

Stefan Ingves: Evaluation of the Riksbank's monetary policy and work on financial stability 2005–2010

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision, to the Riksdag Committee on Finance, Stockholm, 31 August 2011.

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The Riksdag (the Swedish parliament) and the people of Sweden must be able to see that the Riksbank is doing its job well. It is therefore necessary for them to have good insight into our work and for the Riksdag to be able to make regular evaluations of this work. The evaluations are also important for the Riksbank to be able to develop and improve its analyses. We have already said on several occasions that we consider it an excellent initiative by the Committee on Finance to regularly commission highly-qualified external experts to evaluate our work. Today, when we are to discuss the second evaluation of this type, I would therefore like to begin by thanking Professors Goodhart and Rochet for carrying out this work on behalf of the Riksdag Committee on Finance.

We also welcome the Committee on Finance's decision to give the evaluators the task not only of assessing how we conduct monetary policy, but also how we manage the task of promoting a safe and efficient payment system, that is, what we have interpreted as our responsibility for financial stability in Sweden. We at the Riksbank prefer to present our more detailed views on the evaluation during the consultation rounds, so today I intend to make a few more general comments.

Regarding financial stability – we need clear legislation and efficient institutions

I do not believe that anyone would still doubt that the risk of a financial crisis is a very real risk that we must learn to live with and to manage in the best possible way. It is probably also quite clear what is at stake here – a financial crisis could entail substantial costs for society. We must therefore learn from the experiences of the crisis and ensure that we are as well-equipped as possible to face any new crises in the future. This requires in an initial stage taking an overall approach to both crisis management and crisis prevention work, something that the government's recently-appointed financial crisis commission has been tasked to deal with. Ultimately, the goal is to establish effective legislation and efficient institutions.

The financial crisis that we have lived with over the past few years has tested institutions and legislation to breaking point, in Sweden and abroad. This has highlighted some old weaknesses in the legislative framework, and we have also discovered some new deficiencies. Even before the Committee on Finance's evaluation was published, the Riksbank pointed out a number of weaknesses that require attention in a proposal to the Riksdag.¹ It is therefore gratifying that Goodhart and Rochet clearly point out largely the same weaknesses.

The evaluation has had greater scope to discuss these weaknesses in more detail than was possible in the Riksbank's proposal, and it also highlights a number of important principles as to how one can conduct and organise the financial stability work. I believe that these arguments in particular can provide a valuable contribution to discussions in Sweden and to our own development work at the Riksbank, but perhaps most of all to the work of the financial crisis committee.

¹ Proposal to the Riksdag 2009/10:RB4, "Proposal regarding certain areas that require investigation as a result of the financial crisis". (<http://www.riksbank.se/templates/Page.aspx?id=43390>).

Something I consider to be quite crucial in this context is that we do not create institutions that lack the necessary power to make decisions. By this I mean that in all parts of the work on preventing and managing financial crises we should have some institution that is clearly responsible and this institution should also have the necessary mandate, tools and resources to handle this responsibility. When it comes to putting this into practice I believe that Goodhart's and Rochet's more theoretical reasoning regarding allocation of responsibility and institutional solutions could be very useful. But, as they are also careful to point out, the principles they discuss must be implemented in a way that suits each country's individual characteristics. And each country must find its own way.

Regarding monetary policy – even uncertain forecasts have some value

When it comes to monetary policy, we are pleased at Goodhart's and Rochet's conclusion that the Riksbank has discharged its fundamental duty – to conduct a policy of flexible inflation targeting – well. As I mentioned earlier, we will return with more in-depth views on the evaluation during the coming consultation process, but I nevertheless intend to take this opportunity to say a few words about some of the recommendations put forward.

One recommendation in the monetary policy areas is that we at the Riksbank should in future express a little more “self-doubt” when putting forward our proposed paths for policy rates. We can achieve this either by a greater emphasis on the uncertainty of interest rate forecasts, or by basing them beyond some horizon on some formula that incorporates the market yield curve. The reason given for this recommendation is that there is no real information in interest rate forecasts that extend further than a couple of quarters ahead.

We at the Riksbank are well aware of how uncertain interest rate forecasts are in the longer run and we have therefore endeavoured to draw attention to this uncertainty. We have done so, for instance, by publishing uncertainty bands around the interest rate paths and by repeatedly emphasising the fact that the repo rate path is a forecast and not a promise. Of course we can make further efforts to point out the uncertainty of these forecasts if necessary, but we believe that the market and the general public have already understood that the forecasts are uncertain in the longer run and should therefore be taken with a pinch of salt. One indication of this, which Professors Goodhart and Rochet also point out, is that “the market seems to have retained a, healthy, scepticism whether the official projections would be realised” during the period we have been publishing a repo rate path. This applies in particular to the period following the global financial crisis, when there was extreme uncertainty surrounding all of the forecasts.

However, the fact that interest rate forecasts in the longer run are uncertain does not mean that we should not make such forecasts. And when we make our own interest rate forecasts we should also publish them. By publishing these forecasts we can explain more clearly to the general public and the market how we view future developments and how we reason when making our monetary policy decisions. I find it difficult to see how this could be harmful.

To instead base long-term forecasts on market expectations of the policy rate is a method we have already tried and decided to abandon. If we use market expectations of the policy rate as a starting point, it may be difficult to determine how the interest rate is connected to other developments in the macro economy. Our own forecast for the interest rate has the advantage that it is produced together with the forecasts for GDP, inflation, employment and so on. Moreover, market expectations can vary substantially over time, which can lead to the information content in the macro forecasts as a whole declining.

The evaluators also consider that the Riksbank's schedule for the different stages in the monetary policy process does not correspond to how the forecasting and policy-making work is carried out since the new repo rate path was introduced. In their view, the changes have meant that, in practice, the actual interest rate decision has been brought forward. They therefore recommend that the Riksbank should announce the monetary policy decision and

interest rate path earlier, namely directly after the meeting of the Executive Board that is held a couple of days after the second monetary policy group meeting.

However, we consider this proposal to be difficult to implement. Although the analyses and forecasts are largely complete by the second monetary policy group meeting, the monetary policy decision is made at the monetary policy meeting and not before then. Any reservations against the decision are put forward at this meeting, too, and not earlier.

In conclusion, let me once again thank Professors Goodhart and Rochet for their valuable contribution to our continued work on both monetary policy and financial stability. We will have many opportunities during the course of this work to discuss with the Committee on Finance how we can develop and improve our analyses.