SPEECH

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Swedish monetary policy after the financial crisis – myths and facts

"The Riksbank has in recent years conducted a monetary policy experiment where it has aggressively, using a high repo rate, attempted to prevent household debt from rising. The results have been more or less devastating for the Swedish economy. Eventually, the Riksbank has realised that its policy was wrong and has made a 180 degree turn."

This is roughly how some critics have described the monetary policy conducted in recent years. This description has received quite a bit of attention and been widely spread, and many who follow the monetary policy debate have probably gained the impression that this is actually what has happened. I argue that this description is wrong and I now intend to explain why.

I shall divide the criticism into three different parts, or claims, and discuss them one by one. I will present these claims in the form of quotations, but this does not necessarily mean they are exact quotations. However, they capture the spirit of the criticism and I believe that those who have followed the monetary policy debate will recognise them.

It is important to meet the criticism, for several reasons

One question one might begin with, is why it is so important to respond to these claims. It is a natural part of the economic debate that the Riksbank is being criticised, isn't it? Wouldn't it then be better to ignore the criticism and look ahead instead? No, I don't think so.

One important reason is that in the wake of the financial crisis there has been a discussion on the activities and tasks of central banks, what central banks should do and how they should do it. It is, of course, important that our debate on this here in Sweden is anchored in reality and based on how monetary policy has actually been conducted and what it has actually achieved.

But meeting the criticism is important not just for the discussion here in Sweden. The debate on Swedish monetary policy also has an international interest and has been followed abroad, not least by other central banks.[1] The reason is that a central issue in the international discussion has been to what extent cen-

[1] See, for example, Visco (2014) and Yellen (2014).

tral banks' policy rates should be used as a complement to macroprudential policy, to counteract the build-up of financial imbalances, for instance, by trying to prevent lending and housing prices from rising too quickly.[2] This is what is often called a policy of "leaning against the wind", and I will hereafter use this expression for the sake of simplicity. Monetary policy in Sweden has in this context been regarded as particularly interesting, as the Riksbank is one of few central banks that, at least this far, has been explicit about taking such considerations into account in its policy-rate decisions. It would of course be unfortunate for the continued international discussion if the conclusion of the Swedish experiences were that when the policy of leaning against the wind was attempted in practice, it led to a very poor, or even catastrophic, result. Because this is not the case.

Before I continue, I would like to make it clear that my purpose here today is not to justify every single decision the Riksbank has made. It is natural that different observers make different assessments regarding economic developments and thus reach slightly different conclusions regarding what exact policy should be conducted. With hindsight, it is clear that monetary policy could have been somewhat more expansionary if we had known that inflation would be as low as it is now. This is a natural and unavoidable consequence of the fact that monetary policy has to be based on forecasts, which are uncertain. However, most of the recent criticism has gone far beyond discussing this type of difference in assessments. Instead, it has claimed that the policy conducted by the Riksbank was wrong on a more fundamental level. This is the type of criticism I intend to focus on here.

"The Riksbank has aggressively, using a high repo rate, tried to prevent household debt from rising"

The first part of the criticism can in turn be divided into different parts. For one thing, it claims that the Riksbank has leaned against the wind aggressively, and for another thing that household debt has been the main, if not the only, reason for this policy. I intend to comment on these points one by one.

So how much has the Riksbank in practice leaned against the wind in recent years? My view here is clear. The monetary policy conducted after the crisis has for the most part been governed by traditional monetary policy motives, that is, the expected development of economic activity and inflation over the coming years. Giving consideration to the risks associated with the developments in household debt and housing prices has been part of our assessment, but a relatively minor part.

The picture painted in the criticism has been quite different. Here the starting point is instead that the Riksbank's concern over developments in household debt was the *main* motive for raising the repo rate after the financial crisis. Much of the criticism even seems to assume that household debt was the *only* motive for raising the repo rate. In a so-called counterfactual analysis that has played a central role in the criticism, the actual policy conducted is compared with the alternative of not raising the repo rate at all, but leaving it unchanged

[2] See, for example, Blanchard, Dell'Ariccia and Mauro (2013), Borio (2014), Carney (2013), Smets (2013), Stein (2013) and Woodford (2012).

at 0.25 per cent since the crisis.[3] The latter is assumed to represent a policy that does not lean against the wind.

The Riksbank and other economic analysts made similar forecasts

So what support do I have for my view that concern over household debt has only had a limited influence on the repo-rate decisions? To begin with, one can look at the Riksbank's motives as stated in the press releases following the monetary policy meetings. If one does this, it is pretty clear that the focus has been on economic activity and inflation in the coming years. Certainly, it is often mentioned at the same time that the policy conducted is expected to contribute to less risk of imbalances building up with regard to indebtedness and housing prices, but more as a side-effect and not as a main reason. The overall impression is that the policy would have been marginally different if this risk had not been addressed – not that it would have been completely different.

One can also look at the discussions that were conducted within the Riksbank. It is a well-known fact that there were differing opinions within the Riksbank, but how different were they? The situation in July 2011 is an example. The repo rate had then been raised to 2 per cent, the highest level it reached before it was reduced again. The minutes of the monetary policy meeting show the Executive Board members' view of the appropriate monetary policy in the years ahead. In Figure 1, the dotted blue line shows the future repo-rate path advocated by a majority of Executive Board members, while the dotted yellow line shows the path advocated by the two members who argued that monetary policy should be more expansionary. One of these, Lars Svensson, is the Riksbank's most outspoken critic in recent times and also the originator of the counterfactual analysis I mentioned earlier.

It is clear that opinions differed. But it is also clear that the differences concerned at what *pace* the repo rate should be raised and not that any member advocated that the repo rate should never have been raised after the crisis, but remained at 0.25 per cent. Of course, it would have been difficult at that time to advocate a large cut immediately or in the near future. But if one really thought that the repo rate should have been 0.25 per cent, it is difficult to understand why one would advocate a repo-rate path that did not turn down at all over the coming three years, but rose throughout the entire forecast period and reached 3.8 per cent in the middle of 2014.[4]

So what was the view outside of the Riksbank? At around the same time, in June 2011, the National Institute of Economic Research forecast that the repo rate would be 3 per cent at the end of 2012 and that at the end of 2014 – that is, around now – it would be just over 4 per cent.[5] The NIER's forecasts are often something of a benchmark for other analysts and on this occasion, too, they were a good reflection of how most analysts perceived the situation. The forecast for the repo rate was also fairly well in line with the Riksbank's view (see Figure 2). This policy was considered compatible with a balanced resource utilisation in 2014 and a CPIF inflation rate close to 2 per cent in 2013–2015. It

[3] See, for example, Svensson (2014). This counterfactual analysis has been presented in a number of essays, articles and blog entries.

