Karolina Ekholm: Monetary policy, business cycle stabilisation and macroprudential policy

Speech by Ms Karolina Ekholm, Deputy Governor of the Sveriges Riksbank, to a meeting at the Confederation of Swedish Enterprise, Stockholm, 13 March 2013.

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The views expressed in this speech are my own and are not necessarily shared by the other members of the Executive Board of the Riksbank. I would like to thank Kerstin Hallsten, Kerstin af Jochnick, Cecilia Roos-Isaksson, Lars E. O. Svensson, Anders Vredin and Barbro Wickman-Parak for their comments and Magnus Wiberg for help with drafting the speech.

As I am sure most of you know, I have in recent years advocated a more expansionary monetary policy than the policy that has actually been conducted. That I have done so recently, when the growth of the Swedish economy has been relatively weak, is perhaps not so surprising. On the other hand, it may be more difficult to understand the reasons for my stance in 2010, when the Swedish economy had growth rates of over 5 per cent. However, as I intend to explain today, I believe that demand has been too low in Sweden ever since the global financial crisis seriously affected the Swedish economy in the autumn of 2008. The low level of demand is ultimately the result of weak economic development around the world, which is subduing the demand for Swedish exports and making households and companies more pessimistic. In my opinion, however, this could have been counteracted by a more expansionary monetary policy.

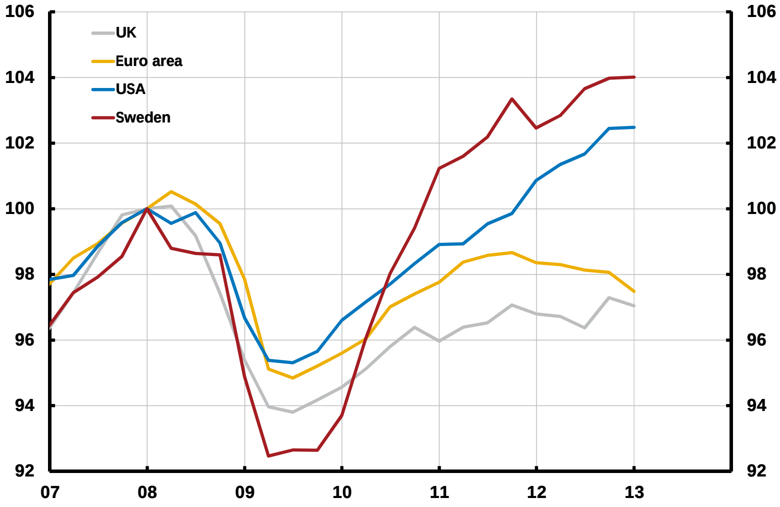
Today I intend to describe the factors that in my view indicate that aggregate demand has been too low in recent years, and to explain why, as I see it, monetary policy and fiscal policy have not been used to a greater extent to counteract low demand. My explanation is by and large that the possibility to use monetary policy and fiscal policy to stabilise aggregate demand has been limited by concerns about financial stability. Even though Sweden has coped well with the financial crisis, I believe that it has left decision-makers with the feeling that they have just had a near-death experience. Financial stability has therefore come to seem far more important that standard business cycle stabilisation. This prioritisation may well be reasonable. However, I believe that it is important to the Swedish economy that we have an effective policy for business cycle stabilisation at the same time as we conduct a policy to promote financial stability. I will discuss how this should be done towards the end of my speech.

Low aggregate demand since the financial crisis

When Sweden was hit by a collapse in the demand for Swedish export products at the end of 2008, GDP fell heavily. However, it did not take long for GDP to rise again and in 2010 growth figures reached almost record levels. To a certain extent, these high growth figures were of course a natural consequence of the major fall in GDP in late 2008 and early 2009. But, in contrast to many other countries, GDP in Sweden also began to exceed its pre-crisis level relatively quickly (see Figure 1).

Figure 1. GDP in Sweden and abroad

Index, Q4 2007=100



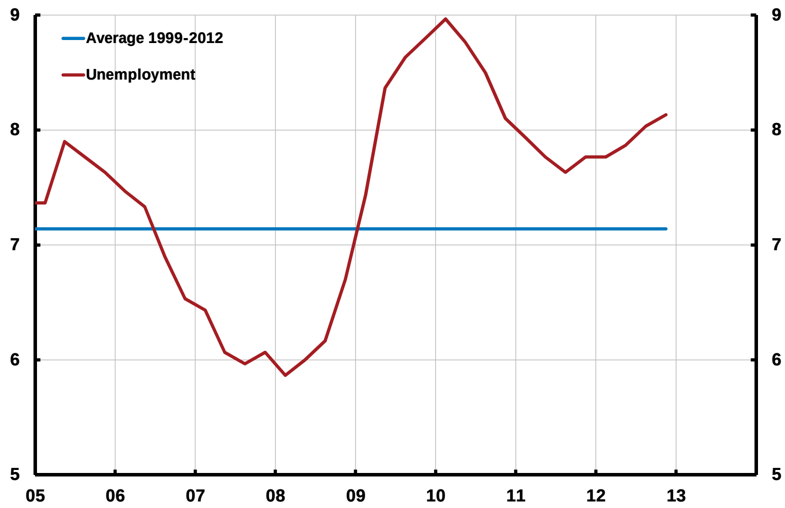
Note. Seasonally-adjusted data

Sources: Statistics Sweden and national sources.

However, despite the relatively favourable development of GDP, it seems that unemployment has become entrenched at a high level. Initially unemployment increased less than we expected given the substantial fall in GDP – it peaked at 9 per cent in early 2010 – but since then it has fallen no lower than 7.6 per cent (see Figure 2). In my view, this is a level that is much higher than what can be considered a long-run sustainable unemployment rate.[1]

Figure 2. Unemployment in Sweden

Per cent of labour force



Note. Seasonally-adjusted data

Source: Statistics Sweden.

