SVERIGES RIKSBANK

Minutes of the monetary policy meeting

DECEMBER 2012

Summary

At the monetary policy meeting on 17 December, the Executive Board of the Riksbank decided to cut the repo rate by 0.25 percentage points to 1.0 per cent and to adjust the repo-rate path downwards.

It was noted at the meeting on 17 December that new information received since the monetary policy meeting in October indicates that the Swedish economy is slowing down more sharply than was assessed then. GDP is therefore expected to increase at a slower pace and unemployment to rise slightly more than was assumed in October. At the same time, inflationary pressures are expected to be lower.

Given the weaker economic activity and lower inflationary pressures, the Executive Board agreed that it is appropriate to cut the repo rate and to adjust the repo-rate path downwards. However, as at earlier meetings, there were differences of opinion with regard to how expansionary monetary policy should be. Five Board members considered it appropriate to cut the repo rate by 0.25 percentage points, to 1.0 per cent. One member instead wanted to cut the repo rate by 0.5 percentage points.

All Board members considered it appropriate to adjust the repo-rate path downwards, but there were differing opinions as to how much it should be lowered. A majority of four members assessed that cutting the repo rate to 1.0 per cent and allowing it to remain at around this low level over the coming year would lead to inflation attaining the target of 2 per cent after just over one year and to resource utilisation normalising.

Two members considered that there was scope for an even lower repo-rate path and they advocated two different repo-rate paths that were assessed as more quickly leading to inflation reaching the target of 2 per cent, at the same time as unemployment would come closer to a long-run sustainable rate.

Another topic discussed at the meeting was the high level of household debt and what risks this could create further ahead; including the role that monetary policy could play. During the meeting, a number of different nuances arose regarding developments abroad. There was continued discussion of several issues regarding the monetary policy apparatus, including the forecasts for inflation and international policy rates. In this context, there was also discussion of how the severe economic fluctuations in recent years have affected the development of the Swedish economy and made it more difficult to assess.

MINUTES OF MONETARY POLICY MEETING
Executive Board, No. 6

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: 17 December 2012

TIME: 9:00

PRESENT:
Stefan Ingves, Chairman
Karolina Ekholm
Per Jansson
Kerstin af Jochnick
Barbro Wickman-Parak
Lars E.O. Svensson

Johan Gernandt, Chairman of the General Council

Meredith Beechey Österholm
Claes Berg
Charlotta Edler
Mattias Erlandsson
Eric Frieberg
Kerstin Hallsten
Ann-Christine Högberg
Pernilla Johansson
Martin W Johansson
Tor Johansson (§ 1)
Pernilla Meyersson
Marianne Nessén
Christina Nyman
Bengt Pettersson
Ulf Söderström
David Vestin
Anders Vredin

It was noted that Pernilla Johansson and Bengt Pettersson would prepare draft minutes of § 1, 2 and 3 of the Executive Board’s monetary policy meeting.

§1. Economic developments

Tor Johansson from the Financial Stability Department began by describing recent developments with regard to economic policy solutions to remedy the problems of weak public finances and banks in certain euro area countries.

Meredith Beechey Österholm of the Monetary Policy Department presented recent developments on the financial markets. Since the monetary policy meeting at the end of October, developments on the financial markets have been calmer, with only minor fluctuations. Long-term government bond yields have fallen somewhat in total in the United States, Germany and Sweden, although there has very recently been a slight upturn. Share prices have risen somewhat and the volatility on the share market has fallen. The Swedish krona has weakened slightly over the past week. According to market pricing, there are expectations of a cut in the repo rate of 0.25 percentage points at today's monetary policy meeting, and a relatively large probability of a further cut in either February or April.

Christina Nyman, Deputy Head of the Monetary Policy Department, presented the draft Monetary Policy Update which, in the assessment of the Monetary Policy Department, should gain the support of the majority of the Executive Board members. She began by noting that the forecasts in the draft Report were discussed by the Executive Board at meetings held on 3, 11 and 12 December. The draft Monetary Policy Update was discussed at a meeting of the Executive Board on 14 December.

Since the monetary policy meeting in October, global indicators have been roughly in line with the forecasts made in October. The weak developments in the euro area are continuing, at the same time as developments are more positive in, for instance, the United States and China. The situation on the financial markets is relatively stable. On the other hand, indicators of the Swedish economy clearly point to a slowdown in the fourth quarter, as a result of weak and uncertain developments abroad. The labour market situation has deteriorated, as the number of redundancies has increased and employment plans have been cut back. Confidence in the future among Swedish households and companies has recently shown a rapid decline, according to the National Institute of Economic Research's Economic Tendency Indicators, for instance. Although GDP growth was higher in the third quarter than the forecast in the October Monetary Policy Report, domestic demand was weaker than expected. Inflation remained low in October and November, roughly as expected in the Monetary Policy Report. Indicators such as producer prices, import prices and electricity prices, indicate that inflationary pressures will remain low in the coming period.

The forecast in the Monetary Policy Update is for a slow recovery abroad, in Sweden's most important export markets. The forecast assumes that economic policy measures in the euro area will be taken to strengthen confidence among households and companies, and that this will lead to higher GDP growth of around 2 per cent a year in the euro area in 2014 and 2015. A higher GDP growth than in the euro area was forecast for the United States and especially for the rapidly-growing BRIC area economies (Brazil, Russia, India and China).

The clear signs that the weak developments abroad are now having more negative effects on the Swedish economy are the most important explanation for the downward revision in the forecast for Swedish GDP growth in the coming quarters. The forecast for unemployment is revised up and is expected to peak at 8.2 per cent in the third quarter of 2013. Lower demand and a weaker labour market contribute to the assumption that wages will increase at a slower pace than was assumed in the October Monetary Policy Report, and that inflation will be slightly lower. Moreover, for the coming year the inflation forecast has been revised down as a result of lower energy prices. Lower inflationary pressures and higher unemployment than expected justify a lower repo rate now and a lower repo-rate path. This lower repo-rate path is expected to lead to economic activity gradually strengthening so that inflation rises to 2 per cent.

§2. The economic situation and monetary policy

Deputy Governor **Lars E.O. Svensson** began by pointing out that it was no secret that he sees major problems with the Riksbank's monetary policy. One can note that both CPI and CPIF inflation are now way below the inflation target of 2 per cent, and unemployment is way above a reasonable long-run sustainable level. According to Mr Svensson, this is largely because monetary policy has been too tight since the increases in the policy rate began in summer 2010. Figure 1 shows that the real policy rate and short rates in Sweden have been high from 2010 onwards compared with real short rates in the euro area, the United Kingdom and the United States. This is despite inflation in Sweden being much lower than in these economies and unemployment now being as high as in the United Kingdom and slightly higher than in the United States. Mr Svensson said that the difference between policy rates in Sweden and abroad contributes to the strong krona. According to him, the assessment that the short real policy rate in Sweden will be negative in 2013 is due to an optimistic inflation forecast, which he will return to in his contribution to the debate.

One possible explanation for the tight monetary policy, judging by what Mr Svensson interpreted from speeches and comments in the media by Stefan Ingves and Per Jansson, is that monetary policy in practice has aimed to limit household indebtedness. As far as Mr Svensson could see, there was a misunderstanding here about what monetary policy can achieve with regard to household indebtedness. According to established theoretical and empirical research, including the Riksbank's own studies and calculations, for instance the Riksbank's assessment of risks in the Swedish housing market[1], monetary policy has very little effect on household indebtedness in the short run and with a low and stable inflation rate, no effect in the long run. A tight monetary policy then leads to inflation being too low and unemployment too high, without having a tangible effect on potential risks arising from household indebtedness. Mr Svensson said that monetary policy has in practice neglected the price stability target and led to unnecessarily high unemployment. Any problems arising from household indebtedness could be better managed by other means than the policy rate, means that unlike monetary policy are effective in both the short run and long run.

In Figure 2 the yellow curve shows how household debt has risen to around 170 per cent of disposable income. The debt is mainly mortgages, so an important question is how housing prices and the value of houses have developed. The blue curve shows households' real assets (owner-occupied houses, second homes and condominiums), which have grown alongside debt and are in a stable relationship to the debt. The loan-to-value ratio, the ratio of debt to real assets, has been relatively stable and remained in the interval of 50-60 per cent since the mid-1990s, as shown in Figure 3. Mr Svensson said that to understand the development of the debt and whether it comprises a problem, it is necessary to understand the developments in real assets and thus housing prices.

Monetary policy is thus, according to established theoretical and empirical research, not able to affect housing prices in the long run, if inflation is held at a low and stable rate. Mr Svensson wanted to explain why this is so. There has been considerable research into the determinants of housing prices and these are now well understood. As Peter Englund shows in the Riksbank's study on the risks in the housing market, the fundamental value of housing is largely determined by the long real mortgage rate after tax and the real value of the housing services provided by the housing.[2] The real value of the housing services in turn has a stable relationship to real disposable income (housing costs comprise 25-30 per cent of disposable income).[3] This means that the relationship between housing prices and disposable income is largely determined by the long-run real mortgage rate after tax, including the effects of wealth and property taxes. As Englund demonstrates, developments in Swedish housing prices in relation to disposable income are largely explained by a strongly negative trend in long-run real interest rates after tax. In Figure 4 one sees a clearly negative trend in the real yield on five-year real bonds. This trend is part of the global downward trend for real interest rates. According to the established view of monetary policy, it is not able to affect long real interest rates in the long run. In the long run, monetary policy can only affect long mortgage rates after tax to

[1] Sveriges Riksbank (2011), "The Riksbank's inquiry into the risks in the Swedish housing market", April 2011.
[2] Englund, Peter (2011), "Swedish house prices in an international perspective", in the Riksbank's inquiry into the risks in the Swedish housing market, April 2011, pp. 23-65.
[3] Statistics Sweden, Housing and construction statistics yearbook 2012, table 9.1.8.

the extent that the rate of inflation for a given tax system affects real tax deductions for interest and real wealth and property taxes. With an inflation target and low and stable inflation, this possible channel for influence disappears. Then monetary policy will no longer have any long-run effect on housing prices in relation to disposable income.

Monetary policy could still affect debt if it could influence loan-to-value ratios. As shown in Figure 5, however, there is no support for the view that a high repo rate will result in a lower loan-to-value ratio. According to Mr Svensson, there is thus no support for the theory that monetary policy could affect indebtedness in the long run.

