## Stefan Ingves: Financial turbulence, monetary policy and inflation

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, to SACO, the Swedish Confederation of Professional Associations, Stockholm, 24 September 2008.

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When storms are raging in the world around you and the course is affected, it is important to keep focus on where you are heading. Take in as much information as possible and steer back towards the target in the way that provides the best journey home. In a way, this is how the Riksbank tries to conduct its monetary policy. The inflation target is to provide economic stability, in particular when there is turbulence in the world around us. The original idea was that I would come here today to talk about monetary policy. And I will do so. But the international turmoil, particularly in the financial markets, has escalated in recent weeks. I would therefore like to begin first by saying a few words about this, and about the measures taken by the Riksbank and others to counteract the effects of the financial crisis in the United States.

### The financial turbulence

One can say that the Riksbank is active in two main areas. One is monetary policy. The other is what is usually known as financial stability – promoting a safe and efficient payment system, as it is written in the Sveriges Riksbank Act. To simplify, this means ensuring that payments in the Swedish economy can be made securely and efficiently. For instance, the Riksbank monitors and analyses the financial system, identifies potential risks and influences participants that are important to financial stability. We shall work to prevent financial crises from arising, but if they should nevertheless arise, it is our task to manage the situation.

What does this mean? For instance, we must be prepared to act in situations where our assessment is that financial stability is threatened. Let us assume, for example, that a Swedish bank which is under the supervision of Finansinspektionen, the Swedish Financial Supervisory Authority, is solvent and has assets that are greater than its liabilities, but experiences serious problems with its liquidity and thereby difficulty in meeting its payments. If the Riksbank's assessment in such a situation is that the stability of the financial system is at stake if the bank collapses, then we can intervene with measures to aid liquidity.

The United States is currently in the midst of a financial crisis, the backwash of which is sweeping through the global financial system. Although financial turbulence has been included in our analyses ever since last summer, the way it has manifested itself and the intensity of the events has varied along the way. And in recent weeks the problems have escalated. The most recent wave of financial turbulence is the worst so far since the original US mortgage crisis broke out.

So what has happened recently? For one thing, large agents in the US financial market have suffered acute problems. The US central bank, the Federal Reserve, has taken measures to safeguard financial stability. The unease we see in the markets is on a global level and affects us all, but the financial crisis is mainly centred on the United States.

### We are not isolated

The Swedish financial system has functioned well and the banks have been able to finance themselves both in Sweden and in the international capital markets. The overnight rate, the shortest interest rate in the economy, has remained stable around the repo rate. In this way the Riksbank's system for steering the interest rate works well. But as I said, up here in Scandinavia we are not isolated from what is happening in the world around us. Swedish banks are now affected more tangibly than before by the global financial turbulence even though they only have small exposures to the US mortgage market, which is the centre of the crisis. Interest rates have now risen substantially here, too, for instance on the interbank market. This is the market where the banks borrow money from one another to cover their short-term liquidity needs. Let me stress, however, that higher interest rates are not the same thing as the Swedish banks experiencing problems, although it is becoming more expensive for them to borrow money. The Swedish banks have had a good development in profits in recent years and they are financially strong. They have a good starting position to meet higher costs.

### Measures to ensure the markets function efficiently

But the markets have not functioned as efficiently as usual. For instance, interest rates in the interbank market have risen as a result of the increased uncertainty. There has also been a surge in the demand for treasury bills. The Swedish National Debt Office and the Riksbank have maintained a regular dialogue regarding the money and bond markets and the need to counteract the effects of the US financial crisis. Last week the Debt Office decided in consultation with the Riksbank to issue treasury bills at a number of additional auctions to meet the large increase in demand. The funds from the auctions will be invested in what is known as covered mortgage bonds. This improves the way the market functions right now.

To ensure that the financial system functions as well as possible, the Riksbank has also implemented some other measures for preventive purposes. On Monday we decided, to put it simply, to increase the access to credit for participants in the RIX payment system. One can say that we are oiling the wheels of the system by making it easier for participants to make their payments to one another during the course of the day. They can now to a greater extent use their own covered bonds, or those issued by an institution with close links, as collateral in the system. A covered bond has collateral in the form of, for instance, a mortgage, which is provided by the credit institution that has issued the bond. This means that the credit granter is more protected than in the case of ordinary bonds. Covered bonds are therefore good collateral and many other central banks accept these bonds on a larger scale than the Riksbank. In our case the permitted share was raised from 25 per cent to 75 per cent. This measure means, put in very simple terms, that participants in the RIX system can use more collateral to borrow against if necessary.

