SPEECH

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SPEAKER: Deputy Governor Svante Öberg

LOCATION: Carlson Investment Management

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

■ Sweden and the financial crisis

Introduction

When I began working at the Riksbank three years ago, I had not during the preceding eight years followed the development of the economy as closely as when I worked at the Ministry of Finance and the National Institute of Economic Research. I was advised by Staffan Viotti, who is a professor of financial economics and adviser to the Executive Board, to familiarise myself with the new financial instruments that had been developed in recent years. These were instruments that the banks used to convert loans into securities that could be sold on the financial markets. I attended a couple of conferences which clarified the advantages of the new instruments; for example that they spread the risks taken by the banks to a larger group of investors. There was really only one problem. Liquidity on the new markets could "dry up", that is, a situation could arise in which there were only sellers but no buyers, but this was considered to be a hypothetical problem. I also asked experts at these conferences about the possible nature of the next financial crisis. A typical answer was that it would be triggered by an event outside the United States and that the hedge funds would be involved.

Now we know better. The crisis was triggered in the United States on the market for mortgages to households with a poor ability to pay, what are known as subprime loans. Hedge funds have played a limited role in the development of the crisis. Instead it is highly leveraged institutions that have been central to the sequence of events, where some of the lending has been outside of the banks' balance sheets.

My main messages today are that so far Sweden has been able to handle the problems that the global financial crisis has caused for the financial system, although the negative consequences for the Swedish economy will be considerable over the next two years. And that there is a need to reform the global financial system in order to reduce the likelihood of new financial crises.

I have divided my speech into three sections. I shall begin with the financial crisis in an international perspective: the course of events, the causes of the crisis and the handling of the crisis. Then I shall discuss how Sweden has been affected by the crisis: Sweden's dependence on the outside world, measures to counter the crisis and our experience of previous financial crises. I shall conclude with a section on the current economic situation and monetary policy, where I shall comment on new statistics without making any new assessment of monetary policy.

The financial crisis in an international perspective

Course of events – from increased spreads to bank failures

Developments during the financial crisis can be illustrated in several ways, for example by using the so-called TED-spreads[1], that is, the difference between three-month interbank rates and government security rates.

The first signs of problems emerged already at the beginning of 2007 when the interest rates of certain so-called structured products with links to the US housing market began to increase. They fell during the spring but rose again in mid-June 2007 when the US investment bank Bear Sterns was forced to liquidate one of its hedge funds due to major losses.

But it was in August that the indications of an approaching financial crisis became clearer and the TED spreads increased significantly. One reason for this was that the French bank BNP Paribas announced that it had stopped withdrawals from three of its mutual funds. The lack of liquidity in certain market segments with financial instruments linked to the US housing market had made it impossible to value the underlying assets. The banks began to protect their own liquidity and were unwilling to lend to each other. The gap between the "uncertain" interbank rate and the safe government security rate increased.

The degree of financial unease then varied during the course of the following year. The TED spreads peaked when the banks wanted to secure their liquidity ahead of the turn of the year 2007-2008. A further peak was reached in March 2008 when Bear Sterns suspended payments, but things calmed down again after the Federal Reserve mediated the takeover of the bank by JP Morgan.

In mid-September 2008, when Lehman Brothers was forced to file for bankruptcy protection, the financial unease became an acute financial crisis. The TED spreads were driven up to very high levels. Many banks, institutions and funds were highly exposed to Lehman Brothers. Few had expected that such an important bank could fail. Previously the US authorities had let the shareholders take the consequences. Now the borrowers also had to take some of the losses. There was a great deal of concern that more players would end up in a similar situation. The remaining large investment banks in the United States also disappeared as independent investment banks.

The TED spreads have risen and varied during different periods of time in Sweden, too, but they have been lower than in the United States and the euro area.

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[1] The TED spread is the difference between an interbank rate and a government bond rate. As the banks lend to one another without collateral (that is, with a credit risk) in the interbank market, while government securities are considered to have no credit risk, the TED spread can be interpreted as a measure of the uncertainty in the financial markets.

