Box 3

RECENT CHANGES IN THE SWEDISH CENTRAL BANK'S MONETARY POLICY

This early-release box was published on 2 March

In December 2019, Sweden's central bank (Sveriges Riksbank) raised its benchmark interest rate (the repo rate) for the second time in twelve months. It set it at 0%, up from the previous level of -0.25%, with effect from January 2020. Swedish interest rates thus abandoned the negative territory in which Sveriges Riksbank had placed them since February 2015 (see Chart 1). Holding rates negative had been part of the raft of unconventional monetary policy measures set in place by Sweden's monetary authority since 2009. This also included forward guidance on interest rates, bond purchases, currency swaps and support for lending to businesses, among other things. This box summarises the macroeconomic and financial stability conditioning factors which, according to the Swedish authorities, are behind this monetary policy decision.

Sveriges Riksbank justified its decision to increase the interest rate to 0%, which it had already anticipated in October, essentially on the basis of inflation developments. In Sweden, the inflation rate had stood at around the target of 2% from 2017 until end-2019 (see Chart 2) and

Chart 1
BENCHMARK RATES AND SVERIGES RIKSBANK'S FUTURE PATHS

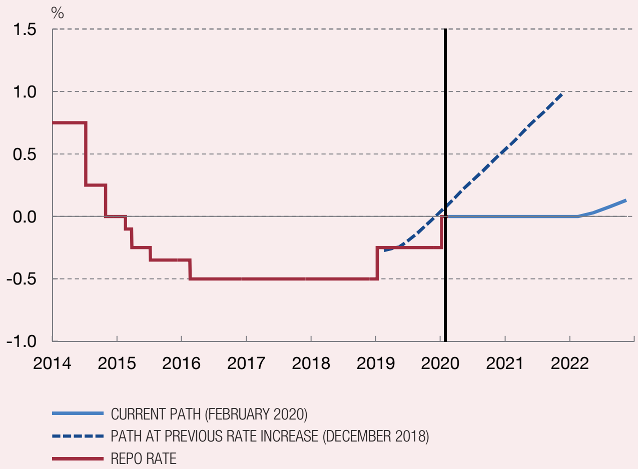


Chart 2
INFLATION AND SVERIGES RIKSBANK'S PROJECTIONS

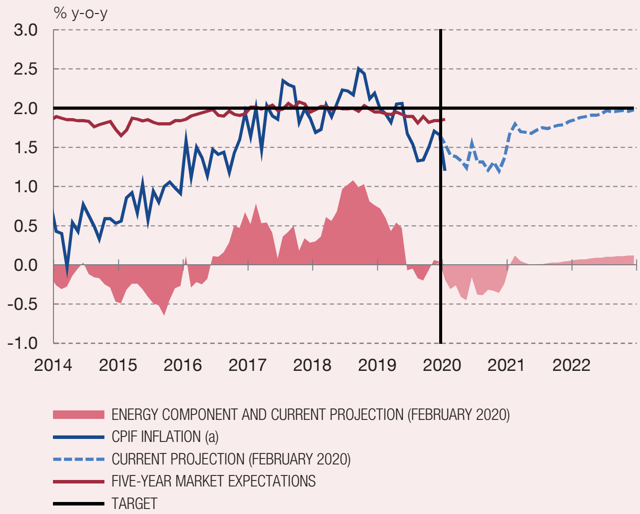


Chart 3
GDP GROWTH AND OUTPUT GAP

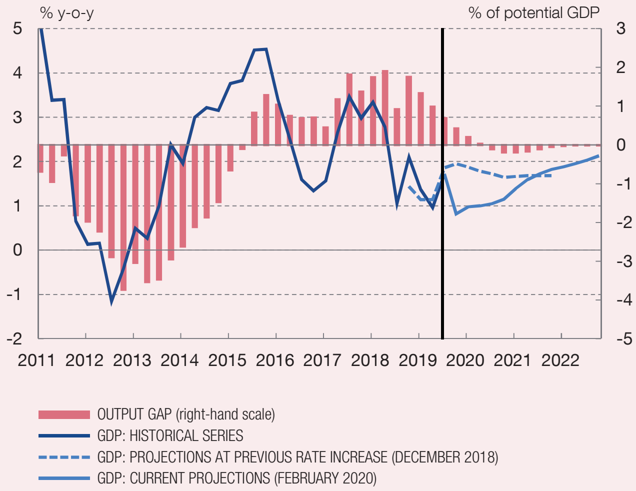
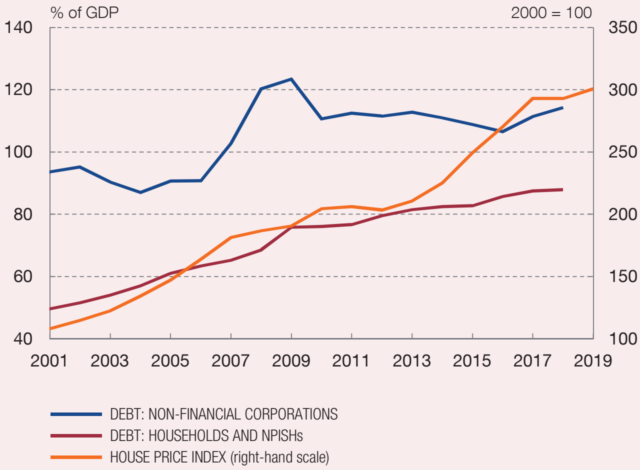


