Lars Nyberg: Monetary and financial stability from a central bank perspective

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at the conference on the 10th Anniversary of the Central Bank of Bosnia and Herzegovina, Sarajevo, 13 September 2007.

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Ladies and Gentlemen,

What is the interaction of monetary and financial stability? This is one of the most discussed issues in central banks and academia today, and is likely to remain high on the agenda for the foreseeable future.

Many central banks, including the Swedish Riksbank, now have dual tasks: maintaining price stability and promoting financial stability. I will begin by discussing these tasks separately, and then turn to the questions the success in bringing down inflation has raised with regard to financial stability, and how this has influenced the conduct of monetary policy in Sweden.

Before proceeding, I should stress that the views I am about to express are my own, and do not necessarily reflect those of the other members of the Executive Board of the Riksbank. Moreover, it should be kept in mind that my remarks primarily are based on my own experiences from an inflation targeting central bank, operating in a small open economy.

Price stability

The taming of inflation, after the destructive price-wage spirals of the 1970s and 1980s, is one of the major success stories in modern economic policy making. Economic theory tells us that high inflation is bad for a number of reasons. These theories now appear to have been vindicated. The last decade has seen strong global economic growth, while, at the same time, output volatility have dropped.

In practice, two paths have emerged for achieving price stability. One way is through a fixed exchange rate regime, such as a currency board. Under such an arrangement, a country simply imports the monetary policy of a country with a highly credible low-inflation regime. This path has emerged as the weapon of choice of many emerging economies. These countries want to achieve price stability, while avoiding the costly deflations which otherwise might be necessary to anchor inflation expectations. The other way is through an independent central bank with a mandate to maintain price stability. This mandate is often formulated in terms of an inflation target. The inflation target operated by the Swedish Riksbank stipulates that consumer price inflation should be 2 per cent per year, with a tolerance interval of plus/minus 1 percentage point. For all practical purposes this arrangement is close to what is found in, for example, the UK, Australia, Norway and the Eurozone. It should also be said that there is a general consensus that the inflation target in Sweden has been a successful one.

Financial stability

As I mentioned earlier, many central banks today also have an objective to promote financial stability. While there is close to universal agreement on what price stability means, there has yet to emerge, some attempts none withstanding, a consensus on a working definition of financial stability.[1] Given the problems in defining and measuring financial stability, why should we pay any attention to it? One answer is that we simply cannot afford not to do so, as financial crises carry with them huge costs to society. This was shown by events in Japan and the Nordic countries during the early 1990s, and in much of South East Asia in 1997. In fact, one could even claim, that financial stability takes precedence over price stability, in the sense that the latter is quite irrelevant if the financial system is on the brink of collapse.

An important difference between price stability and financial stability is that while responsibility for price stability rests squarely on the central bank, financial stability necessitates the cooperation of the central bank, supervisors and the government. However, the exact roles played by different authorities differ from country to country. Another difference is the number of instruments available to policy makers. In the case of price stability, there basically exist one instrument (either the short-term interest rate or the nominal exchange rate). Maintaining financial stability, on the other hand, requires a wide spectrum of policy measures, such as professional supervision, a legal framework that does not encourage “moral hazard”-type behaviour and crisis management plans.

A recent complication is the surge in cross border banking activities, which means that the national authorities engaged in financial stability work, increasingly must work with their foreign colleagues. While the internationalisation of the banking industry holds the potential for efficiency gains, and increased household welfare, it has also added a score of new challenges. Perhaps the most serious of these challenges is what has been termed the home-host problem. This can, in all its essence, be described as follows: Suppose a bank, which is of marginal importance in its home country, sets up a branch in another country, which turns out to be systemically important for that country. Given that the bank is not important in its home country, the home supervisors, who have responsibility for the supervision, might not think that the bank merits close supervision. However, for the host country, which will foot the bill for the salvage operation in case the bank fails, the incentives to monitor the bank are huge. This dilemma is not new in theory, but has now become of great practical importance as financial globalization progressively is making national borders less relevant.

Asset prices, financial stability and monetary policy

Are there instances when these goals come into conflict with each other? This question has become particularly relevant in the last few years as asset prices have surged, while, at the same time, consumer price inflation has remained muted.

On the whole, I think it is reasonable to assume that price stability in the long run reinforces financial stability. The main reason for this is that low and stable inflation reduces the risk of misallocating investments. Although I believe that low inflation fosters financial stability, it would be wrong to disregard the possibility that changes in the inflationary process can have unintended consequences for the stability of the financial system. The success in bringing down inflation has lowered both nominal and real interest rates. Moreover, factors such as the integration of emerging markets into the world trading system, and high productivity growth, has put downward pressure on prices of manufactured goods. This may have induced key interest rates to be lower, than what otherwise would have been justified in this cyclical position of the economy.

Given the fact that the low inflation regime has yielded high and stable growth, in conjunction with low interest rates, it is no wonder that asset prices have surged. While much of this price movement is fundamentally based, there is a risk that households and firms might become too optimistic about future earnings and interest rates. Put differently, there is a risk that

[1] See e.g. Schinasi, G. (2004): ”Defining Financial Stability”, IMF Working Paper, WP/04/187.

asset prices rise to unsustainable levels during the transition from a regime with high inflation to a regime with low inflation.