Causes of the crisis – mortgages, imbalances and inadequate supervision

The factor that triggered the financial crisis was thus the problems on the US housing market and mortgage market. An important element behind the prolonged rise in US housing prices was the rapid growth of lending for house purchases to low-income households- Since the mid-1990s, politicians had been encouraging these households to own their own homes by setting quantifiable targets for how much lending from the mortgage institutions should increase[2]. Subprime loans had become increasingly common and many households bought houses in the belief that house prices would continue to rise. When prices on the saturated housing market then began to fall in 2007, many US households with subprime loans found themselves in a situation where they were too highly mortgaged in relation to their incomes, and the credit losses of the mortgage institutions consequently increased.

The subprime loans are, however, not the only underlying cause of the crisis. One important cause is the imbalances in the global financial system that have built up over a long period of time. The years 2002 to 2006 were marked by strong growth in the global economy, the expansion of credit, historically low interest rates and a dramatic rise in housing prices and other asset prices. The United States built up large deficits in its current account, which it could fund because other parts of the world, mainly China and the oil-producing countries, built up large surpluses in their current accounts.

Another cause behind the crisis is the structured credit products which form part of the financial innovation. Subprime loans were often packaged together with other loans. This resulted in complicated financial products that were sold on by the banks that were responsible for granting the loans to other banks and financial agents. The products were difficult to gain insight into and therefore often came to buyers who found it difficult to assess the risks they had purchased. When the credit losses increased there was uncertainty over where the losses would finally appear. This is in turn led to reluctance on the part of banks and other players to lend money to one another. The structured credit products were created to make the management of credit risks more efficient. At the same time, they in practice contributed to building up the risks that have made the financial crisis so severe.

There have also been problems with credit rating agencies (such as Standard & Poor's, Moody's and Fitch). These agencies used similar methods for evaluating the structured products as those used for ordinary bonds. Many investors assumed that the credit ratings covered all of the risks, despite the fact that they really only focussed on the credit risk and ignored the liquidity risk, which can often be substantial for structured products. This meant that the credit ratings often underestimated the risks to which investors were exposed. This has greatly undermined the credibility of the credit rating agencies and they have a tough job ahead of them to build up this confidence once again.

The supervision of the financial markets has not been effective enough either. In the United States, responsibility for supervision is divided between a large number of authorities and in Europe between a large number of countries, which

[2] See, for instance, the Community Reinvestment Act.

makes it difficult to take the overall approach required. Another problem has been that the causes of the crisis largely relate to macroeconomic phenomena such as the development of housing price bubbles, while supervision traditionally focuses on microeconomic issues such as how individual institutions manage their lending. Nor have the supervisors reacted to the fact that the banks have built up considerable risks alongside their balance sheets. These risks have then returned to the banks via lines of credit, that is, earlier loan agreements entered into, and in other ways when the funding problems have increased.

There are further reasons behind the crisis. For example, the regulations for the financial markets have been procyclical, that is they have tended to reinforce cyclical fluctuations. There has also been a rewards structure among the private players on the financial markets that has encouraged a short-term approach and a high level of risk taking.

Handling of the crisis

The authorities in Europe and the United States have tried to counter the effects of the crisis in a variety of ways and to restore confidence on the financial markets.

The central banks have primarily contributed by adding large amounts of liquidity via loans against collateral to the banks. This has been necessary as the banks have found it difficult to borrow in the short and medium terms. In order to solve this problem, central banks in many countries have provided the funding that the banks have not been able to acquire on the market. Several central banks have also actively handled problems in individual institutions. One example is the Bank of England, which in September 2007 provided liquidity assistance to the British bank Northern Rock. Another example is the Federal Reserve which granted an emergency loan to the US investment bank Bear Sterns in March 2008 when the bank experienced an acute shortage of short-term funding. It was, however, not possible to rescue Bear Sterns and the Federal Reserve helped to mediate the takeover of the bank by JP Morgan. During the autumn of 2008, the central banks also rapidly and significantly cut their policy rates, sometimes in coordinated actions, to dampen the effects of the crisis on macroeconomic development.

Governments have offered guarantees and capital injections to minimise the risk of further bankruptcies in the banking sector. Concern over banks and other financial players going bankrupt has namely been a central component of the financial turbulence. Given the vulnerable situation that the global financial system is now in, it may be unwise to let systemically-important financial institutions go bankrupt. Several countries have also decided on a more expansionary fiscal policy to counteract the downturn in economic activity. During the spring and summer of last year, the US government began to issue tax rebate cheques. Since then, several decisions on measures to stimulate the economy have been taken in the United States and in European countries, but also, for example, in China.

