SPEECH

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The financial crisis from a central bank perspective

Introduction

In normal times, reporting about the Riksbank is dominated by what we do, or do not do, with interest rates. The focus is usually on one of the Riksbank's two main tasks: maintaining price stability. Less attention is paid to the other main task, safeguarding financial stability; health is silent, as the Swedes say. For obvious reasons, financial stability has been given more prominence recently.

We have now lived with turmoil in the international financial markets for rather more than a year and over the past two months have seen it lead to a large-scale global crisis of confidence. The origin of the current crisis, as well as of our Swedish banking crisis in the early 1990s, can be found in reckless lending practices related to property. As we now know, it began when American financial institutions lent money to borrowers with weak credit histories. Whereas the Swedish banking crisis remained altogether Swedish, the American crisis has spread like wildfire and reminded us of just how globally connected the financial markets are. The high-risk sub-prime loans were sold on to a large extent by bundling them together with low-risk loans in what are known as structured credit products. The use of these complex products grew rapidly and had a wide geographical distribution. Investors found it difficult to conduct their own risk assessments and largely relied on the classifications of credit-rating agencies.

When the losses on sub-prime loans became unexpectedly large, genuine uncertainty arose about the value of the structured products and where losses associated with them would occur. Banks and other financial institutions became cautious about lending money to one another. They began to hoard liquidity to meet their own obligations and to avoid losses on loans to counterparties about whose status they felt uncertain in the wake of the general crisis. The cost for bank borrowing on the interbank market rose, causing other market interest rates to climb.

The financial turmoil spread to Europe and resulted in a general aversion to invest in mortgage securities. Banks and mortgage institutions found it increasingly difficult to obtain funds on the securities markets.

Escalating crisis after Lehman Brothers collapsed

When the Lehman Brothers investment bank filed for bankruptcy protection, a full-scale confidence crisis erupted. A major financial player was left to its fate and there was rapidly growing concern that other institutions would follow suit. Credit flows dried up almost completely and investors essentially dared to invest only in government bonds. Companies had already experienced a tightening of credit terms; opportunities for loan financing now essentially disappeared.

In this phase of the crisis, around mid September this year, the effects on the Swedish financial system became clear. When banks' access to liquidity dried up on every market, this hit all banks, including those that are financially strong, like the Swedish banks. Many central banks around the world had been taking measures for some time to strengthen liquidity in banking systems but the Riksbank had not needed to act. The interbank market and other short-term markets had worked, though interest rates had climbed sharply. When the crisis had a more tangible impact on Sweden, the Riksbank also implemented a series of interventions. Meanwhile, central banks in the rest of the world continued with their interventions and governments approved crisis packages to guarantee financial stability.

Against the backdrop of this summary of events in the financial sector over the past year, today I will speak about the effects of this financial crisis on the Riksbank's work of maintaining a safe and effective payments system. But first I would like to briefly describe how we carry out this work under normal circumstances. I will also conclude with a comment on the crisis' effects on monetary policy.

Work with financial stability under normal circumstances

The task of maintaining a safe and effective payments system includes the role of the Riksbank as the banks' bank. This task includes maintaining the RIX payment system for payments in Swedish kronor. Participants in the system may borrow during the day and overnight to cover temporary deficits.

The task also includes continuous oversight of the financial system. For some time the Riksbank has had a well-designed analytical apparatus for early detection of changes and vulnerabilities that could develop into a serious systemic crisis. Above all, its purpose is the timely detection of vulnerabilities in banks that are of central importance for the payments system, which requires knowledge of the status of the various institutions and how the market functions. This in turn presumes continuous follow-up, where frequent contacts with financial market participants play an important role. These established contacts are essential in a crisis situation, both to determine the type of measure that is needed and to ensure timely implementation.

Ten years ago we began to publish stability reports twice a year. These reports provide a basic analysis of financial stability with an emphasis on the four major banks. The report leads up to a comprehensive stability assessment, highlighting the various risks to stability.