With regard to the short run, Mr Svensson said that monetary policy has very little effect on housing prices and even less on the debt ratio, as the numerator and denominator of the debt ratio move in the same direction in the short run. A typical result from empirical estimates, according to Mr Svensson, is that an interest rate that is one percentage point higher for four quarters will lead to housing prices that are a good 2 per cent lower than they would otherwise have been. At the same time, GDP and disposable income become just over 1 per cent lower than they would otherwise have been, while unemployment becomes just over 0.5 percentage points higher than it would have been otherwise, which corresponds to around 25,000 jobs. The debt ratio becomes just over 1 per cent lower than it would otherwise have been. Thus, a one per cent lower debt ratio costs around 25,000 jobs. This is roughly the same relationship that Mr Svensson has mentioned previously, that 10 per cent on housing prices costs about 6 per cent of GDP and 3 percentage points unemployment, that is, 150,000 jobs.[4] As far as Mr Svensson could see, there is thus no support for the view that monetary policy could tangibly limit indebtedness in the short run without major costs in the form of lower inflation and higher unemployment. Other means must be used to influence indebtedness, such as mortgage caps and tax regulations, means that can affect the loan-to-value ratio or long real mortgage rates after tax in both the short and long run.

With regard to today's decision on the repo rate and the repo-rate path, Mr Svensson advocated, as at the previous monetary policy meeting, a much lower repo-rate path than the one in the main scenario of the draft Monetary Policy Update. As at the previous meeting, he considered that the forecasts for policy rates abroad and for growth abroad contained in the Update were too high. He also considered that the Update's forecast for inflation in Sweden was too high. A lower repo rate and repo-rate path will lead to higher CPIF inflation closer to the target and to lower unemployment closer to a long-run sustainable rate and would thus entail a better balanced monetary policy, according to Mr Svensson.

[4] Svensson, Lars E.O., "Monetary policy, debt and unemployment", speech at SNS on 14 November 2012.

Even if one were to accept the assumptions in the draft Monetary Policy Update with regard to growth abroad and higher future policy rates abroad than implied by forward pricing, a lower repo-rate path than that in the main scenario provides better target attainment for CPIF inflation and unemployment. This is illustrated clearly in Figure 6, which shows the main scenario and forecasts for alternative repo-rate paths with the aid of the Riksbank's model Ramses. This conclusion applies regardless of whether one measures the unemployment gap against a 6.25 or 5.5 per cent long-run sustainable rate of unemployment. This conclusion also applies if one assumes that inflation and unemployment react more slowly to interest rate changes than is the case in the Ramses model. If the reaction is slower, then this is an argument in favour of a larger and earlier cut in the repo rate, said Mr Svensson.

Mr Svensson questioned the forecast in the main scenario that CPIF inflation would rise quickly to 2 per cent. As shown in Figure 7, the forecasts from 2010 and onwards have systematically overestimated CPIF inflation for 2012. The forecasts rise fairly quickly to 2 per cent, while actual outcomes show a downward trend. Why should the current forecast, with a rapid rise to 2 per cent, be better than the previous forecasts, wondered Mr Svensson.

Another forecast assumption discussed by Mr Svensson concerned policy rates abroad. According to Mr Svensson, forward rates abroad (the grey line in Figure 8) are a more realistic forecast for policy rates abroad at present than the forecast in the main scenario (the yellow line). Mr Svensson said that this provides arguments for a much lower repo-rate path. This can be seen in Figure 9. Under the assumption of policy rates abroad following forward rates, the figure shows the forecasts for CPIF inflation and unemployment with the main scenario's repo-rate path and with two lower repo-rate paths. With regard to the repo-rate path in the main scenario, lower policy rates abroad as indicated by forward rates give a larger interest differential between the repo-rate path and policy rates abroad, a stronger krona, a lower inflation forecast, lower exports and a higher forecast for unemployment (the red curves in the two right-hand panels of the Figure). The lowest repo-rate path in Figure 9 leads to the best target attainment (the blue curves in the right-hand panels).

Given this, Mr Svensson advocated that the repo rate should be cut now by 0.5 percentage points to 0.75 per cent and should then follow a repo-rate path of 0.5 per cent from the beginning of the first quarter 2013 to the end of the first quarter 2014, followed by an increase to 1.5 per cent at the end of the forecast period. His assessment was that this lower repo-rate path would not noticeably affect any risks associated with household indebtedness, because as he has already mentioned, monetary policy normally has very small short-run effects on household indebtedness and with low and stable inflation no long-run effects.

Deputy Governor **Barbro Wickman-Parak** supported the forecasts presented in the draft Monetary Policy Update. She said that the forecast for developments abroad remains largely unchanged in relation to the forecast presented in October. Ms Wickman-Parak said that she would return to this later, in her contribution to the debate, as she wanted to express further nuances in this context. She thought that developments in the Swedish economy since October were of greater importance for today's decision.

During the autumn it has become increasingly clear that the weak developments abroad and the distrust linked to the political crisis have gnawed their way into the Swedish economy. This has been accentuated since October. She went on to comment on some points that have been important for her monetary policy stance.

The National Accounts for the third quarter showed a weaker development in investment than was expected in the October Monetary Policy Report, but the most surprising figures were the weak private consumption. The earlier only "motor" in the economy slowed down substantially, despite low interest rates and relatively good growth in household incomes. Consumer confidence has weakened quite substantially, although the levels are not yet alarming.

Production in the services sector has shown relatively good resilience, but it is now possible to see that production has fallen and the National Institute of Economic Research's Economic Tendency Survey for November showed a large fall for the confidence indicator, which is thus far below the historical average.

In October, the Riksbank adjusted its forecast for unemployment upwards, primarily on the basis of a new assessment of the functioning of the labour market, but also due to cyclical factors. The forecast has now been revised upwards again, but this time it is solely due to cyclical factors.

Ms Wickman-Parak supported the proposal in the draft Monetary Policy Update to cut the repo rate by 0.25 percentage points at the monetary policy meeting and to revise down the repo-rate path as proposed. She said that she had thought at an early stage of the process that one alternative she could consider would be to propose an unchanged repo rate and repo-rate path. Seen from a political perspective, the autumn has been critical for both the United States and the euro area and thus for growth prospects abroad. She had mentioned this earlier, at the monetary policy meeting in October. There have been, and still are, some economic policy problems remaining to be resolved in a number of countries. As a lot of what happens with regard to falling confidence and weaker figures is essentially based on factors abroad, she has considered it wise to keep calm and wait to see if things appear clearer further ahead. The repo rate is already very low and a further cut would only have very marginal effects on the Swedish economy.

However, she went on, as the statistics have been published the change for the worse with regard to the domestic factors she mentioned has made her think slightly differently. A cut of 25 basis points and a flat repo-rate path for some quarters to follow appears a reasonable alternative.

Ms Wickman-Parak said that during the drafting process cuts of both 25 and 50 basis points were discussed, as well as various different repo-rate paths. She thought that the calculations made for all of the alternatives studied had only had a minor impact on the forecast for the real economy and on the inflation forecast. What could be seen recently, apart from the weak outcomes, was a fairly large fall in confidence among economic agents. She questioned whether it was really possible to correct this with interest-rate policy so that it does not become entrenched and have an even greater impact on the real economy.

A cut in the repo rate of 25 basis points at the monetary policy meeting is expected and has probably already had some impact on the interest rates charged to households and companies. It should also to some extent be priced in the exchange rate and thus if there were no cut, the krona might appreciate somewhat. With regard to strengthening confidence, a cut in the repo rate of 25 basis points is neither here nor there, said Ms Wickman-Parak.

Cutting the repo rate by 50 basis points would have the effect of surprise, which could affect the krona exchange rate and provide some support to exports, but this support should not be exaggerated, as the problem essentially concerns weak demand from abroad. The cash-flow effect for households with variable mortgage rates could also be slightly greater. It could have a positive effect on households' scope for consumption, but given the low level of confidence in the household sector, it could instead lead to increased saving. Companies are uncertain about economic prospects and believing that a lower repo rate would have any decisive effect on investment is not particularly realistic, in Ms Wickman-Parak's view.

There may be a notion that the Executive Board never cuts the repo rate by more than 25 basis points if we are not in the midst of, or on the brink of, a serious crisis. She herself was an advocate of gradual interest-rate adjustments, but said that this is not such a fixed principle that she cannot depart from it except in the case of extreme crisis. One situation that could justify a larger cut, she went on to explain, would be the one we are seeing now, where economic activity has weakened fairly substantially over a rather short period of time. But even with a cut of 50 basis points, one can question whether there is any confidence-creating effect. Her assessment was that this effect is marginal.

The type of deliberations that monetary policy is now facing are fairly subtle and the difference in the effects of the various alternatives is slight. The repo rate is already low and the proposed cut, together with the downward adjustment to the repo-rate path, entails a negative real-interest rate all the way to the end of 2014. The current low inflation rate, and the inflation rate one envisages over the coming year, is not something that monetary policy can influence, and when determining monetary policy one has to look further ahead, said Ms Wickman-Parak. This affected her decision.

She said that one could not be certain how the transmission mechanism would work in different situations. The fundamental problem for the Swedish economy is linked to the uncertainty over economic developments abroad, and it may very well be the case that this uncertainty declines substantially relatively soon, if continued adequate economic policy measures are taken. In this type of situation the effects of Swedish monetary policy, which has an impact with some time lag, would occur in a situation where inflation is already close to the target and resource utilisation is close to its normal level. This risk becomes larger as the interest rate cuts become larger, according to Ms Wickman-Parak.

Ms Wickman-Parak also said that one argument for her decision was her assessment that there is a reasonable chance of better growth abroad during the course of next year. She thought that the statistics from the United States received since the monetary policy meeting in October pointed in this direction, even if the situation is so far clouded by the uncertainty linked to the negotiations on future fiscal policy. China is another country where economic prospects look good. GDP growth in the euro area will be weak, although there are small curves upwards in some confidence indicators. However, these are at very low levels and she did not draw any major conclusions from them. She did think that if the international economy outside of the euro area grows slightly faster, it will also have positive effects on the countries in the euro area. She went on to say that one important factor from a confidence perspective is that the economic policy situation has strengthened in that the danger of a split in the euro area no longer appears imminent.

This type of development abroad would be the best factor to strengthen confidence among Swedish households and companies and would also affect outcomes in the Swedish economy, with some time lag. Ms Wickman-Parak said that the conditions for assessing this would be better later in the winter.