[4] In the minutes, Lars Svensson presents estimates where the dotted yellow repo-rate path is assumed to give an inflation rate of 2 per cent from the beginning of 2013 and onwards and an unemployment rate that would reach what he assumed to be an equilibrium level of 5.5 per cent at the beginning of 2014. It may also be worth noting that at the ensuing meeting, in September 2011, all of the Executive Board members thought that 2 per cent was a suitable level for the repo rate, given the economic situation in Sweden.

[5] National Institute of Economic Research (2011).

is thus obvious that this is a picture of a policy that was essentially governed by traditional monetary policy motives and where concern over household debt certainly did not play a major role.

How did international analysts view the Swedish economy at this point in time? The OECD's Economic Outlook in May 2011 expected the robust growth to continue, with increases in real GDP of on average 3.3 per cent in 2010–2015. It was expected that the policy rate would need to be raised gradually as economic activity improved.[6] A similar assessment was made by the International Monetary Fund (IMF) in July 2011. GDP growth was assumed to gradually decline to 3 per cent in 2014, when inflation was expected to amount to 2 per cent (measured in terms of the HICP). It was assumed that the interest-rate increases that had begun would need to continue.[7]

One conclusion I draw from this is that many unexpected events have occurred in recent years. The situation today is rather different than all analysts – both on the Executive Board of the Riksbank and outside the bank – were expecting at this time. I shall return to this later.

Another conclusion is that the general picture was that the Riksbank's policy was on the whole well-motivated and essentially based on traditional monetary policy deliberations. Although there were different opinions on exactly how high the repo rate should be, as there always are, the policy was thus not perceived as odd or conspicuous. Neither the Riksbank nor any other analyst perceived the monetary policy conducted to be leaning against the wind to any large extent, and the general impression was definitely not that the repo rate should have been left at the level to which it was cut during the financial crisis, that is, 0.25 per cent.

A strange assumption

Given this, it is very strange to claim that an evaluation of the Riksbank's policy should rely on the assumption that the alternative of *not* leaning against the wind would be to hold the repo rate at 0.25 until today. If no one perceived it as such at the time, it appears very strange to paint this picture retrospectively. Basing an analysis on such an assumption is therefore not a reasonable way of evaluating the advantages and disadvantages of leaning against the wind. One needs to assume not just that the Riksbank has lied about its motives, but also that well-known and prominent external economic analysts have said one thing but really meant another.

Nevertheless, this is the starting point for the counterfactual analysis many appear to rely on when drawing conclusions about the Riksbank's monetary policy.[8] In Sweden, this analysis has been given considerable scope, for instance on Dagens Nyheter newspaper's editorial pages, where the Riksbank's policy has

[6] OECD (2011), pp. 191-192.
[7] IMF (2011), p. 25 and Table 9.
[8] See, for instance, Visco (2014): "An actual example of the debate on the macro-prudential use of the policy rate relates to the tightening of monetary policy by the Sveriges Riksbank that began in July 2010 and peaked in July 2011. Deemed a leaning-against-the-wind move out of concern for financial stability, and specifically the risk that maintaining a lower repo rate could have increased the already high ratio of household debt to disposable income, this policy stance has been questioned on the basis of a counterfactual analysis emphasising the macroeconomic costs in terms of below-target inflation and higher unemployment." Another example is the Financial Times (2014): "Sweden's central bank has been lambasted by critics for trying to use interest rates to combat signs of a housing bubble. It lifted rates in 2010 and 2011 as it publicly worried about what it saw as high household debt levels." A further example here is Münchau (2014), who says that the Riksbank "raised interest rates to rein in a domestic housing bubble."

been described as more or less incomprehensible and contrary to the prevailing opinion at that time – an "interest-rate increasing experiment in summer 2010".[9]

One might think it is strange that the claim that the Riksbank's repo-rate increases were only about leaning against the wind, and moreover that the increases were made contrary to prevailing opinion, has become so widely spread. After all, one does not need to make a more in-depth check of the facts than I have provided here to see that neither claim is correct. It doesn't require very much digging to be able to conclude that not only the Riksbank but also external domestic and international economic analysts found it natural, even after the repo rate had been raised to 2 per cent, that the increases would *continue* – and this without any particular reference to household debt. According to, for instance, Dagens Nyheter newspaper's editorial pages, the policy was instead "an interest-rate increasing experiment", based on the Riksbank governors spreading "misleading pictures of the future".[10] The only explanation I can think of for this claim nevertheless being repeated and referred to so often and so uncritically, is that people simply assume that it must be true because it has been expressed with such emphasis and intensity.

A hazardous policy

But claiming that it has all been about leaning against the wind is not only a misleading description of the policy conducted and the motives behind it. There is also good reason to wonder whether a policy whereby the repo rate had remained unchanged since the crisis might not have been rather risky, regardless of what one claims it would have represented. According to the counterfactual analysis, there were only gains and no problems: inflation would have been close to the target and employment would have been higher if the repo rate had not been raised. But I also believe that there would have been a major risk of other, less pleasant things happening that is disregarded in the analysis, consciously or unconsciously.

Something that has received considerable attention since the crisis is that a lot of things can happen with regard to expectations and risk-taking in an economy where interest rates are very low for a long period of time. Expectations regarding, for instance, how high interest rates will be in the future and how the housing market will develop in the years to come can become distorted, and risk-taking in the economy in general could increase in a way that may create problems.[11] This is something that cannot be captured in a good way in the economic models available today.[12] But this should not be an excuse to completely disregard such aspects.

