Stefan Ingves: The current economic situation

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at Avanza Bank, Stockholm, 5 May 2009.

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The minutes of the monetary policy meeting published yesterday show how we Executive Board members reasoned when we decided to cut the repo rate to 0.5 per cent at our monetary policy meeting on 20 April. Today I intend to give my views on economic activity and monetary policy. he central points I wish to take up are:

- The reasons for the global financial crisis and the ensuing recession in Sweden and the world.
- The economic policy measures taken globally and in Sweden to stimulate the supply of credit and cushion the economic downswing.
- The most recent developments in the Swedish and international economies.
- My arguments for cutting the repo rate to 0.5 per cent, the repo rate path and possible new unconventional monetary policy measures.

The financial crisis is a consequence of several factors

High saving in China and oil-producing countries has contributed to low interest rates and credit expansion in a number of countries

From the beginning of the 1990s up to 2005 the US current account deficit increased substantially. The main explanation for this was a reduction in saving among households. The US current account deficit is counterbalanced by a surplus above all in China and a number of oil-producing countries where saving is high. These countries have sought a return on their financial capital abroad by investing, for instance, in US treasuries. The increased demand for US treasury bonds has for a long time been pushing down long-term interest rates in the United States. In addition, the US central bank conducted expansionary monetary policy in connection with the recession at the beginning of the 2000s and in the years immediately following. The low interest rates have stimulated consumption and investment in the United States. They contributed in particular to house prices rising more quickly than household incomes. The rising stock market and house prices contributed to a reduction in household saving, which largely explains the rising current account deficit until the housing market bubble burst. However, the problems of a previously overheated housing market are not limited to the United States, they can also be found in a number of other countries.

New forms of borrowing, including subprime loans, contributed to overheating in the US housing market

During the years 2004 and 2005 new loan forms became increasingly common in the housing market in the United States, not least subprime loans. Subprime loans are loans aimed at households with low incomes. Often the lenders used very low interest rates during the first two years of the loan as an enticement. However, after this period the interest rates rose substantially. It is likely that the credit assessment of the households was not too comprehensive. The lenders expected that house prices would continue to rise, increasing the value of the collateral, an assumption which meant that the risk to the lenders was assessed as slight. The strong increase in the new forms of mortgages contributed to the overheating in the housing market.

Another factor that can also be assumed to have contributed to the housing market bubble in the United States is the US housing policy, which since the mid-1990s had become increasingly aimed at extending house ownership among households. For example, the semi-nationalised mortgage institutions Freddie Mac and Fannie Mae were to offer a particular share of their total lending to low-income families. This contributed to many households receiving loans despite having an uncertain ability to repay. The credit expansion that was seen in the United States can also be seen in a number of other countries.

In autumn 2005 the housing market bubble in the United States burst and house prices began to fall. As the value of the households' most important collateral fell, an increasing number of households could no longer renew their subprime loans at the same low interest rate. The lenders had tightened the credit terms. The interest rate shock that followed meant that an increasing number of households experienced problems in paying, which in turn pushed down house prices even further. This occurred as an increasing number of households and banks were forced to sell the houses at compulsory auctions at a lower price than before.

The problems with subprime loans spread to other parts of the world economy

The subprime loans were repackaged into new investment instruments which were later sold to investors in other countries. As it became increasingly evident that these securities were probably substantially overvalued, it came to light that a number of banks had suffered large losses. The uncertainty over which banks had suffered the largest losses made the banks unwilling to lend to one another. The financial crisis escalated when the US government decided in autumn 2008 to allow US investment bank Lehman Brothers to fail. The unease on the global financial markets increased and the financial crisis that had started in the United States developed into a global crisis.

The supervision in the financial markets has been insufficient

With hindsight, we can observe that many investors took excessive risks. The risk price they had calculated on was too low. It can also be noted that the credit rating agencies gave the new financial products too high ratings because they had not taken sufficient account of the risk that it would not be possible to sell these products in the market. At the same time, the supervision of the financial markets did not give sufficient consideration to the problems that can arise when a house price bubble bursts. The remuneration structure in the private sector has moreover encouraged short-term thinking and substantial risk-taking. However, all of these problems are partly related to the good access to venture capital that has been created by high saving in some parts of the world.

Credit granting has slowed down in a number of countries and the financial crisis has contributed to the recession in the world economy

The problems in the housing market and the financial crisis that arose have led to credit terms being tightened in some of the world's larger economies. The difficulties in obtaining loans have contributed to a number of companies experiencing difficulty in financing their investment, and have subdued household consumption.

