Speech

Deputy Governor Kerstin Hessius

TUESDAY 14TH SEPTEMBER , 1999

The Role of the Central Bank and Market Liquidity

Seminar, Sveriges Finansanalytikers Förening

The financial sector plays a central role in our society's economy. It is this sector that enables us to make payments, to transform savings into investments or future consumption, and to spread and minimise potential financial risks. It is therefore essential that the financial sector functions smoothly when we pass from one millennium into the next.

Many actors share in the responsibility for a smooth transition. Naturally, the Swedish Riksbank is one party involved, but everyone – from private savers and investors to public authorities and the media – must bear their part of the responsibility.

Agents in the financial sector early addressed the potential problems that may arise in connection with the transition to a new millennium. Substantial resources have been devoted to measures designed to minimise the risk of any technical problems arising and to ensure that all systems can cope with the transition. The Financial Supervisory Authority has monitored work on systems adaptation closely since 1997.

Telephone +46 8 787 00 00 | Telefax +46 8 21 05 31 | E-mail registratorn@riksbank.se

The role of the Riksbank in this connection is bound up with our regular tasks as Central Bank in the economy – to implement monetary policy, to promote a secure and efficient system of payments, and to ensure that sufficient notes and coins are available in the economy. My intention today is to concentrate on the central role played by the Riksbank in the management of liquidity in the financial system.

The risks that are generally given prominence as being the greatest where the millennium period is concerned are the risks of technical malfunctions arising, primarily as a result of problems in adapting all computer systems to the year 2000. Such malfunctions have the potential to disrupt the financial infrastructure. Irrespective of how high a degree of probability is assigned to these risks, they have to be treated with the utmost seriousness. The very uncertainty about the possibility of problems arising is enough in itself to lead to disturbances; for this reason, preparations have to do not only with technical adaptations but also to a great extent with instilling confidence that the systems will function in practice.

One way to build confidence is to use various types of agreements to attempt to limit the burden on systems around the millennium period, hence reducing the risks. One example of a measure of this kind is that the European Central Bank, the ECB, has decided that the European payment system, Target, is to be closed on 31 December. The reason for this decision is to enable all measures that need to be taken by the end of the day and the year to be carried out in good time before midnight. The closing of Target makes it possible to close down all financial trade within the EU on New Year's Eve.

A further means of enhancing confidence and reducing vulnerability is to establish contingency plans, i.e. measures that will be resorted to should problems still arise in spite of all preparations. Such plans are not something that should be unique to the change of millennium; they should always exist in organisations in the financial sector.

Many of the measures that have been taken in preparation for the transition to the year 2000 have focused on questions related to confidence. A high degree of confidence in financial markets is important if the markets are to function efficiently. For this reason, anxiety that the functioning of the market may be impaired, or a lack of confidence in the payment systems, are enough in themselves to constitute a problem.

Lately, comments have frequently centred around possible liquidity problems. However, the exact significance invested in the word liquidity is often unclear, as is what, fundamentally, could lead to problems. The word liquidity means "the capacity to quickly obtain funds for the settlement of debts"[1]. In practice, the word liquidity is used to express a variety of phenomena. In my opinion, therefore, it may be appropriate to take a closer look at the concept of liquidity and to clarify the role played by the Riksbank in managing liquidity.

The comment that liquidity in the market is poor often describes a situation in which major price changes occur even when turnover is low. To use market jargon, the market is said to be thin. One explanation for this can be a low level of customer activity. Such situations frequently tend to arise at the end of the year, when companies and financial institutions have adjusted their balances in preparation for closing their books and therefore have little interest in modifying their portfolios. Judging by comments on the market, there are expectations that the period of low activity in the market at the end of this year could turn out longer than usual. In other words, uncertainty about the effects the change of millennium might have on interest rates and financing possibilities could lead agents on the market to make adjustments to their portfolios earlier than usual. On this view, one possible explanation for why the interest rates on loans and investments that run over into next year have risen could therefore be a higher liquidity premium, i.e. a rise in the price that reflects how easily a security can be sold on the market.

However, it is important to point out that this type of liquidity problem – a thin market – has no direct connection with the practical liquidity management exercised by the Riksbank. The Riksbank's role in liquidity management is rather to function as the banks' bank. This leads us to a second definition of the concept

[1] Nationalencyklopedin (The Swedish National Encyclopaedia).

of liquidity: the opportunities available to financial agents to obtain refinancing without needing to sell assets.

Uncertainty regarding the future liquidity situation in both senses risks reinforcing the problems. I shall therefore explain and inform, as far as possible, how the Riksbank will manage the supply of liquidity. I shall also give my opinion of the risk of liquidity problems actually arising in practice.

In Sweden, all major payments between accounts are managed within the RIX payment system, which links together the Riksbank and all major credit institutions. A bank that has a payments deficit always has the option of financing this deficit by borrowing from the Riksbank against collateral at the Riksbank's lending rate. Similarly, a bank that has a surplus always has the right to invest it at the Riksbank at the Riksbank's deposit rate. These rates at present stand at 4.25 and 2.75 per cent respectively. However, a bank that has surplus liquidity always gains by lending it to a bank that has a deficit via the market for lending between banks, the inter-bank market. The bank that lends its surplus funds then receives a higher rate of interest than the Riksbank's deposit rate, while at the same time, the bank that borrows money pays a lower rate of interest than the Riksbank's lending rate. Loans on the inter-bank market occur within the framework of set credit lines, so that here no collateral is required.