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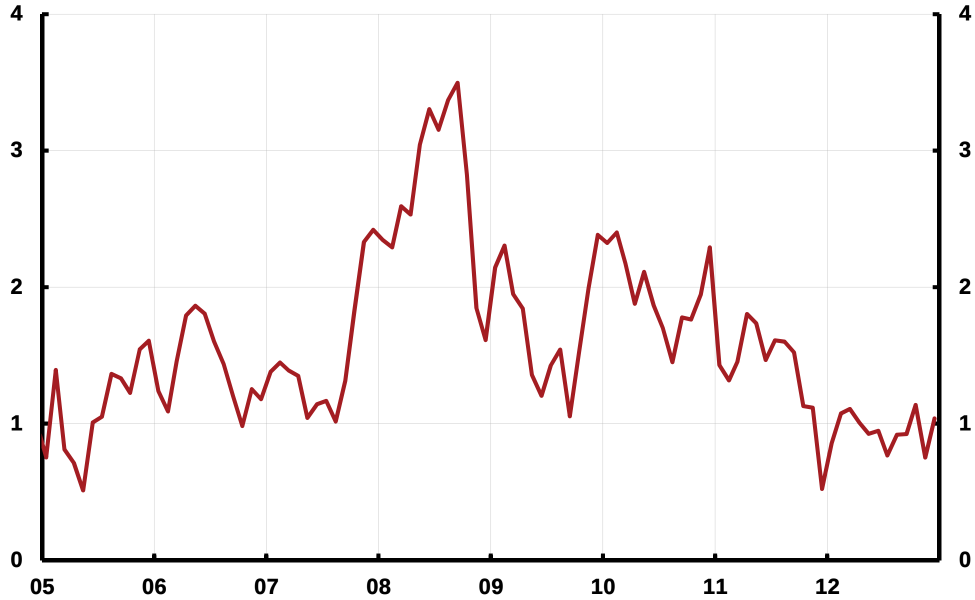
[1] Long-run sustainable unemployment rate here refers to the level of unemployment that is expected to prevail when all cyclical shocks have abated, when ongoing structural changes have had a full impact and when inflation expectations are equal to the actual rate of inflation. See for example “The long-term development of the Swedish labour market”, Monetary Policy Report, July 2012. See also “Correction of the Riksbank’s estimate of the long-run sustainable employment rate”, Appendix 2 of the minutes of the monetary policy meeting, July 2012, for a discussion of the role of expectations in the assessment of the long-run sustainable unemployment rate.

Unemployment has also begun to increase again in recent months and our latest forecast predicts that it will increase further to reach 8.2 per cent in the third quarter of this year.

Figure 3. CPIF inflation in Sweden

Annual percentage change



Note. The series refers to monthly data.

Source: Statistics Sweden.

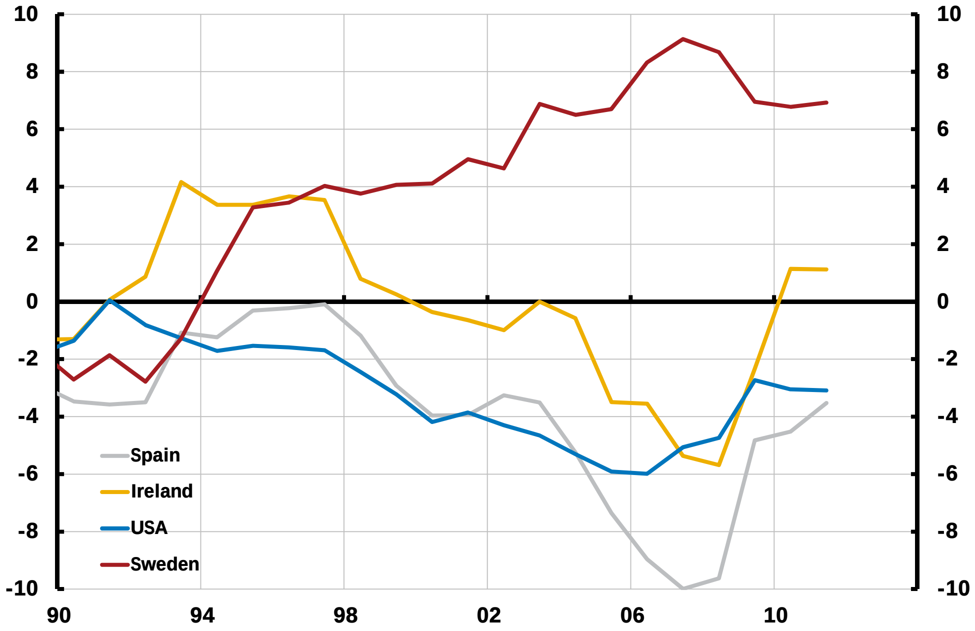
Developments thus indicate that we have had spare capacity on the labour market since 2008. This is one of the reasons why inflation has been low in recent years. It also appears that inflation has in principle shown a downward trend since 2008. As the Riksbank's repo-rate changes have a major impact on inflation measured in terms of the CPI, it is in this context most relevant to look at inflation measured in terms of the CPIF, that is the CPI with a fixed mortgage rate (see Figure 3).

As can be seen in the figure, CPIF inflation was around 3 per cent when the Swedish economy was hit by the fall in demand at the end of 2008. It is now down to levels of around 1 per cent.

The fact that Sweden has a substantial surplus on its current account, as shown in Figure 4, also indicates that domestic demand is relatively low.

Figure 4. Current account as a percentage of GDP

Per cent



Source: IMF WEO, October 2012.

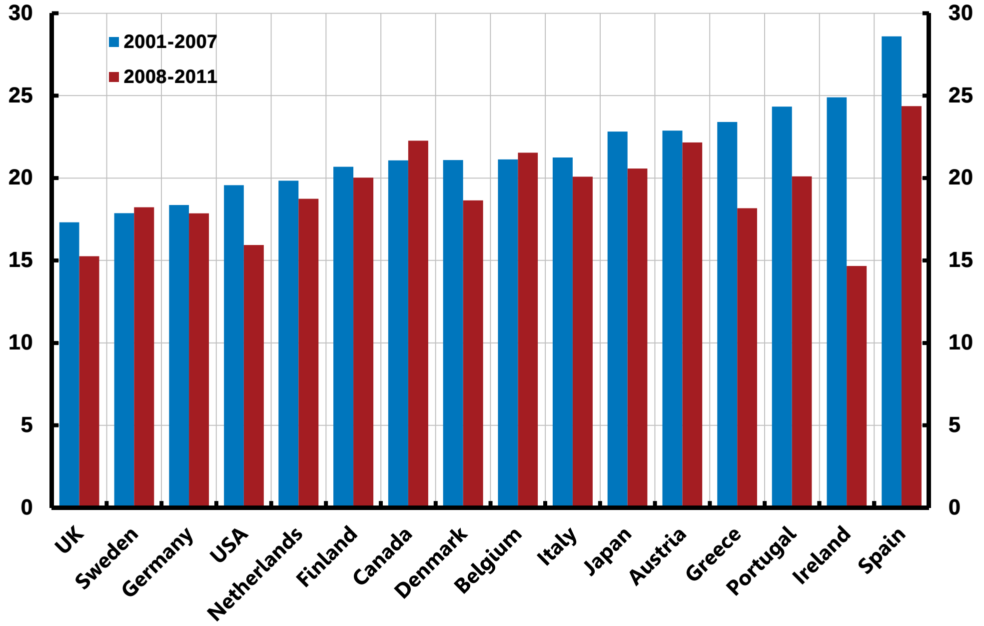
The current account reflects the difference between the value of what is produced and the value of what is absorbed in the economy through consumption and investments. It also shows the difference between total saving and total investment in the economy. The fact that Sweden has a surplus thus means that saving in Sweden is higher than the level needed to fund Swedish investments.

