

# Speech

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## The Riksbank and Swedish democracy

Fristående Sparbankers Förbundsstämma i  
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In my speech today I would like to concentrate on the role of the Riksbank in Swedish society. I am going to begin by trying to clarify the sometimes exaggerated idea about the meaning of the Riksbank having an independent position in relation to our democratically elected representatives. Later in my speech, I will take up issues relating to the Riksbank's role in reducing the risk for financial crises and the important function of the bank system.

### **The duties of the Riksbank**

The Riksbank is an authority subject to the Riksdag. The areas of responsibility that have been delegated to us in one way or another involve ensuring that our money plays its part well in society. In order for a modern economy to function efficiently, there must be access to money that is accepted by everyone as a means of payment. It must also be possible to make payments for the enormous flows of goods and services in a developed economy in a secure and efficient way. Last but not least, it is important that the country's currency functions as a store of value, a demand that is met if inflation is low and predictable. Stable prices reduce uncertainty when agreements about future payments are to be concluded, for instance pay agreements. Another benefit that is usually emphasised is that stable prices do not create the same arbitrariness in income distribution between savers and borrowers as high inflation does.

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By ensuring that our money fulfils its functions, the Riksbank makes its best contribution to citizens' welfare. This is the ultimate objective of all economic policy and monetary policy is no exception. When the value of money and financial stability are maintained, we contribute to creating good conditions for growth, which is usually considered to be an important part of welfare. However, the funds the Riksbank has at its disposal cannot affect productivity growth in the long run. As there is considerable agreement that it is neither possible nor desirable to use regulations as a normally component of policy, changes of the shortest interest rate are normally the monetary policy tool available to the Riksbank.

Our tasks have been formulated as follows; the Riksbank shall (1) maintain price stability, (2) promote a safe and efficient payment system and (3) be responsible for the supply of banknotes and coins.

The core activity that the Riksbank is responsible for is stated and regulated in the Riksbank Act. A new act came into force on 1 January 1999 and was occasioned by the demands made on the conduct of monetary policy according to the so-called Maastricht Treaty.

### **The Riksbank in a democracy**

When Sweden became a member of the European Union and the Government signed the so-called Maastricht Treaty, this entailed, among other things, acceptance of the requirement that the Riksbank was to have an independent position in relation to the Government and the Riksdag. However, many regarded it as a controversial demand, not least in the Swedish trade union movement and within social democracy. It is hardly surprising that there were strong reactions in many places as an independent central bank is a quite new and unfamiliar element in Swedish public administration. It meant that the conduct of monetary policy should be delegated to an authority that was only restricted by legislation. This procedure can be most closely compared with the independent interpretation of laws by the courts.

However, on closer inspection of the content of the new law and the practice established since then, it can probably be said that the reactions and concerns were exaggerated. Mention is often made in general discussion of, for instance, "the independence of the Riksbank" which may call to mind an organisation that can carry out its policy wholly without control and parliamentary supervision. In fact, in my view, what is involved is rather more a sensible arrangement, where the objective of monetary policy, stable prices, has been established by law. In addition, the Act states that the Riksbank, without prejudice to the objective of price stability, shall support general economic policy with a view to achieving sustainable growth and high employment. Furthermore, when the new Act was passed, responsibility for general issues relating to foreign exchange policy was transferred from the Riksbank to the Government. It is thus the Government that is to decide on the krona's relationship to other currencies. This means, for instance, that it is the Government that shall decide whether and when Sweden shall apply for

participation in the European exchange rate mechanism, ERM2. However, the Riksbank is responsible for setting the exchange rate at which the linkage shall be made in this case and the width of the band in which the krona shall be allowed to vary. In practice, it is reasonable to assume that this takes place in consultation with the Government, not least because Sweden cannot decide on this unilaterally.

Control is exercised in various ways to ensure that monetary policy is conducted in accordance with the law and the intentions of the democratically appointed government authorities. What is involved therefore is not at all complete independence. The Government authorities naturally exercise control of how the Riksbank performs its work.

We in the Executive Board of the Bank have also responded to the consequences of this independence by the way in which we have organised the monetary policy decision-making process. I shall here deal briefly with the government authorities' control of the Riksbank and the bank management's response to increased independence.

### **The control of the Riksbank by the government authorities**

The government authorities exercise control of the Riksbank in at least four different ways:

1. The Riksbank is an authority subject to the Riksdag. The Bank was previously controlled by the Riksdag's standing committee, the Governing Board. In the new organisation which started on 1 January 1999, the Governing Council appoints the six members of the Executive Board, the Governor and the five Deputy Governors. However, these appointments take place for different periods of time. This means that the Governing Council renews a mandate or appoints a new deputy governor each year. In this way, the Riksdag's committee, the Governing Council, can indicate discontent with the policy carried out by the Riksbank's Executive Board each year.
2. The Chairman and Vice Chairman of the Governing Council take part as a rule in Executive Board meetings. They have a right to speak but not the right to vote or make proposals. In this way, these persons have a complete insight into the Riksbank's work and can assess the quality of the Executive Board's work.
3. Twice a year, the Governor of the Riksbank and sometimes another Executive Board member appear before the Riksdag's Standing Committee on Finance to give a report on the policy of the Riksbank. This takes place in connection with a written report on the policy carried out and the current state of the Swedish economy.
4. Finally, it is important to remember that the assignment to the Riksbank is given in the form of an ordinary law. It is *inter alia* formulated that the Riksbank shall maintain stable prices. This means that the Riksdag can at any time reformulate the task of the Riksbank in an ordinary law. The EU Treaty sets limits, however, as to how the assignment can be formulated.