In the alternative path that is assumed to represent a policy that does not lean against the wind, the repo rate would have been close to zero since July 2009, that is, for more than five years. This in an economy that began to recover from

[9] Wolodarski (2014).
[10] Wolodarski (2014).
[11] Summers (2014) writes, for instance: "[A] strategy that relies on interest rates significantly below growth rates for long periods of time virtually guarantees the emergence of substantial bubbles and dangerous build-ups in leverage." For a review of the links between monetary policy and financial imbalances, as well as further references to the literature, see Adrian and Lang (2014).
[12] This is discussed, for instance, in Blanchard (2014). One problem with counterfactual estimates where economic policy changes a lot is that they are sensitive to what is known as the Lucas critique. This states that it is very difficult to quantify the effects of a completely different policy (for instance, a much lower interest rate over a long period of time) in a reliable manner. The reason for this is precisely that the expectations of the economic agents change.

the crisis very quickly and where the temperature on the housing market cooled only temporarily. We can see today, when the repo rate has once again been cut to very low levels, that housing prices have begun anew to soar (see Figure 3).[13] Lending to households increased by almost 10 per cent a year when the repo rate increases began in July 2010 (see Figure 4). And lending has begun to rise once again as the repo rate has been cut.

Another important element here is that there was no framework for macroprudential policy for most of the time when the repo rate, according to this alternative, should have been at 0.25 per cent. It was not until August 2013 that the allocation of responsibility for macroprudential policy was clarified and the Swedish government had set formal guidelines for this.[14] As yet, it remains to be seen how well this framework will actually work in practice.

Given this, advocating a repo rate of 0.25 per cent for more than five years and entirely disregarding the risks of distorted expectations and problems with developments in housing prices is quite remarkable. Had this policy been implemented, I believe that the situation today would have been much more worrying than it is – and as we know, the situation today is hardly without problems.

Two relevant questions

Before I continue I would like to take up two questions it is natural to ask in this context. As I have noted, the repo-rate decisions have mainly been governed by traditional monetary policy motives, and consideration to risks associated with the development of household debt and housing prices has played a fairly subordinate role. But what exactly do I mean by "a fairly subordinate role"? That is the first question.

Unfortunately, I believe one must accept that this cannot be quantified in a very precise way. I can only note for my own part that if I had not found the developments in household debt and on the housing market problematic, I would have advocated a somewhat more expansionary policy – but definitely not that the repo rate should remain at 0.25 ever since the crisis. But it is difficult to be more precise than this. For example, it is not possible to argue at a given monetary policy meeting that "of the 25 basis points I feel the repo rate should be raised, 5 points are aimed at dampening risks linked to household debt and housing prices. The remaining 20 basis points are aimed at stabilising inflation and economic activity in the short run". Monetary policy decision-making just does not work like this.

Moreover, the Executive Board consists of six individuals. Each of them has very likely had his or her own view of what role the risks linked to debt and housing prices have played in their decisions. It is therefore not possible to respond to the question of how much the Riksbank has leaned against the wind with a quantified measure. But what I am quite convinced of is that none of those de-

[13] Remarkably, an excessively low repo rate was something that Dagens Nyheter's editorial pages warned against in December 2009, when Lars Svensson entered a reservation against holding the repo rate at 0.25 per cent and advocated cutting it to zero and they commented on his "input to the Executive Board of the Riksbank being reminiscent of a captain slavishly following his nautical chart, even when the ship hits an iceberg. It was one thing to cut the repo rate in an acute situation during the crisis to ward off a depression. But now that the economy has begun to recover, a zero interest rate would only add fuel to the housing price fire." (See Wolodarski, 2009).

[14] Of course, some measures were taken earlier, but the introduction of the framework must nevertheless be regarded as an important condition for being able to conduct macroprudential policy systematically.

ciding on the repo rate has had as their *main* reason, much less their *only* reason, that monetary policy must lean against the wind.

The second question is whether the policy of leaning against the wind has had any tangible effect, given that consideration to risks linked to the development of household debt and housing prices, as I said, has played a fairly subordinate role in policy-making. I am convinced that the policy *has* played an important role, despite the element of leaning against the wind being much more modest than the critics claim. The Riksbank's strategy has been to combine a marginally higher repo rate with communication that emphasises the fact that we perceive the development of high growth in credit and rising house prices to be worrying. The slightly higher repo rate does have some effect in itself, but perhaps its main function is as a concrete reminder of the risks, and it has thereby been an important part of the communication. In my opinion, this has had an impact, not least in increasing general awareness of the problems. The discussion of these questions now going on underlines that this has been the case.

More extensive problem than just indebtedness

After thus having responded to the first part of the first claim – that the Riksbank has leaned aggressively against the wind – I intend to move on to the second part, namely that the purpose of the policy of leaning against the wind has been to limit household debt.

As I have pointed out, the element of leaning against the wind has not been particularly large, but has been there to some extent. However, it is too easy to say that this has only been aimed at getting households to borrow less, or as it is sometimes portrayed, that the Riksbank has a target as to how high debt may become in relation to income, for example. Even though developments in household debts are definitely an important part of the problem, the picture is much more complex. A fairer description is that the Riksbank has tried to do its bit to slow down a trend where housing prices and indebtedness have been rising rapidly and simultaneously for quite a long time now – where there appears to be some slowdown in periods of weaker economic activity, but where the direction is upwards, no matter what the economic situation, and there are few signs that this trend will be dampened. The longer such a trend continues, the greater the risk that it will be broken in the same abrupt way as in many countries in connection with the financial crisis – that is, when housing prices and debt finally adjust downwards, it is in a dramatic manner, with substantial price falls and drops in consumption, with large and long-lasting negative effects on the economy.[15] In general, there is solid empirical support for the idea that the more households and companies borrow during an economic upturn, the greater the risk that this upturn will be followed by a deep recession and a very slow recovery.[16]

One can make a few reflections here. One is that the macroeconomic instability resulting from this type of development could make it more difficult for the Riksbank to stabilise economic activity and inflation in a sustainable manner. It is therefore hardly remarkable that the Riksbank has tried to counteract it, and it is difficult to see that this is something outside of our mandate, as some have claimed.

[15] Mian and Sufi (2014) describe this sequence of events in the US economy in connection with the crisis. In a really bad scenario, problems may also arise with regard to financial stability, see for instance Financial Stability Report 2014:1, Sveriges Riksbank.
[16] See, for instance, Schularick and Taylor (2012) and Jordà, Schularick and Taylor (2013).