Financial stability and implementation of monetary policy

Monetary policy and financial stability have a fundamental relationship in the payments system. Through its repo rate decisions and by determining the conditions for the banks' deposits in and borrowing from the RIX system, in practice the Riksbank determines the overnight rate, that is, the interest rate on overnight interbank loans. Through the steering system, the Riksbank aims to keep this shortest market rate close to the repo rate. The overnight rate in turn affects the interest rates offered to the general public, and thereby economic activity and prices. The repo rate, which is set on the basis of monetary policy considerations, indicates the level at which the Riksbank wants the overnight rate to lie.

Interest rates with a slightly longer duration are determined in the financial markets and usually display a fairly stable relationship to the existing repo rate and expectations of its future level. During periods of financial turmoil and crisis, however, various risk premiums rise and this may disconnect the short-term market interest rates from their normal relationship to the repo rate. That weakens the impact of monetary policy

Financial stability in terms of a functioning payments system and financial markets is thus essential for the Riksbank to conduct an efficient monetary policy.

As can be seen, for a long time the Riksbank has been working intensively on issues relating to financial stability. This assiduous effort, which hardly attracts any attention under normal circumstances, provides a good foundation for crisis management. And this brings me to an account of all the measures taken over the past two months.

Poorly functioning markets require special measures

The crisis we are currently experiencing did not originate in the Swedish financial system. But the global financial turmoil has been imported to Sweden and has had repercussions on the Swedish financial system. As I already mentioned, these consequences became clear when the crisis escalated in the aftermath of the Lehman Brothers bankruptcy filing.

Several components of the fixed-interest market have not been working as well as usual. The uncertainty there is evident, for example, in the banks' difficulties with borrowing at longer maturities and in investors' preference for safe government paper over what they perceive as more risky securities such as mortgage bonds. Even the short-term interest rate on the interbank market has risen sharply as a result of mutual distrust between banks, causing them to avoid lending to each other.

As a result, the banks' borrowing costs rise, access to loans decreases, and companies and households pay more for loans. At times, moreover, trading on certain segments of the fixed-income market has ceased completely. When such disruptions occur, the Riksbank has considered that special measures are required to restore the functioning of the markets so that the supply of credit is not jeopardised and the financial markets, and therefore monetary policy, can work more normally.

The first sign: a shortage of treasury bills ...

The very first, very concrete sign of the financial crisis in Sweden was an acute shortage of treasury bills. The high demand for safe investments, especially in the United States, caused interest rates on American treasury bills to fall almost to zero. Even foreign investors then turned to European countries, including Sweden, to get treasury bills that gave a higher yield. The Swedish National Debt Office decided to implement additional issues of treasury bills. The funds from these extra issues are being used for reversed repo transactions with mortgage bonds (purchase of mortgage bonds with agreements to resell them within a specific period of time). Mortgage bonds that were difficult to sell could be converted into a liquid asset, which meant that the measure simultaneously helped the situation on the mortgage bond market.

About the same time, the Riksbank also made it easier for banks to borrow from the Bank by accepting additional types of securities as loan collateral. Covered mortgage bonds issued by an institution with close links to the counterparty could now be used as collateral to a greater extent than in the past. This measure is also helping the situation for mortgage bonds.

... a shortage of dollars the second

The next problem to address was a general shortage of financing opportunities in US dollars. Since the Swedish banks are not counterparties to the US Federal Reserve (Fed), they cannot be sure of benefitting from the Fed's liquidity injections. In late September, mutual currency arrangements with the Fed were established by the Riksbank and several other central banks. With these swap facilities the Riksbank can borrow US dollars against Swedish kronor. The Riksbank then offered its counterparties large loans denominated in US dollars. The loans are granted against collateral at an interest rate determined by auction, though no lower than a minimum rate related to the expected policy rate in the United States.

General measures to promote liquidity

Since the beginning of October the Riksbank has been implementing measures to support SEK liquidity, aimed at securing bank funding, facilitating the supply of credit and improving the functioning of the financial markets.