Another measure is that, for instance, the Riksbank and the central banks of Denmark and Norway, together with the US Federal Reserve, have reached an agreement for the purpose of increasing access to dollars in the Scandinavian financial markets, if necessary. For the Riksbank this involves the possibility to obtain access to US dollars in addition to the foreign currency reserve. This is what is known as a swap facility and amounts to a total sum corresponding to USD 10 billion. Our assessment is that it will probably not be necessary to use the money. It is nevertheless important to demonstrate that we are prepared to act if it should prove necessary. The agreement can be quickly put into operation if it should actually become necessary.

### Financial stability is satisfactory

What is happening now has not come as a bolt from the blue. And it is not a question of the central banks sitting with their arms folded ignoring the risks taken by the commercial banks. In Sweden, the Riksbank has regularly highlighted many of the risks in the financial system. We did so most recently in our Financial Stability Report. There we pointed out, for instance, that the financial turbulence might worsen and that the banks' access to funding could deteriorate. At the same time, we have all along made the assessment that financial stability in Sweden has been satisfactory. We make the same assessment now, and the Swedish banks are financially strong.

As we have seen, a lot has happened on the financial markets recently. We are following developments closely, constantly updating our analyses and we are prepared to take action if necessary. We have regular contacts with banks, market participants and other government agencies, as well as our central bank colleagues in other countries.

There is a generally high level of uncertainty in the world economy at present and this will probably persist for a good while to come. I would therefore like to return now to what I mentioned at the beginning – the inflation target and the stability it offers to the economy, particularly when storms are raging all around us.

## Monetary policy – focus on the inflation target

The objective of monetary policy is to maintain price stability and this has been established by law since 1999. To be more precise, inflation measured in terms of the consumer price index, CPI, is to be held at 2 per cent, with a tolerance interval of +/- 1 percentage point. This is how the Riksbank formulated the inflation target when it was announced in 1993. One can say that the task of ensuring that prices remain stable has been delegated by the Swedish people through the Riksdag (Swedish parliament) to the Riksbank. And this is actually not merely an objective, it is also a means. By keeping inflation low and stable, monetary policy is to help to create the best possible conditions for good and sustainable economic growth. Delegating monetary policy to the central bank in the way the Riksdag has done in Sweden also reduces the risk of political pressures, short-sighted actions and rapid changes in monetary policy.

Our focus – what governs our interest rate decisions – is on attaining the inflation target within a couple of years in a way that provides the most balanced development of the economy possible. This was also the case at our most recent monetary policy meeting in September, when the repo rate was raised to 4.75 per cent. It was a difficult situation in which to make a decision, with high inflation both in Sweden and abroad at the outset and a very uncertain world economy. Although we Executive Board members agreed on many things, our assessments differed with regard to the interest rate path needed to bring inflation back on target at a suitable pace.

Although the differences in our assessments were actually fairly modest, it is extremely important to be clear about both the common and individual motives behind the stances taken at the meeting. I am therefore now looking forward to first talking about what has recently affected interest rate policy on a more fundamental level and then about the factors behind the decision taken in September.

## High inflation and rising interest rates

The Riksbank is to ensure that we keep inflation in Sweden at a low and stable rate. We have indeed experienced a long period with a fairly low rate of price increase, approximately 1.6 per cent on average since the inflation target was announced. However, over the past year inflation has been higher. In August the rate of increase in consumer prices was 4.3 per cent. This is the highest inflation rate in almost 15 years. Given this, it is perhaps not surprising that expected inflation has also risen in the short term. But expectations of inflation several years ahead are now also clearly above the Riksbank's target of 2 per cent. It is therefore not surprising that many people are concerned.

As inflation has risen, the Riksbank has raised its interest on loans to the banks, the repo rate. This is now 4.75 per cent. The banks’ lending rates to companies and households are higher and have also risen. They have risen more than the Riksbank’s rate increases. This is in turn linked to the uncertainty in the financial markets, which has increased the banks’ borrowing costs around the world. At the same time, the economic activity in the world in general has weakened, which leads to a decline in exports for Swedish companies. We have experienced many years of extremely good economic growth and low inflation. Now we must be prepared for high inflation, higher interest rates and lower employment possibly leading to a deterioration of the finances of many Swedish households over a couple of years. Monetary policy often comes into focus in this type of situation.

### The recent debate – is the Riksbank chasing inflation spectres?

The Riksbank's interest rate increases have been much discussed recently. It has been said that the Bank is chasing a non-existent inflation spectre, that the inflation target should be scrapped or reformulated, and that the Riksbank should take more notice of economic activity than inflation.

To begin with, inflation is a real problem for many households. Inflation means that everyone gets less for their money. Oil, electricity and food prices have risen substantially. These goods are an important part of household consumption. Together food and energy comprise approximately one quarter of the CPI. The fact that, for instance, oil and food prices have risen so much here in Sweden is largely because these goods have become more expensive in the world market.