Despite these measures, the financial markets are still functioning much less efficiently than normal. Ongoing measures are therefore required to improve the functioning of the financial system.

There is a need to reform the global financial system in order to reduce the likelihood of new financial crises. It is probable that the problems on the financial markets have been aggravated by weaknesses in regulation and supervision. There is therefore room for improvement. However, the changes that are made should be carefully prepared and fully justified so that regulations are not introduced that will have more negative than positive consequences. Allow me to mention a few examples of possible improvements.

In the first place, we need to develop the supervision of the financial system. The basic problem is that the financial markets are international while supervision largely takes place at the national level. In Europe, there is therefore a need to strengthen the coordination between supervisory authorities in different countries. Work on this is already underway within the European Commission and in various committees. Supervision must also focus to a greater degree on macroeconomic problems. I personally believe that in the long run we should set up a European supervisory authority with responsibility for supervision of the financial institutions and markets across Europe. This must then cooperate with financial supervisory authorities in Europe and other parts of the world.

Secondly, there is a need to improve the handling of cross-border crises. Financial crises tend to spread from one country to another. For example, many financial institutions have operations in more than one country. When such an institution experiences difficulties this therefore has an impact in several countries. An example of this is the Belgian bank Fortis and the events relating to the rescue of the bank by the authorities in Belgium, the Netherlands and Luxembourg. Crisis management becomes more effective if contacts and concrete arrangements between the countries are already in place. It also becomes simpler to decide how the costs of crisis management should be divided between the countries concerned. Joint crisis management exercises and a better flow of information between the relevant authorities in the countries concerned also facilitate cooperation in the event of a real crisis.

Thirdly, the credibility of the credit rating agencies needs to be restored. They have played a central role in the events of the current financial crisis and their credibility has been seriously undermined. This is, however, an area where it is easy for regulation to go too far. I believe that to a large extent we can and should trust in the ability of the credit rating agencies to develop their evaluation methods and to restore confidence. Some form of registration and supervision may also be needed, but this should not involve intervention in the independent evaluations of the agencies.

Fourthly, the deposit guarantee schemes need to be harmonised. During a financial crisis, it is important that there is a system of deposit guarantees to reduce the likelihood of a bank run. There have been such schemes in all of the EU countries for several years now with a minimum level of EUR 20,000. However, they are designed differently in different countries. The Riksbank has therefore argued in the context of European cooperation that these schemes should be harmonised. Under the pressure of the financial crisis last autumn it was decided that the guarantee level should be at least EUR 50,000 in all countries and in the longer term EUR 100,000. However, there are still differences regarding the funding of the guarantees and other regulations. These differences distort competition between the banks in different countries. They also make it more difficult to achieve effective crisis management.

How Sweden is affected by the financial crisis

Sweden's dependence on the outside world

Sweden is highly dependent on events in the world around us. Sweden is a small and open economy with extensive foreign trade and a financial market that is well integrated with the international markets. Sweden's dependence on the outside world has increased over time. This means that a global financial crisis combined with a severe international economic downturn has a substantial impact on the Swedish economy.

One way of illustrating a country's dependence on developments internationally is to consider exports and imports as a proportion of the total balance of resources. The proportion of Swedish exports has, for example, increased from just over 20 per cent in 1990 to around 40 per cent in 2007. This means that an international economic downturn and a decline in the demand for Swedish export goods have serious consequences for production and employment in Sweden.

The financial links between countries have also become stronger and make the Swedish banks dependent on the outside world. Market funding, that is, funding that is not in the form of deposits, accounts for around 60 per cent of their total balance sheets and is acquired on international markets. Both market funding and the banks' operations abroad have increased substantially over the past ten years. This means that events abroad have an increasing impact in Sweden.

The long-term interest rates for government bonds in different countries usually follow one another quite closely. There is also a close correlation between the stock markets and expectations regarding the future. These links may be one explanation as to why the development of GDP in different countries is currently very consistent. Traditionally, there has been a time lag between developments in economic activity in the United States and Europe, such that an economic downturn in the United States has also been followed by a downturn in Europe, but at a somewhat later date. An issue that has been widely discussed in the last two years is whether other parts of the world would be able to avoid a recession despite the weak development of the US economy, that is if so-called decoupling could arise. We can now note that the rest of the world is following in the wake of the United States into an economic downturn and the debate on decoupling has faded.

