



# SPEECH

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## ■ Monetary policy and financial stability

### *Counteracting the effects of the global financial crisis*

When I have opened my daily newspaper in recent months the headings have often concerned crises, stock market collapse and economic downturn. The contagion effects of the US mortgage crisis that have been around since summer last year, have taken on proportions hardly anyone expected. In mid-September the international financial turbulence entered its most intensive phase so far. The global financial system has since then been shaken to its foundations and even countries like Sweden – far from the centre of the crisis – are tangibly affected.

The Riksbank's main tasks are to safeguard financial stability and price stability. To manage these we are now continuously taking various measures to counteract the effects of the financial turbulence on the Swedish economy. Other authorities, the Government and the Riksdag have also implemented measures to the same end.

One thing I have learnt from the years I have worked with managing financial crises is that things can change rapidly. Each situation is unique and must be dealt with on the basis of the conditions prevailing there and then. Although Sweden has long been on the periphery of the turbulence in the financial markets, we are now more strongly affected. When the situation requires it, we must be flexible and act both quickly and powerfully. This is the way we have tried to work so far, and we will continue to do so as long as necessary.

When I come here to the Committee on Finance hearing to answer questions on monetary policy, that subject is usually what my introductory speech concerns. Today it will be slightly different. Recent developments clearly show how closely our main tasks, financial stability and monetary policy, are linked. I would therefore like to begin by talking about those points of contact and various measures we have taken to ensure that certain financial markets will function more normally. With this as a base, I will then move on to the interest rate decisions and the financial turbulence from a monetary policy point of view. Finally, I would also like to make a brief comment on our own experiences of earlier crises and the future of the global financial system.

## ■ Monetary policy and financial stability – why is the system so important?

One can say that the payment system and to some extent the financial markets are the circulatory system of our economy. What is usually referred to as financial stability concerns, to put it simply, working in various ways to ensure the financial system is stable and functions efficiently. For example, individuals, companies and organisations must be able to make and receive payments in an efficient manner. When goods are transported to consumers via our physical infrastructure, such as the road network or by air, the payment for the product is sent to the end recipient by means of the “financial infrastructure”. If the financial infrastructure did not function, the economy would more or less grind to a halt. The financial system also makes it possible to manage various risks that can arise in the financial markets. This is important to both households and companies.

Another important function is to be able to save and borrow money via the financial system. This gives households and companies the possibility to distribute incomes and consumption over time. The funds that are saved can be borrowed by companies and households to finance various investments which can then create employment and growth. When there is distrust and disturbances in the financial system, this function may be impaired, which can lead to a credit crunch. First the financial sector is affected, but then it gradually becomes more difficult for households and companies to borrow, too. Consumption and investment then decline, which can lead to a substantial economic downturn. A credit market that functions well is thus an important condition for good growth.

To summarise, one can say that the financial system’s functions are very important for economic development. It is important that the system is stable for our society to function properly on the whole. But financial stability is something that most people probably often take for granted. As long as everything is functioning well, the focus of public debate is much more often on our interest rate policy and the inflation target than on our stability task. But more recently, as the functioning of the financial markets has been hampered, the situation has almost been reversed. It has also become very clear how closely related our two main tasks are.

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 the credit markets must function so that the Riksbank’s interest rate decisions have an impact on other interest rates in the economy. Financial stability is in other words more or less a condition for being able to conduct monetary policy in an efficient manner. And of course it works both ways – monetary policy has significance for financial stability, not least through its impact on the banks and on economic activity. For instance, in an economic downturn the number of bankruptcies in the economy increases and so do the banks’ loan losses.

### *A hiccup in the financial machinery*

In Sweden the market for the shortest interest rate in the economy, the overnight rate, has functioned more or less normally, with the interest rate close to the repo rate. So far so good. But internal distrust and uncertainty within the global

■ system, particularly since mid-September, has made financial market participants reluctant to take risks and to lend money to one another at longer durations. It has become expensive and difficult to find funding, even for the Swedish banks who are "in good shape" and have good capital adequacy. It has been particularly difficult to borrow at slightly longer durations.

