Lars Nyberg: The crisis, the Riksbank and monetary policy

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at the Bankmarknadsdagen, Stockholm, 28 November 2008.

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Introduction

The financial system is an important part of our social structure. The payment system and the supply of credit are central to all economic activities. When the general public's confidence in the financial system is shaken and when the participants in the system no longer trust one another, then something serious has happened in our society. This means that all those involved, both in the private and public sectors, must have a discussion on how this situation arose and what we can do to avoid it happening again.

The financial turbulence, which began in summer 2007 with problems in the US mortgage market, has during the autumn become an acute crisis. Also during the autumn we in Sweden have gone from largely watching the crisis from the sidelines, to being very much involved.

Today I will give my views on how this could happen and on what has occurred during the autumn. Last spring there were many indications that conditions in the financial markets were gradually improving. I shall also reflect on the methods used by central banks and governments around the world to try to manage the problems and to safeguard financial stability. It would take too long in this context to analyse what conclusions should be drawn for the future, and it is probably too early to do so yet, but I shall nevertheless share my impressions this far. In conclusion, I shall discuss how monetary policy can complement the more acute financial measures taken, and alleviate the effects of the financial crisis on the real economy.

Acute financial crisis…

The turn for the worse can be clearly dated to the middle of September when US investment bank Lehman Brothers was forced to file for bankruptcy protection. Money market participants had not expected such a prominent bank to default. When the bank nevertheless defaulted, fears grew that more participants risked the same fate. This was when the confidence crisis broke out in earnest. No one dared to lend money to anyone else because of fears that the other party could become insolvent and the money that had been lent would disappear. Investors preferred to put their money in government securities. One result was that interbank lending around the world more or less ceased. The difficulties the banks had experienced earlier with financing at longer maturities were intensified. The banks' borrowing costs increased further and companies outside of the financial sector also experienced financing difficulties.

At the same time, the large US commercial paper market suffered substantial disruptions. This market is an important source of financing, both for financial companies and ordinary industrial companies. The industrial companies tried to make use of their promised loan facilities with the banks, but the banks were not able to lend money as usual. This resulted in a credit gridlock, which severely limited the access to loans. The problems spread from the United States to Europe and the European credit system also essentially ceased functioning. This meant that the Swedish banks and the Swedish financial system also suffered problems.

…followed by countermeasures and stabilisation

In this situation governments, central banks and other authorities were forced to intervene to avoid a collapse in the global financial system. Without these measures the financial markets would most probably have ceased functioning – things were so serious. The measures have taken different forms in different countries, but two main types can be identified. The first is that the banks have been offered risk capital or other guarantees so that they can survive the crisis. The aim is to avoid more defaults like Lehman Brothers occurring when the financial market is so vulnerable. Those who lend money to a bank should be able to feel certain that the bank will still be there when it is time to repay the loan. The second type of measure is that the central banks have continuously supplied the banks with the short and medium-term loans they have not been able to obtain in the usual way on the market.

Although it is not yet possible to know whether the measures will succeed in full, my assessment is that they have been sufficient to counteract the most acute problems. The measures create a basis for restoring confidence among the general public and between participants in the financial markets. If one tries, one can see some signs of normalisation in the form of falling interbank rates and improved liquidity in the form of higher turnover on some markets. But progress is slow. I consider it rather surprising that market functioning has not normalised to a greater degree, despite the extensive and forceful measures taken by central banks and governments. It is possible that the authorities have not succeeded in communicating the fundamental message that all who lend money to a bank will get their money back.

A remaining problem is that, as a result of the crisis, the market is requiring that the banks reduce their risks in relation to equity capital. The banks are therefore selling financial assets, which squeezes the price in the entire world market. This is why the banks want to reduce their balance sheets by cutting back on lending. The process will continue until the banks have reduced their balance sheets sufficiently or acquired new risk capital.

The Riksbank will contribute liquidity as long as is necessary

The Swedish interbank market functioned satisfactorily up to mid-September, although the cost of the banks' international borrowing rose, of course. But the confidence crisis that followed in the wake of Lehman filing for bankruptcy protection also affected the Swedish financial system. To counteract the effects of the financial crisis, the Riksbank has supplied the market with loans in kronor and US dollars in a similar manner to what other central banks have done in their currency areas. The loan facilities have allowed a different class of collateral than usual. The maturities have been longer than those the market has been able to offer and longer than the Riksbank normally provides. In total, the Riksbank has increased its lending by more than SEK 400 billion. We will continue to provide the market with liquidity as long and as far as it is needed.

