Kerstin af Jochnick: Monetary policy and macroprudential policy

Speech by Ms Kerstin af Jochnick, First Deputy Governor of the Sveriges Riksbank, at a meeting at Länsförsäkringar AB, Stockholm, 25 January 2013.

*   *   *

Today I intend to talk about monetary policy and the new policy area, macroprudential policy, and how these two areas are interlinked. My message today can be summed up in a few points. First: in the absence of a clear framework for macroprudential policy, we have taken into account in our monetary policy the risks linked to the high level of household debt in Sweden. This is because we have wanted to avoid the consequences that many other countries have experienced as a result of high indebtedness and falls in house prices. Second: I believe that macroprudential policy, once it is up and running, will be in a better position than monetary policy to manage these risks, as it offers tools that are more effective than the repo rate for these purposes. Third: The Riksbank has an important role to play in macroprudential policy in Sweden, partly because we have long conducted analyses in this field, and partly because there are strong points of contact between monetary policy and macroprudential policy.

The Riksbank has two main tasks: price stability and financial stability. I think that a clear and efficient framework for macroprudential policy – where the Riksbank plays an important role – would give us better conditions to carry out these tasks. Monetary policy would then be able to focus fully on the inflation target, while more precise tools could be used to counteract the build-up of financial imbalances.

Household debt and housing prices have been taken into account in the repo-rate decisions…

Monetary policy in Sweden in recent years can be summarised roughly as follows. The debt crisis in Europe has hampered the conditions for Swedish exports. The Swedish economy has developed relatively well, but there was a clear slowdown towards the end of last year (see Figure 1). Domestic demand showed good resilience for a long time, but has now also begun to weaken. Low cost increases for companies and a stronger krona have also meant that inflationary pressures have declined (see Figure 2). Given this, monetary policy has gradually become more expansionary over the past year, and in December we cut the repo rate even further (see Figure 3). Over the past year, we have also lowered the forecast path for the repo rate. This has been necessary to meet the inflation target and support economic activity.

But in our monetary policy we have also given some consideration to household debt and housing prices – and for good reason, in my opinion. Let me explain this in more detail.

…as there are considerable risks

The financial crisis has made the risks linked to the housing market and high household debt crystal clear. The most well-known examples are the United States, Ireland and Spain. But Denmark, too, has experienced problems in its housing market (see Figure 4).

In Sweden, house prices have risen substantially since the middle of the 1990s, even compared with the countries where prices have since plummeted (see Figure 4). As house purchases are to a great extent funded by borrowed money, it is hardly surprising that this has also entailed a large increase in household debt (see Figure 5).

I think that it is important in this context to try to clarify the actual risks for Sweden here. It is not very likely that a fall in house prices would lead to extensive loan losses from mortgages for banks and mortgage institutions. Both the experiences from the 1990s and the analyses we have made ourselves point to this not being the case.[1] However, a fall in house prices can give rise to other effects, direct and indirect, on both the macro economy and financial stability.

The most direct effects for the macro economy concern household consumption. Experiences show that the countries hit by severe falls in house prices usually experience long periods of very weak consumption. This is because households then tend to increase their savings to restore their wealth. Figure 6 shows developments in household consumption and real house prices in different countries. We can see that Sweden has had a much stronger growth in consumption than the countries affected by severe falls in house prices. Weaker consumption demand has direct effects on growth, and thus also on unemployment (see Figure 7). This in turn has indirect effects on financial stability in that the banks' loan losses in the corporate sector may increase as a result of the poorer economic activity.

Another aspect that can affect financial stability is that an increasingly large share of the banks' funding is through foreign investors (see Figure 8). Confidence among foreign investors may be affected substantially by a fall in house prices. This could have direct effects on financial stability in that the banks have greater difficulty obtaining funding – historically, foreign investors have proved to be "volatile". Indirect effects may then arise on the macro economy in that the banks' lending declines, which subdues demand.

A combination of all of these effects may mean that the consequences for the economy are serious, if there is a decline in the housing market. So how much should we worry about this?

The Riksbank's inquiry into the risks in the Swedish housing market, which was published in spring 2011, showed that the high house prices in Sweden can largely be explained by high incomes, low real interest rates and a low rate of construction. The low rate of construction, particularly in metropolitan regions, is something I consider to be a growing problem. At the same time, our inquiry noted that the fact that there are explanations for the high house prices in Sweden does not offer a guarantee against future price falls. The trend of increasing debt among households, combined with a large share of mortgages at variable rates, may also have meant that households' sensitivity to fluctuations in house prices and interest rates has increased over time. Several international studies imply that a high level of debt in itself can aggravate the negative effects of a fall in house prices on consumption.[2]

Since we published the inquiry into the risks in the Swedish housing market, house prices have levelled off, and household debt has increased at a slower rate. It is important to remember that this development is probably partly explained by the monetary policy conducted; for instance, the repo rate was raised in connection with the strong recovery after the financial crisis, and as I mentioned, we have taken into account the risks linked to household debt in our repo-rate decisions over the past year. Another possible reason for the slower developments is the mortgage cap, to which I will return later. As household debt in Sweden is still high, and higher than in many of the countries that have suffered major problems, I still consider the risks to be substantial (see Figure 5).

---

[1] See, for instance, Sveriges Riksbank (2011), *The Riksbank's inquiry into risks in the Swedish housing market*.

