SPEECH

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Monetary policy and financial stability - the Riksbank's two main tasks

Many countries are currently in the midst of a financial crisis that has repercussions throughout the global financial system. Headlines referring to problems in large US banks, to rising risk premiums, poorly functioning markets and other consequences around the world have been prominently featured on the first pages of many newspapers. Sweden has so far been spared the worst. But now the financial markets here are also clearly affected by the uncertainty and lack of confidence, which thus also affects the Swedish banks and other financial agents. The Riksbank is working intensively on dealing with these events right now, like most other central banks.

The Riksbank’s task is to safeguard both price stability and financial stability. I am going to talk today about current monetary policy and the deliberations at our most recent monetary policy meeting in September. But the recent drama in the financial markets gives me reason to devote some time to explaining what our task of safeguarding financial stability concerns and to our assessment of the current situation.

Two tasks – monetary policy and financial stability

Some of the questions that have been the focus of attention are what the Riksbank and other central banks can and should do about what is happening in the financial markets right now. It is not surprising that these questions arise. But if they are to be discussed, it is important to separate the two tasks the Riksdag (the Swedish parliament) has given us – monetary policy and financial stability. This may not be so easy, as the areas in many ways affect one another. However, I shall try to make things a little clearer.

Two different tasks…

What is happening right now is important, both with regard to financial stability and monetary policy. The financial turbulence has also been included in our analyses of *both* areas, ever since the problems connected to the mortgage market in the United States became apparent last summer. However the perspectives are different. The stability perspective concerns how the banks, the payment system and the financial system in general are affected by the financial crisis. The monetary policy perspective concerns how inflation and developments in production and employment may be affected.

… which are in many ways linked

As I recently mentioned, our two fields of activity are closely linked. The financial turbulence that has spread around the world to a large extent has its roots in the problems in the United States, linked to financial stability. This has led to extensive losses in the bank system in the rest of the world, to considerable uncertainty and poorer functioning in the financial markets. This is of course important to economic activity. However, economic activity in its turn affects factors that are important to financial stability. For example, the number of company bankruptcies and loan losses in the banks is usually higher when economic activity is low and vice versa. There is also a fundamental relationship between our fields of activity. The Riksbank's most important tool in conducting monetary policy is the repo rate. One can say that we try to influence economic activity and inflation by steering the price of credit, that is, interest rates. But to be able to do this, the payment system and our interest rate steering system must function. Financial stability is therefore actually a necessary condition for being able to conduct monetary policy efficiently.

With regard to financial stability, the Riksbank makes regular updated assessments. I shall soon return to our views on current developments. But before I do so, I would like to say a few words about what the task of safeguarding financial stability actually entails. Most people are probably aware that we have an inflation target for monetary policy. But what do we mean by financial stability?

What do we mean by financial stability?

Financial stability is not so easy to define. In the Sveriges Riksbank Act the Riksbank's task that we commonly refer to as safeguarding financial stability is formulated as "to promote a safe and efficient payment system". Put simply, this concerns working in different ways to ensure that he financial system is stable and functions smoothly. This is important for many reasons. The financial system fulfils a number of functions that are fundamental to society and which most people probably take for granted. For example, individuals, companies and organisations must be able to make and receive payments in an efficient manner. Goods are transported to consumers via our usual infrastructure, for instance, the road or railway networks. When one then pays for the goods, one can say that the money is sent to the person who receives it via the "financial infrastructure" – the hub of which is our central payment system, RIX. Almost all financial transactions include some form of payment via the payment system. Without an efficiently-functioning financial infrastructure the economy will come to a halt. Another important function is to be able to save via the financial system. The funds saved become money that others can borrow. An efficiently-functioning credit market is a necessity in a developed modern economy. The financial system also makes it possible for those who invest to manage the risks that can arise. This is also very important for the development of the economy and actually for society to function well on the whole.

How do we work to fulfil our task?

So how do we work to fulfil our task? For one thing the Riksbank monitors and analyses the financial system, in particular the major Swedish banks, but also the efficiency of the payment system as a whole. We identify possible risks and threats to the financial system and evaluate the system's resilience. This is done for instance in our Financial Stability Report, which is published twice a year, and in speeches held by Executive Board members. We also try to influence market participants who are important to financial stability. Part of this work includes regular contacts with the banks, other government agencies and our central bank colleagues in other countries. Most of our work concerns *preventing* problems and ensuring that the payment system functions as smoothly as possible. We can do this in many different ways. Some concrete examples are the recent actions taken by the Riksbank and other government agencies. I shall return to what these actions entail shortly.