During the autumn the Riksbank has received signals from Swedish industrial and trade companies that they have been unable to find satisfactory credit. Quite simply, they have not been able to borrow on the market or from the banks in the same way as usual. This problem originates outside of Sweden and has arisen despite the Swedish banks being financially strong. As a preventive measure, the Riksbank established a new, temporary, credit facility on 29 October. The aim is to improve the opportunities for companies to borrow money. Companies can organise their financing through this facility by issuing and selling commercial paper to the banks. The banks can in turn use commercial paper as collateral for loans from the Riksbank. The purpose is thus to make it easier for companies to borrow in that the banks are given better scope for financing. It is primarily large companies that issue commercial paper, but smaller companies should also benefit as the banks' increased scope for borrowing from the Riksbank means their total lending capacity will be less strained. So far, however, the banks have chosen to use only a small part of the credit facilities offered by the Riksbank. It remains to be seen whether this is because the companies have nevertheless succeeded in borrowing elsewhere or whether they consider the bank loans to be too expensive. Despite the fact that some companies are experiencing problems with borrowing, bank lending in Sweden is continuing to rise. However, this should not automatically be interpreted to mean that the supply of credit is functioning well in every aspect. The international credit markets are still largely closed to Swedish companies and they cannot borrow from foreign banks to the same extent as before.

The Riksbank has also granted special liquidity assistance during the autumn to Kaupthing Bank Sverige AB and Carnegie Investment Bank AB. The liquidity assistance was offered in the form of loans against collateral and at a higher interest rate than on normal loans. The market turbulence and the great uncertainty that prevailed were reasons for granting liquidity assistance to safeguard financial stability, even though these institutions were relatively minor participants in the Swedish financial market. Confidence in the Swedish financial system could have been seriously damaged if a failure like the one at Lehman Brothers had been allowed to occur. The Riksbank's assessment was that the two banks were experiencing temporary liquidity problems, but that their solvency was not threatened. Finansinspektionen later revoked Carnegie's licence to conduct banking activities owing to serious deficiencies in the company's risk management and violation of the law concerning asset management. The decision to revoke the licence thus had nothing to do with Carnegie's liquidity problems or with the Riksbank's loan. Carnegie is now owned by the Swedish National Debt Office and the Riksbank's liquidity assistance has been repaid.

The Riksdag (the Swedish parliament) has also introduced a new act concerning support to credit institutions, which will give the government the opportunity to take the necessary measures to strengthen stability in the financial system. For instance, a government guarantee programme has been presented to support the banks' and mortgage institutions' medium-term funding, and a stability fund has been established to manage potential future solvency problems in Swedish institutions.

The current situation

Despite the crisis in the global financial markets and the increasingly gloomy economic prospects, the assessment is that the Swedish banks still have good resilience to facing the situation that has arisen and future developments.[1] The losses arising from the international crisis have so far been limited, not least in an international perspective, and the Swedish banks have good financial strength. In addition, most of the banks' borrowers have a good ability to pay their loans. To summarise, the Riksbank's assessment is therefore that the stability in the Swedish financial system is satisfactory. But it is important to emphasise that the measures taken by the Riksbank and other authorities are currently a necessary condition for this to be the case.

Improved regulatory framework

The measures the Riksbank has taken after 15 September, and which I have just described, concern stabilising the functioning of the market and ensuring financial stability in the short and medium term. In the longer term, however, other types of measure are required to make the financial system function as it should, both in Sweden and abroad.

The crisis has clearly shown that the regulatory framework and financial supervision need to be improved. But it is not necessarily the case that a larger number of more complicated regulations are needed to make the financial sector function efficiently in society. One must carefully consider how the regulations should be changed.

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[1] For an in-depth analysis of the situation in the Swedish financial system, see the Riksbank's most recent report on stability – Financial Stability Report 2008:2.

I believe that on an overall level it is mainly a question of developing and modifying the regulations that are already in place rather than introducing further regulations. The talk of a new financial order should, in my opinion, be taken with a pinch of salt. But one must try to assess in what areas there are clear market failures and how society should best act to remedy these. The usefulness of new regulations must also outweigh the costs. Unfortunately, the existing regulations are designed so that they have in some respects encouraged rather than limited risk taking in the current crisis. Speedy and short-term changes in regulations should not be allowed to prevail. But experience unfortunately shows that political eagerness to quickly furnish new regulations often prevents a more in-depth analysis of the problems.