Another reflection is that, as the problems with a trend of rising household debt and housing prices affects many parts of the economy, it is necessary for several policy areas to cooperate to be able to achieve a *lasting* solution. Regardless of what measures are taken, neither monetary policy that leans against the wind nor macroprudential policy are sufficient on their own – and probably not even these two combined. Other policy areas, and especially housing policy, need to be included in the equation. This is something that the Riksbank has highlighted and discussed on other occasions and I do not intend to discuss it further here.[17]

A third reflection is that when it comes to the risks of a development of this type, the critics have not been very clear, in my view. At the same time as they have put a lot of effort into criticising the Riksbank's policy, they have often said very little about how they themselves view the potential risks and how they should be managed.[18] A common argument has been, to simplify somewhat: "Firstly, the risks probably aren't so great, and if there are risks they can always be managed effectively by macroprudential policy." Here I think one ought to be able to demand greater clarity from the critics.

Do they think that there is no problem with this kind of upward trend? Or will the trend slow down on its own before problems arise, and, if so, what mechanisms will achieve this? If it slows down but at a level where debt and house prices are elevated, what risks will this entail? Is the fact that housing prices and lending have now begun to accelerate after the Riksbank cut the repo rate nothing to worry about? If there are nevertheless risks, how should they be managed? If macroprudential policy is so effective, exactly what measures should be implemented? And what dosage is appropriate? Are macroprudential policy measures enough, or do other policy areas also need to be involved? These questions are very relevant ones and I wish they had been given as much attention in the debate as the Riksbank's monetary policy.

"The results of the policy have been devastating for the Swedish economy"

The picture that critics like to paint is of a high repo rate pushing down demand and creating a more or less deflationist situation in the Swedish economy. This is something that some international analysts in particular seem to have latched onto, interpreting the situation in Sweden today to be similar to that in Japan in the 1990s.[19]

It should already be clear from what I have discussed so far that this is a misleading description. As monetary policy has not leaned against the wind to any great extent, this can hardly have had any particularly devastating effect on the economy. With what is by now a rather worn but at the same time very telling

[17] See, for example, Jansson (2014).
[18] In some cases, the critics have also had diametrically opposed views. Paul Krugman appears to think that Sweden has probably already had a housing bubble for some time, and that as it is *too late* to do anything about it, the Riksbank should not conduct a policy that leans against the wind (see Andrén Meiton, 2014). Lars Svensson, on the other hand, appears to think that there is no great risk of a housing bubble building up (see Svenska Dagbladet newspaper, 2014a) and that a policy that leans against the wind for this reason is not *needed*, but is harmful.
[19] See, for instance, Krugman (2014a, 2014b) who as well as likening Sweden to Japan, has also characterised monetary policy in Sweden as an example of ”sadomonetarism”. Among Swedish critics it is less common to make comparisons with Japan.

likeness, the Riksbank has not during this period hit the repo-rate brake, but rather eased up on the accelerator somewhat.

No deflationist development driven by a weak real economy

This picture is confirmed if one examines how, for instance, GDP and employment have developed since the crisis. Figure 5 summarises the percentage change in GDP per capita and the employment rate in relation to the pre-crisis figures in the countries Sweden is normally compared with.

As can be seen, Sweden is not right at the top, but nor is it very far from it. There are only a few countries, according to these statistics only New Zealand and Germany, that have had a better development in both GDP and employment, that is, that are above and to the right of Sweden in the figure.

Some claim that the development of unemployment has been less favourable. But here we must bear in mind the fact that the labour force in Sweden has increased relatively substantially during the period. This is essentially positive, but in the short run it will also contribute, purely mathematically, to keeping up the unemployment figures. The differences in this respect in relation to the United States, for instance, are fairly striking. The United States has had a more favourable development in unemployment, but quite a lot of this can be explained by the fact that labour force participation in the States has actually declined (see Figure 6).

Of course, the relatively good development is not solely due to the monetary policy conducted by the Riksbank. Economic policy in general plays a large role, as does the fact that Sweden was not hit so hard by the crisis, for reasons not necessarily related to the policy conducted. It is also possible to have different views regarding exactly how good one thinks developments have been. But at a very minimum, it should be clear that it is difficult to find support in actual figures for an overly tight, "aggressive" monetary policy having sent the economy into a state of deflation, driven by poor development in the real economy.

If one looks ahead, then? Could it not be the case that the Swedish economy has managed fairly well so far, but that things will go badly in the future, as a result of the policy conducted? Of course, one cannot make any guarantees with regard to the future, but one can in any case note that the National Institute of Economic Research, the Ministry of Finance and the Riksbank are all currently forecasting growth of around 2 per cent this year and around 3 per cent in 2015-2016. This is hardly the picture of an economy in a state of recession or crisis.

Low inflation difficult to predict – for the Riksbank and others

But what about inflation? It has become very low and prices have even fallen at times, at least when measured in terms of the CPI. Is this not a sign that the policy has failed and that the repo rate should never have been raised?

It is important to understand two things here. Firstly, it should be clear from what I have just described that the low inflation is *not* a result of an economy that has been brought to its knees. The picture of high interest rates causing a more or less recession-like state that has in turn resulted in low inflation, and sometimes deflation, is thus incorrect.

Secondly, as I have also mentioned, a lot has happened in recent years that has had an effect on inflation. Remember the National Institute of Economic Research's forecast in the middle of 2011, which I mentioned earlier. In this, the repo rate was expected to continue to rise, from the 2 per cent level it was at then, to around 4 per cent in 2014. This policy was considered compatible with an inflation rate of around 2 per cent in 2013-2015. The reason I am returning to this forecast is that I don't think anyone would question that the National Institute of Economic Research is a serious and competent forecaster – and it can scarcely be accused of deliberately spreading "misleading pictures of the future". And as I said, the National Institute of Economic Research's forecasts were not in any way unique, but reflected well how forecasters in general viewed the situation.

Anyone who claims to have predicted the current low inflation back when the repo rate increases began in 2010 must thus have had much greater insight than all of the Swedish and international analysts. I would rather argue that this instead is a good illustration of the fact that things have happened in the economy, which could not be predicted and which have pushed down inflation in an unexpected manner.