An important reason why saving has been relatively high in Sweden since the mid-1990s is the relatively high level of financial saving in the public sector since the budget consolidation process carried out in connection with the crisis of the 1990s. Another reason is that the Swedish households also increased their saving in connection with this crisis. At the same time, the level of investment in Sweden has been relatively low compared to that in other countries (see Figure 5). This is largely due to relatively low investments in housing.[2]

[2] See for example Chapter 3 in Vredin et al. (2012), Report of the Economic Policy Group 2012, "Simple rules, difficult times: does stabilisation policy need to be changed?"

Figure 5. Total investment as a share of GDP

Per cent



Note. Average value 2001–2007 and 2008–2010.

Source: IMF WEO, October 2012.

The current account surplus has in fact decreased somewhat in recent years. It was approximately 9 per cent of GDP in 2008 and approximately 7 per cent of GDP in 2011. However, it is still high in historical terms and in comparison with other countries. It is hard to see that there are any major advantages for the Swedish households of a significant part of their incomes being used to fund investments abroad, which in reality is what this means. To me, this is another sign that demand is too low in Sweden. Low demand is restraining consumption so that saving is high, and is also restraining investment.

My interpretation of developments regarding the labour market, inflation and the current account is thus that demand in the Swedish economy has been far too low since Sweden was hit by the fall in demand in the autumn of 2008. Although both monetary policy and fiscal policy have been used to counteract the fall in demand, this has not compensated in full for weak economic development abroad and for the weakening optimism of the households and companies.

The fact that unemployment was relatively high in Sweden already prior to the financial crisis (as can be seen in Figure 2, unemployment has averaged just over 7 per cent since 1999) and that the current account surplus has been substantial since the second half of the 1990s, raises the question of whether aggregate demand has been weak in an even longer perspective. My colleague Lars E. O. Svensson has, for example, claimed that unemployment has been unnecessarily high since the mid-1990s because monetary policy has not been used to a sufficient extent to counteract shocks that have pushed down inflation.[3] It is of course important to determine what the situation was with regard to resource utilisation before the financial crisis in order to be able to assess the level that unemployment should eventually fall to. But this is not the issue that I intend to focus on today: my focus

[3] See the paper "The possible unemployment cost of average inflation below a credible target" or the speech "Monetary policy and inflation: monetary policy is too tight", 16 January 2013.

here is instead on the issue of how economic policy could be used more effectively to stabilise business cycle fluctuations in the future despite the risks to financial stability.

Limited stimulation from fiscal policy

In contrast to the situation in many European countries and the United States, there was a significant surplus in public net lending in Sweden when the financial crisis began. In the euro area and the United States, public net lending as a percentage of GDP had shown an average deficit of just under 2 per cent during the 10 years before the crisis. The corresponding figure for Sweden was a surplus of over 1 per cent; in line with the so-called surplus target.[4] The much stronger state of public finances than in many other countries was largely a consequence of the fiscal policy framework that has gradually been developed since the 1990s.[5] This put Sweden in a much better initial position in terms of its public finances when the financial crisis began.

Fiscal policy contributes to stabilising business cycle fluctuations without any specific decisions being made through the so-called automatic stabilisers; that is through the fact that tax revenues fall and expenditure for various grants and benefits increases automatically when economic activity declines and unemployment increases.[6] However, in addition to this, active decisions can also be made that affect revenues and expenditure. Despite the severe downturn in 2008–2009, public net lending in Sweden fell to only –1 per cent of GDP in 2009. This is much less than in the euro area, the United Kingdom and the United States (see Figure 6).

Public indebtedness has increased substantially in the United States and in many European countries in recent years, partly as a result of the automatic stabilisers and partly as result of government intervention in the financial sector to deal with systemically-important banks that have experienced problems. In these countries, the scope to influence the economy using fiscal-policy stimulation measures is therefore very limited today. The countries that have the weakest public finances in Europe are forced to implement tightening measures despite the weak state of their economies because the high level of debt is creating uncertainty about the ability of the countries to repay further loans. In Sweden, on the other hand, there is scope for active fiscal-policy stimulation measures if they were needed.

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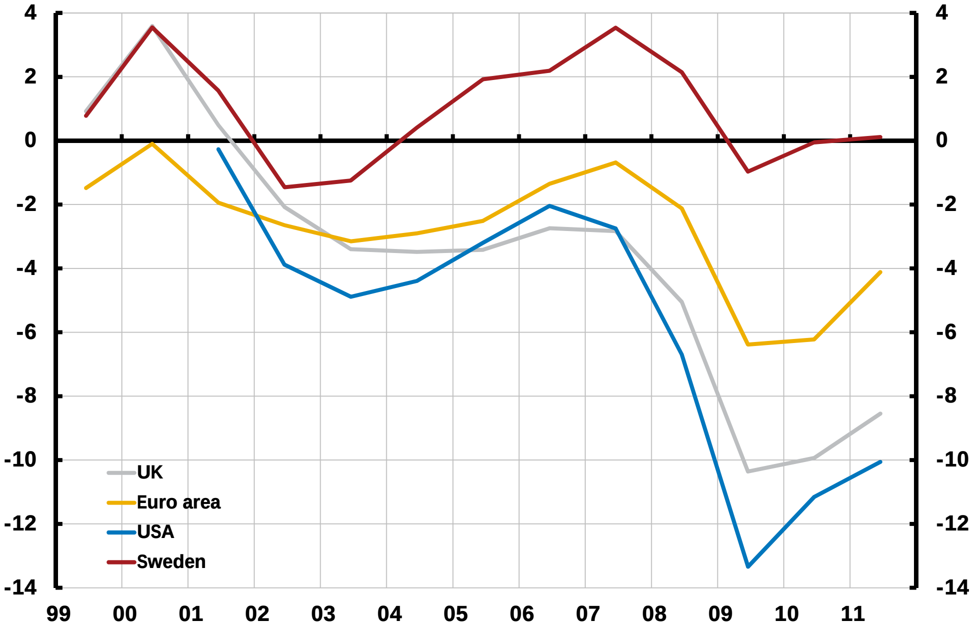
[4] OECD Economic Outlook, November 2012; IMF WEO, October 2012. The surplus target is that public sector net lending should average one per cent of GDP over an economic cycle.

