# SPEECH

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## ■ What is a Useful Central Bank?

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Thank you for inviting me to this event in the honour of my colleague of many years, Mr Svein Gjedrem. The programme of the symposium raises several highly-relevant issues for central bankers. In my presentation, I would like to talk about crisis as a momentum for change, both in what we do and how we do it. I will start from the Swedish banking crisis of the 1990s and its implications for the development of the Riksbank. I will then proceed by looking at the present situation and what conclusions we and other central banks may need to draw from the recent global financial crisis. My focus will be on nexus between monetary policy, financial stability and macro-prudential regulation.

In common with all leaders, central bank managers face the fundamental issues of "Where are we going?" and "How do we get there"? As in most other sectors, central banking experiences changes over time and, also as in other sectors, the momentum for change is never stronger than in the aftermath of a crisis. Today, I would like to illustrate this by describing the Riksbank's thinking after our previous crisis, the changes this led to, and how we should use the current momentum for change (that is following the latest global crisis) to create a useful central bank in the period ahead. This refers to our organisation as well as to the main substantive issues in monetary policy, regulation and the supervision of financial stability.

Prior to the crisis of the 1990s, Sveriges Riksbank was an organisation in which operational tasks, and to a certain extent regulation, predominated. The flagship of our organisation was the trading room, which had the task of maintaining a stable exchange rate, but most of our employees worked with the manufacture and distribution of cash. As long as the regulations governing the credit markets and currency flows remained in place, the Riksbank had scores of employees working with these regulations too.

## What are the tasks of the central bank?

The crisis of the 1990s forced us to reconsider all this. The forced change of currency regime from fixed to floating implied a failure, although in reality the Riksbank could not have succeeded. We had two main goals, maintaining low interest rates but also the fixed exchange rate, but we had only one instrument, namely monetary policy. Instead we became an early adopter of what was then the relatively new concept of inflation targeting, at the same time as the exchange rate was allowed to float. Sweden had also been hit by a severe bank crisis and we saw that the central bank should play an important role in the effort to prevent anything like this happening again. These became our two main tasks, just as they have become in many other countries. Maintaining price stability and preventing financial crises – monetary policy and financial stability.

Both of these tasks required three things that in combination with each other make great demands of an organisation – accountability, openness and confidence. These prerequisites are required not least in the field of financial stability, where we were not given any operational tools to use in peacetime; we were expected to be able to influence behaviour through our analyses and communication – moral suasion.

### *How should these tasks be achieved?*

So, my example of how to define a useful central bank began with the question WHAT, that is what tasks should we perform? Obviously, however, we must also ask ourselves HOW we should perform these tasks. Regarding the HOW, I will focus on two issues: The staffing and competencies of the internal organization and the governance structure. The journey that we have travelled since the 1990s has entailed building up know-how and expertise for our main tasks and focusing our operations on these tasks. In order to fund this costly investment in competence and communication and to focus the organisation on the main tasks, all of the other operations of the Riksbank have been reviewed and made more efficient. A clear illustration of this renewal and redirection of competence at the Riksbank is that the number of employees has fallen significantly in this period from 1 100-1 200 including companies, or 750 excluding companies, to the current level of 350, while personnel costs are at approximately the same level as previously. Today, more than 70 per cent of our employees have an academic degree and we have some 50 PhDs. I am sure that the same tendencies can be seen in other central banks.

The concrete effects of this in our case are that we have reduced our involvement in cash management to a minimum, subcontracted the production of statistics, rationalised our administration and so on. In other words, we simply decided to perform only those tasks that we had the potential to perform better than anyone else. Only around 5 per cent of the Riksbank's employees worked directly with monetary policy and financial stability when we began this journey (even fewer if we include all those who worked with the manufacture of cash in our companies); today, more than one third of our employees work in these policy fields. Traditional operational duties for a central bank like cash management, payment system, asset management and statistics still occupy a significant share of our workforce, but they are not dominating the organization like they used to.

Managing independent and self-financed institutions, we must find ways to constantly put the pressure of efficiency on the organisation ourselves. We do not have the "time to market" pressure that private companies have. This raises questions that in my opinion have appeared far too seldom on our agendas; questions about management, about setting objectives and managing resources, about internal control and, not least, questions about governance. How should we lead the operations of a central bank?

