# Kerstin af Jochnick: Low inflation and high indebtedness – expansionary monetary policy makes demands of other policy areas

Speech by Ms Kerstin af Jochnick, First Deputy Governor of the Sveriges Riksbank, to the Swedish Society of Financial Analysts, Stockholm, 21 August 2014.

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Inflation in Sweden is currently below the target of two per cent. But at the same time, household debt is a threat to the long-term stability of the development of the economy. How are we to handle this challenge?

A very expansionary monetary policy is necessary to attain the inflation target. At the same time, the low interest rates could increase the risks linked to household indebtedness. Major demands are therefore being made of other policy areas to deal with these risks.

In this context, it is good that we now have a framework for macroprudential policy in place, which enables further and more precise measures to manage household debt. Finansinspektionen (the Swedish financial supervisory authority) has the main responsibility for macroprudential policy instruments, at the same time as a financial stability council has been established, in which the Riksbank, the Government, the Swedish National Debt Office and Finansinspektionen all participate.

Today I intend to discuss current monetary policy and the work on the financial stability council, and to give my view of how we can attain the inflation target at the same time as managing household debt.

## Repo-rate cut in July

Let me begin by talking about current monetary policy and the repo-rate decision in July.

### *Economic recovery continuing...*

If we begin with economic prospects, we can observe that the recovery is continuing, both in Sweden and abroad. For a small economy that is dependent on foreign trade, like Sweden, developments abroad are important, particularly in the euro area, which is our most important export market.[1] The euro-area economy has for some time shown positive growth figures once again, but the recovery is progressing slowly and marked by repercussions from the sovereign-debt crisis. Things look rather better in the United States and the United Kingdom, and growth there is expected to be higher. All in all – when foreign countries are aggregated according to the KIX index – it seems we can expect a relatively good recovery in the coming years.

At the same time, geopolitical developments over the past six months cast new clouds of doubt over global growth. Here I am mainly thinking of the effects on the euro-area economy of developments in Russia and Ukraine. It is still too early to draw any definite conclusions with regard to the effects on growth prospects in Europe. But there is a risk that developments abroad will be worse than we have previously assumed.

Given that international developments are in line with our forecasts, however, we envisage improved economic activity in Sweden. However, the picture is divided. Household consumption has so far held up relatively well in recent years, while exports have developed less well, against the backdrop of the weak developments in the euro area. In the coming

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1 When these countries are weighed together in relation to their significance for Swedish foreign trade using the KIX index, the euro area accounts for almost 50 per cent.

period, domestic demand is expected to continue to strengthen, at the same time as the economic improvement abroad will help exports to gradually pick up. When growth in Sweden accelerates, unemployment is also expected to fall.

All in all, we see a fairly clear improvement in economic activity ahead of us.

### *…but inflation is too low*

The Swedish economy's international dependence applies not only to the real economy, but also to inflation. It is clear that inflation in several of our important export regions has shown a downward trend in recent years (see Figure 1). Given this, central banks abroad have conducted a very expansionary monetary policy. In our most recent assessment in July we also revised down our forecasts for policy rates abroad (see Figure 2).

The low inflationary pressures abroad are one explanation why inflation in Sweden has been low in recent years. When measured as the CPIF, where the effects of the Riksbank's repo-rate changes on mortgage rates are excluded, inflation has been clearly below the target of 2 per cent since the start of 2012, and since the end of last year it has fallen further (see Figure 3). One indication that the low inflation is a global phenomenon is that most central banks with inflation targets experienced inflation undershooting the target last year (see Figure 4).

However, inflation abroad is not the only explanation for the low inflation in Sweden. The exchange rate is significant for how prices abroad are "translated" into prices for Swedish import goods. During the financial crisis in autumn 2008, the krona depreciated substantially, but after that there was a fairly long period with a clear appreciation, which contributed to pushing down import prices in Sweden. But over the past year the trend has levelled off, and the krona has even weakened slightly so far this year (see Figure 5). The development of the krona is therefore probably mainly a partial explanation for the earlier low inflation, and is less so now.

A further explanation for the low inflation in Sweden is that the uncertain economic climate in the wake of the European debt crisis has meant that companies have not been able to pass on cost increases to consumer prices in the same way as before. Moreover, their margins have been squeezed by the stiff competition.[2] This picture is confirmed by the preliminary results of the survey we made together with the National Institute of Economic Research, where we asked 1,500 companies in mainly the services, retail and construction industries what factors have significance for their pricing.[3]

But inflation in Sweden has repeatedly been lower than both the Riksbank and market analysts have expected (see Figure 6). I consider it very important that we continue to carefully analyse the reasons for the low inflation, both in Sweden and abroad. An interesting question is what role global and domestic factors respectively will play for inflation in individual countries, something that the BIS discusses in its most recent report.[4] The BIS points out the structural effects of globalisation and increased world trade that have increased competition and may have contributed to squeezing prices in many parts of the world.

### *Household indebtedness has been considered in the monetary policy decisions*

As you know, I and my colleagues on the Executive Board have also discussed the high level of household indebtedness at monetary policy meetings in recent years, as it could comprise

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2 An article in the July Monetary Policy Report, "Why is inflation low?" describes the possible reasons for the low inflation in Sweden.

3 We will return to our analysis of the questionnaire in the early autumn.

4 See "84th Annual Report, 1 April–31 March 2014", Bank for International Settlements, 2014.

a risk to the economy in the longer run. Swedish household debt has risen very substantially since the mid-1990s. Even if the increase in indebtedness, measured in terms of debt in relation to disposable income, has slowed down in recent years, the level is still very high in a historical perspective (see Figure 7). The development of household debt is linked to the development of housing prices, which is not so strange as housing purchases as largely financed through loans (see Figure 7).

A high level of indebtedness makes households more vulnerable to various shocks. Ultimately, shocks in, for instance, incomes, housing prices or interest rates can trigger adjustments that have fairly significant effects on the macro economy: weak demand, high unemployment and difficulties stabilising inflation around the target. Naturally, we wish to avoid this type of development.

There has recently been a debate on whether giving consideration to financial imbalances in the repo-rate decisions is compatible with the Riksbank's monetary policy assignment.

I consider it to be entirely compatible with the monetary policy assignment, as financial imbalances ultimately risk jeopardising both real economic stability and inflation stability. In a really negative scenario, financial imbalances may not only lead to unfavourable macroeconomic outcomes, they may also pose risks to financial stability.[5] Financial stability is an important condition for monetary policy to function smoothly. The monetary policy transmission mechanism and the possibility to attain the monetary policy objectives – price stability and real economic stability – deteriorate substantially if a financial crisis breaks out.

The monetary policy decisions taken in recent years have thus involved a balance between stabilising inflation in the shorter term and also taking into consideration the effects the repo rate has on household indebtedness and thus the risk of an unfavourable scenario later on. Figure 8 is a way of illustrating this balance within monetary policy. The upper half illustrates the effect of the repo rate on inflation and resource utilisation during the forecast period, and the lower half illustrates the effect of the repo rate on indebtedness and risk in the longer run.[6] In the situation we have had in recent years – with inflation undershooting the target – a lower repo rate and repo-rate path has typically meant that inflation will approach the target faster, but also that household indebtedness – and thereby the risks in the longer run – will increase more.

Our most recent assessment assumes that household indebtedness, measured as debt in relation to disposable income will increase from an already high level, and moreover increase somewhat faster than in the previous forecast (see Figure 9). At the same time, the percentage of loans at a variable rate is increasing. This is natural in a situation where the Riksbank is signalling that interest rates will be low for a long time. However, the combination of high indebtedness and a large percentage of variable-rate mortgages makes households more sensitive to changes in interest rates.

### *The low inflation is motive for lower interest rates – indebtedness must mainly be managed within other policy areas*

As on so many previous occasions in recent years, the monetary policy balance in July concerned balancing the low inflation against the high household indebtedness and the risks this entails.

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5 For an in-depth description of the risks linked to household indebtedness in Sweden, see for instance, Alsterlind Jan, Ulf Holmberg, Kristian Jönsson, Björn Lagerwall and Jakob Winstrand, "Risks to the macro economy and financial stability arising from the development of household debts and housing prices", Council for Cooperation on Macroprudential Policy's memo 6, Sveriges Riksbank.

6 One can read more about this in, for instance, the article "Financial imbalances in the monetary policy assessment" in the Account of Monetary Policy 2013, Sveriges Riksbank.

However, there was agreement among the Executive Board on the need to cut the repo rate to bring inflation up to the target within the forecast period. Although the economic prospects look fairly good, inflation is too low, and has moreover been lower than expected recently. Our assessment is that inflationary pressures will be lower in the coming period, too, compared with the assessment made in April (see Figure 10).[7] A further factor that I mentioned earlier, is that policy rates abroad are expected to be lower (see Figure 2). When the policy rate is higher in Sweden than abroad, the krona exchange rate tends to strengthen, which contributes to lower inflation through lower import prices. All else being equal, lower policy rates abroad therefore imply that interest rates in Sweden will also be lower, so that the krona does not strengthen too much (see Figure 5 for the latest forecast for the krona). All in all, these factors clearly indicated that the repo rate and repo-rate path should be lowered in July (see Figure 11).

As you know, I entered a reservation against the decision to cut the repo rate by 0.5 percentage points and advocated a smaller cut of 0.25 percentage points, and to wait until 2016 before making the first policy rate increase. There are several reasons for this. Firstly, I consider that the smaller repo-rate cut entails a better balance between bringing inflation up towards the target and taking household indebtedness into consideration. As I see it, there are also clear signs that economic activity is about to improve, and the conditions are therefore right for stabilising inflation around 2 per cent by means of a smaller cut in the repo rate. Moreover, the smaller repo-rate cut is more in line with our earlier actions, which was reflected in the market expectations of a 0.25 percentage repo-rate cut. I do not think one should surprise economic agents unnecessarily, and our actions should as far as possible be predictable and long term.

I would like to emphasise that there is, on the whole, consensus among the Executive Board with regard to economic developments and monetary policy. As I have said before, it is a question of a difficult balancing act, and it is natural that there will be some minor differences of opinion on the assessments. One of the reasons why we have an Executive Board consisting of several members is that different assessments and approaches can be tested against one another, which should ultimately lead to better decisions.

In addition to the agreement on economic developments and the direction for monetary policy, there was also broad unity among the Executive Board that household indebtedness is a risk that needs to be managed. The low interest rates mean that there is an increased risk that the economy will not develop in a way that is sustainable in the long run. There are thus now even greater demands for measures within other policy areas to deal with household indebtedness and developments on the housing market. Macroprudential policy plays an important role in this context.

### Welcome framework for macroprudential policy – it improves the conditions for managing household indebtedness

One message I have conveyed time and time again – including in my August speech last year – has been that a framework for macroprudential policy would facilitate the monetary policy deliberations.[8] More accurate tools could be used to manage household indebtedness (see the lower half of the diagram in Figure 8), at the same time as monetary policy could to a greater extent focus on the inflation target within the normal forecast period (see the upper half of the diagram in Figure 8).

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7 One must bear in mind that the inflation forecasts in the Figure are calculated on the basis of the current repo-rate paths. In July, the repo-rate path was lowered substantially, and without this downward revision to the path, the forecast for inflation would have been even lower.

8 See also my speech "Monetary policy and macroprudential policy", published on 25 January 2013.

In principle, macroprudential policy tools can reduce the risks linked to household indebtedness in two different ways. First, one can increase the resilience of the financial system through, for instance, higher capital levels in the banks. It reduces the risk of a macroeconomic shock, for instance, a sharp fall in Swedish housing prices, developing into a banking crisis if the banks have more capital to absorb loan losses. Second, one can try to directly slow down growth in household indebtedness through, for instance, different types of limits to how much household are allowed to borrow.

However, Sweden has long lacked a framework for macroprudential policy, with clear guidelines as to which authority should take action and what tools they should use. I and several of my colleagues have called for such a framework on many occasions. Now we have this framework in place. I now intend to describe the framework, the measures that have been taken and what remains to be done.

### *The allocation of responsibility for the tools and the establishment of a Financial Stability Council*

The Government announced last autumn that Finansinspektionen would have the main responsibility for decisions on macroprudential policy measures and that a Financial Stability Council would be established. The Riksbank's mandate remains unchanged. We shall continue to safeguard financial stability. We shall therefore continue to analyse and oversee the financial system, to inform and warn of risks and to make recommendations regarding measures to take. As I mentioned earlier, financial stability is also an important condition for monetary policy to function.

The new framework also entailed establishing a forum for representatives of the Government, Finansinspektionen, the Swedish National Debt Office and the Riksbank to meet and discuss questions of financial stability, what is known as the Financial Stability Council. The Council meets regularly, normally twice a year, and the information provided and discussions held at these meetings are publicised in the form of minutes no later than two weeks after the meetings. The meetings give us the possibility to discuss how the policy areas interact and what types of measure are needed to avoid new financial crises as far as possible. The authorities represented on the Council then make decisions independently within their fields of responsibility, as to which measures should be taken. Figure 12 illustrates the new framework for macroprudential policy in Sweden.

### *This spring's work in the Council – focus on capital requirements*

We have so far had two meetings of the Financial Stability Council. The first, inaugural meeting was held in February, and we noted there that there was a need for further measures to reinforce financial stability. At the end of May the first real meeting was held, and we were able to conduct a more in-depth, concrete discussion. Some issues that were taken up at this meeting were tougher capital requirement for Swedish banks and the need for measures to manage households' high and growing indebtedness.[9]

Prior to the May meeting, Finansinspektionen published a proposal for how the new European capital adequacy regulations should be applied in Sweden. The measures presented by Finansinspektionen were mostly already known, but the way they are implemented is of course important. This applies in particular to the implementation of a CET 1 capital requirement of 12 per cent for the major Swedish banks, an increase in the risk weight floor for Swedish mortgages to 25 per cent, and the introduction of countercyclical capital buffers.

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[9] Other macroprudential policy issues discussed include the risks linked to our large and interlinked banking system, which has a high degree of market funding, and various types of measure related to these risks. You can read more about this in the minutes from the meeting in May. See http://www.regeringen.se/sb/d/18209/a/241631.

The Council's meetings are prepared in the drafting committee, which consists of high-level representatives from the various authorities. The drafting committee has held regular meetings during the spring. Each respective authority has worked intensively on various questions, and there has been a substantial exchange of information and analysis between the authorities under the umbrella of the drafting committee.

It has been both useful and educational to hear the other authorities' views on the stability situation and the need for measures. I believe that it can also lead to better understanding of our various tasks and assessments. Hopefully, this could ultimately lead to well-founded decisions on the measures needed to safeguard financial stability.

The discussions in the Financial Stability Council during the spring have concerned both the risks in the financial system and the need for further measures. With regard to the risks, the Riksbank and Finansinspektionen make similar assessments. The assessment is that we have a large and closely interlinked banking system that is heavily dependent on market confidence, as the banks to a large degree finance themselves on the markets. And that household indebtedness comprises an important risk to macroeconomic and financial stability. The minutes indicate that we have different views on some issues. For instance, the need for measures to manage household indebtedness.

***Further macroprudential policy measures aimed at households' demand for loans are needed***

If we take a step back and regard the capital adequacy requirements announced in the spring in a broader perspective, they are clearly a step in the right direction. The capital adequacy requirements made of the major Swedish banks will increase in relation to the requirements that applied prior to the financial crisis. This is very welcome, as it increases the resilience in the Swedish banking system. This reduces the risk that household debt will ultimately lead to problems for the Swedish banks, which could threaten both macroeconomic and financial stability.

In addition to increasing the resilience of the banking system, higher capital adequacy requirements could also contribute to slowing down household indebtedness as the banks' funding would become more expensive if they had to have more capital, which could lead to higher lending rates and reduced credit granting. However, further capital requirements of the magnitude now being discussed would have only relatively marginal effects on household indebtedness.[10]

At the same time, both household debt and housing prices are continuing to increase from already high levels, despite the fact that Finansinspektionen introduced a mortgage cap already in 2010.

I therefore feel that further measures are needed to subdue household demand for credit. The Riksbank has proposed, for instance, the introduction of healthy minimum levels for the standard values used by the banks in their discretionary income calculations, which form part of their credit assessment of households. This means that a borrower should be able to manage certain minimum levels with regard to interest rate, amortisation rate on both first and last mortgages, as well as maintenance and general living costs.

Examples of further measures that might have an effect on indebtedness are amortisation requirements, limits to loan amounts or interest payments in relation to income or a stricter mortgage cap. The question of measures to increase households' amortisation of their loans was discussed by the Financial Stability Council in May. The Riksbank considered at the meeting that the amortisation culture needs to improve with regard to both new and old

[10] See the article "Stricter capital requirements for Swedish banks – effects on the macroeconomy", Monetary Policy Report, July 2014, Sveriges Riksbank.

loans, and that the Financial Stability Council should discuss a proposal for an amortisation requirement at its meeting in November. Such requirements can be formulated in different ways and affect all borrowers or a particular group, such as new borrowers or borrowers with a high loan-to-value ratio. It is therefore important to closely analyse different types of amortisation requirement and how they affect household indebtedness and the macro economy in general. It is also important to take into account the experiences of other countries. Prior to the meeting in November, the Council will make an overall analysis of the household situation and discuss the need for further measures with regard to household indebtedness.

My assessment is that a package of complementary macroprudential policy measures are probably needed to help manage various aspects of the risks linked to household debt, and that such a package could be more effective than individual measures. The IMF proposes, for instance, in its annual review of the Swedish economy, a combination of macroprudential measures aimed at the demand for loans: amortisation requirement, limits to the loan amounts in relation to income and a stricter mortgage cap, lowered from 85 to 75 per cent of the value of the housing.[11]

### *Measures within other policy areas must also be considered to manage household indebtedness*

All in all, I think that the new framework for macroprudential policy is a very important step with regard to both discussing systemic risk and managing household indebtedness. My assessment is that there is a fairly large degree of consensus that household indebtedness is developing in an unsustainable manner. The important thing now is that we do not get stuck in the analysis of the problems, but that macroprudential policy measures are implemented before the problems materialise.

However, I also believe that measures in other policy areas may be necessary. The basis for the high level of household indebtedness is that we have had substantial imbalances in the housing market for several years. For the third year in a row, the European Commission pointed out in its report on macroeconomic imbalances that measures need to be taken with regard to the Swedish housing market. The Commission proposed, in addition to further macroprudential policy measures, measures to improve the tax system and increase housing construction.[12] One element in this is the tax deduction, which has favoured mortgage borrowing. I believe that the tax deductions for interest paid should be reviewed, and that a broad political agreement would be desirable. Measures should also be taken to increase the construction of housing. In the long run, it would be desirable to have housing construction that develops apace with demand, to avoid creating further imbalances.

Let me now conclude with a look ahead to the next monetary policy meeting.

## The situation ahead of the monetary policy decision on 3 September

Some time has now passed since the monetary policy decision in July, and I intend to briefly discuss what has happened over the summer and how I see the situation ahead of our next monetary policy meeting on 3 September.

If we begin abroad, we can conclude that developments in Russia and Ukraine have had some negative effects on confidence among households and companies, particularly in Europe. The GDP outcome for the euro area with regard to the second quarter was also a little weaker than we had been expecting in July, although it is difficult to know exactly how much of this relates to developments in Russia and Ukraine. The signs of a slowdown in

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[11] See ”Sweden – 2014 Article IV Consultation Concluding Statement of the Mission”, June 2014, IMF.

[12] See “Macroeconomic imbalances Sweden 2014”, Occasional papers 186, March 2014, European Commission.

GDP growth in the euro area are to some extent counteracted by the good development of the economies in the United States, the United Kingdom and China. In the United States, GDP grew rapidly during the second quarter, and labour market data indicate that developments will remain strong.

Prior to the next monetary policy meeting, we will of course continue to monitor developments in Russia and Ukraine, and we will analyse what they may mean for economic prospects abroad.

With regard to developments in Sweden, GDP growth was somewhat weaker during the second quarter than we were expecting in July. Household consumption and housing investment remained strong, while exports remained weak. The indicators we have received regarding growth give slightly mixed signals. The business tendency survey, which summarises the situation for the Swedish economy, fell somewhat in July. On the other hand, the purchasing managers' index for the services sector for the same month increased substantially. One can also note that the outcomes for unemployment received for June and July on the whole have been somewhat lower than the July forecast. The inflation figures for June and July show that both the CPI and the CPIF increased somewhat faster than the forecast in July.

As you may note, the information received since the monetary policy in July tends to point in different directions, and it is too early yet to say how monetary policy will be affected. We will return with this information on 4 September, when we present our next repo-rate decision.

## Concluding thoughts

The Riksbank has two main tasks: price stability and financial stability. On this basis, it is worrying that inflation is too low and below our target, at the same time as household indebtedness is very high, which creates risks for developments in the long run. In my speech today I have discussed how we can manage this challenge.

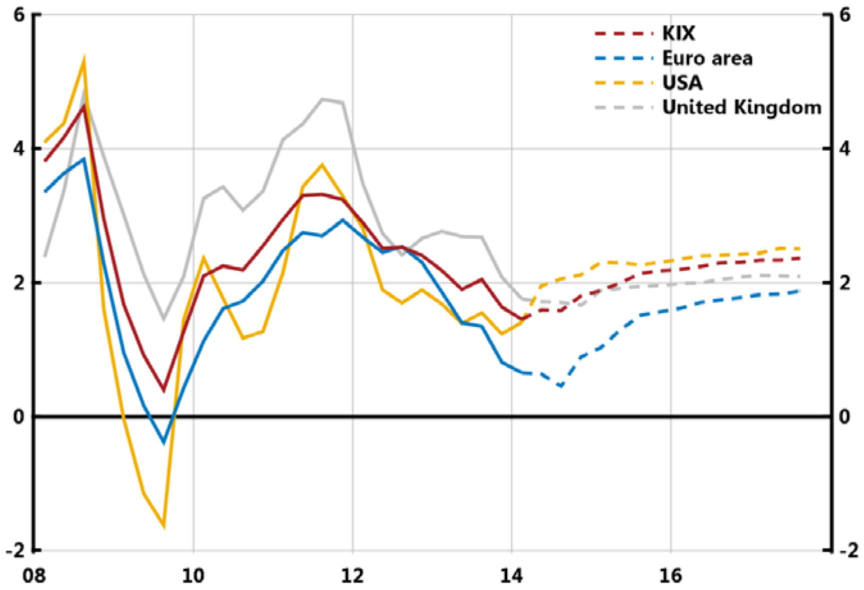
It was necessary to cut the repo rate in July to attain the inflation target, but at the same time it is even more essential to take macroprudential policy measures to deal with household indebtedness. So far the new framework for macroprudential policy has mainly resulted in sharper capital adequacy requirements for the banks, which increase the resilience of the banking system. As I see it, one important piece of the puzzle still remains, however; namely measures aimed at directly limiting household indebtedness. However, to create a development that is sustainable in the long run, it may also be necessary to take measure in other policy areas, such as a review of tax deductions for interest paid and measures to increase housing construction.

## Figures

Figure 1.

**Inflation in various countries and regions**

Annual percentage change



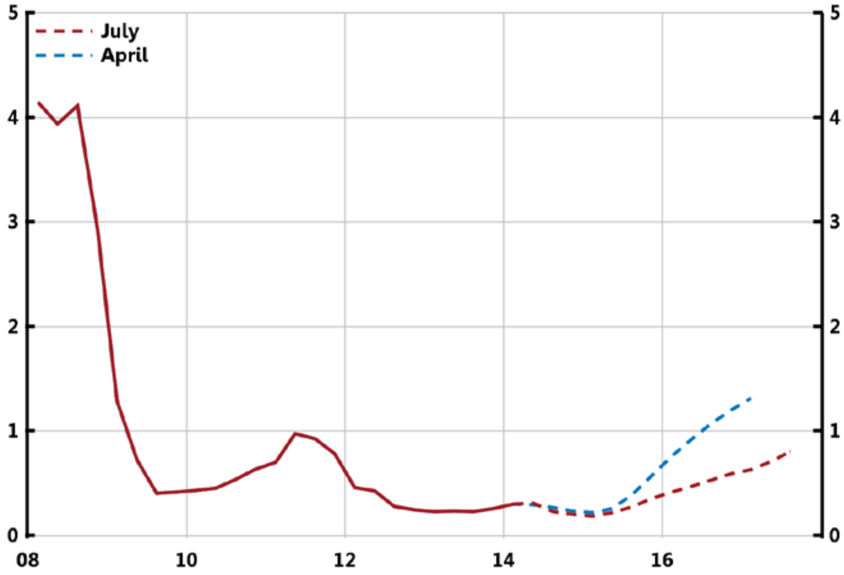

Note. KIX is an aggregate of the countries that are important to Sweden's international transactions. When calculating KIX-weighted inflation, the HICP is used for the euro area and the CPI for other countries. Inflation for the euro area is shown measured using the HICP and for the United States and the United Kingdom measured using the CPI.

Sources: The Bureau of Labor Statistics, Eurostat, national sources, Office for National Statistics and the Riksbank

Figure 2.

**Policy rate abroad**

Per cent



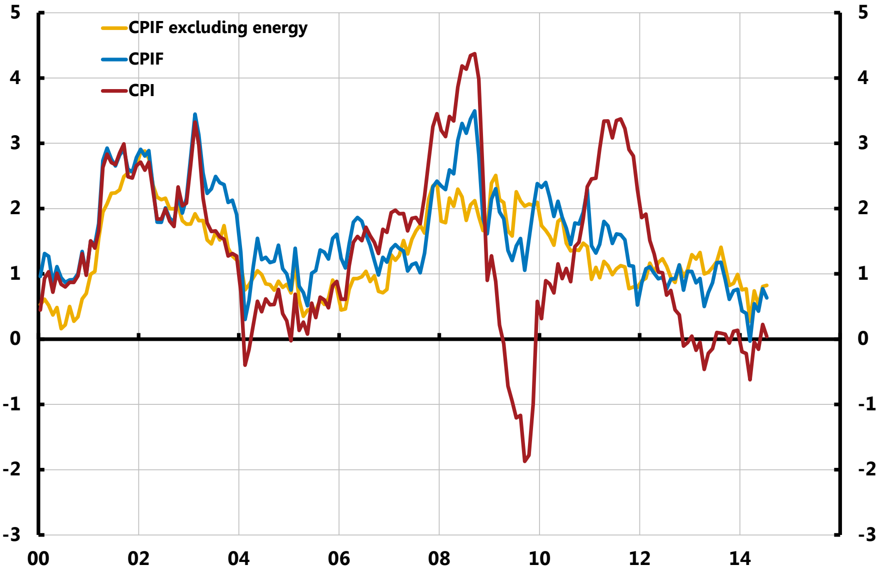

Note. Refers to an aggregate of the USA, the euro area, the United Kingdom, and Norway. The euro area refers to EONIA.

Sources: Bank of England, EURIBOR FBE, Federal Reserve Bank of New York, Norges Bank and the Riksbank

Figure 3.

**Consumer prices**

Annual percentage change



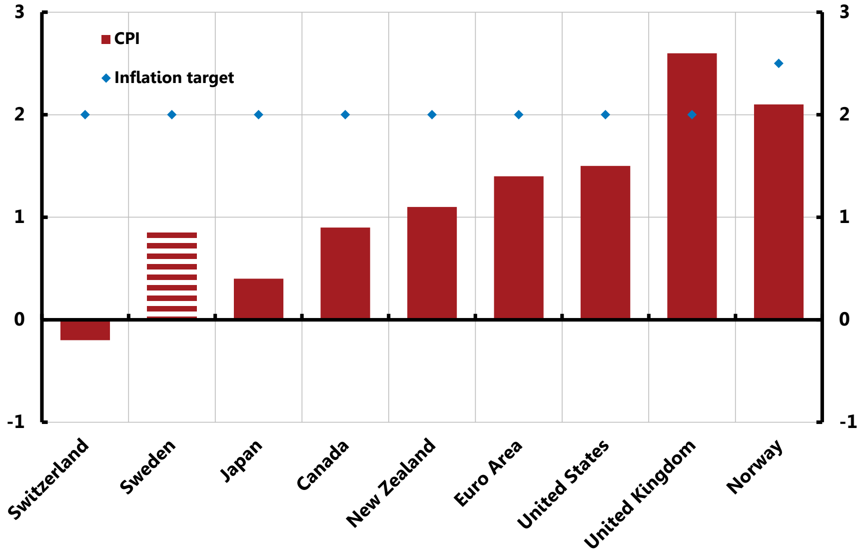

Note. The CPIF is the CPI with a fixed mortgage rate.

Source: Statistics Sweden

Figure 4.

**Inflation in 2013 in a number of countries with inflation targets**

Per cent




Note. Euro area refers to HICP. Countries with an inflation target in the form of an interval have their mark in the middle of the interval. Countries with a ceiling for inflation have the ceiling as a mark. The broken column for Sweden refers to the CPIF (the CPIF is the CPI with a fixed mortgage rate).

Sources: The OECD and each country's central bank

Figure 5.

**KIX-weighted nominal exchange rate**

Index, 18 November 1992 = 100

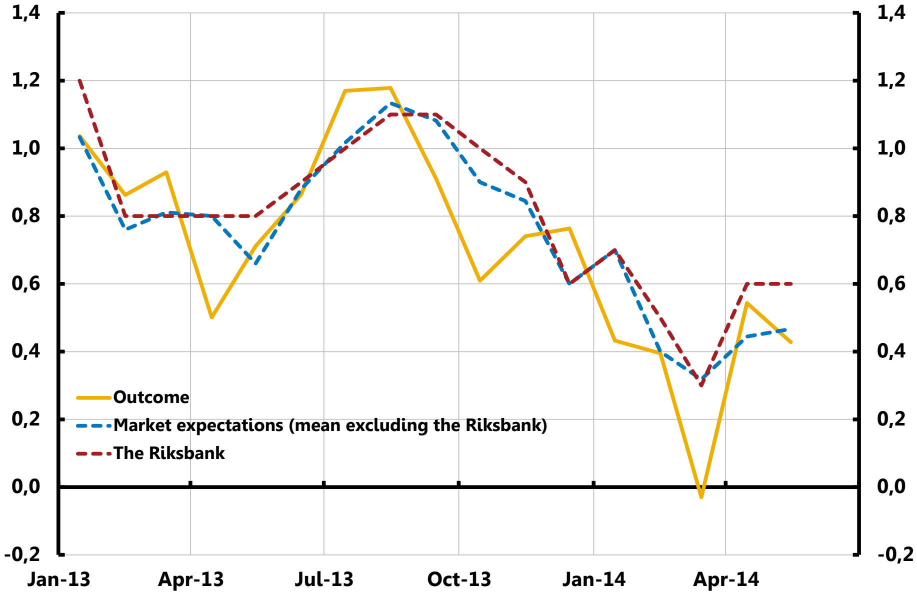

Note. Outcomes are daily rates and forecasts refer to quarterly averages. KIX is an aggregate of the countries that are important to Sweden's international transactions.

Source: The Riksbank

Figure 6.

**The Riksbank's and markets' short-term forecasts for inflation**

Annual percentage change



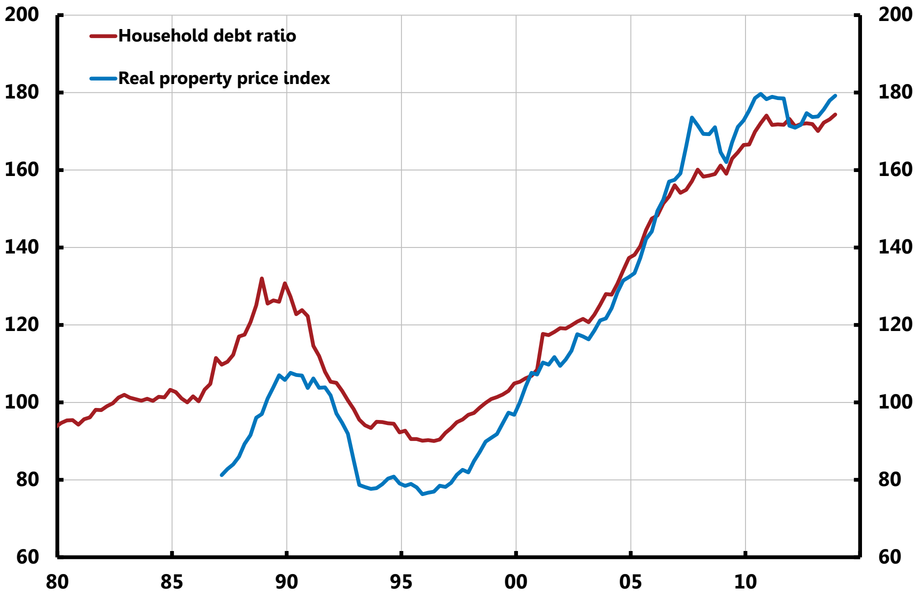

Note. The Riksbank's forecasts according to the most recently-published assessment and market expectations, compared with outcomes. The Riksbank's figures are not entirely comparable with market participants' expectations, as the Riksbank's forecasts are often older.

Sources: Bloomberg, Statistics Sweden and the Riksbank

Figure 7.

**Household debt and real housing prices**

Per cent of disposable income and index, 2000 Q1 = 100

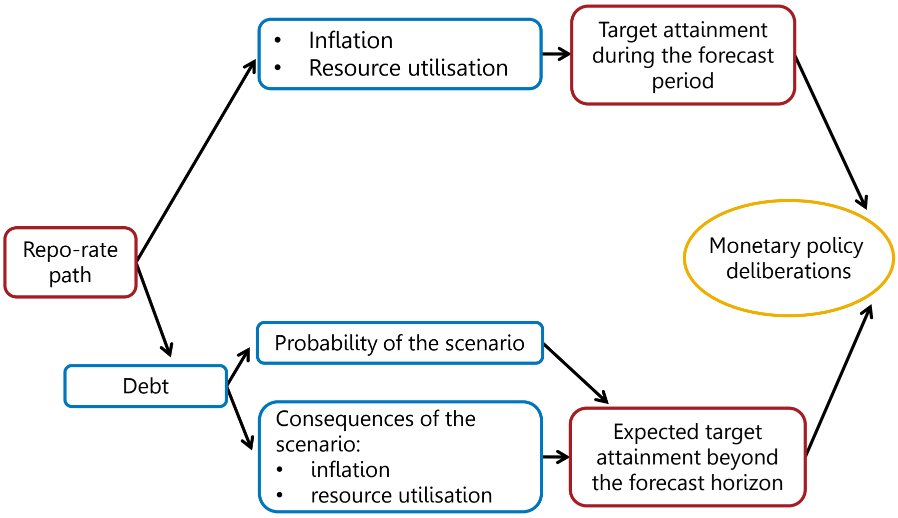



Note. Debts refer to total debts. Real housing prices are nominal property price index deflated using the CPIF.

Sources: Statistics Sweden and the Riksbank

Figure 8.

**Monetary policy deliberations**

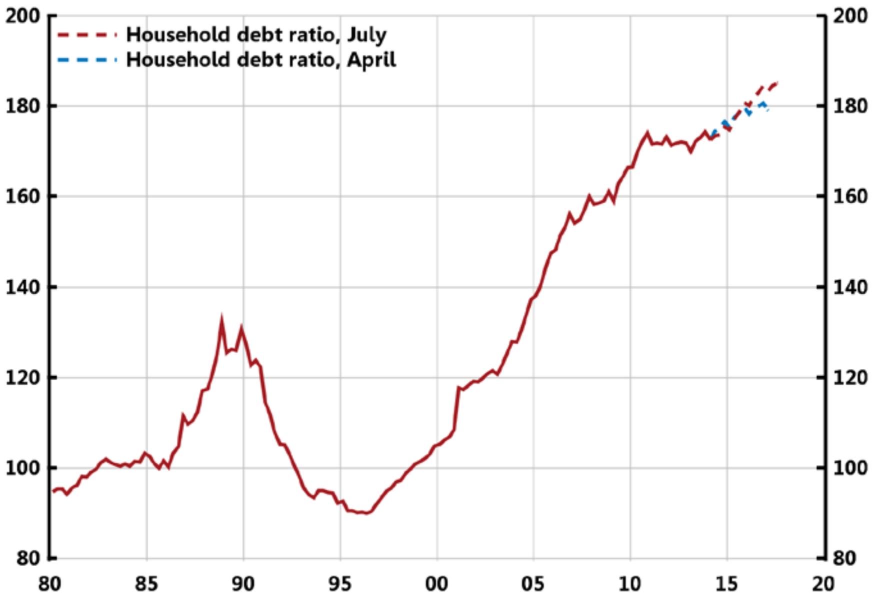



Source: The Riksbank

Figure 9.

**Household debt ratio**

Per cent of disposable income

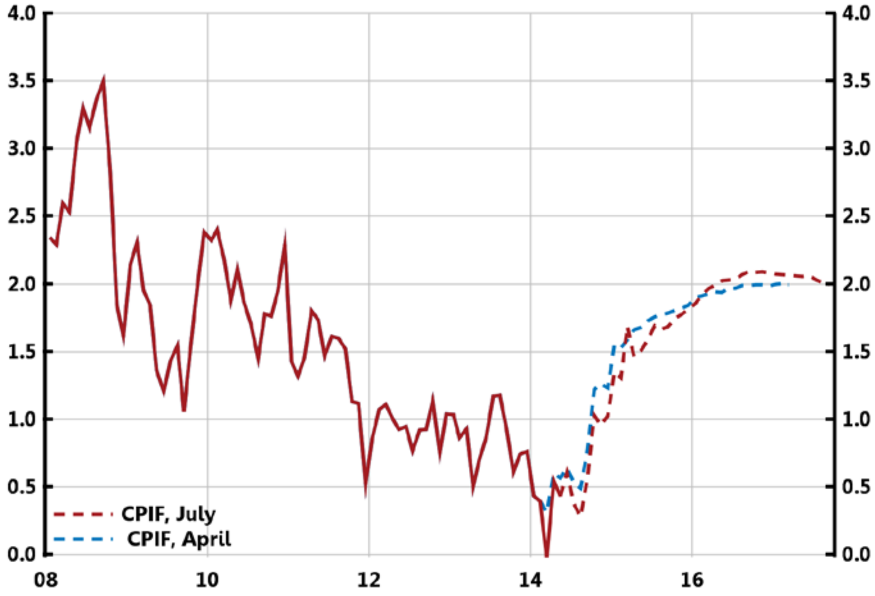



Note. Households' total debts as a share of their disposable incomes, totalled over the past 4 quarters.

Sources: Statistics Sweden and the Riksbank

Figure 10.

**CPIF inflation**

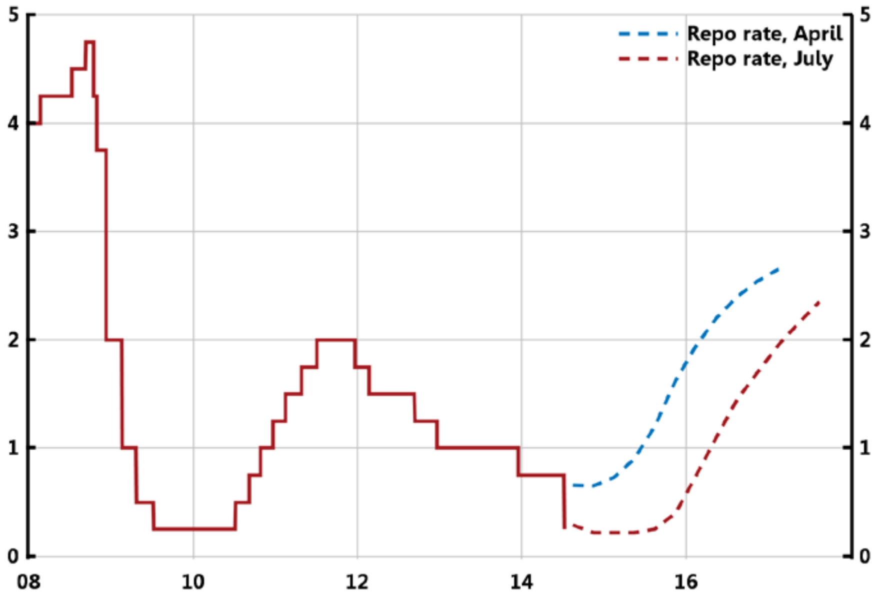



Note. Annual percentage change. The CPIF is the CPI with a fixed mortgage rate.

Sources: Statistics Sweden and the Riksbank

Figure 11.

**Repo rate**

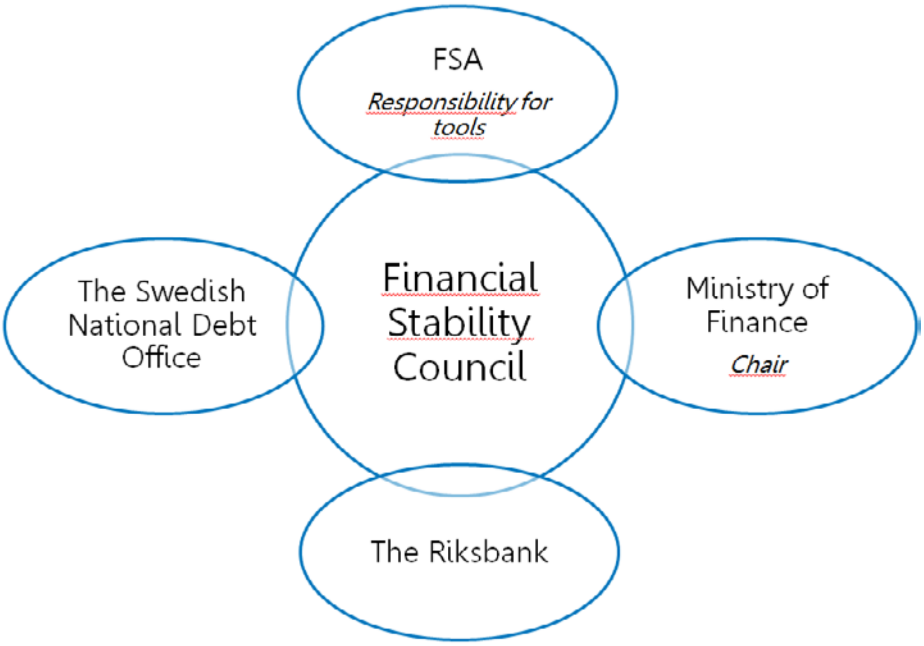



Note. Repo rate, per cent. Forecast refers to quarterly mean values, outcome refers to daily data.

Source: The Riksbank

Figure 12.

**New framework for macroprudential policy**




Source: The Riksbank