Stefan Ingves: Introduction on monetary policy

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, to the Riksdag Committee on Finance, Stockholm, 4 March 2010.

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This figure (Figure 1) is one I showed the Committee around a year ago. At that time, acute crisis management still required most of our resources. I compared our means of handling the climax of the crisis to an ice-skater who notices that the ice has suddenly become very thin, or unexpectedly begun to crack just in front of him. Then there is only one sensible alternative – to make a sharp turn and try to return to safer ice as quickly and smoothly as possible. To act quickly and forcefully. This is what we did, but the ice under our feet was still uncertain.

Figure 1

On safer ice and with the acute crisis behind us

Photo: Fredrik Edin, Cykloteket Racing Team

Today the situation is different. And the picture of the lovely, thick ice stretching ahead of the skaters in the sunshine is actually more appropriate now than it was one year ago, both literally and figuratively. We have safer and firmer ground beneath our feet. We have entered a new phase of the economic recovery and the acute crisis is behind us. But we are now facing new challenges and considerations. The work on preventing future crises is both important and urgent. Here we must show ability to take action, and I shall return to this at the end of my speech here today. Some of the difficult considerations to be made concern when and how quickly central banks, governments and other public authorities around the world will withdraw the strong economic stimulus they have been providing during the crisis. Now that the financial markets are more stable and the recovery in the economies has begun, it is time to move towards a more normal situation, not least with regard to monetary policy. We must make the transition from monetary policy during a crisis to monetary policy in an economic downturn. For the Riksbank and many other central banks, the question of when to begin raising the policy rate, and how quickly, is a fairly difficult balancing act.

I intend to begin by talking about the considerations behind our most recent policy rate decision and our forecast – the policy we consider necessary for inflation to be close to the target of 2 per cent, at the same time as providing support for production and employment.

Transition from crisis interest rate to monetary policy in an economic downturn

At the most recent monetary policy meeting three weeks ago the Executive Board decided to hold the repo rate unchanged at the historically-low figure of 0.25 per cent. We are on our way up out of the steepest downturn in the economy for decades and the low interest rate is necessary to provide sufficient support to the recovery. But at the same time, we are also approaching a situation where it is time to leave the crisis interest rate behind us and take steps towards an interest rate that is normal for a "regular" economic downturn. We are expecting to begin raising the repo rate with effect from the summer or the beginning of the autumn this year. This is slightly earlier than assumed in our earlier forecast.

There are two main reasons why we are revising our assessment somewhat. One is that the situation in the financial markets has become increasingly stable over a long period of time. The other is that the upturn in economic activity has gradually become more evident. Roughly as the long, cold winter has steadily made the ice thicker than last year, developments in the financial markets and the economy as a whole have contributed to the recovery being able to continue on firmer ground. But the road ahead of us is certainly not lacking in challenges. Before we reached agreement on our forecast we took into account a number of different risks and deliberations in the two areas I just mentioned. And I would now like to explain our reasoning to you.

Financial markets more stable

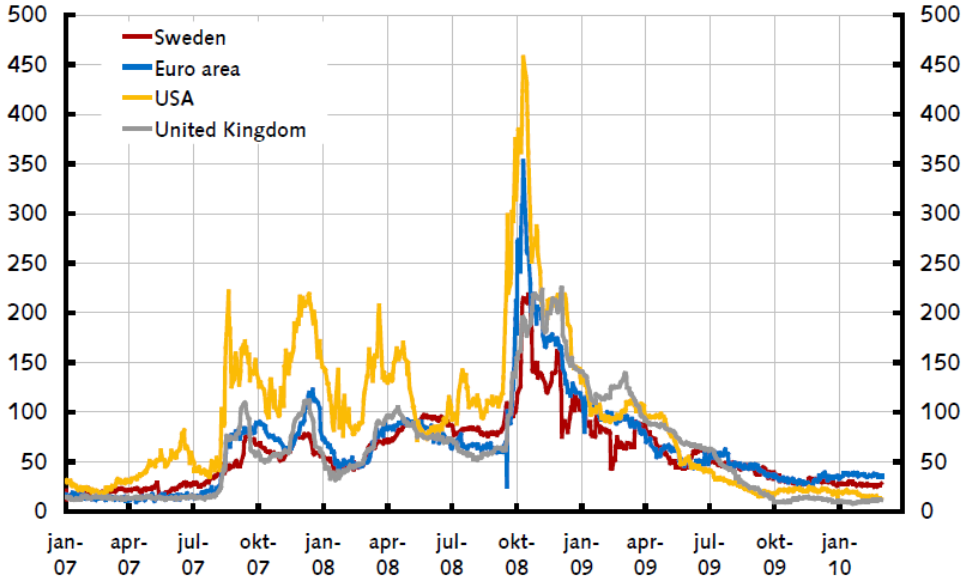
The situation in the financial markets is becoming increasingly stable. Previously the uncertainty in the credit markets around the world in particular has appeared to be an obstacle to economic recovery. But now there are many indications that we are approaching a more normal situation and that the widespread uncertainty and mistrust during the crisis has declined. Many measures taken by central banks and other authorities to restore confidence in the financial markets and to stimulate the economy are still in place. Naturally, this makes it difficult to say how the situation would look without this support. But some measures have already disappeared. This is in itself a sign of greater stability. In Sweden, for instance, measures such as the loans to the banks in US dollars and the loans with a maturity of 12 months at a variable interest rate have more or less phased themselves out. The demand for the measures, and in other words the need for them, has quite simply faded.

