Martin Flodén: My view of monetary policy and household debt

Speech by Mr Martin Flodén, Deputy Governor of the Sveriges Riksbank, at Swedbank, Stockholm, 24 September 2013.

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This is my first speech since taking up the post of Deputy Governor of the Riksbank. Since I started in the spring I have taken part in two monetary policy meetings. On both occasions I have entered a reservation against the majority decision and advocated a lower repo rate. It therefore seems natural for me to devote my speech today to explaining my view of monetary policy and the reasons for my reservations.

Should monetary policy take into account households' high and rising indebtedness? This is a question that has been central for monetary policy in recent years and also at my first monetary policy decisions. I consider it clear that the Riksbank has a responsibility to safeguard financial stability and prevent crises linked to credit granting. However, it is not so clear what consequences this responsibility has with regard to conducting monetary policy in practice. I shall explain my reasoning at the recent monetary policy meetings. I also intend to comment on how the new framework for macroprudential policy may affect my view of monetary policy. However, I shall begin with a brief description of my view, and the Riksbank's view, of the economic situation.

Positive signs but risks remain

In recent months we have been able to see some positive signs in the Swedish economy, and also abroad. Confidence has risen in both the household and corporate sectors in Sweden, and there are some signs that unemployment is falling. In the euro area, GDP increased in the second quarter, after six quarters in a row of falling GDP. Here, too, the confidence indicators are giving more positive signals.

However, one must remember that the economies still have a long way to go to reach a normal status. GDP growth and inflation are at low levels in both Sweden and the euro area. And there are still large downside risks for economic developments. In the euro area, the weak public sector finances and problems in the banks' balance sheets have scarcely improved in recent months. In the United States, the full effects of the sequester have not yet been realised, and there is also uncertainty over how the debt ceiling will be raised during the autumn.

Growth rates in large emerging markets like China and India have fallen, albeit from very high levels. Previously, international capital has tended to move towards emerging markets as interest rates have been low in the more developed economies. However, as yields on US government bonds have been rising since the spring, the capital flows have changed direction. The outflow of capital means that exchange rates are weakening, which may improve the countries' international competitiveness and contribute to maintaining their high level of economic activity. But the large fluctuations in growth rates, capital flows and exchange rates are in themselves problematic and create uncertainty regarding economic developments in the emerging markets.

A divided Swedish economy

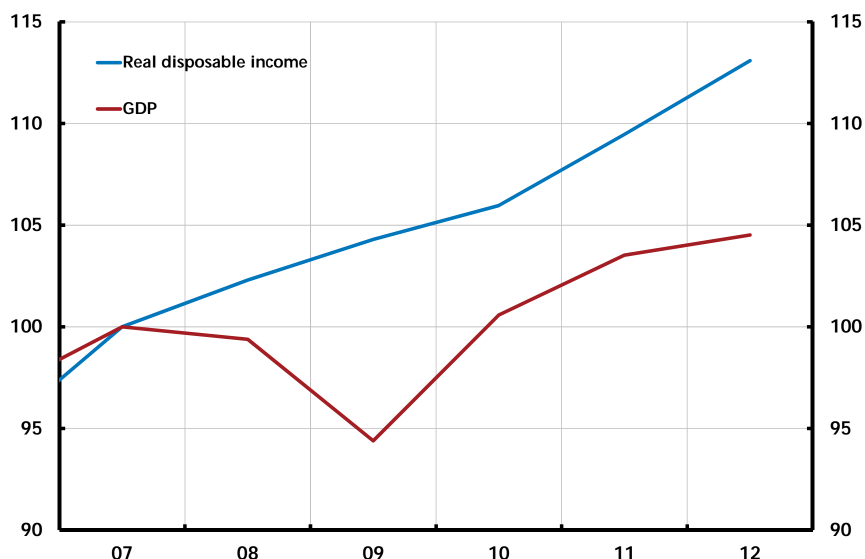
The Swedish economy is dependent on developments abroad, and of course has been affected by the financial crisis and economic downturn in recent years. In an international comparison, overall quantities such as GDP and employment have nevertheless developed well since the financial crisis.