[5] The fiscal-policy framework comprises a budget-policy framework, principles for stabilisation policy, principles for government intervention on the financial markets and principles for openness and transparency. In turn, the budget-policy framework comprises a surplus target for the public sector as a whole, an expenditure ceiling for the central government, and demands that the local-government sector should exercise sound financial management and have balanced budgets and a strict budget process.

[6] Automatic stabilisers consist of the effects that arise when tax revenues and various grants and benefits adapt to the economic cycle without active decisions being made.

Figure 6. Public sector net lending in Sweden, the euro area and the United States

Per cent of GDP



Source: IMF WEO, October 2012.

It is important in this context to remember that the primary aim of the fiscal-policy framework that we have in Sweden is to make public finances sustainable in the long term. Prior to the financial crisis, the greatest threat to the long-term sustainability of public finances appeared to be an ageing population.[7] An ageing population increases the demands on the public sector at the same time as the extent to which the sector can be funded by taxes on employment income decreases.

However, the experience gained in countries where the need to rescue systemically-important banks has exerted great pressure on public finances has given us a somewhat different perspective. In a country like Sweden, which has a large banking system in relation to the size of the economy, a banking crisis could quickly have a devastating effect on public finances. Given this, the risk of a financial crisis is therefore perhaps the greatest potential risk to the long-term sustainability of public finances. The need to save for a rainy day also probably appears to be greater as it is much easier to manage a financial crisis if public finances are strong from the outset. It is for this reason that I believe that the willingness to use fiscal policy to stimulate demand in the economy is limited by concerns about financial stability.

At present, therefore, we should probably not expect fiscal policy to contribute much more than the effects of the automatic stabilisers when it comes to stimulating the Swedish economy. The Riksbank's forecast is that public net lending will be negative at –1.1 per cent of GDP this year. However, it is expected to gradually increase to 0.3 per cent of GDP in 2015 as economic activity improves.

The fact that fiscal policy is not contributing more actively to stimulate demand in the economy is, however, completely in line with the established procedure for stabilisation

[7] See, for example, the calculations of the National Institute of Economic Research: "A Longer Term View of General Government Finances - Developments Will Require More Hours Worked", The Swedish Economy, December 2005.

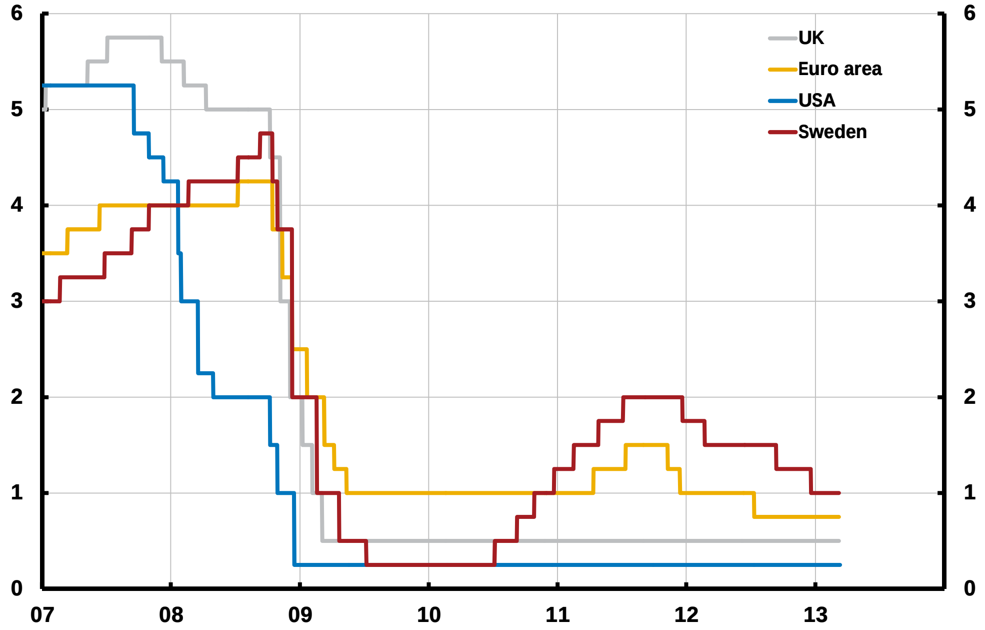
policy in Sweden as I perceive it. In my view, the main responsibility for active business cycle stabilisation has lain with monetary policy since the crisis of the 1990s.[8] However, this view is based on a flexible interpretation of our inflation target in the sense that the target comprises a stabilisation of the development of the real economy.[9]

Too little stimulation from monetary policy

Monetary policy also became much more expansionary when demand in the Swedish economy fell rapidly in late 2008 and early 2009. Between October 2008 and July 2009, the repo rate was cut by a total of 4.5 percentage points to the record-low level of 0.25 per cent, and it remained at this level for a year (see Figure 7).

Figure 7. Policy rates in Sweden, the euro area, the United States and the United Kingdom

Per cent



Sources: The Riksbank and national sources.

However, the Riksbank began to raise the repo rate in July 2010 and in July 2011 it was at 2.0 per cent. Since then, the repo rate has been cut again in a number of steps to 1.0 per cent as the weak development in the euro area has had a negative impact on the Swedish economy. As can be seen in Figure 7, policy rates in the United States and the United Kingdom have remained close to zero throughout this period. The ECB began to raise the policy rate in the euro area in 2011, but quickly had to begin cutting it again.