Of course, it is possible that the European economy could suffer a worse crisis. If this were the case, it would change the conditions for monetary policy in Sweden. The monetary policy conducted by the Riksbank is the subject of lively debate, and this is positive. But one should remember that the repo rate is already very low and one must take into account how effective a repo-rate cut will be if there is a massive confidence crisis originating abroad. One might wish that the discussion of which policy mix is appropriate in different situations was given greater scope in the debate, concluded Ms Wickman-Parak.

First Deputy Governor **Kerstin af Jochnick** began by noting that she largely agrees with the assessment of future economic developments abroad and in Sweden as described in the draft Monetary Policy Update.

The Swedish economy has slowed down substantially in recent months. Although this slowdown was expected, it has become somewhat more severe than we predicted in the October Monetary Policy Report. Developments in Sweden must be regarded in the light of what is happening in our export markets, in particular. Despite a strong start to the beginning of the year in Sweden, the economy has now been gradually affected by the weak developments abroad, especially in Europe. Lower demand for Swedish export products is now also having a spillover effect on domestic sectors. This is noticeable in the form of a decline in domestic demand and lower employment.

A large share of Swedish exports goes to the euro area, continued Ms af Jochnick. The Swedish economy is therefore dependent on a turnaround in developments in the euro area to the positive. For developments in the euro area to be more positive, it is necessary that the proposed economic policy measures are adopted and implemented so that financial stability is maintained. She said that there is reason to believe that an upturn can be expected towards the end of 2013. However, the euro area must be analysed country by country. Some progress has been made with regard to competitiveness and debt adjustment, but it is fairly clear that several countries in southern Europe will suffer adjustment problems for a longer period of time. Growth in Germany is also low and GDP is expected to fall in the euro area as a whole this year. However, if the euro zone crisis is managed in the right way, household and corporate sector confidence in the euro area is expected to gradually recover next year. Germany has a competitive export industry, which creates the right conditions for a recovery when growth in the global economy increases again. When German exports increase at a faster pace once again, this will have positive effects for both the euro area and Sweden.

Following a weak 2012, the forecast in the draft Monetary Policy Update is that the global economy will grow at a relatively good pace in 2013-2015. However, there are still question marks regarding the management of the "fiscal cliff" in the United States. Nevertheless, the indications are that politicians will ensure that the fiscal policy tightening in the US economy is not too severe in 2013. This means that growth in the United States will show a positive development. With regard to the emerging markets, they are expected to develop well in 2013 and, for instance, the BRIC countries are expected to have a growth rate of 6.7 per cent.

Ms af Jochnick emphasised that when the economies in other parts of the world recover, Europe will be able to benefit. Demand for Swedish goods will also gradually lead to an increase in Swedish exports and thus to higher growth, lower unemployment and higher inflation.

The financial markets in Europe have stabilised during autumn 2012. Risk premiums for both governments and financial companies have declined significantly since the summer. A decisive factor for the calmer developments has been the decisions taken to strengthen cooperation in the euro area. Decisions on various types of support programmes and the decision to establish a banking union have had a calming effect on the markets. However, the decision-making process in the euro area is slow and there is a lack of concrete information on many issues. It is nevertheless important to note that essential decisions have been made. There may therefore be increased scope for confidence in both the institutional framework and banks and companies in the euro area to strengthen gradually.

The stress index, which measures volatility in various parts of the financial market, has declined to much lower levels than we have seen in recent years. The volatility in various market segments has declined as decisions have been made regarding the measures and the uncertainty has thus declined. The most recent piece of the puzzle concerns the design for banking supervision within the scope of a banking union. The decisions made appear reasonable for the participating countries. The cooperation on the supervision of large banks in the euro area is strengthened and the focus will initially be on the large, cross-border banks. This is a reasonable balance, as it is mainly these banks that are important to the stability of the European banking system and ultimately to the ability to support companies and households effectively, said Ms af Jochnick.

With regard to the Swedish economy, it is clear that it is now slowing down significantly. Several large companies have issued notices of coming redundancies in the autumn. One can also see that households and companies have a more pessimistic view of the future and of developments in the macro economy than might be expected, given the forecasts in the October Monetary Policy Report. This has contributed to lower demand, as households and companies are more cautious with regard to consumption and investment and are instead increasing their saving. Ms af Jochnick's assessment is that the Swedish economy will remain weak during most of next year, and it is only when it is possible to see a stabilisation in the euro area and a recovery in Swedish exports and greater confidence regarding the future that Swedish GDP growth will improve, said Ms af Jochnick.

Inflation is now at an historically low level in Sweden, and is expected to remain low for a period of time, and then rise and reach the inflation target during 2014. She said that there are several reasons for the current low level: a low rate of increase in labour costs in connection with the financial crisis, a low level of resource utilisation and a stronger krona. The inflation forecast has been revised downwards, particularly for the year immediately ahead. In the short term, this is partly because energy prices are expected to increase slightly less than was assessed in the October Monetary Policy Report. In the slightly longer run, it is largely because wages are expected to increase at a slower rate. Inflation expectations have also come down to low levels in the short-term perspective, but are at 2 per cent in a longer perspective.

Ms af Jochnick said that a somewhat poorer demand situation in Sweden compared with the assessment in October and low inflation and rising unemployment mean that there is reason to cut the repo rate by 25 basis points and to adjust the repo-rate path downwards. This monetary policy will provide support for the Swedish economy and inflation will attain the target of 2 per cent in 2014.

Finally, Ms af Jochnick concluded by saying a few words about household indebtedness, as this was a question debated earlier in the autumn. From her perspective, the question of the level of household debt was still important. However, she emphasized that the household sector debt ratio was not something that monetary policy could quickly influence with the repo rate. From a monetary policy point of view, the primary goal is to focus on the inflation target of 2 per cent. Given the weak economic situation and the pessimistic household sector, she envisaged limited risks from household debt in the short term. Moreover, since the mortgage cap was introduced, households' loan-to-value ratios have declined. But there are still risks entailed in household debt. She therefore saw a need in the longer perspective to reinforce the demands concerning household debt to reduce the risk of shocks.

Deputy Governor **Karolina Ekholm** began, like Ms af Jochnick, by mentioning that the October Monetary Policy Report had assumed that the Swedish economy would be affected by the weak economic activity abroad. Now this had been realised, with rising unemployment and falling demand on a broad front. Ms Ekholm assessed that all of the Board members probably agreed that monetary policy needs to be more expansionary in this situation.

However, she said that she was frustrated that the response to developments had come at a late stage and been reactive rather than forward-looking and proactive. She therefore wondered whether the decision in October should not have been to cut the repo rate, given that it was already possible to see a number of downside risks and that weaker international developments were anticipated. But Ms Ekholm said that the focus appears to have been on household debt and on the hope that Sweden would not be as hard hit by the weak international developments and that monetary policy would therefore not need to be used to counteract a fall in demand.

Ms Ekholm emphasized, however, that if one looks at how the Swedish economy has developed recently, most indicators show that demand pressure has been too low for a fairly long time. Sweden has a large surplus on its current account, despite the fact that the exchange rate is now not particularly weak, which indicates that domestic absorption of goods and services is relatively low. CPIF inflation appears to have fallen more or less as a trend since 2010 – which is shown in Figure 7 in the collection of figures distributed by Mr Svensson – and it is now below 1 per cent. Unemployment has remained high, much higher than can be assumed to be a sustainable long-run level. All of this is a sign that demand is too low in Sweden and that it has in principle been so since the financial crisis 2008-2009, said Ms Ekholm.

Ms Ekholm pointed out that the Riksbank's main task is to ensure that demand is held as stable as possible at the level compatible with the inflation target. She then went on to explain that she did not think the Riksbank had done a very good job accomplishing this task recently. Monetary policy has fallen behind the curve and has not contributed to stabilising developments in the way one might have expected.

She asked the question of whether it is worth missing bringing inflation up to around 2 per cent and bringing down unemployment to some form of sustainable long-run level, to try to influence household debt with the repo rate. Ms Ekholm did not think it was. She said that it entails considerable economic costs in exchange for something that it is highly unlikely can actually be attained using the repo rate. All of the calculations made by the Riksbank so far imply that the repo rate has very little effect on households' indebtedness, which is for instance clear from Figure 16 in the draft Monetary Policy Update. At the same time, it has substantial effects on inflation and resource utilisation.

Ms Ekholm said that she might possibly have thought that it could have been justified to pursue some sort of leaning against the wind policy during the period when a rapid build-up of household debt really did take place. But it was in the years before the financial crisis that the growth rate in lending to households reached double figures. Then there really was a wind to try to lean against. Now, however, credit growth is below 5 per cent as an annual rate and has been so for most of this year. It appears that housing prices have been rather stable over the last two years. So why pursue such a leaning against the wind policy now? The aim can hardly be to use the repo rate to significantly reduce the household debt ratio, as this would probably presuppose a fall in housing prices. Monetary policy could perhaps manage to achieve such a fall in prices if it were so tight that the economy was running below full capacity because of a lack of demand, but she assumed that none of the members of the Executive Board wanted this.

Ms Ekholm then explained that she believed that the Riksbank should promote the protection of households against the risks associated with high indebtedness but that it should do so in ways other than setting the repo rate higher than is justified by the inflation target. She said that the Riksbank should instead work for an effective macroprudential policy in Sweden and address the issue of whether, and if so how, the housing market needs to be changed for the Riksbank to assess that it no longer poses any risks to the development of the macro economy and to financial stability.

Ms Ekholm was thus critical of the policy conducted recently and thought that it should have been more expansionary. The draft Monetary Policy Update proposes a repo-rate reduction of 0.25 percentage points now and then a path that lies slightly below 1 per cent until the third quarter of 2013. She actually thought that a larger cut than 0.25 percentage points was justified and would have preferred a cut of 0.5 percentage points. However, as in her view the proposed cut was nevertheless a step in the right direction she did not intend to enter a reservation against it. She would, however, enter a reservation if the proposed repo-rate path was supported by a majority of the Board members as she did not believe that a reduction to just under 1 per cent constituted a well-balanced monetary policy. The repo-rate path in the draft Monetary Policy Update gives rise to a forecast in which CPIF inflation reaches 2 per cent quite some way into the forecast period – some time in early 2014 – and then remains at this level at the same time as unemployment does not even fall to a long-run sustainable rate by the end of the forecast period. A lower repo-rate path would provide a better-balanced monetary policy by enabling inflation to reach 2 per cent more quickly and unemployment to fall to a long-run sustainable rate. Figure 6, which Mr Svensson referred to earlier, shows this clearly.