We can also note that the price of risk has fallen, for instance, on the interbank market where the banks are lending to and borrowing from one another, and on other credit markets. This can also be seen in a measure called the TED spread, which I have also shown earlier to the Committee on Finance (Figure 2). The TED spread is the difference between an interest rate in the interbank market and a government bond rate, both with three-month maturities. The measure provides an indication of the confidence between the banks. The TED spreads have gradually fallen and for some time have been at around the same levels as in summer 2007, before the financial crisis became acute. Although measures such as the central banks' loans to the banks have probably played a role here, the low TED spreads indicate increased confidence and a more stable situation in the interbank market.

Figure 2

More stable situation in the financial markets

The difference between interbank rates and government bond rates (TED spread), basis points



Sources: Reuters EcoWin and the Riksbank

Another healthy sign is that individual problems have not spread exaggerated unease in the financial markets around the world. I refer here to Dubai World, for instance, which defaulted on its payments earlier in the winter and has since suffered new problems, and to Greece, which is struggling with very poor public finances. A further example is the economic problems in the Baltic countries. While these events are reminders in themselves that we still have some way to go before we can declare this crisis completely over, if the same things had happened in autumn 2008 the waves of turbulence would probably have been much higher and affected markets far from the eye of the storm. We are now on firmer ground – or on safer ice, if you prefer. A further positive sign is that activity in the financial markets has increased after being very low in some cases, particularly during the most intensive phase of the crisis. For example, it appears easier for companies to fund themselves directly in the markets.

When will the central banks and government phase out their support measures?

The extensive measures taken by governments and central banks around the world to counteract the effects of the crisis have contributed strong economic stimulation. But in many countries some of the measures, however necessary they may have been, have led to much poorer government finances. In countries such as the United Kingdom, Ireland, Spain, Greece and the United States public finances are under great strain, for various reasons. This means, for instance, that there is a risk that the long-term interest rates in these countries will rise quickly, which to some extent has already happened. This in turn can hamper the economic recovery. Sooner or later it is also necessary to do something about the budget deficits. This is a cause for concern and we are expecting that such measures will hold back GDP growth abroad somewhat at the end of the forecast period.

Most central banks which have managed the more acute phase of the crisis with the aid of various support measures and very low interest rates, are now in a phase where it is time to think about exit strategies and to return to more normal interest rate levels. At present the Riksbank is lending almost SEK 370 billion to the banks, and around SEK 295 billion of this is in fixed-rate loans. The fact that the loans are falling due is of course included in our calculations when we assess how we will formulate our future monetary policy.

Phasing out the loans is fairly undramatic. The measures will disappear, as I mentioned earlier; in principle this will occur automatically as the need for the measures disappears. The fixed-rate loans that currently have the longest maturities mature in the autumn 2010. At present we do not expect there will be a need to offer new fixed-rate loans at longer maturities beyond this horizon. But of course we are closely following developments in the financial markets, and are prepared to implement new such measures if necessary.

