Karolina Ekholm: Macroprudential policy and clear communication contribute to financial stability

Speech by Ms Karolina Ekholm, Deputy Governor of the Sveriges Riksbank, to the Swedish Banker's Association, Stockholm, 30 March 2012.

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The views expressed in this speech are my own and are not necessarily shared by the other members of the Executive Board of the Riksbank. I would like to thank Mr Johan Molin and Mr Per Sonnerby for all their help with writing this speech.

A new policy area has attracted a lot of attention recently – an area that has come to be called macroprudential policy. Macroprudential policy entails focusing on the financial system as a whole instead of on the health of an individual institution, as is the case in traditional supervision. In my view, such a broad approach is an important, and perhaps even a necessary, complement to traditional supervision. However, we must of course be realistic about what macroprudential policy can actually achieve, particularly as monetary policy and fiscal policy are also important to the stability of the financial system.

Today I will speak about how I believe macroprudential policy can be used as an element of the work to prevent financial crises. This also gives me the opportunity to mention that we have recently taken a step towards a broader approach to promoting financial stability. We have namely set up a council for cooperation on macroprudential policy together with Finansinspektionen. I will tell you how we expect this council to work and I will also touch upon the need to develop communication concerning financial stability. However, already at the outset I would like to emphasise that this macroprudential council should be seen as a temporary solution while awaiting a more permanent framework for macroprudential policy in Sweden. In the longer term, we need to clarify where responsibility for macroprudential policy should lie. It is also important that there are clear and well-defined tools for macroprudential policy.

The financial crisis in the United States became a debt crisis in Europe

What began as a financial crisis in the United States in 2007–2008 has now become a debt crisis in Europe. However, the current problems in a number of euro countries are basically due to the fact that they pursued policies that were not in line with economic development. The introduction of the euro meant that the euro countries lost the possibility to conduct their own monetary policies. All of the responsibility for stabilising an economy when it was exposed to asymmetric shocks fell instead to fiscal policy. But fiscal policy has not been used to the full in this way in several euro countries. In countries such as Greece and Ireland, growth and inflationary pressures have been much higher than the average for the euro area. These countries should have conducted a much tighter fiscal policy in order to counteract this. But, unfortunately, they did not. The budget rules at the national level were too weak to enforce an effective fiscal policy. And the EU rules that are intended to promote sound public finances, the so-called Maastricht criteria, simply did not work.[1]

What appeared to be the emergence of an acute crisis at the end of last year has been averted, partly by measures taken by the European Central Bank. This has provided a necessary breathing space, but it has not solved the fundamental, underlying problems.

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[1] The lack of budget discipline cannot only be blamed on the countries that have now been hit hardest. The relaxation of discipline really began some 10 years ago, when both Germany and France deviated from the Maastricht criteria. Today, 23 of 27 member States fail to meet these criteria.

Growth prospects have weakened, partly as a result of the consolidation measures that the crisis has forced governments to take. Unfortunately, there are no good alternatives to such measures. If the countries that have the weakest public finances refrain from implementing them the interest rates on their sovereign debts will rise and there will thus be a risk of the crisis spreading to other countries.

We have also seen some signs of credit tightening in parts of the euro area.[2] One of the factors contributing to this may be the European Banking Authority's recommendation to introduce a capital adequacy requirement of at least 9 per cent for European banks no later than June this year.[3] However, as in the case of the impact of consolidation measures on growth prospects, one could argue that the alternative to requiring a higher level of capital adequacy would be even worse. Without such requirements for banks with a low degree of capitalisation, there is a risk that the crisis will spread to other banks through poorer access to market funding. Although we ourselves do not belong to the euro area, we are still highly affected by developments there. Sweden is a small, export-dependent country and our most important export markets are in Europe. It is therefore of crucial importance to the Swedish economy that the euro crisis is managed in an orderly way.

Can crises be avoided with different fiscal and monetary policies?

As the European drama has unfolded, many observers have asked how we can prevent similar crises from occurring in the future. When, like me, you come from a central bank, it is natural to ask whether a different monetary policy had been able to prevent the crisis. Some analysts have identified the low interest rates that prevailed in many countries, and above all in the United States, for some years before the crisis as an important cause of unsustainable increases in indebtedness and property prices.