Generally, a central bank may learn from any type of successful organisation, we are not that different. But we face a special challenge. Our governance model has often been created to arrive at a well-founded monetary-policy decision. Such a decision benefits from a careful process with a wide-ranging discussion of different scenarios that finally results in a collective decision-making discussion in (in our case) a group of six. This is a structure that has worked well for our policy decisions, but few organisations voluntarily choose a collective of six individuals for the operational management of its activities.

Our challenge has thus been to draw a clear line between the structure for making policy decisions and that for other decisions. At the Riksbank, this has entailed relieving the Executive Board of responsibility for day-to-day management and transferring this responsibility to a lower level in the line organisation. This has been – and still is – easier said than done and requires constant attention. It also demands discipline on the part of those at the top of the organisational chart. Nevertheless, this has been important in not burdening those at the top with micro-management tasks and in ensuring that no decision-maker has an information advantage ahead of a policy decision.

A final reflection regarding internal matters (following the perspectives of WHAT we should do and HOW we should do it) is in fact WHERE? Our playing field is increasingly stretching beyond national borders, above all in the case of stability work in an open economy with cross-border banking operations. In the central bank of the past, international work was something that was conducted by experts in this "craft" (whatever this craft may be). Today, the international arena is a necessary playing field for us in the performance of our ongoing tasks and we must create an organisation that is capable of working effectively and in a coordinated way in several different arenas at the same time. International work must become an integral part of our day-to-day work on the issues, not least since the outcome of international negotiations will affect ourselves in the form of EU-legislation or peer pressures from the BIS, IMF or other bodies.

## Lessons from the recent financial crisis

So far, I have discussed how the Riksbank organisation has developed on the basis of the experience gained during the previous crisis. What lessons should we now learn from the latest global crisis? What are the greatest challenges and what form should a useful central bank take in the future? I will now go on to speak about some conceivable changes in the work on monetary policy, financial regulation and financial stability and – not least – the interaction between them. In addition to new thinking on policy and other issues, we also need to adapt our organisations and our governance to achieve optimum efficiency.

The recent financial crisis provided additional input into the discussion on how the work on financial stability can become more effective and what instruments are appropriate in achieving this goal. Furthermore, having clearly proved that there are close links between monetary policy and financial stability, the financial crisis has revitalised the debate on whether central banks need to consider not only price stability but also financial stability when setting interest rates. Just a couple of years back, the common view was that since it was difficult to predict a crisis, a central bank should try to do no more than react forcefully when the crisis was already a fact. The main explanation of this reassessment is probably that the costs of a financial crisis – and hence the potential benefits of preventing a crisis – can turn out to be much bigger than previously thought.

In my view, regulation and supervision remain the first line of defence in preventing unsound developments in financial markets. The financial crisis has clearly shown that there is an urgent need to reassess the regulation of the financial sector, in addition to strengthening the macro-prudential framework. But even with stricter regulation and supervision in place, this will not necessarily exclude monetary policy from having some role to play in the prevention of a financial crisis. Both instruments have their own advantages and disadvantages. I believe that one of the challenges for the future is to find an appropriate mix between monetary policy on the one hand, and regulation and supervision combined with macro-prudential surveillance on the other. Let me elaborate on these points.

Monetary policy may naturally play some role in the prevention of financial crisis. After all, the policy rate affects the cost of credit, as regulation does. Simply put, the banks' lending rate can be described as a function of the central bank's policy rate plus an interest rate margin or spread. The interest rate margin is a function of the compensation charged by the banks for administrative costs and capital costs, risk premiums and the banks' profit margins. More stringent regulations will entail increased costs for the banks, and the interest rate margin and the lending rate will thus increase, as it will when the policy rate is increased.

In this sense monetary policy and financial regulation are clearly intertwined. Thus, a central banker must always keep in mind that the increased use of regulatory tools will inevitably affect monetary policy in different ways. Regulations will affect the interest rates that firms and households meet and this is something that the central bank needs to take into consideration when setting the policy rate – in much the same way as monetary policy has to take into account changes in interest-rate spreads due to changes in financial conditions.

## ***Regulation vs. policy rate***

Even if regulation and supervision are the first lines of defence, I do believe that the policy rate can also be used to counteract the build-up of imbalances in financial markets. When facing an excessive and rapid increase in property prices and credit volumes, central banks should "lean against the wind", that is keep interest rates higher than would otherwise be the case.