The lack of trust between banks has complicated their long-term funding, including financing that only extends a few months into the future. The banks have therefore been forced to borrow in the market for shorter and shorter terms. Even though financing could be found, it has become much more difficult for the banks to manage liquidity and the risks also increased. In an effort to enable the banks to restore more normal conditions, the Riksbank has provided three- and six-month SEK loans so that funding is available at longer maturities than what the markets can currently provide and longer than what the Riksbank would normally offer. These loans will continue for as long as the need exists.

The Riksbank is thus offering the banks an opportunity to replace short-term financing with the longer-term funding which the market normally provides.

These measures are clearly aimed at improving the functioning of the fixed-income market. However, they should also help to ensure that short-term market interest rates revert to a more normal relationship with the repo rate, thereby strengthening the impact of monetary policy.

Two institutions receive special liquidity assistance

The Riksbank can also provide liquidity to individual institutions if extenuating circumstances are present. Such assistance has been given to Kaupthing Bank Sweden and Carnegie Investment Bank. These loans are against collateral and carry an interest rate that is higher than normal borrowing costs (penal rate). Both the Riksbank and Finansinspektionen (Swedish Financial Supervisory Authority) consider the banks to be solvent. The Riksbank provided the liquidity assistance to Kaupthing because it wanted to prevent the crisis that has afflicted the Icelandic banking system from spreading to the Swedish financial system. Common to both instances of liquidity assistance is that they occur in a situation in which the entire global financial system is characterised by great uncertainty. Against this background the Riksbank has deemed it necessary to provide support to these institutions, which under normal circumstances would not receive it. In the current situation, suspension of payments by these financial institutions would pose a risk of serious disruption to the rest of the financial system and therefore lead to an undermining of confidence in the payments system. It is these assessments, not concerns about individual institutions, that motivated the Riksbank in granting the assistance for which the banks in question applied. With respect to Carnegie, a few days ago its operations were taken over by the Swedish National Debt Office, which granted a loan that replaces the liquidity assistance previously granted by the Riksbank.

Financing assistance for companies

Another problem begging for a solution is the financing situation of non-financial companies. As the financial crisis escalated, the credit supply to these companies has also become more troublesome, which could have strong repercussions on economic activity. To alleviate these problems, the Riksbank has temporarily offered banks the opportunity to borrow at three months against collateral comprising more commercial papers than usual. In practice this means that non-financial companies may obtain funds by issuing and selling certificates to the banks, which in turn use them as collateral for loans from the Riksbank. This credit facility is also available through an auction, where the minimum rate is the current repo rate plus a premium. Since it is mainly large companies that issue certificates, it is they that will benefit directly from the advantages of these facilities. But since banks can increase their liquidity by using the certificates to borrow from the Riksbank, there is less risk of them cutting back on loans to small and medium-sized enterprises that are directly dependent on bank financing.

The way ahead?

When the dust after the crisis has settled, we face a major task. We must carefully analyse the crisis and determine the areas in which supervision, regulations, etc. need to be tightened up and in which areas the problems are best solved by players from the finance industry. Crises create space and acceptance for necessary reforms. At the same time, extreme situations such as this always generate demands for extreme measures. Careful deliberation is therefore important before implementing new regulations. It is all too easy to go too far and implement regulations that are too far-reaching and extensive. Such regulations could control and conserve market structures for a long time to come or involve major costs that reduce efficiency.

This crisis will need follow-up care. In conclusion let me briefly focus on a few issues that will probably need to be discussed carefully, both in Sweden and on an international level.

One lesson that can be drawn already is the need to develop and improve the rules for supervision and management of liquidity risks. More stringent demands for transparency in the financial sector will provide customers and investors with better opportunities to assess the risks associated with companies.

Similarly, transparency in the structured credit instruments should be improved so that their associated risks can be assessed. More effective trading with these products is also important; the financial infrastructure needs to be strengthened. This discussion and any resultant changes in regulations should aim to ensure that this part of the credit market can work efficiently once again.