Before the crisis, the most common view among central bankers was that monetary policy should only react to sharp increases in indebtedness and asset prices if these could be expected to lead to overheating in the economy as a whole and thus to a too high rate of inflation. Otherwise, the central bank should wait-and-see before adjusting monetary policy, but be prepared to quickly cut the policy rate if a burst asset-price bubble initiates a dramatic fall in demand in the economy.

However, this view has been called into question recently. Many observers, including myself in one of my first speeches as a member of the Executive Board, have asked themselves whether monetary policy shouldn't also be used to counteract the development of bubbles.[4] Would it have been possible, for example, to prevent this financial crisis if monetary policy had been tighter in the United States in the years leading up to 2007, when the problems on the US financial market began? As can be seen in Figure 1, the actual real policy rate was relatively low in this period. However, it is doubtful whether a higher policy rate would have been able to bring growth in property prices and credit to a more moderate pace in the United States without driving the economy into a recession at the same time.[5]

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2 See for instance BIS (2012): European bank funding and deleveraging, BIS Quarterly Review, March 2012.

3 EBA (2011): EBA recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1)

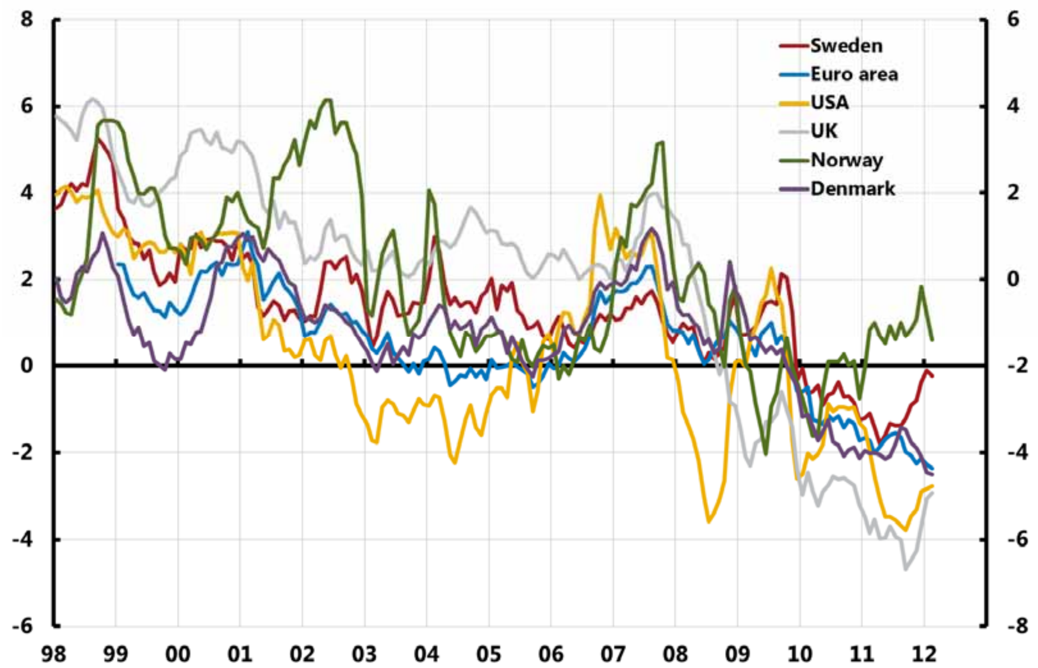
4 Ekholm (2009): Some lessons for monetary policy from the financial crisis, speech held on 4 December 2009.

5 See for example Bernanke (2010): Monetary Policy and the Housing Bubble, speech held on 3 January, 2010, and Dokko, Doyle, Kiley, Kim, Sherlund, Sim and Van der Heuvel (2009): Monetary Policy and the Housing Bubble, Finance and Economics Discussion Series 2009-49, Federal Reserve Board.