Unexpected international economic slowdown in 2011 and even lower inflation in 2013-2014

I would like to give examples of two occasions in recent years when developments have turned out rather differently than expected. The first is the slowdown in international economic activity that became apparent during the second half of 2011. Global growth prospects deteriorated in connection with increased unease over the sovereign debt problems in the United States and euro area. Uncertainty over the future led to increased pessimism among households and companies and also affected the financial markets. Towards the end of the year, there were clear signs that growth in the Swedish economy had also slowed down, partly due to reduced demand for Swedish exports. Figure 7 shows how the Riksbank and other analysts revised down their forecasts for the increase in Swedish exports in 2012 during the second half of 2011.

The second occasion is when inflation began to fall from already low levels during the latter part of 2013 and the beginning of 2014. This happened in connection with a sequence of negative inflation surprises indicating that the underlying inflationary pressures in the economy had fallen. For example, inflation had appeared unusually low for a time in relation to the increase in unit labour costs (see Figure 8). Even after that, inflation has been lower than expected, most recently in September this year. Figure 9 shows how the forecasts for CPIF inflation in 2014 have been revised down from just over 1 per cent to around 0.5 per cent.

It is clear in both of these examples that it is the general picture that has changed, not that the Riksbank suddenly realised something that everyone else had known for a long time. The fact that inflation has been surprisingly low is by the way not a specific Swedish problem, but very much an international phenomenon.

"Eventually, the Riksbank has realised that its policy was wrong and has made a 180-degree turn."

The last part of the criticism is that the Riksbank rather late in the day realised that it had been wrong all the time and therefore made a 180-degree turn. I have indirectly answered this in part as well.

Let me, to be able to make the points I wish to make, describe how I view the way the Riksbank has been conducting monetary policy. In the same way as the conventional flexible inflation-targeting framework in some situations needs to find a balance between stabilising inflation and stabilising economic activity, one may sometimes also need to take various risks into account in the deliberation. The risk that the Riksbank has included to some extent has thus been that a rapid and persistent rise in housing prices and debt could cause setbacks later on and potentially lead to major problems for the development of the economy in general and for monetary policy.

Leaning against the wind is a question of degrees – not either or

But it is important to realise that it is a question of achieving a balance. Allowing risks of this nature to influence policy-rate decisions does not mean neglecting the traditional monetary policy objectives. For one thing, the purpose of trying to manage the risks is to stabilise inflation and economic activity in a *sustainable* manner, by avoiding, or at least alleviating, dramatic downward adjustments in housing prices and indebtedness. But inflation and economic activity in the shorter run – during the normal forecast period – also play a major role in the decisions.

A monetary policy that leans against the wind is thus, like most economic policies, a question of degrees. It is not the case – as one might sometimes believe from the debate – that one either refrains entirely from leaning against the wind or leans against the wind one hundred per cent and disregards everything else. It is thus no 0-1 variable. As I have explained, the Riksbank's policy in recent years has been *at the same time* to support the recovery and get inflation to rise towards the target, *and* to some extent to address the risks that may be a threat to sustainability.

When things happen in the economy, this balance is of course affected. As I mentioned earlier, inflation has for some time been lower than the Riksbank and other analysts have expected, and it has now undershot the target for a fairly long time. Moreover, long-term inflation expectations have fallen. Although these are only a few tenths of a percentage below the target of 2 per cent, the trend has been downward for some time (see Figure 10). As the basis of an inflation-targeting policy is that long-run inflation expectations are anchored around the target, this development has made it even more important to prioritise bringing up inflation. In other words, the cost of taking risks into account by holding the repo rate a little higher has increased.

It is in light of this that the Riksbank's gradual cuts in the repo rate down to zero should be regarded. It is thus a question of adapting monetary policy to *changed circumstances* and not of a 180-degree turn as a result of a sudden insight that the policy conducted has been wrong from the start.

Criticism also from other quarters

However, cutting the repo rate to zero has not only been criticised for being a "last-minute conversion". It has also been criticised from other quarters. There are those who say that the Riksbank's attempts to give consideration to the risks linked to indebtedness and housing prices have been well-founded, and that a very low interest rate over a long period of time is risky – like "throwing petrol on a fire".[20]

[20] See, for instance, Malmqvist (2014), Svenska Dagbladet (2014b, 2014c) and Mitelman (2014).

- Without doubt, the situation with regard to the housing market and household debt will become more problematic the lower the repo rate is and the longer it remains low. Nevertheless, I think that the Riksbank has made the right decision and that there has not really been any other alternative. In the end, a central bank's main task is to maintain confidence in price stability and when there is a risk that this will fail – when the scale starts to tip – there is no other possibility than to give top priority to a faster return to the inflation target. Even if the risks linked to debt and housing prices are as large as before, or have even increased as a result of the repo-rate cuts, the problems linked to low inflation have become *relatively* more important. However, it is unavoidably the case that this places greater responsibility on other public authorities and policy areas with regard to managing developments in household debt and housing prices.

I consider it important to note that there has also been criticism from this quarter – as a counterweight to the opinion that in principle everything the Riksbank has done in recent years, and in particular the leaning against the wind, has been wrong, unjustified and harmful.

My most important messages

Let me conclude by summarising my main messages. The purpose of my review has been to point out the flaws in several notions of how monetary policy in Sweden has been conducted in recent years and what the results have been. One thing I hope I have made clear is that it is not reasonable to regard the difference between what the repo rate has actually been in recent years and a fictitious interest-rate development of 0.25 per cent since July 2009 as a measure of how much the Riksbank has leaned against the wind. This is a rather odd reconstruction after the event. Nevertheless, much of the criticism has been based on this assumption, for instance, the claim that the Riksbank's policy of leaning against the wind after the crisis has cost 60,000 jobs. As I have shown, the general view among forecasters at the time when the repo rate had been raised to 2 per cent was that it would be necessary to *continue* to raise the repo rate – and for traditional monetary policy reasons. The increase from 0.25 to 2 per cent was thus not perceived as particularly remarkable or as purely justified by concern for household debt.

I also hope I have convinced you that the low inflation rate in Sweden today does not reflect an economy that has developed very poorly since the crisis as a result of misguided, tight monetary policy. On the contrary, the Swedish economy has developed relatively well and has definitely not been in a state of deflation driven by a weak real economy. The main focus for the monetary policy conducted after the crisis has been to support the recovery and bring inflation back towards the target. Giving consideration to the risks linked to developments in household debt and housing prices has been part of the assessment but has not played a major role.