This is by no means in contradiction with monetary policy's goal of stabilising inflation and the real economy. The reason is that by "leaning against the wind", the development in property prices and credit volumes becomes more balanced, and then the real economy and inflation become more stable as well. However, there are complications involved when trying to integrate this thinking into the conventional forecasting framework. It is, for example, not entirely easy to incorporate the risks that may be associated with the rapid increase of property prices and credit volumes into the normal work of forecasting and analysis. At present, efforts are being made to better include financial variables in the central banks' forecasting models. A related problem is that property prices and borrowing are occasionally driven by psychological factors. These factors are difficult to capture in economic models, as these are often based on the assumption that participants will act in a rational manner. Thus, central banks are often forced to think outside the box and also rely on judgement.

There are also other challenges facing "leaning". Firstly, the imbalance must be identified at a sufficiently early stage. Because of monetary policy lags, reacting too late can be counterproductive. Of course, one must also be sufficiently certain that unsustainable leverage building up, so that the upturn is not being driven by fundamental factors. Otherwise, a higher interest rate would hinder growth unnecessarily. Furthermore, the policy rate is a blunt instrument in so far as it impacts all lending in the economy. If imbalances in financial markets require a significant tightening of monetary policy, this could have severe negative effects on the rest of the economy. It can require decision-makers to make difficult choices and it is a tough challenge to communicate.

In this sense, regulations have the advantage that they can be applied in a more focussed manner, which can mean that they can be applied more flexibly than leaning against the wind. At the same time, the very bluntness of the policy rate is one of its strengths compared with regulations. As the policy rate impacts the cost situation in the economy in general, it is difficult to circumvent it. Consequently, applying the policy rate or regulatory tools as the situation requires may be the most practical path.

Let me now shift the focus from monetary policy to the work on financial stability, but the issue will still to a large extent be how to achieve a balance between financial stability and monetary policy.

## *Challenges for regulatory design*

Not only the regulations but also the whole area of macro-prudential surveillance aiming at financial system stability have become a highly topical issue in the aftermath of the latest crisis. Prior to the crisis, financial regulation was excessively focused upon individual institutions under the erroneous assumption that the system would remain stable as long as the individual institutions were stable. Consequently, processes that created risks on the system level were ignored. I certainly welcome the current international discussion regarding the inclusion of more explicit systemic-risk preventive regulations, or macro-prudential regulation, in the regulatory framework.

An important challenge for the design of a new regulatory framework will lie in finding an appropriate balance: On the one hand, the regulations will need to be sufficient to effectively reduce the risk of financial crisis; on the other hand they should not be so stringent as to impose unnecessary costs on the financial sector. It is a matter of finding the right level of regulation. In this context it is very illuminating to read the so called MAG and LEI reports which attempt to translate various levels of Basel III-regulation into estimated higher interest costs for the end-borrower. As an example, each percentage point in higher capital is calculated to lead to 15 basis points in higher interest cost.

Proposals of time-varying regulation, such as time-varying capital requirements, are particularly interesting. Their more apparent connection with risk build-up may make them less costly than the alternative of introducing a constant higher minimum requirement. Time-varying regulations might also be structured in a way to be more pointed than monetary policy, which also varies with time. For instance, reducing the LTV threshold ratio for maximum lending against real estate can be more effective in mitigating a housing bubble than general interest rate increases. Along the same line of thought, another possibility is to introduce differentiated regulation. After all, the credit market is not entirely homogenous and it is, for example, possible to make a distinction between a household market and a corporate market. Making some regulation sector specific is also a viable way of reducing the regulatory costs.

There is also a debate regarding the role that central banks should play in matters of supervision and the application of rules. Various institutional arrangements can be imagined. One possibility would be for the central bank to determine the policy rate and for the supervisory authority to determine regulations. Time-varying regulations also raise the issue of what would be an appropriate form of institutional organisation. In this context, one possibility would be for the central bank to not only to determine the policy rate but also to determine the time-varying regulation, while the implementation of non-time variable regulation would be the responsibility of the supervisory authority. Does it make sense to merge the central bank with the supervisory agency? Obviously, the financial-stability analysis, and to some extent also the monetary-policy analysis, must be informed by the micro-prudential analysis, and vice versa. Countries have chosen different approaches to this, often based on country-specific characteristics such as legislation or even tradition. I am open and do not believe in a one-size-fits-all solution. The important aspects are that you ensure an open exchange of information and close cooperation between the functions, as well as adequate resources.

