Stefan Ingves: Introduction on monetary policy

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, to the Riksdag Committee on Finance, Stockholm, 11 November 2010.

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It is always a pleasure to come here and meet the Committee on Finance. And it is a particular pleasure to see many new faces. I had the same experience four years ago when I had been Governor of the Riksbank for less than a year. It is particularly inspiring to have the opportunity to discuss monetary policy with new representatives of our employer, the Riksdag (Swedish parliament) – and it is, of course, as always interesting to discuss it with the ones I have met before.

Just as I did four years ago, I will begin with a summary of the situation. So where do Sweden and other countries stand today, and how did we get there? I intend to give a fairly rough outline of my own view of the situation, without going into too many details. This is usually the best way of conveying the essential features. It will also make it easier to put current monetary policy in the right perspective.

Several explanations for the crisis

The past couple of years have been rather dramatic, since the financial market turmoil erupted into an acute global crisis in autumn 2008. It will probably take some time before we have the complete picture of why the crisis arose and how it could become so deep. But there are a number of circumstances that almost certainly contributed, although there is still debate on their relative significance.

Poorly adjusted regulations and insufficient oversight

One fact that definitely did play a role is that the regulations and supervision did not function satisfactorily. One of the problems was that there was too much focus on the situation of individual agents and too little focus on the financial system as a whole – too much micro and too little macro, if you like. Moreover, the supervision lacked the necessary international oversight as it was largely conducted on a domestic basis by each individual country. There were also loopholes in the regulations that, for instance, meant that some institutions and markets were not covered and could expand without the authorities having any real oversight. Things were not made easier by the fact that there was also great ingenuity in the financial markets that resulted in new financial instruments, where no one properly understood the risks. So all in all, one can say that the deficiencies in regulation and supervision meant that the brakes did not catch when events got out of control and the risks became too great.

A North Atlantic property bubble…

One of the main reasons behind the financial crisis is sometimes said to be that a property bubble arose in the United States, which then burst and spread extensively. This is largely true, although a simplification. However, property markets in many other countries had experienced substantial price increases over a number of years, followed by a dramatic fall in connection with the crisis. Obvious examples of this are the United Kingdom, Ireland and Spain. It is probably therefore more correct to talk about a North Atlantic property bubble.[1]

[1] The concept of "the North Atlantic real estate bubble" was introduced, as I understand it, by Paul Krugman and Robin Wells in "The Slump Goes On: Why?" in the New York Review of Books, September 2010.

Developments in the United States may have been the trigger, but problems had already built up in many other countries, too, and not only in the property markets.

…as a result of a long period of macroeconomic stability?

What was the driving force behind this process? Macroeconomic factors probably played an important role. The global macroeconomic environment in the years prior to the crisis was characterised by low interest rates, low and relatively stable inflation and high and relatively stable growth. In brief, there was an awful lot that looked awfully good – so good that this period was given its own name: "The Great Moderation". It is perhaps not so surprising that in this environment of low interest rates and an apparently new era of macroeconomic stability households and financial institutions became over-optimistic and took on too much risk. Households were happy to borrow and financial institutions were happy to lend. Much of this credit was used to buy houses and property prices began to soar.

…because of overly expansionary monetary policy?

There is a debate as to the role of monetary policy in creating this situation. The debate has mainly concerned claims that the US central bank had held interest rates too low for a number of years prior to the crisis. But other central banks, such as the European Central Bank, also held interest rates low during this period. It is not entirely clear what role monetary policy played – and plays in general – for the development of property prices and for risk propensity among economic agents. This is a subject that will probably continue to be discussed. However, on the basis of the information available at the time, there was no obvious reason for conducting another monetary policy than the one that was actually conducted. In the United States, for example, there was justified concern that the country might suffer the same deflation problems as Japan, and many other countries also perceived the threat of deflation as something to be taken very seriously.

…as a result of a global savings glut?

But there was also another and probably more important factor contributing to the low interest rates. Since the end of the 1990s the emerging economies in Asia, particularly China, and in the Middle East had experienced large current account surpluses, particularly in relation to the United States, but also to other western countries. In other words, the countries with surpluses had exported many more goods than they had imported. In return, they had invested the surpluses in bonds and other assets in the countries with deficits. One could say that this reflected an increased willingness to save in the world economy – a global savings glut. This surplus contributed to pushing down long-term interest rates in the world. At the same time, there was a lot of capital to invest in the countries with deficits. A large share of this found its way into the property markets, where prices soared.