However, behind the overall picture is a divide, where household finances in particular have been strong. Their disposable incomes have increased every year during and since the crisis (see Figure 1). Growth in consumption has also been good. Housing prices and loans to households have increased rapidly, probably partly due to strong households finances and an expansionary monetary policy (see Figures 2 and 3). Developments in the corporate sector have been weaker, which is reflected in weak growth in exports, low investment and only modest growth in loans to companies (see Figure 4).

Figure 1

GDP and real disposable income

Index, 2007 =100

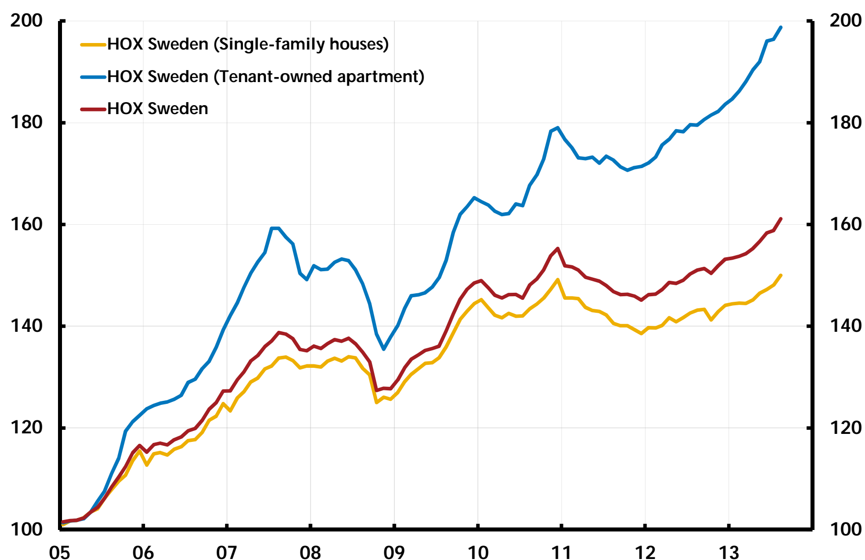


Source: Statistics Sweden

Figure 2

Housing prices

Index, January 2005 = 100, seasonally-adjusted data

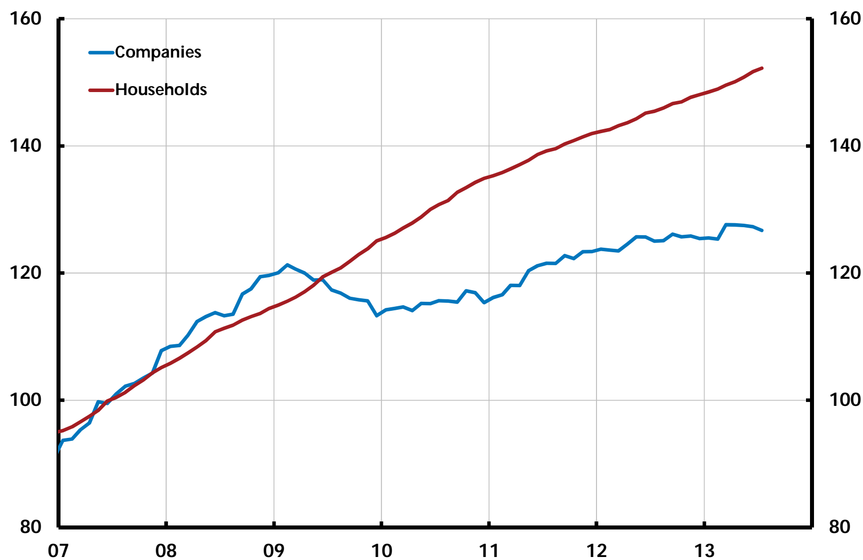


Sources: Valueguard and the Riksbank

Figure 3

Lending to households and companies

Index, 2007 =100

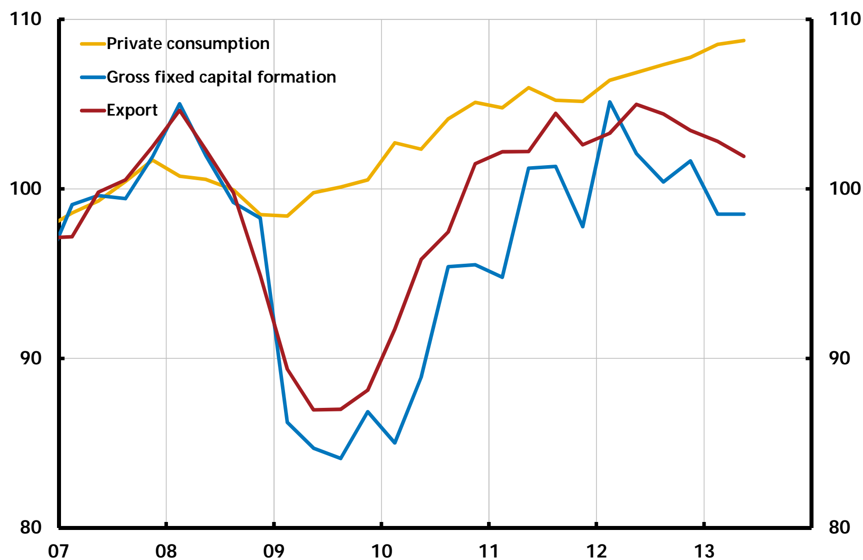


Source: Statistics Sweden

Figure 4

Exports, investment and consumption

Index 2007 = 100, seasonally adjusted data



Source: Statistics Sweden

The division in the economy is a problem for monetary policy. With only one tool, the repo rate, we are trying to attain the inflation target and at the same time attain a balanced development in economic activity. In practice, the repo rate is often adequate as a tool to

give both inflation and economic activity a push in the right direction.[1] But in recent years, we have also needed to manage the problem of economic activity being at different levels in different parts of the economy. We cannot use the repo rate to stimulate the corporate sector and limit the build-up of household debt all at the same time. In this situation, it is not evident how monetary policy should manage the balance between inflation, economic activity and the risk of an overly rapid increase in housing prices and household credit. Let me elaborate on my thoughts a little further here.

Monetary policy must take financial risks into account