8 The spring budget bill for 2008 describes situations in which discretionary fiscal policy is justified as “crisis situations or in connection with supply shocks where fiscal policy may need to support monetary policy”. The Swedish Fiscal Policy Council interprets this to mean that, in the government’s view, the Riksbank has the main responsibility for business cycle stabilisation. See Chapter 1 of the 2011 report of the Swedish Fiscal Policy Council, “Swedish Fiscal Policy”.

9 The publication “Monetary Policy in Sweden” describes the Riksbank’s flexible inflation targeting regime (Sveriges Riksbank 2010).

Many central banks have also conducted so-called unconventional monetary policy by purchasing assets or providing liquidity at longer maturities than normal in other ways.[10] All in all, this has led to a more expansionary monetary policy in large parts of the rest of the world than in Sweden, despite the fact that the repo rate is at an historically low level.

The fact the Swedish monetary policy has been less expansionary than in many other countries may seem reasonable considering that the Swedish economy has also performed much better than that of many other countries. This is particularly true in comparison with other European countries, as shown in Figure 1. But, it is a problem that monetary policy has not been expansionary enough to keep inflation at a rate of around 2 per cent and to bring unemployment down to a long-run sustainable rate.[11]

Why hasn't monetary policy been expansionary enough? One reason is that to a certain extent we overestimated the strength and duration of the temporary recovery in the Swedish economy in 2010 and therefore also overestimated inflationary pressures. Another reason is the fear that a more expansionary monetary policy would increase the risks associated with household indebtedness. Here, it is once again the events in other countries during the financial crisis that have given rise to such fears. In several countries with a high level of household indebtedness and high housing prices, substantial falls in housing prices have led to a fall in consumption demand, which in turn has weakened the development of the real economy. In some areas, this has also led to higher loan losses and risks to financial stability.

Risks associated with household indebtedness

Personally, however, I do not believe that the risks associated with household indebtedness have represented a weighty argument against conducting a more expansionary monetary policy recently. There is of course every reason to avoid a situation in which housing prices fall dramatically. However, I find it difficult to see that current developments regarding housing prices and loans to households in Sweden are such that they justify further measures.

Housing prices and the households' debts as a percentage of their disposable incomes rose substantially in Sweden from the mid-1990s until the start of the financial crisis. As can be seen in Figure 8, real housing prices also increased dramatically in the other Nordic countries in this period. However, the situation has been different in recent years. The rate of growth in loans to households has fallen significantly and the debt ratio has therefore levelled out, although at an historically high level (see Figure 9). Increases in housing prices have also been much more subdued in recent years. As in Finland, real housing prices seem to

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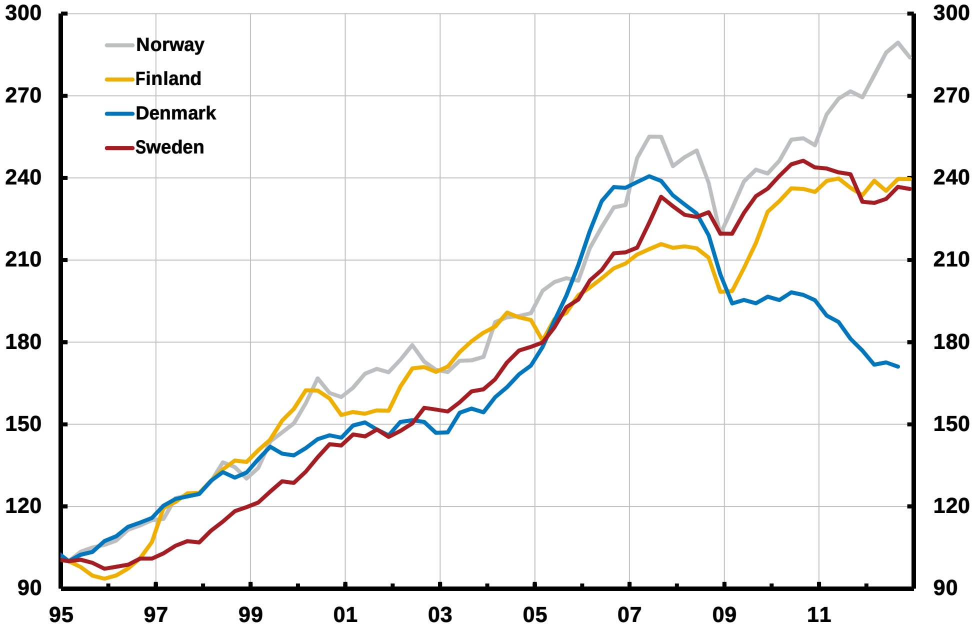
[10] In the United States, the central bank has added liquidity to the markets by purchasing bonds. The central banks in the United Kingdom and Japan have also launched extensive asset-purchase programmes. The ECB has offered loans to European banks in the form of three-year LTRO loans (Long-term Refinancing Operations). The ECB has also announced a new support programme, Outright Monetary Transactions (OMT) which enables unlimited purchases of government bonds in countries that apply for emergency loans and thus accept the conditions for such loans.

[11] In the Monetary Policy Report published in July 2012, the Riksbank's assessment was that the long-run sustainable unemployment rate is in the interval 5–7.5 per cent. The mid-point of the estimated interval is thus 6.25 per cent. There are also other estimates of the long-run sustainable unemployment rate. In the latest issue of its report "Wage Formation in Sweden", the National Institute of Economic Research assesses this rate to be around 7 per cent at present, but that it will fall to around 6 per cent in the years immediately ahead (see Wage Formation in Sweden 2012, National Institute of Economic Research). According to a calculation by Lars Svensson of how the deviation between the actual inflation rate and the inflation target affects unemployment, the mid-point of the Riksbank's estimated interval is at 5.5 per cent (see "Correction of the Riksbank's estimate of the long-run sustainable unemployment rate", Appendix 2, minutes of the monetary policy meeting, July 2012).

have levelled out. This differs from the situation in Norway where prices continue to increase, and in Denmark, where there has been a significant fall in prices.