It is not unusual for such international imbalances to lead to problems sooner or later. The situation is reminiscent of that which arose following the oil crises in the 1970s. The large increases in oil prices then meant that the oil-producing countries were sitting on huge amounts of dollars, the currency in which oil is normally traded. These so-called oil dollars, or petrodollars, were channelled through banks in the west into loans to countries in, above all, Latin America. However, it was gradually revealed that the loans had been granted on overly optimistic grounds, and many countries found it increasingly difficult to pay the interest on their debts. This led to the debt crisis at the beginning of the 1980s.

We thus now have a similar problem with global imbalances in the form of large current account surpluses in some countries and deficits in others. The difference today is that the surplus this time has contributed to excessive borrowing in many western countries rather than to a debt crisis in Latin America. But the theme remains largely the same: Plenty of

money to lend, excessive optimism among lenders and borrowers and inadequate controls and supervision – this is usually a sure recipe for a crisis.

Global challenges

So much for the causes of the financial crisis. What about its consequences? One obvious consequence has been that many countries have needed to use fiscal policy to support the bank sector and to maintain demand in the economy. As tax revenue has fallen as demand has weakened so much, this has led to large budget deficits and rapidly growing government debt. One might say that the debt problem has been transferred from the private sector to the public sector. So to return to my earlier discussion of the debt crisis in the early 1980s, one can perhaps say that the result of the international imbalances was once again a form of public debt crisis.

All in all, this means that the global economy is now facing at least three major challenges:

Firstly, the regulations for the financial system need to be tightened, and supervision needs to be more effective. The aim is, of course, to increase stability and resilience in the financial system and reduce the risk of future crises.

Secondly, as I recently noted, many countries have experienced problems with large deficits in their public finances. This is a problem that has now become acute, and needs to be dealt with. We in Sweden are all too well aware of the confidence problems that can arise from mismanaged public finances. It is of course easier to make the necessary consolidation if private sector demand is kept up. One could say that many countries therefore need to undergo what could be described as an *internal* adjustment of demand – from public to private.[2]

Thirdly, an *external* adjustment of demand is also needed. Many countries in the western world, and not least the United States, which was overly dependent on high domestic demand before the crisis, must rely more on exports in the future. Correspondingly, countries which have accumulated large current account surpluses, and in particular China, will have to rely more on domestic demand. Thus, what is needed is a changeover from domestic to foreign demand in some countries and the reverse changeover in other countries.

Create new regulatory systems

There is currently fairly substantial international unity on the first issue – the need for a better regulatory framework and more effective supervision of the financial sector – even though much of the details remain to be discussed. There has also been some progress in this field. One example is what is known as the Basel III regulations, agreed by central banks and financial supervisory authorities around the world some weeks ago. In brief, these involve raising the international requirements regarding the capital and liquidity the banks must hold. For instance, a larger share of the capital must be real equity capital. Another example is that the EU has established a special body, the European Systemic Risk Board, which is to identify risks in the financial system and to provide warnings and recommendations to the countries and authorities concerned.

Public finances an acute but difficult problem

The two other challenges are rather more difficult. The problems with public finances entail a difficult balancing act for the countries concerned. On the one hand, it is desirable that the

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[2] This and the third challenge are taken up by, for instance, Olivier Blanchard in the foreword to the IMF's World Economic Outlook, October 2010.

savings do not increase too much too soon thereby withdrawing public sector demand while private sector demand is still weak. This could lead to a negative spiral, with falling demand and production, where public finances are weakened rather than strengthened. On the other hand, the deficits and the government debt must not continue to grow to the extent that doubts arise regarding the ability to repay the debt at all. Such a situation would hardly be preferable. A further complication is that this time there are many large countries who need to save at the same time. The effects on the global economy could then be substantial, particularly if the balancing act is not successful.

Adjusting the global imbalances is not made easier by the crisis

The third challenge – that some countries must begin to rely more on exports and others more on domestic demand – was debated intensively even before the crisis. After the crisis the problems of this global imbalance have in some way become even clearer. One means of maintaining demand and creating scope for consolidation of public finances is to increase exports. And one means by which exports can increase is if the currency weakens so that the country's own goods become cheaper for other countries to buy. The problem is that all countries cannot by definition export their way out of the crisis at the same time. All countries can conduct an expansionary policy, but all countries' currencies cannot weaken at the same time.