We work to prevent financial crises from arising. But if they do nevertheless arise, it is also our task to manage them. We have to be prepared to take action although we hope that we will never need to do so. This preparedness includes, for instance, regularly holding crisis exercises, both internally and together with other Swedish authorities, and sometimes together with central banks and authorities in other countries. The work on financial stability is reminiscent of fire safety work. We have to provide information about the risks, but it is also our job to be prepared to put out the "fires". And to be able to do this efficiently, we must have practised. In purely practical terms, we have the possibility to take a number of different measures if this should prove necessary. But one should bear in mind that each situation is unique and must be dealt with on the basis of the conditions prevailing at that time.

Worst case scenario

One fundamental function of a central bank is the role as "lender of last resort". If the Riksbank's assessment is that financial stability is threatened, we have the possibility, in exceptional circumstances, to contribute liquidity to Swedish banks and other financial companies by granting liquidity assistance on special terms. However, this assumes that these institutions are sound and that they are under the supervision of Finansinspektionen, the Swedish Financial Supervisory Authority. Let us assume, for instance, that a bank that meets the requirements and thus is assessed as having assets that are greater than its liabilities, nevertheless experiences severe problems in financing and acquiring sufficient liquidity to meet its payments. I shall briefly explain how such a situation can arise.

In general, the banks finance themselves by borrowing money in the short term and lending it out on a longer term basis. When the banks lend to individuals and companies it is often on long-term contracts, which means that the bank cannot get the money back earlier if this should prove necessary. On the other hand, when the bank receives deposits from individuals and companies, they usually have the possibility to withdraw the money whenever they wish. Also when the banks borrow money in the financial markets this is often as short-term loans, that is with a short duration. If it should suddenly become difficult or very expensive for the bank to borrow money, it may experience difficulty in meeting its payments. The terms for the more long-term lending are largely restricted. In such a situation the Riksbank can help to manage the bank's financing problems by granting liquidity assistance. But we only do this on condition that the terms I recently mentioned are met and if our assessment is that the stability of the financial system would be jeopardised if the bank in question failed.

Another fundamental function that it is important to mention in this context "to keep the different tasks separate" is that the Swedish banks can borrow overnight from the Riksbank against collateral at an interest rate of 0.75 percentage points above the repo rate. They *always* have this possibility and this is not what we mean by liquidity assistance.

But what if the bank suffering problems does not have larger assets than liabilities? Should the Riksbank provide liquidity assistance? No, in such a situation it is a question for the government, not the Riksbank, to decide. What the Riksbank can do is provide additional liquidity under certain conditions. We do not have the task of managing a bank's problems with its creditworthiness. Even in this hypothetical reasoning it is important to point out, that in principle all those who have deposited money in the bank are protected by the deposit guarantee in the event that a Swedish bank should default. This applies for amounts of up to SEK 250,000 per customer and institution. It is only if the deposit has been made by another financial institution or in some cases if the amount is frozen that the deposit guarantee does not apply.

This reasoning concerned what we could do in a situation where financial stability is threatened. Some central banks have recently been forced to take this type of measure. But none of the Swedish banks has had problems with its liquidity in the way I described in my example. So how do we view the current situation?

Recent developments

As I mentioned earlier, the financial turbulence has been included in our analyses for some time now, both with regard to monetary policy and financial stability. The Riksbank has regularly emphasised many of the risks in the financial system and what could happen if the financial turbulence should grow worse. The Riksbank bases its assessment on an analysis that focuses on the four major Swedish banks, as they account for around 80 per cent of the market. The Swedish banks have considerable equity, good profitability and limited loan losses. Our assessment is that there is a high degree of resilience to the international turmoil that has prevailed for some time now. But this is not the same as saying that the Swedish financial markets and banks are not affected by the situation. Of course they are.

The financial markets have been affected more noticeably

The international markets where the banks obtain funding by taking out bond loans have been functioning poorly. Borrowing has become more expensive and more difficult. Normally the financial market participants trade with one another and thus contribute to the smooth functioning of the market. However, recently above all mutual distrust has meant that they are more wary of lending money to one another. One can say that this has "thrown sand in the wheels". Many central banks and other government agencies are trying to counteract this, as I will discuss shortly. This has also affected the Swedish banks, although the problems have been less serious here than in many other parts of the world.

We can observe that short-term interest rates have now risen substantially in Sweden, too. This applies, for instance, to the interbank market, which is the market where the banks borrow money from one another to cover their short-term liquidity needs. However, in this context it is worth pointing out that the overnight market has functioned as usual and that the overnight rate, the shortest interest rate in the economy, has remained stable around the repo rate. In this way the Riksbank's system for steering the interest rate functions well, which is of course important not least for monetary policy.

