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■ Unusual market rate developments

First Deputy Governor Eva Srejber spoke on Thursday at the annual meeting of the Association of Swedish Finance Houses at the Grand Hotel in Stockholm.

"Let me begin by pointing out that despite a gradual rise in growth since 2001 in Sweden and abroad, long-term interest rates have fallen to low levels in many OECD countries," began Ms Srejber.

"The fact that at the same time central government finances in the United States and several EU countries have been weak for some years now, and in some countries have deteriorated, makes the trend in bond yields appear unusual. Weak fiscal policy usually, all other things being equal, leads to higher interest rates, partly because the supply of government papers increases, partly because the lenders take a greater risk the poorer the central government finances are. At the same time the "crowding out" effect normally leads to higher interest rates for private borrowers. It is possible that the fact that companies have plenty of cash after several years of rationalisation and thus do not yet need to borrow for investment to any great extent may partly explain why there has been no "crowding out" effect yet," continued Ms Srejber.

"The low long term interest rates are partly a result of the monetary policy conducted. International resource utilisation and inflationary pressure have been low. The central banks have tried to avoid excessively low inflation by cutting their instrumental rates to historically low levels and market expectations are that these rates will remain relatively low for some time in continental Europe and Scandinavia. This is also one of the factors behind the low bond yields," said Ms Srejber.

"Another factor that may have contributed to falling long-term interest rates is that inflation expectations have declined. Internationally, the trend towards more independent central banks and a clearer focus on price stability has continued. One result of this is that international inflation has fallen significantly since the early 1990s. Greater confidence in a low inflation rate in the long run reduces the risk premium in the bond market. In addition, the financial markets are continuing to develop, which has led to greater liquidity and improved risk management. The overall effect of these factors could be slightly lower equilibrium interest rates in the long term, on a global basis," said Ms Srejber.

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"A further aspect that has probably affected global interest rate trends is the Asian central banks' purchases of US dollars for their foreign exchange reserves, which have been invested in US treasuries and driven up the prices of these securities and therefore pushed down the yield on them. However, it is worth remembering that the private sector actually accounts for the greater part of the total capital inflow to the United States. The Asian central banks are not financing the major part of the US current account deficit, although the purchases have probably had an effect on interest rates in the USA, hence affecting other markets as well. One of the reasons that private portfolio managers are nevertheless interested in long term investments could be certain changes in recent years in the regulations for financial institutions; changes which have included liabilities to a greater extent being valued at market value in the same way that assets are. Similarly, many agents are focusing more on achieving a better balance between assets and liabilities. This has resulted in increased demand for long-term investments," said Ms Srejber.

"There are thus several explanations for the historically rather unusual situation of long-term treasury bond rates falling to such low levels in recent years despite an increasingly rapid recovery in growth. It is worth noting that last year global growth reached its highest level for around 30 years," continued Ms Srejber.

"However, it is not only treasury bond yields that are low, given the present rates of growth and economic activity. The same applies to the premium companies need to pay in order to borrow, compared with the risk-free central government borrowing. This applies in particular to high-risk bonds, including corporate bonds and bonds issued by emerging economies. Trends for yields on bonds issued by emerging economies are interesting, among other things because few fundamental economic factors have changed in these countries. For instance, their debt burden as a percentage of GDP has not declined significantly. Nor have there been any major structural changes that would indicate that growth rates in these countries will be significantly higher in future. All in all, this could indicate that the financial markets are presently pricing risk at an unusually low rate," said Ms Srejber.

"Interest rates are thus such that it is reasonable to ask oneself whether risks are currently being underpriced in the financial markets. I have no clear answer to this question, but there are some signs that lenders and portfolio managers historically tend to be slightly too optimistic in economic booms, when aggregate growth is good, bankruptcies few and an increasing number of companies are receiving better credit ratings," said Ms Srejber.

"As economic activity continues to strengthen and employment picks up, it is reasonable to believe that both long-term and short-term interest rates will return to more normal levels. It is uncertain how long this will take, but the Riksbank's assessment in the March Inflation Report was that international real economy developments would remain strong and that growth would remain good, even if it had already peaked. The outlook for Sweden was similar. The information received since the Inflation Report was published on 15 March indicates a development broadly in line with the picture painted in the Inflation Report," explained Ms Srejber.

All in all, I believe that there are reasons to assume that, in future, long-term interest rates should rise from their present low levels to more normal levels, both in terms of risk-free central government borrowing becoming more expensive and of risk premiums increasing," concluded Eva Srejber.