Figure 1

Policy rates minus actual inflation (CPI change), 1998–,

per cent



Sources: Central banks and statistics agencies in the respective countries

Countries such as Ireland and Spain have also seen a bubble-like development of their housing markets: first a situation with gradually rising prices over a long period of time which was then followed by a rapid fall. Would it have been possible to avoid this if the ECB had conducted a tighter monetary policy and what would this tighter policy have cost in terms of unemployment and possible deflation in countries such as Germany, where the economy was developing quite differently?[6]

I have no clear answers to these questions. But even though it is possible that an expansionary monetary policy contributed to the development of housing-price bubbles in some countries, it is still the case that other factors were the prime causes of the global financial crisis. The Federal Reserve began raising the interest rate already in 2004. Over the course of two years it increased by more than four percentage points, at the same time as loans continued to grow. In the United States, deficiencies in the regulation of the mortgage market and a housing policy that promoted homeownership among low-income earners were more prominent contributing factors.

A study based on Swedish data has indicated that low real interest rates in combination with increasing incomes have been important factors behind the increases in prices for housing in Sweden.[7] As both real interest rates and incomes are affected by monetary policy it should be possible to say that movements in housing prices have been indirectly affected by monetary policy. However, the same study points out that if monetary policy had been used

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[6] A study that shows that asset prices are dampened to only a relatively limited extent by a policy rate increase while the negative effect on GDP is relatively substantial is Assenmacher-Wesche and Gerlach (2010): Credit and Bubbles, Economic Policy, July 2010.

[7] Claussen, Jonsson and Lagerwall (2011): A macroeconomic analysis of housing prices in Sweden, *The Riksbank's commission of inquiry into risks on the Swedish housing market*.

to stem housing-price increases, then this would have been extremely costly in terms of lower growth and lower employment.[8]

So, although we cannot entirely discount the role of monetary policy as a tool for averting financial crises, it is not reasonable to assume that monetary policy can do this on its own:[9] at least not without risking serious side effects in the economy as a whole. The repo rate affects the entire economy and cannot be directed at specific markets alone. It can thus have a negative impact on sectors that are not overheated. Increasing the repo rate in order to mitigate household credit growth and increases in housing prices also makes it more expensive for firms to fund new investments. In situations in which investment is low and unemployment is high this is something one wants to avoid. In such situations it would be inappropriate to use the repo rate as a means of pursuing macroprudential policy. My view is that it is only justifiable to use the repo rate in this way in cases where there is reason to believe that the central bank is the only body that can take measures to counteract what appears to be an unbalanced development.

So what about fiscal policy? Can't fiscal policy be used to counteract an unbalanced development? Yes, under certain circumstances. As I mentioned earlier, stricter budget discipline would probably have counteracted overheating in some European countries, but it could not of course have averted the financial crisis, which was largely "imported". On the other hand, a tighter hold on the reins during the good years preceding the crisis would have increased resilience and provided more room for manoeuvre to manage the crisis when it did occur. It would then have been possible to manage the crisis within a couple of years and we wouldn't still have to be dealing with it today.

My conclusion is that well-balanced monetary and fiscal policies offer the best possible chances of preventing financial crises, but essentially other measures are needed. We need tools that are specially designed for working with the stability of the financial system.

Macroprudential policy – a new policy area

Traditionally, financial supervision has had a rather one-sided focus on the health of individual financial institutions. In practice this has also been the case in Sweden, although formally Finansinspektionen has the task of working for a stable and efficient financial system alongside its consumer-protection tasks.

However, the fact that individual parts of the financial system appear to be healthy does not mean that they are immune to contagion from other parts of the system. The institutions have exposures to one another and it is sometimes unclear who is exposed to what risks. When an individual institution experiences problems, this may then have serious repercussions for the financial system and, ultimately, the real economy. However, traditional supervision has not sufficiently taken into account the risk of financial problems becoming contagious. Monitoring those risks is also a rather different process to monitoring the risks in an individual institution.

Traditional regulation and supervision have also found it hard to handle the tendency to rollercoaster behaviour of the financial sectors. In good times, there is almost always a tendency to expand lending and to ignore the risks this entails. However, when the downturn comes, the same players tend to run for the exits at the same time, which serves only to

[8] According to the analysis, a monetary policy designed such that housing prices continued to rise in accordance with the trend in the period 2000-2004 would have entailed a repo rate around 8.5 per cent, an inflation rate of –4.3 per cent and a level of GDP growth of –0.6 per cent in 2007, that is in the year before Sweden was hit by the global financial crisis (see Claussen et al., 2011).

