Riksbank to lower key rate, while seeking new role

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RIKSBANK IS UNDER INCREASED PRESSURE TO CARRY OUT FURTHER KEY INTEREST RATE CUTS due to continued low inflation, falling inflation expectations and clear signals from the European Central Bank that powerful monetary stimulus measures are on their way in the euro zone.

RECENT CRITICISM OF SWEDEN'S RIKSBANK HAS OCCASIONALLY BEEN OVERLY STRIDENT. This applies especially to its responsibility for the fact that unemployment is stuck at a high level. Structural labour market changes, including a growing percentage of unemployed people with weak ties to the labour market, have undoubtedly been of greater importance than monetary policy, for example. Rather weak international economic conditions have also played a major role. Yet factors that have more or less explicitly been cited as arguments for allowing Sweden to maintain a tighter monetary policy than most other industrialised countries are becoming weaker. In *Nordic Outlook*, published on May 13, we changed our forecast; we now expect the Riksbank to lower its repo rate both in July and October so it reaches 0.25 per cent. If inflation expectations continue to fall, we also believe that the Riksbank may be forced to reconsider its stance on other issues such as exchange rate, wage formation and interest rate signalling. Pricing in fixed income markets mainly indicates a key interest rate cut to 0.50 per cent, although the markets have begun to price in a small probability of a further cut to 0.25 per cent. In public discourse on this issue, we can detect doubts that further rate cuts are actually the right medicine for the Swedish economy. There is thus reason to discuss what strategies are available to the Riksbank.

THE RESPONSIBILITIES OF CENTRAL BANKS IN COUNTERING THE EMERGENCE OF BUBBLES in asset markets and excessive debt build-up have been discussed for a long time. Around 2010 there were clear signs that the lessons of the financial crisis would lead to a weakened position for inflation targets and that central banks would more clearly factor in asset price trends when setting their key interest rates. An influential IMF document, "Rethinking Macroeconomic Policy" (Blanchard et al) presented arguments along these lines. At the Riksbank, opinions were divided. Governor Stefan Ingves seemed to enjoy broad support for his ideas about "leaning against the wind", while then-Deputy Governor Lars EO Svensson and others continued to argue that inflation targets should remain uncompromised.

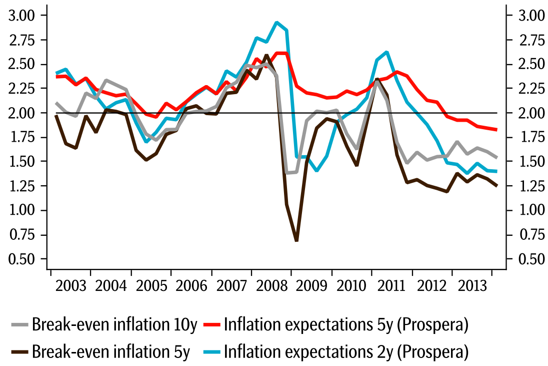
TODAY THERE IS A TREND TOWARDS SEPARATING THESE ISSUES, in such a way that monetary policy focuses on inflation targets and the new policy field of "macroprudential supervision" is given responsibility for avoiding systemically dangerous debt and asset price trends. The United Kingdom is an example, with two independent policy committees working within the Bank of England, with well-delineated responsibility for monetary policy and macroprudential supervision, respectively. In Sweden, the government put its foot down last year and gave the Financial Supervisory Authority (FSA) the main responsibility for macroprudential supervision. At the same time, it created an advisory Financial Stability Council chaired by the Minister for Financial Markets and with the heads of the FSA, the Riksbank and the National Debt Office as members. The Council's first meeting was held last Friday (May 23), followed by a brief communiqué. Giving the FSA clear responsibility for macroprudential supervision eases the burden on the Riksbank and interest rate policy; we have already seen signs that that role of the inflation target has again strengthened.

YET THE RIKSBANK APPEARS TO BE SEEKING A NEW ROLE on the issue of what manoeuvring room remains for monetary policy in ensuring financial stability. The way the Riksbank handled the analysis it presented on May 7, "Household debt under the microscope", indicates that at least some leading figures at the bank are alarmed about household debt. There is also still room to counter rising debt as part of inflation targeting policy. For example, escalating home and share prices may stimulate real economic activity, helping boost inflation pressure. Another example is the Riksbank's attempts to show how, given certain assumptions, a rapid path to fulfilling the inflation target could create an asset price bubble that might burst at a later stage, resulting in a sharp recession and possibly also deflationary tendencies (see, for example, the July 2013 *Monetary Policy Report*).