The fact that inflation has been low is to a large degree, as always, a reflection of events over the course of time that have been difficult to predict. Examples are the slowdown in international economic activity which became evident during the second half of 2011 and the fall in inflation at the end of 2013 and the beginning of 2014. It is easy to verify that these events were difficult to predict – and not merely something that everyone but the Riksbank was aware of in advance – by examining how forecasters in general viewed developments at the time. Thus, I think it is quite clear that the current low inflation is not a logical and predictable consequence of the repo rate not being held at 0.25 per cent after the crisis.

As I mentioned at the start, there is an international debate on to what extent the central banks' policy rates should be used as a complement to macroprudential measures to try to prevent lending and housing prices from rising too quickly, or more generally to counteract the build-up of financial imbalances. This is an important discussion and it would be very unfortunate if the critics' alarmist but incorrect conclusions regarding the Swedish experiences, which can roughly be summarised as "don't try this at home – you may burn down your house", were to be regarded as a truth in the debate.

It is important that monetary policy is evaluated. But one condition for drawing the right conclusions is that the evaluation is based on a correct description of what has actually happened. The recent criticism has, in my opinion, become alienated from actual events.

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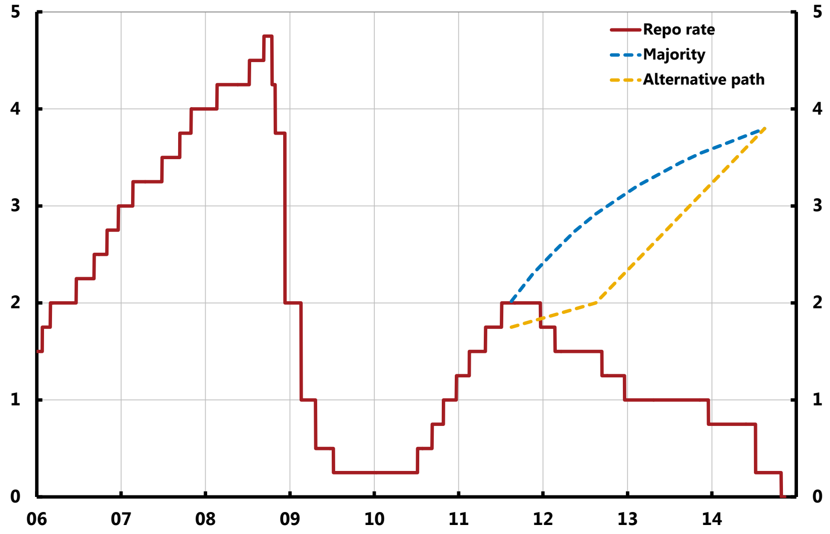
Figure 1. Repo-rate paths at the monetary policy meeting in July 2011

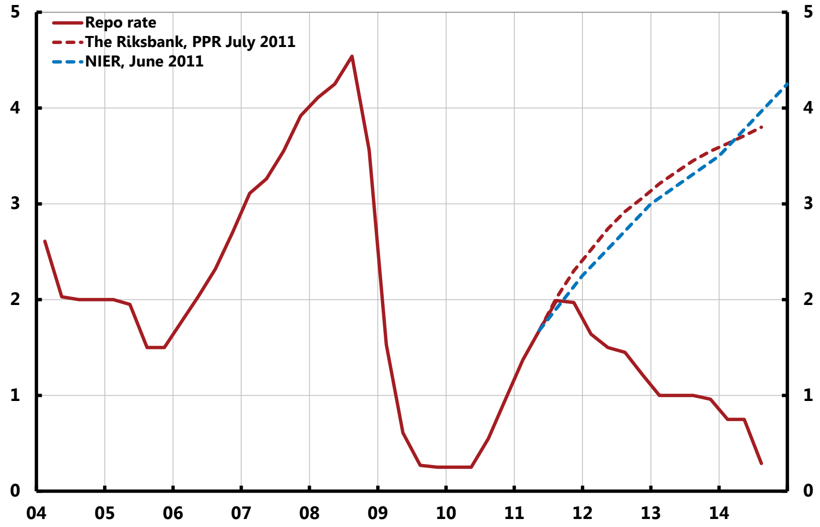
Per cent



Source: The Riksbank

Figure 2. The Riksbank's and the National Institute of Economic Research's repo-rate paths in summer 2011

Per cent

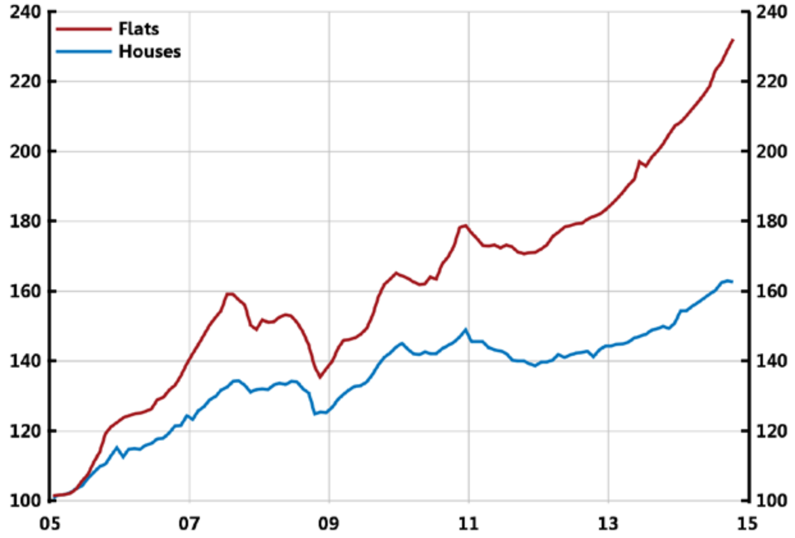


Note. The repo rate and the Riksbank's forecasts refer to quarterly averages. The National Institute of Economic Research's forecast refers to the repo rate at the end of the year.