The banks normally have what may be called financing risk. When they lend money to individuals and companies it is often on long-term contracts. This means that the bank finds it difficult to get its money back earlier if it needs it. The banks receive money deposits on a short term but they lend out money more long term; this is also expressed as deposits being liquid while loans are illiquid. As the functioning of the financial markets has deteriorated, the banks have been forced to refinance at shorter and shorter maturities, often only overnight. This has increased the banks' financing risk. The fact that they have been forced to finance themselves at shorter durations has in itself increased the uncertainty over which banks can manage their financing, and this has contributed to even greater anxiety and a lack of confidence. When fewer and fewer market participants are willing to expose themselves to risk the banks' access to credit declines. This in turn reduces the possibilities for households and companies to borrow money. This type of development can ultimately lead to a credit crunch.

Interest rates on longer-term loans between the banks; interbank rates, have been much higher than normal. The demand for safe assets, such as treasury bills, has been very high at the same time as the demand for mortgage bonds and high-risk assets has been very weak. Many interest rates, for instance, households' mortgage rates, have risen much more than would normally be motivated by the Riksbank's interest rate and forecasts of the future development of the repo rate. This means in practice that access to credit for households and companies is tightened even without the Riksbank having raised the interest rate. The fact that it is more expensive and more difficult to borrow affects economic activity.

In a situation where the markets are affected by uncertainty, it is also possible that the interest rates faced by the general public do not follow suit when the Riksbank cuts the repo rate. One can say that the repo rate then becomes a blunter instrument than normal and that its impact is weaker. Such a situation could therefore require more powerful adjustments to the interest rate than would otherwise have been necessary.

### **Measures to ensure the financial system functions more normally**

It is thus very important from several aspects that the financial system functions well. And it is the Riksbank's task, as written in law "to promote a safe and efficient payment system". This means in practice that the Riksbank regularly analyses risks and threats to the stability of the Swedish financial system. The purpose is to detect changes and vulnerabilities that can lead to a serious crisis and in various ways to prevent such a situation from arising. We also maintain a good level of crisis preparedness and carry out different types of crisis exercise. This means that we are well prepared to act if a situation arises whereby stability is threatened.

When shocks occur in the financial system we have different tools for managing the situation. An important part of this is providing information, highlighting risks and conducting a dialogue with financial market participants. The Riksbank also

■ has the possibility to supply the system with liquidity or to provide liquidity to financial companies under the supervision of Finansinspektionen, the Swedish Financial Supervisory Authority, that are solvent but lack sufficient liquidity to manage their payments. This gives the Riksbank a central role in a financial crisis situation which is often connected with this type of problem. It is usually said that the Riksbank can in such cases act as lender of last resort.

Other authorities working with these issues in different ways are Finansinspektionen and the Swedish National Debt Office. As those of you here are well aware, the Riksdag and the Government also contribute. This can be by formulating legislation and regulatory frameworks, or by intervening with measures in those cases where those of the authorities do not suffice. One example is the stability plan for the financial system decided by the Riksdag just over two weeks ago. This was a measure that the Riksbank welcomes. With regard to legislation, I also believe that further supplementary measures will be needed in future. I will return to this later on.

During the recent financial turbulence the Riksbank has not only had regular contacts with other authorities and the political system – we have also had closer contacts with market participants than usual. Central banks around the world have also had close cooperation with regard to reducing the strains in the financial markets in various ways. So what have we at the Riksbank done to make the markets function better?

### *Improving the functioning of the markets*

The Swedish banks have mainly experienced two problems. One has been the lack of access to more long-term funding in Swedish kronor. The other has been the limited possibilities to borrow in US dollars. As I mentioned earlier, it has been much more difficult and costly for the banks to obtain financing other than at very short maturities. The banks' possibility to finance themselves is of course important to financial stability. It also affects other interest rates in the economy and thereby the impact of monetary policy. We at the Riksbank try to counteract these effects of the financial turmoil. We have therefore offered the banks financing – against collateral and at an interest rate – at longer durations than normal, and than what is currently available in the markets. We have so far granted loans in Swedish kronor at maturities of three months and six months to a total of SEK 203 billion. One can say that we in this way replace part of the bank's short-term financing with more long-term financing. This reduces their financing risk. It is important to point out that these measures do not have any direct monetary policy effects. The Riksbank supplies liquidity with regard to loans of longer maturities, but at the same time withdraws the same amount of loans with short maturities at the repo rate.