Which areas of the international regulatory framework are in most urgent need of review? Essentially, of course, the problem is that the risk taking was too great in relation to equity capital. Both the trend towards increased securitisation and a focus among financial institutions on short-term activities have contributed to an increase in risk taking. It is of course important to eliminate any loopholes in the capital adequacy rules, and the capital adequacy requirements in both banks and other financial institutions will probably need to be tightened once we have come through the financial crisis.

It is undeniable that the liquidity risks have been underestimated and a review of the banks' management of these risks will be necessary. It is also evident that increased insight is necessary, both into the banks' balance sheets and into certain markets and instruments. Some products that have been common outside of Sweden have had such complicated structures that they have been difficult to understand and to valuate. It is also evident that the reputations of the credit rating agencies have become tarnished, but how much of this can be remedied through regulation is not so clear.

In addition, the trading, clearing and settlement of certain derivatives has been carried out in such a way that insight has been poor and counterparty risks have been substantial. There is thus reason for the authorities to press for the development of the underlying infrastructure of, for instance, OTC-traded derivatives.

Many ideas regarding what needs to be done to reduce the risk of future crises will probably be put forward over the coming six months. Let us hope that the wise and well-reasoned proposals will be the ones that are implemented.

Crisis management

I would also like to touch briefly on some crisis management issues. Good preparedness and good preparations are the be-all and end-all of crisis management. Both in Sweden and other EU countries, and in particular in the United States, it has been necessary on this occasion to improvise measures to a great extent in the management of the financial crisis. This is of course not exactly desirable. Experiences of earlier crises point to improvised measures often coming too late and costing more than ought to have been necessary.

It is as yet too early to say what the outcome of the measures taken now will be, but there are nevertheless some bright spots. It has recently become slightly easier for the banks to issue at longer maturities both in Sweden and other parts of Europe. In the United States, too, the issue volumes in the commercial paper market have increased. The Swedish mortgage spreads have also declined. We can thus see positive effects of the measures taken, although there appears to be a long way to go before the crisis has run its course.

However, looking ahead to future crises – and I do not believe that we can entirely avoid crises occurring in the future – it is desirable that we acquire a better preparedness. If there is one thing we have learned from this crisis it is that we need to have in place regulatory frameworks for managing banks in distress. Such regulations should include several different aspects, everything from a deposit guarantee system to insolvency procedures for banks.

Above all, the crisis has pointed to the need for cross-border cooperation. We have seen examples of this in Europe. This type of cooperation on crisis management should begin in "peace time". Contacts that have been cultivated already and a common parlance may be decisive factors in determining how efficiently a crisis in a cross-border institution is handled. It is also important to hold joint crisis exercises, using different scenarios.

We can also observe that the Memorandums of Understanding in the field of financial crisis management, which have been drawn up between authorities in Europe in recent years have proved to be too vague. In future, therefore, we need to have more concrete and binding arrangements. One complicated and important question is how the costs should be distributed when a crisis spreads to several countries.

Differences in regulation and supervision also complicate the crisis management. Greater harmonisation is in actual fact an important condition for both crisis management and crisis prevention work. As a result of the crisis, the EU has begun to look into how its framework for supervision can be improved. My view is that after the crisis it is both essential and possible to take a step towards better joint supervision in Europe. But although the supervision issue is important, the systems for deposit guarantees and crisis management must be designed to function when needed, not merely within individual countries, but also between countries. This has not always been the case during the current crisis.

Monetary policy and the build-up of risks

Does monetary policy have a role to play in preventing a financial crisis? This has long been a controversial issue, where economists have held differing opinions. However, the financial crisis has undoubtedly given us experiences we should make use of.

The predominant view has probably been that one should not use the interest rate to try to counteract a credit boom that is expressed in rapid price increases on houses or financial assets. This view is based on the fact that it is difficult or almost impossible for a central bank to determine whether a credit boom has its base in the real economy or whether it is due to unrealistic expectations of continuing price increases. Instead of trying to deliberately burst the bubble, one should use monetary policy to counteract the negative effects that may result if it bursts.

The disadvantage of this reasoning is that the negative effects when the bubble bursts may be fairly substantial – which to a large degree is illustrated by the current financial crisis. It is also difficult to deny that the long period of low interest rates in the world prior to the crisis may have contributed to an unreasonably high build-up of credit. With hindsight, this view does not appear so controversial.