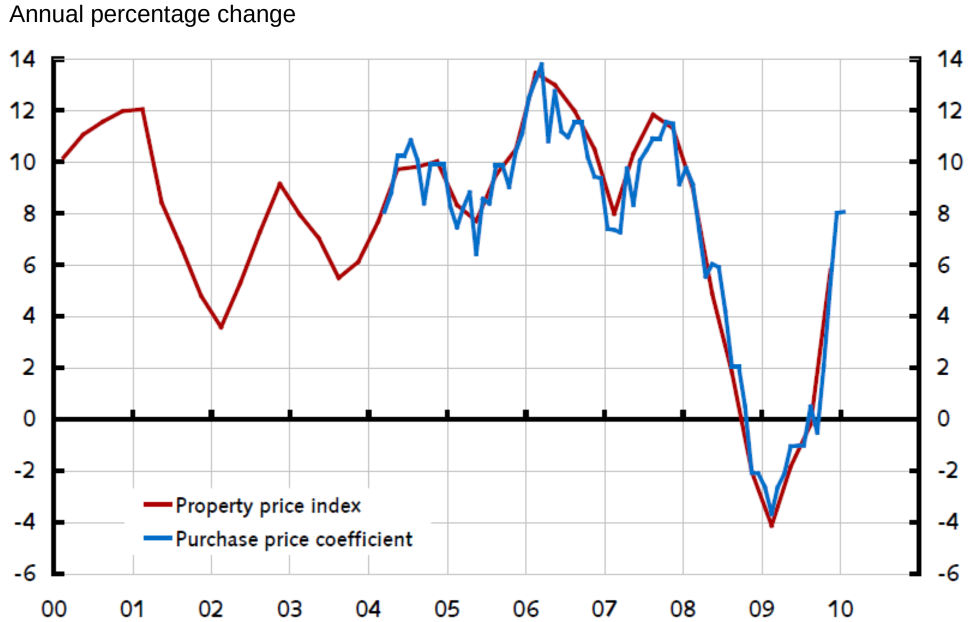
The interest rate increases entail slightly more difficult considerations. For many central banks the question of timing is a difficult one. Withdrawing support measures and beginning to raise interest rates too early or too quickly may slow down the economic recovery in a sensitive phase. If the expansionary policy instead continues too long, there is a risk that inflation will be too high or that imbalances will build up, for instance, on the housing market or between different countries. Assets such as commercial property, but also residential property, have often played an important role in economic crises. There are links between house prices and the financial markets, not least through interest rates and lending. And low interest expenditure usually stimulates both credit growth and house prices, all else being equal.

Considerations regarding the housing market...

The monetary policy we have needed to conduct to attain the inflation target and to provide sufficient support for the recovery has entailed historically-low interest rates and support to lending through fixed-rate loans to the banks. In Sweden house prices have risen substantially over several years. During the crisis, for instance, while house prices fell during a period of time, data from Statistics Sweden indicate that they have been rising again since the end of 2009 (Figure 3).

Figure 3

House prices



Source: Statistics Sweden

There are many indications that the rise in house prices in Sweden as a whole is due to fundamental factors, such as the fact that demand has increased more than the number of new housing. But there may be risks. The Riksbank, like many other central banks, must achieve the balance I just described – evaluate possible risks of an imbalance in the housing market in relation to what we believe will happen in the economy as a whole. We have done this when making decisions on interest rates right now and in our forecast of future monetary policy.

In a way, this is nothing new. We always follow developments in the housing market very closely. At the same time, we see a need to develop the analysis of house prices and credit growth – not least with regard to the question of how the links between the housing market and the Riksbank's tasks and objectives look. We have therefore appointed a special commission of inquiry into the Swedish housing market – a broader and more coherent approach which will supplement the analysis of individual issues that we and others conduct. The inquiry will be based on two perspectives – financial stability and monetary policy.

…not just the Riksbank's field

Having said this, I would like to point out, or rather repeat something I have mentioned on previous occasions. Monetary policy can probably only function as a complement to effective regulation and supervision. Moreover, households have a responsibility to make realistic assessments of what interest expenditure they can manage in the long run. The current interest rate reflect the management of an acute crisis and not monetary policy under normal circumstances. And as shown in our interest rate forecast we will probably begin raising the repo rate within six months.

The banks must also make responsible assessments when lending money. Here Finansinspektionen, the Swedish financial supervisory authority, plays an important role due to its task of examining banks and credit institutions from a consumer perspective. Finansinspektionen also has the possibility to implement more targeted measures than the Riksbank has. The repo rate is a blunt instrument that affects the whole economy. In February Finansinspektionen warned that even moderate falls in house prices could mean that a number of households have mortgages that exceed the market value of their property. Finansinspektionen believes there is reason to consider new regulations regarding household loans in relation to collateral to create better margins. Without wishing to anticipate this inquiry, let me just note that we should, as far as possible, manage problems before they arise. Finansinspektionen's inquiry appears to be a step in this direction.

The Baltic countries – more stable but still cause for concern

One risk tied to the financial markets and which is particularly important to Sweden, is economic developments in the Baltic countries. Just a few weeks ago, we met here in the Riksdag Committee of Finance to discuss the Swedish banks' commitments in Estonia, Latvia and Lithuania – what has happened in recent years, what we are expecting to see in the future and what we can learn from recent events. I do not intend to repeat what we talked about then, but can note that developments in the Baltic countries do appear somewhat brighter now than they did a while ago, but that the future is still very uncertain. One question that could affect the region as a whole is, for example, Estonia's application to join the EMU. Loan losses in the Baltic countries are still increasing, which in turn has a negative effect on the Swedish banks' profitability. We are counting on loan losses there peaking during 2010, but also on the Swedish banks being able to cope with the strains this will entail. An important element here is that the banks have increased their capital and thus their resilience to increased loan losses.

The road ahead of us is not without problems. It is lined with a number of potential worries and difficult considerations, not least for central banks. But the situation in the financial markets is currently much more stable than it was during the crisis and the risk of setbacks has declined. One can say that the ice is safer.

