SPEECH

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My thoughts on monetary policy and financial stability

As this is my first public speech as a member of the Executive Board of the Riksbank I would like to take this opportunity – from the starting point of my previous background – to point out a number of factors that are important to my view of monetary policy and financial stability.

First: Sweden has become increasingly dependent on what happens abroad. How the debt crisis in Europe is managed is the most important factor for economic activity and monetary policy in the period ahead. Second: There are links between monetary policy and financial stability. We must be aware that imbalances and risks to financial stability can arise if interest rates remain low for too long. Third: One of the most important lessons of the financial crisis is the need to adopt a broader perspective on financial stability – as in the new policy area macroprudential policy. The Riksbank should play a major role in the work with macroprudential policy.

How my background has shaped my view of the Riksbank's work

As most of you know I am a new member of the Executive Board of the Riksbank, which I joined at the turn of the year. However, what most of you probably do not know is that this is not my first spell at the Riksbank. I previously worked there for a period of almost 15 years, from the end of the 1970s and throughout the 1980s (see slide 1). When I began working at the Riksbank in 1977 times were very different, which was reflected in both the economy and the work environment The economy was marked, for instance, by the fixed exchange rate regime and the banking and foreign-exchange markets were extensively regulated – far from the economy that we have today. When I started at the Riksbank there was also just a very small group of people that drafted and made the important decisions. Today the Riksbank is a flat organisation and our personnel are highly involved in our main tasks.

It was in the early 1990s that I left the Riksbank to begin working at what was then the Bank Inspection Board, now Finansinspektionen, and I stayed there until 2007 (see slide 1).

As the financial markets have become increasingly interlinked, and since Sweden joined the EU in 1995, the international perspective has become increasingly important. This has led me to several international assignments.[1]

In the last two years before I returned to the Riksbank I was Managing Director of the Swedish Bankers' Association, a trade organisation for banks in Sweden. This involved a readjustment as my perspective was now from inside the banking sector. One of the issues that I pursued in my role as Managing Director of the Swedish Bankers' Association was that Swedish banks should be competitive in a European context.

So, how has my background shaped my view of my new job as a member of the Executive Board of the Riksbank? A marked change since I last worked at the Riksbank is Sweden's increased dependence on developments abroad. One could also say that what I primarily "bring with me" from the different perspectives of my earlier working life – the supervisory perspective, the international perspective and the banking-sector perspective – is this realisation of the increase in Sweden's international dependence.

Monetary policy – my view

Sweden is what we usually call a small, open economy. This means that our economy cannot be seen in isolation as we are highly dependent on the world around us – a factor that it is important to take into account, not least in monetary policy.

Sweden – a small, open economy

The situation in Sweden in recent years reflects our great dependence on the outside world; exports make up approximately 50 per cent of our GDP.[2] The global financial crisis of 2008-2009 thus had a dramatic impact on us and contributed to the largest fall in GDP in Sweden since World War II. When global economic activity recovered in 2010, growth was instead the highest for 40 years (see slide 2). But this is history now. Over the last 12 months in particular, the European debt crisis has had a considerable impact on economic development. And Sweden is a part of Europe – not just geographically but economically too.

A majority of our goods exports go to Europe and over 35 per cent to the euro area (see slide 3). The weak development of the Swedish economy during the fourth quarter of last year also reflects a dramatic fall in exports. Let me therefore comment on the situation in Europe, as it has such a significant impact on the Swedish economy and, by extension, monetary policy.

The debt crisis in Europe – a lot of work remains to be done but things are moving in the right direction

One of the most important pieces of the puzzle with regard to economic development in the period ahead is how the debt problems in Europe are

[1] I was, for example, a member of the Basel Committee from 2003 to 2009 and chaired the Committee of European Banking Supervisors (CEBS) – which was the forerunner of the European Banking Authority (EBA) – in 2008-2009.
[2] This figure may vary somewhat depending on how it is calculated.

managed (see slide 4). I think we can go as far as to say that the entire global economy is dependent on the debt crisis in Europe being managed in a sensible way over the next few years. The problems in Europe must be solved so that the financial markets work effectively and the real economy grows if global growth is to pick up again.

My assessment is that we have a few years of weak growth in the euro area ahead of us. Several countries are facing gigantic problems, partly in the form of large public debts and partly in the form of seriously weakened competitiveness. It will be hard to find the right balance of measures to deal with these problems as budget consolidation, which is necessary to restore confidence in sustainable public finances, must not be allowed to restrict growth too much in the short term. Structural reforms are also required to improve competitiveness.