Does this mean that monetary policy can and should be used to prevent financial crises? I believe that monetary policy can be a complement to other measures when overly large risks appear to be building up in the financial sector, but that the main responsibility must lie with other methods of regulating the relationship between capital and risks. The emphasis here is on regulatory frameworks and supervision. Putting all of the responsibility on monetary policy would probably mean such high interest rates that they would have seriously negative repercussions for the real economy. Moreover, the argument remains that it is difficult to determine when a credit boom changes from being beneficial for growth to becoming a risk that can trigger a financial crisis.

I nevertheless think that the crisis has taught us that when we conduct monetary policy we must also follow a number of variables that are linked to the build-up of risk in the financial markets, primarily credit growth in different sectors of the economy. The fact that monetary policy alone cannot prevent financial crises does not mean that we can only look at an inflation target and otherwise disregard what a long period of low interest rates may entail with regard to risks in the financial system. This is also the view the Riksbank has expressed in recent years, occasionally, one must say under strong criticism from both academics and various other parties in society.

Monetary policy can alleviate the consequences of the financial crisis

The financial crisis has meant that the focus normally placed on monetary policy has been transferred to the measures taken to safeguard financial stability. Monetary policy cannot be used to resolve acute problems in the financial markets. This requires a different type of measure, as I have already described. What role can monetary policy then play in the current situation? How has the Riksbank formulated monetary policy during the autumn to counteract the negative events?

On 8 October the Riksbank took part in a joint action with other central banks to alleviate the consequences of the financial crisis. The Riksbank, together with the Bank of England, the ECB and the Federal Reserve, announced cuts in their monetary policy rates. The advantage with this type of coordinated action is that it reinforces confidence and increases the chances of the rate cut having positive effects. The Riksbank cut the repo rate by 0.50 percentage points in this action.

At our most recent ordinary monetary policy meeting on 22 October the decision was to cut the repo rate by a further 0.50 percentage points, to 3.75 per cent. The Riksbank adjusted its forecast for the repo rate path downwards, compared with that presented at the beginning of September. The members of the Executive Board were unanimous regarding both the repo rate cut and the new interest rate path. Together with the joint central bank action on 8 October, the Riksbank thus cut the repo rate by a total of one percentage point in the space of two weeks. Other central banks have also substantially cut their policy rates. For example, the Bank of England has cut its bank rate from 5 per cent to 3 per cent since the beginning of September.

The reason for the repo rate cuts was to alleviate the effects of the financial crisis on the real economy, while ensuring that inflation stabilised around the target of two per cent. Although monetary policy cannot be used to resolve the financial problems, it can help to dampen the negative effects on the real economy, without jeopardising the inflation target.

The Riksbank’s assessment is that the financial crisis aggravates the ongoing economic downturn resulting in weaker growth, a deterioration in the labour market and lower inflation. The repo rate therefore needs to be cut by a relatively large amount during a short period of time. In addition to the cuts already made, the assessment at the most recent meeting was that the repo rate needs to be cut by a further 0.50 percentage points, to 3.25 per cent, over the coming six months.

The repo rate is currently less effective than normal as a tool for influencing the economy. The repo rate cuts in October did not lead to an immediate fall in interbank rates. The confidence crisis in the financial system has meant that the normal link between market rates and the repo rate has been broken. Although market rates also declined, there remains an unusually large gap between the repo rate and mortgage rates in particular. The gap between the 3-month lending rate to households and the repo rate has been around 100 basis points in less turbulent periods than that we are experiencing now. At present the gap is around 200 basis points. This is a lot in an historical perspective. Although some mortgage rates have declined slightly following the repo rate cuts, the gap remains. Mortgage rates are to a great extent governed by the banks' possibilities to borrow abroad. The effect of this is that interest costs for households with mortgages fall less than one might have expected. As a result of the financial crisis, the stimulating effect of a repo rate cut is thus less than it would have been otherwise.

I would like to emphasise that there is unusually great uncertainty surrounding the assessments and forecasts at present and that it is thus more difficult to judge the effects of our monetary policy. The outcome data and indicators the Riksbank has received since the monetary policy meeting in September clearly pointed to a severe deterioration in economic activity, both in Sweden and abroad. Compared with the assessment made in September, the Riksbank revised down its forecast for international growth by almost one percentage point. Growth in 2009 was assumed at the monetary policy meeting held on 22 October to be close to zero in the United States, the euro area and Sweden. There are also signs that the economies in Asia are slowing down. In China, growth has fallen during the first half of the year and is expected to continue to fall. Economic activity in Japan has also slowed down and the most recent GDP figures show that the economy is now in a recession.