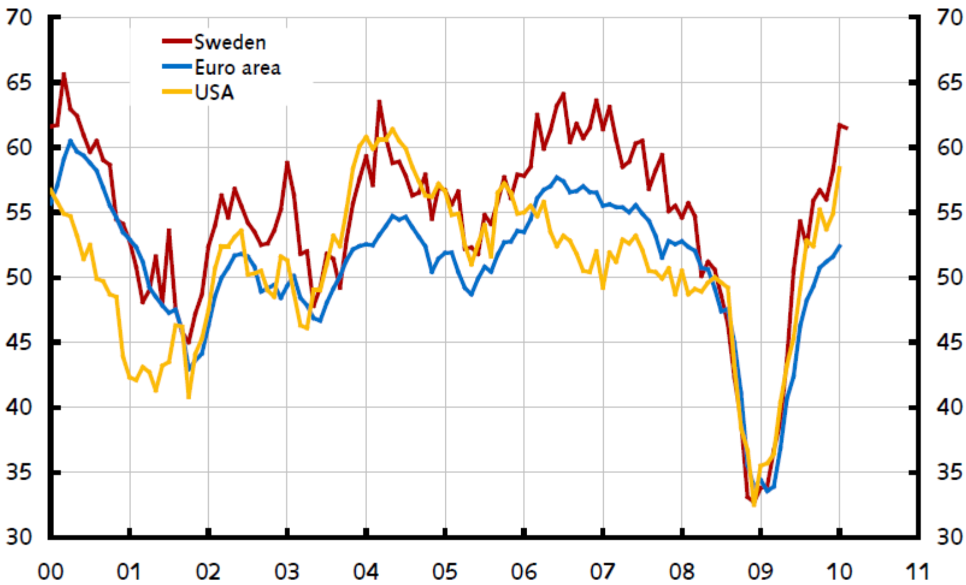
Clearer signs of a recovery in the economic statistics

As I have mentioned, there is a further overall reason that we are now on firmer ground. The economic statistics that have been coming in have been mainly positive. Confidence in the future development of the economy has also taken a sharp upturn in Sweden, the United States and the euro area (Figure 4).

Our assessment is that the situation in the world economy is continuing to improve. In most countries the economy is growing again and world trade is beginning to pick up after the abrupt slowdown in connection with the acute crisis (Figure 5). New figures have been published by Statistics Sweden since our most recent forecast was published. These show that GDP at the end of last year was lower than we had estimated. At the same time, for instance, confidence indicators have continued to strengthen. However, the Executive Board will weigh up and assess the new information at our next monetary policy meeting on 19 April.

Figure 4

Increasing confidence according to purchasing managers index



Note. An index over 50 indicates growth

Sources: Institute for Supply Management, Markit Economics and Swedbank

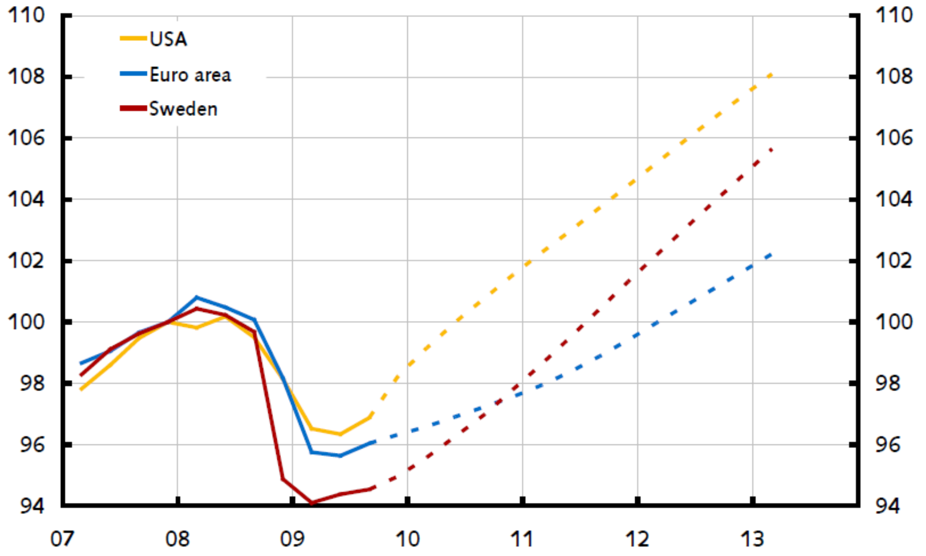
In the Swedish economy domestic demand has so far been supported primarily by consumption and public investment. The expansionary fiscal and monetary policy has stimulated household consumption. This includes tax cuts, low interest rates and other measures.

