Barbro Wickman-Parak: The financial crisis – where do we stand today and where are we heading?

Speech by Ms Barbro Wickman-Parak, Deputy Governor of the Sveriges Riksbank, at Danske Market's Central Bank Seminar, Snekkersten, Denmark, 11 June 2009.

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When I joined the Executive Board of the Riksbank almost exactly two years ago, in May 2007, I expected my new job to be varied and exciting. Though I perhaps wasn't expecting it to be exciting in the way it turned out to be. Of course we were then already aware of the problems with subprime loans in the United States. But, like most other people in Sweden and abroad, I didn't foresee that the worrying signs we saw then would gradually develop into a global financial crisis of historical proportions. Nor did I anticipate that as a result of this crisis the Riksbank would lend several hundred billion kronor to the banks. Or that the Riksbank would cut the repo rate by 4.25 percentage points during the course of just over six months, to its lowest level ever – the fastest monetary policy easing in the period we have had an inflation target. And of course I could not anticipate that several other central banks would by then have reached the lower limit for their policy rates and have begun to resort to unconventional measures. But nevertheless – this is where we stand now.

Several explanations for the crisis

One usually says that the crisis began in 2007 with problems in the US mortgage market and that this gradually developed into a global financial crisis, which became acute in autumn 2008 in connection with Lehman Brothers filing for bankruptcy. But the picture is more complex than this. The origin and course of the crisis will be analysed thoroughly and we probably will not have a complete history of it until much later.

However, we can already note that there are several explanations as to why the crisis arose and why it became so widespread. One circumstance that probably played some role is that growth had long been good in many countries, at the same time as inflation was low – quite simply, things had gone unusually well for an unusually long period of time. And when things have gone well for a long period of time it is probably human nature to relax and become slightly incautious. This is what appears to have happened this time in various ways and places, not solely in the US mortgage market.

One factor that probably also contributed was that there was a global saving surplus that meant there were large capital sums to be invested in the financial markets. This surplus pushed down the interest rate on risk-free assets. The combination of a lot of money to be invested and low risk-free interest rates contributed to an increase in the demand for assets that were profitable to invest in and led to an intensified hunt for high yield. This type of environment often inspires great inventiveness in the financial markets and many new financial instruments were also created. These were often complex and difficult to valuate correctly. But in the optimistic climate prevailing then – everything had gone so well for so long – it was nevertheless easy to sell them. Those who invested in the new instruments disregarded, or failed to sufficiently understand, the risks that were "inbuilt" in them. The financial supervisory authorities and regulations also lagged behind this development.

The problems in the international financial markets began to become more apparent as early as summer 2007. But the Swedish economy and the Swedish financial markets long appeared able to manage fairly well, despite the fact that the turbulence was having more and more effects on the world around us. Of course, economic activity in Sweden began to weaken as international economic activity declined, but this did not initially seem to entail any very serious downturn. However, when Lehman Brothers filed for bankruptcy in September

2008 the situation worsened dramatically. The confidence that had existed between financial institutions was shaken to its foundations when no one was certain who might be next in line to default on their payments. Now the Swedish financial markets were also hard hit and some sub-markets were practically at a standstill. The earlier expectations that the decline in economic activity would be fairly mild were replaced by a much more negative view of future developments, both in Sweden and abroad. The Lehman Brothers crisis was also the prelude to a series of measures to stabilise the Swedish financial markets. At the same time the Riksbank took several rapid and resolute steps down the interest ladder to alleviate the effects of the crisis on economic activity.

Still sensitive but liquidity risk has declined

The first phase of the crisis can be described as a liquidity and confidence crisis. No one trusted anyone else and very few were willing to lend money and take risks. The price of loans between the banks, interbank rates, also rose sharply. Since the crisis started the central banks have lent large amounts to the banks. For example, the Riksbank has offered loans in Swedish kronor at longer maturities than normal to facilitate the supply of liquidity to the Swedish banks. We have also lent US dollars to Swedish banks and we have made the collateral requirements for the loans somewhat more generous. The government has tried to reduce the banks' liquidity risks through its guarantee programme, which basically involves banks and other credit institutions being able to sign contracts with the government on guarantees for some of their borrowing. Without the measures taken by the Riksbank and other authorities the financial system would have ceased functioning and would still not be functioning. The same applies of course in many other countries.

As we note in the Financial Stability Report that we published just over one week ago, these measures have contributed to ensuring that there is no imminent risk of a liquidity shortage for the banks. Interbank rates have fallen, although it still appears difficult to find funding at longer maturities. There are also other signs that the conditions on the international credit markets have eased somewhat and it appears to have become slightly easier to obtain funding by issuing securities, even when these are not backed by a government guarantee.