[9] Monetary policy is also ineffectual if one wants to counteract contagion risks due to the size and complexity of the banks and their exposures to each other.

make the downturn worse. A vicious circle arises when a credit crunch leads to lower production and lower employment, which in turn feed back into in the financial sector by making loan losses even higher. This type of feedback effect between the financial system and the macro economy is not the province of traditional financial supervision either.

This is where the concept of macroprudential policy comes in. Quite simply, financial supervision must be complemented by a much broader approach. This broader approach is usually referred to as macroprudential policy.

At the European level, the efforts to develop a framework for macroprudential policy have resulted in the formation of the *European Systemic Risk Board* (ESRB). This body, in which the Riksbank is represented, will be responsible for overall macroprudential policy for the financial system in the EU.

The ESRB's tasks include identifying and ranking systemic risks. When such systemic risks are discovered and are deemed to be significant, the ESRB should issue *warnings* and, when appropriate, *recommend that corrective measures should be taken*. When necessary, the ESRB will make these warnings and recommendations public. A so-called *comply or explain* mechanism is linked to these recommendations. This means that the recipient of a recommendation is expected to comply with it or otherwise *explain why* it will not do so.

The ESRB thus has no direct regulatory tools. In order for this to work, there must therefore also be effective frameworks for macroprudential policy at the *national* level. It is at the national level that the ESRB's warnings and recommendations must be met. It is also at the national level that the actual macroprudential policy decisions must be made. Each country thus needs an institutional framework for this. There is also a need for concrete tools that the national authorities can use for the exercise of macroprudential policy.

What tools are needed and how do they work?

But what tools are we talking about? Work is now underway in various international forums to develop a toolbox for macroprudential policy. So far, however, relatively few specialised macroprudential-policy tools have emerged. The tool that is probably attracting most attention at the moment consists of the countercyclical capital buffers that have been adopted within the framework of the Basel III Accord. The aims of these buffers are to make the banks more resilient and to dampen the cycles in credit growth and asset prices. The idea is that the authorities should force the banks to hold extra capital in good times, when lending is beginning to increase too quickly, in order to be able to reduce capital requirements later when times are not so good. This will make it more expensive for the banks to build up risks in good times at the same time as buffers are created that the banks can use in bad times when the risks materialise. However, this thus means that there must be a national authority that can decide when the countercyclical buffers should be turned on and off.

The tools that can be characterised as "specialised" macroprudential-policy tools also include capital requirement surcharges for systemically-important financial institutions. Apart from this, most of the tools that can be considered for macroprudential policy are those that in one way or another are already included in financial supervision's toolbox. These include, for example, the so-called mortgage cap, although this is usually justified in terms of consumer protection. However, as development in this area progresses it is probable that the number of specialised macroprudential-policy tools will increase.[10]

[10] The Bank of England recently carried out an inventory of the tools that could be used to conduct macroprudential policy, see Bank of England (2011): Instruments of Macroprudential Policy: A Discussion Paper prepared by Bank of England and Financial Services Authority staff, December 2011.

But do we really need any new tools in this area? Isn't it enough that the supervisory authority can introduce a mortgage cap for consumer protection reasons and that the central bank can raise the interest rate to stabilise inflation and resource utilisation when credit growth is high? No, I don't think so. Referring to consumer protection seems to be an overly narrow approach in the face of a rapid growth in lending to households and rising housing prices. On the other hand, the impact of the interest rate is too wide-ranging to be effective and risks doing more harm than good.

A tool such as the countercyclical capital buffers may seem to be so wide-ranging that it should be able to work in approximately the same way as the interest rate. Both tools affect the price of credit in the economy. When the banks are forced to hold more capital their funding costs increase, as they do when the interest rate is raised, and the price of credit also increases. However, there are important differences between the impact of the interest rate and the impact of countercyclical capital buffers. As different types of asset on the banks' balance sheets have different risk weights, not all types of lending are affected in the same way when the authorities increase or reduce the buffers. It is easier for the banks to increase the buffers by reducing lending that is relatively risky rather than reducing other lending. An interest-rate increase, on the other hand, makes all lending more expensive. The countercyclical capital buffers thus have a more direct impact on that part of lending that is associated with high risk, which is just that part that is important to financial stability.

