Stefan Ingves: Introduction on monetary policy and financial stability

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, before the Riksdag Committee on Finance, Stockholm, 5 November 2009.

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A little more than a year has passed since the financial crisis swept over the Swedish economy with full force. A dramatic year, which, despite vigorous measures by central banks and other authorities around the world, has led to the worst economic recession for many decades. But now the economy is beginning to recover, although it will take time before we are on firm ground again. So where in the crisis cycle do we stand today? How should the Riksbank act to attain the inflation target and to provide support to the economic recovery in the best possible manner? It appears as though the Swedish economy will land on its feet on this occasion, but it is also necessary to keep our balance in the future. This is in many ways a global challenge and a process of change, in which Sweden should play an active role.

When we met here at the Committee on Finance hearing about a year ago, the global financial crisis had quite recently had its major impact on Sweden. The problems mainly originated abroad – through the now cross-border financial markets and through the downswing in the world economy hitting an export-dependent economy like ours particularly hard.

In the very turbulent and uncertain situation prevailing at that time, the main focus was on quickly making a diagnosis and implementing more or less acute measures – “intensive care” if you like. It was necessary to take rapid and forceful action to safeguard financial stability and to minimise the negative effects of the crisis on economic developments in general. For the Riksbank and many other central banks the "normal” tools have not been sufficient to achieve this. But we have adapted quickly, taken out a whole range of complementary tools from our workboxes, and even constructed some new ones!

Now, one year later, the most acute phase of the financial crisis is now hopefully behind us. Although we have not yet climbed out of the trough that turned out to be the worst economic downturn since the war. But there are many indications that we have passed the turning point.

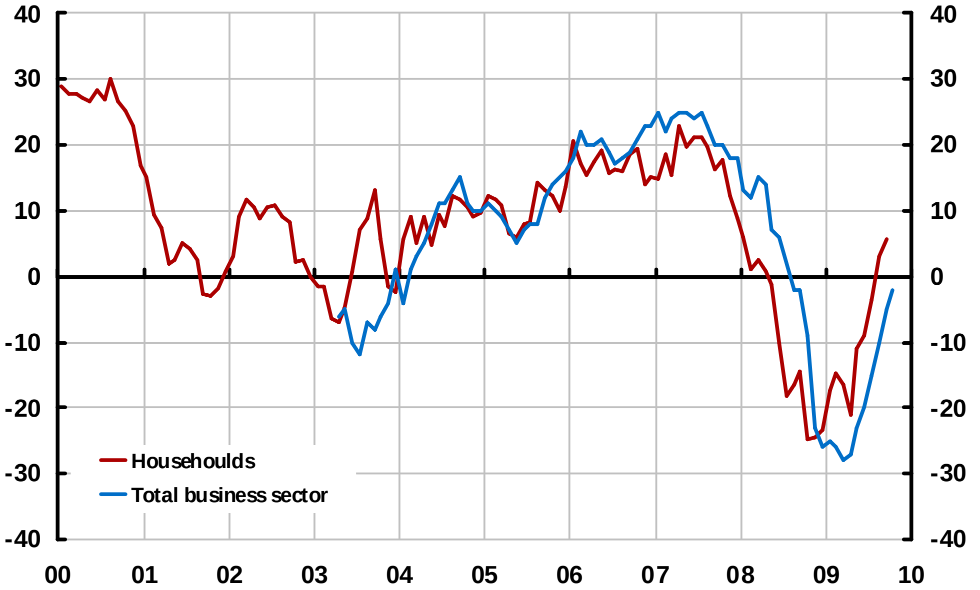
In my speech today I intend to provide a brief status report of where we stand today and how we should to proceed. Are we about to land on our feet? How does the economic situation look today from a monetary policy perspective and what lies ahead of us? What is the outlook for the financial system? Have the “extraordinary” measures taken had an effect and how should they be phased out? Even after we have landed properly it will be necessary to keep our balance. But the road ahead may be difficult to negotiate. So how do we create a better and more sustainable structure for the financial markets both nationally *and* globally?

I do not have the perfect answers to all of these questions. I doubt that anyone has. But I shall spend the next 20 minutes trying to answer them to the best of my ability. And I hope this will provide a good basis for the coming hearing.

Monetary policy and the economic situation

The downturn in the world economy has been very rapid and severe – in this way the worst in many decades. Sweden is an export-dependent economy and has been hit hard partly because of this. It will take time before the economy is back at the same level as prior to the crisis. But now we have come so far that the recovery has begun. One important component to which I shall also return is that the conditions on the financial markets have improved. Several indicators are also showing that confidence in the future among both companies and households has become much stronger, an important factor in the economic recovery (Figure 1).

