Speech

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The Riksbank and the stock market turbulence

Swedish Shareholders Association

My thanks for the invitation to visit Gothenburg to talk to you this evening. Share prices have fallen this autumn on exchanges around the world. The news value of dramatic share price movements is naturally high and such matters attract attention on a wide front. Public interest has grown, moreover, as more and more people invest at least some of their savings in shares, either directly or via mutual funds.

A stock market crash can be dramatic. One example is the Wall Street slump of 1929, which triggered a very deep recession and accordingly had serious consequences for the real economy. A more recent example is the Black Monday of 1987, when the New York exchange plunged more than 22 per cent in a single day; but this did not have any lasting economic effects. What determines whether or not a large share price fall has serious real economic consequences is its impact on the financial system. Whereas many banks in the United States and elsewhere had major problems in 1929, in 1987 the financial system coped fairly well.

There are various reasons why share price movements in one country are liable to spread to other countries. Large international companies operate in a common global market. When actual or expected economic activity moves up or down in an expansive part of the world, this will have at least some consequences for the large concerns and thus for the price of their shares, regardless of whether the latter are quoted in New York, Tokyo, Hong Kong or Stockholm.

Even in industries with a more domestic orientation, many firms are engaged in supplying production for export. In this way, firms as well as consumers are indirectly dependent on the course of events in world markets. An expansion or

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contraction of world trade can have consequences for employment and real income and thereby influence consumer behaviour.

Then there are the financial mechanisms. In today's global financial markets, savers and investors have access to a wide international range of instruments for investment and financing. We can see from the statistics that a growing number of people in Sweden have placed savings in Southeast Asia, for example. The same is true of savers in other countries. It follows that share price movements in one country can affect savers and share prices in other countries.

In my talk today I shall discuss the Riksbank's appraisal of the stock exchange turbulence this autumn and its implications for our two primary functions: *promoting a safe and stable payment system* and *safeguarding the value of money.*

Recent weeks

October ended dramatically on stock markets around the world. Exchanges slumped on Monday and Tuesday the 28th and 29th. Following the turmoil in Southeast Asia at the end of the previous week, on Monday the Hong Kong exchange plunged 14 per cent. The fall in Hong Kong, which is now the world's seventh largest bourse, should be seen in the context of the economic crises and currency unrest that have afflicted a number of countries in Southeast Asia.

The problems in Southeast Asia have to do with impaired competitiveness, falling property prices, an earlier expansion of credit, non-performing bank loans and short-term external borrowing. These problems have been encountered in other parts of the world, not least in Sweden in the early 1990s. In many respects the pattern in Southeast Asia therefore seems familiar.

On Monday October 28th the Stockholm exchange fell 4.4 per cent. Later that evening, Swedish time, Wall Street's Dow Jones index dropped more than 7 per cent - the twelfth biggest dip in the history of the New York exchange and the largest since 1987.

Wall Street trading on Monday was suspended twice under regulations that were introduced after the turmoil in October 1987. The purpose of suspending trading when share prices are falling steeply is to give the market time to take stock and avoid panic behaviour.

As a digression it may be asked whether the effect in New York on that Monday was not the opposite. If the tendency is such that trading has to be suspended, it becomes probable that when trading is resumed the fall will continue; the system will then be flooded with sell orders that push share prices down still further. Such behaviour was discernible in New York on Monday. The dramatic tendency in Europe during the first half-hour on Tuesday morning - when most European bourses plunged around 10 per cent - also illustrates what may happen if a price fall is widely expected when trading opens. There is therefore room for doubts about introducing rules for suspending trading on the Stockholm exchange, a step that has been discussed in some quarters.

The drop on Wall Street led to strong expectations that European stock markets would fall steeply. After the initial plunge of around 10 per cent, however, the Stockholm exchange recovered and closed 4.3 per cent down, which resembled the pattern elsewhere in Europe. During the month of October the price level on the Stockholm exchange declined 10 per cent.

Share prices in perspective

A 10 per cent fall in one month on the Stockholm exchange is rather unusual. Since 1920 a fall of 10 per cent or more in the course of one month has happened 15 times. But there have also been months when the index has risen 10 per cent or more. This has happened 25 times. In other words, an average monthly share price rise of 10 per cent or more on the Stockholm exchange has occurred more frequently than a corresponding fall. This, to me, is the essence of saving in shares.