Inflation is still high at present, but the forecast for inflation was adjusted downwards for the entire forecast period in the Monetary Policy Report published in October. Our assessment was that inflation will fall quickly over the coming year and then rise slightly, reaching the target of 2 per cent in 2011. The slowdown in economic activity will in all likelihood have a dampening effect on domestic price pressures. Another factor that contributes significantly to the changed view of inflation prospects is the fall in commodity prices. It is mainly increases in energy and food prices that have earlier pushed up inflation in Sweden far above the target. During the fourth quarter of last year commodity prices began to rise. The inflation rate will fall if there are no price increases or if the increases are lower than last year. To summarise, there are several factors pointing to a decline in the inflation rate. The Executive Board's assessment at its most recent meeting in October was therefore that a repo rate cut was not incompatible with the price stability target. It was possible to use monetary policy to alleviate the negative effects of the crisis on the real economy without any risk of neglecting the inflation target.

What has happened since the most recent monetary policy meeting? The picture of a drastic slowdown in economic activity has been reinforced, both in Sweden and abroad. New statistics confirm the picture of an economic downturn and falling inflationary pressures. With regard to Sweden, a record-low level in the purchasing managers index points to a continued slowdown in economic activity. The purchasing managers' index for the manufacturing sector fell in October, for the fifth month in a row. Households' confidence in the economic situation, as reported in the National Institute of Economic Research's economic tendency survey, plummeted in October to the lowest level since the beginning of 1993. Confidence did not change substantially in November, but remained at a historically low level. The confidence indicator for the manufacturing industry fell further in November and is well below the average. A large number of redundancies have been notified by Swedish companies in both October and November. Inflation fell in October, which was entirely in line with the Riksbank's most recent forecast, and there are also signs of lower inflation expectations. At the same time, the krona has been weaker than in our most recent forecast, which in all likelihood will somewhat weaken the forces pushing down inflation. The indicators and outcome data that have been received regarding international growth point to a sombre development. The GDP figures for the United States indicate negative growth during the third quarter and a weak beginning to the fourth quarter. The confidence indicators are pointing downwards, the retail trade is weak and orders are falling. The euro area is in a recession as growth was negative during both the second and third quarters. Since the monetary policy meeting on 22 October, growth prospects have deteriorated considerably, both in Sweden and abroad.

Concluding remarks

During the autumn, the Riksbank has taken measures, together with governments and other central banks, to counteract the confidence crisis that arose in the financial markets in connection with Lehman Brothers filing for bankruptcy. The measures have been taken different forms. The Riksbank has taken part in these measures through both general liquidity support to the Swedish banking sector and special support to Carnegie and Kaupthing Bank, but also through cooperation with other central banks. The Riksbank will continue to contribute liquidity as long as is necessary.

Although the most acute problems in the global financial markets have been counteracted, I consider it slightly surprising that the markets have not normalised to a greater extent than they have. Although the interbank rates have fallen, they are still at a high level in historical terms. The measures implemented by central banks and governments have nevertheless been both extensive and forceful. An important part of the counter-measures implemented by governments and central banks around the world during the autumn has been to ensure that no systemically-important bank is allowed to fail.

The financial crisis has meant that the focus has been moved from monetary policy to the efforts made to safeguard financial stability. This is entirely natural. Monetary policy is not an effective tool in preventing financial crisis or in resolving a crisis that has broken out. It has had some impact on financial stability in that the Riksbank's repo rate cuts have helped to push down market rates. However, the large gap remaining between the repo rate and market rates shows that monetary policy cannot resolve the financial crisis. But I would nevertheless like to emphasise that monetary policy fulfils an important complementary function in alleviating the effects of the financial crisis on the real economy.

As I described earlier, the stimulating effect of the Riksbank cutting the repo rate has been weakened as the normal link between the short-term market rates and the repo rate has been broken. This situation should gradually change as conditions in the financial markets normalise. When the inflation rate falls again, there will be good opportunities for monetary policy to dampen the economic downturn without jeopardising the Riksbank’s inflation target.

Thank you!