[2] See, for instance, IMF (2012), *World Economic Outlook*, April, and also R. Glick and K.J. Lancing (2010), "Global Household Leverage, House Prices, and Consumption", *Federal Reserve Bank of San Francisco Economic Letter* 1. For an interesting comparison of different geographical areas in the United States, see A. Mian, K. Rao and A. Sufi (2011), "Household Balance Sheets, Consumption, and the Economic Slump", *Chicago Booth Working Paper*, November.

The repo rate is a blunt instrument for dealing with financial imbalances

We have seen that there are risks in Sweden linked to household debt, but is the repo rate really the best tool to deal with them?

It is obvious that the repo rate affects the supply of credit in the economy. When one discusses the effects of the repo rate on the economy, one usually talks about the interest rate channel, the credit channel and the exchange rate channel. *The interest rate channel* means, to put it simply, that it becomes more attractive to borrow than to save when the interest rate is cut, and vice versa. *The credit channel* has an impact through asset prices, for instance, house prices, rising when the interest rate is cut. This means that the value of the collateral for the loan increases, which pushes up the banks' lending. *The exchange rate channel* means that a lower interest rate tends to weaken the exchange rate and contribute to higher import prices. To the extent that the real exchange rate also weakens, it contributes to an increase in net exports, as the relationship between export and import prices changes.[3] Two of the three channels for monetary policy thus have an impact by affecting demand and supply with regard to credit in the economy. One sometimes also talks about a fourth channel; the risk-taking channel, which means that a lower interest rate contributes to the banks increasing their risk-taking when lending.[4] All in all, it is clear that monetary policy has an effect on household debt and asset prices, although it can be difficult to determine exactly how large and how lasting this effect is. We have limited experience of low interest rates over longer periods of time. There is a clear risk that the current low interest rates will encourage greater indebtedness than is reasonable in a long-run perspective.

But, at the same time, the interest rate is a blunt instrument to manage the risks linked to household debt and house prices. One reason for this is that an adjustment in the interest rate also affects the economy through the exchange rate channel, which has further effects on inflation and the real economy. But the impact of the interest rate can also be too broad in other ways, such as when one wishes to slow down household borrowing but not corporate investment. A higher interest rate aimed at limiting financial imbalances therefore entails a balance, where short-term losses in the form of lower inflation and growth, must be weighed against long-term gains in the form of lower risks linked to a high level of household debt.

As I am sure you are aware, I think that the recent monetary policy decisions entail a reasonable balance between these factors under the prevailing circumstances. However, this does not mean that there is no room for improvement in the future. A new policy area – macroprudential policy – could offer better honed tools than the interest rate for dealing with financial imbalances.

Macroprudential policy is better suited to managing financial imbalances than monetary policy…

The experiences of the global financial crisis have led to extensive international work on regulation, and to many countries now establishing new organisational structures and tools in what is known as macroprudential policy.[5] Unlike the traditional financial supervision – microprudential supervision – which focuses on the risks in an individual institution, the

---

[3] The real exchange rate is defined as the nominal exchange rate adjusted by prices in Sweden in relation to prices abroad. An alternative definition is that the real exchange rate compares prices in Sweden and abroad, measured in the same currency.

[4] See, for instance, M. Apel and C.A. Claussen (2012), "Monetary policy, interest rates and risk taking", *Sveriges Riksbank Economic Review* no. 2.

[5] For a more detailed description of macroprudential policy, see for instance C. Nordh-Berntsson and J. Molin (2012), "A Swedish framework for macroprudential policy", *Economic Review*, no. 1, Sveriges Riksbank, and my colleague Karolina Ekholm's speech "Macroprudential policy and clear communication contribute to financial stability," published on 30 March 2012.

focus for macroprudential policy is the risks in the financial system as a whole (see Figure 9). The supervision of individual institutions is, of course, also important to the stability of the financial system, not least as financial institutions are regarded as "systemically important". But to capture the build-up of risks that could threaten the stability of the financial system – what are known as systemic risks – it is not enough to keep an eye on individual institutions. One needs to supplement this with a systemic, or macro, perspective.

Macroprudential policy also requires appropriate tools. Let me discuss some of the macroprudential tools that could be useful to specifically manage the risks linked to house prices and household debt.[6]

Countercyclical capital buffers are one of the most discussed tools, and are a part of the Basel III international regulatory framework.[7] The idea is to vary the capital requirements made of the banks; when there is strong credit growth, the requirements will be increased, while they will be reduced during financial stress, when there is otherwise a risk of a credit crunch. The reason for this is simple: the banks will build up capital during the good times, which can then be used during the bad times. The main aim is to increase the banks' resilience in that more capital can be used to absorb losses during tougher times, so that they avoid becoming insolvent. Moreover, higher capital requirements during the good times will contribute to slowing down the credit cycle by reducing the banks' lending. However, it is important to remember that countercyclical capital buffers are a broad tool, which affects all bank lending.

Other macroprudential instruments are even more specifically aimed at limiting the risks linked to household mortgages, for instance.