Now it is unfortunately not the case that the problems are over – we are not yet on solid ground with regard to financial stability. There is still a lack of confidence between financial institutions and the international credit markets are fairly far from functioning as they did before the crisis. The situation is still sensitive and there is still a risk of a surprisingly negative shock giving the crisis new energy and once again making it more difficult for the banks to obtain funding. The Riksbank will of course follow developments very closely. We will continue to supply the banks with liquidity and we are prepared to do so as long as necessary. But to summarise briefly, the situation does look somewhat brighter with regard to liquidity risk.

Greater focus on credit risks

Now that liquidity risks are less prominent, there is instead a greater focus on credit risks, as economic activity has weakened and growth prospects have deteriorated. The very large policy rate cuts made by central banks around the world and the fiscal policy stimulation from governments have not been able to prevent a severe weakening in economic activity. Our most recent forecast published in April points to GDP in the world falling by a good 1 per cent in 2009. This is a something quite unique: since 1970 GDP in the world has increased by on average 3.6 per cent a year and growth has not been negative even for a single year. The export-dependent Swedish economy is hard hit by the international downturn. In our April Monetary Policy Update we forecast a fall in GDP of more than 4 per cent in 2009.

When economic activity weakens and the demand for goods and services declines it becomes more difficult for the banks' borrowers to meet their payments. Bankruptcies increase and the banks suffer loan losses. The loan losses in their turn make the banks even less willing to lend money and the economy risks ending up in a spiral where falling activity and stricter credit terms reinforce one another.

The banks can cope with loan losses

The main scenario in the Riksbank's forecasts does not involve Sweden ending up in a serious downward spiral. But in the recently published Financial Stability Report we are nevertheless assuming, even in the main scenario, that the Swedish banks will face fairly substantial loan losses in 2009 and 2010. A large share of the losses, approximately 40 per cent, is expected to arise from operations in the Baltic countries and the rest of eastern Europe. But in the Report we also note that all of the major Swedish banks have sufficient capital to cope with the losses that will arise if the Riksbank's forecasts are correct. We also observe that the Swedish banks are well-capitalised in an international perspective.

One cannot disregard the fact that there is great uncertainty over future developments in economic activity. When one has the task of safeguarding financial stability, it is natural preparing for situations where things go very badly. And when assessing the resilience of the financial system it is also of greater interest to study a more negative development than the one forecast. We have therefore investigated in our Financial Stability Report how the banks would cope with a scenario of a much weaker development than that considered most likely today. There we assume, for instance, that GDP in Sweden will fall twice as much as predicted in our main scenario forecasts for 2009 and 2010 in the Monetary Policy Update published in April. It is assumed in the really negative scenario of the Financial Stability Report that developments in the Baltic countries and the rest of eastern Europe will be much weaker, although that is far from the only reason behind the poor development. Here, too, approximately 40 per cent of the loan losses are expected to come from operations in these regions.

In this scenario all of the banks meet the statutory requirement of Tier 1 capital adequacy of at least four per cent. However, it may be necessary to have higher capital adequacy to avoid negative consequences such as funding problems and downgraded credit ratings. In the unlikely event that this very negative scenario were to occur, several banks might therefore be forced to act to strengthen their capital bases. If this could not be achieved solely through private capital injections, there is a possibility for the government to inject capital by virtue of the Government Support to Credit Institutions Act of last autumn. The Riksbank's assessment is that we, together with other Swedish authorities, are also well prepared to be able to manage the problems that could arise if the situation were to deteriorate to the level of the stress test described in the Financial Stability Report.

Let me just clarify that the Financial Stability Report's test of the financial system's resilience cannot be compared with the alternative scenarios of a "more probable" nature that are usually presented in the Monetary Policy Reports. The latter normally describe the consequences for monetary policy of developments being better or worse than the situation described in the main scenario, but where the alternatives are not normally too far from the main forecasts. In the Financial Stability the scenario is rather more exaggerated.

So where do we stand now and where are we heading?

Let me briefly summarise where we stand now in terms of risk focus; the liquidity problems have been dampened, while credit risks and feared loan losses are increasingly in the limelight as economic prospects have deteriorated. Credit risks and the size of loan losses are of course closely interlinked with economic activity. So I shall now, not least for this reason, move on to talk about economic activity – the assessments made by the Riksbank at the most recent monetary policy meeting in April and the nuances in the views of future economic developments that I put forward at the meeting.

Things could be better or worse

It is natural in times like these to paint a gloomy picture and focus on downside risks. And I am probably the last person to deny that such risks exist. It is also natural that the focus of the monetary policy discussion should be on what a central bank can do when the policy rate approaches zero and further stimulation may be necessary as this is to some extent “uncharted territory” for us.