Figure 8. Real house prices

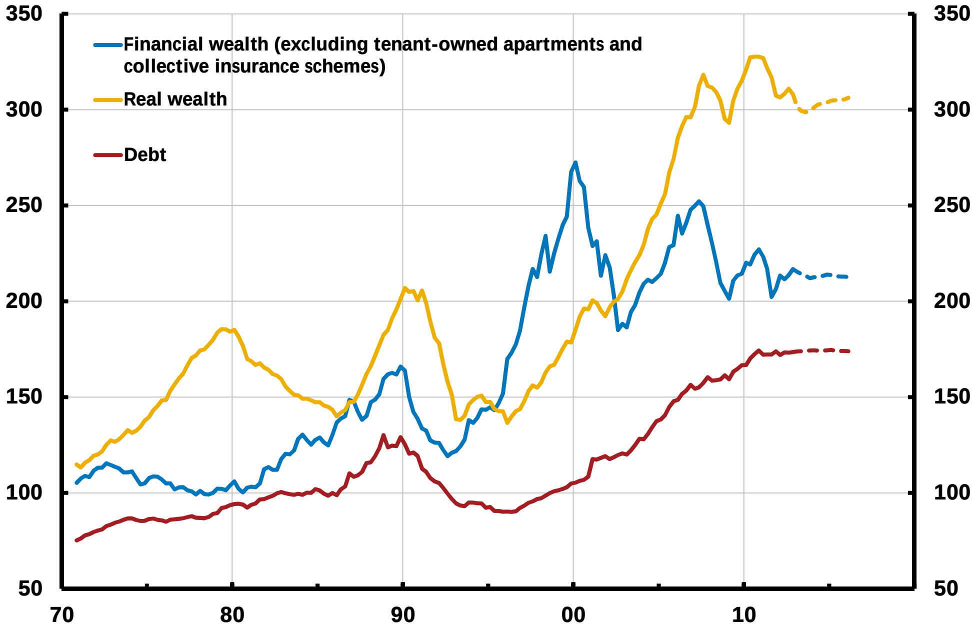
Index, 1995=100



Sources: Statistics Sweden and national sources.

Figure 9. Household wealth and debt

Per cent of disposable income



Note. The broken line is the Riksbank's latest forecast (from the Monetary Policy Report, February 2013).

Sources: Statistics Sweden and the Riksbank.

Developments on the Swedish housing market thus appear to be much calmer now than before the financial crisis. However, it is of course important to constantly analyse whether developments can pose risks to financial or macroeconomic stability. The development of household indebtedness could lead to problems if housing prices began to fall for some reason or if unemployment began to increase sharply in connection with a downturn. In order to assess to what extent this constitutes a risk we need to analyse the risk of a fall in housing prices and the extent to which the level of debt makes the households vulnerable. In the case of the latter, it is important to determine what assets the households have in addition to their housing. The relatively high level of private saving in Sweden is an advantage here as it has led to a situation in which the households have relatively substantial financial assets (see Figure 9).

Analysing the risk of a fall in housing prices is not easy, but a natural starting point is to try to find good indicators of such price falls based on the experience gained in other countries. According to a study by the IMF, the likelihood of a fall in housing prices increases if the growth of loans as a percentage of GDP is high, the current account is in deficit and housing investments are high in relation to GDP.[12] Put simply, one can say that the risk of a fall in housing prices is high in economies where there is a loan-financed building boom and where the loans are largely backed by funding abroad rather than by domestic saving.

Credit growth has indeed been relatively high in Sweden for a number of years, so on the basis of just this indicator there is some reason to believe that there is an increased risk of a fall in housing prices. However, the situation with regard to the current account and housing investment has rather been the opposite of that associated with an increased risk of such price falls. As I mentioned earlier, Sweden has a substantial surplus on its current account and this has now been the case for many years. Figure 4 also illustrated developments in a number of countries where housing prices have fallen, such as Ireland, Spain and the United States, and we can see that the current account deficits have been relatively substantial in all of these countries. One explanation of the relatively low level of overall investment in Sweden, which is one of the factors behind the current account surplus, is in fact the low level of investment in housing (see Figure 10). There are thus no signs that the credit growth we have experienced has financed a building boom or that it is associated with a low level of domestic saving.

In recent years, the number of new-builds in the housing sector in Sweden has been around 20 000 per year, which a low figure in historical terms.[13] The low level of new housing construction is thus an important factor behind rising house prices.[14]

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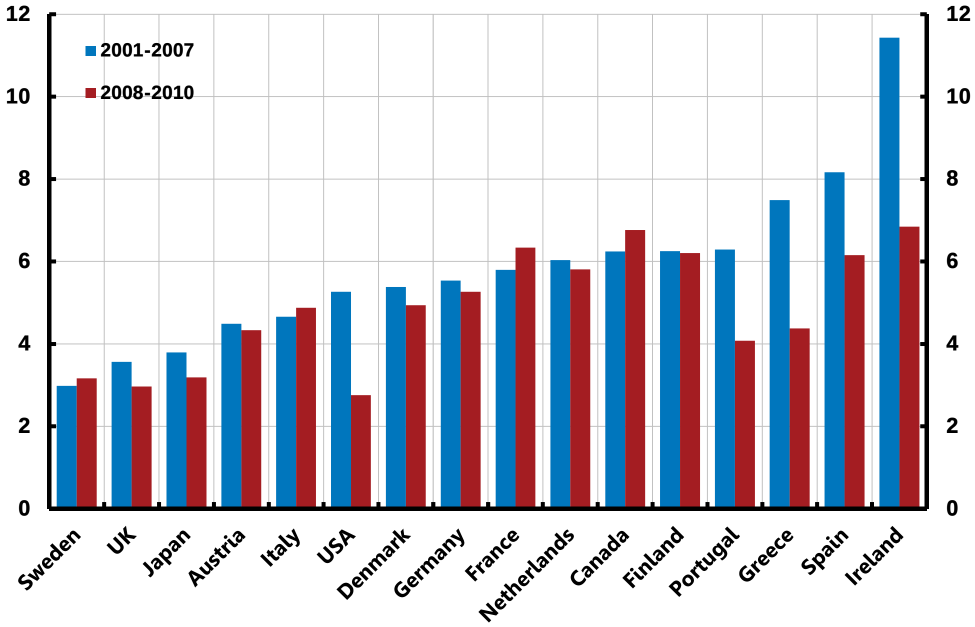
12 When all of these three factors deviated significantly from their normal patterns at the same time, there was a 56 per cent probability of a substantial fall in housing prices. See IMF (2009), World Economic Outlook, October.