One means of more specifically limiting the risks in the banks' mortgage lending is to apply *sector-specific risk weights*. Put simply, this means that the banks must hold more capital for certain parts of their lending, in this case mortgage lending. Finansinspektionen (the Swedish financial supervisory authority) has recently announced a proposal for a minimum level for risk weights on mortgages. We at the Riksbank have also been arguing for a long time that the risk weights on mortgages in Sweden need to be increased. But a general increase in risk weights is of a more structural nature.[8] On the other hand, if the risk weights are allowed to vary over time, they can be used as a specific macroprudential instrument with the aim of counteracting risks in the mortgage market: the banks must hold more capital during the good times for their mortgage lending, but not for all forms of lending; rather like a countercyclical capital buffer, but just for mortgage lending.

A further example of more specific macroprudential instruments are the different *limits as to how much households may borrow*. This can be done by setting a limit for how large a mortgage can be in relation to the collateral, also known as a mortgage cap or LTV (loan-to-value) requirement. This was introduced in Sweden as a general recommendation from Finansinspektionen in the autumn of 2010. In simple terms, it imposes a maximum loan-to-

---

6 Of course, there are also macroprudential tools with other purposes than to reduce the risks linked to household debt and the housing market, for instance, limiting the risks arising from the links between the banks, what are known as structural risks. See, for instance, C. Nordh-Berntsson and J. Molin (2012), "Creating a Swedish toolbox for macroprudential policy," Riksbank study, Sveriges Riksbank, and my colleague Karolina Ekholm's speech "How can financial crises be avoided in Sweden?", published on 27 September 2012. For a general discussion of possible tools to manage the risks linked to the housing market and household debt, see T. Andersson, C.A. Claussen, B. Lagerwall and P. Torstensson (2011), "Tools and institutions for influencing house prices and household debt", in *The Riksbank's inquiry into the risks in the Swedish housing market*, Sveriges Riksbank.

7 See also R. Juks and O. Melander (2012), "Countercyclical capital buffers as a macroprudential instrument", Riksbank study, December, Sveriges Riksbank.

8 See the article "Higher risk weights for Swedish mortgages promote financial stability", in Financial Stability Report 2012:2, Sveriges Riksbank.

value ratio of 85 per cent when purchasing a house. One alternative is to limit borrowing in relation to income, what is known as an LTI (loan-to-income) requirement. A further means of limiting household debt is the amortisation requirement for mortgages. A mathematical example is used in our most recent Financial Stability Report to show that amortisation requirements can have substantial effects on household debt.[9]

…but there is no framework for macroprudential policy in Sweden, and one needs to be implemented as soon as possible

There are thus a number of tools that can be used instead of the repo rate to reduce the risks related to household debt, and which in many cases would probably be more effective.

But one condition for macroprudential policy to work as intended is that there is a framework in place, with a clear division of responsibility and which clarifies how the various instruments should be used. One reason why monetary policy in Sweden has needed to give consideration to financial imbalances is because there has been no framework for macroprudential policy.

While awaiting a permanent framework in Sweden, the Riksbank and Finansinspektionen started a joint council for cooperation on macroprudential policy at the beginning of 2012. But even if this council offers an important forum for analysis and discussion, it has no powers of decision-making and no tools of its own at its disposal. Two days ago, however, the Financial Crisis Committee produced a proposal for macroprudential policy in Sweden – which I will return to later on.

Central banks should play an important role in macroprudential policy

When drawing up a framework for macroprudential policy in Sweden, I think there are good reasons for giving the Riksbank a central role.

One important reason is that the Riksbank has long been conducting *extensive analysis of macroprudential policy issues*. Ever since the Swedish bank crisis in the early 1990s, the Riksbank has gradually built up substantial knowledge and experience of analysing the risks that can threaten the stability of the financial system. The basis for this was the Bank's task of promoting a safe and efficient payment system – what we in practice define as financial stability.[10] In 1997 the Riksbank began publishing its assessment of the stability of the financial system, in the form of the Financial Stability Report, published twice a year. It was one of the first central banks in the world to do this. The special Macroprudential Policy Division at the Riksbank's Financial Stability Department has as one of its tasks to assess the need for specific macroprudential policy measures. The Riksbank's Monetary Policy Department has long conducted macroeconomic analysis to provide a good guidance for interest-rate decisions, which are based on macroeconomic analyses and forecasts. The analysis of financial stability, combined with the monetary policy analysis, provides good grounds for understanding the repercussions between the financial and real economy, which is essential for successful macroprudential policy. In recent years the cooperation between the Financial Stability and Monetary Policy Departments at the Riksbank has intensified.

There are also *clear links between monetary policy and macroprudential policy*. Both policy areas ultimately aim for a stable macroeconomic development – macroprudential policy by limiting systemic risk and monetary policy by keeping inflation low and stable and stabilising the real economy. But they also affect the conditions for one another (see Figure 10).

[9] Sveriges Riksbank (2012), Financial Stability Report 2012:2.

[10] The Riksbank shares the responsibility for financial stability in Sweden with Finansinspektionen, the Swedish National Debt Office and the Swedish government, through the Ministry of Finance. However, these authorities all play slightly different roles in the work.

Macroprudential instruments affect the amount of credit in different ways, and thus also have an effect on the macro economy. Monetary policy needs to relate to these effects. Monetary policy can also, as I mentioned, affect household debt and asset prices through various channels, and thereby the conditions for macroprudential policy. Both the monetary policy transmission mechanism and the monetary policy objectives – price stability and real economic stability – are dependent on the financial system being stable and thereby on macroprudential policy being able to manage systemic risk. As I see it, there is a need for a close cooperation between those responsible for monetary policy and those responsible for macroprudential policy, to ensure that one does not make decisions that counteract one another.