Figure 5

Economies around the world are now growing

Outcome and forecast, Monetary Policy Report, February 2010

GDP level, index 2007 Q4 = 100



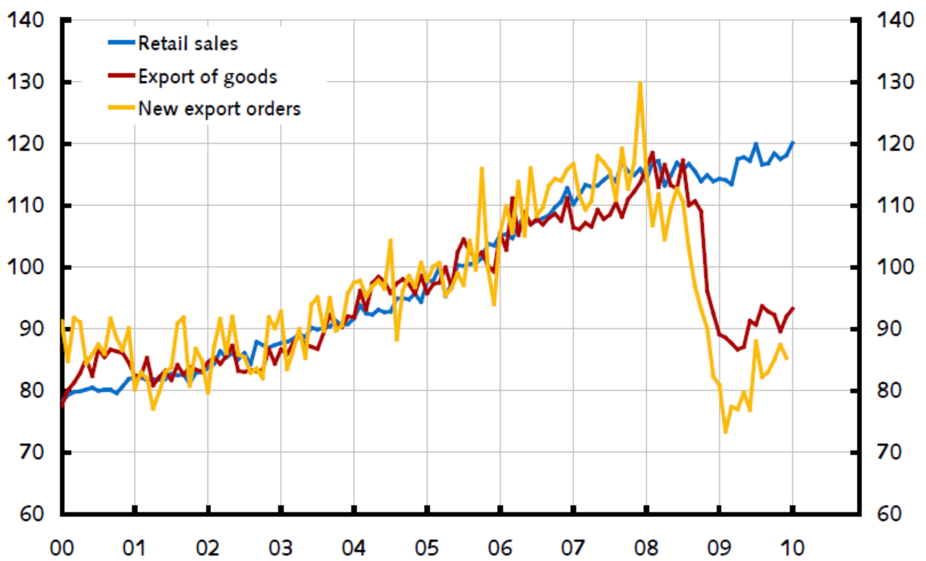
Sources: The Bureau of Economic Analysis, Eurostat, the OECD, Statistics Sweden and the Riksbank.

However, the export sector has been hit hard by the fall in world trade and one can now say there is a divide in the economy. This can be seen, for instance, if one looks at how retail trade and exports have developed (Figure 6). But at the same time, export orders and world trade have increased, which indicates that exports will recover, albeit from a low level.

Figure 6

Divided economy

Index 2005 = 100, seasonally adjusted data



Source: Statistics Sweden

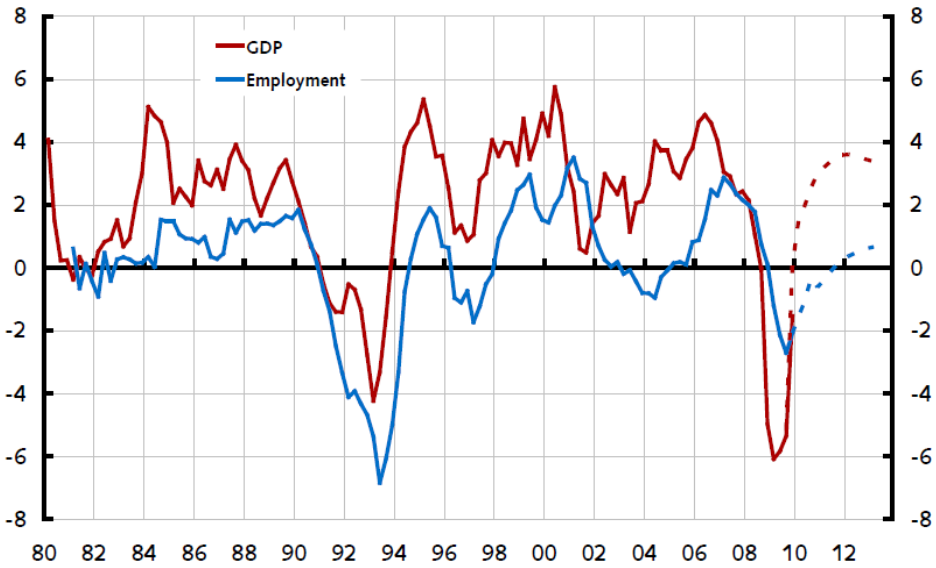
Rising domestic demand but low resource utilisation

The prospects for demand in the Swedish economy continuing to increase are good. Household income has developed well and households have a high level of saving. As public finances are sound, the need for fiscal policy constraint further ahead is lower in Sweden than in many other countries. As growth abroad increases, exports will also rise again. All in all, we are expecting GDP to increase fairly strongly in 2011 and 2012, by around 3.5 per cent a year (Figure 7). This nevertheless means that it will take roughly three years before GDP is back at the same level as prior to the crisis.