Another problem for the Swedish banks has been the shortage of loans in US dollars. Therefore we have also offered the banks loans in US dollars. Both the loans in kronor and the loans in US dollars have the aim to maintain financial stability by creating the right conditions for the markets to return to a more normal situation. This is also the aim of the Swedish National Debt Office's extra issues of treasury bills. A further effect of the measures is to improve the functioning of the mortgage bond market. For instance, the Riksbank accepts covered mortgage bonds as collateral for its loans to the banks. In addition, the

■ money from the Swedish National Debt Office's extra issues of treasury bills is mainly being invested in mortgage bonds.

To increase access to credit also for non-financial companies, the Riksbank has introduced a new temporary possibility for the banks to borrow against collateral consisting of more commercial paper than before. This means that the companies can obtain financing by issuing commercial paper and selling to the banks, which can in turn use this as collateral to borrow from the Riksbank. The interest on the loans provides compensation for risk and time to maturity and the banks can only use the credit facility if they buy *new* commercial paper. If large companies outside of the financial sector gain greater access to credit, then the banks should have more scope to lend more money to small and medium-sized enterprises as well.

### ***Liquidity assistance on special terms***

The Riksbank has also provided special liquidity assistance to two Swedish financial institutions, namely Kaupthing Bank Sverige AB and Carnegie Investment Bank AB. These loans have been granted against collateral and at an interest rate that is higher than the normal borrowing cost. Although neither of these two market participants has a dominant position in the Swedish market, the Riksbank chose in both cases in the current turbulent market situation to grant liquidity assistance to prevent serious disruptions to the financial system and to maintain confidence in Sweden's credit and payment systems. The decisions were based on assessments that the participants were solvent, but that they nevertheless were unable to acquire the necessary liquidity themselves to meet their payment obligations.

With regard to this type of loan, liquidity assistance on special terms, it is important to remember why they are being granted. The issue is to safeguard the financial system and important social values. It is *not* a case of rescuing banks and bank management for their own sake or that of the shareholders or of "giving away taxpayers' money" as it is sometimes wrongly described in the debate.

### ***In the long term we need a well-developed system for managing insolvent institutions***

The Riksbank's possibility to provide liquidity assistance to a financial institution when financial stability is threatened assumes that the institution is solvent and able to continue to pursue its operations. In the case of Carnegie, Finansinspektionen withdrew the institution's licence to conduct banking operations on Monday this week. The Riksbank then withdrew its liquidity assistance to the bank, as it no longer met the criteria for being granted this type of credit. The Riksbank's loan to Carnegie Investment Bank AB has been repaid by the Swedish National Debt Office, which has taken over the debt and now owns the company.

The Debt Office can now take over a financial institution, as in Carnegie's case. This applies in a situation where an institution that does not meet the requirements for liquidity assistance from the Riksbank has to default on its payments and this is assessed to threaten financial stability. This is made possible by the stability plan for the financial system decided by the Riksdag just over two

■ weeks ago. The stability plan also means that the government can extend guarantees to individual institutions or to a group of institutions. These are important components for putting together a suitable financial safety net and I welcome the Riksdag's decision. I also believe that it would be good if we further develop this legislation in the long term. It should be possible for the government to reconstruct a credit institution without having to take over ownership. And it is not only in situations where financial stability is seriously threatened that such laws and regulations are needed for banks and other credit institutions. It is important for the credibility of the banking system as a whole that there is a regulatory framework which amongst other things enables depositors to quickly regain their money.

### **Monetary policy and the financial crisis**

A small, export-dependent economy like Sweden's is not unaffected by world economic activity and what is happening in the global financial system. In a way, I think that one can say that the distinction between monetary policy and financial stability is erased when a financial crisis breaks out. If one does not forcefully counteract the crisis, there is a risk that it will have a strong impact on inflation and growth. The decline in production and employment can then be both profound and prolonged.

Monetary policy cannot solve all of the problems in the financial markets. This requires additional measures. And as I said, such measures are now being taken in most parts of the world now, as well as in Sweden. But monetary policy can *alleviate* the effects of the financial crisis on the economy. The Riksbank has also implemented monetary policy measures, largely as a result of the international financial crisis. In the space of just over two weeks, we cut the interest rate on two occasions, by a total of one percentage point, to 3.75 per cent.