Sources: The National Institute of Economic Research and the Riksbank

Figure 3. Price developments for houses and apartments

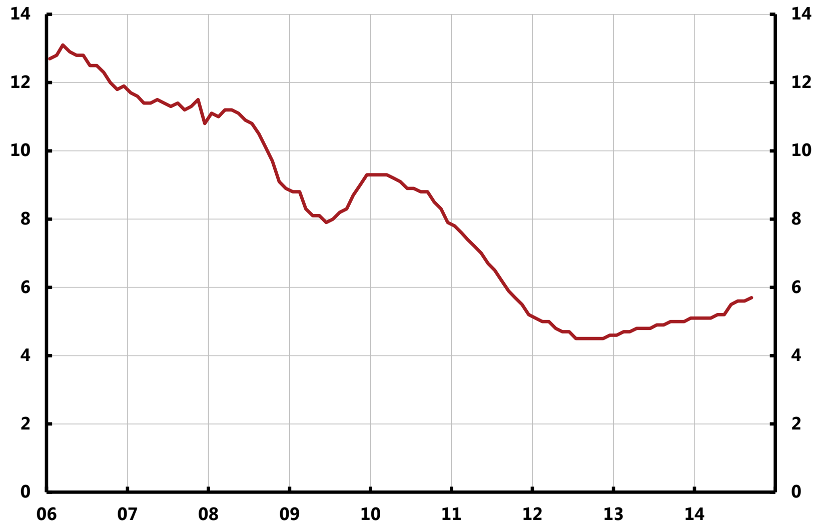
Index: January 2005=100



Source: Valueguard

Figure 4. Lending to Swedish households

Annual percentage change

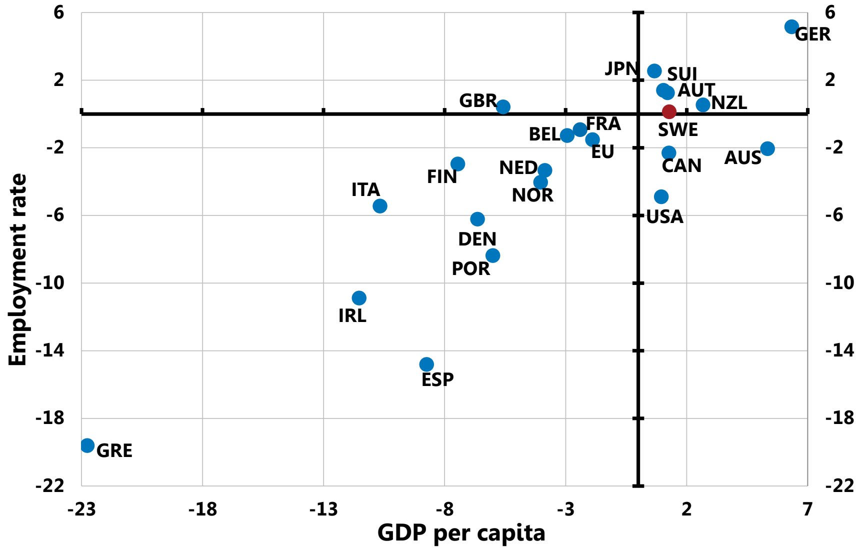


Note. Refers to the MFIs' lending to Swedish households including HIOs (households non-profit organisations), with a home as collateral, adjusted for reclassification and bought and sold loans.

Source: Statistics Sweden

Figure 5. GDP per capita and employment rate compared with pre-crisis figures

Change in per cent 2007–2013 and 2008Q1–2014Q2

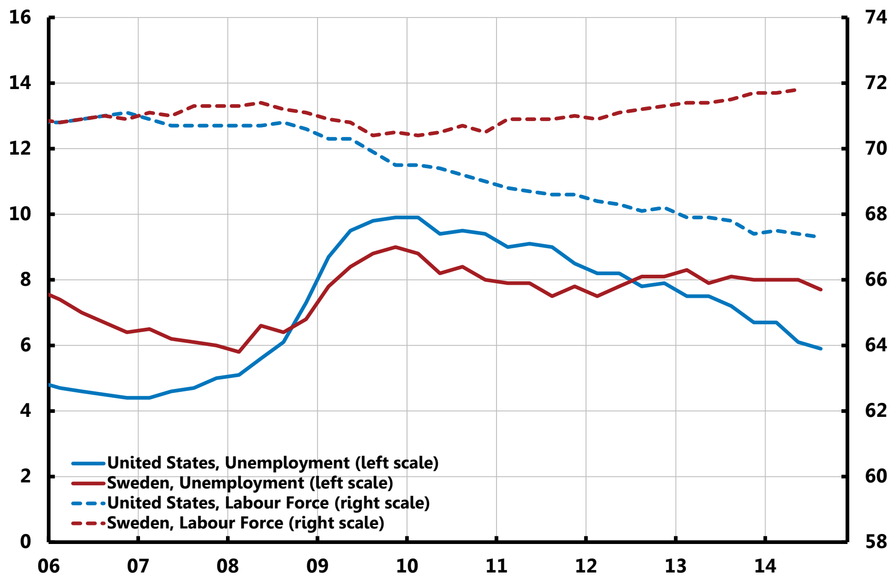


Note. GDP per capita, annual data, constant 2005 USD (adjusted for purchasing power parity), 2007–2013; Employment rate, 15–64 years, 2008Q1–2014Q2. Seasonally-adjusted data.

Sources: The OECD and the World Bank WDI

Figure 6. Unemployment and labour force in Sweden and the USA

Percentage of labour force and percentage of population

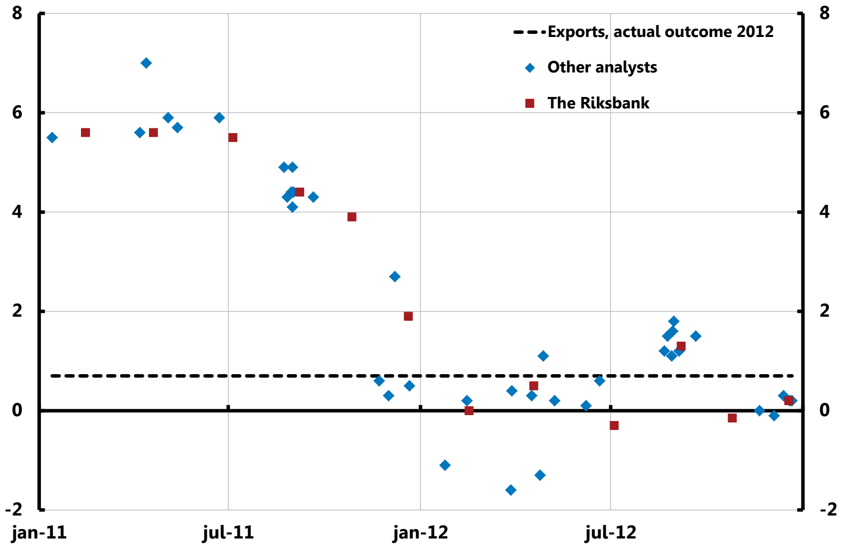


Note. Refers to 15-74 age group. Seasonally-adjusted data.