Figure 1. Confidence indicators, net figures, seasonally-adjusted data

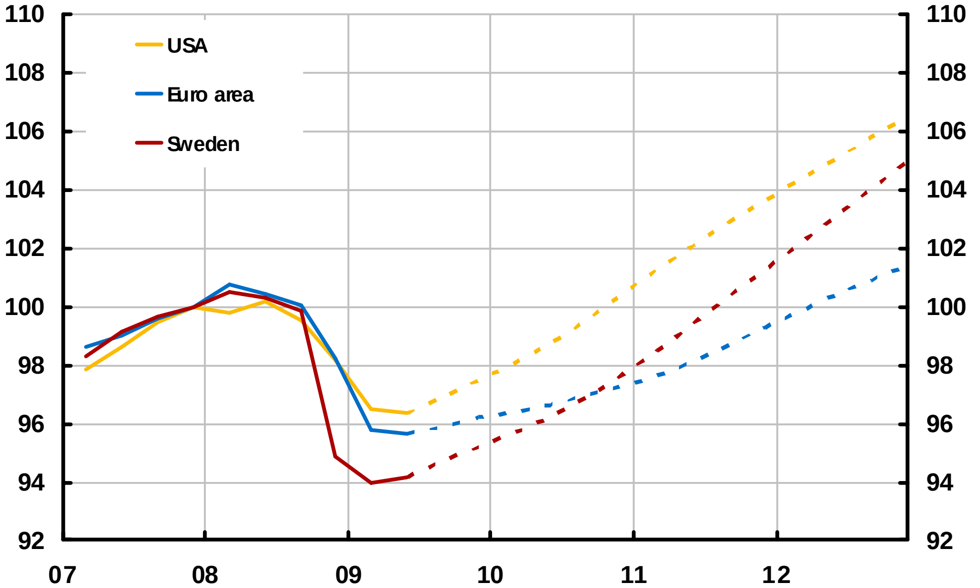


Source: National Institute of Economic Research

The recovery will take time

But although growth will recover during the final two quarters of this year, we believe that GDP in Sweden will fall by more than 4 per cent in 2009. And it will take a long time before the economy is back at the same level as prior to the crisis. 2009 will be the first year since the 1940s in which GDP falls in the world as a whole. But, all in all, there are many indications that the growth rate abroad and in Sweden has bottomed out and will rise in the years ahead (Figure 2).

Figure 2. GDP level, index 2007 Q4 = 100



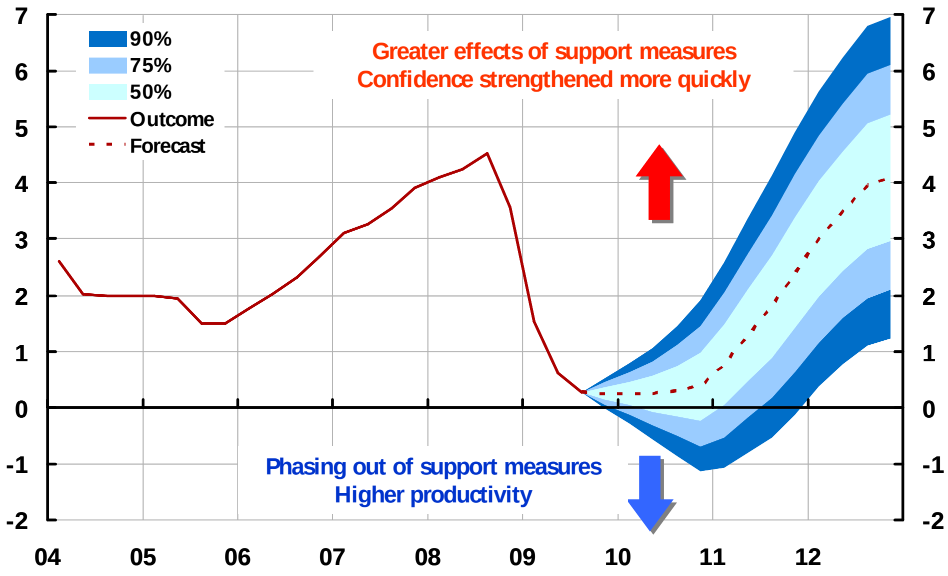
Sources: Bureau of Economic Analysis, Eurostat, Statistics Sweden and the Riksbank.

With regard to the labour market, we are assuming that it will remain weak and that unemployment will continue rising until the end of next year. Employment will not increase until the beginning of 2011. Historically, it is usually the case that employment recovers with some time lag after production has picked up. The weak labour market is expected to hold back wage increases in the central wage bargaining rounds during 2010, which should contribute to lower cost and inflationary pressures. And even if economic prospects look better than we anticipated in our earlier forecast in September, we will have more spare capacity than normal in the Swedish economy throughout the forecast period.

Repo rate low until autumn 2010

The Riksbank has cut the repo rate very substantially over a fairly short period of time, from 4.75 per cent last autumn down to 0.25 per cent in July this year. The largest cuts were made mainly during last autumn and winter. Since February the repo rate has been lower than ever before during the period we have conducted inflation targeting (Figure 3).