Falling stock market prices and house prices have contributed to household wealth declining rapidly in many countries. This also slows down consumption and investment. The financial crisis has contributed to GDP in the world as a whole declining this year and to unemployment rising in most countries. The Riksbank's assessment is that the recession in the global economy in 2008-2009 will be the worst since the post-war period.

Extensive economic policy measures have been taken

In contrast to the way that economic policy was conducted at the end of the 1920s and the beginning of the 1930s, the authorities have on this occasion acted quickly and forcefully.

Central banks have acted quickly

In the United States the policy rate has been cut from 5.25 per cent in autumn 2007 to 0.25 per cent. The European Central Bank has cut its policy rate from 4.25 per cent in autumn 2008 to 1.25 per cent and the Riksbank has cut the repo rate from 4.75 per cent to 0.5 per cent. A number of other central banks have implemented similar monetary policy easing with the aim of stimulating demand and alleviating the repercussions of the financial crisis on production and employment.

In addition to the interest rate cuts, some central banks have implemented what is known as unconventional measures. The purpose has been to secure the supply of credit and to counteract the threats to financial and macroeconomic stability. The central banks have contributed large liquidity injections, that is, lent money to the banks against collateral. Several central banks have also provided emergency liquidity assistance to individual institutions. The Federal Reserve, the European Central Bank and a number of other central banks have also lent money to other central banks through what are known as swap agreements to increase the access to foreign currencies in some other countries. Governments have offered guarantees and capital injections to reduce the risk of further bankruptcies in the domestic banking sector.

Another important measure to reinforce confidence in the world economy is the decision at the G20 meeting in London at the beginning of April to increase the IMF's resources to provide assistance to emerging economies experiencing problems.

The measures taken by central banks and governments around the world so far have contributed to reducing the pressure on the interbank markets. Without these measures we would probably have faced a financial meltdown. One sign that the crisis is no longer as acute is that what are known as TED spreads have fallen in Sweden, as well as the United States and the euro area. The TED spread is the difference between a three-month interbank rate and a three-month treasury bill rate. The spreads are now back at around the levels prevailing immediately prior to the worsening of the crisis in autumn 2008. But the financial markets are still functioning much less efficiently than normal. It is also still difficult for companies to finance themselves in the capital market. Moreover, the liquidity injection from the central banks does not solve the banks' capital problems. For this reason it is not surprising that the international discussion is currently aimed more at solvency than liquidity. It would be very much appreciated if many countries could begin to distinguish bad banks from good ones in an effective and transparent manner.

In Sweden, too, we have implemented a large number of unconventional measures to safeguard financial stability and mitigate the negative effects of the financial crisis. During the second half of 2008 the Riksbank increased its lending to the banks by more than SEK 450 billion. Almost SEK 200 billion of this was comprised of loans in US dollars. This has largely been financed by means of swap agreements with the Federal Reserve in the United States. Our own foreign exchange reserve was not sufficiently large to manage such extensive lending in dollars. The increased lending has meant that the Riksbank's balance sheet has grown since summer 2008 from around SEK 200 billion to around SEK 600 billion.

We have also changed our collateral requirements for lending to the banks so that the banks can offer more types of security as collateral and thus more easily sustain their functions in the market. We have provided special liquidity assistance to Kaupthing and Carnegie to safeguard financial stability and the functioning of the financial markets. We have decided to lend at longer maturities, with variable interest rates and with smaller supplements. We have also extended the number of counterparties in our lending. In addition, we have signed swap agreements with Iceland, Estonia and Latvia to support crisis management in these countries.

Developments in the Baltic are important to the Swedish financial sector. Here the economic downturn has been particularly severe and the necessary adjustments have not been made. In other words, there are substantial risks in our neighbouring area and if things go very badly the Swedish financial sector will suffer negative effects. However, the measures taken by the Riksbank and by government authorities have had a positive effect on the supply of credit in Sweden. So far there are few signs that companies have been affected by a credit crunch over and above the credit tightening caused by a deep recession. As the banking sector is a very important part of the way monetary policy affects the economy, it is essential to closely follow developments in the credit market. Indirectly it also means that it is important that the Swedish banks attend to their problems in the Baltic both forcefully and quickly. This is to avoid the domestic transmission mechanism being disturbed by the international uncertainty. Here monetary policy and financial stability merge.

The Swedish National Debt Office and Finansinspektionen (the Swedish financial supervisory authority) have also taken measures to alleviate the financial crisis. The Government has raised the state deposit guarantee and extended it to cover all types of deposits in accounts, it has introduced a guarantee programme, established a stability fund and decided on means of capital injections to the banks.