Like monetary policy, macroprudential policy is linked to uncomfortable decisions that have a beneficial outcome in the long run, but where it may be difficult to see the benefits in the short run. It is therefore necessary to have a substantial degree of *independence*, from both the political system and sector interests, for macroprudential policy to function properly. As the Riksbank already has a statutory independence, this also indicates that it should play a major role in macroprudential policy.

The financial supervisory authority in Sweden, Finansinspektionen, also promotes stability in the financial system, but with a greater focus on individual institutions – what we usually call microprudential supervision. As knowledge of the risks in individual financial institutions is extremely important for successful macroprudential policy, it is essential that Finansinspektionen also participates in macroprudential policy (see Figure 9). This is particularly important in a country like Sweden with four dominant major banks. Thus, the competence and experience of both the Riksbank and Finansinspektionen will need to be utilised if macroprudential policy is to be effective in Sweden. What other requirements can one reasonably make of a framework for macroprudential policy so that it will function efficiently?

The framework for macroprudential policy in Sweden should entail a clear mandate and effective tools…

The Riksbank has earlier highlighted a number of general criteria that should be met for macroprudential policy to function successfully, and which I certainly agree with. There are four main criteria.[11]

Firstly, it is necessary to have a good power for decision making, in the form of a clear mandate and well-defined tools. Secondly, a strong *independence* from political and sector-specific considerations is needed, as I mentioned earlier. Independence assumes, thirdly, that there are forms for clearly holding the authorities *accountable*, for instance, through far-reaching requirements for transparency and reporting. Fourthly, a substantial and lasting *capacity for analysis* is required.

These criteria – combined with an important role for the central bank, which I have argued in favour of today – are also largely reflected in a recommendation from the European Systemic Risk Board (ESRB). The European macroprudential supervisory body ESRB was created in response to the financial crisis and began operating in 2011.[12] The purpose is to contribute to preventing or reducing systemic risks in the EU. The primary instrument for doing this is the ability to issue warnings or recommendations if significant risks are identified. The ESRB

---

[11] See, for instance, the Executive Board's consultation response to the report Evaluation of the Riksbank's monetary policy and work on financial stability 2005–2010 (2010/11:RFR5), published on 30 November 2011. In addition to the four criteria, it is also emphasises there that the Riksbank should play a central role in macroprudential policy, which I have argued in favour of today.

[12] It is headed by ECB Chairman Mario Draghi and consists mainly of the central banks and financial supervisory authorities within the EU, with the first-mentioned having the right to vote.

does not have any binding instruments of its own at its disposal; instead it assumes that the EU member states themselves will establish systems for this. Thus, an important part of the discussion on how macroprudential policy should be organised is the ESRB's recommendation to the EU member states' governments in this field, which was published in January 2012.

The ESRB recommends that macroprudential responsibility should lie with one institution or one council and that this body should have control over suitable tools to attain its objectives. This is to establish a clear responsibility. Moreover, they recommend that the central banks should play a leading role in macroprudential policy and that the macroprudential supervisory body should have operational independence.

It is now time for me to return to the Financial Crisis Committee's proposal, and how this relates to the demands I consider should be made regarding a framework for macroprudential policy – demands that are also expressed in the ESRB's recommendation.

…but the Financial Crisis Committee's proposal does not go very far…

Two days ago, 23 January, the Financial Crisis Committee published its proposal as to how we should organise macroprudential policy in Sweden.[13] In principle, the proposal is that the current council for cooperation on macroprudential policy between the Riksbank and Finansinspektionen is confirmed by law and supplemented with independent experts and an observer from the Ministry of Finance. The council shall work to promote greater knowledge of systemic risks and to develop macroprudential tools. Moreover, it shall analyse risks and discuss suitable measures. A secretariat for the council will be established at the Riksbank.

However, the council will not have any powers of authority; its work will consist of exchanging information and discussion. Decisions on the application of macroprudential tools will lie with Finansinspektionen or the Riksbank, with both being given responsibility for macroprudential policy. They are also to consult with one another prior to decisions on applying macroprudential tools. The committee does not offer any suggestions as to which macroprudential tools are needed or how they should be divided between the authorities.

My assessment is therefore that the Financial Crisis Committee's proposal, which means that both the Riksbank and Finansinspektionen will become macroprudential bodies, does not fulfil the important criteria regarding decision-making powers, independence and accountability. And nor does the proposal appear to be in line with the ESRB's recommendation.

…and differs from the practice that is emerging in Europe

Moreover, the Financial Crisis Committee's proposals differ from the structures emerging in other EU countries. Two models are predominant in this context, and both of them are in line with the ESRB's recommendation. Either the responsibility for macroprudential policy is given to the central bank, as in the United Kingdom, or it is given to a number of authorities, with the central bank playing the leading role, expressed for instance in the form of a chairmanship or right of veto, as in the case of Germany. If the council's solution is chosen, the council normally also confers the right of making recommendations regarding macroprudential measures.

I think it would be good if we introduced a structure for macroprudential policy that does not differ too much from those being introduced in other EU countries, as the financial markets are strongly integrated and a similar structure for macroprudential policy within the EU would

---

13 Here I am giving my personal views on the Financial Crisis Committee's proposal. The Riksbank will present a consultation response later in the spring containing more detailed views and comments.

facilitate international cooperation. The need for international cooperation is based on the fact that measures introduced, or not introduced, on one country can often have consequences for the financial stability of other countries.