However, several important steps have been taken in the EMU over the last 12 months to deal with the weaknesses that led to the debt crisis becoming so extensive: imbalances between the economic development of different countries, a lack of discipline in fiscal policy and inadequate financial supervision.[3] One example of this is the fiscal compact, which was signed in March this year. The ECB has also taken short-term crisis management measures that have helped to improve confidence on the markets since the end of last year. Here I am thinking mainly of the three-year loans. To increase confidence in the long term, however, we need real changes and the credible implementation of requirements for sustainable public finances. Nevertheless, the situation looks much better now than it did in the autumn.

If we look outside Europe, we can see the beginnings of a turnaround in the US economy and China, for example, is still experiencing good growth. Despite this, however, we should probably expect the impetus to the Swedish economy from abroad to be limited over the next few years, mainly due to weak development in Europe.

Inflation and growth prospects justify keeping the repo rate low

Developments abroad, and above all in Europe, are thus highly important to the Swedish economy. But the development of domestic demand, for example household consumption, was also weak in the second half of 2011.

Since then, however, we have received a number of somewhat more positive signals. Share prices have risen since the end of last year and confidence indicators are clearly pointing in the right direction, although from relatively low levels. There is thus potential for an eventual increase in household demand. Growth may gradually increase.

The main objective of monetary policy is to keep inflation close to the target. Without prejudicing this objective, it should also strive to promote a stable development of the real economy, or stabilise resource utilisation if you like. So what can we say about inflation in Sweden? At present, inflation is low and it is probably fairly safe to say that it will continue to be low for some time. Resource utilisation is difficult to measure, but it is probably below its normal level at the moment and will remain so for a while. Economic activity will

[3] See also the article "The EMU and the debt crisis in Europe" in the Monetary Policy Report of February 2012.

gradually improve, which will lead to rising inflation and the normalisation of resource utilisation. But this will take time. Growth may not increase significantly in Sweden until next year.

Given this, my assessment was that it was necessary to cut the repo rate to 1.50 per cent in February and to leave it at this level in April. I have also expressed my support for the repo-rate forecasts in the Monetary Policy Report and the Monetary Policy Update, which predict that the repo rate will remain unchanged in the year ahead. The forecasts also say that we will need to raise the repo rate when economic activity recovers and inflationary pressures increase. Let me say that the situation is really uncertain at the moment. The greatest uncertainty factor is how the situation will develop in Europe.

Since the monetary policy meeting of 18 April, some new statistics have become available for Sweden, including figures for unemployment, the retail trade and foreign trade in March and the tendency survey of the National Institute of Economic Research for April. By and large, these statistics do not indicate any significant changes in the course of development than that we saw ahead of us in the Monetary Policy Update in April. However, I think we should be cautious about reading too much into figures for individual months. I will therefore wait to make an overall assessment of the new statistics until our next monetary policy meeting in July.

A factor that I think should be highlighted – although it did not directly determine my stance at the latest monetary policy meetings – is the link between monetary policy and financial stability. Let me explain this in more detail.

The link between monetary policy and financial stability

In my opinion there are links between monetary policy and financial stability. We should be careful to monitor the incentives that low policy rates can create over time (see slide 5). Both housing prices and household debts have increased dramatically in Sweden for some time now. This has been noted, for example, by the European Commission in an Alert Mechanism Report.[4] These tendencies have slowed down over the last 12 months.

However, if the expansion of credit really accelerates again this may lead to problems in the longer term.[5] It is therefore important to carefully monitor the situation so that risks to financial stability do not arise. Financial stability is also a precondition for the ability of monetary policy to have the desired effects on inflation and the real economy. I therefore see it as natural that aspects of financial stability may have to be taken into account in monetary policy decisions.

On the other hand, we should not exaggerate the importance of the policy rate as a tool for promoting financial stability. The policy rate is a relatively blunt instrument that has an impact over a broad front. I am convinced that there are other instruments that are more effective for managing financial stability. This naturally leads on to how we can adopt a new perspective on financial stability

[4] See European Commission (2012): *Alert Mechanism Report,* published on 14 February.
[5] See, for example, IMF (2012): *World Economic Outlook, April,* where it is pointed out that recessions that are preceded by a rapid increase in indebtedness tend to be both longer and more severe than other recessions.

against the background of the financial crisis – and the new policy area macroprudential policy.