As opposed to the interest rate, countercyclical capital buffers do not have an obvious impact on the exchange rate. All else being equal, a repo-rate increase is expected to lead to a strengthening of the exchange rate as the expected return on financial assets denominated in kronor increases. Raising the capital buffers, on the other hand, could therefore possibly be used to dampen a domestic expansion of credit without undermining the competitiveness of the export industry.

Obviously there is a great interest from the banks to find out how countercyclical capital buffers could be applied in Sweden, However, at this point in time it is too early to tell. For instance, I shall soon explain that we do not have a permanent macroprudential framework in place yet.

Responsibility for macroprudential policy in Sweden?

So who should be responsible for the macroprudential-policy tools? In Sweden, as in many other countries, there has long been a lack of a clear mandate and a clear division of labour and responsibility for this type of supervision. Initiatives have therefore been taken in several parts of the world recently to fundamentally reorganise financial supervision. In the United Kingdom, for example, the main responsibility for macroprudential policy has been given to the Bank of England.

In Sweden, both Finansinspektionen and the Riksbank have tasks relating to the stability of the financial system. Both authorities also have a role to play in the prevention of financial crises.

Finansinspektionen has the task of exercising supervision over financial companies, in particular those that are of the greatest significance to the stability of the system, and of working for orderly financial markets by supervising securities trading on stock exchanges and other marketplaces.

The Riksbank has the task of promoting a safe and efficient payment system, which in practice means that the Riksbank has a broad responsibility for financial stability. The Riksbank oversees the development of the financial system as a whole, with a focus on institutions, markets and infrastructure of importance to financial stability, and presents its views on risks in, and the efficiency of, the financial system.

Finansinspektionen and the Riksbank thus have partly overlapping tasks, but have different ways and means of performing these tasks and base their analyses and assessments on slightly different perspectives.

A council for cooperation on macroprudential policy

How Sweden should best organise macroprudential policy for the financial system is one of the – very difficult – questions currently being addressed by the *Financial Crisis Commission*.

While awaiting the report of the Commission and a future parliamentary decision on a long-term solution for a macroprudential policy framework we will have to try to make the most of the existing arrangements. It makes sense that a small country like Sweden should utilise the expertise and know-how that already exist at the Riksbank and Finansinspektionen. In January 2012, these two organisations set up a joint *council for cooperation on macroprudential policy.* The idea behind this council is that the authorities should consult and exchange information concerning their assessments of risks to the financial system as a whole, and discuss appropriate measures to prevent these risks. Another task will be to discuss the development of tools and methods in the area of macroprudential policy.

The first meeting of the council was held on 24 February and the aim is that the council should meet at least twice a year. The minutes of the meeting are available on the websites of the Riksbank and Finansinspektionen. The intention is to publish the minutes of all the meetings.

Great need for clear communication

The publication of these minutes is an expression of the ambition to be open and transparent – an ambition that has become something of a trademark of the exercise of public authority in Sweden. Openness and transparency facilitate democratic control and evaluation. This is an area very close to my heart, so I would like to say a little more about it before I go on to present my view of how macroprudential policy can be developed further.

The Riksbank is often ranked as one of the most open central banks in the world. At the Riksbank it is now self-evident that we should strive be open and accessible. The only exception is when limits are imposed by the regulations and legislation on secrecy.

In the field of monetary policy, the Riksbank was one of the first central banks to publish attributed minutes of its monetary policy meetings. We were also one of the first to publish our own path for the policy rate – the repo-rate path.

How we communicate is not only of importance to monetary policy, but also to the work with financial stability. In this field, the Riksbank has strictly speaking no tools with which to affect the behaviour of financial agents other than to communicate its warnings and recommendations. This of course demands a high degree of credibility. The Riksbank broke new ground when the first stability report was published in the autumn of 1997. Other central banks were also somewhat surprised when we published the results of stress tests for individual major Swedish banks for the first time.