Figure 7

Employment has fallen less than expected

Employment and Swedish GDP, annual percentage change



Sources: Statistics Sweden and the Riksbank

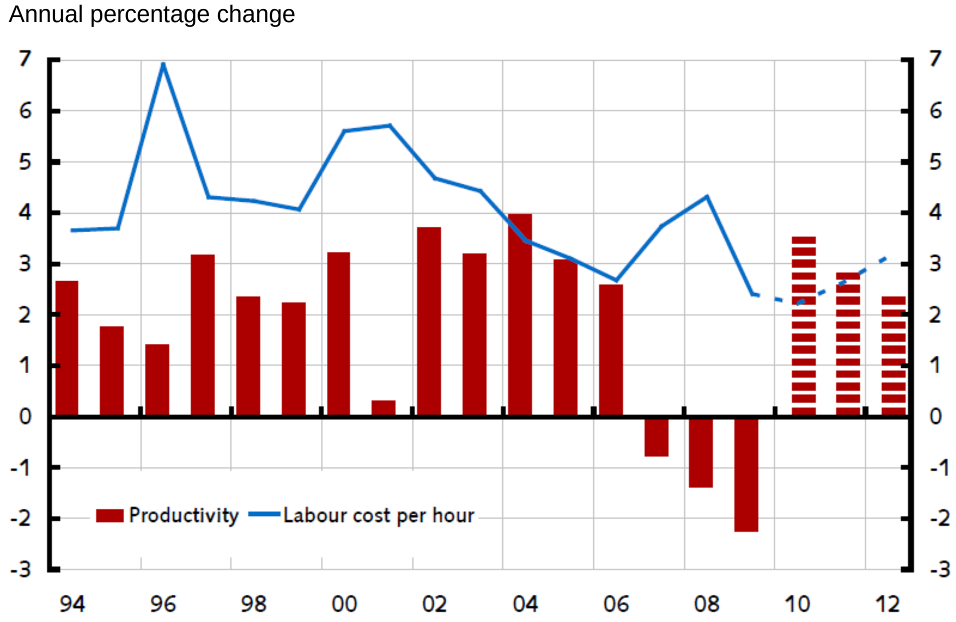
Resource utilisation in Sweden is at present very low. The crisis may have lowered the economy's long-term output level – it is not unusual that such radical changes will have a more lasting negative effect on both capital and labour. But one can probably assume nevertheless that there will be ample spare capacity which can be used relatively smoothly in the upturn. This will entail, for instance, the need for investment, particularly in manufacturing, remaining low for some time to come. It also means that there is hardly any reason to expect a strong growth in employment over the coming period (Figure 7). We are also assuming that the labour market will continue to weaken somewhat, but that the downturn has begun to slow down.

It is worth noting that employment has nevertheless been maintained better than we had previously assumed. Unemployment is still expected to be high, but the situation does look much brighter now than in recent assessments and we have gradually revised down our forecasts. During the 1990s crisis employment fell more than GDP, but during this crisis the situation has been the reverse. Many companies appear to have chosen to retain existing staff, perhaps because their assessment has been that demand will return fairly soon.

Many wage agreements will be renegotiated this year, but we are expecting the weak labour market situation to contribute to holding back wage increases during the forecast period. This contributes to lower cost pressures in the economy. As the companies have considerable spare capacity, they can manage to meet increased demand abroad and here at home without their production costs rising significantly. This has a strong impact on productivity, which is now expected to increase after having fallen for three years in a row (Figure 8).

Figure 8

Lower cost pressures and increased productivity



Sources: The Riksbank and Statistics Sweden

The krona has been weak during the crisis. It is not unusual that small, open economies like the Swedish one are affected by a depreciation of their currency in times of turbulence in the international financial markets. The krona has strengthened considerably since its weakest point and we are now assuming that it will gradually strengthen further, as we put the financial crisis behind us. This will help to reduce inflationary pressures in the period ahead.

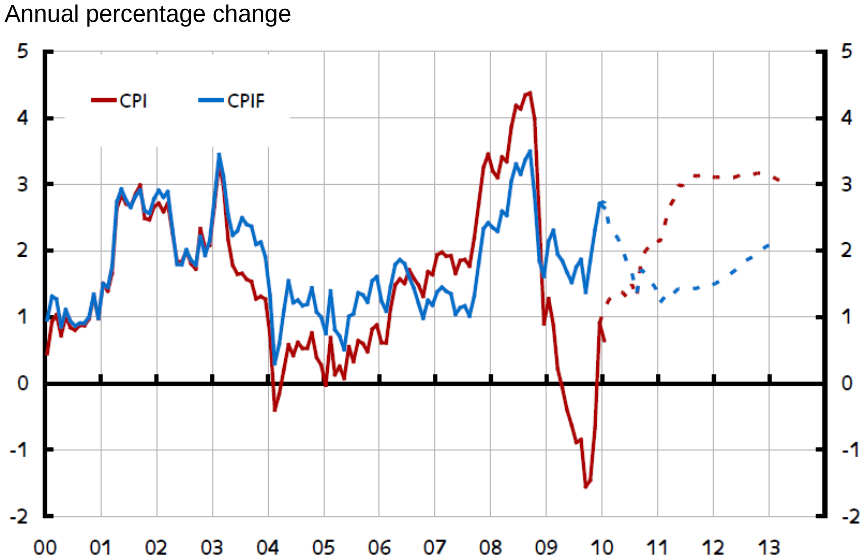
CPIF close to 2 per cent at the end of the forecast period