As I mentioned earlier, it is extremely important to create a clear mandate and efficient tools for macroprudential policy in Sweden. I would like to have seen the Financial Crisis Committee present a proposal that provided a more active structure, and which was closer to the ESRB's recommendation.[14] For instance, it will probably often be unclear who should react to a risk that has arisen, and it will therefore also be difficult to hold an authority accountable for what it has done or failed to do.

However, I am glad that the Financial Crisis Committee has now presented its proposal, as it provides an important contribution to the discussion on how macroprudential policy should be developed and organised in Sweden.

Efficient macroprudential policy increases the Riksbank's possibilities to carry out its main tasks

Let me summarise by emphasising my most important message today. Monetary policy has to some extent also given consideration to the risks arising from household debt, in addition to inflation and resource utilisation. We are eager to avoid the unpleasant developments in a number of countries in recent years. At the same time, I believe that there are several macroprudential policy tools that could be more efficient than the repo rate in preventing financial imbalances.

So far, there is no framework for macroprudential policy in Sweden, and this needs to be remedied as soon as possible. In my opinion, there are good reasons why the Riksbank should play a major role in macroprudential policy. We have long conducted analysis of macroprudential policy issues; moreover, there are clear points of contact between monetary policy and macroprudential policy, for instance, the fact that they affect the conditions for one another. The Financial Crisis Committee's proposal does not provide a clear framework for macroprudential policy in Sweden, and the proposal also differs from the ESRB's recommendation and from the practice in other EU countries.

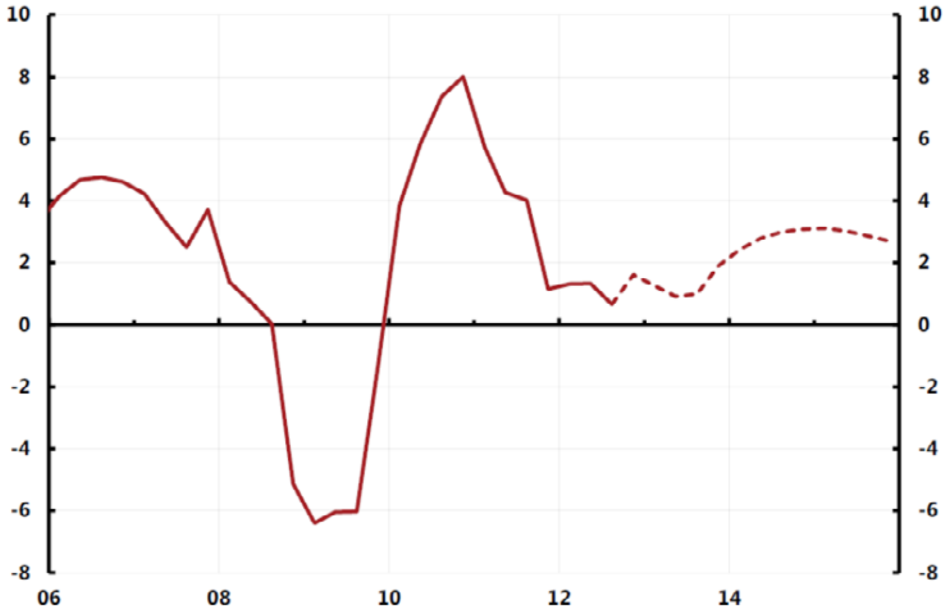
In the future, it is desirable that the Riksbank should be able to use the policy rate to an even greater extent to stabilise inflation and the real economy in the future, and that more appropriate tools than the repo rate can be used to reduce the risks of financial imbalances. A functioning framework for macroprudential policy can improve the conditions for ensuring that the Riksbank attains its two main objectives: price stability and financial stability.

---

14 An on-going inquiry into capital adequacy rules is to present its report by 15 May. Its task includes appointing an authority to be responsible for countercyclical capital buffers in Sweden.