But let me now change perspective and adopt a slightly more positive tone. In the discussions at the two most recent monetary policy meetings I have pointed out that there is some possibility that the recovery both in Sweden and abroad could come more quickly than most people are assuming. One could perhaps say that I have acted as the devil’s advocate, if one can use this expression for arguing that there is some chance that things will be better than is generally believed.

A more general reason as to why an upturn might come more quickly than expected, once it starts, is that the crisis can to a large extent be described as a massive confidence crisis that has made a lasting impression on the real economy. Households hesitate over consumption and companies hesitate over investment. But confidence is in many ways an on-off variable – either you have it or you don’t. All countries have been affected more or less at the same time and world trade has declined dramatically. Once confidence and faith in the future return, it may well be the case that the upturn is rapid and forceful as more and more countries come on board.

My views at the April monetary policy meeting did not primarily concern 2009. I think everyone is agreed that this year will unfortunately be a really poor growth year. In Sweden, as in many other countries, growth plummeted in the fourth quarter of last year. Recently published preliminary GDP figures for the first quarter also show that growth continued to fall, although the rate of the fall slowed down. My main emphasis was on what lies ahead of us – the economic cycle further on this year and into 2010. I shall not repeat everything I said at our two most recent monetary policy meetings; anyone who is interested can read the minutes of the meetings. But I would like to take the opportunity to bring up some of the views I expressed then.

One view that I wished to highlight concerned the housing market in the United States, which is in many ways the origin of the problems. Some signs of stabilisation are now visible there, although some quarters of adjustment still remain before the stocks of unsold houses have been reduced and house prices stop falling. Falling housing investment has provided large negative contributions to growth in recent years. Very little housing has been built for several years now in relation to the increase in the number of households. When the turnaround comes, housing investment should provide a good contribution to growth.

I also mentioned that stocks in the United States have been phased out rapidly and they will sooner or later be down to levels where the demand flow, even if it is declining, will need to be met with increased production. However, here one must bear in mind that this “cyclical” upturn will be temporary if final demand does not catch on further ahead. I could also see signs of stabilisation in important forward-looking indicators, particularly orders in the purchasing managers’ index. However, the picture is not clear-cut and never is when economic activity is in the balance. But, as I mentioned at the meeting, if the signs of stabilisation become clearer they may affect the mood more permanently, not least on the stock market. This can in its turn have a positive effect on households’ undermined wealth and help increase consumption. Further ahead it may be possible to reinforce a positive cycle and for investment to pick up. I also mentioned that a large part of the economic policy stimulation, particularly investments in the US infrastructure, would have its greatest effect in 2010.

Having said this, I would like to point out, as I did in the discussion at our most recent monetary policy meeting, that it might very well be the case that the signs of stabilisation I mentioned then were delusive. And it is definitely not the case that I fail to see the seriousness of the economic downturn we are in. Nevertheless, the recovery could as I have said be quicker or slower than expected.

Inflation outlook may change quickly

Falling resource utilisation and inflationary pressures have meant that we could conduct a strong, expansionary monetary policy to alleviate the effects of the economic downturn and at the same time ensure that inflation does not undershoot the target very far. We will see a negative inflation rate this year if we measure inflation by the consumer price index, the CPI. But this is largely due to our own interest rate cuts. The low inflation rate is temporary and should not trigger expectations of future deflation. Inflation expectations according to, for instance, Prospera's survey, are anchored in a slightly longer perspective around the target of 2 per cent.

My view at the April meeting was that we should begin to see signs next summer or autumn that the extremely low interest rate needs to be raised. I said then that it was not merely a question of an upturn possibly being on the way; I also pointed out that monetary policy is forward-looking and its effects come after a time lag. It is therefore more guided by developments in 2012 and 2013 the closer we come to this period. I also emphasised that although inflationary pressures were not a problem at that point, or in the near future, the situation could look very different in a year or two. For example, commodity prices could have begun to rise more than we had predicted, or the expansionary monetary policy and fiscal policy conducted in large countries could have pushed up international inflation with a risk of increased imported inflation. I also mentioned that we could not be certain that the krona would strengthen in the way we had assumed, or that productivity would recover as we had predicted.

We know from experience that the inflation outlook can change rapidly. During the late spring and summer of last year we were concerned over inflation being too high, even though this was mainly due to rising oil and food prices. Rising unit labour costs were also taken into consideration. Fears that high inflation expectations would become entrenched also formed part of the picture. We then raised the interest rate despite beginning to see signs of weaker economic activity in the future. The assessment was that this was necessary to attain the inflation target a couple of years ahead. When developments turned out differently, we had to quickly change our course. We are of course always prepared for situations like that. We are ready to act as quickly and as forcefully as is necessary, both to attain the inflation target and to carry out our financial stability responsibilities.