### Should the inflation target be reformulated?

Some of the recent criticism has concerned whether the inflation target should apply to some other measure than the CPI. The idea is that monetary policy should stabilise around a measure of inflation that excludes import prices. The Riksbank is in any case unable to affect prices in the world market. However, this is not a convincing argument. Swedish conditions also affect the prices of the goods we import. The world market price of a product is not the price that Swedish households see in the shops. The value of the krona in relation to other currencies for example plays a part. Demand and factors such as transport, mark-ups in the wholesale and retail channels are also significant.

What the Riksbank can do is to conduct well-balanced monetary policy so that consumer prices on average rise by 2 per cent a year. When the Riksbank raises the repo rate, demand is dampened, which reduces the scope for price increases in all areas, including energy and food. It is important that monetary policy is aimed at keeping down the general price increases and that the inflation target is not redefined merely because some prices are rising more than others. Households' total purchasing power is affected when prices of imported goods change, and this would be the case even if we had an inflation target that excluded these prices. When, for instance, the price of oil rises over a longer period of time there is a risk that price increases will spread to other areas of the economy. This risk would hardly decline if the inflation target was formulated differently.

Of course one must be open to change that could improve the current monetary policy regime. But it is important to think things over very carefully. And we shouldn't fix something that isn't broken. If we look back over the period with the current inflation target, it is difficult to describe it as anything other than successful. The inflation target for monetary policy has without a doubt contributed to providing a stability in economic policy that was lacking in the Swedish economy during the 1970s and 1980s.

### Temporary effects – with the right monetary policy

What the Riksbank needs to keep in check is the general price increases. Monetary policy neither can nor should try to counteract the fact that prices of some goods increase more than others. So, if it is mainly a few products that have led to consumer prices increasing so much, why is the Riksbank tightening monetary policy? The argument put forward by some critics is that the increases in oil and food prices only affect inflation temporarily. The

Riksbank should not do anything about this. Such a view assumes that the increases in oil and food prices will not spread to other prices, to demands for wage compensation and to even higher inflation. But this is not something one can automatically assume. There are many examples over the years. Those of you who were around during the oil crisis of the 1970s will perhaps remember how the substantial rise in oil prices had an impact on the rest of the economy. The inflation rate reached two figures. Wise from this experience, I believe we should handle things differently now. It is our task to ensure that the temporary effects remain temporary and do not become entrenched.

### Do we only focus on inflation?

Another question that has arisen in the recent debate is to what extent the Riksbank should take production and employment into consideration. Let me first say that when it comes to the relation between low and stable inflation and good growth, one does not exclude the other. The actual purpose of the inflation target is to provide the conditions for good economic growth that is sustainable in the long term.

Furthermore, the Riksbank shall also give some consideration to developments in production and employment in the individual interest rate decisions, as long as it appears possible to attain the inflation target. Monetary policy is flexible. We are no “inflation nutters” as my British colleague Mervyn King has put it. The Riksbank cannot stabilise inflation at 2 per cent all of the time. Sudden increases in oil, food, clothing or any other kind of prices can push up inflation. Our interest rate policy is then designed so that inflation can be expected to be back on target within a couple of years, not next week. The fact that it may take some time before inflation is back at 2 per cent provides some scope to take into account production and employment.

The Riksbank thus has some scope to give consideration to developments in economic activity. This is something we actually do. Over the past year, for instance, the interest rate has not been raised dramatically, but at a more gradual pace, despite a rapid increase in inflation. The Riksbank’s assessment is that a cautious increase in the interest rate is sufficient to bring inflation back around the target of 2 per cent a couple of years ahead. However, the Riksbank’s task is to maintain price stability. This sets a limit as to how restrictive one can be with the interest rate weapon. Without the interest rate increase inflation could have soared similar to the way it did in the 1970s and 1980s. At that time the economic policy did not prevent inflation from becoming entrenched. The inflation target has been set to create conditions for good growth that is sustainable in the long term. An expansionary monetary policy which perhaps contributes to more favourable developments in economic activity in the short term can provide major problems for production and employment in the long term.

### The most recent decision

When the most recent interest rate decision was made, we six members of the Executive Board held differing opinions. I and two of my colleagues voted to raise the interest rate to 4.75 per cent. There have not been many cases where the voting is a “draw” and the casting vote determines the decision; this has happened only four times since the Executive Board was formed almost ten years ago. The result is not particularly strange or surprising given the situation when the decision was made. We are six different individuals on the Executive Board. We have different backgrounds and different perspectives. Sometimes this leads to our assessments differing, even if we work towards the same objective. It applies in particular to very uncertain situations like the present one. But the whole idea of having an Executive Board is that disagreement is permitted. Different approaches and opinions enrich the discussions and hopefully lead to better decisions.