Ms Ekholm therefore believed that there was a need for a larger cut in the repo rate and advocated a path that is lowered to 0.75 per cent at the beginning of next year, stays at this level through the first quarter of 2014 and then gradually rises to 1.75 per cent. This is roughly the repo-rate path she advocated at the meeting in October, although slightly adjusted, and a path that lies approximately 0.25 percentage points above that proposed by Mr Svensson.

As usual, the forecast for policy rates abroad is a very critical component of the international forecast when it comes to assessing what is an appropriate repo-rate path for Sweden. As has been the case recently, the forecast in the draft Monetary Policy Update is rather close to market expectations as expressed in implied forward rates for most of the forecast period, but begins to deviate towards the end of the period, as can be seen in Figure 8, which was referred to by Mr Svensson. This deviation potentially has great significance for the rest of the forecast as, according to the relationships on which our models are based, it is of great significance to the exchange rate and thus to inflation and resource utilisation. Ms Ekholm said that her strategy for finding an appropriate repo-rate path is that it should look acceptable in model simulations irrespective of whether one bases the forecast for foreign policy rates on implied forward rates or on the relations that have formed the starting point for the forecast contained in the draft Monetary Policy Update. She thought that the path she advocated met this objective quite well. However, as she had emphasised at previous meetings, she did not claim to have found the path that provides the best possible balance between stabilising inflation around 2 per cent and unemployment around a long-run sustainable rate.

Deputy Governor **Per Jansson** shared the assessment of the previous speakers that it was now appropriate to conduct a somewhat more expansionary monetary policy than in October. His thinking had primarily centred around two alternatives. The first entailed cutting the repo rate by 0.25 percentage points and the second cutting the repo rate by 0.5 percentage points. In October, Mr Jansson's view was that the repo rate could be left unchanged and that it was enough to lower the repo-rate path. Now, however, Mr Jansson believed that the repo rate should be cut immediately. In his comments he intended to explain why his assessment now was that an immediate repo-rate cut was appropriate and which of the two monetary policy alternatives he had finally opted for.

With regard to developments abroad, Mr Jansson's view was that no major changes had taken place since the monetary policy meeting in October. The need to cut the repo rate thus had little to do with a poorer international outlook. As Ms Wickman-Parak had already suggested, the reason was instead that the weak development abroad was now having an unexpectedly severe impact on the Swedish economy. This has of course not happened overnight but has been a gradual process during the autumn. However, Mr Jansson believed that sufficient information had now been gathered so that a rather clear picture was emerging.

One piece of the puzzle is the GDP outcome in Sweden for the third quarter. On the face of it, this outcome may have appeared to be strong; a seasonally-adjusted increase of 0.5 per cent compared to the second quarter, while the forecast in the October Monetary Policy Report was 0.2 per cent. But as we examine the aggregate figure more closely it becomes clear that both exports and important components of domestic demand were weaker than expected. The factors that contributed to a faster growth in GDP than forecast in October were that companies increased their stocks more than expected and that imports were surprisingly weak. This means that underlying growth is much weaker than suggested by the actual figure for GDP.

Mr Jansson went on to say that GDP indicators in the form of hard data and data from household and company surveys provided further pieces of the puzzle. Here a rather gloomy picture emerged in which the weakening of various parts of the economy had gradually become more pronounced and spread to an increasing number of sectors and areas of activity. Since the forecast in October, the Economic Tendency Indicator of the National Institute of Economic Research has fallen by almost 10 units and is now approximately 1.5 standard deviations below a normal level. Apart from the crisis years 2008-2009, the Indicator has been at such a low level on only one other occasion during the 2000s. It is particularly worrying in this context that the signs of weakness are now becoming increasingly clear in the service sector too.

All in all, Mr Jansson thus believed that it was evident that GDP growth will be rather weak in Sweden in the fourth quarter and the early part of 2013, and weaker than forecast in the latest Monetary Policy Report. The forecast in the draft Monetary Policy Update is that GDP will fall by 0.2 per cent in the fourth quarter and increase by 0.2 per cent in the first quarter of 2013. In the Monetary Policy Report, the corresponding figures were 0.2 per cent and 0.5 per cent. The downward revision of short-term growth prospects is thus rather substantial. Despite this, Mr Jansson said that he could easily see development being even weaker than now assumed in the draft Monetary Policy Update.

Consequently, he did not want to rule out the possibility that the Swedish labour market could also be hit harder than assumed in the draft Monetary Policy Update. The Update predicts that unemployment will peak at 8.2 per cent in the second half of 2013. It is true that the number of new and unfilled job vacancies is still rather high, but the number of redundancy notices has increased significantly during the autumn and the companies have cut back their employment plans. Given this, it is not unlikely that employment will be slightly lower and unemployment slightly higher than predicted in the draft Monetary Policy Update. However, Mr Jansson wished to make it clear that although his views on the GDP forecast and the forecast for the labour market differed, it did not mean that he intended to enter a reservation against the assessments in the draft Monetary Policy Update.

Several of the Executive Board members that have belonged to the majority during the year have pointed out that monetary policy has entailed balancing the need to stabilise inflation and economic development in the short term against the need to avoid financial imbalances, such as excessive indebtedness among the Swedish households, in the longer term. Mr Jansson shared the view that such a balance has been, and still is, required. However, the fact that economic activity in Sweden is now weakening more than was previously expected has clearly strengthened the reasons for conducting a more expansionary monetary policy. This is also why Mr Jansson now believed there was a need to immediately cut the repo rate.

This led him to the question of by how much it would be appropriate to cut the repo rate. As he said initially, he had considered two alternatives: cutting the repo rate by 0.25 percentage points or by 0.5 percentage points. After weighing up the advantages and disadvantages, he had finally come to the conclusion that he wanted to support the more cautious alternative; that is, a repo-rate cut of 0.25 percentage points. With this, Mr Jansson concluded that he not only supported the economic forecasts in the draft Monetary Policy Update but also the monetary policy on which they were based.

When considering the reasons for this stance, Mr Jansson said that to start with it was important to note that the forecast differences compared with the larger cut are very limited. According to the calculations made by the Monetary Policy Department, inflation would rise towards the target approximately as quickly in both alternatives. In 2014, CPIF inflation would be a couple of tenths higher if the repo rate was cut by 0.5 percentage points.

Another important part of the picture, as has been pointed out several times previously, is that the repo rate is already very low. If the repo rate is now cut by 0.25 percentage points, the real repo rate will bottom out at approximately -1 per cent in 2013 and remain negative for the next two years.

Mr Jansson also believed that the more cautious monetary policy meant that the risks associated with household debt would, all else being equal, be internalised in a slightly better way. Neither of the alternatives of course represented any dramatic increase in the risks relating to household debt. But a smaller repo-rate cut was nevertheless to be preferred in this context. He repeated that the indebtedness of the Swedish households is worryingly high and that it is important that decision makers in Sweden together consider whether measures need to be taken - and if so - which measures. Mr Jansson pointed out here that he agreed with what Ms af Jochnick said earlier; that this is primarily a more long-term problem. The fact that the repo rate is actually very low also illustrates that monetary policy prioritises the more short-term prospects for inflation and economic activity.

Another argument against the larger cut that has arisen during the discussions ahead of this meeting is that such a cut, contrary to intentions, could increase unease on the part of the households and companies. This argument is based on the fact that to date the Riksbank has only chosen to cut the repo rate by more than 0.25 percentage points in very exceptional circumstances. As the idea is to create as positive an impact as possible on sentiment among the households and companies, increased unease is of course not at all what we want to achieve. Mr Jansson said that this had also been a marginal factor in his final decision not to advocate the alternative with a larger repo-rate cut.

Governor **Stefan Ingves** said that he shared the view of international developments and the Swedish economy presented in the draft Monetary Policy Update. He also supported the proposal to cut the repo rate by 0.25 percentage points and the new repo-rate path.

The recent performance of the economy, the weak development of economic activity abroad, particularly in the euro area, and the low inflationary pressures have made it appropriate to cut the repo rate in order to enable inflation to rise towards the target of 2 per cent and to normalise resource utilisation.

The economic recovery is continuing in the United States and some progress has been made in the debt adjustment process. There are also still signs of a turnaround on the housing market. The labour market is also recovering, although slowly. Mr Ingves based his monetary policy stance on the expectation that the problems relating to the fiscal cliff will ultimately not lead to a dramatic tightening of fiscal policy or to a major disaster for the economy. He also expected overall global growth to be rather normal, which would of course favour an export-oriented nation like Sweden.

Developments in the euro area are marked by the debt crisis. Several macro indicators, for example industrial production and consumer confidence, are weak in the euro area, and unemployment has increased. However, according to Mr Ingves there are some signs that the crisis may have bottomed out, for example in terms of the latest outcome for the purchasing managers' index in the manufacturing industry. Some progress has been made in adjusting the imbalances that developed before the crisis with regard to competitiveness, current accounts and the growth of public and private debt. A wave of structural adjustment is passing through Europe; Ireland and Spain, for example, are on the way to balancing their current accounts. There are thus reasons for believing that growth will gather pace again during the forecast period.

Risk premiums for governments, companies and banks stabilised during the autumn at lower levels than in the summer. The European Central Bank (ECB), the EU and the IMF have introduced various support measures to resolve the more acute problems. Uncertainty is gradually being reduced, although this will be a long process. The forecast in the draft Monetary Policy Update assumes that measures will be taken in the euro area and that confidence will gradually improve. Mr Ingves said that the main responsibility for this still lies with the politicians in the respective countries.

If uncertainty were to increase concerning the implementation of these measures, then there is a risk that debt consolidation could take longer and thus prolong the downturn. Developments in the euro area thus still pose a risk to the economies of other countries, including Sweden. This is something that Ms Wickman-Parak and others have already addressed very well in their earlier comments.