Figure 3. Repo rate forecasts, per cent, quarterly averages



Source: The Riksbank

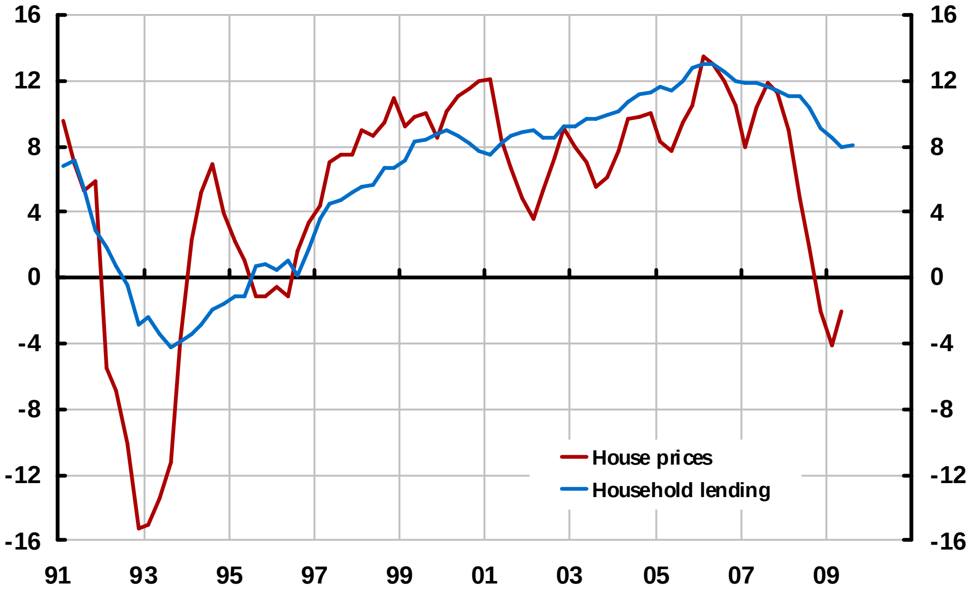
We are currently expecting to hold the repo rate unchanged at a low level for a further period to come, until autumn 2010. This is necessary to contribute to a stable recovery and to attain the inflation target of 2 per cent. Moreover, we Executive Board members decided at the most recent monetary policy meeting that further measures were necessary to contribute to interest rates on loans to companies and households remaining low. We therefore decided to offer the banks the opportunity to borrow from the Riksbank at a fixed interest rate and a maturity of around 11 months. The loan auction was held on Monday this week and the final amount lent was SEK 95.3 billion. We expect the loans to the banks to complement the repo rate tool in a way that enables monetary policy to have the desired effect.

Once economic activity has recovered, we are intending to raise the repo rate to more normal levels. This is necessary to ensure a balanced economic development and an inflation rate in line with our target. Our repo rate forecast is exactly that – a forecast, not a promise. But it is nevertheless important that anyone borrowing money to buy a home or for other reasons should include a sufficient margin, taking into account that today's low interest rates will not last for ever. Let me linger a bit with the housing market and interest rates as these subjects have much discussed recently.

Monetary policy and house prices

One issue that has been taken up, not least in the media, is that the policy we are now conducting could possibly contribute to a further rise in house prices, despite the weak economic activity. This could in turn increase the risk of imbalances arising in the housing market. It is true that the Riksbank's policy, by affecting interest expenditure, has significance for the way housing prices develop, although many other factors are also important. But the policy we are currently conducting is what we consider to be necessary to attain the inflation target and to provide sufficient support for the recovery in the Swedish economy. We cannot adapt monetary policy on the basis of individual markets as long as we do not regard this as something that affects our ability to meet the inflation target and to safeguard financial stability. But this does not mean that we do not care about house price movements. On the contrary, we closely follow developments in the housing market.

Figure 4. House prices and lending to households, annual percentage change



Source: Statistics Sweden

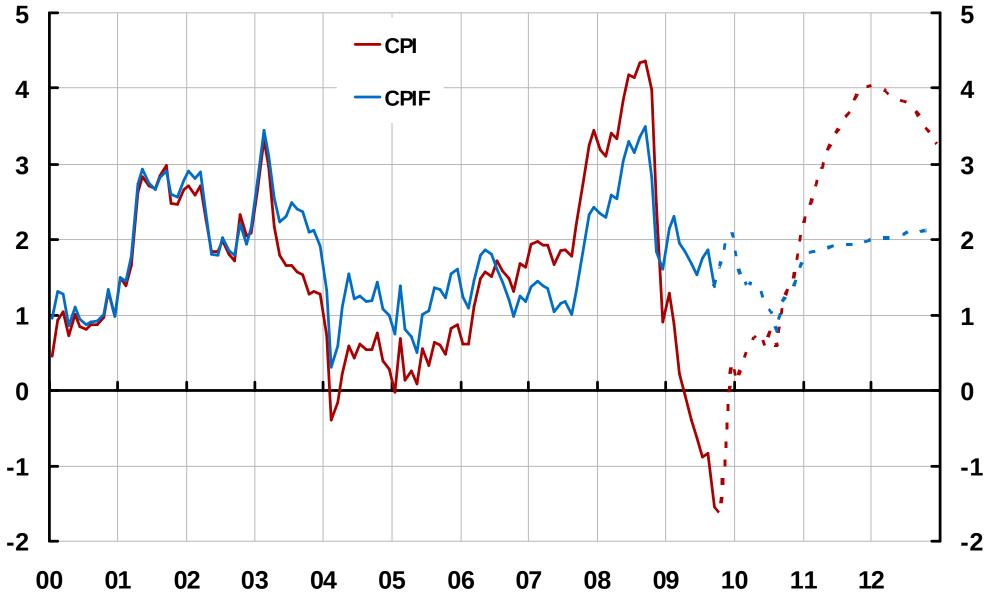
In the long term it is hardly sustainable that house prices should continue to rise as quickly as they have done since the mid-1990s (Figure 4). Since 1996 house prices have increased by around 8 per cent a year. But in the shorter term, our assessment is that there is no reason for the Riksbank to give greater consideration to house prices than we already do in our forecasts for the economy.