13 This is a level that over the last 50 years has only been lower for a few years during the 1990s (Statistics Sweden, 2012 “Housing construction low for a long time”, *SCB Economic Indicator*, no. 2012:92).

14 Peter Englund, among others, points to the low level of housing construction in Sweden as one of the reasons for the sharp increase in prices; see Englund, Peter (2011), “Swedish house prices in an international perspective”, Chapter I.1 in *The Riksbank’s inquiry into risks in the Swedish housing market*.

Figure 10. Housing investment as a proportion of GDP

Per cent



Note. Average value 2001–2007 and 2008–2010. No figures are available for 2010 in the case of Ireland and Japan, so the red bar refers only to 2008–2009.

Source: Vredin et al. (2012), R*eport of the Economic Policy Group 2012. Simple rules, difficult times – does stabilisation policy need to be changed?*

Other indicators of falls in housing prices have also been proposed, for example the positive deviation of housing prices from a long-term trend, which at present is relatively high in Sweden.[15] However, the point is that the picture provided by the typical indicators of a fall in housing prices is mixed for Sweden. Some appear to be alarming while others are practically the opposite of what is typically the case before a fall in housing prices. This does not of course mean that we can be certain that prices will not fall, but it is still important to have this background clear in order to be able to assess the risks on the housing market.

If developments in the period ahead are such that it seems justified to take measures to dampen housing prices and household indebtedness, I am nevertheless doubtful about using the repo rate to do this. It would be better to reduce the level of the loan-to-value ceiling that Finansinspektionen recommends the banks to stay below, or to raise the banks' risk weights for mortgages.[16] Another alternative would be to reduce the tax deductions for interest payments somewhat. Unlike repo-rate increases, these measures are aimed directly at mortgages. These are of course measures that do not lie within the Riksbank's mandate, but it is in everyone's interest to ensure that the risks associated with the Swedish housing market are managed effectively.

So why am I against using the repo rate to influence housing prices and household indebtedness? The main reason is that the costs – in the form of inflation below the target

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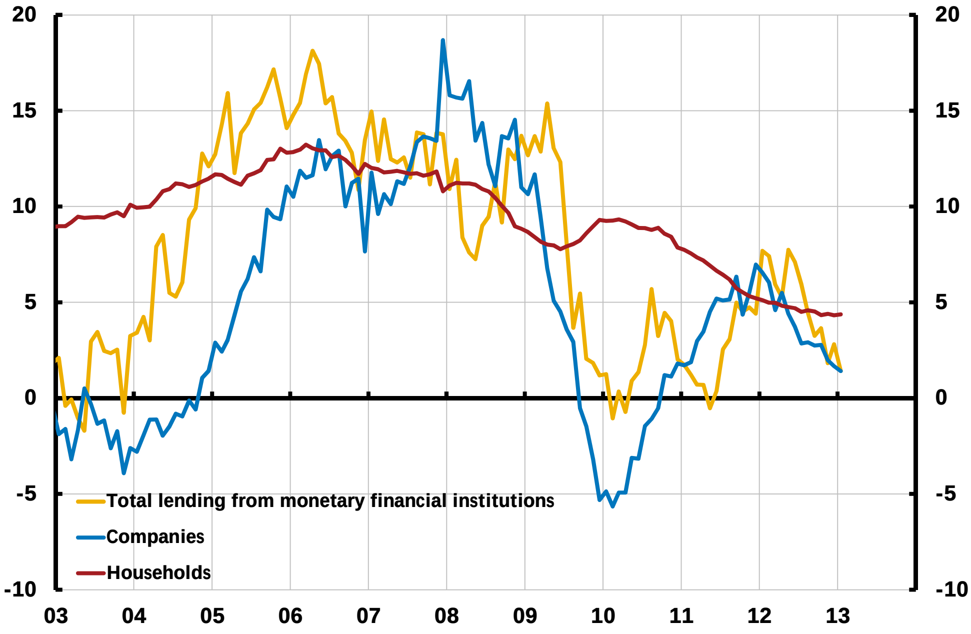
[15] For example, Borio and Drehmann (2009) present an indicator of financial crisis based on trend deviations for private loans as a percentage of GDP and property prices in the paper "Assessing the risk of banking crises – revisited". The latter components are intended to capture the likelihood and magnitude of a fall in property prices.

[16] Finansinspektionen has recently proposed a floor of 15 per cent for risk weights for mortgages. This floor could be raised if there seems to be a need to dampen the banks' lending for housing purposes.

and unemployment – appear to be high in relation to rather uncertain gains. Most analyses indicate that the policy rate has very little impact on housing prices and thus also on household indebtedness.[17] Using the repo rate would be justified if what we were seeing was a credit boom throughout the Swedish economy. But this is not what we are seeing. Household indebtedness is increasing at approximately the same rate as disposable incomes. The rate of growth in bank lending to companies typically varies with the business cycle, and at present this rate is low (see Figure 11). All in all, credit growth is relatively low in the Swedish economy.

Figure 11. Lending to households and companies from monetary financial institutions

Annual percentage change



Source: The Riksbank.

Another problem with using monetary policy to influence household indebtedness is that this also has an impact on the exchange rate. All else being equal, higher interest rates lead to a stronger currency and, again all else being equal, a stronger currency leads to lower inflation and lower resource utilisation.

There are thus clear costs associated with using monetary policy in this way. The alternative – and a better one – is to separate monetary policy from the policy that aims to promote financial stability. This could be done by establishing an effective framework for macroprudential policy that is a policy that aims to counteract risks in the financial system as a whole.

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17 See for example Kuttner, Kenneth (2012), "Low Interest Rates and Housing Bubbles: Still No Smoking Gun", under publication in *The Role of Central Banks in Financial Stability: How Has it Changed?*, and Claussen, Carl Andreas, Magnus Jonsson and Björn Lagerwall (2011), "A macroeconomic analysis of housing prices in Sweden", Chapter II.1 in *The Riksbank's inquiry into risks in the Swedish housing market*.

A separate macroprudential policy

In January 2013, the Financial Crisis Commission presented an interim report that discusses, among other things, how financial crises can be prevented in Sweden. The Commission proposes the setting up of a council for macroprudential policy. This would entail the existing council for cooperation on macroprudential policy between the Riksbank and Finansinspektionen being established by law and complemented by independent experts and an observer from the Ministry of Finance. The council should also work to develop macroprudential policy instruments, analyse risks and discuss appropriate measures. The intention is that responsibility for deciding whether or not to apply a macroprudential policy instrument would lie with either Finansinspektionen or the Riksbank.