It is our belief that openness and transparency are important components of the effort to prevent financial crises. Many crises, not least the most recent one, have been preceded by a lack of transparency in the financial system. During the latest crisis, the lack of transparency made it almost impossible to know which participants were exposed to the most serious risks. This impenetrable uncertainty was one of the main factors that contributed to the paralysis of the world's financial markets in the autumn of 2008. It is often uncertainty about the true state of things that in itself makes people nervous and that sometimes leads to bank runs and panic selling, which in turn can lead to devastating chain reactions in the financial system. Of course, the need to increase transparency primarily falls on the participants in the financial system. But the Riksbank can also contribute by being open about its assessments and analyses of the state of the financial system, for example by publishing stress tests.

How open the Riksbank should be about its assessments, its preparedness and its own measures is determined by how this can be expected to affect confidence. In a crisis situation, we may of course be forced to carefully consider what can or cannot be said. However, the fundamental rule is that it is better to be open and clear than to be uncommunicative and ambiguous. A "negative" but reliable announcement can therefore be better for confidence than a "positive" but uncertain announcement. Openness about the problems that underlie a crisis may therefore be the key to regaining confidence. This is a lesson we learned from the Swedish banking crisis of the early 1990s[11] – and a lesson that proved useful during the crisis of 2008–09.[12]

How we communicate is, however, something that we need to work on and develop constantly. At present, we are trying to improve our communication concerning our assessments of the risks in the financial system. Not least, we want to be even clearer about how we want the banks and other financial agents to respond to these assessments. We are therefore currently developing ways and means of presenting our recommendations to the participants in the financial sector. From this it follows that we also need to review ways and means of following up the recommendations we have made.

The recently-formed macroprudential council also means that we will be able to coordinate our communication with that of Finansinspektionen to a greater extent than before.

Macroprudential policy needs clear mandates and effective tools

The cooperation between the Riksbank and Finansinspektionen will probably lend greater weight to the communication of risks and countermeasures, which is good. But the new macroprudential council does not make any decisions on its own. The council will not alter the independence, responsibility and decision-making powers of the Riksbank and Finansinspektionen. Consultating and "communicating" risks are all very well, but in the long term we probably need something more than an advanced forum for discussion.

This is why I believe that the macroprudential council is only a temporary solution. To become really effective, macroprudential policy needs to acquire the distinct status of an independent policy area with its own tools for promoting stability in the financial system as a whole. There are a number of factors that I believe are particularly important in order to create an effective institutional framework.

1. ***The power to make decisions*.** This presupposes a clear mandate and effective and clearly defined tools. However, as macroprudential policy is a policy area that is still under development, the legislation also needs to clarify how new tools can be added to the toolbox in the future.
2. ***Independence*.** The body that is given responsibility for macroprudential policy should be free from external pressure, both from the political sphere and from the financial sector. I believe that this is particularly important, as macroprudential policy will entail making many unpopular decisions.
3. ***Accountability*.** If a body for macroprudential policy is given a high degree of independence, it must also be made accountable for the actions it has taken – or

[11] Ingves & Lind (1996): The management of the bank crisis – in retrospect, *Sveriges Riksbank Economic Review 1996:1*.

[12] See for example Hallvarsson & Halvarsson (2010): The communication of the major banks and the authorities during the financial crisis 2007–1 July 2009.

failed to take. This means that both the mandates and the tools must be clearly defined. For example, the mandate could include demands that the body must take action, or publicly explain why it refrains from taking action, when certain predetermined levels for key variables are passed. Accountability would also be facilitated by demands for far-reaching transparency and reporting, for example to the Riksdag.

Macroprudential policy is only a complement

I have now expressed my heartfelt support for the need to make it possible to conduct effective macroprudential policy in Sweden. However, I would like to conclude by referring back to what I said initially about having realistic expectations of what macroprudential policy can achieve. We can ask ourselves, for example, if we would have avoided the stress on the financial markets that we have seen recently if an effective macroprudential policy had been conducted in the euro area. No, we probably wouldn't have, because the problems essentially relate to the fact that monetary policy and fiscal policy have not been appropriate given the economic development in a number of euro countries. Macroprudential policy cannot take the place of well-designed monetary and fiscal policies. But it can act as a well-needed complement, as well-designed monetary and fiscal policies provide no guarantees against being hit by financial crises.

Thank you!

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