Let me just add something that may not arise very often in the general debate on these issues. Although interest expenditure is one of the factors that has significance for the way house prices develop, the responsibility for sustainable growth with regard to lending and house prices is largely beyond the Riksbank's control. Monetary policy can probably only function as a complement to effective regulation and supervision. And there are many factors that are important in ensuring a balanced development in the housing market. One fundamental factor is that households endeavour to make realistic calculations of how much interest expenditure and amortisation they can manage in the long run, not only when interest rates are as low as they are now. Something that can be said to be the flip side of the same coin is that the banks make responsible credit assessments when lending money. If these two basic components are in place, there is a good chance of avoiding an out-of-control situation further ahead, although as I said before there are many other factors that may be important. Finansinspektionen (the Swedish Financial Supervisory Authority) carries out very important work here in that they monitor developments in the banks and credit institutions and are prepared to take action if they consider it necessary.

Underlying inflation stable around target of 2 per cent

The impact of monetary policy on households' living costs is something that creates large fluctuations in CPI inflation during the forecast period (Figure 5). The fact that the repo rate has been cut heavily over the past year has contributed to a rapid fall in CPI inflation, as changes in households' mortgage expenditure are included in this index. With effect from autumn 2010, however, the repo rate is expected to rise relatively quickly, which will correspondingly mean that CPI inflation will be close to 4 per cent at the beginning of 2012. On the other hand, one can use a measure of underlying inflation, the CPIF, which excludes the direct effects of the repo rate on mortgage rates. Measured in terms of the CPIF, we expect inflation to be much more stable and to be close to 2 per cent for most of the forecast period.

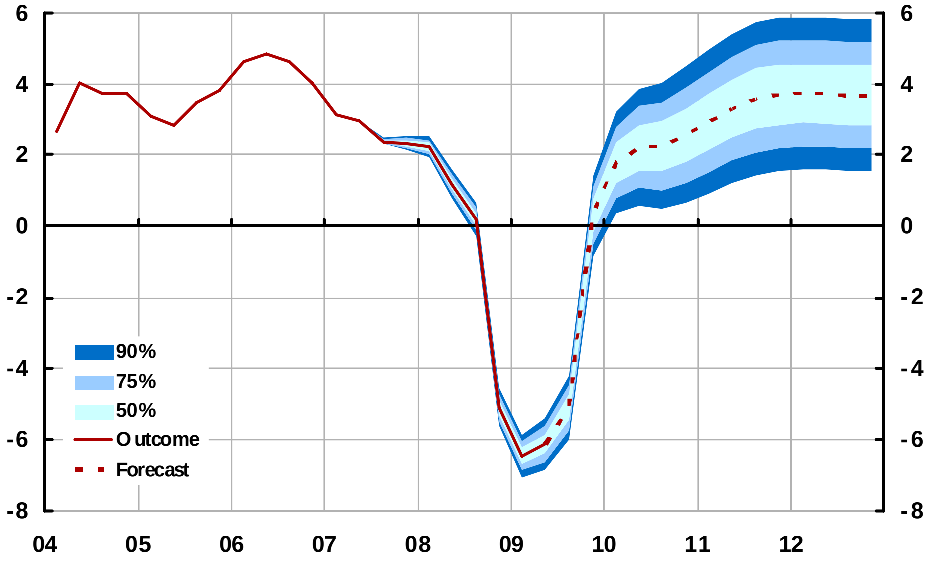
Figure 5. Inflation measured in terms of the CPI and the CPIF, annual percentage change



Sources: Statistics Sweden and the Riksbank

There is still considerable uncertainty surrounding future developments (Figure 3). It is possible that the improved situation in the financial markets will contribute to a faster recovery in the world economy than we are expecting in the main scenario of the Monetary Policy Report. On the other hand, the recovery may be slower than expected when the fiscal policy stimulation packages around the world are gradually phased out. There are many potential risks along the way. But our forecast is that if we hold the repo rate low up to autumn 2010 and then begin raising it, this together with other measures will contribute to a stable recovery and mean we attain the inflation target of 2 per cent.

