

# SPEECH



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## Monetary policy in a changing world\*

Over the past year it has become increasingly clear that economic growth is slowing down, both in Sweden and abroad. It is not surprising that growth is slightly lower than during the strong years 2014-2018. But there have recently been increasing signs that the slowdown will be larger and occur faster than we at the Riksbank have been expecting.

To determine how monetary policy should react to this, we need to understand why growth is falling. Is it due to weaker cyclical economic activity, or to deeper, structural changes in the economy?

Today I intend to first briefly discuss some structural changes that may have had significance for economic developments in recent years. These are changes that may have entailed lower underlying interest rates and growth and lower inflationary pressures, and which may affect the conditions for the Riksbank's work going forward.

After that, I will say a few words about the possibilities open to monetary policy if economic developments become weaker than we have forecast. In conclusion, I would like to say a few words about climate change, one of the structural changes that affects the way the economy functions. How is the Riksbank's work affected by climate change and how can the Riksbank contribute to greener financial markets?

## The economy changes

The international economic playing field has changed in many ways in recent years. Let me give some examples:

- The **geopolitical situation** has deteriorated and nationalistic tendencies have become more common. This has led to increased protectionism and new

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trade barriers. After many decades of increased international trade and international capital flows, globalisation has now taken a step back.<sup>1</sup>

- **China** has emerged as an increasingly important actor on the world market. This has led, for instance, to increased saving in the world economy and contributed to lower interest rates.<sup>2</sup>
- **Life expectancy has increased** and we anticipate spending a longer period in retirement. Population growth is falling in the major economies. As a result, GDP growth and investment needs are lower, but we wish to save more. All of this contributes to lower interest rates.
- **Digitalisation** means that we do our shopping in new ways. E-commerce is becoming increasingly common and websites for price comparison are used regularly. Consumption is shifting from goods to services and experiences, often with low marginal costs in production. This leads to increased price competition and to inflationary pressures being lower temporarily. But despite the rapid technological changes, the productivity growth figures have fallen both in Sweden and abroad.<sup>3</sup>
- We are becoming increasingly aware of the problems linked to **climate change**. This also contributes to changing our consumption and production patterns. The adjustment to such changes may be difficult and may also lead to the measured GDP growth being lower. But this adjustment can also in many ways lead to new markets and new opportunities opening up and to new, large-scale investment needs arising.

## Why are economies slowing down now?

We would normally believe that structural changes occur slowly and that they therefore should not be behind a rapid change in the sentiment of the economy. But there are nevertheless many indications that the subdued economic growth and the rapid fall in confidence shown by the indicators over the past year have several links to the structural changes.

When the number of trade barriers increases, the opportunities to benefit from economies of scale and international specialisation decline. The uncertainty regarding the rules for international trade dampens the willingness to invest. The uncertainty regarding future regulations and taxation of, for instance, diesel and petrol driven cars reduces demand for them. The intensive discussions on the climate impact of air travel may dampen demand for air travel. In Sweden, for instance, travel by domestic flight has declined.

Monetary policy cannot affect these structural changes or ensure that we attain a certain level of economic growth. Some of the changes are unavoidable, for instance because of technological advances. Other changes are due to political choices and priorities.

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<sup>1</sup> See Sveriges Riksbank (2019).

<sup>2</sup> In the United Kingdom, yields on 10-year real government bonds have fallen from 3.5 per cent on average in 1985-1999 to -0.9 per cent in 2010-2019. The development has been similar in other countries, including the United States and Sweden.

<sup>3</sup> In Sweden, annual productivity growth has fallen from an average of 2.6 per cent a year in 1998-2007 to 1.0 per cent in 2010-2018.

But the structural changes affect the conditions for monetary policy. The low real interest rates have reduced the scope for monetary policy to manage economic fluctuations. Policy rates in many countries cannot be cut much from the current levels. The possibilities to push down interest rates with further quantitative easing are limited. If policy cannot be made more expansionary in other ways, the structural changes, combined with a normal economic downturn may lead to the economies getting stuck in a situation with unnecessarily low growth.<sup>4</sup>

## Fiscal policy will play a larger role in stabilisation policy

In the debate, and especially internationally, many suggestions have been put forward on how to make monetary policy more expansionary with other means. There is talk of coordinating fiscal and monetary policy, “helicopter money”, “modern monetary theory” and the purchase of specific private assets.<sup>5</sup> What this means in more concrete terms, is that central banks should start giving out money to individual households, to the treasury, or that they should subsidise the private business sector, tasks which would usually fall to fiscal policy rather than monetary policy.