Measures to counter the crisis

Sweden has so far been able to manage the problems caused in the financial system by the global financial crisis. The Swedish banks are profitable and have substantial buffers following a number of good years. They have not granted loans as hastily as the banks in the United States and they have not been exposed to any great extent to the type of financial products that have been part of the problem. The TED spreads have not been as large as in the United States and the euro area. The interbank market for overnight loans has functioned well in Sweden throughout the crisis, unlike in many other countries. But the Swedish banks have nevertheless experienced problems with funding and this has required that a number of measures be taken by Swedish authorities.

The Riksbank has implemented a large number of measures to safeguard financial stability and mitigate the negative effects of the financial crisis. These measures have largely related to the provision of liquidity. Liquidity can be supplied generally to the market or in the form of specific assistance for individual financial institutions. The Riksbank has used both of these alternatives.

The general liquidity assistance has been designed so that the Riksbank has supplied the banks with loans in kronor and dollars at longer maturities than the market has been able to offer. In total this lending has amounted to over SEK 450 billion. Lending in kronor has increased by more than SEK 250 billion and lending in dollars by almost SEK 200 billion. This means that the Riksbank's balance sheet for the second half of 2008 has increased from SEK 200 billion at the end of June to SEK 700 billion at the turn of the year.

The loans from the Riksbank together with Swedbank's borrowing under the government's guarantee programme mean that the State provided or guaranteed more or less all of the banking sector's borrowing in the last few months of 2008.

The Riksbank has also set up a temporary credit facility based on commercial papers in order to improve the supply of credit for non-financial companies. These companies can fund their operations by issuing commercial papers and selling them to the banks. The commercial papers can then be used by the banks as security for loans from the Riksbank. However, the scope of these activities has been fairly limited.

The Icelandic bank Kaupthing experienced problems in Iceland and the Riksbank granted the Swedish subsidiary Kaupthing Bank Sverige AB liquidity assistance in October 2008. Carnegie Investment Bank AB also received liquidity assistance in October when it had problems finding funding. Given the financial market turbulence, the Riksbank’s assessment was that a suspension of payments by one of the banks could entail a risk of a serious disruption in the financial system and could undermine confidence in the payment system. Finansinspektionen (the Swedish financial supervisory authority) later revoked Carnegie’s licence to conduct banking activities. The Swedish National Debt Office took control over Carnegie and Finansinspektionen therefore changed its decision regarding the revocation of the licence to instead giving the bank a warning. The Riksbank’s liquidity assistance has been repaid.

The Riksbank has also participated in the international cooperation to strengthen financial stability in Sweden's neighbouring countries. In May 2008, the Riksbank and the central banks in Denmark and Norway entered into a euro/Icelandic kronor swap agreement with the central bank of Iceland. The aim of this swap agreement is to support the Icelandic central bank in its efforts to safeguard macroeconomic and financial stability. Sweden's part of the swap agreement amounts to EUR 500 million. The agreement was extended in December after the IMF had drawn up a programme for financial assistance for Iceland.

Latvia has negotiated a support package with the IMF and the EU which will make it possible for the country to retain its fixed exchange rate against the euro. In December, the Riksbank and the Danish central bank entered into a swap agreement with the Latvian central bank. Under this agreement, Latvia may borrow up to EUR 500 million in exchange for Latvian lats. The intention was that this agreement would act as temporary funding in order to strengthen financial stability in Latvia until the IMF decided on its support package. The support package was approved by the IMF just before Christmas.

It is not only the Riksbank that has taken action to counter the effects of the financial crisis. The Swedish National Debt Office, Finansinspektionen and the Government have also acted to safeguard the functioning of the Swedish financial system and to mitigate the effects of the crisis on the real economy.

The National Debt Office has acted to meet the dramatic increase in demand for treasury bills. Extra auctions have been held in order to issue larger volumes of short-term treasury bills than normal. By the turn of the year, the National Debt Office had issued more than SEK 190 billion in treasury bills over and above the regular loan programme.