Figure 6. GDP with uncertainty bands, annual percentage change, seasonally-adjusted data



Sources: Statistics Sweden and the Riksbank

I and my colleagues on the Executive Board want the growth curve to look like a "v" when the economy recovers after the recession, as in the figure with our forecast for GDP growth, and not a "w" (see Figure 6). Having said that, let me just briefly comment on my own view of monetary policy as expressed in the minutes of our most recent monetary policy meeting. As I see the situation with regard to the Swedish economy, it is more important to allow some safety margin for a weaker outcome than for a stronger outcome. In my opinion, it would be more problematic if the recovery ground to a halt because we had provided too little stimulation than if we were later forced to put the brakes on a little harder than expected.

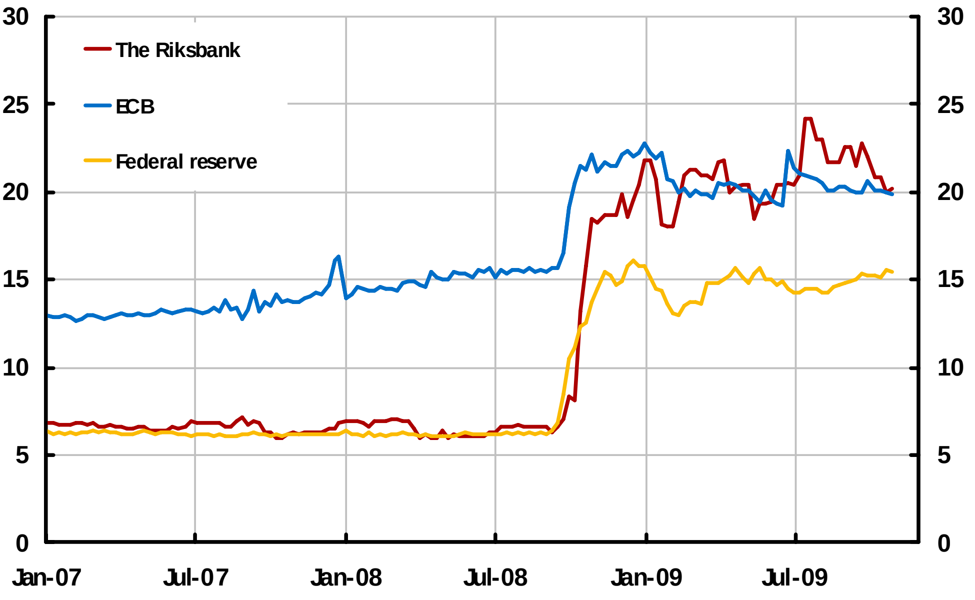
So where do we stand with regard to the financial system?

Where we stand in terms of the economic cycle is to some extent connected to developments in the financial markets. The second part of my status report therefore concerns where we stand in the crisis cycle with regard to the financial system, how the so-called unconventional measures we have taken appear to have worked and how we look upon them in the future. But, before we go on to this – let me give you a brief summary of the "extraordinary" or "unconventional" measures taken as a result of the financial crisis and its effects.

"Extraordinary" or "unconventional" measures…

When the international financial turmoil escalated into a worldwide crisis in September last year, many countries found it necessary to dig much deeper than usual into the economic policy toolbox to find partly new methods and tools. Governments, central banks and other authorities around the world have taken extensive measures to recreate confidence in the financial markets, to maintain financial stability and to counteract the negative effects of the crisis on economic activity. The central banks' measures, such as lending to the banks, are reflected in the fact that their balance sheets have increased substantially during the crisis, as can be seen in Figure 7.

Figure 7. Central banks' balance sheet totals, percentage of GDP



Sources: Bureau of Economic Analysis, Eurostat, Statistics Sweden and the respective central banks

As we have discussed earlier, the Riksbank has also implemented unconventional measures – measures in addition to the policy we would probably have conducted under more normal circumstances. The effects of these measures are in many cases similar, which means that it is difficult to compartmentalise them. However, even if the boundaries are not razor-sharp, it is possible to divide them up according to their basic purposes. There are measures which are explicit monetary policy measures with the aim of stimulating demand in the economy further – since the repo rate is close to zero, the possibilities to use the "traditional" interest rate tool are limited. There are also measures that have been implemented to safeguard financial stability.

…to attain the inflation target...

To attain the inflation target, it has been necessary to make use of new tools to get the financial markets functioning better, to increase the access to loans and to try to bring down various interest rates and risk premiums that have counteracted monetary policy. One example is that we have clearly communicated that we assume that the repo rate will remain at 0.25 per cent for a fairly long period of time. In our most recent forecast the repo rate remains around this level until autumn 2010. Another measure is that the Riksbank lends money to the banks at longer maturities than normal. The purpose is to contribute to continued lower interest rates on loans to companies and households. As I mentioned when I described the economic situation, we decided at our monetary policy meeting two weeks ago to supplement the low repo rate with such a loan.

…and to safeguard financial stability.