Unconventional measures

There have been many discussions on what the Riksbank could be expected to do if developments turn out weaker than we are now assuming. And our toolbox is not empty because the repo rate is so close to its lower limit.

Put simply, the way the repo rate tool works is that the banks either borrow or buy Riksbank Certificates with a maturity of one week from the Riksbank at the price of the repo rate. In addition, there are what is known as daily fine-tuning operations between the Riksbank and the banks at an interest rate very close to the repo rate. The current level of the repo rate and expectations of what it will be in the future in turn affect other interest rates with longer maturities and, of course, activity in the economy. As I mentioned earlier, the Riksbank has implemented a number of measures that work through the banks in order to improve the functioning of the financial markets. This includes loans at maturities of 3 and 6 months to Swedish banks, against collateral and at a variable interest rate. These measures were recently supplemented with the possibility to borrow at a 12-month horizon. The primary aim of the lending has been to manage financial stability. But the measures also have monetary policy side-effects in that the Riksbank is active further out on the yield curve than normal. The liquidity premiums decline, which in turn should lead to lower interest rates.

If a central bank wants to affect interest rates more directly at slightly longer maturities there are various measures at its disposal. Central banks such as the US Federal Reserve and the Bank of England are for example buying government bonds with long maturities to influence long-term interest rates in the economy, thereby trying to attain monetary policy easing. However, the effects of such a strategy are uncertain. As yet our experience of that kind of action is rather limited. Moreover, government bond rates are affected by many other factors than the central banks' possible purchases of these securities.

The Riksbank has not taken any such measures. The Executive Board decided at its meeting in April that the time was not yet ripe for this. But nor could we exclude the possibility that this might be possible further ahead, if the economic situation were to deteriorate more than we were assuming.

During our discussion of this type of unconventional measure at our most recent monetary policy meeting I pointed out that the Riksbank is already implementing extensive measures through its lending to the banks. These measures will continue as long as is necessary. I also considered that it was not necessarily the case that we would need to take the same measures as, for instance, the Federal Reserve and the Bank of England. There are several different reasons for this. The companies in these countries are more dependent on market funding, while in Sweden the banks are the most important source of funding. I also said that we had not yet seen the full effect of the radical interest rate cuts we had made, which contributes to an even greater uncertainty in the question of whether further stimulation through unconventional measures is needed.

When we meet in July we will present our forecasts for the economy and the repo rate over the coming three years and discuss once again whether there is a need to carry out other measures than those we have already carried out. We must always maintain the best possible level of preparedness to deal with various situations that might arise. But this is not the same thing as needing to put those plans into action.

Concluding thoughts

I would like to carefully emphasise that what I have taken up regarding economic activity and monetary policy should not be interpreted to mean that in a sudden outburst of uncontrolled optimism I have a much brighter view of the coming period than most others. And my message today does not contain anything new in relation to what I said at the most recent monetary policy meeting. I can assure you that I am aware of the seriousness of the ongoing downturn. And it is not a question of my being hawkishly “trigger-happy” and wanting to raise the interest rate again as soon as we see the slightest sign of a recovery. I believe, like my colleagues, that we need to maintain a low interest rate for a relatively long period of time. What I want to say is rather this: I believe it is easy to become a hostage to the situation when all of the figures are falling and to put a large emphasis – possibly too large – on the downside risks. And, of course, one cannot rule out the possibility that the crisis and the economic downturn will be more protracted and more profound than we are now assuming. But there is also a risk that one may thus give too little weight to the possibility that things could actually go better than we believe and thus we may receive a surprise from a different direction.

I have worked with forecasting for many years, and there are two things in particular that I have noted, and for which I also believe there is scientific evidence: that it is difficult to predict turning points in the economy, and, once they have happened, it is easy to underestimate the strength of the development that follows. This applies to both downturns and upturns. There is perhaps no reason today to assume that a rapid recovery will be the most likely alternative. But it is definitely something that it is worth being prepared for in the slightly longer perspective.

A central bank must have good long-term planning. Even if we are busy trying to alleviate the effects of a collapse in economic activity we must ensure that we bear in mind the medium-term perspective. This may seem self-evident, but I believe it may be important to point it out. Not merely emphasising the short-term perspective is important for maintaining confidence in the inflation target in the long term. There must be a preparedness to act in a situation which could differ from the expected by being both better and worse. We currently have an extremely low interest rate and we are in a crisis that to some extent stems from having had a low interest rate for a long time. We must be aware of the imbalances that may build up and neither be “deflation nutters” nor “inflation nutters”.