Large fiscal policy stimulus packages

Governments in many countries have presented substantial fiscal policy stimulus packages, which have been supported by the countries' parliaments. Large packages have been presented in China, Japan and the United States, but there is substantial fiscal policy expansion even in a number of European countries. These include Sweden, where there is greater scope, in the form of strong public finances to begin with, than in most other countries. However, it is difficult to determine exactly what effects the fiscal policy measures will have on individual countries and on the global economy. In addition to the positive effects from the recently decided measures, growth is being stimulated by what is known as the automatic stabilisers. This concerns public expenditure linked to the economic situation, for instance, expenditure for support to the unemployed, which automatically rises when economic activity deteriorates. In general, these stabilisers are much more important in Europe than in, for instance, the United States, as the public sector's share of the economy is greater there than in the United States.

Economic activity in the world economy and in Sweden has deteriorated rapidly since the February monetary policy meeting

Rapid deterioration in global economic activity at the end of last year

Global economic activity deteriorated rapidly at the end of last year. GDP fell by around 1.5 per cent between the third and fourth quarters of last year in both the United States and the euro area. GDP fell by around 3 per cent in Japan and by just over 5 per cent in Korea. In Sweden, GDP fell by just over 2 per cent. At the same time, world trade has more or less collapsed. In addition to a decline in demand, world trade is also affected by supply shocks related to funding problems in the form of fewer trade credits. A rapid decline in world trade naturally affects a small, trade-dependent economy like Sweden's.

However, there have recently been some positive signals abroad

Around a month or so ago it was difficult to see any positive tendencies at all in the world economy. However, since the end of March the situation has brightened marginally as the bad news has been followed by some positive news. In the United States a number of confidence indicators are pointing upwards, there are some signs of stabilisation in the housing market and in household consumption. It is as yet too early to talk of a stabilisation in the US economy, particularly given that the labour market is continuing to weaken rapidly. However, there are signs that the rate of the downturn may be slackening.

The Riksbank cut the repo rate further in April to attain the inflation target and to counteract the fall in production and employment

Weaker growth is predicted

The economic downturn in the world and in Sweden at the end of last year was greater than expected in the February Monetary Policy Report. Indicators point to developments still being weak at the beginning of the current year. There are still risks that the development of the global economy will be weaker than the Riksbank is predicting as a result of self-reinforcing contagion effects between the weak real economy and undercapitalised financial systems. It is also important to remember that different countries have different capacities and willingness to resolve the problems in the financial sector. They have also been affected to different degrees by the decline in world trade. The countries that have quickly taken concrete measures will probably come out of the recession first. This indicates that the recovery will not be synchronised.

In Sweden we are now assuming that GDP will fall almost as much as during the crisis in the 1990s. At that time the crisis was domestically-generated with financial imbalances, high nominal interest rates and an overvalued currency. On this occasion much of the disruption comes from outside. Public finances are in a good condition to begin with, interest rates are low and we will probably continue to have a current account surplus. At the same time, exports are declining rapidly, which has negative repercussions on investment. Household consumption is subdued by the deterioration in the labour market and an increase in precautionary saving. The outcomes and confidence indicators in recent months emphasise the weak developments.

The recession is assessed to be unusually deep, which affects the supply of credit. Although corporate borrowing is still increasing, loan terms for companies have been tightened. There are also signs that there has been some substitution from market borrowing to bank borrowing. It is the larger companies that are experiencing the biggest problems with funding in the market and taking up a rising share of bank loans, which contributes to smaller companies seeing themselves at a disadvantage. There are now clear risks that increased credit losses will subdue the banks’ lending to companies. There is also a risk that small and medium-sized companies will be pushed aside.

Funding difficulties and weak international demand have led to companies revising down their investment plans.

All in all, this points to the Swedish economy being weaker than was expected in February. It means that resource utilisation will be lower than normal during 2009-2011. This entails a risk that inflation could be lower than the monetary policy target. In addition, inflation expectations have fallen and are slightly below 2 per cent two years ahead.

The repo rate and the repo rate path need to be lower to counteract the weak resource utilisation and inflationary pressures. This is why the repo rate was cut to 0.5 per cent and the Riksbank considers there is some probability of a further cut in the future. The future repo rate path has also been lowered and the interest rate forecast now points to a very low repo rate during a relatively long period of time. The repo rate is expected to remain at a low level until the beginning of 2011.

The economic policy measures that have already been taken and are expected to be taken in the future will contribute to a recovery abroad and in Sweden as the global financial system begins to function better. At the same time, a weak krona stimulates the economy. GDP growth is expected to be positive but relatively low in 2010. However, the labour market will lag behind and employment will not begin to rise until 2011.