To determine whether it is a good idea for central banks to step into the field of fiscal policy, we need to clarify the difference between the government’s and the central bank’s finances. Is there a difference between money issued by the central bank and bonds issued by the government? Is there a difference between the central bank’s and the government’s access to liquid funds?

Although both central bank money and government bonds are a form of claim on the same counterpart in the same currency, there are nevertheless some differences that in certain situations can be important. The first difference concerns liquidity. Central banks create liquidity on their own by issuing banknotes or by increasing the commercial banks’ balances in their central bank accounts. A central bank can thus always “pay” if it wants to. However, in a country with an independent central bank, the government does not have access to a credit line that can be extended freely. To obtain access to more liquidity, the government must instead issue bonds and sell them on a market.

The second difference concerns the exposure to credit risk when holding central bank money or government bonds. Both the central bank and the central government can default on their payments in two ways: by not repaying the debt, or by inflating away the debt. It does happen that countries fail to repay their debts. If the debt lies with the central bank, it is more likely that it will be inflated away.

Based on this reasoning, are there situations where the central bank should step into areas similar to fiscal policy? Yes, there could be such situations. One might be if an acute shortage of liquidity arises, for instance, during a financial crisis.

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<sup>4</sup> In a speech given in 2013, Larry Summers talked about “secular stagnation”. See Rachel and Summers (2019).

<sup>5</sup> See, for instance, Bartsch et al. (2019), Bernanke (2016), Bernanke (2019), Eichenbaum (2019), Reichlin et al. (2019) and Shirai (2019).

Central banks are better than government at creating liquidity quickly.<sup>6</sup> Another situation is if the market begins pricing a higher credit risk in government bonds than in central bank money. If one wants the credit risk to be transformed into an inflation risk, it may be desirable for the central bank to step in and support the government's funding, for instance by buying government bonds or through direct transfers to the treasury. A similar situation may arise in a monetary union if there is no fiscal policy at union level.

But we are not close to one of these situations in Sweden today. Our public finances are in good shape. National debt is low. Fiscal policy is then best handled by the government, not by the central bank.

The Riksbank's monetary policy is already expansionary and contributing to supporting demand in the Swedish economy. But there are limited possibilities to make monetary policy even more expansionary, in my opinion. There are, however, good possibilities to make fiscal policy more expansionary. I therefore believe that fiscal policy will play a larger role in stabilisation policy if economic activity weakens further in the coming years.

## Climate change entails new economic and financial risks

Climate change is one of the structural changes I have talked about today. I have noted that Örebro was one of the first municipalities in Sweden that issued a green bond. Here at Kommuninvest, in Örebro, I think that it may be appropriate to conclude by elaborating on what I see as the Riksbank's role in the work to achieve greener financial markets.

Climate change affects the way the economy functions. Its impact is most clear in the insurance sector, as a direct consequence of the risks of climate-related damage. The risks may also increase on the financial markets when various branches are forced into major changeovers as a result of demand, taxation or regulations being changed.<sup>7</sup> Monetary policy can also be affected more directly, for instance if economic data becomes more difficult to interpret when the effects of the weather lead to larger fluctuations in prices and production.<sup>8</sup>

It is important that the Riksbank understands these changes, both to be able to conduct an effective monetary policy and to be able to identify risks on the financial markets. In other words: the Riksbank must be able to manage the economic consequences of climate change.

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<sup>6</sup> Some people talk about central banks' role being not just "lender of last resort" but also "market-maker of last resort". See, for example, the Bank for International Settlements (2014).

<sup>7</sup> NGFS (2019) talk about physical impacts and transition impacts, respectively.

<sup>8</sup> See Cœuré (2018).

## Should the Riksbank buy green bonds?

Another question that is sometimes discussed is whether the central banks themselves should try to affect climate change. This usually involves two different directions. The first is regulating the financial markets to steer investments in a more sustainable direction. In many countries it is the central bank that is responsible for this type of regulation, but in Sweden it is the responsibility of Finansinspektionen (the Swedish financial supervisory authority). The Riksbank does not have any of these tools at its disposal.