Developments in the American investment banks in particular have made us aware that even financial companies that do not accept deposits from the general public, and which therefore are subject to weaker supervision and regulation, may have a crucial impact on financial stability. We should therefore consider how to design regulations and supervision of financial companies that do not accept deposits from the general public.

Due to the global scope of the crisis, countries must coordinate measures to solve it. Separate national solutions could result in higher crisis management costs than would otherwise be the case. In all of these areas where supervision and regulation need to be improved, they must be coordinated and harmonised internationally.

The international component is particularly apparent in that the majority of banks today conduct a considerable amount of business in several EU countries. At the same time, the responsibility for supervision and crisis management remains at the national level. This entails obvious risks of coordination problems and conflicts of interest between countries, which naturally do not promote financial stability. It is therefore necessary that organisations for supervision and crisis management be coordinated within the EU.

Lower repo rate in the wake of the crisis

The escalating crisis intensifies the downswing in the Swedish economy, which was already apparent. As can be seen in the Monetary Policy Report from 23 October, our growth forecast for next year has been revised sharply downward to the prospect of zero growth. To alleviate the real economic effects of the financial crisis, over a short period the repo rate was cut by one percentage point to the current level of 3.75 per cent. Our forecast for the repo rate shows that in the future it may need to be lowered by an additional half percentage point over the course of the next six months.

We can do this without jeopardising the inflation target. It is mainly rising commodity prices in the global market, such as the price of oil and food, that have driven inflation upwards. Now that the price trend for these commodities has broken and turned downwards, the rate of inflation will drop rapidly. At the same time, domestic inflationary pressure will be eased by the weaker economic trend. We are in a situation in which there is hardly any conflict between inflation and real economic considerations in monetary policy. Our decision to lower the interest rate is guided by normal monetary policy considerations - in other words, "business as usual".

When we lowered the interest rate we also noted that the effect of the lower rate would probably be smaller than usual. This is because the confidence crisis in the financial system has led to high risk premiums whereby short-term market interest rates were disconnected from their normal relationship to the repo rate, as I described earlier. The reduction we implemented on 8 October did not lead to an immediate drop in interbank rates. Consequently the mortgage institutions' borrowing costs did not drop either, neither did interest rates for loans to end customers. This clearly illustrates how the impact of monetary policy is dependent on financial stability.

Some closing thoughts

The Riksbank has worked on two levels during the current crisis. Interest rates were cut to alleviate the effects of the financial crisis on the real economy. In addition, measures have been taken on an ongoing basis to improve the functioning of the financial markets and to support financial stability.

The interest rate decisions have been based on essentially the same type of considerations as those on which monetary policy is usually based. The idea is to avoid unnecessarily large fluctuations in output and resource utilisation at the same time as inflation approaches the target within a reasonable time horizon.

The Riksbank's other measures, such as lending denominated in both Swedish krona and US dollars, have resulted in a general functional improvement, primarily in the Swedish credit markets, thereby also creating conditions for the markets to return to more normal conditions and allowing financial stability to be maintained – which in turn is a requirement for conducting an effective monetary policy.

During the current crisis the Riksbank cooperates closely with other regulatory authorities to handle situations that arise to achieve the best possible outcome. The Riksbank's frequent contacts with Finansinspektionen, the Swedish National Debt Office and the Government Offices play an important role in crisis management. Like other regulatory authorities, the Riksbank also has frequent contacts with its foreign colleagues.

Central banks around the world are also working to improve the functioning of the financial markets. In addition, governments in the United States and the EU have adopted bailout packages to support the financial system. In Sweden, the government launched a guarantee programme and a regulatory framework that improves the ability to handle banks in crisis in an orderly manner. Having such regulatory frameworks in place is extremely important.

It is still too early to say how soon all the measures that have been taken will have an effect and result in a return to more normal conditions in the financial market. Even if the Riksbank's assessment is that the most acute phase of the crisis may subside over the next few months, it will probably take time before conditions return to normal. Confidence must be restored on several levels and that takes time.