Despite this insight being relatively widespread, fears have been expressed of a currency war, where countries deliberately try to weaken their own currencies. And if a currency war begins, it is only a short step to a trade war, where countries begin to introduce tariffs to protect their own manufacturing. This was what happened during the great depression of the 1930s, and it of course only made the problems worse. Such a development would be very unfortunate and have a considerable negative impact on small economies with extensive foreign trade, such as Sweden. At present there are major efforts being made in various international forums to avoid the global economy spinning off in this direction.

The Swedish economy has coped relatively well

This is a general outline of the international picture. Although the world economy has begun to recover, there is no doubt that it is facing fairly major challenges over the coming years. But what is the situation here in Sweden? Well, in many ways things look rather good. The Swedish economy appears to have coped fairly well in the crisis. Although production fell more in Sweden than in many other countries, the recovery has been much quicker. The situation now looks much more stable than in most other places.

One important reason why we have managed so well is, I believe, that it is not so long since we experienced a crisis here in Sweden – both in the bank system and the economy as a whole. The crisis at the beginning of the 1990s was much more isolated than the recent crisis and can in many ways be described as "home made". But we nevertheless managed to learn some important lessons from it.

Stable frameworks provide security…

Perhaps the most important lesson is that both monetary policy and fiscal policy need stable long-term frameworks. The previous crisis therefore led to a number of changes in this direction, many of them through decisions made here in the Riksdag. Unlike the situation in the previous crisis, monetary policy is now conducted by an independent Riksbank with an inflation target. We also have an expenditure ceiling and a surplus target in the fiscal policy area, which are designed to prevent public finances being undermined or savings having to be made in inappropriate situations. Sweden has been one of the countries in the front line, both in reforming the framework of monetary policy and that of fiscal policy. Many other countries have later made changes similar to the ones we made. It is also worth noting that

the most recent crisis, and the public finance problems it has entailed, have triggered a new wave of interest in fiscal policy regulation.[3]

The stable frameworks for monetary policy and fiscal policy have in many ways functioned as "shock absorbers" in this crisis. Unlike during the previous crisis, economic agents have been able to assume that inflation will be fairly stable and that public finances will remain under control. This creates a security which I believe is particularly valuable during periods like this, when there is considerable uncertainty in general around the world. I imagine, for instance, that households in countries with weak public finances are much more concerned about the future.

…and make it easier to stimulate the economy

The stable frameworks have also made it easier to stimulate the economy strongly during the crisis without anyone questioning the credibility of the inflation target or the sustainability of our public finances. One could also say that long-term credibility and sustainability are necessary conditions for monetary policy and fiscal policy to be able to provide short-term stimulation. A rather worn but appropriate expression used with regard to fiscal policy is to "save for a rainy day" during good times. We appear to have succeeded in doing so this time. So the second of the three global challenges I listed does not actually apply to Sweden.

Better regulatory framework also important for us

One cannot rule out the possibility that our previous crisis contributed to some extent to our bank system managing better this time than banks in many other countries. But the Swedish banks' memories still do not appear to have been terribly long. A couple of them were carried away by the over-optimism in the Baltic countries, and most of them would have faced much larger problems if the Swedish authorities had not intervened so resolutely. On the positive side, they largely avoided securities containing high-risk US mortgages. New share issues and good earnings capacity mean that the Swedish banks now appear well-capitalised from an international perspective.

The first challenge – the design of a better regulatory framework and more effective supervision – is of course something to which Sweden is contributing in various ways. Our own financial markets and banks coped relatively well on this occasion, but it is nevertheless clear that we are also hit hard when there is international turmoil. Moreover, the financial sector in Sweden has some distinguishing characteristics which make stability and clear game rules particularly important. From an international perspective, the Swedish banks' collected balance sheet totals are large in relation to our GDP, market funding comprises a larger share than in most other countries, and funding from abroad is relatively extensive and largely short-term.

Our own Swedish regulatory framework also needs to be renewed. For one thing, we need to look into the division of responsibility and the powers of authority of the different government agencies. For instance, the Riksbank is responsible for the stability of the financial system in Sweden, but has no really effective tools to carry out this task. Finansinspektionen (the Swedish Financial Supervisory Authority), on the other hand, has tools that could be used to influence the banks' behaviour. But it does not have the task of counteracting macroeconomic developments than entail risks for financial stability. Another important issue that needs to be addressed in a new regulatory framework is how the state should manage banks in distress.