The concern over lending to households increasing too rapidly has led to a majority of the members of the Riksbank's Executive Board voting to hold the repo rate at a higher level than would otherwise have been justified. I have entered reservations against these decisions and advocated a lower repo rate, for reasons I will return to later. Despite my reservations, I share the majority's concern over the rapid increase in household debt. And I consider that monetary policy should, in principle, take into account financial imbalances and risks that may arise as a result of the monetary policy conducted.

In what way is this compatible with the Riksbank's mandate?

According to the Sveriges Riksbank Act, the objective of the Riksbank's activities is to maintain price stability. Moreover, the Riksbank shall promote a safe and efficient payment system. In addition, the preliminary works to the Act state that the Riksbank, without prejudice to the price stability target, should support the goals of general economic policy with a view to maintaining a sustainable level of growth and high rate of employment.

At the Riksbank we consider the task of promoting a safe and efficient payment system to have a broad meaning and that it is, in practice, a matter of taking responsibility for promoting the stability of the financial system.[2] But it is not actually this task that justifies monetary policy taking into account a rapid expansion in household borrowing. It is namely the case that the preliminary works to the Sveriges Riksbank Act emphasise that the monetary policy instruments shall only be used to maintain price stability, and thus not to promote a safe and efficient payment system.[3]

We sometimes say that monetary policy shall take financial risks into account, as it can be difficult to stabilise inflation around the target if households are forced to rapidly reduce their debts.[4] Such difficulties could arise, of course, but for me it is not consideration of the inflation target that mainly justifies letting monetary policy take financial risks into account.

