Review of the Riksbank's Monetary Policy 2010–2015 commissioned by the Riksdag Committee on Finance

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Following the global financial crisis in 2007-2009, the Swedish economy started to recover rather quickly. Interest rates, having been cut sharply during the crisis, were raised slowly in 2010 and 2011. Subsequently, this tightening of monetary policy proved highly controversial. That debate is at the heart of our Review. The Review analyses the decisions that were made in the light of the information available to participants at the time.

Prior to the global financial crisis, the Swedish economy appeared in good shape. Growth and inflation were performing satisfactorily, there was a sound banking system, the fiscal position was strong, and in terms of conventional macroeconomic indicators there seemed no obvious problem on the horizon. But underneath this apparently calm surface, as with other major economies, tensions were growing. House prices and mortgage debt were rising at double digit rates, and markedly faster than household incomes. There was also a growing maturity and currency mismatch in the banking system, and the trade surplus was unsustainably high. When the crisis intensified in the autumn of 2008, Sweden was badly affected. GDP fell by 6% in a year. But following the sharp downturn there was a strong rebound in 2010, more so in Sweden than in most other countries.

Since the start of the Review period in February 2010, monetary policy in Sweden has come full circle – from a repo rate close to zero, rates were gradually raised as recovery took hold, and then were cut again as recovery disappointed and inflation fell further below the 2% target, until today the repo rate is negative.

The evaluation of monetary policy from 2010 onwards leads to **six** main conclusions:

First, the response of the Riksbank to the rapid recovery of the Swedish economy from the global financial crisis – which entailed raising official interest rates from 0.25% to 2% between July 2010 and July 2011 – was broadly accepted by all members of the Executive Board, and appears not unreasonable in the light of all the information available to the Riksbank at the time.

Second, the situation started to change in late 2011 and 2012. During the second part of the period covered by our Review, the Riksbank was slow to realise the extent of the problems in the euro area and, especially during 2013, the majority was slow to cut interest rates.

Third, it is striking that all members of the Executive Board devoted so much time to thinking about the future path of the repo rate and to providing guidance as to their views on how it should evolve over the following three years. There is something surreal about the precision of the guidance provided by individual board members as to the future path of the repo rate when contrasted with the sheer uncertainty about the future and the fact that markets took rather little notice of the published path in determining their own expectations.

Fourth, there was heavy reliance, among both the majority of the Board and the dissenters alike, on forecasts produced by models developed by Riksbank staff. Although such models are useful in putting together consistent quantitative forecasts, inevitably they are based on strong assumptions and can act as no more than a starting point for a discussion of the challenges facing monetary policy at any particular juncture. They cannot be used mechanically.

Fifth, tensions among members of the Executive Board, while not leading to significant differences in policy judgements in 2010 and 2011, grew in 2012 and spilled over in 2013 into disagreements not only about the setting of interest rates but also, and significantly, about the objectives of policy. The Riksbank's task was made much more difficult by the dithering of the Government in introducing a clear regime for macro-prudential policy.

Sixth, the success of the decision-making process in the Riksbank is heavily dependent on the willingness of Board members to respect each other's viewpoint and to use the Monetary Policy Meetings to further a collective understanding of developments in the economy and the appropriate response of monetary policy. Differences of view and judgement are an important part of this process, but they must be expressed in a manner conducive to the collective venture on which the Riksbank is embarked. It was not helpful that minutes and interviews by Board members displayed a degree of brusqueness uncharacteristic of normal public debate in Sweden. The minutes of the Monetary Policy Meetings should contain a balanced explanation of the decision reached by the majority and the arguments against that put forward at the meeting by the dissenting minority.

These are our fifteen recommendations as they are set out in Chapter 2 of the Review. We list our recommendations under four subject headings.

Monetary Policy:

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

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

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

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

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

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

Financial Stability:

7. The Government should ensure without further delay that Finansinspektionen has the legal powers and range of macro-prudential instruments appropriate to its role in promoting financial stability.

8. That a joint Prudential Policy Committee (PPC) of the Riksbank and Finansinspektionen be established to meet quarterly to discuss the setting of the main macro-prudential policy instruments. The PPC should make recommendations to the Riksdag from time to time on whether the set of instruments delegated to Finansinspektionen should be expanded or contracted. The PPC should be the primary source of reports on financial stability and should appear before the Finance Committee at least once a year.

9. The Sveriges Riksbank Act should be amended to clarify the role of the Riksbank in financial stability, whether limited to participation in the proposed Prudential Policy Committee (see above) or more extensive if macro-prudential powers gravitate to it. The mandate of the Riksbank should include financial stability, and the Riksbank must have some formal powers to enable it to achieve its objective.

10. In 2020 the Government should ask a small group of experts to carry out a review of the allocation of responsibility for macro-prudential policy between Finansinspektionen and the Riksbank.

Accountability of the Riksbank:

11. The Finance Committee of the Riksdag should hold three sessions of evidence a year with the Riksbank Executive Board following publication of the *Monetary Policy Reports*. In addition to the Governor (each time), three deputy governors should appear so that each member of the Board would appear at least twice in any twelve-month period to explain and defend his/her votes on monetary policy decisions.

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

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

Organisation of the Riksbank:

14. The Executive Board should become the Monetary Policy Board comprising three executive members of the Riksbank, the Governor and two deputy governors with responsibility for monetary policy and financial stability respectively, and three non-executive members.

15. The Finance Committee of the Riksdag should invite the General Council of the Riksbank to submit recommendations for amendments to the Sveriges Riksbank Act.