Figure 1. GDP growth in Sweden

Annual percentage change

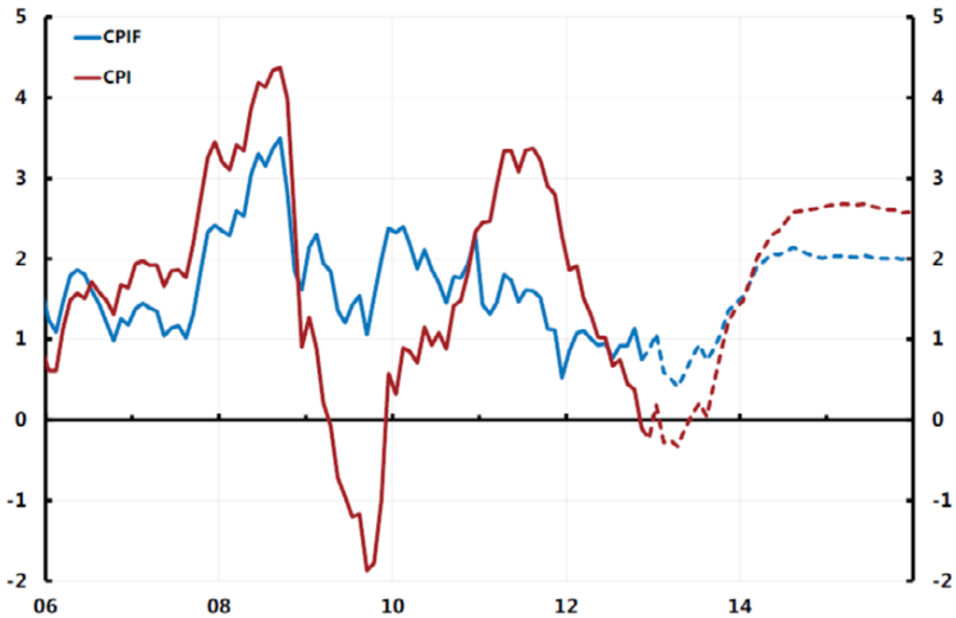


Note. The broken line refers to the forecast in the MPU December 2012.

Sources: Statistics Sweden and the Riksbank

Figure 2. CPI and CPIF inflation

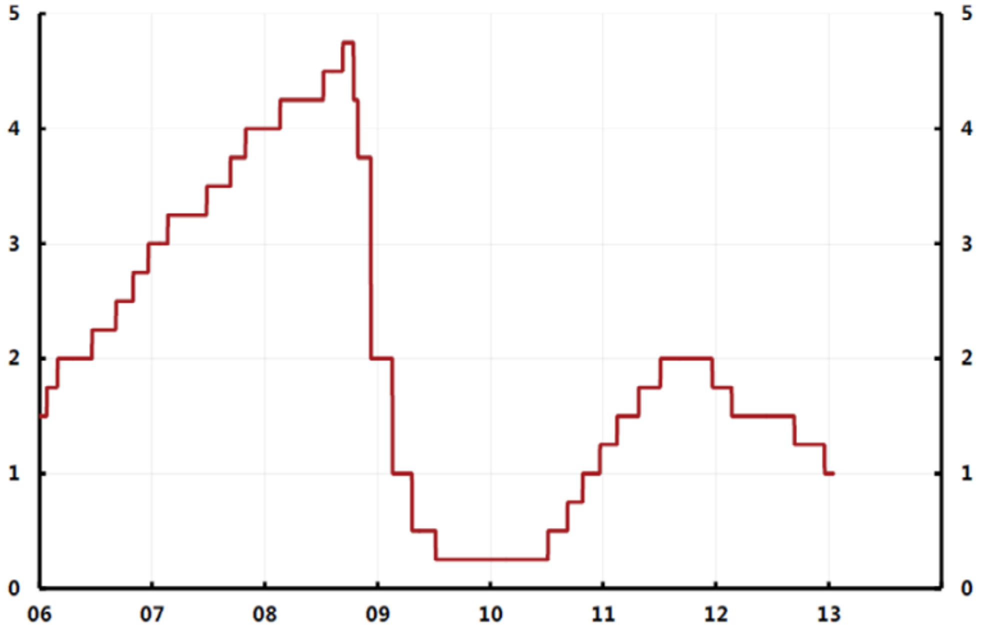
Annual percentage change



Note. The CPIF is the CPI with a fixed mortgage rate. Broken lines refer to the forecasts in the MPU December 2012.