With regard to inflation measured in terms of the consumer price index, CPI, future developments will be affected by the rise in interest rates, or rather by the increase in households' mortgage interest expenditure. This is clearly visible if one looks at the same time at CPIF inflation, which quite simply is CPI inflation with a fixed mortgage rate. The CPIF is thus not directly affected by changes in mortgage rates, which means that these measures differ quite considerably over the coming years, although they approach one another further ahead.

Both CPI and CPIF inflation rose in the months prior to the publication of the Monetary Policy Report (Figure 9). This was mainly due to rising energy prices, but also to weak productivity growth and to the previous year's weaker exchange rate having a delayed impact. However, data published two weeks ago show that both the CPI and the CPIF fell in January. During 2010 CPIF inflation is expected to fall, primarily as a result of companies' costs falling and the krona strengthening, which is expected to make imports cheaper. The rate of increase in the CPIF will rise from 2012 and onwards as economic activity improves and companies' costs begin to rise again. At the end of the forecast period, we expect inflation measured in terms of the CPIF to be close to 2 per cent. However, CPI inflation is expected to continue to rise. This is mainly because households' interest expenditure will stop falling and then rise as the repo rate is raised.

Figure 9

Inflation measured as the CPI and the CPIF



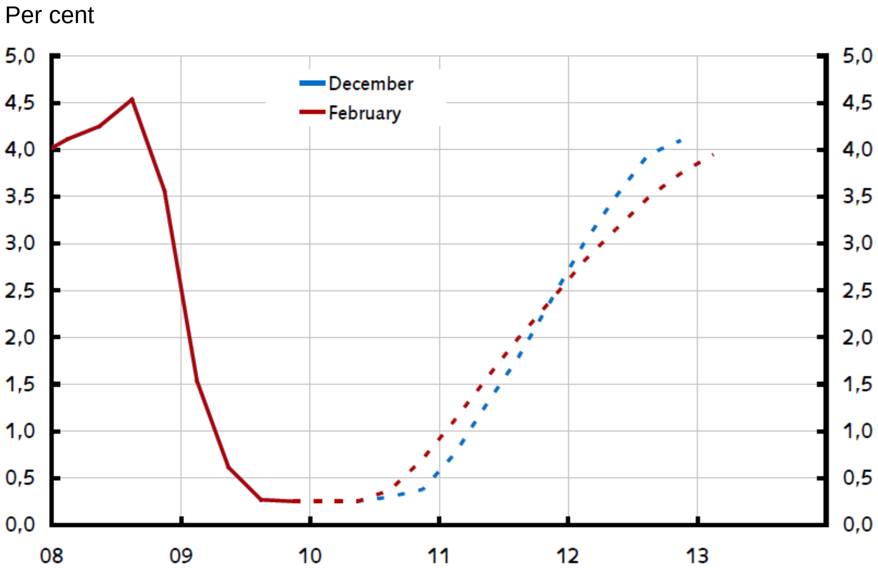
Source: Statistics Sweden

From crisis interest rate to monetary policy in an economic downturn

The Executive Board of the Riksbank decided at the latest monetary policy meeting to hold the repo rate unchanged at 0.25 per cent to attain the inflation target of 2 per cent and to give sufficient support to the economic recovery. We are expecting to begin raising the repo rate again in the summer or in early autumn 2010 (Figure 10). This is slightly earlier than in our last forecast, which is because of the two components I mentioned. The financial markets have become increasingly stable and statistics on economic activity – such as slightly higher growth abroad, stronger employment and higher inflation – have gradually confirmed the picture of the recovery being on firmer ground.

Figure 10

From crisis interest rate to monetary policy in a recession



Source: The Riksbank

At the same time, we are now assuming that the increases in the repo rate can be made more gradually. This means that the forecast for the repo rate in the longer term is marginally lower than before, just under 4 per cent at the beginning of 2013. But, of course, forecasts so far ahead are very uncertain.

Even in the slightly shorter term, there are difficult considerations that must be made and risks connected to our interest rate decisions. As we often point out, the repo rate path is a forecast and hence by definition uncertain; it is not a promise. How we will conduct our monetary policy in practice in the future will depend on how economic developments in Sweden and abroad affect the prospects for inflation and economic activity. There is a risk that the upturn in inflation during the winter will not be temporary, but will persist a little longer. One indication of this is the fact that the rate of price increase has risen with regard to many goods and services. Risks that could put greater upward pressure on inflation in the future are if the krona were to weaken or wage increases were to be higher than the Riksbank has forecast. We may then need to raise the repo rate more quickly than expected. If, on the other hand, wages increase more slowly or the supply of labour is higher, then monetary policy may instead need to be more expansionary than in the forecast.

