Monetary policy when the policy rate is close to zero

What can the central bank do to further stimulate the economy when the policy rate is close to zero? This article lists various measures that central banks around the world have taken in recent years. The repo rate has now been cut to zero and the Riksbank assesses that the situation in the Swedish economy does not require any supplementary monetary policy measures at present. However, if conditions were to change, the Riksbank has the same possibilities as other central banks to take further measures to increase the monetary policy stimulus.

During the financial crisis of 2008–2009, many central banks made drastic cuts to their policy rates, in several cases to levels close to zero, to counteract the economic downturn and low inflation. In addition, several central banks have chosen to take complementary monetary policy measures to further stimulate the economy. These measures are primarily aimed at making monetary policy more expansionary. But exactly which measures have been adopted depends on which problems the central bank has chosen to address.

Measures to influence interest rates on long maturities

One way of making monetary policy more expansionary when it is not possible to cut the policy rate is to push market rates on long maturities down, if these are relatively high for various reasons. This can be done by either influencing expectations of future short-term interest rates, or by direct purchases of bonds.

To influence expectations, some central banks have chosen to communicate the length of time over which the policy rate is to be held at a low level or the circumstances under which the policy rate may start to be raised. For example, the Bank of Canada, the Federal Reserve and the Bank of England have issued such forward guidance on various occasions. Similarly, the Riksbank uses its repo-rate path to communicate that the repo rate is expected to be low for a longer time.

Many central banks, including the Federal Reserve and the Bank of England, have also purchased large amounts of bonds, thereby expanding their balance sheets. Their aim was not only to push down interest rates on the bonds purchased by the central banks but also on other types of bond. When a central bank purchases large amounts of government or mortgage bonds, investors who have previously invested in these bonds may instead be expected to increase their investments in other securities. The supply of risk capital or credits elsewhere in the economy may thus increase, and this may then push interest rates on these markets down too.

Measures to improve the impact of monetary policy

When the Riksbank lowered the repo rate and the repo rate path at the start of the financial crisis, market rates indicated that the period of low interest rates would be shorter than the Riksbank had assessed. Consequently, in 2009, to ensure that monetary policy would have the intended effect, the Riksbank offered loans to the banks with fixed and low interest rates.

The ECB has recently launched a programme of large and inexpensive loans to the banking sector to boost lending to households and companies, as this kind of lending has long been weak. Like the Riksbank's measures in 2009, this is aimed at increasing the efficiency of monetary policy.

Since the financial crisis, central banks have also purchased different types of financial asset to improve the functioning of the market. For example, the Federal Reserve started to purchase large amounts of mortgage bonds when these markets threatened to close down entirely, which could have had serious consequences for the credit supply to the household sector.

Measures to influence the exchange rate

One further way of making monetary policy more expansionary is to intervene in the foreign exchange market with the aim of slowing down a substantial strengthening or achieving a weakening of the exchange rate. After the financial crisis, the Swiss franc strongly appreciated against more or less all currencies. This strengthening of the exchange rate was considered to be a threat to Swiss exports and thereby to entail a major risk to the development of the macroeconomy. There was a risk that inflation would be very low, as prices of imported goods plummeted. When the strengthening of the currency reached 40 per cent, the central bank introduced an exchange rate floor against the euro, which was clearly communicated to the market. In November 2013, the central bank of the Czech Republic announced that it would carry out interventions on the foreign exchange market to weaken the value of its own currency against the euro. This took place against a background of falling inflation and the weak development of the economy.

The situation in Sweden is different

Present conditions in Sweden differ from those in other countries where central banks have adopted complementary monetary policy measures. The financial markets and financial sector as a whole are functioning relatively well, lending to households and companies is increasing, interest rates at both short and long maturities are low and the krona is not remarkably strong. In addition, economic development is relatively strong, GDP is increasing at a normal rate and employment is rising. At the same time, inflation is too low. The repo rate has therefore been cut to zero per cent and is expected to remain at this level until inflation has clearly picked up. This highly expansionary monetary policy will stimulate demand and contribute to CPIF inflation rising to 2 per cent in the first half of 2016. The Riksbank therefore assesses that the situation in the Swedish economy does not require any supplementary monetary policy measures at present. However, if conditions were to change, the Riksbank has the same possibilities as other central banks to take further measures to increase the monetary policy stimulus.