Although the Swedish economy has been resilient during the financial crisis in Europe, it can now be noted that weak development abroad is having a greater impact. Confidence weakened in several sectors in November, and export orders have also fallen. The households' view of the Swedish economy has become more pessimistic, although their view of their own financial situation is not as gloomy. Redundancy notices have increased on the labour market and this is one of the reasons why the forecast for unemployment has been revised upwards in the draft Monetary Policy Update. The forecast for GDP growth for the quarters immediately ahead has been revised downwards. However, the expansionary monetary policy will contribute to a gradual increase in growth in 2013 and 2014. The analysis is based on the assumption of a weak 2013 but then a rather rapid normalisation of Swedish growth and inflation.

Inflation is currently low due to limited increases in wage costs, the earlier strengthening of the krona and a low level of resource utilisation. Energy prices and wages are expected to increase less than was previously expected. Mr Ingves said that the Riksbank's repo-rate cuts will contribute to the rate of change in the CPI, which is affected by the households' interest expenditure, being negative in the months ahead.

However, inflationary pressures will gradually increase during the forecast period. Monetary policy is now highly expansionary and this will contribute to an increase in resource utilisation and a more rapid increase in wages. In addition, the krona is expected to be stable and its dampening effect on prices is expected to weaken. Measured in terms of the CPIF, which is not affected by interest costs, inflation will approach 2 per cent in 2014. CPI inflation, which will be affected when the Riksbank eventually increases the repo rate, is expected to be just over 2.5 per cent at the end of the forecast period.

Mr Ingves also wished to point out that the risks associated with the high level of household indebtedness remain. He believed that there is a link between monetary policy and the build-up of debt. The repo-rate decision was justified by the weaker economic situation and the lower rate of inflation, even taking into account the risk of financial imbalances in the years ahead. Other measures are necessary as problems may arise beyond the forecast horizon.

All things considered, Mr Ingves said that the poorer economic outlook and the low inflationary pressures justified cutting the repo rate. The repo-rate decision also entails a downward adjustment of the repo-rate path. This will contribute to inflation rising towards the target and to employment stabilising in the long term. At the same time, monetary policy will continue to take the risk of financial imbalances into account. Better regulatory frameworks are needed to reduce the risks in this area. Developments abroad must also be carefully monitored, said Mr Ingves.

§3. Discussion

Deputy Governor **Per Jansson** began the discussion by noting that the monetary policy conducted has been clearly expansionary and that the Riksbank has made it clear that this is necessary given the situation regarding inflation and the real economy. For his part, Mr Jansson therefore found it a little difficult to understand the sharp criticism of monetary policy from some quarters. He also pointed out that it was good that the high level of household indebtedness has gradually attracted more attention and that this has happened without the Riksbank needing to do so much with the repo rate. It is sometimes argued that household indebtedness is a factor that lies outside the Riksbank's mandate; but this too is, according to Mr Jansson, a little difficult to understand. It is, after all, basically a question of avoiding macro imbalances in the slightly longer term. This is of course entirely in line with the Riksbank's mandate, said Mr Jansson.

He also put a question to Ms Wickman-Parak who, like himself, seemed to have thought a great deal about the possibility of cutting the repo rate by 0.50 percentage points at today's meeting. Mr Jansson wondered how in this connection Ms Wickman-Parak had assessed the risk of such a measure increasing, rather than reducing, unease among households and companies. Could such a measure really be perceived as a signal that the Riksbank believes that Sweden is now in a crisis?

Deputy Governor **Barbro Wickman-Parak** replied that Mr Jansson's question is an important one, partly because those who report on the Riksbank may have a tendency to highlight factors that can be seen as alarmist. However, Ms Wickman-Parak's assessment was that such a risk is limited as she has great confidence in the Riksbank's ability to effectively communicate the message it wants to get across. She said that this risk would not therefore prevent her from making such a decision if she believed it to be appropriate.

Deputy Governor **Karolina Ekholm** said that she found the figure for the development of CPIF inflation and the Riksbank's forecasts that Mr Svensson referred to earlier (Figure 7) disquieting. She said that it looks as though the Riksbank has had to adjust the inflation forecast downwards recently because the outcomes have been lower than forecast. It also seems that the forecasting errors have been rather significant over the last 12 months. Ms Ekholm said that this made her wonder whether the current forecast that inflation will reach 2 per cent in early 2014 is realistic. She thought it was important to clarify what is needed for the rate of inflation to really do this. As Mr Ingves mentioned earlier, an exchange-rate forecast that remains stable at approximately the current level does not at least entail any downward pressure on prices from the exchange rate. But she wondered whether this would be enough to enable inflation to reach 2 per cent in just over a year's time.

Ms Ekholm also referred to Mr Jansson's comment that he thought it was positive that household indebtedness had attracted increasing attention recently without the Riksbank needing to do so much with the repo rate. Her interpretation of the fact that the level of household debt had stabilised without any repo-rate increases was that the level is simply not affected so much by the repo rate compared to other factors. Mr Jansson also said that it was important to understand that the repo rate needs to be held up to avoid macroeconomic imbalances further ahead. However, Ms Ekholm thought that it would be difficult to get people to understand that the repo rate should be kept up to avoid inflation being too low at some point in the future as it is generally accepted that a higher repo rate leads to lower inflation.

Deputy Governor **Lars E.O. Svensson** commented on one of Ms Wickman-Parak's earlier contributions. Ms Wickman-Parak's contribution could be interpreted to mean that if repo-rate cuts would have less of an impact on inflation and unemployment than usual then this would be a reason for cutting less rather than more. Mr Svensson did not agree with this and said that if the impact would be less and/or come later then this was rather a reason for cutting the repo rate more and earlier. He compared this to driving a car along a winding road. If the front wheels turn less and respond later to a given turn of the steering wheel, then you have turn the steering wheel more and sooner to avoid ending up in the ditch.

Several members of the Executive Board claim that monetary policy is now highly expansionary, with reference to the fact that nominal and real policy rates are low in historical terms. Mr Svensson said that an historical comparison is misleading in this situation. As can be seen in Figures 1 and 4, there has been a clear trend towards lower short and long real interest rates since the mid-1990s. This trend is global and is not something that Swedish monetary policy has been able to affect. This means that a comparison with historical nominal and real rates is misleading, according to Mr Svensson. He said that it is more relevant to compare with real short rates in the euro area, the United States and the United Kingdom. Figure 1 shows that the Swedish one-year real interest rate is much higher than in the United States and the euro area, even if it becomes negative in 2013. That it will also be negative in 2013 is based on the forecast in the main scenario that CPIF inflation will rise sharply to 2 per cent in 2014. Mr Svensson claimed, however, that there are good grounds for questioning this forecast and for believing that it is an overestimation, as Figure 7 indicates.

Mr Svensson went on to comment on Mr Jansson's remarks on the importance of preventing monetary policy giving rise to financial imbalances in the longer term. Mr Svensson wondered what was meant by "imbalances" in this case. Is it the loan-to-value ratio that is too high? But, according to Figure 3, the loan-to-value ratio is fairly stable at around 50 to 60 per cent. And according to Figure 5, it does not seem that there is any strong link between the loan-to-value ratio and the policy rate; at least a higher policy rate does not seem to reduce the loan-to-value ratio. Mr Svensson wondered whether it was instead housing prices that are too high? But housing prices can be explained by real disposable income and the real long mortgage rate after tax. Is it the real long mortgage rate that is the problem? Is that what monetary policy should affect? But according to established theory and empirics, monetary policy has no long-run effect on long real interest rates and thus – with low and stable inflation – not on long after-tax mortgage rates either.

Mr Svensson then went on to say that the discussion of the risks associated with household debt seems to be largely based on superficial comparisons with other countries. "The Swedish debt ratio is at a level that has led to problems in other countries" is a commonly-heard phrase in this context. Mr Svensson claimed, however, that it is not clear that it is the high debt ratio itself that has been the problem in other countries. It is rather that the assets funded by the debt have turned out to be over-valued, uncertain and have fallen in value. To assess the risks associated with the debts one must therefore examine and assess the assets, as well as the households' debt-servicing ability and resilience to shocks, said Mr Svensson. All else being equal, it is reasonable to assume that the larger the debt, the more vulnerable to shocks a household will be. All else being equal, it is reasonable to assume that the larger the assets, the less vulnerable to shocks a household will be. Both the debt and assets of the Swedish households have increased, but the proportional relationship between them remains the same. It is thus not self-evident that vulnerability has increased, said Mr Svensson. He asked whether there is an example of an economy with a debt ratio of around 170 per cent that at some point suffers a crisis but, like Sweden now, is not overheated, does not have a construction boom, has strict lending standards, has well-capitalised banks, has a high level of saving, has a loan-to-value ratio for mortgages of 50 to 60 per cent and has a level of gross solvency for households of almost 70 per cent?

Deputy Governor **Barbro Wickman-Parak** responded to Mr Svensson's comments on uncertainty regarding how the transmission mechanism works in different situations. She made it clear that she takes into account how uncertainty regarding the transmission mechanism may affect developments in the period ahead. If the repo rate is cut substantially now, the risks that may be associated with a delayed transmission mechanism will be greater.

Ms Wickman-Parak also said that it is important to be cautious when looking at models and historical links. Relations that have applied historically can change, temporarily or permanently. Mr Svensson himself has on previous occasions noted that historical relations do not always apply. She took Okun's Law as an example. When the Riksbank and other analysts attempted to forecast unemployment during the financial crisis, the increase in unemployment was expected to be much higher given the substantial fall in GDP. This proved not to be the case; we had to go back to the drawing board.

With regard to the inflation forecast, Ms Wickman-Parak pointed out that the Riksbank always openly analyses forecast deviations and their causes. Mr Svensson said earlier that the Riksbank has systematically made incorrect assessments and she hoped that he was not suggesting that the forecasts are deliberately incorrect. The Riksbank strives to produce the best possible forecasts and to continually improve the tools used. But several factors, such as the exchange rate and its effects, are difficult to forecast. Ms Wickman-Parak also said that comparisons with other forecasters show that the forecasting ability of the Riksbank is good.

First Deputy Governor **Kerstin af Jochnick** thought that it was unfortunate that so much of the focus of today's discussion had been on household indebtedness. Now that Sweden is facing a serious downturn she believed that the international outlook and domestic demand were the most important issues to evaluate. It was important to keep the discussion focused on how different scenarios would affect the development of the economy and on what monetary policy alternatives are available.

The repo rate is low today and Ms af Jochnick's assessment was that monetary policy should continue to be expansionary to support economic activity. To attain credibility it is important that monetary policy is seen in the perspective of a focus on the inflation target, said Ms af Jochnick.