Sources: Statistics Sweden and the Riksbank

Figure 3. The repo rate

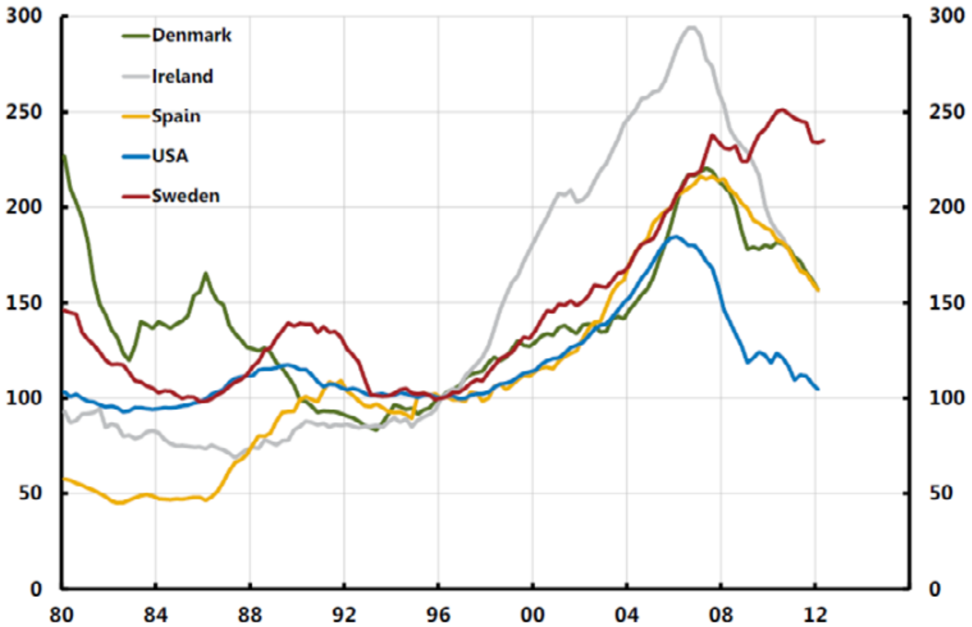


Per cent, daily data

Source: The Riksbank

Figure 4. Real house prices

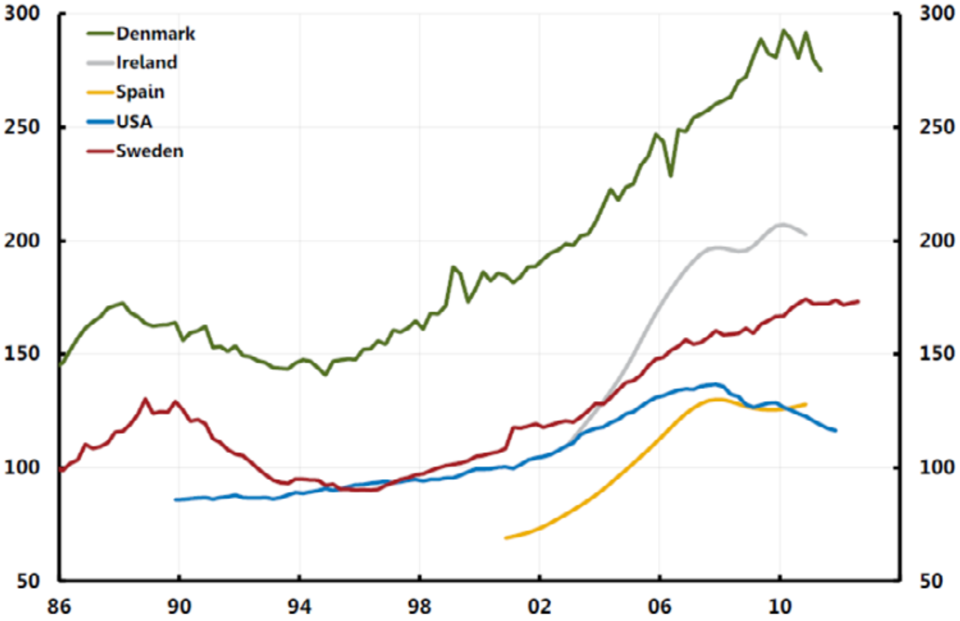
Index, 1996 Q1 = 100



Source: Reuters EcoWin

Figure 5. Household debt

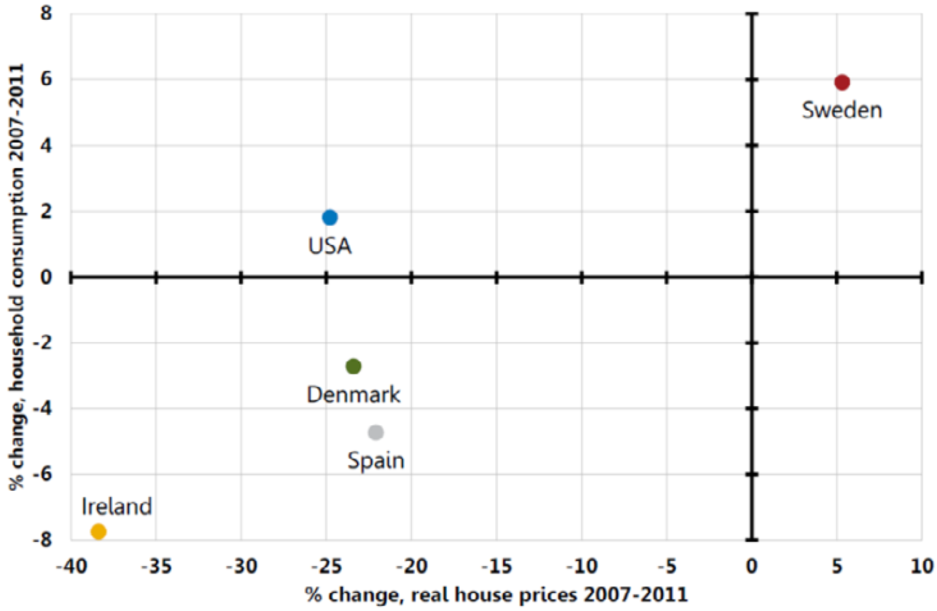
Total debt as a percentage of disposable income