The measures implemented to safeguard financial stability have similar effects, but the fundamental aim is different. The intention has mainly been to make it easier for the Swedish banks to manage their short-term and medium-term funding. Particularly during the most intense phase of the crisis it was difficult for the banks to borrow other than at very short maturities. It may also be necessary to help financial markets that have suffered serious disruptions to function more smoothly. One can say that the Riksbank has functioned as an intermediary in the bank system – a function that the market does not normally require. One example in this area, too, is the loans offered to the banks at longer maturities, in both Swedish kronor and US dollars. Another example is that the Riksbank has entered into what are known as swap agreements with the Fed and the ECB, which means that if necessary we can borrow dollars or euro in exchange for Swedish kronor. This type of swap agreement is, put simply, an agreement to buy a currency at a particular time and to sell it back at a later date. A further measure is that we accept more types of security as collateral when the banks borrow money from the Riksbank. Moreover, the Riksbank has in different contexts extended the list of eligible counterparties so that more financial agents will have the chance of easier management of liquidity and funding.

Need to coordinate?

"Exit strategy" is a buzzword that has been used for a while now. There is currently much discussion on how and when the measures taken around the world during the financial crisis are to be phased out. One question that is highlighted is that international coordination might be necessary for some of these processes.

Some of the discussion concerns timing and how "aggressive" one can be when slowing down the powerful stimulation from fiscal and monetary policy. If one eases up on the stimulation too soon and too hard, it may jeopardise the economic recovery. If one instead eases up too late and too little, there is a risk that inflationary pressures will be too strong. Here I believe that every country must make its own assessment, as conditions differ in different countries. One factor that could become important is that the stimulation from fiscal policy has put a lot of pressure on government finances in many countries. It might well be that countries with a high national debt will be forced for budget reasons to change their fiscal policy sooner than they desire. This could be a risk that hampers the economic recovery, in the worst case for the world economy as a whole.

There are also individual differences to take into account when coordinating the phasing out of the extraordinary measures taken to safeguard financial stability. The situation looks different in different countries and it is not certain that everyone is prepared to throw away their crutches at the same time. When it comes to phasing out the support to the bank sector, however, there is reason to coordinate the measures as far as possible. Otherwise the competition between banks in different countries may be distorted, which was an issue discussed when some countries introduced support measures at an early stage.

Phasing out measures not so complicated for the Riksbank

So how does the Riksbank intend to phase out its extraordinary measures in the cases where the changes should not become permanent solutions? Some measures will in principle phase themselves out. The loans in US dollars from the Riksbank to the Swedish banks have actually already phased themselves out to some extent. The demand for dollar loans from the Riksbank has disappeared as the market has begun to function better. The mechanism is largely the same for the loans in Swedish kronor at longer maturities, which are offered at the repo rate plus a certain premium. By regulating the premium the Riksbank determines how attractive the loans will be compared to the conditions prevailing in the market.

The diagnosis that a measure is no longer needed may be difficult to make. Although, for instance, the demand for a particular type of loan may have disappeared, the fact that there is still a possibility to borrow may have a stabilising effect. We will not be in too much of a hurry. And there are at least two items we need to be able to cross off the list before we begin phasing out the measures. We must be able to say with a good degree of certainty that the situation in the financial sector is stable and that it can function normally without support. We must also be in a situation where we expect to be able to attain the inflation target and stimulate the economy sufficiently without the unconventional measures.

There are other measures that require more active decisions by the Riksbank to be phased out. For instance, the number of counterparties allowed to participate in fine-tuning operations and the list of securities accepted as eligible collateral for credit from the Riksbank. However, it is not self-evident that these measures will actually be phased out. These are questions of a more technical nature that we will examine further before it is time to make a decision.

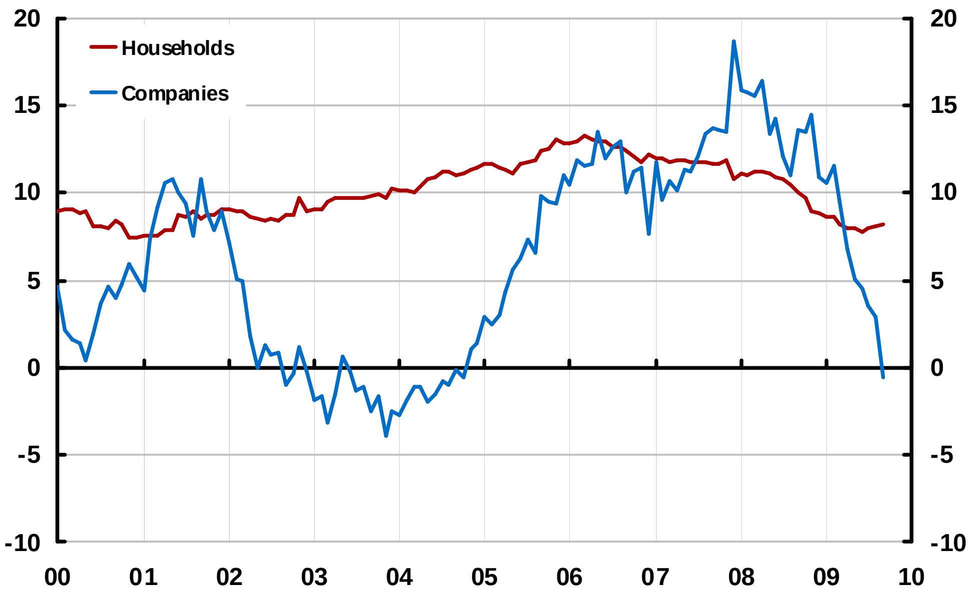
Have the extraordinary measures had an effect?