During the autumn, Finansinspektionen decided to change the regulations for calculating the discount rate for life insurance companies. The aim was to arrive at a more reasonable calculation of the companies' debts and to mitigate disruptions on the bond markets. Finansinspektionen has also altered the capital adequacy rules for credit institutions and securities companies. The aim of this change is to make it possible for the financial companies to strengthen their capital situation by being able to have a greater proportion of financial instruments other than shares in their capital base.

At the beginning of October, the Government decided to increase the maximum sum in the deposit guarantee scheme and to extend the scheme to cover all types of deposit in accounts. During the autumn, the Government also presented a plan to further safeguard the stability of the financial system. This plan includes a guarantee programme of a maximum of SEK 1,500 billion to support the medium-term funding of banks and mortgage institutions. It also comprises a stability fund to handle any future solvency problems in Swedish institutions. In common with several other countries, Sweden is also pursuing an expansionary fiscal policy in order to counter the downturn in economic activity.

Experiences of earlier financial crises

The negative consequences for the Swedish economy will be considerable over the next two years. There are two essential differences between the current financial crisis and the Swedish bank crisis at the beginning of the 1990s. Firstly, the current crisis is a global one, spread over a large number of markets, assets and institutions, while the bank crisis at the beginning of the 1990s was limited to Sweden and other Nordic countries. Secondly, the major problem so far has been the financing of the banks' operations, while the problem last time was credit losses linked to falling property prices. The positive element here is that the current problems are not due to poor profitability or large credit losses. The negative element is that even a country with a profitable bank system with large buffers can experience problems. Iceland is one example of how a small country with an open economy and its own currency can be affected by a financial crisis.

I pointed out on several occasions at the monetary policy meetings held last year that there is a considerable risk that the crisis will be both more profound and more prolonged than we assume in our forecasts. I would like to take this opportunity to develop my reasons.

Kenneth Rogoff is another of the advisers to the Executive Board of the Riksbank. Together with Carmen Reinhart he has made a number of studies of financial crises. They consider the Swedish bank crisis of the 1990s to be one of the most serious financial crises, "the big five"[3]. One of their studies shows that the financial crises that have occurred in industrial nations in recent decades have been followed by long periods of weak growth[4]. Seen as an average of the 18 crises reported, this concerns a period of three years of low growth and for the "big five" an average of three years of negative growth.

The most recent study also includes financial crises in emerging economies[5]. Here they point to three common features. Firstly, house and share prices fall substantially and over a long period of time. For house prices the average fall in real terms is 35 per cent extended over six years and for shares it is 55 per cent over three and a half years. Secondly, production and employment fall. On average, GDP per capita falls by 9 per cent over two years and unemployment rises by an average of 7 percentage points over four years. Thirdly, central government debt almost doubles, not as a result of the costs of recapitalising the financial system, but due to falling tax revenues and fiscal policy stimulation measures.

How relevant are these comparisons in analysing the current crisis? Reinhart and Rogoff themselves point out on the one hand that the monetary policy frameworks are now more flexible and that the central banks have acted more aggressively than before. On the other hand, the crisis in question is a global financial crisis, which makes it more difficult to grow out of the crisis by, for instance, increasing exports than when it is a national or regional crisis as most of the previous crises have been.

My assessment is that one should not attach too much importance to the exact figures. They are dependent on which countries are included in the averages. But they nevertheless imply that there is a tangible risk that the economic downturn will be both more profound and more prolonged than we are assuming in our main scenario, and that 2010 will also be a year of weak or negative growth in many countries.

The current economic situation and monetary policy

Using monetary policy to combat a financial crisis is not particularly effective. It is not possible to manage a financial crisis by means of adjustments to the repo rate. The Riksbank has therefore been concentrating on other measures to promote financial stability since the Lehman crisis. On the other hand, monetary policy can be used to alleviate the effects of the financial crisis on macroeconomic developments.

At the most recent monetary policy meeting on 3 December, we Executive Board members decided to cut the repo rate by 1.75 percentage points. This was the largest cut made since the repo rate system was introduced in 1994. It meant that during the autumn the Riksbank had cut the repo rate from 4.75 per cent to 2.00 per cent. The ECB has also cut its policy rate over the past two months to the current 2 per cent and in the United States the policy rate is close to zero.