Sources: Bank of England, Eurostat, national sources and the Riksbank

Figure 6. Real house prices and household consumption

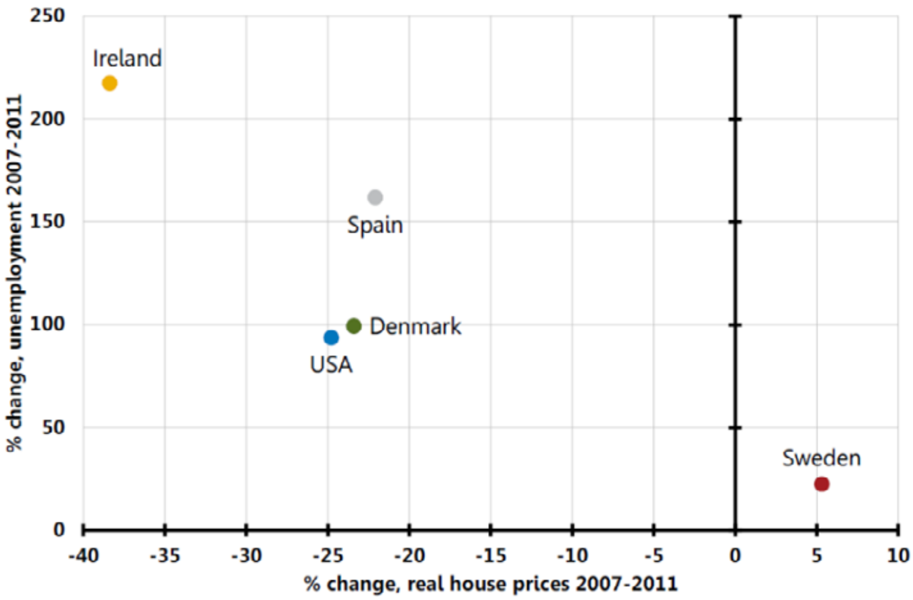
Percentage change 2007-2011



Source: OECD

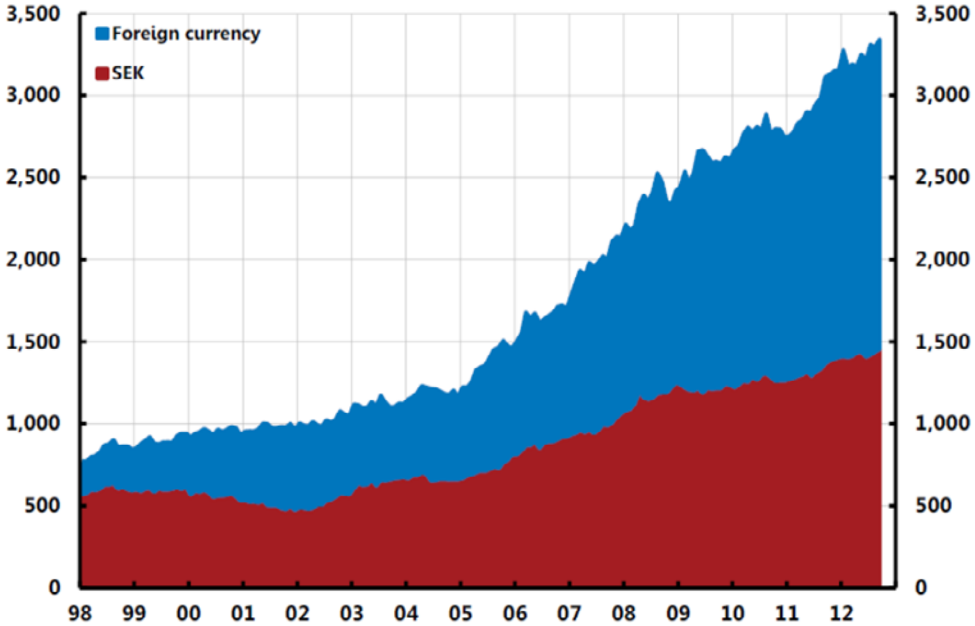
Figure 7. Real house prices and unemployment

Percentage change 2007-2011



Source: OECD

Figure 8. The major Swedish banks' market funding



Note. Funding through Swedish parent companies and subsidiaries, SEK billions.

Sources: Statistics Sweden and the Riksbank

Figure 9. Macroprudential supervision – a new policy area

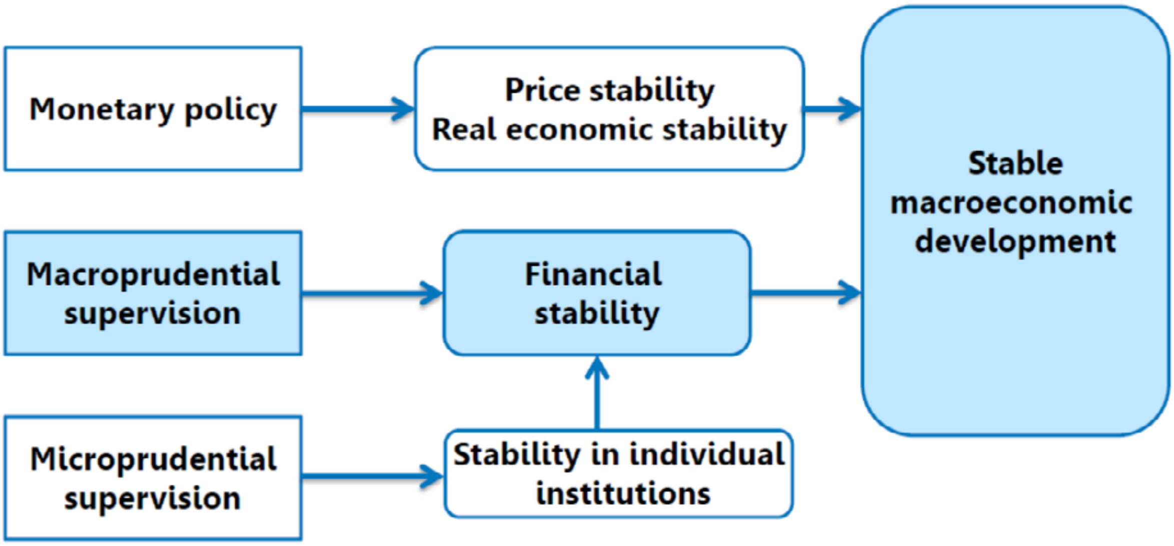


Figure 10. Points of contact between macroprudential and monetary policy