If the financial system as a whole has a liquidity deficit with respect to the Riksbank – as a result of the banks ordering banknotes from us – the deficits and surpluses cannot be settled on the inter-bank market. The banks then have to borrow from the Riksbank at an interest rate normally close to the repo rate; this occurs by means of "fine tuning" transactions on the part of the Riksbank.

As long as the Swedish banks feel sufficient confidence in one another and the banks have adequate collateral to borrow from the Riksbank, the banks will encounter no difficulties in obtaining refinancing. Refinancing can then normally occur at the repo rate or a rate close to the repo rate.

So do the banks have sufficient confidence in one another, or is there any possible cause to reconsider the size of credit lines because of uncertainty about the year 2000? I can see no reason for any such revisions. For one thing, solvency in the Swedish banks is high. The Riksbank publishes stability reports twice a year in which we analyse the Swedish banking system. In our judgement, the financial strength of the banking system and its capacity to resist disruptions is good. Furthermore, the reports of the Financial Supervisory Authority make a "second opinion" available on the progress of preparations for the year 2000. The Financial Supervisory Authority will publish its next report on 1 October.

One further question is whether the banks possess adequate collateral to finance increased borrowing requirements from the Riksbank. In addition to Government securities, we also accept securities issued by housing credit institutions and some foreign countries as collateral for loans from the Riksbank. As of 30 June, the stock of Government and housing securities in Sweden came to approximately SEK 1700 billion[2]. At the same time, only about SEK 50 billion worth of securities were being used as collaterals for loans from the Riksbank. The banks held securities that are approved as collateral in the RIX system amounting to almost SEK 200 billion at the time. It is therefore reasonable to conclude that collateral ought not to constitute a restriction for increased borrowing from the Riksbank.

In order to judge whether this safety margin is adequate, it is also necessary to estimate how much collateral might be needed. Essentially, an augmented demand for banknotes is the only factor that might be capable of increasing the total refinancing the banks need to obtain from the Riksbank. However, a substantial rise in demand for cash on the part of the general public appears to be unlikely. The surveys that the National Board of Psychological Defence has carried out indicate that the general public has great confidence that the banking sector will function in the millennium period. However, the possibility that the situation may change as a result of psychological factors and the demand for cash may increase cannot be discounted. Nevertheless, there is not the remotest possibility of the sums involved being so large that the collateral held by the banks might impose limits on their borrowing from the Riksbank. In an earlier financial stability report, we outlined a highly hypothetical argument in which we followed the assumption that all households wanted to hold an extra SEK 10 000 in cash. This would be equivalent to increased withdrawals totalling approximately SEK 38 billion. A more reasonable assessment of the risk is that each household might withdraw an additional couple of thousand kronor; this would be equivalent to about SEK 10 billion. I am therefore on firm ground when I say that the Swedish bank system is well equipped to cope with any rise in the demand for cash.

Nevertheless, some central banks have announced special lending facilities for the banking system in preparation for the turn of the millennium. These central banks include the Federal Reserve and the Bank of Canada. However, both the structure of the banking market and the central banks' systems for managing the supply of liquidity vary from country to country. In Sweden we have financially strong banks and the banking market is easily surveyed, since the number of banks is so small. Moreover, as a result of the rules that the Riksbank follows for collateral requirements and because of the structure of the Swedish securities market, a considerable stock of pledgeable securities exists.

In supervising financial stability, the Riksbank also has other means at its disposal. Although in my judgement the risk of liquidity problems in the run-up to the coming year-end is small, it is of course never possible to rule out the possibility that technical hitches might lead to temporary problems. One hypothetical issue that has been discussed is what would happen if a single bank, in spite of everything, encountered technical problems in sending out its payments. The banks that were to receive these payments would then run the risk of a temporary deficit that would have to be financed by the Riksbank. If it should prove impossible in that situation to present an adequate amount of collateral, the Riksbank would be able to make use of the existing legal option of offering loans on special terms, always assuming that those affected were solvent. The situations in which this option is to be used and exactly how this is to occur is considered on a

---

[2] Sveriges Riksbank: Finansmarknadsstatistik Nr 6 (Sveriges Riksbank: Financial Market Statistics No. 6).

case to case basis. The Riksbank always maintains a high level of preparedness for taking quick decisions about loans of this kind.

The financial sector was early in paying attention to the millennium problems. Representatives of the financial sector meet in varying constellations for discussions and to make sure that adequate measures have been taken to avoid problems. Already in April 1998, “The Joint Year 2000 Council” was established[3]; its principal task is to ensure coordination between the various actors in the market and to provide a platform for an exchange of information and experience. Everybody is working for a common goal – to ensure that the turn of the year pass by in a smooth fashion.

Up to now, the preparations for the millennium shift has, in all essentials, been working according to plans. However, it is of great importance that this issue continues to have a top priority. My opinion is that the financial sector and all interested parties can look ahead to the new millennium with confidence.

In conclusion, it is worth recalling that the introduction of the euro at the beginning of this year was able to take place without any serious hitches, even though many systems were being taken into use for the first time.

[3] Basel Committe on Banking Supervision, the Committe on Payment and Settlement systems, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors.