SPEECH

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Introduction on monetary policy

In September last year the global financial crisis gained a serious hold on the Swedish financial markets. Since then the Riksbank has cut the repo rate by a total of 3.75 percentage points to 1 per cent – the lowest level since the inflation target came into force in 1995.

We have had outstanding loans to the banks of on average around SEK 370 billion since the end of September, slightly more than half of which has been loans in US dollars.[1] We are offering loans at longer maturities than normal. We have extended the types of securities that can be used as collateral for loans in the Riksbank. We have provided special liquidity assistance to two financial institutions; Kaupthing Bank Sverige and Carnegie.

Since the end of September we have implemented measures that have meant our balance sheet total has almost tripled! This sounds rather dramatic. At least in relation to the past 15 years. But managing our tasks, attaining the inflation target and safeguarding financial stability, makes different demands under different circumstances. The circumstances in recent months have required tools we do not normally need to take out of our toolbox. They have also required greater flexibility, speed and force in our actions.

When I was out ice skating at Norrviken not far from here a couple of weeks ago a metaphor came to mind for the way the Riksbank has to adapt to different conditions as they occur. It should be appropriate in this winter holiday period. Say that the ice you are skating on is good, but seems to become gradually worse the further you go. Then there is no harm in going a bit further – waiting and seeing what happens – as long as you are observant. Perhaps you will change course slightly to be on the safe side. More than that is not necessary. But let us say instead that the ice is suddenly really thin. Then it is no longer a good idea to keep on going and wait and see what happens further ahead. A minor change of course is not enough. If the conditions become really bad you will have to do even more – turn around immediately – to get back onto safe ice.

What I am trying to say is not that we are skating on thin ice. What I mean is that decisions are linked to, and must also be assessed on the basis of the situation in which they are taken – what information is available and what one believes lies ahead. Like when you are wondering whether you should carry on

[1] This calculation is based on the SEK/USD exchange rate on the respective auction date.

skating on ice that may be uncertain. How much do you need to change course for everything to go well? Like when we Executive Board members take a decision on what interest rate path is needed for inflation to be close to the target of 2 per cent a couple of years ahead. How much do we need to change it and how quickly?

Decisions in times of uncertainty and how we manage this is a recurring theme today. You members of the Committee on Finance will later be asking questions on the basis of the material for assessing monetary policy published by the Riksbank on 16 February.[2] Your views on our interest rate decisions of recent years – whether you consider they were well-balanced given the information at the disposal of the Executive Board at the time the decision was made – comprise important information for us. I am therefore looking forward to discussing the assessment later, during the actual hearing. But first I would like to talk about how the financial crisis affects the conditions for our policy. I shall also discuss the most recent interest rate decision and our readiness for dealing with unexpected economic developments.

The financial crisis affects the conditions for monetary policy

For a long time, the global financial crisis only had a fairly limited effect on the Swedish economy. But when the US investment bank Lehman Brothers filed for bankruptcy in September the uncertainty over borrowers' credit ratings increased dramatically. Access to credit in the financial markets around the world declined and the interbank rates, that is, interest on loans between banks, rose substantially in Sweden, too. In a couple of days we went from a situation where Swedish financial markets were functioning fairly well to one where some sub-markets were in principle at a standstill. We also went from expectations of a fairly smooth slowdown in economic activity, to significantly more gloomy economic prospects.

I myself was sitting in a meeting in Frankfurt when I was told over the telephone that the Swedish treasury bill market had been put on hold. This was on 18 September and it was now clear that events had put a spanner in our otherwise well-oiled financial works. This changed the conditions for our policy. Although monetary policy and financial stability have always been closely linked, under the circumstances that have prevailed since September one can say that the dividing lines between our two main tasks have in many ways been erased.

Financial stability affects monetary policy…

Our most important tool in conducting monetary policy is normally the repo rate. By adjusting it we can influence, by means of the banks and the rest of the financial system, the interest rates faced by households and companies when borrowing money. In this way we try to influence activity in the economy and ultimately inflation. It is therefore necessary for the payment system and credit markets to function so we can carry out our monetary policy tasks efficiently. Financial stability is thus a necessary condition for efficient monetary policy. As I have said on an earlier occasion, our task of safeguarding financial stability is in some ways like taking care of an electricity network. Most people give it very

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[2] See "Material for assessing monetary policy 2006-2008".

little thought until there is a power failure. But since last autumn one can say that there have been severe disruptions in the network and numerous measures have been required to keep the electricity flowing. Although there are some indications that the crisis is not as acute now as it was last autumn, many markets would probably not be functioning if the authorities in various countries were not regularly taking measures to promote financial stability.

The effects of the crisis are also still affecting the situation for monetary policy and access to credit in the economy. Although the spread between Swedish mortgage rates and risk-free securities such as government bonds has declined since the most intensive phase of the crisis, households are for instance still facing slightly higher interest rates than normal if they want to fix their mortgage rates at longer periods. The financial crisis may also result in declining access to credit. Many companies in the Riksbank's company survey state, for instance, that they are finding it difficult to borrow at longer maturities. The financial crisis has also contributed to a fall in equity and house prices. Lower wealth, together with the widespread uncertainty over future events, may lead to companies and households postponing investment and consumption. All of this affects the activity in the economy and is something we must take into account when formulating our policy. Many measures that are taken mainly with the aim of safeguarding financial stability at the same time have monetary policy effects. For instance, measures that lead to greater confidence in the markets contribute to lower interest rates and increased access to credit.

…and monetary policy affects financial stability.

But inversely, monetary policy also has an effect on financial stability through its influence on economic activity. An economic downturn normally leads to unemployment rising and more companies going bankrupt. Households and companies find it more difficult to pay interest and amortise their loans and the banks risk facing loan losses. The banks become more cautious, require larger margins and collateral as compensation for lending money. This reduces the supply of credit, which further reinforces the downturn in economic activity. In addition, it may be the case that the banks earn less money from their lending in such a situation. Lower wealth together with greater uncertainty over future economic developments can mean that households and companies neither will nor can borrow as much. To the extent that monetary policy measures alleviate the fall in economic activity, they are also beneficial to financial stability.

Measures to create confidence

The Riksbank and other authorities, both in Sweden and abroad, have regularly injected oil into the machinery to ensure that financial markets function more smoothly. To alleviate the type of effects I just mentioned. As I said earlier, in our case it is a question of taking measures to directly increase the access to loans in SEK and USD, providing the banks with loans at longer maturities and against a broader spectrum of collateral than normal. By allowing the banks to borrow against newly-issued commercial paper, we have also tried to facilitate the supply of credit to the corporate sector, although interest in these auctions has so far been moderate. As you know, we have also granted special liquidity assistance to Kaupthing and Carnegie. Other authorities have also taken significant measures.

These include various market measures taken by the Swedish National Debt Office and the fact that the Riksdag and Government have decided on and implemented guarantee programmes and changes in the law.

It is quite simply a question of using various tools that complement one another and together help to restore confidence in the markets. In some cases it merely concerns "being there" in the background in various ways. The total, massive stability measures taken around the world have had an effect. The fact that the spread between interbank rates and treasury bill rates with the same maturity has fallen is one example of this. But many ups and downs and a lot of work remain before we can declare this crisis officially over. And it is in the light of this that we must formulate our monetary policy.

The financial crisis has affected the conditions for our actions – how we need to work to manage our two main tasks. As long as the conditions require it, we will also take whatever measures necessary to safeguard financial stability. When necessary we will also act with greater flexibility, speed and force than usual regarding our monetary policy. The latter also affected our most recent interest rate decision and I will now go on to talk about this in more detail.

The most recent interest rate decision

As I have already mentioned, economic activity has weakened unusually quickly. In addition, there is considerable uncertainty regarding economic developments. To dampen the fall in production and employment, and to manage the inflation target of 2 per cent, our assessment was that it was necessary to adjust the interest rate forecast downwards and to quickly cut the interest rate at the same time. We therefore decided just over two weeks ago to cut the repo rate from 2 per cent to 1 per cent. We are also assuming that the interest rate will remain at around the same level over the coming year, with some probability of a further cut being necessary.

But the prospects are brighter further ahead. We are expecting that the measures taken by us and other authorities, both in Sweden and abroad, will contribute to the Swedish economy beginning a recovery next year. We are therefore expecting to begin raising the interest rate again towards the end of 2010, and fairly quickly, to just over 3 per cent at the end of our forecast period.

Sharp deterioration in world economic activity…

The main reason why we cut the repo rate and adjusted the interest rate forecast in this way is that economic activity has weakened both in Sweden and abroad – much more than we had expected in the assessment we made in December. To return to my ice skating metaphor – we were once again in a situation where conditions had changed so quickly that it was also necessary to change course significantly and at once.

Households' and companies' expectations of future economic prospects are now as low as they were during the crisis in the 1990s. And since last autumn in principle all types of confidence indicators around the world have fallen substantially. Almost all statistics on economic activity published since our December assessment have been worse than expected. The situation looks particularly gloomy in the United States and the euro area, but prospects have deteriorated more or less around the world. We have revised down our forecasts for growth in the world economy, and GDP in the countries that are our most important trading partners is expected to fall by around 2 per cent on average in 2009.

The fact that the economic downturn has worsened so substantially is largely due to the global financial crisis. The crisis leads to higher risk premiums and limited access to loans for households and companies. It also contributes to uncertainty and to lower wealth, which leads to a decline in consumption and investment. I have mentioned this earlier. The uncertainty regarding economic developments in the world in the future is also very widespread.

…naturally affects a small, open economy…

A small, open economy like the Swedish one is of course very much affected when world economic activity slows down. The statistics received show, for instance, that exports and export orders have fallen drastically. The krona has also remained weak, which is something that often happens to the currencies of small economies in times of turmoil. A weaker krona normally stimulates exports and thus growth. But as demand is also weak abroad, it is not certain that the effects will be so great. In addition, a weaker exchange rate means that imported goods will be more expensive, which pushes up inflation. But this effect is largely counteracted by the expectation that cost pressures and resource utilisation will be lower.

Labour market prospects have also deteriorated. The number of redundancy notices has remained as high as it was in the autumn. Our forecast is that unemployment will rise to just over 9 per cent during the latter part of 2010. Both the number of persons employed and the number of hours worked will fall. Labour productivity has been weak over a long period of time; it has even fallen, but in 2009 GDP is expected to grow more quickly than the number of hours worked. Productivity will thus increase again, albeit weakly to start with. We are expecting productivity growth to average at just under 3 per cent in 2010 and 2011.

…but brighter prospects await after the decline

The picture I have now painted is certainly not very cheerful. But global growth is expected to bottom out this year. Developments do look brighter for most countries as early as the beginning of 2010. As with all economic downturns, sooner or later there will be an upturn, although it may take time. It is necessary to adjust to the new conditions and it may take some time before households and companies have the confidence to begin consuming and investing again. But once the adjustment has come, when consumption and investment have picked up, the wheels of the economy will begin to turn more quickly. The stimulation from monetary policy, fiscal policy and other measures around the world will also contribute to dampening the decline and speeding up the recovery that is waiting around the corner.

As I said, growth here at home has weakened rapidly as well. Our assessment is that GDP during the final quarter of last year fell by almost 4 per cent on an annual rate, compared with the previous quarter. But we are also assuming that economic policy and various measures will slow down the fall in Sweden. The weak krona will also provide some assistance. And brighter prospects are in sight! We are expecting GDP to show a turnaround at the end of 2009, although growth will then be fairly modest over the coming two years. But as growth abroad increases it will also stimulate the Swedish economy. We are therefore assuming that growth will be around 4 per cent at the end of our forecast period.

However, the forecasts are of course very uncertain in this situation. And there are uncertainty factors that can push developments in different directions. One of the prerequisites for our forecasts is that the measures taken to improve the functioning of the financial markets will have an effect. But in a crisis that is as closely linked to lack of confidence as this one, the recovery could come very quickly once the distrust is dispelled. We assume that our forecast is fairly cautious. Compared with other recessions, the recovery predicted for Sweden is fairly slow, although quicker than that following the financial crisis of the 1990s.

Large fluctuations in CPI inflation and the interest rate

We are expecting fairly large fluctuations in CPI inflation in the coming period. This is largely connected to the substantial changes in the repo rate in our forecast. Our inflation target is formulated in terms of the change in the CPI, and I would therefore like to pause and develop this a little further.

CPI inflation has fallen rapidly in recent months and we are assuming that this will continue during 2009. The annual change in the CPI is expected to be at its lowest in September this year, when it will be -1.6 per cent. This fall is largely due to the rapid interest rate cuts we have made during the autumn and now in February having an impact on the part of the CPI that reflects housing costs. It is also due to the fall in energy prices.

However, if one disregards the cost of mortgage rates the picture is quite different. Inflation measured in terms of the CPIF, which disregards changes in mortgage rates, is around 1.6 per cent on average in 2009. And if one moreover disregards the change in energy costs from the CPIF the forecast is even higher. According to our assessment, the CPIF excluding energy will increase on average by just over 2.2 per cent a year.

There are several reasons why underlying inflation trend is being held up. Unit labour costs have increased fairly rapidly over the past two years and resource utilisation has been high. In addition, the krona has been weaker, which contributes to higher import prices. With effect from 2010, CPI inflation will also rise, according to our forecast. Once again interest rate changes have had a powerful impact, but they are now pushing in the opposite direction. In 2010 we are expecting to raise the repo rate again. Mortgage rates will then cease falling and begin to rise instead. At the same time, energy prices will begin to rise slightly. The repo rate will then be raised fairly rapidly, from a level of around 1 per cent to around 3 per cent at the end of the forecast period.