On governance we must also take into account what is called "political economics". The most efficient theoretical solution may not be achieved if it contradicts interests of power and influence.

How should we structure the decision-making process in order to take account of the nexus between monetary policy and financial stability? Central banks have adopted different approaches: Some have a separate Board for monetary policy, others also have a separate Board for financial stability. Most central banks have the same Board for both, but may have separate Deputy Governors responsible for each of the two strands.

What matters, as I see it, is that "the buck stops somewhere". There must be a decision at some high managerial level which balances the interests of monetary policy and financial stability as well as other central bank responsibilities. The organisation and processes of the central bank must also be structured so that they facilitate the analysis preceding the decision leading to a balanced view, based on both monetary and financial stability considerations. For instance, there should be inter-departmental working groups.

## *Financial stability lies within the Riksbank's mandate*

The importance of having a well-structured framework for monitoring overarching financial system stability and identifying potential weaknesses is relatively new compared to the structures for conducting monetary policy. In Sweden (probably also in Norway), it started as a result of the banking crisis in the early 1990s.

The Riksbank sees system stability as being in our remit. The Riksbank Act states that we shall "promote a safe and efficient payment system" and we interpret "payment system" in a broad sense including not only the narrow payment infrastructure but also major banks and other institutions and markets that are necessary for the intermediation of payments.

Should the responsibility for financial stability rest with the central bank? Yes, I think so. The supervisory agencies are structured to focus on the microprudential aspects, but the central banks are organised and staffed for macroprudential analysis, which is also needed for the conduct of monetary policy. The supervisory work needs to take the overall systemic situation into account but the macro analysis they need could well be performed elsewhere and shared with the supervisors.

The next question is what kind of mandate the central bank needs for its financial stability work. This is a tricky issue. An inflation-targeted monetary policy is relatively straight-forward, but how to define "financial stability"? A seemingly precise definition, without matching tools, could lead to failures and reduced confidence in the central bank, and also for its monetary policy. On the other hand, if the definition is too general it will be impossible for Parliament and others to evaluate how the central bank manages the task. Maybe, there could be a hierarchy of targets – a broad one in the legislation and a narrower one, which may be adapted to the actual situation, which is then communicated by the central bank to the general public on a regular basis. This is similar to monetary policy practices.

A related issue is the one on central bank independence. Our present independence refers to the conduct of monetary policy. Do we need an extension so that it also covers our work on financial stability? This question has not been fully analysed yet, but I think that the politicians would hesitate to transfer such powers unless central bankers can find really strong arguments.

There are several arguments for conducting financial stability work in the central bank such as:

- There is a clear link to monetary policy;
- Central banks usually run the large value payment system which is an important nexus in the financial system;
- Central banks may provide exceptional liquidity assistance – ELA - to problem banks, but must then understand the implications for the system as such;

Much of the stability work is crisis-oriented – both the precautionary work and that dealing with actual crisis situations. The Riksbank participates in many international fora that promote stronger frameworks to prevent or at least to manage crises. The recent global crisis led to a number of conclusions showing that we need a broader framework in which to analyse financial stability and deal with problem situations. For instance:

- Not only banks will destabilise the system;
- Systemically-important institutions pose even greater challenges than we thought;
- Liquidity developments must be closely monitored;

There are clear linkages between submarkets and also between jurisdictions.

The experience gained during the crisis leads to some specific challenges for central banks:

- Central banks must maintain a sufficient capacity to provide liquidity to meet sudden needs, but at the same time we must maintain strong incentives to avoid the banks and markets relying on central bank funding rather than approaching their normal channels.

- We must review our framework for extending ELA;

- Our analysis needs to focus more than before on liquidity developments in major cross-border bank groups. Where such groups exist, the home country of the parent bank is vulnerable to threats to financial stability in other countries, both where the funding markets are located and those where the group has subsidiaries or branches. For Sweden, this situation is accentuated since our banking system is four times larger than our GDP, and since our major banking groups depend on funding in international markets to a high degree. The financial stability analysis will have to expand to identify threats early on and to deal with them. We must be alert to potential contagion between unsustainable monetary and fiscal policies in other countries and their potential repercussions on the stability of our own country's financial groups.