So have the extraordinary measures had an effect? It is difficult to say exactly what has affected the economy and in what way during a period when so much has happened, and so quickly. But certainly there are signs that the situation has improved.

A more general observation is that lending in the Swedish economy does not seem to have been tightened more than can be expected in a recession. The fact that confidence between different participants in the financial markets more or less completely drained away at the beginning of the crisis raised concern over a potential credit crunch. If the banks themselves experience funding problems, this could ultimately lead to a much more severe contraction in the supply of loans to households and companies than would normally occur in an economic downturn. This could in turn further worsen the economic situation, which we neither wished nor wish to see.

But it appears as though the measures taken to restore confidence in the financial markets, together with the substantial cuts in the repo rate, have had the right effect. The opportunities to borrow in the market are relatively good, both for large companies and for banks. The Riksbank's company surveys and the National Institute of Economic Research's Business Tendency Survey also indicate that the funding situation has improved. Financial market statistics show that lending to households via banks and credit institutions is increasing, but at a slower rate than before (Figure 8). Lending to companies is declining, but not by very much considering that we are in a recession.

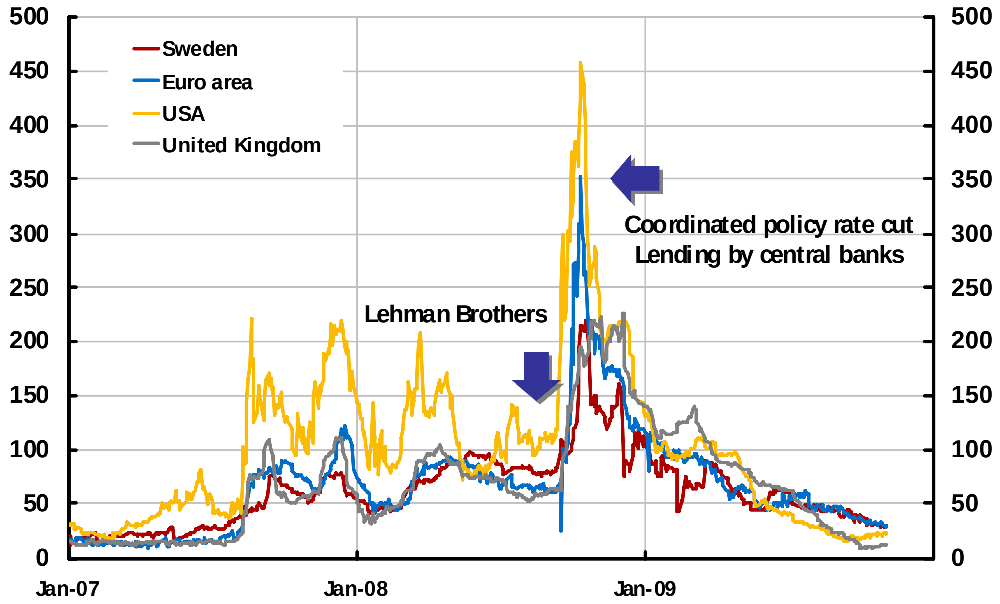
Figure 8. Households' and non-financial companies' total borrowing from credit institutions, annual percentage change



Sources: Statistics Sweden and the Riksbank

If we look at the conditions in the financial markets from an interest rate perspective – in terms of price instead of volume – they have become less strained during 2009. This can be seen, for instance, if one looks at what are usually known as TED spreads – the difference between the interbank rate, where the banks lend to one another, and the government bond rate, both with a maturity of three months (Figure 9). The TED spread can be regarded as an indicator of confidence between the banks. One can say that this is a premium that reflects liquidity risk, credit risk and the demand for safer assets. The demand for government securities tends to increase during times of financial market turmoil.

Figure 9. TED spread, basis points



Sources: Reuters EcoWin and the Riksbank

Both in Sweden and in other countries the TED spread rose substantially when the crisis became acute in connection with Lehman Brothers filing for bankruptcy last autumn. Since then it has gradually fallen, although it is still above the levels that prevailed prior to the crisis. This indicates greater confidence between the banks. The total measures have probably had considerable significance. In particular, the large injections of liquidity that come from the central banks still lending large amounts to the banks should contribute to reducing the TED spread.

Yes, although we are not yet on solid ground!

For part of my professional life I have come to work with managing financial crises in different parts of the world, both here in Sweden and for the IMF. I know that it is difficult to say exactly where in the course of the crisis an economy is at a particular point in time and how fast the recovery will be. The financial system is functioning better, but we cannot say with any certainty to what extent the recovery is still dependent on support measures from various authorities. We still have, for instance, outstanding loans to the banks of around SEK 385.3 billion. The financial markets are approaching normality. It is actually difficult to say exactly what can be regarded as “normality”, but I would like to emphasise that in several cases it should mean a situation where the price of risk is higher than it was prior to the crisis. It is fairly natural that someone investing their money should want compensation for taking a risk. And the price of risk was unrealistically low in many cases prior to the crisis. The same applies to the investors’ impression of how much risk they were exposing themselves to. It is therefore possible that what is counted as normal in the future with regard to risk will entail slightly higher interest rates with a given repo rate.