THE EXPERIENCES OF COUNTRIES THAT HAVE SUFFERED MAJOR HOME PRICE SLIDES indicate that the response to weakened balance sheets is an upswing in saving. The economy thus usually enters a downward spiral of lower economic activity, higher unemployment and a new wave of home price declines. However, it has been rather unusual for these recessionary tendencies to result in deflation. Our conclusion is that there is normally very little chance of linking the issue of financial stability with the inflation target. Scenarios easily become speculative and arbitrary. Only in an acute situation, when we are prepared to let the impact of rising asset prices intrude into our main inflation and growth forecast, will it be natural to "internalise" risks to financial stability in our inflation analysis. We thus believe that the Riksbank will mainly pursue financial stability issues through the new Council. We also saw signs of this at last Friday's meeting.

Falling inflation expectations

Per cent



Source: The Riksbank, Bloomberg, SEB

THE RIKSBANK'S INFLUENCE ON INFLATION EXPECTATIONS WILL BECOME INCREASINGLY IMPORTANT. Although for a long time inflation has tended to end up somewhat below 2 per cent, inflation expectations have remained close to the Riksbank's 2 per cent target. Among other things, this has influenced the way of making inflation forecasts 2-3 years ahead. Given firmly rooted inflation expectations, a long-term forecast that diverges significantly from 2 per cent must meet a heavy burden of proof.

Yet for some time, SEB has presented inflation forecasts that have generally been lower than those of the Riksbank. For example, we have pointed to various long-term trends and made the assessment that the productivity trend and average pay increases are actually compatible with inflation of around 1.5 per cent. But we have not seen strong reasons to fundamentally distrust the Riksbank's chances of achieving its target. The bank's forecasts have generally indicated that its 2 per cent target will be achieved within a few years. Recently the bank has mainly assumed that inflation will rise because in a stronger economic situation, businesses will be able to raise their prices and thereby pass on earlier unit cost increases to consumers.

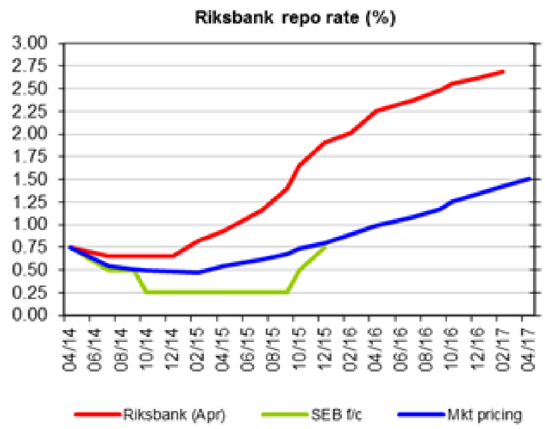
IF INFLATION EXPECTATIONS REMAIN LOW OR CONTINUE TO FALL, the Riksbank will probably have to take clearer action to maintain the credibility of its inflation target. In that case it will hardly be possible to rely on forecasts in which business pricing drives up inflation. It is not so easy to assess what alternatives are available. But it is reasonable to believe that one or more of the positions we have become accustomed to seeing the Riksbank adopt in public discourse may change.

1) In the case of currency exchange rates, the Riksbank has based its forecasts and assumptions on what a reasonable real equilibrium exchange rate is. This has often implied **krona** appreciation, although this has recently been rather small.

2) Looking at **wages and salaries**, the Riksbank has chosen slightly different strategies during different wage negotiation rounds, but the main picture has been that the bank welcomes collective *pay agreements* that are lower than what is compatible in the long term with its inflation target.

3) As for the **interest rate outlook**, for a long time the Riksbank has signalled a far more aggressive rate path than is found in market expectations. Despite risks that this may undermine the credibility of its rate path, the bank has wanted to send a warning signal to households that they should be prepared for a tougher interest rate environment.

The above kinds of interest rate signals and forecast assumptions are hardly typical of a central bank that is fighting to boost inflation expectations. If the Riksbank is actually forced to enter into such a battle in earnest, it will be difficult to maintain all these positions.



NON-EXISTENT INFLATION AND FALLING INFLATION EXPECTATIONS are thus in the process of changing the situation both in the euro zone and in Sweden. The ECB's clear signals that broad stimulus measures are on their way are putting further pressure on the Riksbank. In a situation where the FSA has the main responsibility for macroprudential supervision, our assessment is that two key rate cuts, bringing the repo rate down to 0.25 per cent, are likely in the next six months. Reversing a trend in which expectations are moving ever further away from the 2 per cent target may require the Riksbank to change its signalling on more long-term issues. One possibility is that the bank will be forced to accept more sources of inflation in its forecasts and curb its tendency to lecture economic players when presenting its inflation forecasts. The future will show whether this is the right medicine for the Swedish economy. Given the prevailing economic policy framework, it still seems like a logical forecast. The risks of acting in a different way may also be significant.

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