksbank the explicit task of issuing recommendations on macroprudential measures to Finansinspektionen, which Finansinspektionen would either comply with or publicly explain why it chose not to comply with ("comply-or-explain"). This is similar to the system applying in the ESRB. The ESRB can issue

¹¹ Recommendation of the European Systemic Risk Board (ESRB) of 22 December 2011 on the macroprudential mandate of national authorities (ESRB/2011/3).

- recommendations to the EU as a whole, to member states and to the European and national supervisory authorities, which must then "comply or explain".

A possible further, and more far-reaching, solution would be a merger of the Riksbank and Finansinspektionen. This would gather together the expertise of both authorities into one place and create synergy effects in several areas. In most of the EU countries the central bank and banking supervision come under the same roof, in some cases in the form of two separate organisations with partially joint management. The overall effects of this would need to be analysed thoroughly, not least given that Finansinspektionen's assignment covers different policy areas, such as microprudential supervision, macroprudential policy, consumer protection, and so on. Also the question of governance of different parts of the Riksbank's operations would require careful discussion in this case, as it is more difficult, for instance, to regularly assess the attainment of the objective for macroprudential policy than for monetary policy. It should also be noted that such a change is very profound as it means merging authorities that currently have different principals.

Regardless of the organisational solution chosen, each has its specific challenges as regards governance and accountability. The choice of solution therefore requires thorough analysis. The Executive Board underlines that the most important aspect is that the structure chosen involves good decision-making power and a clear allocation of responsibility.

3.3 Allocation of powers and macroprudential tools to Finansinspektionen

Recommendation 7

The report recommends that the Government should ensure without further delay that Finansinspektionen has the legal powers and range of macroprudential instruments appropriate to its role in promoting financial stability.

The Executive Board agrees with the authors' recommendation that Finansinspektionen should – without further delay – be given the legal powers and tools to be able to counteract risks that have arisen.

As stated above, the Executive Board considers it necessary to make an overall review of the Swedish framework for macroprudential policy. However, it will probably take several years before a commission of inquiry is complete and its proposals incorporated into Swedish law. At the same time, there is an urgent need to counteract Swedish households' high and growing indebtedness. The Executive Board therefore welcomes the recommendation in the report that Finansinspektionen should immediately be given the legal powers and tools to counteract risks that have arisen.

If the Riksdag were to decide not to review the Swedish framework for macroprudential policy again, the Executive Board considers that at least the following changes should be made:

First, Finansinspektionen should be given a broad macroprudential mandate, with a clear objective and adequate tools. Second, when the Sveriges Riksbank Act is reviewed, it should be explicitly prescribed that the Riksbank shall openly report its analyses and assessments of systemic risks and possible measures to deal with them. This could be done, for instance, by legislating that the Riksbank shall report its view on the formulation of macroprudential policy to the Riksdag Committee on Finance at least twice a year. This would make it clear that the Riksbank plays a central role in the



- preventive work relating to financial stability, including macroprudential policy, even if it would not have the formal decision-making power. This is also important to enable the Riksbank to manage its role as lender of last resort in a responsible manner.

4. A review of the Sveriges Riksbank Act

The Riksbank, like other central banks, is currently discussing strategic choices at many levels. The strategies and regulatory frameworks followed by central banks in recent decades come under broad scrutiny. Mandates, roles and governance are the subject of lively debate. As mentioned at the start, the Riksdag Committee on Finance has announced that the Sveriges Riksbank Act will be subject to a review. A review of this act is a good way of seeing whether the Sveriges Riksbank Act is appropriate for the tasks the bank currently faces. The Executive Board thinks, like Goodfriend and King, that there are several areas where the legislator can clarify the act, but that at the same time the basic model we have now should be retained. The report highlights several monetary policy issues that deserve further analysis and discussion. One important question is how detailed the target for monetary policy should be stipulated in law. However, the Executive Board wishes to emphasise that the most important individual issue in a coming review of the Sveriges Riksbank Act is to bring about a thorough examination of the financial stability area. The Riksbank's role with regard to promoting financial stability needs to be clarified. It is also clear that the model Sweden has chosen for macroprudential policy does not function well, and needs to be reviewed.

On behalf of the Executive Board:

Stefan Ingves

Kerstin Haglund

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