### ***Rapid change in the situation when anxiety escalates in mid-September***

Normally, we raise or cut the repo rate in smaller steps and emphasise that it is a series of interest rate decisions and not one single interest rate adjustment that is important. When we raised the interest rate by 0.25 percentage points at the beginning of September it still appeared as though the Swedish financial markets would be relatively spared from the effects of the financial turmoil then prevailing in the world markets. The majority assessment of the Executive Board was that inflationary pressures were too high for the economic downturn to bring inflation back to the target of 2 per cent quickly enough without a high interest rate. Of course, we did not know then that the international economic situation would soon look very different, although we were aware of both upside and downside risks.

Just over a week later, investment bank Lehman Brothers suffered serious problems and filed for bankruptcy protection, in accordance with US bankruptcy legislation. The financial anxiety then escalated considerably. We were soon in a situation where the global financial crisis paralysed many credit markets. It became clear that the crisis severely aggravated the ongoing economic downturn, which together with falling commodity prices had a considerable dampening effect on inflationary pressures. Both we and others assessed that a rapid and

■ substantial interest rate cut was necessary to alleviate the effects of the crisis. On 8 October the Riksbank and several other central banks, including the Bank of England, the ECB and the Federal Reserve, decided to cut our policy rates in a joint action. This action has later been followed by several interest rate cuts by central banks around the world. Last week, for instance, the ECB cut its policy rate by half a percentage point and the Bank of England cut its rate by 1.5 percentage points.

### ***The most recent interest rate decision***

Just over two weeks' later, at the monetary policy meeting held on 22 October, the Executive Board of the Riksbank decided to cut the repo rate by a further 0.5 percentage points to 3.75 per cent. In our forecast for the future repo rate we are also expecting that it will be necessary to cut the rate by a further 0.5 percentage points within six months. The purpose is to alleviate the effects of the financial crisis on production and employment, and at the same time to attain the inflation target of 2 per cent. In the current situation with considerable uncertainty in the world economy, it is important, as I said at the beginning, that we are flexible and prepared to act quickly and forcefully. One expression of this is that we are expecting to all in all cut the interest rate by a relatively large amount during a short period of time.

### **Less impact than usual to begin with**

The effects of the lower repo rate will probably initially be weaker than usual. As I mentioned recently, the confidence crisis and the uncertainty in the financial system have led to high risk premiums. This means that some market rates are not affected by the development of the repo rate in the same way as usual. For instance, it is not certain that the loan costs faced by households and companies will fall as much as they usually do when the repo rate is cut. To correct the problems in the fixed-income and credit markets it is necessary to implement other measures beside monetary policy. But this is, as I mentioned earlier, something we and other authorities are working on, both in Sweden and abroad.

### **Other effects of the international financial crisis**

One important reason for the interest rate cut is that the crisis in the financial markets has led to higher loan costs for companies and households than we had anticipated in our assessment at the beginning of September. Access to credit has also declined. As I mentioned earlier, this has a restraining effect on the economy, not least in that investments fall. Developments on stock markets around the world have fluctuated considerably and on the whole there has been a substantial fall. In many countries property prices are also falling, but in Sweden the decline has on the whole been fairly limited so far. However, all in all this development has led to a decline in wealth for many Swedish households, which is expected to dampen consumption. Various surveys indicate that households and companies have a more pessimistic view of the future now.

The financial crisis has contributed to a deterioration in the prospects for global economic activity and to dampening international demand. The price of many commodities, such as oil and food, has fallen. This gives lower inflationary pressures. When international demand is lower, the Swedish economy is also

■ affected via exports. We are assuming that exports will slow down next year, but recover during 2010.

It is also clear that the uncertainty in the economy has increased in general. This affects households' and companies' financial decisions regarding the future. The uncertainty can also have contributed to the recent substantial weakening in the Swedish krona against most other currencies. It is not unusual that the value of currencies of small and very export-dependent economies, like Sweden's, falls in times of market turbulence. This was the case, for instance, after the Asia crisis and the acts of terrorism on 11 September 2001. Although a weaker exchange rate contributes to boosting exports, the effects are limited if international demand is low. At the same time, a weak krona provides higher imported inflation. We are expecting the exchange rate to strengthen in the slightly longer term, but to remain weak until the most acute stage of the crisis is over.