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[3] See, for instance, Ben S. Bernanke, "Fiscal Sustainability and Fiscal Rules", speech given at the Annual Meeting of the Rhode Island Public Expenditure Council, Providence, Rhode Island, 4 October 2010.

In February we presented a report to the Riksdag proposing that the regulatory framework in Sweden should be reviewed. We mentioned these two areas as examples of important objects for analysis. The Riksdag has decided that an inquiry shall be made, and hopefully this work will begin soon.

Natural explanations for Sweden's current account surplus

With regard to the third of the challenges – the changeover from exports to domestic demand or vice versa – one can note that Sweden is one of the countries with large current account surpluses. This has in principle been the case since the previous crisis at the beginning of the 1990s. However, the surplus is hardly the result of a deliberate policy to build up a strong external position. The fact that we are saving as much as we are is partly due to our public finances being in good order and partly due to commercial decisions in the private sector. Nor have we tried to benefit exports by holding our currency artificially low. We conduct inflation targeting, and the exchange rate is simply left to its own devices. There are thus natural explanations for our current account surplus and there have not been any strong requests from abroad for us to reduce it. So really, one can say that the third challenge does not have any direct implications for Sweden, either.

The forecast and the interest rate decision

It has thus become increasingly clear that the Swedish economy is growing strongly. Many indicators of developments in the real economy are now at very high levels and GDP outcomes have been surprisingly strong. How do we see developments in the coming period? And what monetary policy is needed now?

Recoil from the crisis

To some extent, the rapid Swedish recovery is a recoil from the drastic fall in demand during the crisis. An important part of the fall in world trade was due to the postponement of purchases of investment goods and durable consumer goods – goods that comprise a large part of Swedish exports. The global economic recession therefore had a strong impact on the Swedish economy, which is very dependent on exports. World trade has now recovered, mainly through the rapid growth in emerging economies in, for instance, Asia. Growth has also been good in the Nordic countries. The upturn in our exports is to a great extent driven by demand for the goods that were previously postponed. In the same way as Swedish exports fell as markets shrank, they are now rising as the markets are growing again (Figure 1).

Good public finances…

But to a large part the good developments concern what I just tried to convey: That we actually acquitted ourselves fairly well this time. This includes the good public finances. Since the end of the 1990s our national debt has shown a declining trend. There has not been any corresponding decline in, for instance, the Eurozone and the United States (Figure 2), where the national debt moreover began to increase substantially during the financial crisis. In many areas it is thus necessary to tighten fiscal policy, but this does not apply to Sweden.

...and a high level of household saving gives scope for growth

But Swedish households have also acted in a way that has increased resilience during the economic downturn. Unlike in many other countries, savings in Sweden have shown a rising trend over the past decade (Figure 3).

During the crisis, saving increased both in Sweden and in most other countries. This is largely due to what is known as precautionary saving as a result of increased uncertainty. In many countries this uncertainty concerns the large deficits in public finances and what consequences these may have for household incomes in the future. As this uncertainty can be expected to remain over the coming years, private consumption will probably be held back. But we do not have this situation in Sweden. Although one can note that consumer confidence has strengthened in many areas in recent years, it is primarily in Sweden that it has reached historically high levels (Figure 4). The combination of sound public finances and high household savings means there is scope to reduce saving over the coming years. Together with relatively large increases in disposable incomes, this means that private consumption is likely to increase at a good pace.

Sweden is one of few countries in the OECD area where the labour market has clearly begun a recovery. Moreover, the upturn in employment is on a broad front. The manufacturing industry has once again begun recruiting and is expected to continue to do so over the coming period. Employment in the services sector, which managed the crisis better, is also expected to continue increasing.

Resource utilisation is rising gradually

Swedish GDP growth is expected to amount to almost 5 per cent in 2010, before gradually falling back to around 2.5 per cent at the end of the forecast period. But as the fall in 2008 and 2009 was so great, GDP will not return to its pre-crisis level until the beginning of next year (Figure 5). The overall assessment of resource utilisation is that it is still lower than normal, but that it will successively rise towards normal levels during the forecast period. It is natural to assume that the higher resource utilisation will gradually have an impact on inflation. Although CPIF (underlying) inflation will continue to fall slightly over the coming year, partly due to a stronger krona, it will then increase, reaching 2 per cent at the end of 2013 (Figure 6). CPI inflation will be slightly higher, as it is affected more directly by the Riksbank's interest rate increases via households' mortgage rates.