Instead I perceive taking financial risks into account to follow on from the task of "supporting the objectives of general economic policy with the aim of achieving sustainable growth". A monetary policy that leads to an unhealthy build-up of credit or other financial imbalances is scarcely compatible with sustainable growth.

But this task, like the task of stabilising economic activity, is subordinate to the inflation target. Monetary policy's consideration of financial risks must therefore be weighed against the inflation target and economic developments.

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[1] For a tool to be sufficient to meet the inflation target and attain a balanced development in economic activity, it is necessary for the economy to mostly suffer demand shocks, not supply shocks. This observation is sometimes called *the divine coincidence*, an expression coined by Blanchard and Gali (2007).

[2] See the Riksbank (2013a) p. 3.

[3] See Bill 1997/98:40, p. 54.

[4] See, for example, the Riksbank (2013b).

From principle to practice

The question is then how the principle of consideration of financial risks and imbalances should be put into practice in monetary policy. How should the balance between the different tasks be managed?

When determining this we must consider whether other tools than monetary policy are more suitable for managing financial risks, whether our concerns regarding household debt are justified and what effects monetary policy has on the imbalances and risks that concern us.

I do not intend to conduct any deep discussion of the links between monetary policy and other tools today. As expressed by the Riksbank (2010), I note that it is not primarily monetary policy, but an efficient regulatory framework and supervision that is important to prevent financial imbalances. The way in which monetary policy should take into account financial risks may therefore depend on the formulation of the regulatory framework and the supervision. I shall return to this question when I discuss the new framework for macroprudential policy.

Household indebtedness is worryingly high

Also, I do not wish to get into a detailed discussion now as to whether the concern over rising house prices and household debt in recent decades is justified.[5] It is clear to me that we do not fully understand what the underlying factors are. We therefore do not know whether the upturn is largely explained by fundamental factors or whether it reflects imbalances that have built up in the economy.

Fundamentals that we are not able to disregard include the fact that housing construction is low and has been so for a number of years. A low level of construction, combined with a growing population and a move to metropolitan areas also contribute to a rise in housing prices, and ultimately to an increase in debt. And the conversion of rental properties to tenant-owned properties also contributes to increased debt. A further aspect is that household savings are high and have increased at the same time as debt has increased.

But high indebtedness probably means that the economy will be more sensitive to shocks, even if it can be explained by fundamentals. An economic downturn could then be reinforced by households with large debts trying to increase their saving by reducing their consumption. Moreover, we can hardly rule out the possibility that households' increased indebtedness in recent years has at least partly been caused by unrealistically low expectations of future mortgage rates. In my opinion, it is therefore in principle justified for monetary policy to now take into account the rapid increase in household indebtedness.

Risks with a low repo rate

A further question is thus in what way monetary policy can lead to financial imbalances building up. International academic research discusses several potential problems that can arise if a central bank holds its policy rate at a low level for a long period of time. Perhaps the most common problem mentioned is that investors will then seek assets with a higher yield, which also have a higher risk. One of many reasons for such behaviour could be that some portfolio managers are required to attain a minimum return on their portfolios. This behaviour risks causing an unwarranted rise in asset prices when interest rates are low.[6]

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[5] There is a lively debate on this question. One important contribution to the discussion is the Riksbank's commission of inquiry into risks on the Swedish housing market (Riksbank 2011). The National Institute of Economic Research (2013) and Svensson (2013a) are examples of newer contributions to the debate, claiming that housing prices and household indebtedness do not comprise an evident problem.

[6] See Rajan (2005).

Another possible problem with low interest rates is that the monetary policy stimulus can help weak companies to get along without having to deal with their problems. In this way, a necessary structural transformation in the economy may be postponed. There is also a risk that the stimulus will help the banks to struggle along with weak balance sheets, which will inhibit credit granting in the economy.[7]

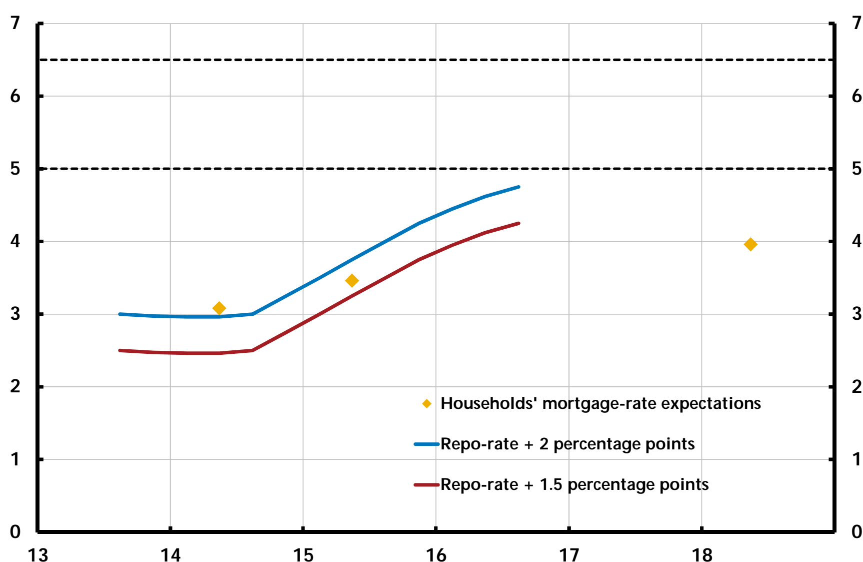
The problems I have just mentioned nevertheless appear less relevant to current developments in Sweden. But I would like to mention two other potential problems linked to low interest rates, which I think justify the concern over the Swedish economy.

My first source of concern is perhaps a little far-fetched.[8] Let us say that for some reason we find ourselves in a situation where the repo rate is low and many households are heavily indebted. In this situation a repo-rate increase could have large negative consequences for the indebted households and consequently for the economy as a whole. Then households might believe that future economic policy will be formulated so that such negative consequences are avoided or alleviated. They may then choose to take on even higher debts if they believe – with or without justification – that economic policy will take this into consideration. And these problems risk increasing the longer the repo rate is kept at a low level.

Figure 5

Households' mortgage-rate expectations one, two and three years ahead

Per cent



Note. Repo-rate forecast from the September MPU. The households' mortgage-rate expectations refer to expectations regarding the variable mortgage rate. The broken lines show an interval based partly on an interval for the long-term repo rate of 3.5–4.5 per cent and partly on an interval for the difference between a three-month mortgage rate and the repo rate of 1.5–2 percentage points.

Sources: The National Institute of Economic Research and the Riksbank.

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7 See Rawdanowicz, Bouis and Watanabe (2013).

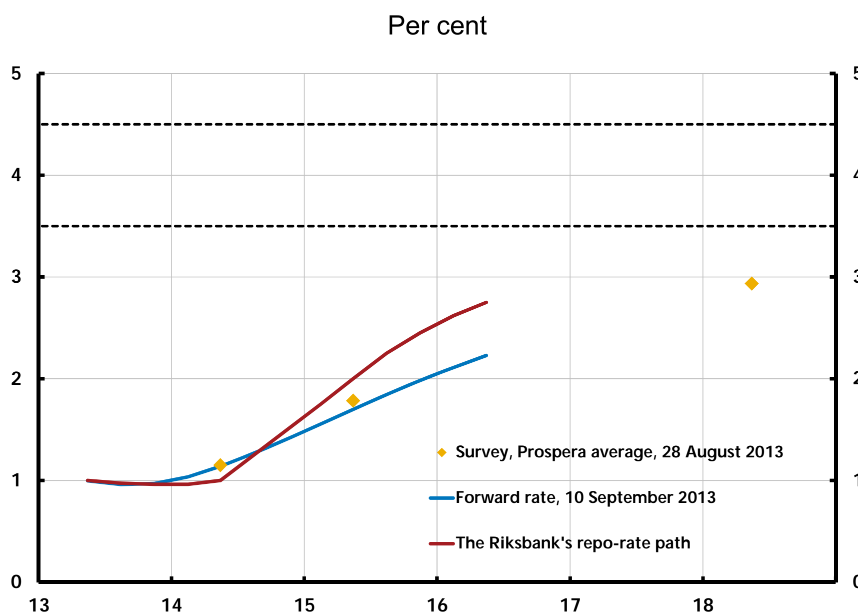
8 This reasoning is based on Farhi and Tirole (2012).

A more tangible source of concern is households' expectations of future interest rates. Surveys show that households (and market agents, for that matter) are expecting much lower interest rates in the longer run than we at the Riksbank are expecting (see Figures 5 and 6).[9]

Figure 6

Expectations of the repo rate

Per cent



Note. Repo-rate forecast from the September MPU. Repo-rate expectations among money market participants 1, 2 and 5 years ahead. The broken lines show an interval for the long-term level of the repo rate of 3.5 to 4.5 per cent.

Sources: The National Institute of Economic Research, TNS SIFO Prospera and the Riksbank

One possible interpretation of these expectations is that households place too much emphasis on the low interest rates in recent years when they are looking ahead. In this case, further repo-rate cuts risk reinforcing the difference between households' expectations and the Riksbank's expectations of future interest rates. And such incorrect expectations may then lead to unwarranted increases in housing prices and household indebtedness.

But I would like to point out that it is genuinely difficult to know what will be a "normal" or average level for future mortgage rates. It is not at all certain that the Riksbank's long-run assessments of the repo rate are more correct than those of households or other market agents.

A low repo rate is necessary, despite the risks

I have observed that there are risks linked to holding a low repo rate over a long period of time, and that monetary policy should in principle take these risks into account. But at the

[9] At the Riksbank, we usually say that the average repo rate in the longer run can be expected to be in the interval of 3.5 to 4.5 per cent (see, for instance, the Riksbank 2013b, p. 47). Short-term mortgage rates are usually 1.5 to 2 percentage points higher. Households' expectations of short-term mortgage rates five years ahead are now around 4 per cent. And market agents' expectations of the repo rate five years ahead are around 3 per cent. See Figure 5 and Figure 6.

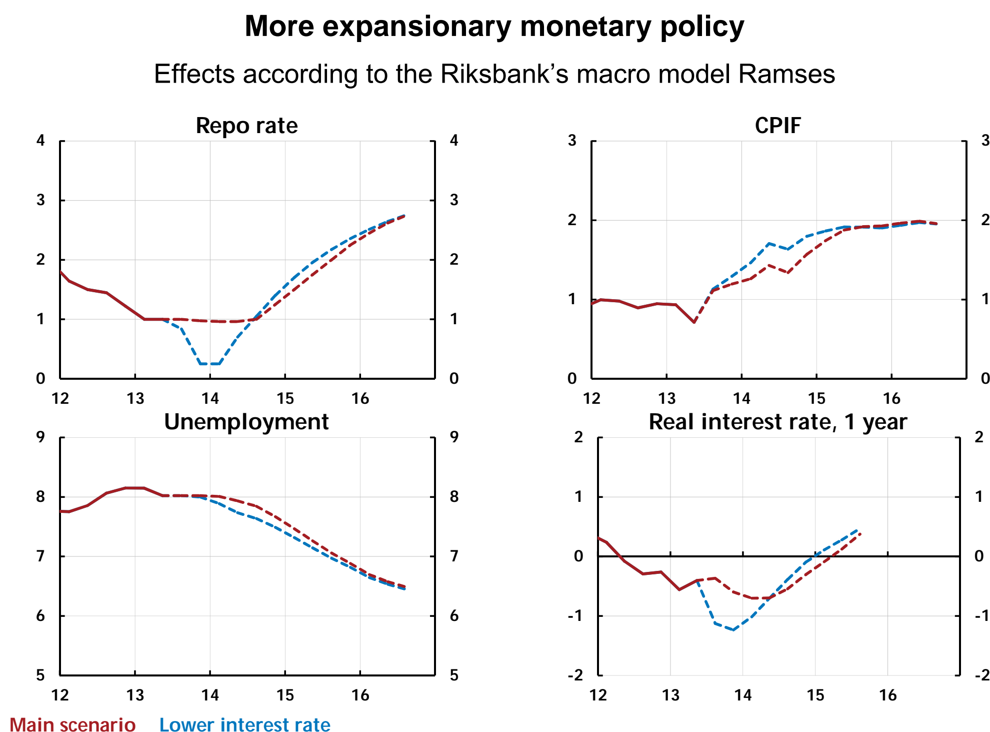
most recent monetary policy meetings I have nevertheless advocated cutting the repo rate even lower.

There are several factors behind this stance. Firstly, a lower repo rate would mean that CPIF inflation returns to 2 per cent even faster and that resource utilisation is more balanced than in our forecasts (see Figure 7).

Figure 7

More expansionary monetary policy

Effects according to the Riksbank's macro model Ramses



Sources: Statistics Sweden and the Riksbank

Secondly, I have seen an incipient credibility problem and wanted to formulate monetary policy so that it appears well-balanced even when combined with assessments made outside of the Riksbank. The problems I have seen are based on a combination of inflation having clearly undershot the target, the Riksbank's inflation forecasts having been more optimistic than those of other analysts, the Executive Board's repo-rate paths having indicated a tighter monetary policy than the market and analysts have expected and the repo-rate paths having been revised down time after time. I have said that in such a situation it is better to cut the rate immediately rather than continuing to present a repo-rate path that is not perceived by outsiders as entirely credible. However, these problems have become a little less important in recent months as other analysts' forecasts of inflation and the repo rate have been revised up.

Thirdly, it is not self-evident that taking into account household debt means setting a higher repo rate than we would otherwise have done. The current repo rate, 1 per cent, is undeniably low. In the long run, the repo rate will be raised to much higher levels. But we cannot raise the repo rate until we see that inflation has clearly begun to move towards the target of 2 per cent. And when this happens will of course depend on monetary policy. If we cut the repo rate now, inflation will rise faster towards the target. If the repo rate is left unchanged it will take longer before inflation begins to rise, and this in turn means that it will take a long time before the repo rate can be raised. It is not even self-evident that inflation will return to the target level in the long run if monetary policy is too tight.

If we are worried that a long period with a low repo rate will give rise to an unjustified upturn in housing prices and indebtedness, we should perhaps ensure we conduct a monetary policy that means we quickly move towards the inflation target, and that still works even if

economic developments are less favourable than forecast in our main scenario. Such a monetary policy could entail cutting the repo rate now to increase inflation and then raising the repo rate slightly faster in the coming period when inflation accelerates (see Figure 7).

Admittedly, preliminary assessments within the Riksbank, based on model calculations combined with empirical relationships, indicate that a large repo-rate cut now, followed by faster increases in the future would entail slightly higher risks linked to household indebtedness than if the repo-rate path advocated by the majority is followed. However, the difference in the risk outlook for these two alternatives is almost negligible. A lower repo rate now and faster increases in the coming period seems to me a better monetary policy, when weighing the risks against the opportunity to return to the inflation target sooner and to have a more balanced resource utilisation (see Figure 7).[10]

The assessments and calculations I refer to here are based on the general framework presented in our Monetary Policy Report published in July.[11] It is not entirely clear how this reasoning should be translated into recommendations for practical monetary policy. We are working on this issue within the bank. It scarcely needs to be said that the assessments and calculations I have implied today are uncertain, and that they will remain uncertain even when work on these issues has progressed further.[12]

Further measures are needed to strengthen financial stability

In conclusion, I would like to discuss how the new framework for macroprudential policy affects my view of how monetary policy should be conducted.