Inflation measured in terms of the consumer price index will fall very rapidly in 2009. This is primarily because the Riksbank's substantial interest rate cuts at the end of 2008 and the beginning of 2009 reduced households' housing costs. If the effects of unchanged mortgage rates are excluded, inflation will develop in a more stable manner and be close to the target of 2 per cent for most of the forecast period. It is weak productivity developments and the weak krona that will contribute to holding up inflation despite the economic recession.

If the Swedish economy risks deteriorating more than expected, it may be necessary to implement further unconventional measures

The future direction for monetary policy will depend, as usual, on how new information on economic developments abroad and in Sweden will affect the prospects for economic activity and inflation in Sweden.

If the economic situation deteriorates further it is possible to use monetary policy easing to further stimulate the economy. But there are also reasons for further consideration of what is an appropriate level for the repo rate. If the repo rate were to become too low the transmission mechanism might become less effective. This is because some market rates are lower than the repo rate. When the repo rate approaches zero, these interest rates would no longer be able to follow. A too low repo rate could also create costs in the financial sector as the result of, for instance, a reduction in the banks' margins. There is thus a risk that the functioning of the financial markets will deteriorate if the repo rate is cut further. In this case monetary policy will not have the intended effect.

However, the Riksbank can stimulate the economy further in other ways without needing to cut the repo rate to zero. The most important measure concerns ensuring that the real interest rate, that is, the repo rate adjusted for inflation expectations, is sufficiently low. This can be done by influencing inflation expectations, which is made easier as we have a numerical inflation target and we publish forecasts for both the inflation rate and the repo rate. We can, for instance, announce that we are going to hold a low repo rate for a longer period than we assumed at the monetary policy meeting in April and show how the inflation path will then approach 2 per cent more quickly than otherwise. This would raise inflation expectations.

A further possibility would be for the Riksbank to contribute to pushing down the rate on government bonds, housing bonds or commercial paper by purchases in these markets. There may also arise a portfolio balance effect if other market participants' demand for corporate bonds, for instance, were to rise as a result of the Riksbank's purchase of government bonds. However, there is reason to await a more detailed analysis of the need for, and possibilities with, these measures. There are also a number of legal issues surrounding this type of measure that must be taken into account before such measures are implemented.

At the most recent monetary policy meeting I did not consider that it was yet time to do anything other than cut the repo rate. What the Riksbank must consider further ahead is whether economic developments require further interest rate cuts and whether the current monetary policy then needs to be supported by more unconventional methods. We must be prepared to be able to implement an alternative monetary policy if developments should so require. However, one should be aware that the situation in the financial markets differs in different countries, which means that not all central banks choose to take exactly the same measures.

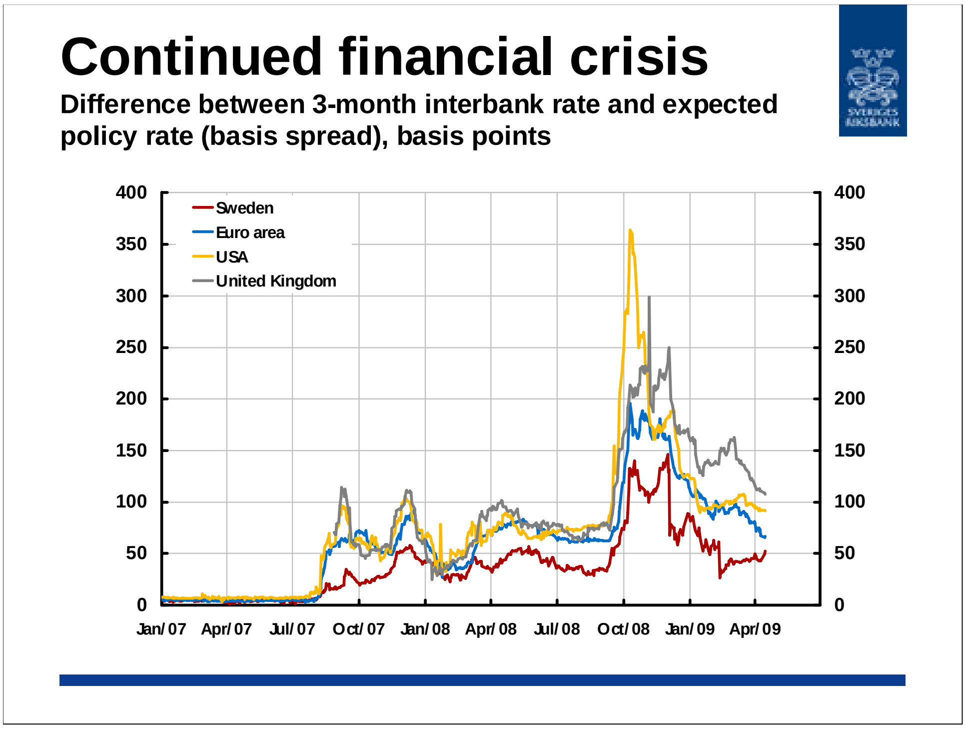
I would also like to mention in this context that the Riksbank is not the only institution involved with regard to managing the alternative measures to improve the functioning of the financial markets. It is important in this situation to analyse the financial structure in Sweden and how one wishes this to look in the future. The measures will to some extent govern the structure of the financial sector when the crisis is over.