- The crisis showed the need for clear roles and mandates for the authorities involved in crisis management, in particular for resolving problem banks. The Riksbank, the Financial Supervisory Authority, the National Debt Office and the Ministry of Finance had frequent contacts throughout the crisis and coordinated their actions. That said, the division of responsibilities is not clear in all situations and the Riksbank has asked

Parliament to clarify the legislation on this and a number of other crisis-related issues.

## Matching goals with tools

The Riksbank has a fairly well-developed structure for macro-prudential analysis. But if we do identify deficiencies, how can we implement the necessary changes? Winston Churchill once pleaded, in a famous World War II speech, to President Roosevelt: "Give us the tools, and we will finish the job!"

So far, the Riksbank has lacked specific "hard" tools for financial stability. We have relied on communication and moral suasion, hoping that our arguments will convince financial system actors to change their behaviour. Our experience is mixed. Before the crisis, our banks reduced their credit expansion to the Baltic countries, warned by us, but they did too little and too late. One conclusion is that we must be even clearer and more forceful in our communications. The Riksbank is presently analysing its tool kit with the aim of arriving at a proposal in the near future.

I do not think it is necessary that the tools should be vested with the central bank. For instance, there could be a rule implying that if the central bank sends a recommendation to the supervisory authority, they must "act or explain". The supervisors could then use micro-prudential tools such as increasing bank capital requirements for certain activities or jurisdictions or reducing the maximum level of loan-to-value ratios.

As in my previous discussion on monetary policy versus regulation, I believe that monetary policy and promoting financial stability are mutually interdependent. During the recent financial crisis, we observed the difficulties of conducting monetary policy in a non-stable financial environment. Interest rate signals from the central banks were sometimes dwarfed by contradictory events in the markets. Conversely, financial stability is dependent on a smooth and predictable monetary policy. Hence, in the long run, the interests of monetary policy and financial stability coincide. However, in the short term we may need new tools, which are better focussed on the specific situation.

To sum up: Central banks need to adapt their work processes, organisation and governance to achieve an optimal balance between monetary policy, financial stability and micro-prudential goals. There is not yet any internationally-agreed best practice on these issues but the debate is vivid. Everybody realises that these issues must be solved before there is another system-wide crisis.

## External evaluation also of financial stability work

Before ending, I would like to mention the present external analysis of the Riksbank on the lessons from the financial crisis in relation to our monetary policy and financial stability work. This will reveal if we are – indeed – a useful central bank.

Each year, since the Riksbank was granted autonomous status in 1999, the Committee on Finance has carried out its own evaluation of monetary policy. In 2006, the Committee commissioned an external independent evaluation of Swedish monetary policy covering the period 2000-2005. In 2007, a year after the first external independent evaluation was published, the Committee on Finance decided to repeat this exercise every four years. In the spring of this year, the Committee appointed professors Charles Goodhart and Jean-Charles Rochet to carry out the second external independent evaluation, which is to be completed by the autumn of 2011.

This time, the evaluators are to review Swedish monetary policy in 2005-2010 and in particular to analyse the lessons to be learned from the financial crisis. The evaluation will not only cover monetary policy but also the Riksbank's work with financial stability and the results of this work, with emphasis on the analysis done and measures taken before and during the financial crisis. Among other things, the terms of reference of the evaluation also stipulate the need to examine whether the remit of promoting a safe and effective payment system in the Riksbank Act is formulated in such a way as to ensure that the Riksbank can effectively work for financial stability. Furthermore, the evaluators are to investigate whether the Riksbank has the instruments and competencies required to maintain financial stability.

## Final words

To end where I started: I foresee that current trends on staffing will continue. The portion of the Riksbank staff outside the core activities will be further reduced, but the competence level will increase yet higher. Governance issues will be high on our agenda, not least trying to find suitable solutions for monetary policy, financial stability and the interdependence between them.

All of these issues are very much in line with my thoughts on what has to be done to create a truly useful central bank – to allude to the theme of this Symposium. I thank you for listening.