[3] The countries that have suffered these crises are Finland, Japan, Norway, Spain and Sweden.
[4] Carmen M. Reinhart, and Kenneth S. Rogoff. "Is the 2007 U.S. Subprime Crisis So Different? An International Historical Comparison." *American Economic Review* Vol. 98 No. 2: 339-344. (2008).
[5] Carmen M. Reinhart, and Kenneth S. Rogoff. "The Aftermath of Financial Crises." Paper prepared for presentation at the American Economic Association meetings in San Francisco January 3, 2009.

We Executive Board members were agreed that a large cut in the repo rate was necessary to dampen the rapid economic downturn that had become evident. Inflation had already begun to decline and is expected to undershoot the Riksbank's target of 2 per cent in 2009. However, underlying inflation, which is when the effects of our own interest rate cuts and falling energy prices are excluded, will be close to 2 per cent during 2009, according to the forecasts in the Monetary Policy Update.

A complicating factor is that the relationship between the repo rate and market rates has not been normal in recent months. Market rates fell less than might have been expected when the repo rate was cut in October. The spread between the repo rate and the banks' lending rates increased. But towards the end of the year the repo rate cut had a greater impact. For instance, short-term mortgage rates have been lowered more or less as much as the repo rate up to January. But in other areas the difference between the repo rate and market rates is much greater.

The financial crisis has also affected the Swedish krona. However, the Riksbank's assessment is that the weakening of the krona is temporary and primarily a result of the financial crisis. In times of financial turbulence investors tend to turn to the larger currencies, which are regarded as "safer". The result of this flight to quality is that smaller currencies like the Swedish krona weaken. The Norwegian krona has also depreciated substantially.

But there is a risk that this weakening will be more prolonged. This would normally lead to exports strengthening and imports slowing down, and at the same time provide an inflationary impulse. During a normal economic downturn it may be an advantage that the currency depreciates in this way and thus dampens the downturn. In the current circumstances, with a serious global financial crisis that may result in financing problems for entire countries, the situation may become more problematic. Several countries in Europe, in addition to Iceland, have seen their currencies depreciate substantially.

In December the forecast was that GDP will decline by 0.5 per cent during 2009, but that growth will recover in 2010. The information received since then indicates that GDP growth in the fourth quarter of last year was weaker than we had been expecting, which will also push down the average for the year 2009. Industrial production, production of services and the activity index all fell in November. The National Institute of Economic Research's Economic Tendency Survey and the purchasing managers' index continued to fall in December, reaching all-time lows.

Inflation fell from 4.0 per cent in October to 0.9 per cent in December. Inflation was much lower than we had expected in December, as a result of the repo rate cuts made in the autumn having a greater impact on mortgage rates than anticipated and petrol prices being lower than forecast. Underlying inflation excluding interest rates and energy (the CPIF excluding energy) declined slightly from around 2 per cent earlier this year to 1.7 per cent in December, entirely in line with the forecast at the most recent monetary policy meeting.

The krona has weakened further since the beginning of December. Since the financial crisis moved into an acute phase in mid-September, the krona has weakened by around 12 per cent when measured against a trade-weighted index. This could give a slightly larger inflationary impulse than we had previously forecast.

- There are a number of signs that the situation in the financial markets has improved somewhat since the beginning of December. The TED spreads have fallen to the levels that applied prior to September and it has to some extent been possible to issue bonds. The forceful measures taken in many countries have in any case meant that it has been possible to avoid a collapse in the financial markets. But there are other signs that are more worrying. The financial markets are still far from functioning normally. Surveys indicate that the companies' difficulties in obtaining loans have increased, although there is as yet no solid data showing that bank lending has begun to decline. Another problem is that the difference between rates on different euro countries government bonds has increased, at the same time as one can envisage substantially increasing deficits in public funds and thus an increased supply of government bonds.

Concluding remarks

My main messages today have thus been that so far Sweden has been able to handle the problems that the global financial crisis has caused the Swedish financial system. However, the negative consequences for the Swedish economy will be considerable over the next two years. And the global financial system needs to be reformed to reduce the likelihood of new financial crises.

The new information received since the most recent monetary policy meeting at the beginning of December indicates lower growth and inflation at the end of last year than we had forecast. However, the krona has weakened further, which can lead to some inflationary impulses. But more information will have come in by the time we are to make our next monetary policy decision in early February. Not until then will I take a stance once again on the future direction for monetary policy.