The market for mortgage bonds has also functioned less efficiently than normal. In times of uncertainty investors often prefer to buy safe assets and sell those that are higher risk, even if the latter have a higher return. So when the situation becomes uncertain the demand for government securities with a short duration, such as treasury bills, usually increases. At the same time the demand for less liquid securities considered to have a higher risk declines. As an example, in the United States they have been selling off mortgage bonds, as these have been regarded as particularly high-risk investments as a result of the US mortgage crisis. But even in Sweden there has been a strong demand for treasury bills with a short duration, at the same time as the supply of mortgage bonds has increased. This has occurred despite the Swedish mortgage bonds having a very high credit rating. Normally these have an interest rate just marginally higher than the rate for treasury bonds with a corresponding duration. However, recently the interest rate differentials between these securities have been much higher.

Measures to improve the functioning of the markets

The Swedish National Debt Office and the Riksbank have maintained a regular dialogue regarding the money and bond markets and the need to counteract the effects of the US financial crisis. To alleviate the problems here, the Swedish National Debt Office, in consultation with the Riksbank, decided two weeks ago to increase the supply of treasury bills through a number of additional auctions and at the same time buy, by reverse repo as it is called, the corresponding amount of mortgage bonds. These measures mean in total that the Swedish National Debt Office will probably have invested around SEK 150 billion in covered mortgage bonds by the end of November. However, there is also a flexibility to adjust the issue volumes on the basis of market developments. It is worth noting that the Swedish market for mortgage bonds has been open during the whole period of financial turbulence, although it has functioned less efficiently than before.

Just over a week ago the Riksbank also increased the possibility for credit for the participants in the RIX payment system. The purpose of this is to facilitate the banks' payments to one another during the day, where necessary. To oil the wheels a little, one might say. RIX participants can now to a greater extent use their own covered bonds, or those issued by an institution with close links, as collateral in the system. The collateral for a covered bond is directly tied to a particular portfolio of mortgage loans with high collateral. This means that the credit granter is protected, even if the institution issuing the bond were to collapse. Covered bonds are therefore good collateral and many other central banks accept them to a greater extent than the Riksbank. In our case, the permitted share was raised from 25 per cent to 75 per cent. This measure meant, to put it simply, that participants in the RIX system, were given the opportunity if necessary to use more collateral as a base for their loans from the Riksbank.

Another preventive measure taken by the Riksbank has been to establish, together with other central banks, a swap facility with the US central bank, the Federal Reserve. This agreement entails the Federal Reserve supplying US dollars in exchange Swedish krona if the need should arise. But it should also be pointed out that the Riksbank has a substantial foreign currency reserve. The agreement is not the only means for the Riksbank to obtain loans in US dollars, but it makes it easier for us to take action quickly. Right now, the situation regarding short-term funding in USD has been very strained on many markets.

To increase access to liquidity in US dollars and to make the markets function more normally, several central banks, including the Riksbank, have agreed on coordinated actions. The Riksbank has decided to lend dollars to Swedish banks in two auctions during October. The first was held yesterday and amounted to USD 7 billion. A second auction with loans extending over the turn of the year will be held on 22 October and amount to USD 15 billion. A large part of the collateral the banks pledge for these loans will probably be comprised of covered mortgage bonds. The measures should therefore also have a positive effect on the functioning of the mortgage market. Together with the measures taken by other central banks, this should lead to better liquidity in the financial markets globally.

A further measure is that the Riksbank as recently as today decided to establish a loan facility in Swedish krona to increase access to loans of longer duration.

There have thus been disruptions in the financial markets, but the Riksbank, other government agencies and central banks have taken action to improve the functioning of the markets. We will of course continue to follow developments very closely. We are constantly updating our analyses and we are prepared to take action if necessary. In addition, as I have already mentioned, we have close contacts with the banks, market participants, other government agencies and our central bank colleagues in other countries.

Monetary policy

When the Executive Board met for our most recent monetary policy meeting on 3 September, the decision was to raise the repo rate by 0.25 percentage points to 4.75 per cent. However, the forecast for how the repo rate would develop in future was lowered in relation to the interest rate path that had been presented in July. The July forecasts contained a fairly high probability for a further two raises during the autumn. But at the September meeting the Executive Board's assessment was that there would not be any more raises and that the interest rate might need to be cut during 2009. The decision was reached by a narrow majority. Three members of the Executive Board supported the decision, while three were against it, and the Governor's casting vote was decisive. I was part of the minority who wished to hold the repo rate unchanged at the September meeting and to see a slightly faster reduction in the rate in the future.

The main reasons put forward by the majority for raising the interest rate were that inflation had continued to rise and was far above the target, that inflation expectations remained high and that cost pressures had increased. The majority assessment was that it was necessary to raise the repo rate to prevent the increases in energy and food prices from spreading to other areas. The reasons for lowering the interest rate path included the fall in the oil price and other commodity prices over the summer. Another reason was that growth had slowed down more than expected, both in Sweden and abroad. The turmoil in the financial markets was of course also included in the picture.