Macroprudential policy - financial stability from a new perspective

Despite the fact that there are plenty of historical examples, not least our own banking crisis in the early 1990s, I think that many people were surprised by the latest global financial crisis, and the size and scope of it. There were probably few people who thought that problems on the US housing market could lead to a debt crisis in Europe. Despite enormous support measures, the recovery has been slow in both Europe and the United States, and few people would dare to guess what the final bill for the crisis will be. In other words, we need to do all we can to avoid ending up in a similar situation again. This involves strengthening the resilience of the financial system and counteracting the development of risks.

The latest crisis also clearly demonstrated that we live in a world with a highly-integrated financial system. The financial institutions have major exposures to each other, which means that problems at one institution can spread like wildfire throughout the financial system and even between countries. With hindsight, it is easy to see that we lacked institutions and regulatory frameworks with the ability to predict and manage a global financial crisis. This lesson has led to the emergence of an entirely new policy area - macroprudential policy.

Focus on the financial system as a whole – and its link to the macroeconomy

Macroprudential policy can be seen as a complement to both traditional supervision and monetary policy when it comes to promoting financial stability (see slide 6). The focus changes from supervising individual institutions to analysing systemic risks in the financial sector and the links between the different players in the financial system. Macroprudential policy also aims to analyse the links, between the financial system and the macroeconomy over time.

A prerequisite for macroprudential policy becoming an efficient and effective policy area is that there is a clearly defined objective for the work. We must be clear about what we want to achieve and why. Otherwise there is a risk that we will see macroprudential policy as the new panacea for future crises rather than as a well-needed complement to monetary policy and micro supervision.

The importance of wider safety margins

One way of reducing systemic risks is to increase the safety margins in the financial sector. However, the international capital flows and the interlinked financial system mean that we must reach international consensus on how this should be done. I would also like to underline the importance of having a transparent process so that investors and the market understand the thinking of the national authorities.

A large part of the work to establish a safer and more robust banking sector is conducted within the framework of the Basel III regulations. An issue of the highest priority for the Basel Committee has been to ensure that the financial markets never again suffer such a severe case of liquidity fever as the one we saw in the initial phases of the financial crisis. The Committee has therefore required the banks to hold sufficient liquidity to cope with a highly-strained market situation for a period of at least 30 days and to better match the maturities of their assets and liabilities.

Another cornerstone of the Basel III regulations is increased capital requirements for the banks. The idea behind this is simple: more and better capital will increase the resilience of the banks. This in turn will increase confidence in the banks and in the system as a whole. It has proved to be increasingly important to have a large capital base, not least in order to get access to the capital markets. However, the exact capital ratios for an individual bank should be subject to national decisions. As long as the responsibility for dealing with systemically-important banks lies at the national level then the right to set the size of "risk premiums" should also lie there.

An interesting instrument that has been put forward within the framework of Basel III is countercyclical capital buffers, which entail the banks holding extra capital in good times that they can then use when times are not so good. It will, in other words, be more expensive for the banks to increase lending in good times at the same time as this will create some protection against losses when a downturn comes. As I mentioned earlier, the policy rate is an instrument that has an indiscriminate impact on the economy, while countercyclical buffers, for example, can be seen as an instrument that is more specifically aimed at the "credit cycle". Instruments of this type could also reduce the need to use the policy rate to promote financial stability.

The special characteristics of the Swedish banking market – what demands do they make?

I would now like to draw your attention to the conditions on the Swedish banking market that indicate that substantial safety margins are justified. Sweden has a large banking sector in relation to the size of the economy and the banks have substantial operations abroad (see slide 7). At the same time, the market is dominated by a few large players. These banks also have low risk weightings for, among other things, mortgages. Another risk factor is that Swedish banks are highly dependent on market funding, particularly in foreign currencies (see slide 8). In addition there is the effect of the market players' expectation that the government will ultimately act as a guarantor of the banks' operations and will not let them fail, in other words there is an implicit state guarantee.

There is thus a significant risk that the collapse of a Swedish bank would have major, negative consequences for the entire Swedish banking system and for the economy as a whole. It is important for a central bank to manage these risks in such a way that they can never threaten financial stability. A reasonable consequence of this is that a systemically-important bank should be subject to particularly stringent capital requirements. The study that the Riksbank published at the end of last year shows that increasing capital ratios is an effective way of safeguarding financial stability, at the same time as the economic costs of this – in terms of lower GDP – are not necessarily significant.[6] Sweden's historical experience of low capital ratios is also bad, which is demonstrated not least by the banking crisis of the 1990s, and this has led to a gradual improvement.