It is good that one single authority, Finansinspektionen (the Swedish Financial Supervisory Authority), is given a clear responsibility for decisions on supervisory measures. In this way, we avoid the problem that different authorities may try to put responsibility on others, which could have arisen if the responsibility was shared between several authorities.

At the same time, it is positive that several authorities, including the Riksbank, are given a role to play in the work on macroprudential policy through the new financial stability council. Identifying and analysing factors that can give rise to financial imbalances is and will remain an important part of the Riksbank's work. The Riksbank needs this analysis for several reasons. As I mentioned earlier, the Riksbank has responsibility for promoting a safe and efficient payment system. We must also understand if monetary policy risks contributing to financial imbalances arising. Moreover, a development of the economy that proves to be unsustainable will affect the way in which inflation develops and what type of monetary policy it is appropriate to conduct. The financial stability council will give us a forum where we can and shall openly present our analyses of financial risks and recommendations for supervisory measures.

In the recent Monetary Policy Update our forecasts was based on no new macroprudential policy measures being introduced. But how will my view of a suitable monetary policy be affected if such measures are implemented?

The answer depends entirely on the measures implemented and their effects.

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[10] The scenarios shown in Figure 7 should primarily be regarded as an illustration of the different alternatives. The repo-rate path there does not coincide with the one I have advocated at the monetary policy meetings.

[11] The Riksbank (2013c).

[12] A central element of uncertainty is how the repo rate affects the degree of household indebtedness. The Riksbank's estimates imply that the debt ratio will increase when the repo rate is cut, but that the increase will be small. Svensson (2013b) says on the other hand that a lower repo rate would entail a *lower* debt ratio. But in his model there is no real reason to be concerned over household indebtedness, regardless of how the repo rate affects the degree of household indebtedness. For example, he does not allow for households' interest-rate expectations becoming unjustifiably low if the repo rate is cut.

Supervisory measures can have direct effects on financial risks and imbalances by limiting the possibilities of particularly vulnerable households, companies or banks to take certain decisions. However, the measures may also have indirect effects on risks and imbalances, or side effects on the economy by affecting the cost of capital or the general demand situation.

An example of a measure that probably first and foremost has direct effects is the mortgage cap. This affects primarily a small group of highly-indebted households and can be expected to contribute substantially to preventing financial imbalances arising. But the mortgage cap scarcely has any major effects on the general demand in the economy, or on the cost of capital for a typical household.

An example of a measure that can affect the cost of capital is higher risk weights on mortgages. Such a measure would probably lead to an increase in mortgage rates in relation to other lending rates. And higher risk weights would probably also push up average lending rates at a given repo rate, at least in the short run.

As I in practice have not let concern for households' rapid build-up of debt affect my view of how the repo rate should be set today, measures of the first type, that is, measures that directly limit vulnerable households' opportunities to become or remain heavily indebted, would probably also have little effect on my choice of repo rate and repo-rate path. On the other hand, measures that entail an increase in the average lending rates or a weakening of general demand would justify cutting the repo rate. The purpose would then be to counteract the effects of the supervisory measure on total economic developments. However, the supervision measures could nevertheless affect financial imbalances, for instance, by changing the level of household mortgage rates in relation to companies' borrowing rates.

Further macroprudential policy measures thus need not change my view of which monetary policy is most appropriate now. However, such measures are nevertheless important to monetary policy as they can reduce risks and uncertainties. It is easier to conduct monetary policy if financial stability is good.

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