The fact that I am now talking about the forecast for the CPIF should not be interpreted to mean that we have changed the monetary policy target. Our target is still that CPI inflation shall be 2 per cent. But we are also constantly studying a number of other measures of inflation. In this situation with exceptionally large changes in the repo rate –first down to just below one per cent and then rapid increases at the end of the forecast period – it is very important to openly and clearly illustrate the direct consequences this can have on the CPI. However, in the longer term, beyond the horizon for our forecast, the repo rate is assumed to be stable and then the rate of increase in the CPI and the CPIF will coincide.

To summarise – with the most recent interest rate cut and the forecast for the future interest rate we are expecting to be able to counteract the restraining effects of the financial crisis on the Swedish economy. The economy will gradually return to a more normal situation and the Swedish economy will begin to recover next year. Resource utilisation will be lower than normal for the entire forecast period but will rise in 2011. We are assuming that CPI inflation adjusted for the effects of changes in mortgage rates will be close to the target of 2 per cent at the end of the forecast period.

Uncertainty but also preparedness for unexpected developments

It is important to bear in mind that economic prospects are unusually uncertain at the moment. For example, it may take longer than expected before the financial markets function normally once again. It is also possible that the effects of the economic policy will come sooner and with greater force than anticipated in our main scenario. The future direction for monetary policy will depend, as always, on how new information on economic developments abroad and in Sweden will affect the prospects for inflation and economic activity in Sweden.

The Riksbank's decisions are based on forecasts for a more or less uncertain future. Unforeseen events in principle occur all the time. This is something we have to live with, no matter how good are forecasts are. To return to the ice skating metaphor, you may fall through the ice despite being careful. But then you will hopefully have both the equipment and the training to manage to get out of the water and get home in dry extra clothing. Everything may not happen exactly as you have trained for, but you know what to do – you have both the tools and the techniques required.

And we do. We are well-prepared to manage our task, even when there is turmoil in the world around us and when unforeseen events occur. We are aware that extraordinary events may require extraordinary measures. If necessary, we can act both quickly and forcefully. If necessary, we can implement more unconventional measures as a complement to our interest rate policy. This is the way we have worked so far, and this is what we will continue to do. If necessary!

Concluding reflections – why are things better this time?

There have been many gloomy headlines regarding economic developments recently. We are certainly in an economic downturn. And the global financial crisis will probably affect us all for some time to come. But, particularly in the light of all of the measures taken and those that will be taken around the world, we are expecting economic activity in Sweden to pick up again next year.

After our most recent interest rate decision some analysts wondered why we believe that the Swedish economy will recover more quickly now than after the crisis at the beginning of the 1990s. Let me go back a little way to 18 September last year when the market for treasury bills was put on hold. I spoke that day with the Director General of the Swedish National Debt Office, Bo Lundgren, with whom I worked during my time at the Swedish Bank Support Authority in the 1990s. It was not without some feelings of déjà vu. But at the same time I felt then – and still feel – confident that a lot of things are different. That is, better!

Of course we are an export-dependent economy and of course economic activity abroad looks worse than it did at the beginning of the 1990s. The effects of the global financial crisis contribute to considerable uncertainty and also make the situation very difficult to assess. One example of this is the economic downturn and adjustment the Baltic countries still have to work their way through, something that of course affects the Swedish banks with operations there. But there is on the other hand a lot in our favour. We do not have a "home-made" bank crisis now as we did at the beginning of the 1990s. Swedish banks have on the whole been much more responsible in granting credit, compared with the lending merry-go-round that followed the deregulation of the credit markets in the 1980s. We have not entered into an economic downturn with an economy that it out of balance, as we did then. Today we have instead a surplus on the current account and sound public finances that provide a different degree of freedom for fiscal policy. Nor do we have a starting situation with nominal interest rates in some cases way above 10 per cent as we did then. The current established inflation target also provides scope for stimulation from monetary policy. The interest rates in the economy are relatively low, despite the crisis, and we are expecting the real repo rate to be very low over the coming years. All of this means that things should go better this time.

There probably remains a lot of hard work before we can leave this financial crisis behind us – until we reach a situation where the financial markets are functioning efficiently without the aid of government measures, and where uncertainty over future developments has taken on more normal proportions. But in addition to the measures aimed at managing the more acute stage of the crisis, a number of changes that may provide a more stable, better development have begun to take shape around the world. As I said last time I was here – 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. I am still convinced that we will succeed in this together!