The assessment we made a couple of weeks ago was that an increase in the repo rate of 0.25 percentage points was justified. We also assumed that we will need to continue raising the repo rate over the coming years to stabilise inflation close to the target and to attain normal resource utilisation. However, we do not believe that the repo rate will need to be raised quite as quickly as we had previously assumed. The slower recovery abroad, with lower policy rates, indicates that interest rates in Sweden will not need to be so high.

Household debts still cause concern

One factor that I personally have taken into consideration when raising the repo rate this time and supporting the forecast for continued increases, is the development of household debt. If this does not slow down, I believe that there is a risk of financial imbalances arising, if not within, then beyond the forecast horizon. I believe that a gradual increase in the repo rate will contribute to reducing this risk. Finansinspektionen's recently introduced loan restrictions are also one step in the right direction. A future challenge will be to find an appropriate balance between supervisory regulation and interest rate-setting.

Of course, this overall picture may have to be revised if developments do not turn out as we are expecting. I have already pointed out that the global economy is facing fairly major challenges. A new economic downturn abroad could lead to lower resource utilisation and inflation in Sweden, too. Monetary policy would then need to be more expansionary than in the forecast. But there is also a possibility that the economic upturn in Sweden turns out to be faster and stronger than we have assumed. In this case we might need to raise the repo rate slightly faster. But none of these alternatives is our main scenario at present.

In the pipeline: Assessment of monetary policy and inquiry into the housing market

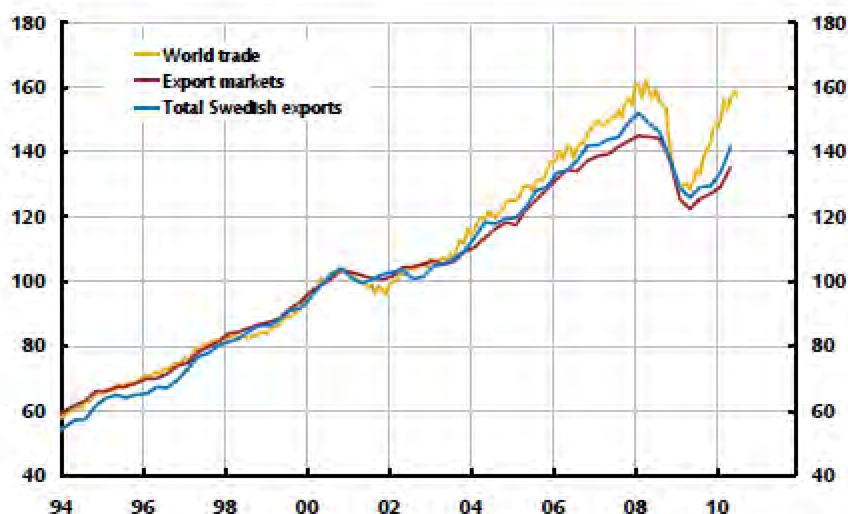
So much for the forecast and the repo rate decision. Before I finish, I would like to mention a couple of things that are in the pipeline. Work has now begun on the external assessment of the Riksbank during 2005–2010, which the Committee has commissioned Professors Charles Goodhart and Jean-Charles Rochet to carry out. The professors have already visited the Riksbank and will be visiting us again soon. We will of course provide them with every possible assistance. Unlike the previous external assessment, which covered the period 1995–2005, this assessment covers not only monetary policy but also our work on financial stability. What is of particular interest this time is that the professors will analyse what lessons can be learned from the financial crisis. The assessment will be complete in autumn 2011.

An inquiry with a shorter time span is the one concerning risks in the Swedish housing market, which was decided at the beginning of this year. In more concrete terms, this involves giving external experts as well as our own employees the task of analysing issues that in different ways illustrate the relationship between the housing market and the Riksbank's objective and aims. The inquiry as a whole should be complete at the beginning of next year. However, as a part of this inquiry the Riksbank is organising a workshop tomorrow with the title "Housing markets, monetary policy and financial stability", where a number of invited international academics will present essays they have written on this topic. We hope that this inquiry will improve our knowledge of a field that is important both to monetary policy and the economy as a whole.