To summarise in brief, we are assuming that the financial crisis will in various ways make the wheels of the economy turn much more slowly. Growth is expected to slow down both in Sweden and abroad. Our forecast is that the increase in GDP in Sweden, Europe and the United States will remain around zero next year, but recover in 2010 and 2011.

### **The labour market, resource utilisation and inflation**

In that the financial crisis aggravates the ongoing economic downturn, we are assuming that the labour market will show weaker development and that inflation will be lower than we forecast at the beginning of September. Resource utilisation in the economy is still at a slightly higher level than normal. However, we are assuming that it will fall rapidly and be somewhat lower than normal over the coming years. Inflation is still high at the beginning of the forecast period. But during next year we are expecting it to fall rapidly. Opinion polls also indicate that inflation is expected to be lower in the future. Our assessment is that inflation will be below two per cent in 2009. It will then rise slightly and be on target in 2011.

### **Considerable uncertainty in the assessment**

I would like to add that the uncertainty in our assessment is unusually large on this occasion. As always, it is therefore important to remember that the path we present for the repo rate is a forecast and not a promise. It may be necessary to cut the rate more, or less, than we are assuming now. If the financial crisis worsens, or if the effects on production and employment are more powerful than we believe, a lower interest rate might be necessary. However, if the krona were to remain weak or if inflation were to become entrenched at a high level, a higher interest rate might be necessary. The interest rate decisions we will make in the future will depend quite simply on how new information affects the outlook for inflation and economic activity in Sweden. We are following developments closely and are prepared to take action when necessary.

### **A concluding reflection**

Around 15 years ago I was appointed head of the Swedish Bank Support Authority. Sweden was in the midst of a deep economic crisis; a crisis which had largely been caused by problems on home ground. The situation was serious, not

■ least for the bank system, where loan losses during the recession totalled record sums. The Bank Support Authority was established as one of the measures taken to prevent the collapse of the Swedish financial system, in particular the payment system. Today we are once again in a situation where such bank support authorities are being established in many parts of the world, including Sweden. We are also facing a period of poorer economic activity. But this time the situation is very different for Sweden.

### ***Experience and measures have given resilience***

The anxiety that has had a stranglehold on the financial markets since the end of September comes from outside this time, not from problems in the Swedish bank sector. Swedish banks have on the whole shown much more responsible credit granting, both compared with the years following credit deregulation and compared with parts of the US mortgage market. The banks have good capital buffers and can manage substantial loan losses, even if they are nevertheless affected by the general mood of distrust on the market. We are also much better equipped in many ways to meet an economic downturn than we were at the beginning of the 1990s. I am thinking here of the effects of the changeover in monetary and fiscal policy after the crisis, and the fact that we now have sound public finances and a substantial surplus on the current account.

Although a small, open economy like Sweden's is never immune to what is happening in the world economy, and particularly to an international financial crisis, we learnt a lot from the difficult years in the 1990s. This applies to the banks as well as to the supervisory authorities and the political system. We tackled many difficult problems, although it was unpleasant, and resolved their underlying causes. This has definitely given us better resilience to what is happening now.

### ***At what stage is the global financial system now?***

The global financial system is currently in the middle of such a process. Deficiencies in the system that have lain in wait in many parts of the world have now come into focus in an acute situation. This includes supervision, regulatory frameworks and the possibility for insight with regard to somewhat fanciful constructions of financial instruments. And it is not only the regulations and supervision that need to be reviewed and harmonised between countries - the same applies to the frameworks for crisis management and financial stability. Otherwise one country's crisis management can easily become another country's problem. We can now see examples of initiatives taken towards better and more coordinated crisis management in the EU, for instance.

Now we are facing the task of fixing what is broken so that it will stay fixed and function better in the future. This applies both to resolving the deadlock on certain markets and the distrust that has been created within the financial system, as well as putting the problems to rights in the long term. Some measures have already been taken and more are on the way. It is not a simple process and it will probably take some time before the measures take full effect. But once we have closed the accounts on this crisis, we will hopefully have purged the parts that function poorly and replaced them with something better. It is necessary for the financial system to function in a safe and efficient manner for the central banks to

- be able to conduct monetary policy efficiently. This is a necessary condition for good and sustainable economic development on the whole. I have every hope that we can work together to achieve this!