Chart 4
PRIVATE-SECTOR INDEBTEDNESS AND HOUSE PRICES



SOURCES: Sveriges Riksbank, Swedish National Institute of Statistics and Konjunkturinstitutet.

a CPIF inflation, which excludes changes in mortgage rates, is Sveriges Riksbank's target variable.

inflation expectations had remained relatively anchored between 1.8% and 2% over the previous year. According to the Swedish central bank's analysis, inflation is estimated to be on a path compatible with the fulfilment of its objective. Admittedly, the Swedish economy slowed in 2019 and the growth outlook was revised downwards (see Chart 3); but Sveriges Riksbank's analysis points to the pace of growth in activity returning to normal following a period of relatively high buoyancy. The decision emerged from Sweden's Monetary Policy Committee after intense debate, as evidenced by the minutes of its December meeting. In particular, the minutes noted the difficulties of accurately gauging the extent to which inflation expectations are firmly anchored around the central bank's target. And this against a background in which Sveriges Riksbank foresees an inflation path slowly converging at the end of the projection horizon on the aforementioned target (see Chart 2).

According to the central bank's projections, published in December with the press release on the monetary policy decision, the policy rate will be held at 0% until 2022 Q2. This contrasts with its previous December 2018 projection, which anticipated a path of further increases over the coming years (see Chart 1).[1] Therefore, for Sveriges Riksbank, the rate rise does not necessarily mean a tightening of the monetary policy stance,[2] but a return to a more conventional monetary policy without negative interest rates which, among other things, would provide some leeway, if needed.

In addition to the above-mentioned considerations, in its press release Sveriges Riksbank also lists some of the financial stability-related arguments taken into consideration. Particular mention is made of the possibility that economic agents would no longer perceive the negative rates situation as temporary. Among other risks, the Swedish monetary authority considers the hypothetical adverse consequences for the banking system, the private sector's potential over-indebtedness and a possible excessive increase in risk appetite, which might give rise to distortions in the functioning of financial markets, including the overvaluation of certain assets.

As for the first risk, according to Sveriges Riksbank banks have not passed on negative interest rates to household deposits, owing to the perceived temporariness of the measure, and banks' lending capacity and profitability have not been affected significantly to date. However, the Swedish monetary authority does not completely rule out that continuing to apply a negative interest rate policy for a very long period of time could hypothetically prompt a decline in the demand for deposits. And that could in turn produce a shortage of this type of financing at some banks.[3] Additionally, according to the monetary authority, squeezing bank margins for a sufficiently protracted period of time could theoretically affect new lending by some banks.

Possible adverse effects of a premature increase in interest rates on financial stability were also pointed out; agents' ability to pay could be hampered against a backdrop of lower growth and high levels of private debt (see Chart 4). Nevertheless, Sveriges Riksbank has stressed that private-sector indebtedness-related risks – largely linked to the real estate market[4] – must be addressed by macroprudential policy instruments (within the remit since 2014 of the *Finansinspektionen,* which reports to the Ministry of Finance) and by structural reforms.

In conclusion, and based on the foregoing considerations, of different sign, Sveriges Riksbank considers that, in net terms, the negative rates policy has been beneficial for the Swedish economy. It likewise believes any future side-effects can be assumed, though it highlights the need for them to be analysed in greater detail.

1 Note that, unlike ECB/Eurosystem projections, which assume that interest rates will follow the path expected by financial markets, the Riksbank's macroeconomic projections are shaped by its own expected path of policy rates.

2 In the weeks following Sveriges Riksbank's announcement in October, the Swedish krona appreciated against the dollar and the euro after a period of protracted weakness, which could mean that the financial markets perceived a tightening. However, attributing the appreciation solely to monetary policy is difficult since it coincided with a period of upward surprises in economic indicators and greater optimism about world trade, which is highly significant for a small open economy like Sweden's. Since early 2020, the Swedish krona has depreciated again due to global uncertainty and worse-than-expected macroeconomic data.

3 Note that the low use of cash in Sweden could soften the possible difficulties of potential liquidity problems. Worldwide, Sweden is the economy which least uses cash, and its objective is to replace it with electronic means of payment by 2023. Thus, if negative interest rates were applied to household deposits, this would possibly have a more subdued effect on the demand for cash.

4 Since 1994, there has been a robust upward trend in house prices in Sweden which is essentially attributable to structural factors such as supply shortages and high construction costs.