There is also a discussion on whether the Riksbank should try to weaken the krona directly in a situation where the repo rate cannot be cut further. I would like to emphasise that such measures are not under consideration.

If inflation risks rising more quickly than expected in the future, monetary policy will have to be tightened sooner than is indicated by the repo rate path

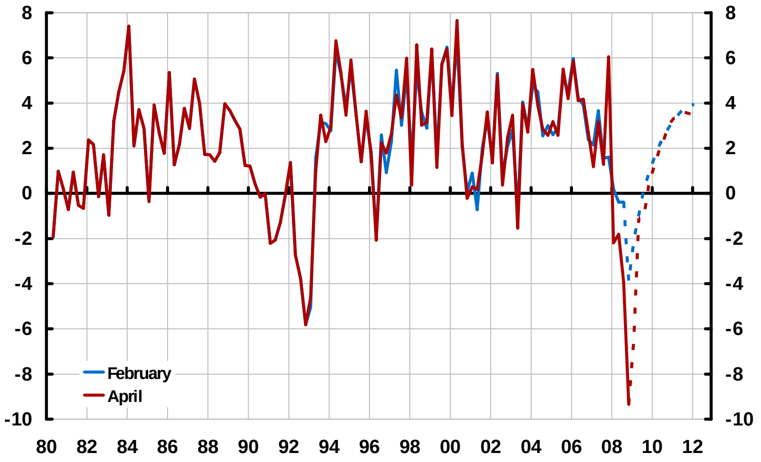
It is important to emphasise that the Riksbank has changed over to very expansionary monetary policy over the past six months. The real interest rate is expected to be very negative throughout the forecast period. This entails a powerful stimulus of the Swedish economy. The discussion is currently dominated by the question of how we should manage monetary policy in the prevailing recession. As monetary policy is forward-looking, it is important not to overlook the potential inflationary impulses now being built in for the future. Price impulses from a weak krona and from high unit labour costs are two such factors. If the global economy recovers more quickly than we are predicting, this will also contribute to making monetary policy less expansionary.

Before further measures are taken, there are thus many reasons to evaluate the effects of all of the measures taken so far, and to evaluate the new information on economic activity and the financial market situation that is received.



Economic downturn worsens in Sweden

GDP, quarterly changes in per cent calculated as annual rate, seasonally-adjusted data



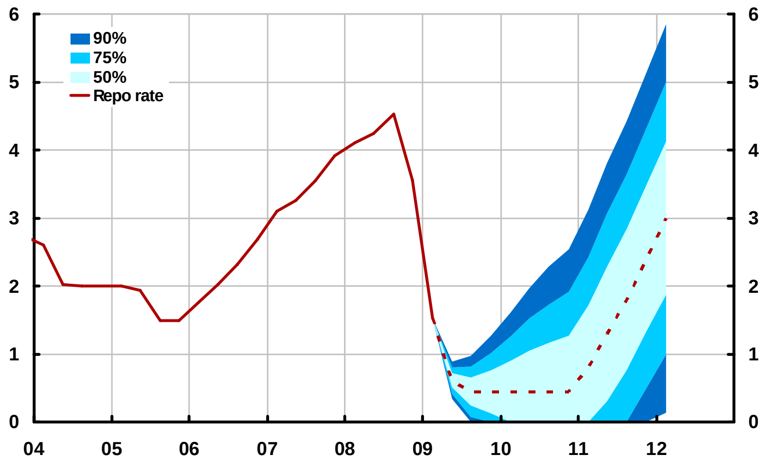
Sources: Statistics Sweden and the Riksbank

Repo rate cut to 0.5 per cent

- Economic downturn worsening
- Low repo rate for long period of time
- Positive growth in 2010

Low repo rate for long period of time

Per cent, quarterly averages



Note. The uncertainty interval does not take into account the zero bound. Source: The Riksbank