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■ The US mortgage crisis and the financial turmoil

Deputy Governor Lars Nyberg gives his views on the recent developments in the financial markets. Mr Nyberg also describes his outlook on the situation regarding the monetary policy decision when he gives a speech today at Styrelsekollegiet in Stockholm.

“During the past six months, developments in the financial markets have been turbulent. The problems began in the fairly limited US market for borrowers with poor credit ratings, what is known as the subprime market. A large share of the loans in this market had been repackaged in various structured products and sold on to investors around the world. When borrowers experienced problems in paying their credit, it became difficult to value products with subprime loans as underlying assets. At the same time, there was considerable uncertainty over who was actually carrying the risks.”

These comments were made by Deputy Governor Lars Nyberg, speaking to Styrelsekollegiet in Stockholm today.

“What we are seeing now extends far beyond the crisis in the US mortgage market. It has manifested itself in a number of different ways. Investors are now demanding much higher compensation for risk. It has become both more expensive and more difficult to borrow in the market, particularly for financial companies. During the autumn there were also severe shocks to the interbank market. Several central banks chose to intervene to provide the market with additional liquidity. The market for short-term financing appears to have recovered somewhat since December, but far from completely.”

“Another effect is that a number of large, well-established banks have been forced to write down the value of subprime-related assets which they own directly or indirectly. The write-downs currently amount to more than USD 130 billion. This has led to several major financial groups requiring new capital. In many cases it has been possible to achieve this through contributions from public funds and other investors from Asia and the Middle East.”

“At the same time as the pressure has eased somewhat on certain sub-markets, there has been renewed international turmoil. This has in many respects concerned the large insurance companies known as monolines, which specialise in insuring bond loans. The buyers of these companies' insurances are, for



instance, municipalities and states with poorer credit ratings. The insurances give their bond loans top credit ratings and mean they can be sold at better interest rates. But the recent turmoil has now caused problems for monolines, too, as they are exposed in various ways to the subprime sector. Some of the companies have already had their credit ratings reduced, and there are risks of further reductions."

"When monolines are given poorer credit ratings this also affects the bonds they insure. They also have their credit ratings reduced. However, many institutions that buy such bonds have investment regulations that only allow investment in securities with top credit ratings. They are then forced to sell their holdings. As monolines insure bonds worth around USD 2,000 billion, this could have a major impact on the market. It could also entail further strains on the banks' liquidity."

"At the same time, the decline in economic activity in the United States has gained a firm hold, partly as a result of falling property prices. There is evident concern that this will worsen the financial crisis. And of course the financial crisis may also reinforce the economic downturn."

"In Sweden we have not been directly affected by the crisis as the Swedish banks are not to any great extent involved with subprime-related products. But their financing costs have increased, which affects their customers in the form of higher interest rates. In this way, the turmoil in the financial markets has already led to a tightening of monetary policy."

"We have received a lot of criticism for not commenting on the economic developments and how we view the monetary policy situation. I can understand this criticism. At the same time, the present situation is one of the most difficult to assess that I have experienced during my time at the Riksbank. The monetary policy considerations we have to make are for this reason unusually complicated."

"On the one hand there is a risk that the crisis will be both more prolonged and more profound than we believed earlier. The large interest rate cuts made by the Federal Reserve and the statements that have accompanied these certainly indicate that they are very concerned. It is difficult to determine how a deepening crisis would affect the world in general and Sweden in particular. But the market turmoil is substantial here, too, which is reflected in the monetary policy expectations. Hopefully the markets are wrong in their assessment of economic developments, but as I see it, it is too early yet to say whether this is so."

"On the other hand, economic activity in Sweden is still good, resource utilisation is strained in some areas and inflation over the coming year looks to be moving upwards some way above the inflation target of two per cent. In addition, inflation expectations have risen, both in the short-term and the slightly longer term. And Swedish monetary policy can only be conducted on the basis of Swedish conditions. This indicates that the Riksbank needs to raise the repo rate roughly at the pace discussed at the end of last year."

"Thus, developments in the Swedish economy indicate the interest rate should be raised, but the international turmoil implies that it would be better to wait. We have a monetary policy meeting in one and a half weeks' time. We are six members on the Executive Board and we are all now considering on the basis of our own experiences and analyses how to achieve the best possible balance."