The Commission's proposal is well-reasoned and wise, but, as I see it, has one flaw: it is unclear who is ultimately responsible for conducting macroprudential policy. As it will usually be a question of taking measures that are unpopular – for example limiting the possibilities of households to borrow money in a way that will restrict their choices about where they can live, or limiting the possibilities of financial companies to earn money – it is vital that someone is made responsible for ensuring that the measures are actually taken. This may well be, as the Commission suggests, the Riksbank or Finansinspektionen. However, I am sceptical about both authorities being responsible, as it will be all too easy to blame each other when a crisis actually develops.[18]

It is of course natural for the Riksbank to play a central role in macroprudential policy, as financial stability is a precondition for macroeconomic stability and risks to financial stability are therefore analysed on an ongoing basis.[19] However, a responsibility for macroprudential policy may potentially come into conflict with the independence the Riksbank has in the field of monetary policy. This is an independence based on the realisation that a politically-governed monetary policy tends to be inflationary, as it may be tempting for political reasons to renege on a promise of low inflation and to conduct a more inflationary monetary policy that reduces unemployment in the short-term.[20] However, independence goes hand in hand with a clearly-defined objective for monetary policy that can be constantly evaluated. Macroprudential policy is different in nature, as the objective is to prevent crises. It is of course possible to constantly register whether a crisis has occurred or not, but if a crisis has not occurred it is difficult to determine whether the measures taken have been well-designed or not. As it is a case of unpopular measures, one might think that it would be an advantage if the decisions were made by people who in practice cannot be dismissed. But this this may not be a particularly good solution from a democratic point of view.

At the same time, macroprudential policy may address the issue of macroeconomic stability in such a way that it comes close to what monetary policy aims to achieve. The historically-high level of household indebtedness in Sweden does not perhaps in the first instance pose a risk of financial crisis but to macroeconomic development in the longer term. A fall in housing prices in connection with an economic slowdown with increased unemployment could lead to a severe downturn if the households reacted by significantly increasing their saving to compensate for declining wealth.[21] This risk relates to financial and macroeconomic

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18 Similar criticism was expressed by my colleague Kerstin af Jochnick in the speech "Monetary policy and macroprudential policy", 25 January 2013.

19 The European Systemic Risk Board (ESRB) highlights the role of the central bank in its recommendations on institutional frameworks for national macroprudential policy (see the Recommendation of the European Systemic Risk Board of 22 December 2011 on the macroprudential mandate of national authorities).

20 See for example Kydland, Finn and Edward Prescott (1977), "Rules rather than discretion: The inconsistency of optimal plans", *Journal of Political Economy*, vol. 85, pp. 473–490.

21 The February Monetary Policy Report discusses the macroeconomic consequences of a fall in housing prices in the article "The household balance sheet and the macroeconomic assessment".

imbalances rather than to financial stability. They are also imbalances that must be viewed in a much longer perspective than the perspective we usually adopt when we make decisions about the repo rate.

Financial and macroeconomic imbalances of this type can of course result in financial crises, but do not do so automatically. We should therefore distinguish between avoiding such imbalances and avoiding crises than threaten the financial system. In both cases I believe that we need an active policy alongside the standard stabilisation policy. I am sure that everyone agrees that the Riksbank has a central role to play in analysing the emergence of financial and macroeconomic imbalances. However, what the role of the Riksbank should be when it comes to deciding on measures to counteract imbalances in the longer term is a more open question at present. In my view, it is important that macroprudential policy is put in place as a separate policy area. This would be good for financial stability, but also good for macroeconomic stabilisation. The proposal of the Financial Crisis Commission has now been circulated for comment and I and the other members of the Executive Board of the Riksbank will now formulate our joint response to the proposal during the spring.

Conclusions

I thus believe that there are many indications that demand is too weak in the Swedish economy and that in principle this has been the case ever since the autumn of 2008. One should not have exaggerated expectations of what monetary policy can achieve when it comes to reducing the relatively high level of unemployment in Sweden. However, as long as inflation is expected to be clearly under the target of 2 per cent I believe there is scope to use monetary policy to try to alleviate the situation on the labour market.

I have argued that one of the reasons why fiscal policy and monetary policy have not been used more actively to increase demand in the Swedish economy is the concern about financial stability. The risk that public finances will be radically weakened if the government is forced to intervene to support banks in crisis seems to be an argument for being cautious with public finances at present. The risk that low interest rates will increase household indebtedness and that this in turn will increase the vulnerability of the households if, for example, housing prices fall for some reason has been put forward as an argument against lowering the repo rate.[22] Personally, I do not believe that the latter risk is particularly serious at present as the rate of increase in lending to households has declined significantly since before the financial crisis. Nevertheless, it is a risk that is taken into account in the monetary policy decisions. All in all, therefore, economic policy has not sufficiently counteracted the effects of weak development abroad and pessimistic households and companies.

How can we establish an effective policy for business cycle stabilisation in Sweden without at the same time exposing the economy to considerable risks with regard to financial stability? One important step is to establish a separate policy area with explicit responsibility for preventing financial crises. If we succeed in creating an effective framework for such a policy area, monetary policy would be better able to focus on its main tasks: stabilising inflation around the inflation target and resource utilisation around a sustainable level. The interim report of the Financial Crisis Commission, with its proposal to set up a council for macroprudential policy, is welcome in this context. However, as I have pointed out earlier, the division of responsibility is not set out very clearly in this proposal and it is unclear which authority should do what. For me it is not important that it is the Riksbank, rather than any other authority, that is given the responsibility and the instruments to conduct

[22] See, for example, Apel, Mikael and Carl-Andreas Claussen (2012), “Monetary policy, interest rates and risk taking”, *Sveriges Riksbank Economic Review* 2012:2, pp. 66–80, for an outline of the relationship between low interest rates, increased credit expansion and the boom on the property market in many countries that to a large extent lay at the centre of the crisis.

macroprudential policy. But it is important that someone is given responsibility, otherwise we will have created a framework that is no clearer than the one we have today. Exactly how responsibility should be allocated is an issue that I am not prepared to discuss further today. It is an issue that will have to wait until the Riksbank submits its response to the interim report of the Financial Crisis Commission later in the spring.

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