The second direction concerns the central bank's own investments. After the financial crisis, many central banks, including the Riksbank, built up large balance sheets through asset purchases. Shouldn't these purchases reward sustainable assets, for instance by focusing on green bonds?

This is a question faced by central banks today, and the answer is not evident. I shall try to describe my views on this. But I would like to point out that these are preliminary views. I am happy to listen to arguments against them.

The Riksbank's assets can be roughly divided into two parts. We have a portfolio of Swedish securities (almost SEK 400 billion), that has been built up through quantitative easing for monetary policy purposes. And we have foreign exchange reserves (just over SEK 500 billion) that we hold for contingency purposes.<sup>9</sup>

The Swedish portfolio consists solely of government bonds. This is partly to hold down financial risks, and partly because monetary policy, apart from determining the general interest-rate level, should disturb pricing on the financial markets as little as possible. The state is the Riksbank's principal. It would therefore seem inappropriate to me if the Riksbank chose government bonds to attempt to give the government incentive to work towards a more sustainable development. I therefore do not think that the Riksbank should treat green Swedish government bonds any differently from other Swedish government bonds.<sup>10</sup>

The conditions for active climate consideration are slightly better in our work with the foreign exchange reserves. To ensure that the foreign exchange reserves fulfil their purpose, they need to consist of assets that can be rapidly converted to money even when the markets are not functioning properly. Our assessment is that the foreign exchange reserves best correspond to this need if they consist of 75 per cent US government bonds, 20 per cent German and 5 per cent British, Danish and Norwegian government bonds.

But to attain a higher yield and reduce the financial risk, the Executive Board has decided that a limited part of the foreign exchange reserves can be invested in other assets. The condition is that these are assets with a high credit rating and good liquidity, issued by central governments, provinces or intergovernmental organisations.<sup>11</sup>

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<sup>9</sup> In addition, the Riksbank owns 125.7 metric tons of gold (worth almost SEK 60 billion).

<sup>10</sup> The government has given the Swedish National Debt Office the task of issuing green bonds. See the Swedish Ministry of Finance (2019) and SOU (2017:115).

<sup>11</sup> Our regulations also allow investments in US agencies and in bonds issued by local authorities or state-guaranteed organisations.

## The Riksbank gives consideration to the climate in its investments

Last year we stated in our risk and investment policy that we would also give consideration to sustainability aspects when choosing assets. The Riksbank has not yet fully decided how sustainability aspects should be taken into consideration in the investment decisions. There are two main lines to choose between: either we choose which assets or which issuers we want to have in the foreign exchange reserves.

The choice between assets would mean trying to invest some of the foreign exchange reserves in particularly climate-friendly assets, such as green bonds. I have doubts about this type of strategy, primarily as our investments are largely in bonds issued by central and federal governments. It is difficult to earmark money for special projects in government budgets.

## The Riksbank rejects issuers with a large climate footprint

I believe it is better to instead focus on the issuers, and to make an overall assessment of how they work to promote a sustainable climate. Indicators of this could be, for instance, their greenhouse gas emissions. This is how we are now beginning to give consideration to sustainability in our new risk and investment policy. We will not invest in assets issued by issuers with a large climate footprint when we are choosing other assets than those best corresponding to our policy need.

This has some consequences for the holdings in our foreign exchange reserves. The Riksbank has invested around 8 per cent of the foreign exchange reserves in Australian and Canadian central and federal government bonds, as they give relatively high yield and a good diversification of risk, at the same time as being traded on liquid markets.

But Australia and Canada are countries that are not known for good climate work. Greenhouse gas emissions per capita are among the highest in the world, but vary considerably between the different states. For instance, greenhouse gas intensity is more than three times higher in production in Alberta than in Ontario and Quebec. As a result of the new investment policy, we sold our holdings of bonds issued by Alberta in the spring. For the same reason, we have recently sold our holdings in bonds issued by the Australian states of Queensland and Western Australia.

The Riksbank needs to develop its work on how to take climate change into consideration in asset management. For instance, we need broader and deeper analysis of the issuers' climate footprint. At the same time, one must remember that the foreign exchange reserves are unavoidably dominated by US and German government bonds. The Riksbank's contribution to a better development of the climate will therefore remain small. This is entirely natural. The important decisions on how climate change should be counteracted in Sweden are political and should be taken by the government and the Riksdag (parliament).

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