Deputy Governor **Karolina Ekholm** agreed with Ms Wickman-Parak that the Riksbank is assessing and analysing why inflation has been so low. However, she said that what has not been done is to examine to what extent monetary policy has contributed to this. If, in principle, it is solely a question of low energy prices then this is nothing that monetary policy could have affected. But Ms Ekholm believed that the low rate of inflation is one of the signs that demand pressures have been too low and, if this is the case, this is something that monetary policy could have counteracted.

Ms Ekholm also agreed with Ms Wickman-Parak about Okun's Law. This relation seems to have broken down in connection with the financial crisis of 2008-2009, not only in Sweden but in a number of other countries too. It also appears to have changed in entirely different directions in the United States and Europe. Ms Ekholm said that there is a need to update Okun's Law in order to understand how GDP growth, unemployment and productivity growth relate to each other.

Deputy Governor **Lars E.O. Svensson** said that Okun's Law temporarily broke down during the crisis of 2008–2009 due to labour hoarding and agreements that reduced working hours and wages but kept people in work. However, he believed that the relation will eventually return to normal.

With regard to the discussion on the inflation forecasts and what role monetary policy plays in this context Mr Svensson referred to Figure 7, which shows how the inflation forecasts from 2010 onwards have systematically overestimated the actual rate of CPIF inflation. Mr Svensson pointed out that during this time both he and Ms Ekholm have warned that inflationary pressures may have been overestimated and have said, among other things, that the forecast for interest rates abroad has been too high and that a lower, in their view more realistic, forecast for foreign rates together with a high repo rate path would contribute to a stronger krona, weaker exports and a lower inflation outcome. Their warnings have now been realised and CPIF inflation is lower than the main scenario's forecasts, said Mr Svensson.

Governor **Stefan Ingves** pointed out how difficult it was to find the appropriate balance when deciding on monetary policy. The level of the repo rate should reflect a balance between inflation and resource utilisation while taking into account the prevailing build-up of debt. Mr Ingves said that it cannot be ignored that the build-up of debt, in both the private and public sectors, is an important factor. However, it is not self-evident how this should be taken into account in the monetary policy decision, for example how major risks that exist beyond the forecast horizon should be weighed in. Mr Ingves said that the Riksbank should continue to address the analytical issues relating to this, which is something that other central banks are also struggling with.

Mr Ingves also pointed out that the real economy appears to be more volatile since the financial crisis, which means that we must ask how the models used are handling this volatility. A related question is how the long-run sustainable paths have been affected by the higher volatility in recent years. One example is unemployment and how it has developed. It seems that matching between job-seekers and job vacancies has deteriorated. The part of the increase in unemployment that is due to less efficient matching is not something that monetary policy can influence, said Mr Ingves.

Mr Ingves highlighted another aspect relating to the build-up of debt. Even if the build-up of debt is subdued using measures other than the repo rate, this will still affect monetary policy. When the level of debt is reduced, the level of demand in the economy also falls, which has an impact on economic activity in general. Mr Ingves said that it is therefore important to give more thought to the transmission mechanism and how the models used take this factor into account.

He went on to say that another central issue relates to the risk of imbalances in the longer term. As a result of the crisis abroad, interest rates are generally very low in historical terms and we should therefore ask what the consequences of a low interest rate for a long period of time may be. How are the companies affected by a low interest-rate environment, for example? Is there a risk that the companies' capital allocation will be affected? Do companies become less innovative when there is access to low-cost funding? Mr Ingves pointed out that the negative consequences of a low interest-rate environment have long been discussed in Japan. A discussion has begun in the United Kingdom about so-called zombie companies, which are kept alive in a low interest-rate environment without contributing to real investment and which may instead actually dampen the development of productivity in the economy. Although this is not happening in Sweden today, the experience gained in other countries should be studied, said Mr Ingves. A low repo rate is justified from a cyclical point of view, but a negative real interest rate also carries the risk of excessive indebtedness and the risk that necessary structural changes will not take place.

In response to Mr Ingves, Deputy Governor **Lars E.O. Svensson** noted that the Fiscal Policy Council's report for 2012 shows that matching on the labour market is cyclically dependent, and more cyclically-dependent in the case of inexperienced labour. This means that an expansionary monetary policy can improve matching, particularly for inexperienced labour. It is thus not true that matching is independent of monetary policy, said Mr Svensson

Deputy Governor **Barbro Wickman-Parak** said that Mr Ingves had raised many interesting issues in his comments. She agreed that it is important to take into account that the monetary policy decision can have effects beyond the forecast horizon. She also agreed that it is important to ask what a low interest rate over a long period of time entails. If the price of money loses its impact as an allocation mechanism, investments that are not profitable in the long-term may nevertheless be made, thus impairing the quality of the capital stock and obstructing structural transformation. As investors demand a certain return, a low interest-rate environment may also mean that an increasing number of investors are attracted to high-yield and high-risk alternatives.

Ms Wickman-Parak then responded to the argument that the repo rate was of no significance to the development of debt. She said that the interest rate, that is the price of money, should be a significant factor in the development of the volume of credit. After all, all of the other instruments one can use to affect credit growth ultimately work through their impact on how expensive it is to borrow. If the repo rate is ineffective, then all these other instruments must be ineffective too.

The Chairman, Governor **Stefan Ingves**, then summarised the monetary policy discussion.

It was noted at the meeting today that new information received since the monetary policy meeting in October indicates that the Swedish economy is slowing down more sharply than was assessed then. GDP is therefore expected to increase at a slower pace and unemployment to rise slightly more than was assumed in October. At the same time, inflationary pressures are expected to be lower.

Given the weaker economic activity and lower inflationary pressures, the Executive Board agreed that it is appropriate to cut the repo rate and to adjust the repo-rate path downwards. However, as at earlier meetings, there were differences of opinion with regard to how expansionary monetary policy should be. Five Board members considered it appropriate to cut the repo rate by 0.25 percentage points, to 1.0 per cent. One member instead wanted to cut the repo rate by 0.5 percentage points.

All Board members considered it appropriate to adjust the repo-rate path downwards, but there were differing opinions as to how much it should be lowered. A majority of four members assessed that cutting the repo rate to 1.0 per cent and allowing it to remain at around this low level over the coming year would lead to inflation attaining the target of 2 per cent after just over one year and to resource utilisation normalising.

Two members considered that there was scope for an even lower repo-rate path and they advocated two different repo-rate paths that were assessed as more quickly leading to inflation reaching the target of 2 per cent, at the same time as unemployment would come closer to a long-run sustainable rate.

Another topic discussed at the meeting was the high level of household debt and what risks this could create further ahead; including the role that monetary policy could play. During the meeting, a number of different nuances arose regarding developments abroad. There was continued discussion of several issues regarding the monetary policy apparatus, including the forecasts for inflation and international policy rates. In this context, there was also discussion of how the severe economic fluctuations in recent years have affected the development of the Swedish economy and made it more difficult to assess.

§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 publish the Monetary Policy Update on Tuesday 18 December 2012 at 9.30 a.m.,
- to lower the repo rate to 1.0 per cent and that this decision would apply from and including Wednesday 19 December,
- to publish the repo-rate decision above at 9.30 am on Tuesday 18 December with the motivation and wording contained in a press release, and
- to publish the minutes of today's meeting on Tuesday 8 January 2013 at 9.30.

Deputy Governor Karolina Ekholm supported the decision to cut the repo rate by 0.25 percentage points, but entered a reservation against the repo-rate path in the Monetary Policy Update. She advocated a repo-rate path that is lowered to 0.75 per cent at the beginning of 2013, stays at this level through the first quarter of 2014 and then rises to about 1.75 per cent by the end of the forecast period. This was justified by her assessment that a repo-rate path that is associated with a higher forecast for CPIF inflation and a lower forecast for unemployment constitutes a better-balanced monetary policy.

Deputy Governor Lars E.O. Svensson entered reservations against the Monetary Policy Update and the decision about the repo rate and repo-rate path in the Monetary Policy

Update. He advocated lowering the repo rate to 0.75 per cent and then a repo-rate path that stays at 0.5 per cent from the second quarter of 2013 through the first quarter of 2014, and then rises to 1.5 per cent by the end of the forecast period. This was justified by his assessment that the Update's forecasts of foreign policy rates further ahead, foreign growth and Swedish inflation are too high and that given these circumstances his repo-rate path implies a forecast for CPIF inflation that is closer to the inflation target and a forecast for unemployment that is closer to a long-run sustainable rate and therefore constitutes a better-balanced monetary policy. His assessment was that his lower repo-rate path would not noticeably affect any risks associated with household indebtedness, since monetary policy normally has very small short-run effects on household indebtedness and with low and stable inflation no long-run effects.

This paragraph was verified immediately.

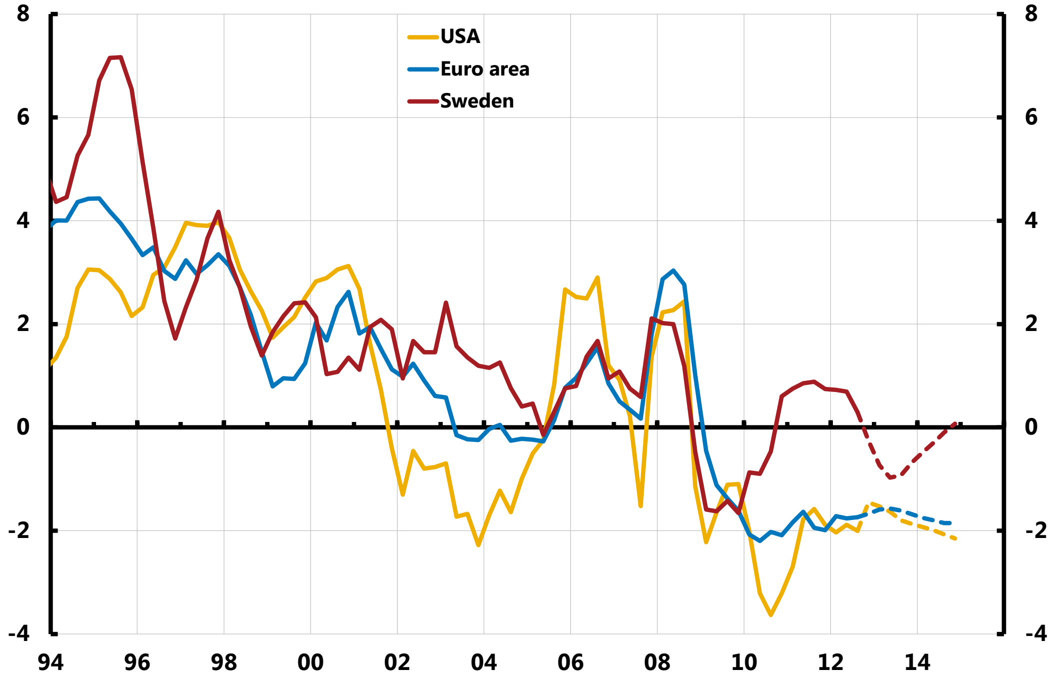
Minutes by
Ann-Christine Högberg

Verified by:

Karolina Ekholm	Stefan Ingves	Per Jansson
Kerstin af Jochnick	Lars E.O. Svensson	Barbro Wickman-Parak

Figure 1. Real Policy Rate, 1 year

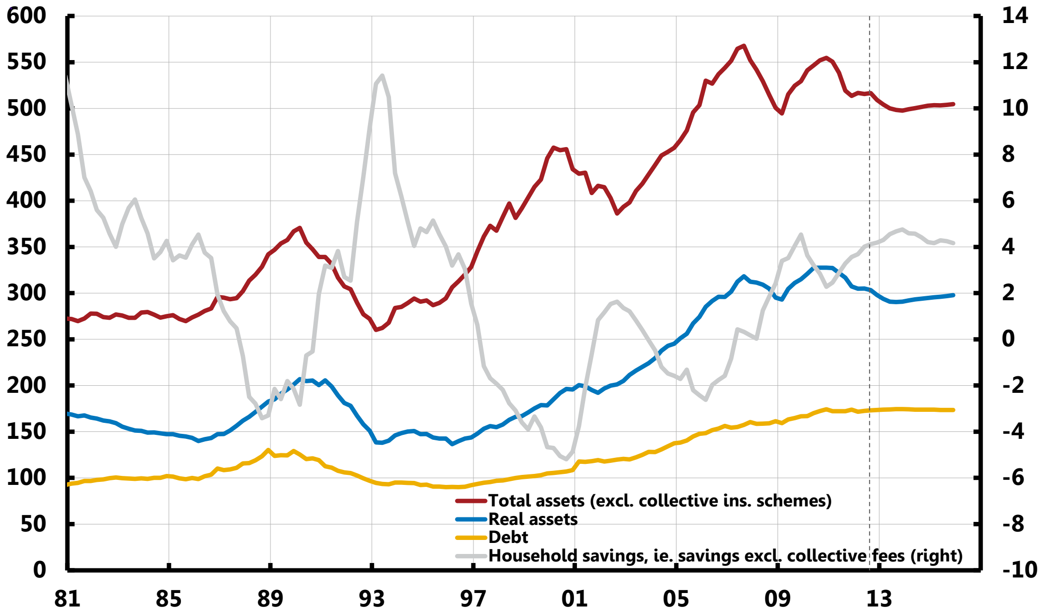
Per cent



Sources: ECB, Bureau of Labor Statistics, IMF, OECD, Statistics Sweden and the Riksbank

