

Stefan Ingves: Monetary policy, openness and financial markets

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at Skandinaviska Enskilda Banken, Stockholm, 24 September 2007.

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"Say as little as possible and say it cryptically".¹ This type of communication strategy is probably quite unthinkable for most central banks today. But this is how US professor of economics Alan Blinder describes central bank communications not so long ago. And I believe that this description is a pretty good one of how things actually worked, say 15 to 20 years ago. I would also guess that those of you here this evening who either monitored or worked in the financial sector at that time would agree with me.

But since the beginning of the 1990s the Riksbank as well as most other central banks has taken considerable steps towards greater openness and clarity – both with regard to what we are trying to achieve and how we are going about it. Constantly working towards more efficient communication has been high on the Riksbank's priorities list ever since the inflation target was introduced. But the pace of this work has varied as conditions for monetary policy and demands on the central bank have changed. So sometimes we have had fairly long periods without any major changes in our methods of communication, sometimes we have made many changes in a fairly short period of time.

Particularly over the past two years we have made a number of changes and this has led to some debate. This often happens in times of change, particularly if it requires a learning process – for all those involved – before everything falls into place. And this is also the case with the changes in the Riksbank's communication. It is therefore quite natural that some questions have arisen: Why has the Riksbank made these changes? Haven't you made things unnecessarily complicated – tried to "fix something that isn't broken"? Have you even gone too far in your openness? These are important questions that I shall try to answer here tonight.

Giving the right information at the right time and in the right way is particularly important in times of unease. There has recently been unrest in the financial markets around the world. Sweden has not been affected by the market turbulence to the same extent as several other countries. I would nevertheless like to take the opportunity to say a few words about our views on what is happening right now and on the Riksbank's role in this context. But before I do so, I would first like to discuss the changes in our method of communication made over the past two years and the reasons behind them.

What are the reasons behind the increased openness and clarity?

Many consider that the Riksbank is currently one of the world's most open central banks.² And we have taken further steps in this direction over the past two years in particular. But what are the reasons behind this development towards greater openness? I think there are two reasons – democracy and efficiency. The first concerns our role as an independent authority. The second is linked to the fact that our communication with the financial markets and the general public is essential for monetary policy and the financial system to function efficiently.

¹ Page 38 in Blinder, A. S., (2006), "Monetary Policy Today: Sixteen Questions and About Twelve Answers". I Fernandez de Lis, S. and F. Restoy (ed.), *Central Banks in the 21st Century*, Banco de España.

² See, for instance, Eijffinger, S. and P. Geerats, (2006), "How Transparent are Central Banks?" *European Journal of Political Economy*, vol. 22, 1-21.

Our independence requires openness

The Riksdag and ultimately therefore the Swedish people have given the Riksbank considerable independence. But this is a “freedom with responsibility” that goes hand in hand with the requirements for insight and accountability. This is how things should be in a democracy. Openness is also something that traditionally imbues the Swedish public administration system in general. One of the corner-stones is the principle of public access, which means that the authorities’ activities should as far as possible be carried out in an open way. And this also applies to the Riksbank, of course.

But openness is not only a requirement in itself but also a necessary condition for monetary policy to work. It does not work unless the Riksbank and the objective of our activities are supported and legitimated by the people. And this requires that we are open and clear. It should be easy to critically examine how monetary policy is conducted and how well we live up to our principles. Most people probably agree that the Riksbank’s openness has contributed to a good monetary policy debate in recent years.

Openness and clarity contribute to monetary policy functioning better

But it is not only democratic reasons that have led to the Riksbank and most other central banks becoming more open and clear. Another important reason is that we have quite simply regarded it as a means of more easily achieving our objective and of making monetary policy more efficient. There are three main aspects I would like to emphasise in this context:

- Firstly, it will be easier to communicate that the interest rate decisions made are really aimed at achieving low and stable inflation. This provides greater credibility and helps to anchor expectations around the target. It was an important reason why the Riksbank began to publish its inflation forecasts and other material on which decisions are based early on in the new inflation-targeting system. I do not believe that it would have been possible to build up confidence in the price stability target as quickly as we did if we had not been as open as we were regarding our work and our decisions.
- Secondly, openness and clarity are currently an important part of monetary policy in itself. You could say they are one of the tools in our toolbox. So what do I mean by this? There is a relationship between interest rates with different durations. And expectations of short-term interest rates, which the central bank governs, are important to the long-term interest rates. A central bank can therefore “indirectly” influence interest rates with longer durations by influencing expectations of short-term interest rates. Greater influence over interest-setting throughout the economy – the yield curve – makes the impact of monetary policy more effective. This is often called conducting monetary policy with the aid of “management of expectations”. And the best way to do this is to provide good information.
- The third and final aspect is that increased openness and clarity “outwards” can contribute to our working more efficiently within the Riksbank. This is a quite important argument. The more open we are, the easier it is for others to evaluate how well our monetary policy functions. This gives us an extra incentive to do a good job.

What has the process towards openness and clarity resulted in?

The path towards becoming more open and clear has not always been easy, it has at times caused some debate. Two issues in particular have been the subject of lively discussion over the past year. The first is that we now publish our own forecasts for the interest rate path. The second concerns how representatives of the Riksbank send signals regarding the interest rate in speeches and press releases.

Interest rate path a natural step towards openness

In February 2007 we presented for the first time our own forecast for the development of the repo rate. Prior to this only the central banks in Norway and New Zealand published their own interest rate paths. But this group has now grown, with the addition of the Riksbank and in March this year also the Icelandic central bank.

At the beginning of this month we also decided to publish our forecast for the path of the policy rate – and a number of other important variables – in connection with each monetary policy meeting. This means that we will publish our interest rate forecast six times a year, instead of three as before.

By publishing our own forecast for the interest rate we have become more open and clear with regard to our view of future monetary policy. Along the way we have used three different assumptions for the policy rate – that it will remain unchanged, that it will develop according to market expectations, and, accordingly, that it will develop in the way we ourselves find most likely.

Reasons why we want to present our own interest rate path

Making its own forecast for the policy rate provides the central bank with a better tool for influencing expectations among households, companies and agents in the financial markets. In the cases where our view differs from the market view, we no longer need to take the rather circumstantial route via qualitative assessments of market pricing.

Additionally, it becomes easier for us to show not only *what* we are thinking but also *how* we are thinking – it will be simpler to communicate how we view the driving forces behind economic developments and what monetary policy can achieve. If we succeed in communicating our view of how we think, then it will be easier for others to make good assessments on a continuous basis of how new information should affect the future development of the interest rate. This should reduce the fluctuations in the interest rate that are due to speculations regarding the Riksbank's intentions.

One aspect that may not have been given so much attention is that it has become simpler for households planning their private economy to form an impression of what the Executive Board considers to be a suitable development for the interest rate in the future. Previously, many probably had to refer to the interpretations made by financial advisers. But now the information is available in our Monetary Policy Report. Although the forecast for the interest rate will of course be regularly revised, it should reduce the uncertainty over how we ourselves view future developments. I believe this will be positive for everyone.

The objections are not convincing

But of course there are also some potential problems when a central bank presents its own forecast of the interest rate path. One is that the decisions in many central banks are currently made by a group of persons. How can a group of decision-makers agree on a forecast for the policy rate? The Riksbank's experiences so far show that this need not be a problem. Nor does the Norwegian central bank, where decisions are made by an Executive Board consisting of seven persons, appear to have any major difficulties in agreeing on an interest rate forecast.

Other arguments have also been raised against an own interest rate path. One such argument is that it could impair our credibility and instead make it more difficult for us to communicate with the general public and the financial markets. Let us assume that the Riksbank first publishes a particular interest rate path. Would our credibility be impaired if new information leads to our making another decision regarding the policy rate than we have previously announced?

I don't think so. I believe that there is a broad understanding among households, companies and market agents that we need to adapt monetary policy and reconsider how we should set

the repo rate in future when new information changes the economic picture. We have been clear about the fact that a forecast is by definition uncertain and that it becomes more so the further ahead it stretches. And the interest rate path presented in the Monetary Policy Report is indeed a forecast. It is not a promise!

The fact that we do not have perfect knowledge of the future is no reason to refrain from being as open and clear as possible with regard to what we believe will happen. We must form an opinion of how the policy rate should develop in the future regardless of whether we publish it or not. If it turns out that we have made an incorrect assessment in our forecast, it would not have been less incorrect just because we had refrained from telling anyone about it. It is hardly reasonable that we should try to gain greater credibility by hiding things or sending unclear signals about one of the most important variables in our analysis. I believe it is better that we are open about what our decisions are based on, now that the inflation target is so well-established that we are able to be open.

Another objection to central banks publishing their own interest rate forecasts is connected to the functioning of the market. This means that in principle the financial market agents could stop looking for other information if they have access to the central bank's forecasts for interest rates in the slightly longer term. How the market views economic prospects is normally reflected in the long-term market rates. This source of information could thus be lost and this would impair the functioning of the market.

But as I perceive it, there have not been any such signs so far. In addition, I find it very difficult to imagine that the market agents would stop making independent assessments because we are publishing our own view of interest rate developments. They if anyone know that the interest rate path is a forecast and they therefore have strong reasons for continuing to search for information via other channels than the Riksbank. So far it has been clear that we and other market agents have actually had slightly different views regarding how the interest rate will develop in the future. And this is actually a sign that things are as they should be. It is quite natural that forecasters make different judgements, particularly in the slightly longer term. In the long term, there are also more factors than expected monetary policy that have significance for interest rates.

We have so far only presented two forecasts for the policy rate, and as I mentioned earlier, there is a fairly large measure of "learning by doing" for all those involved before everything falls into place. Everything does not always work perfectly from the start. But as I said, the purpose is that our communication will become clear and more efficient. And I am fairly convinced that we will get there, once the new system has been established.

Clarity in the way we express ourselves in speeches and press releases

The Riksbank has also changed its method of signalling monetary policy in speeches and press releases. In a broad sense, signalling means that we communicate in some way what we are intending to do with the repo rate. A narrower – and perhaps more common – interpretation of signalling is that it is when representatives of the Riksbank describe in speeches and press releases how they consider the interest rate should be set at the next meeting, and perhaps slightly further ahead.

Previously, the Riksbank signalled "by degrees". Between the monetary policy meetings the individual Executive Board members held speeches on the theme of "the current situation" or something similar. There we indicated, more or less explicitly, how we thought the interest rate should be set. When it was time for the monetary policy meeting, sufficient information was assumed to have been released "by degrees" with regard to how the Executive Board as a whole were reasoning so that the economic agents would not be surprised by the interest rate decision taken at the meeting.

But with the broader definition of signalling – when we in some way communicate what we are intending to do with the repo rate – the publication of our own repo rate forecast of

course also becomes part of the signalling. At intervals of two months, the general public and the financial markets now receive a detailed description of how a majority of the Executive Board consider that the interest rate should be set in the future. It is thus evident that the need for “signalling by degrees” in speeches between the monetary policy meetings has declined significantly. It was also the most important reason why we earlier this year decided that there would not normally be reason to indicate in speeches and press releases how the repo rate would be set at the next meeting.

But there were also some problems with the earlier signalling that lay behind the decision. In certain situations it was probably difficult to determine whether the signal being sent in a speech should be interpreted as an individual member’s opinion or whether it reflected the views of a majority on the Executive Board. If the individual members sent out different signals it was probably also difficult to distinguish a clear message from this “cacophony of voices”, to quote Professor Blinder again. This type of problem seems rather unnecessary. A central bank should be able to be so clear with regard to its view of the future that there should be no need for loosely-grounded speculations and interpretations – it should not be necessary to be a Kremlinologist to interpret the Riksbank. We hope that we have solved this problem with our new way of working.

A further weakness of the earlier signalling process concerned the responsibility the Riksbank has in its role as independent authority. It is a question of democracy. This responsibility includes, for instance, the fact that the general public must have good insight into the decision-making process – the decisions at the monetary policy meetings must be made in a correct manner. This is why minutes are taken at the monetary policy meetings and then published, and the chairman and deputy chairman of the General Council of the Riksbank have the right to attend the Executive Board meeting. There must be no doubt that the interest rate decisions are actually made at the monetary policy meetings and not at some other point in time – in some informal way that prevents insight. If the signalling prior to the meetings leads people to believe that the interest rate decisions have been made in advance of the meetings, then doubts may arise.

A concluding reflection on the Riksbank’s communication

Let me, before I go on to discuss the recent developments in the financial markets, conclude my discussion of the Riksbank’s communication with a reflection.

The fundamental purpose of the changes we have made in our communication is that we shall become even more open and clear with regard to what we do and how we think. But at the same time the changes – particularly our own interest rate path – mean that we have stuck our necks out and opened ourselves up to criticism in a different way than before. We no longer describe our policy in the form of a simple – albeit perhaps slightly misleading – policy rule, but show a more composite picture; the way it looks to us when we make our decisions.

The publication of our own interest rate path also means that it has become clearer than before when we reconsider our views of what policy will be appropriate in the future and when our views differ from those of the market. It is therefore perhaps not so surprising that some debate has arisen.

But to refrain from making changes that we consider to be necessary because we run the risk of being criticised is not a good strategy. I am convinced that the best method of conducting monetary policy in the long term is to describe as openly and honestly as possible how we are acting and reasoning. This is definitely something the general public can require of us in our role as an independent authority.

So, to refer back to the questions I asked at the beginning. No, I do not think we have made things unnecessarily complicated or tried to fix things that are not broken. We have made changes we consider to be necessary both to improve the base for making monetary policy

decisions and to provide as true and honest a picture of how monetary policy is conducted as possible.

What has happened on the financial markets?

In principle, communication is always important to a central bank and is a corner-stone in most parts of our activities. When the world around us is marked by uncertainty and unrest, the question of communication becomes even more important. There has recently been considerable unrest in the financial markets. But the Riksbank has nevertheless seen no need to *specifically* go out in public and comment on these developments. Sweden has not been affected to the same extent as many other countries and the Swedish interbank market and the financial system have functioned comparatively well. But let me nevertheless say a few words about what has happened and about the role the Riksbank plays in this context.

General uncertainty has increased the need for liquidity abroad...

Over the summer we saw signs of problems in the US housing market. The unrest increased when it was revealed at the beginning of August that several financial institutions had made significant losses in connection with the US sub-prime market. The background to this was that the number of households experiencing difficulties in paying their mortgages had gradually increased. It was also difficult to assess to what extent the different market agents were exposed to the assets concerned – in which balance sheets the credit risks had ended up. This was the starting point for a more general reassessment of risk in the financial markets.

To make a long story short, one can say that the general uncertainty led to an increasing demand for safe assets such as treasuries. Government bond rates have fallen, while rates on some other investments have been pushed up. This is probably because risk premiums have increased, after being very low for a long period of time. For instance, interest rates on loans and deposits between banks, interbank rates, have risen in many countries.

For instance, the European Central Bank (ECB) and the Federal Reserve have seen a need to supply extra liquidity to slow down the rise in interbank rates. In the United Kingdom, the Bank of England has chosen to use its position as lender of last resort and to grant emergency liquidity assistance to a mortgage institution, Northern Rock. Emergency liquidity assistance is only given if the institution in question is assessed to be solvent but lacking sufficient liquid funds.

...and here at home

Sweden has also been affected by the turbulence in the financial markets, albeit to a much lesser extent than, for instance, the United Kingdom, Germany and the United States. The fact that Sweden has been affected despite not being, as it were, involved in the problems that started the unrest is not so remarkable. We are a part of the global financial system and not an isolated northern outpost.

The Riksbank governs the short-term rate that applies for one day, the so-called overnight rate, and this has remained stable around the repo rate. In brief, the Riksbank's method of steering interest rates has worked well. But the interbank rates with slightly longer durations have risen, although not as much as in some parts of the world. This is primarily a question of different effects from the uncertainty in the financial markets, such as rising risk premiums. On the whole, the Swedish financial system and the interbank market have nevertheless functioned well.

What is the role of the Riksbank?

What does the Riksbank do when there is unrest in the money market?

One of the most important tasks is to continue to ensure that the economy develops in a stable manner. We have to conduct our monetary policy so that we attain the inflation target of 2 per cent. Where possible, when the price stability objective allows scope for this, we should also ensure that production and employment develop in a balanced manner. This involves closely monitoring developments and following how the forecasts for growth and inflation develop. At our most recent monetary policy meeting we made the assessment that the financial unrest could slow down growth and inflation somewhat in the future and that the uncertainty had increased. At the same time, economic growth is strong both in Sweden and abroad. To attain the inflation target of 2 per cent and ensure a good development in the economy in the future, we decided to raise the repo rate. We also made the assessment that the interest rate would need to be increased further in around the same way as outlined in June. But the continuing developments in the financial markets are one factor among many that we will take into consideration in our decisions.

If monetary policy is to function, interest rate-setting must also function. As I mentioned, we can only steer the shortest interest rate in the market. We do this by setting the repo rate and by daily adjusting the liquidity in the bank system at an interest rate that is very close to the repo rate. The banks can also receive as much liquidity as they need during the day against collateral. In addition, they can also deposit or borrow against collateral overnight with the Riksbank at the deposit or lending rate respectively.

If we were to see serious and lasting problems, we have the possibility to take action. How we act depends on what has happened and on the situation at the time. And if we take action, we will clearly describe what we are doing and why.

The Riksbank has close contacts with the Swedish banks and with other financial market agents. Although we do not see any indications of extensive liquidity problems at present, we will continue, as always, to closely follow developments in the financial markets.

This is where our responsibility for financial stability also comes in. We have to ensure that the payment system functions in a safe and efficient manner. Part of this work involves regularly analysing developments in the financial market and the financial system's capacity to withstand any shocks that might arise. We present our analyses regularly; most recently in May this year. We are also involved in shaping the regulatory framework to ensure it is designed to achieve a stable system. In all of our work regarding financial stability we work in close cooperation with other Swedish and international authorities.

If the situation were to go so far that more serious liquidity problems nevertheless arose, we have detailed plans for how we can deal with them. If the worst came to the worst, we have the possibility to grant emergency liquidity assistance to the financial institutions under the supervision of Finansinspektionen (the Swedish Financial Supervisory Authority). But we only do so if the institution in question is solvent. Loans are then granted at an interest rate that is higher than the lending rates in our steering interest rate system and only if we see that the Swedish financial system is threatened. Swedish banks must not take this possibility for granted and thus take unnecessary risks.

Here there is a link to our ambition to be open and clear. An open attitude sets limits and shows the game rules. We have clearly described how we view our role as "lender of last resort", for instance, in our Financial Stability Report.³ By being open about how we manage emergency liquidity assistance we reduce the risk that a situation may unnecessarily arise

³ Financial Stability Report 2003:2

where we are forced to provide assistance. It also reduces the risk that we will be forced to provide support when this is not appropriate.

Giving the right information at the right time and in the right way is important. It is particularly important in times when uncertainty is increasing. I hope that I have managed to communicate today not only the principles that have guided us with regard to our external communication in recent years, but also our picture of the recent situation. I also hope that I have succeeded in communicating that our ambition is to clearly report what we do and why.

Thank you!