## My own assessment

So how did I reason at the most recent meeting, when I voted for another increase of a quarter percentage point? Well, to begin with it is important to put an individual decision in the right perspective. Monetary policy acts with a time lag and what affects inflation a couple of years ahead is a series of interest rate decisions rather than an individual interest rate increase, or cut, for that matter. My decision in September was therefore closely connected to both the interest rate policy we have conducted over the past few years and the interest rate path I expected to see in the future.

## A new phase

We have experienced a long period of low inflation and high growth from a global perspective, but we have now entered a new phase. In developed economies like the United States and the euro area growth is falling, while it remains high in emerging economies such as China, India and Brazil. The effects of the high demand for certain commodities from rapidly-growing economies are something that central banks around the world must manage in the future. Another example is the imbalances in the global economy. Access to credit was too high for a long time in many countries and contributed to an unsustainable development. The imbalances that were built up are being corrected, but it is still uncertain how long the adjustment will take.

What we see now is a world less stable than we have been seeing in recent years. Sweden is a small open economy and the Riksbank conducts an independent monetary policy. We have an inflation target which we endeavour to attain. An inflation target becomes an even more important anchor for monetary policy in a situation like the present one. If financial imbalances and large fluctuations in commodity prices create global shocks over a long period of time, the inflation target can in itself have a calming effect on our own economy. It therefore feels particularly important to maintain our focus on the inflation target right now.

## The interest rate decision

In connection with the Executive Board's monetary policy meeting on 3 September, we saw signs that inflation is falling in various parts of the world. But this fall in inflation is from a very high level and as yet no clear decline is visible in the statistics. Swedish inflation is still at its highest level since the mid-1990s. At the same time, growth has been weaker than anticipated. Productivity has also been weak and this has led to rising production costs. The weak productivity appears to be persisting and leads to continued high cost pressures. Resource utilisation measured in terms of the number of hours worked is still slightly higher than normal. However, we expect it to decline.

Expectations of inflation have been high, both in the short and long term. At the time of the September meeting they were still above the inflation target. Expectations are an indication of confidence in monetary policy. Both interest rate increases and falling energy and food prices may have contributed to the slight fall. But it is important to remember that inflation expectations are still too high. There is considerable uncertainty regarding commodity prices and global developments and as I see it we cannot sound the all clear yet.

To meet the inflation target it is important to conduct a monetary policy that contributes to long-term inflation expectations being close to 2 per cent. My assessment was that a further increase was required to achieve this. When I looked ahead I considered that both inflation and inflation expectations must be closer to the target before expansionary monetary policy can be reconciled with bringing inflation back to 2 per cent within a couple of years. Weaker economic activity is no guarantee that inflation will "automatically" fall. This is connected to, for instance, the risk of contagion effects and the fact that inflation can become entrenched, as I mentioned earlier. Both in Sweden and abroad there are many examples of inflation remaining high when growth slows down or falls.

Compared with the assessment we made in July, we made a downward adjustment in our forecast for the future repo rate. New statistics indicated that both global and Swedish economic activity had weakened sooner than expected and we therefore revised down our forecasts for growth. Given this, I considered that we have now completed our interest rate increases. I expected that the next stage will be a cut and that monetary policy will ease slightly during 2009.

I think it is difficult to claim that the interest rate path we presented in September is too strict. The interest rates are not particularly high, either from an historical perspective or in comparison with many other countries with a floating exchange rate. Resource utilisation, the good public sector finances and the surplus on the current account provide us with a good starting point. The Swedish economy has the necessary requirements to meet both a limited downturn in economic activity and growth around the long-term average towards the end of our forecast horizon, at the same time as attaining the inflation target. In addition, the current interest rate provides some support for the exchange rate. This has some value with regard to meeting the inflation target.

## A few final words

Let me just very briefly summarise what I have talked about today. The Riksbank strives constantly both to attain the inflation target and to manage its task of safeguarding financial stability in the best possible way. If we succeed, we provide stability in the Swedish economy, particularly in times when there is international turmoil.

We will probably have to live with the financial market turbulence and the crisis in the United States for a good while to come. It is too early yet to be able to foresee when this will all be over. However, what we can say is that it will take time. The next occasion when we will be weighing together all of the new information received and assessing how these developments affect the prospects for growth and inflation is at our next monetary policy meeting at the end of October. Until then we will of course continue to follow developments very closely and to have regular contacts with banks, market participants and other government agencies. We are constantly trying to include all important information in our analyses. This is the way we always work, and it applies to both financial stability and monetary policy. Let me conclude with what must be the most important thing for Sweden right now – the observation that financial stability here at home is satisfactory and that Sweden is well-equipped to meet the global economic downturn on this occasion.