The experienced saver knows that in the long run, equities tend to give a higher return than investment in other financial assets. But it is also the case that the potential return fluctuates appreciably from month to month and year to year. In other words, share prices can rise strongly but also fall appreciably in the short run. These variations need not be all that important provided the investor's horizon is fairly distant.

This autumn's events should be seen in context. Since 1990 the average level of share prices in Sweden has risen several hundred per cent and the rising trend has been virtually unbroken since 1992. It should be added that in the course of the 1980s the increase was considerably larger than it has been to date in the 1990s. Even with the fall this autumn, moreover, during 1997 the level of share prices has risen approximately 20 per cent.

History has taught us that share prices do not go on rising continuously. Sooner or later the tendency becomes more subdued, with a lower return. Such an adjustment is sometimes abrupt and sometimes more gradual.

Earlier this autumn predictions of corporate profits were generally fairly high. The level of share prices at that time accordingly presupposed that a rapid growth of profits would continue for some years to come. Under such circumstances share prices are usually susceptible to shocks of various kinds.

The Riksbank oversees financial system stability

Besides conducting monetary policy and safeguarding the value of money, the Riksbank has the task of promoting a stable financial system. The Riksbank's approach to this task is evident from our first financial market report, which was published last Friday. The task is grounded in the Riksbank's provision of Sweden's central payment system, through which virtually all payments in Sweden are channelled. This RIX system has a daily turnover of around 300 billion kronor and disturbances would be liable to have serious consequences throughout the economy.

Such disturbances are likely to occur in the first place if problems arise for one of the enterprises that are directly linked to the payment system. These enterprises are the banks and certain clearing organisations, for example OM. In its assessment of effects of a share price fall, the Riksbank's immediate analysis therefore focuses on the impact on these enterprises.

Market conditions are currently so favourable that the entire payment system, including the bank system, should be capable of managing a stock market fall. Unlike the situation in 1987, the level of pledged shares is currently less than 1 per cent of the Stockholm exchange's market value. Available statistics indicate that in relation to the exchange's market value, at the turn of the 1980s equity-backed lending by the securities companies was twelve times higher. The lower level reduces the vulnerability to large share price adjustments.

The financial institutions that operate in the stock and derivative markets are generally sound, with good liquidity. For the first three quarters of 1997, for instance, the return on equity for the four largest bank groups averaged 18 per cent. Lending losses are low and capital adequacy remains good. The banks' share holdings are very small and so is the proportion of their lending that is secured with equity; these exposures add up to about 1 to 2 per cent of the major banks' total assets.

The securities companies are more exposed to the stock market but the level here is not substantial either. It was appreciably higher at the time of the stock market crash in 1987. It is also worth noting that the high stock-market turnover associated with periods of high volatility is an advantage for the securities companies in that commissions are their primary source of income. On Tuesday, October 29th, for example, turnover on the Stockholm exchange reached a new record of over 11 billion kronor, compared with a normal level of about 5 billion kronor.

When share prices are falling and turnover is high, banks and securities companies need to have sufficient liquidity to meet their commitments. During the past eighteen months, bank sector liquidity - measured as liquid assets less short-term financing - has exceeded 100 billion kronor. The liquidity of the securities companies is likewise good; it is appreciably lower than the bank sector's but the need is not as great. Securities companies are less exposed to liquidity risks in their balance sheets and are less engaged in the mediation of payments. During the past eighteen months the liquidity of the securities companies has consistently exceeded 6 billion kronor and the average level has been 12 billion kronor. For comparison it can be noted that, as I just mentioned, the Stockholm exchange has a daily turnover of about 5 billion kronor.

How the Riksbank acts when stock markets fall

When share prices fall as they did at the end of October, the Riksbank routinely intensifies its surveillance. As it is primarily among financial firms that acute problems are liable to arise, a closer watch is kept on them. Above all, the Riksbank assesses the likely effects on the enterprises' solvency and liquidity. For the Riksbank, the problems will be most urgent if banks encounter difficulties with liquidity. In the first place this may happen if the function of the interbank market as the distributor of total liquidity is impaired. This could be the case if, for example, a bank finds it hard to borrow in the interbank market because other banks perceive its position as uncertain.