I hope that this talk has given you, and in particular the new members of the committee, an insight into how I view the situation in Sweden and abroad. I shall now do my best to provide good answers to any questions you may have.

Figure 1. Exports increases

Index 2000=100, seasonally adjusted

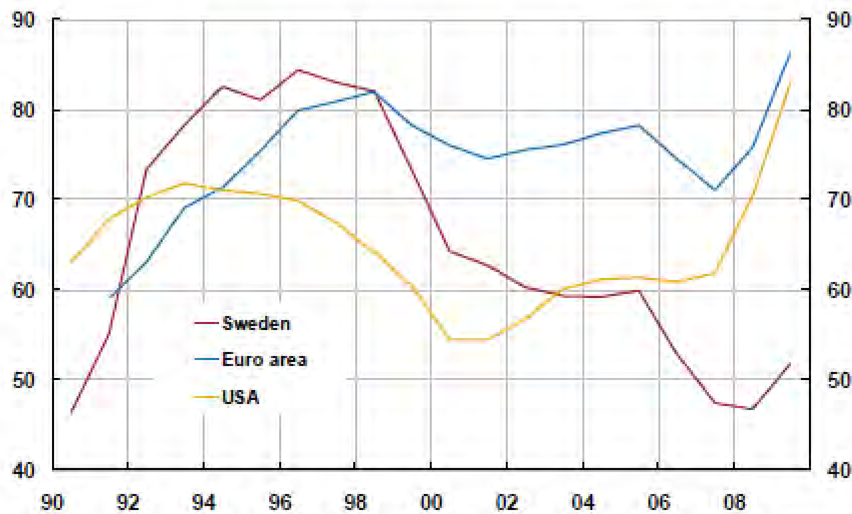


Note: Export market is defined as the weighted imports of the 15 countries receiving most Swedish exports.

Sources: Netherlands Bureau of Economic Analysis, Statistics Sweden and the Riksbank.

Figure 2. Central Government Debt in Sweden, the euro area and the US

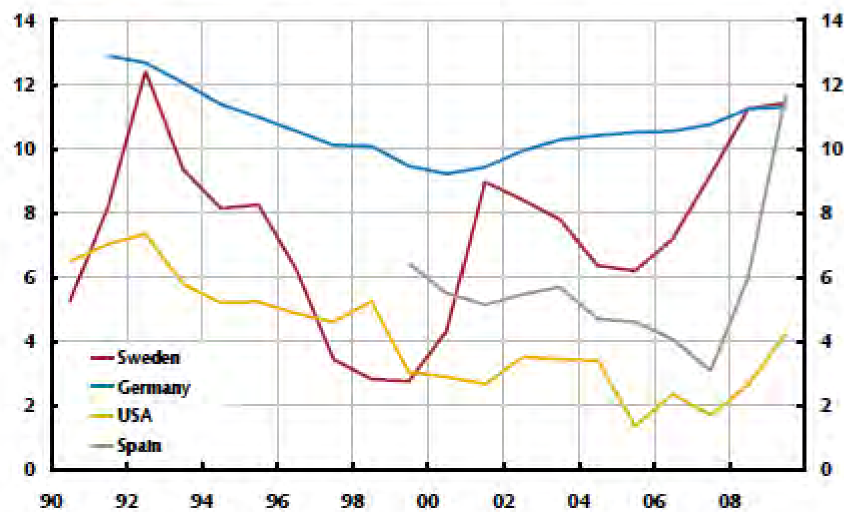
Percentage of GDP



Note: Public gross debt. Source: OECD.