Figure 2. Households' total assets, real assets, debt and savings

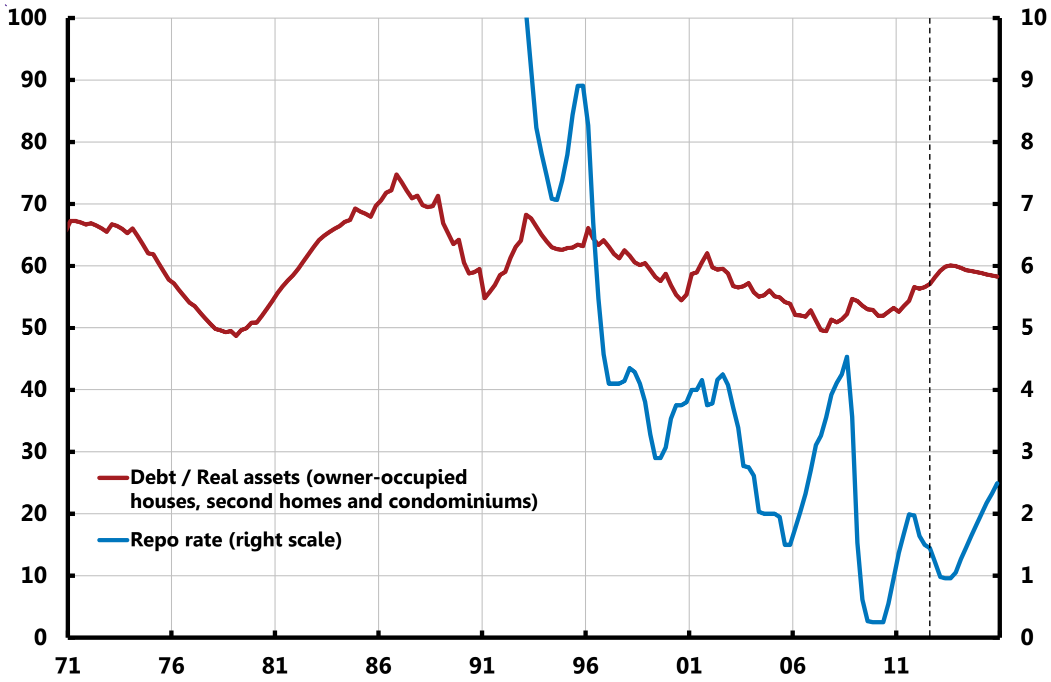
Per cent of disposable income



Sources: Statistics Sweden and the Riksbank

Figure 3. Households' loan-to-value ratio (debt/real assets) and the repo rate

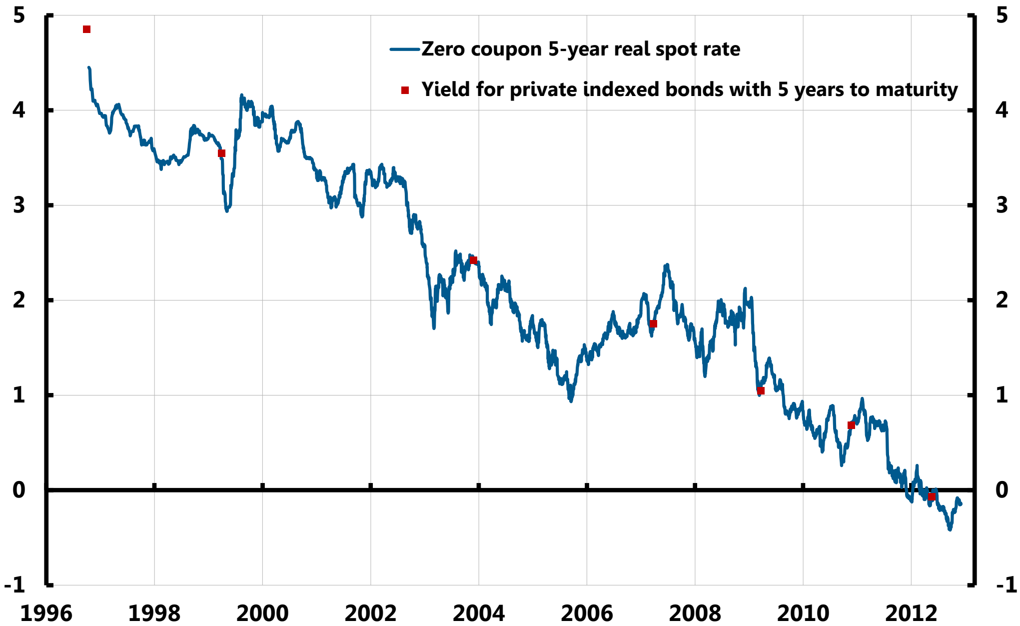
Per cent



Sources: Statistics Sweden and the Riksbank

Figure 4. Swedish 5-year real interest rate

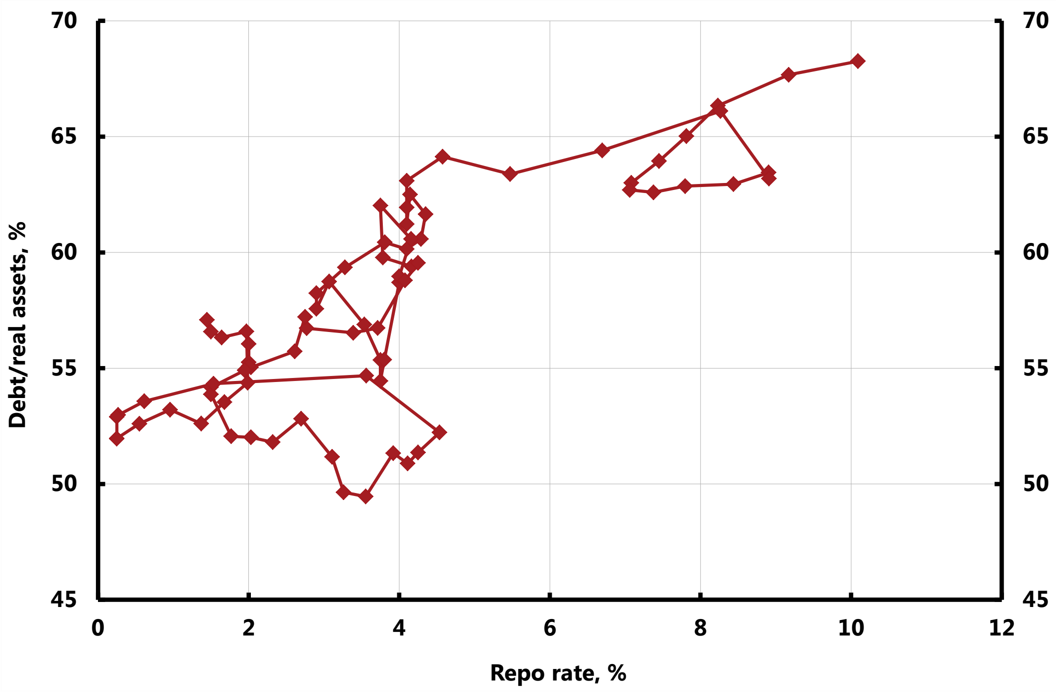
Per cent



Sources: The Riksbank and the Swedish National Debt Office

Figure 5. Households' loan-to-value ratio (debt/real assets) and the repo rate

Per cent. Quarterly data from 1993Q1 to 2012Q3

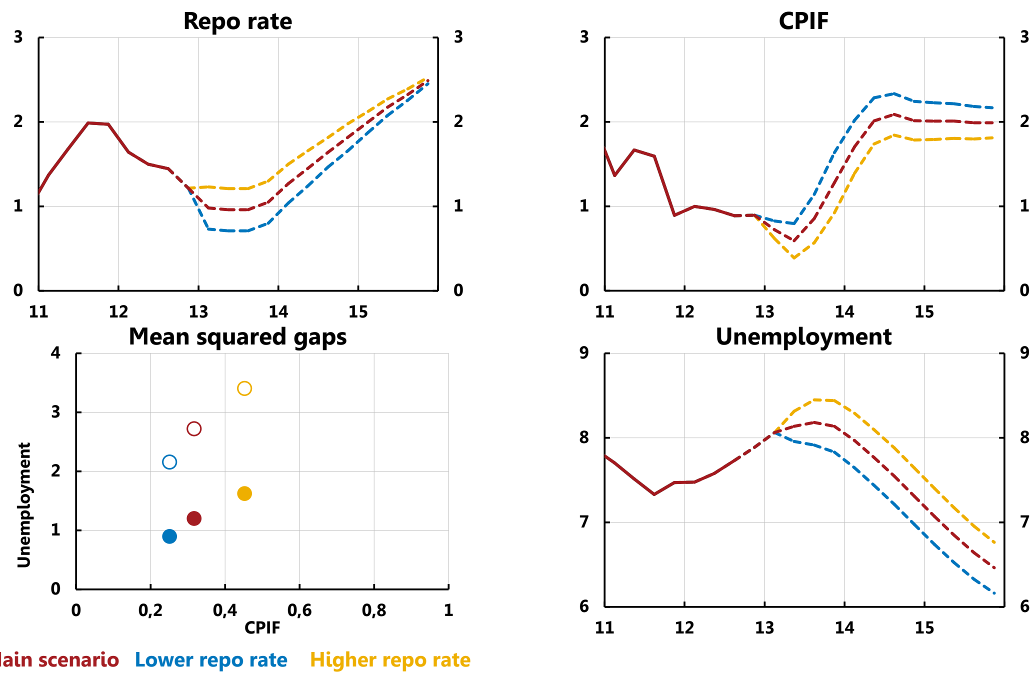


Sources: Statistics Sweden and the Riksbank

Figure 6. Monetary policy alternatives around the main scenario

Effects according to Ramses. Policy rates abroad according to the main scenario.

Long-run sustainable rate of unemployment 6.25 per cent

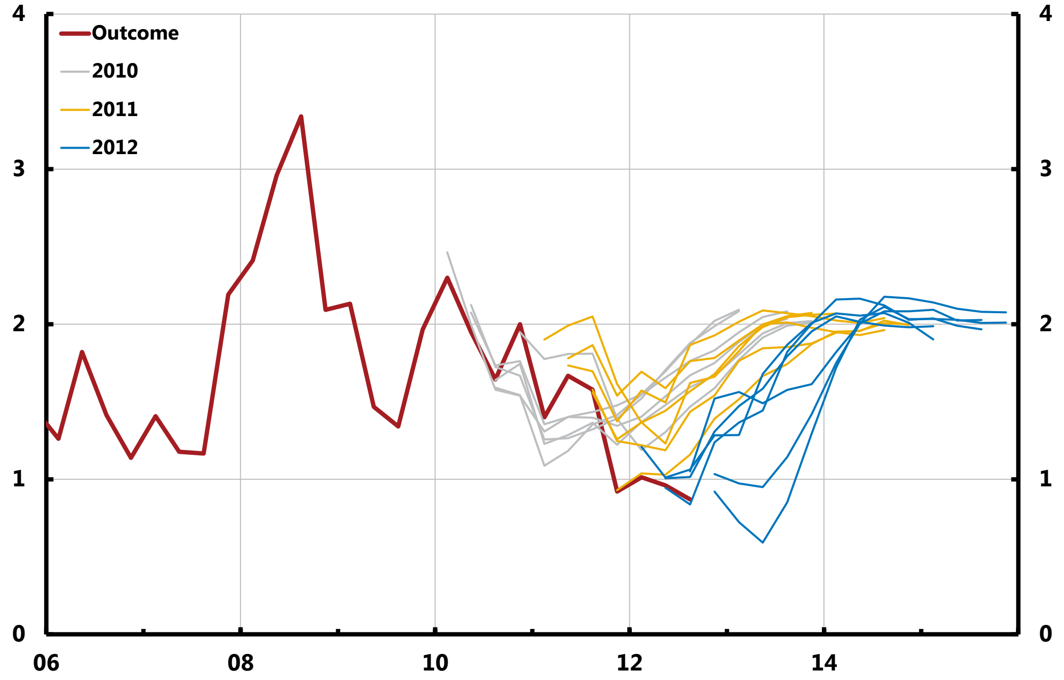


Sources: Statistics Sweden and the Riksbank

Note. Empty circles indicate mean squared gaps calculated with a long-run sustainable rate of unemployment equal to 5.5 per cent.

Figure 7. CPIF-inflation, outcome and forecasts for 2010–2012

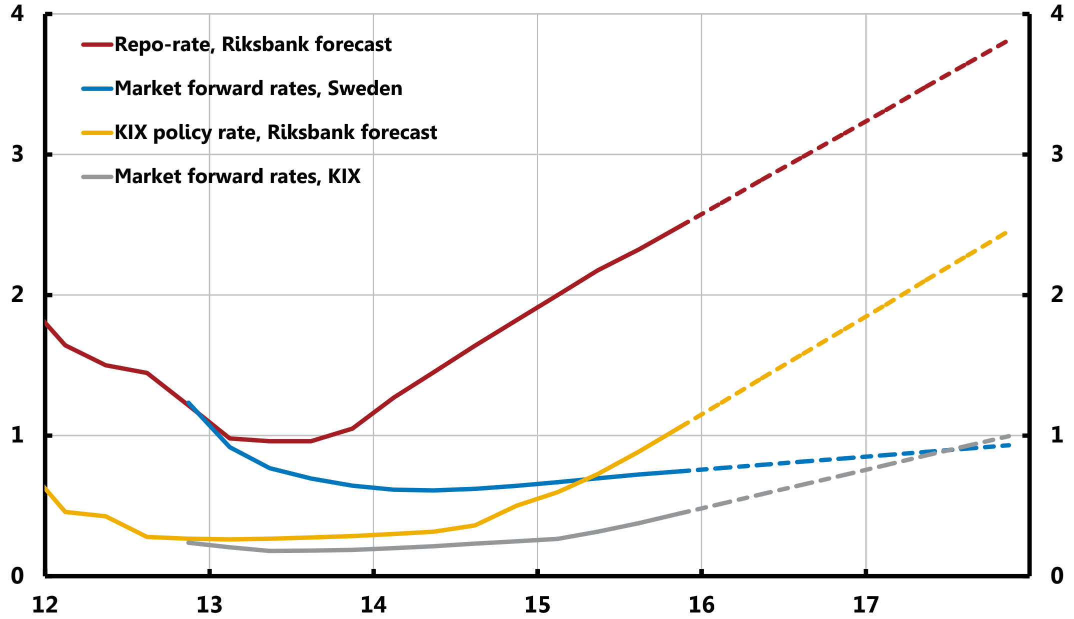
Annual percentage change



Sources: Statistics Sweden and the Riksbank

Figure 8. Repo-rate path, forward rates and forecast for KIX-weighted policy rate, December 2012

Per cent. Forward rates from 13 December. Technical assumption beyond 3 years.

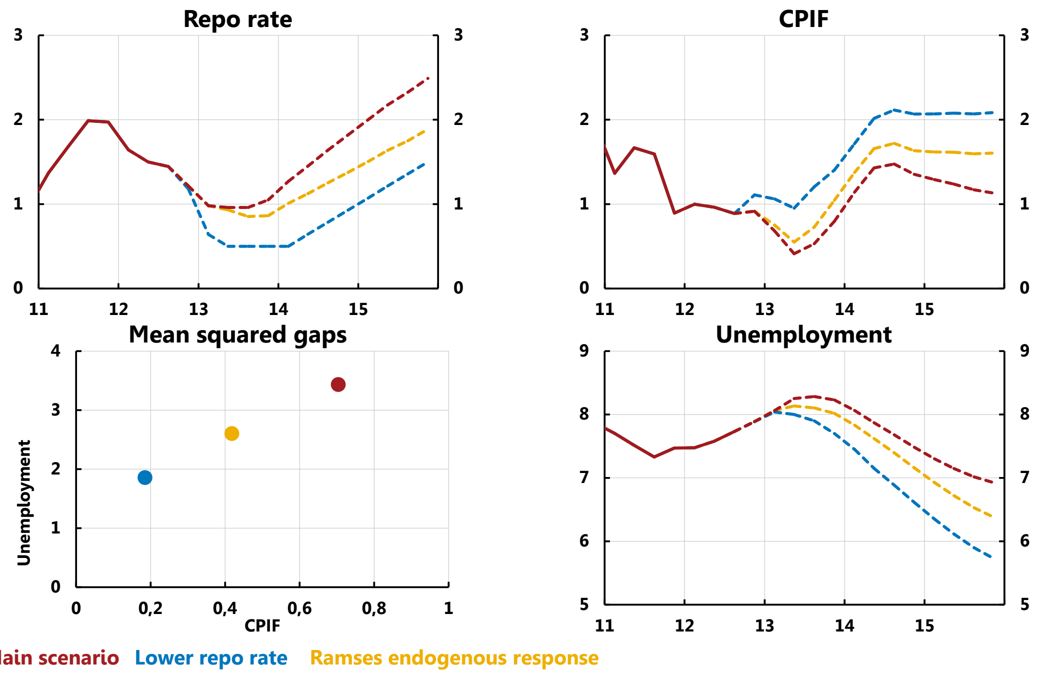


Sources: National sources, Reuters EcoWin, the Riksbank and own calculations

Figure 9. Monetary Policy Alternatives, December 2012

Policy rates abroad according to implied forward rates.

Mean squared gaps calculated with long-run sustainable rate of unemployment 5.5 per cent



Sources: Statistics Sweden and the Riksbank