The Riksbank has a central role in the payment system in that it controls the bank sector's total liquidity. Under normal circumstances the banks have to provide full collateral for their loans from the Riksbank. If a bank is not in a position either to obtain liquid funds for its payments or to provide the normal collateral, the Riksbank may have to consider its function as the lender of last resort. But this is indeed a last resort for very special circumstances. In that it is primarily in this respect that the Riksbank may play an active part, it is natural for its intensified surveillance to spotlight bank liquidity.

An exchange of information between the competent authorities in this field is routine practice in the event of increased turbulence. This is accompanied by enhanced surveillance of payment traffic in the Riksbank's payment system, the RIX system.

Considering the limited effects that falling stock markets have, at least at present, on the payment system's central enterprises - the banks and certain clearing organisations - the recent turbulence on the Stockholm exchange does not give cause for concern about the financial system's stability.

The share price fall has major consequences for many investors but on this occasion it has not caused the Riksbank to take any action apart from the heightened surveillance. During the turmoil the Riksbank's payment system worked as expected, without any problems or delays, despite the large price adjustment. The financial system has also functioned as it should in other respects. Moreover, the market conditions are so favourable that both the payment system as a whole and the individual banks should be able to manage a stock market slump. Good solvency and liquidity, small stock market exposures and a low level of pledged equity mean that the financial system is in a good position to withstand negative effects of a share price fall.

Consequences for future growth and inflation

As we noted in the September inflation report, the economic recovery is continuing. Private consumption as well as investment and exports are contributing to increasingly strong growth. More and more indicators are confirming this.

In addition, government finances are moving towards a surplus. The current account of the balance of payments has been in surplus for some years. The level of indebtedness is low among households as well as firms. Most signs point to good profits in the private sector. As I mentioned earlier, the financial system is stable and a marked recovery has been achieved since the crisis in the early 1990s. In recent years, moreover, confidence has grown in the determination and ability to conduct economic policy with a long-term commitment to low inflation in line with the price stability target.

In view of the moderate risks of inflation, for some time now monetary policy has been supporting the expansive economic tendency. I have said before that this monetary stance cannot be maintained throughout the economic cycle. The Riksbank works consistently to ensure that monetary policy continuously fulfils its target of 2 per cent inflation. The other week I told the Standing Committee on Finance that the Riksbank may need "to take its foot off the gas so as to avoid having to step on the brakes later one". The time will come, though it is not clear when, for an adjustment to a more neutral monetary stance. The criterion is the outlook for inflation twelve to twenty-four months ahead. The time is not yet ripe.

The need to "take the foot off the gas" at some future date is in keeping with our latest inflation report. As time passes and economic activity strengthens, monetary policy must gradually adjust its sights to the new future. In the next inflation report we will have to look further into the future than we did in September. If the economy is expanding at more than its potential rate, as our outlook shifts forward we will come closer to the point at which the amount of unitilised capacity diminishes, given that the earlier forecast still holds.

What we now have to consider is whether the stock market turmoil will have effects that alter the conjunctural situation and modify the outlook for inflation. We must also ask ourselves whether the analysis is changed by other factors. Thus, the question is whether the outlook for growth and inflation is still in line with the September inflation report or whether the picture has changed. Today I shall comment briefly on the impact of the stock market turbulence in the light of the information that is currently available.

The first thing to note is that the financial system, in Sweden as well as in other industrialised countries, seems to be coping with the share price fall without any shocks. While we do not know whether the stock market adjustment is over, it can be said that Sweden's economy and financial system are well equipped to manage price movements of this type. The stability of the financial system is one reason why this autumn's events will probably not have any appreciable negative repercussions in the real economy.

One then has to consider whether the effects of weaker exports to Southeast Asia, of lower asset values and of any uncertainty among households in the light of what has happened, will have an appreciable conjunctural impact.

Southeast Asia has admittedly been taking a growing share of Swedish exports in recent years but the level is still not more than around 10 per cent. But some effect on exports cannot be ruled out. If the crisis continues and is exacerbated, the negative impact on the Japanese economy, for example, could be greater.

The real economy could conceivably be affected via the impact of the share price fall on household wealth. This might tend to weaken private consumption, though it should be noted that even after the recent fall, the level of share prices is higher than at the beginning of the year.

On the whole, therefore, the information currently available to the Riksbank suggests that for the Swedish economy, the impact of the recent events in Southeast Asia and in stock markets will probably be no more than marginal. However, the Riksbank will have occasion to return to this matter, as well as to other factors that condition the outlook for growth and inflation, at the latest in connection with the inflation report in December.