Figure 3. Households' savings ratio in various countries

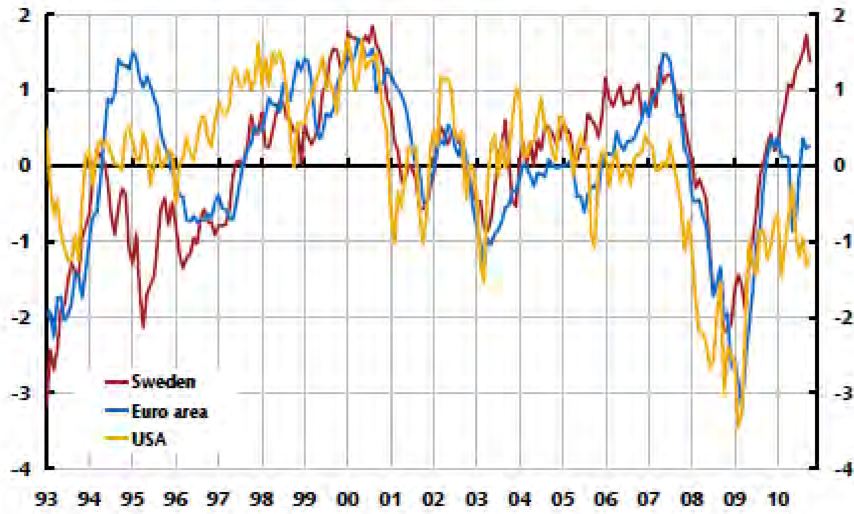
Percentage of disposable income



Sources: National statistical authorities and the OECD.

Figure 4. High consumer confidence in Sweden

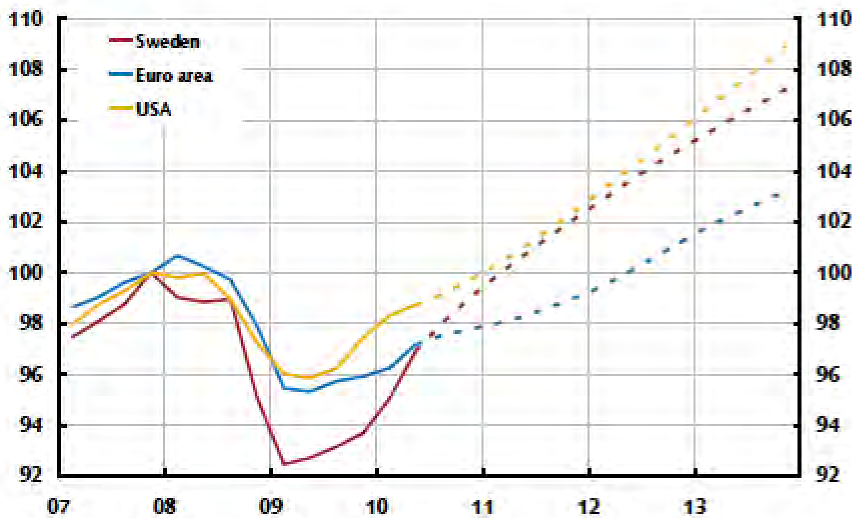
Number of standard deviations from mean value



Sources: The Conference Board, DG ECFIN and the NIER.

Figure 5. Comparison of the recovery in Sweden, the euro area and the US

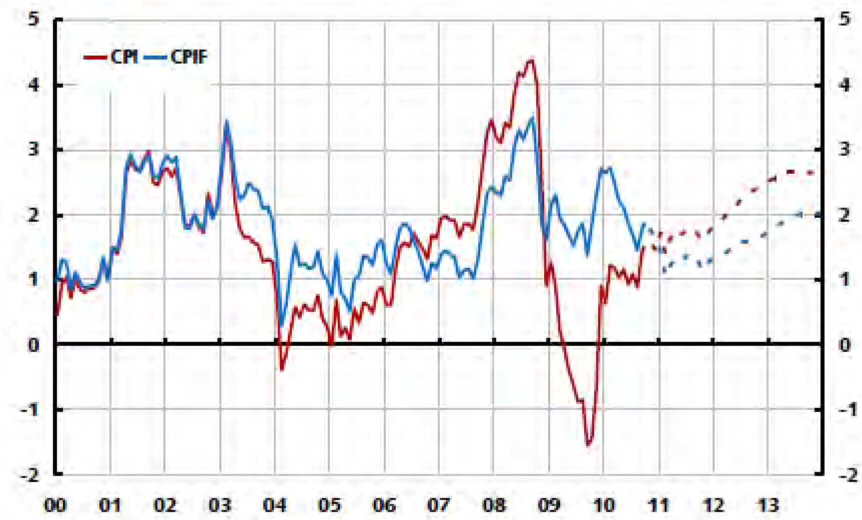
Index 2007:4 = 100



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

Figure 6. Inflation increases gradually

CPI and CPIF, annual percentage change



Sources: Statistics Sweden and the Riksbank