We must now begin to lay a safer foundation for the future

With the monetary policy we presented a couple of weeks ago we expect to meet the inflation target and for the recovery to continue from a more stable foundation. We will probably have to live with some of the repercussions of the crisis for some time to come, but we expect the financial markets to normalise. But it is necessary to achieve a balanced economic growth even beyond the monetary policy forecasting horizon. If we are to do so we must attend to any deficiencies regarding, for instance, regulation, supervision and the allocation of responsibility, deficiencies which have come to light rather clearly in recent years. It is important to establish a system that covers all aspects; a system that prevents unnecessary risks and imbalances from building up.

Experiences of the financial crisis in the 1990s have in many ways contributed to changes that have given our economy better resilience during periods such as the past few years. Merely the fact that we entered this crisis with sound public finances, a surplus on our current account and a lower, more stable inflation rate has given us room to manoeuvre that we previously lacked and which many other countries lack now. Some changes have also been made with regard to financial supervision and analysis of the bank sector. The banks themselves have also learnt from the previous crisis and have acted, at least in Sweden, in a much more responsible manner with regard to credit granting, for instance.

But to some extent I think our memories were too short in the 1990s, when the acute crisis was behind us and crisis management was no longer such a pressing issue. One central area where I believe we should have achieved more is legislation and regulation with regard to how and by whom banks in distress should be managed. Following the previous crisis I saw important reforms in legislation being investigated over a long period of time only to be more or less forgotten with nothing implemented. I fervently hope this will not happen again. Quite simply, it must not happen again.

Towards a cohesive and efficient financial regulatory framework

The Executive Board of the Riksbank and the General Council of the Riksbank have presented a joint report to the Riksdag where we propose that one or several commissions of enquiry should be appointed to review the regulatory framework in the financial sector. We need to create a cohesive and efficient regulatory framework. It should contribute to maintaining financial stability and if a crisis nevertheless arises, it should minimise the costs to consumers and to society as a whole. These are questions that should neither be discussed endlessly nor allowed to come to nothing when the situation stabilises. If we are to prevent costly crises in the future, we must together investigate and implement changes. Urgently!

Around the world there is already extensive work being carried out in this field, particularly with regard to the international supervision perspective. But implementing changes at international level can take time. Even if some progress has been made, it is likely that no comprehensive measures will be implemented until we have in principle left the crisis entirely behind us. We should not wait for this work to be completed in all areas. In several cases we should instead remedy deficiencies as quickly as possible and improve our own financial regulatory framework.

More tangibly, we propose, for instance that the Sveriges Riksbank Act should be reviewed. This is with the aim of clarifying the Riksbank's responsibility for financial stability and what tools the Riksbank needs to manage this task. There are several important issues in this field. For example, should it be explicitly stated in the Instrument of Government or the Sveriges Riksbank Act that the Riksbank has a responsibility for financial stability? I hope that we will fairly soon have the answer to this and other related questions.

Another area concerns investigating how the allocation of responsibility and coordination between the Riksbank and Finansinspektionen can be improved. Moreover, the distribution of responsibility between the Riksbank and the Swedish National Debt Office with regard to loans to the foreign currency reserve should also be made clearer. A further question is the one I raised just now, namely that an efficient regulatory framework is needed for managing banks in distress.

Concluding remarks

Let me finish where I began. We are on safer and firmer ground now than we were a few months ago. The acute crisis is behind us. We have passed the worst economic trough in several decades and have now entered a new phase of economic recovery. Monetary policy will probably begin to be adjusted to a more normal economic downturn situation in the summer or early autumn this year. And this is a healthy sign. The road ahead of us is certainly not an easy one. New challenges and considerations await us, but we are at the same time more than ready to meet them.

The resources that we were forced to use some time ago for more or less acute crisis management can now be partly used for analysis, development of our methods and the work on preventing imbalances in the economy and future crises. No one can say that the latter is a simple task. There are many problems that need to be solved. But we are not alone in this work, which must be conducted on both a national and an international level. As long as we have the motivation and the will to succeed our chances are good.

In the most acute phase of the crisis many of the countries of the world joined together and took action to prevent a total collapse. When it has been necessary, the authorities here in Sweden have showed an excellent ability to cooperate. We must make use of the drive and spirit of cooperation that were demonstrated in the crisis. If we do this, I believe that we will acquire a financial regulatory framework that can efficiently prevent unnecessary risks and imbalances from building up, both nationally and globally. But we must act now while we have the chance. The lessons from this crisis must not be forgotten.