The need for the authorities' measures will decline as conditions in the financial sector improve and the world economy shows clearer signs of a recovery. But the risk of further complications arising cannot be ruled out. One example is the uncertainty over how the severe recession in the Baltic countries and eastern Europe will affect the Swedish banks' loan losses. However, if all goes well and the situation remains stable, then it is time to move on without support. But we are not there yet.

How shall we keep our balance in the future?

In a financial crisis most of what is not built on stable foundations and does not have a robust structure is washed away. But when the situation has calmed, we have the chance to build up something new that will work better than that which failed the trials. We have this chance now.

We must take part in the change work

Keeping our balance once we have landed on our feet will require reforms with regard to legislation and supervision. Difficult and important challenges lie ahead of those of us who work with these issues – the central banks, the financial supervisory authorities and the legislators. Here Sweden must take on the challenge and play an active role in the international discussion. And it is necessary to act quickly. The reform work has already begun. Within the EU a new supervisory structure is being built up with regard to banks, insurance, securities and systemic risk. The new body, the European Systemic Risk Board, ESRB, will play an important role in this.

Change is required in a number of different areas. The most recent crisis has demonstrated how a liquid market can very quickly dry up and become illiquid under certain conditions. Tougher rules are required regarding liquidity and the buffer that banks and credit institutions need to be able to withstand shocks. Further consideration is required here before we find a good solution. It is also necessary to develop further the analysis of asset prices and how the financial markets can be better integrated into our models and forecasts. This applies both with regard to the work on financial stability and the work on monetary policy.

The supervision map is being redrawn

A further area for reform concerns the supervision of the financial system as a whole, and the possibility to take measures when risks to the stability of the system are detected. The central banks often have both the responsibility and the best resources to analyse such systemic risks, as they are called. But they usually do not have particularly sharp tools for dealing with them. In most cases the central banks must rely on being able to affect unsatisfactory states of things by providing information and warning of risks. But when times are "good" on the financial markets, it may be difficult to get anyone to listen to this type of warning. Before the crisis broke out, for instance, the Riksbank warned in several speeches and reports that there were risks regarding developments in the Baltic and risks connected with low compensation for risk in the financial markets. And we were not the only ones to point out these risks. But the market participants did not pay sufficient heed to the warnings. The crisis has shown that there must be an opportunity to put greater force behind the words if warnings are to have any effect.

The tools for exercising greater pressure may entail, for instance, changing the requirements regarding an individual bank or several banks if necessary. But such tools are not usually at the disposal of the central banks; they are held by the financial supervisory authorities. The problem is that these supervisory authorities often do not have the task of supervising banks and other financial agents from a system perspective at “macro level”. They more often examine the individual participants at “micro level". This task is of course very important. However, there may be systemic risks that need correction, but which are not evident when individual banks are examined separately.

The recent crisis has clearly shown that supervision is necessary, and also the opportunity to take measures at both micro level with regard to individual participants and macro level from both a national and an international systemic perspective. The financial supervision map is being redrawn. Bearing in mind the experiences of the recent crisis, I believe for instance that the Riksbank and Finansinspektionen will work more closely together than before. Greater cooperation between the authorities is one part of the solution, but I believe that the central banks also need to have slightly “sharper teeth” – more and sharper tools in this area.

Cooperation and trust

When it comes to handling and preventing a global crisis like the one we are currently emerging from, something more is needed, namely trust. This is required to improve cross-border crisis management and to create effective cooperation between authorities even in an emergency. Trust can also be a key factor in preventing a crisis from occurring at all. It is not enough for individual authorities and countries to take action when the banks’ playing field is the entire international arena. The scope of the crisis on this occasion was connected to the financial markets’ national boundaries largely being erased. But the cure in this case concerns, as I see it, meeting globalisation with globalisation. More cross-border cooperation is required, and perhaps using different methods than before.

Landing on our feet and keeping our balance in the future

Let me conclude by saying that I have every hope that we will land firmly on both feet when this crisis is over. There are many things that have been out of balance around the world. And the longer the imbalances are allowed to continue growing, the larger the fall will be when one finally loses one’s footing. We have been hit by a financial crisis that is without precedent in a global context. We have been hit by the worst recession since the Second World War. The recovery will take time, both with regard to the financial system and the economy in general. But it has begun, even if there is considerable uncertainty over future developments and there are many risks lining the path.

Once we have regained our balance we must keep it. Creating the right conditions for this is a difficult but important task. It involves the work on both financial stability and monetary policy. It involves extensive reforms and cooperation between central banks and other authorities around the world. We must tackle this task not only at a national level, but also from a global perspective. The work has already begun, and we are in a phase of the crisis where there are good prospects for achieving change. It is now that we have the chance to really create something that will last and will work better. We must not miss this opportunity!