Sources: Eurostat and the OECD

Figure 7. Forecasts 2011-2012 for export increase 2012

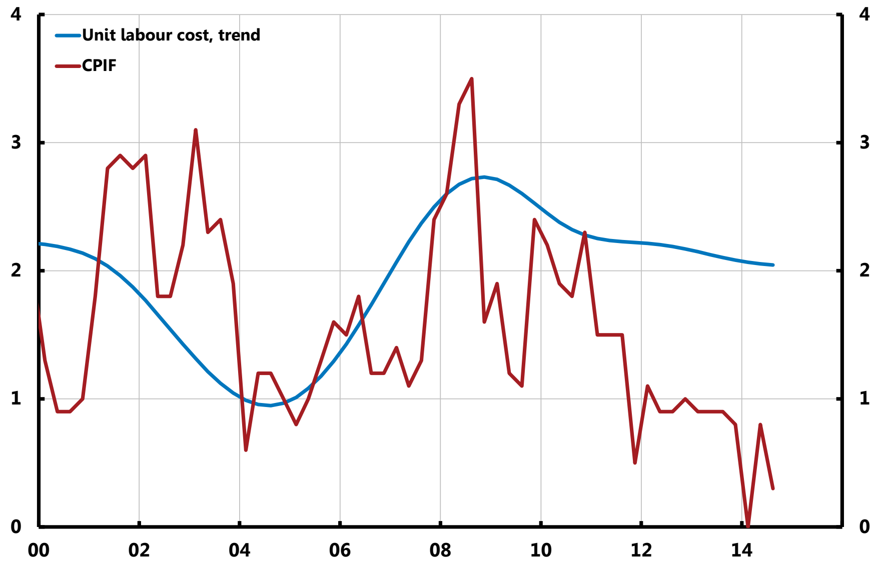
Annual percentage change, annual average



Sources: Respective forecasters (6 of them), Statistics Sweden and the Riksbank

Figure 8. CPIF and trend in unit labour costs

Annual percentage change

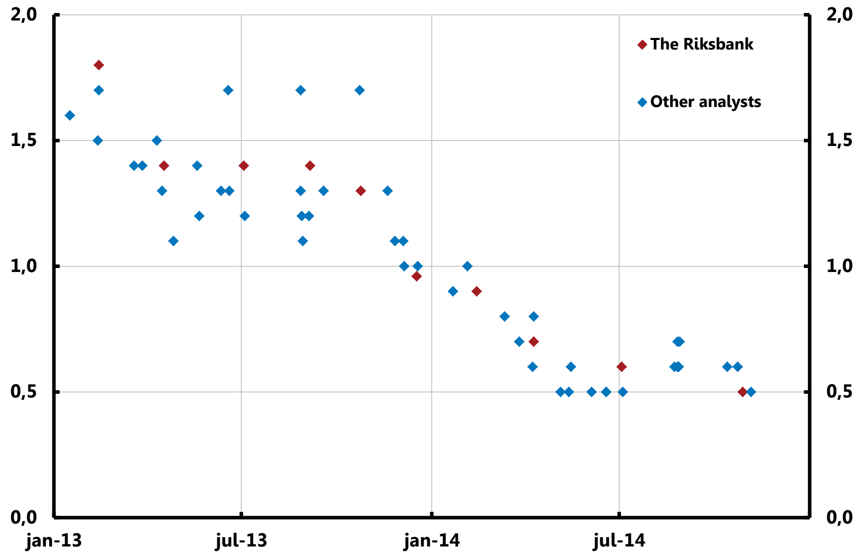


Note. The trend is calculated using an HP-filter (λ=1600) on a series extended with the Riksbank's forecast.

Sources: Statistics Sweden and the Riksbank

Figure 9. Forecasts 2013-2014 for CPIF inflation 2014

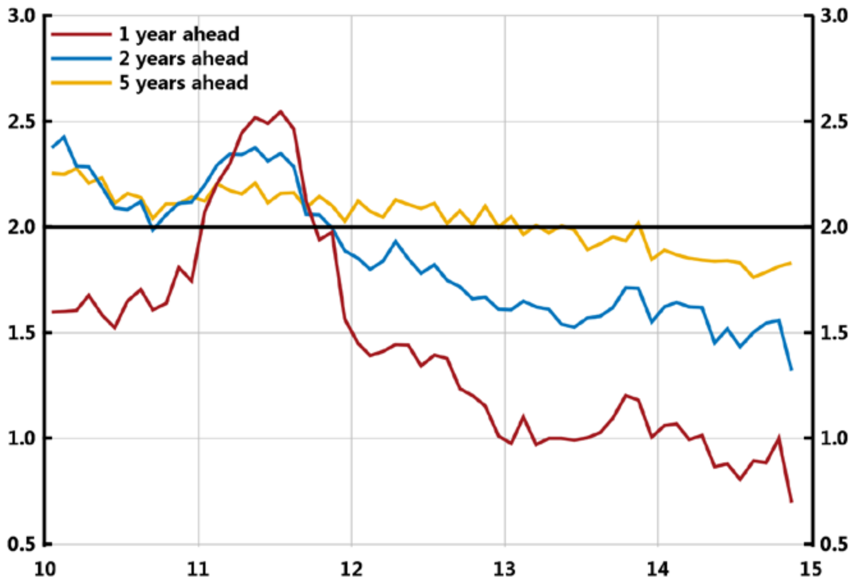
Annual percentage change, annual average



Sources: Respective forecasters (8 of them), Statistics Sweden and the Riksbank

Figure 10. Inflation expectations, money market participants

Annual percentage change



Source: TNS Sifo Prospera