At the end of November last year, the Riksbank, the Ministry of Finance and Finansinspektionen issued a joint press release in which they declared how much capital they believed the four major Swedish banks should have. The capital ratio should be at least 10 per cent by 1 January 2013 at the latest, and at least 12 per cent by 1 January 2015.[7] I would like to emphasise that it is very important that the banks reach these levels. However, we should not make this sound more dramatic than it actually is. The Swedish banks are already well-capitalised (see slide 9). I do not think, therefore, that the new capital requirements will be much of a problem for the Swedish banks.

We have now made some progress in clarifying what regulations should apply to the banks in the future. This is good. A lot of the earlier criticism from, for example, the Swedish banks, stemmed from the great uncertainty about the form of the new regulations and how they would affect the future playing field. I am also convinced that well-capitalised Swedish banks will do well in the fact of international competition in the period ahead.

Central banks should play an important role in macroprudential policy

In Sweden, both the Riksbank and Finansinspektionen have a responsibility to maintain financial stability. However, although the objective is the same the areas of responsibility differ. Finansinspektionen is responsible for supervising individual institutions, in particular those that can affect the stability of the entire financial system. The authority should also work to promote orderly financial markets by supervising securities trading. The Riksbank has a broader assignment and monitors the development of the financial system as a whole.

How responsibility for macroprudential supervision should be divided is now being studied by the Financial Crisis Commission. Some guidance can be taken from the European Systemic Risk Board (ESRB). The ESRB was set up in early 2011 to manage macroprudential policy at the EU level. However, the body has no binding instruments; it can instead issue warnings and recommendations to various players. Since its inception, the Board has issued three public recommendations.[8] One of these addresses how macroprudential policy should be organised at the national level. The ESRB proposes that national legislation should be passed to appoint a body with responsibility for macroprudential policy and that this body could in turn consist of one or several institutions. At the same time, the ESRB stresses that the central banks should play a leading role in macroprudential policy. I think that there is a lot to be said for this, even from the point of view of the situation in Sweden. A lot of the analysis of macroprudential policy issues is already conducted at the Riksbank, and there are also clear links between monetary policy and macroprudential policy.

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[6] See Sveriges Riksbank, (2011): "Appropriate capital ratios in major Swedish banks – an economic analysis"

[7] These demands relate to the core Tier 1 capital ratio that is the ratio between equity and risk-weighted assets. See http://www.riksbank.se/en/Press & published/Press/Press releases /2011/New capital requirements for Swedish banks.

[8] See http://www.esrb.europa.eu/recommendations/html/index.en.html.

- While awaiting further guidance on how the work with macroprudential policy should be organised in Sweden, the Riksbank and Finansinspektionen have formed a temporary collaboration council. The idea is that this council should act as a forum for discussion and the exchange of information with regard to preventive work in the field of financial stability. The council should be seen a first step towards creating robust macroprudential policy. But talk alone is not enough; we must also show that we can take action. I am really looking forward to playing my part in this work together with my colleagues at the Riksbank.

Concluding thoughts

I have worked in the financial sector for the last 35 years, and for most of that time with financial regulation, supervision and crisis management. I have experienced the development of the world of finance and banking from different perspectives – the supervisory perspective, the international perspective and the sector perspective. Perhaps the most important lesson I have learned from my previous experience is that Sweden has become increasingly dependent on the rest of the world, from both the real economic and the financial points of view.

In the field of monetary policy, the development of the European debt crisis is the most important – and most uncertain – factor to take into account. To attain the inflation target and stabilise resource utilisation, a low policy rate will be needed for some time to come. Monetary policy and financial stability must also be seen in a joint context. Low interest rate levels may eventually create imbalances that we must be wary of. It may therefore be necessary to take some aspects of financial stability into account when making monetary policy decisions.

One of the most important lessons of the financial crisis is the need for macroprudential policy. Important work lies ahead of us here, at the European level and in Sweden. Several important steps have already been taken. The Riksbank's possibilities to influence factors that are important to financial stability must be improved, and I think there are good reasons why the Riksbank should play a major role in the work with macroprudential policy. New instruments within the framework of macroprudential policy can complement monetary policy and traditional micro supervision in order to promote financial stability.

I am really looking forward to continuing to work with monetary policy and financial stability at the Riksbank.