Another, but not unrelated issue, concerns how risk is priced in the credit markets. The last few years saw risk premiums in credit markets falling to record low levels. The fall in risk premiums meant that the effect on asset prices were more important than what the changes in the risk free rate alone would suggest. While low risk premiums, taken at face value, signal a healthy economy, many supervisors and central banks were concerned that risk premiums had fallen too far. As we all know, risk premiums in credit market rose dramatically this summer. Uncertainty over the value of US subprime mortgage backed securities then ignited a furious "flight-to-quality", which actually seized up important segments of the money market. It is too early to tell what the permanent outcome of these events will be. However, it is clear that if they signal a return to higher risk premiums and tighter credit conditions, asset price inflation is likely to slow down.

The area where the current regime of low interest rates and small risk premiums has had its most marked impact is probably that of residential property and household debt. The rise in house prices the last ten years have indeed been unprecedented in duration, magnitude and synchronisation across countries. In Sweden, this has caused a substantial amount of public concern, and an often asked question is if there is a significant overvaluation in the housing market and if the households are overly indebted.

Answering these questions is a daunting task, and requires an educated opinion on the equilibrium price of residential property and on the optimal level of household indebtedness. Such assessments are further complicated by the fact that there have been a number of important structural changes in the mortgage markets. Without going into detail, weighing the available evidence together, we do not think that residential property in Sweden is significantly overpriced in general. Nor do we believe that households in general are overly indebted. However, this does not preclude the possibility that there are other countries where house prices and household indebtedness have risen to levels beyond what can be fundamentally motivated.

Yet, even if we don't believe that house prices and household indebtedness have been disconnected from their fundamental drivers, there are still reasons for us to be concerned by the rise in property prices and household indebtedness. In the last years, in Sweden as elsewhere, household debt has grown much faster than disposable income. Obviously, this is not sustainable in the long run, as households then ultimately would be unable to service their debts. In the long run it is likely that indebtedness and house prices will increase roughly at the same rate as the nominal growth of the economy. This type of adjustment, to more restrained growth rates, will normally occur smoothly, as households begin to feel that their finances cannot tolerate a higher level of indebtedness. However, if there is an overly sharp correction or "hard landing" if you like, it could lead to weak growth in the economy for a long period of time. In this case, it would also have effects on inflation.

So, in short, in Sweden a situation has prevailed where subdued inflationary pressures have called for an expansionary monetary policy, while, at the same time, property prices have been surging in a fashion that in no way can be deemed as sustainable. How can, and should, a central bank in a small open economy with an inflation target deal with such a situation?

The first thing a central bank can do is to engage in "open-mouth operations" and constantly remind everyone of the existence of the risks through speeches and documents. One publication that can prove particularly useful in this regard is the Financial Stability Reports, which are now published by an increasing number of central banks. By taking a systemic view of the financial system, the Financial Stability Reports investigate the collective impact stemming from the actions of individual financial institutions. By communicating these findings to market participants and the general public, the central bank can raise awareness of risks to financial stability, which might otherwise go unnoticed.

But, at times, all this may not be enough, and then the inevitable question begs to be answered – How, if at all, should a central bank let changes in asset prices influence its monetary policy? The Riksbank runs a flexible inflation target, which means that we also take the real economy into account when we set interest rates. Changes in, for example, property prices are routinely taken into account in such a framework since the trajectory of the policy rate for the forecast horizon is set by the outlook for inflation and output, and these outlooks are affected by changes in property prices among other things.

However, it is close to impossible to properly quantify, or capture the risks, of overly sharp corrections of property prices some time in the future. We therefore have to take risks of that kind into account in a different way than in the normal approach, where the forecasts for inflation and the real economy serve as the foundation. This is done by adjusting the timing of the policy rates changes, for example by raising the policy rate somewhat earlier than would be justified by the forecasts for inflation and the real economy. By doing so, we hope to minimize the probability of a hard landing scenario.

Concluding remarks

If I were to sum up my experiences from the last few years, I think three conclusions can be drawn.

First of all, as long as asset price inflation only is deemed to be a macroeconomic risk, it can be addressed within the framework of a flexible inflation target. If it is deemed to be a threat to the stability of the financial system, the brunt of the policy response would not be on monetary policy, but rather on the regulatory side.

Secondly, I think that the problem of how to manage the risks from asset prices in the monetary policy decision process to a large extent is pedagogical, i.e. explaining that we do not target asset prices, but that we do not completely ignore them. However, monetary policy is a topic on which a lot of people have an opinion, and you are never going to please everyone. In fact, in recent years the Riksbank has been criticized for putting either too much, or too little, emphasis on property prices.

Finally, I would like underscore the necessity of stress-testing the banking sector for sudden shifts in property prices. You can have a whole staff of PhDs running all kinds advanced models telling you that assets are not overvalued. That’s fine, but at the end of the day they might be wrong, and then you would like to know what the consequences are going to be for the banking system.

Let me end by thanking the central bank of Bosnia and Herzegovina for hosting this conference and congratulate the bank on its 10th anniversary.