My own assessment

I personally had entered a reservation as early as July against the forecast that it would be necessary to raise the repo rate a couple more times during the autumn. At the September meeting I considered that the arguments against further interest rate raises were even stronger. Although inflation was high and far above the inflation target, the information received during the summer indicated that inflation would be weaker in the future than we had predicted in July and my assessment was that the risk of contagion effects had also declined. Let me explain my reasoning at the time.

There were three main areas where my assessment differed from that of the majority. These were economic activity in Sweden and abroad, the risk of contagion effects from the increases in oil and commodity prices in the world market and to what extent the weak productivity risked leading to inflation effects.

Oil and food prices

Oil and food commodity prices had fallen slightly during the summer, but were still a good bit higher at the time of the September meeting than they had been a year previously. There was also considerable uncertainty over how they might develop in the future. But my view was that the risk of these prices rising again had declined as a result of the clear weakening in economic activity both in Sweden and abroad. I also assessed that the risk of contagion effects on wages and prices in other areas had declined. I therefore considered that no further increase in the interest rate was necessary to counteract these effects.

I would like to take the opportunity to answer the criticism against us that we care too much about the price of oil and food commodities in the world market when we make our monetary policy decisions. The reason given is that we cannot affect these prices with our monetary policy. Of course it is quite true that we cannot affect world market prices. But nor have we tried to stop the direct effects of the upturn in oil and commodity prices. If this had been our aim, the interest rate would have been much higher than it is now. Inflation is also much higher now than our target, because of the direct effects of higher commodity prices. The reason we have not tightened our monetary policy severely is out of consideration to the real economy, production and employment. However, what we are anxious to see is that the indirect effects of the increases in oil and food prices are not allowed to push up inflation more permanently. We conduct a flexible inflation-targeting policy. If shocks occur that mean inflation will deviate from the target, we can allow it to take some time to attain the inflation target.

The normal time horizon is a couple of years, but sometimes it may be sooner and sometimes it may need to take a little longer.

Weaker growth

With regard to growth in Sweden and abroad, my views were more pessimistic than the assessment presented in the September Monetary Policy Update. Developments in the United States appeared particularly uncertain. The crisis in the housing sector, together with falling employment and weaker growth in real wages meant that I found it hard to believe that the US economy would turn upwards as quickly as assumed in the forecast. Moreover, the forecast for global growth assumed that there would not be any substantial slowdown in economic activity in the emerging economies. However, my assessment was that growth would also weaken there. The rises in energy and food prices entail cost increases and reduce purchasing power in these countries too. I also pointed out the rapid slowdown in the growth rate in the euro area. All in all, I considered there were risks that economic activity abroad would weaken more than was forecast in the September Update.

In Sweden, there were clear signs of an economic downturn as early as the monetary policy meeting in July. In September we could see that growth in the second quarter had slowed down much sooner than expected. The situation in the Swedish labour market remained strong, but even here there were indicators, such as labour shortages, the number of job vacancies and redundancies, pointing to a cooling down.

Productivity and inflation

Productivity in Sweden has been weak since the beginning of last year. This means that unit labour costs as measured in the National Accounts are increasing more quickly. There is thus a risk that companies will try to pass on their cost increases to consumers, which would result in higher inflation. However, I considered that this risk is slight at present, now that economic activity is slowing down. The labour market usually lags behind production in the economic cycle. Employment has risen rapidly in recent years and when demand and production slow down as quickly as they are now, my assessment was that companies are more likely to cut their workforces rather than raise prices substantially. The redundancies announced at the beginning of the autumn may be an indication that many companies have had to reduce their labour forces.

To summarise, my assessment was that inflation would slow down sooner than was assumed in the Monetary Policy Update. It was therefore my conclusion that no further interest rate increase was necessary to bring inflation back on target within a reasonable period of time. Further, my assessment was that the repo rate might need to be cut more than indicated by the proposed interest rate path and I therefore entered a reservation against the new interest rate path.

Some concluding thoughts

The Riksbank, like many other central banks around the world, is currently facing difficult challenges. But although they are difficult, we are well-equipped to meet them. For instance, we have an entirely different starting point from that during the finance crisis of 1992, which largely concerned problems that had originated here at home. Today we are suffering contagion effects from problems in the US mortgage market, a market to which the Swedish banks have only small direct exposures. The situation with regard to monetary policy is also quite different from during the early 1990s. The inflation target and the current regulations regarding monetary and fiscal policy together with sound public finances provide a stable base on which to stand and meet the coming economic downturn.

Even if the Swedish banks are affected by current events, they have good capital buffers and good earnings, and are therefore well-equipped to meet the turmoil in the financial markets. The biggest problem for the banks at present is to borrow at longer durations. The Riksbank, together with other government agencies and central banks, has taken measures to improve the situation. We are also prepared to take further measures if necessary.