## **The bank management's reaction to independence**

When the new Executive Board met before the New Year in 1999 to draw up policy for independence, the starting point was that the Bank was to work in conditions of complete openness. A very substantial openness is required for the Riksbank's monetary policy to obtain public confidence and for the approach to an inflation target to be completely understood. This has been our lodestar when planning our work.

1. The Riksbank's target for stable prices is given as 2 per cent inflation measured by the consumer price index with a tolerance interval of one per cent in each direction. When we consider that the CPI has been affected by factors that do not permanently affect the CPI, we can, however, decide to disregard these. The reason is that if we try to counteract these, it would lead to unnecessary fluctuations in production.
2. The underlying material for the monetary policy decisions is published. Four times a year the Riksbank produces a so-called inflation report. This is a detailed account of the state of the Swedish economy, which leads to an assessment of inflation in the coming two years. These assessments are based on the development of GDP, investments, consumption, public expenditure, the central government budget balance, foreign trade and various prices. The forecast horizon is adapted to the time period that "the Riksbank's weapon", the so-called repo rate has an effect on the economy.
3. The morning after the Executive Board has made an interest rate decision, which normally takes place 6-8 times a year, the decision is published with a motivation in a press release. The Governor of the Riksbank, the executive board member responsible for preparing the monetary policy decisions and some of the Bank's economists also take part in a press conference and answer questions when decisions have been made to change interest rates or when the so-called inflation report is published.
4. A few weeks after the Executive Board has had a monetary policy meeting, minutes are published from the Executive Board meeting where the submissions made by the different board members are presented anonymously but where any reservations against the inflation report and/or majority decisions on the interest rate are reported stating names.

The Riksbank, together with the Bank of England, has a distinctive position among central banks with regard to openness. In this respect the Bank of England has shown the way for the Riksbank. I dare say that the Swedish general public know more about the Riksbank's monetary policy now than when it was controlled by elected politicians. And this is how it has to be. As I said before openness is a prerequisite for independence.

Sometimes, I come across fantastic ideas about the Bank's independence, but when I have explained the situation, I often meet understanding for the Riksbank's new position.

What I have talked about primarily concerns how we handle the duty to maintain price stability. The changes that took place at the beginning of 1999 were, as I said earlier, occasioned by the demands made by the Maastricht Treaty on the monetary policy decision-making process, which made necessary a new Riksbank Act. The Riksbank's conduct of monetary policy is also what usually gives rise to discussion. As long as the payment systems function, financial stability is not threatened and access to cash means of

payment is good, there is no reason on the part of the general public and the media to focus attention on this issue. The Riksbank will only be called to account if problems arise, although the Bank devotes considerable resources to these areas under normal conditions too.

### **The Riksbank is responsible for the supply of cash**

For about a year now, an independent subsidiary, PSAB, Pengar i Sverige AB, has been responsible for the operational cash management in Sweden. The Riksbank still has overall responsibility for cash supply, of course, but we now exercise this largely by carrying out supervision of PSAB.

### **Financial stability leads to a secure payment system**

An important component of the Riksbank's task of promoting a secure and efficient payment system is to monitor and evaluate developments in the bank system. Since the banks have a key role in provision of banknotes and payment services to the general public, it is important that their activities function well. A prerequisite for this is that financial stability is not threatened. Unlike many other countries, the Swedish central bank does not have the role of supervisory authority. Here instead there is a special authority *Finansinspektionen* (the financial supervisory authority) that bears the responsibility of supervising the individual institutions while the Riksbank focuses its supervision on detecting systemic risks.

The Riksbank has decided to act with the same openness and clarity as regards the responsibility for a secure efficient payment system that characterises the monetary policy decision-making process. An important component of this strategy is the production and publication of a report on financial stability a couple of times a year. This report goes systematically through the risk factors that could lead to major imbalances being created in the financial systems so that financial stability is threatened in a broad sense. Since the Swedish bank system is concentrated in four major banks which have large exposures to one another, problems in one bank can rapidly spread to the entire bank system. By pointing out the risks that the Riksbank sees and publishing our assessments, it is probable that conduct that could otherwise lead to systemic risks can be prevented. Openness can thereby be said to constitute a means in our monitoring of the payment system. This also applies to monetary policy where openness and clarity do not only have the function of creating understanding for the inflation target but also probably affect and stabilise inflation expectations in the economy.

### **Stable prices reduce the risk of financial crises?**

An issue that is highly relevant for the Riksbank is the extent to which monetary policy focused on price stability reduces the risk for the incidence of financial crises. An economic policy focused on price stability is considered to create the basis for macroeconomic balance. The financial crises we have seen to date have often been preceded by periods of strong credit expansion and building-up of macroeconomic imbalances. Increasing asset prices have also commonly preceded a crisis. Borrowers as well as banks seem often to have based their decisions on loans and lending on expectations of continued high asset prices and that the growth in wealth that rising share

and property prices give rise to would be permanent. When these expectations subsequently prove to have been exaggerated, this has initiated a process that in some cases has led to financial crises in the bank system.

The development in the U.S. economy has brought up the risk that financial imbalances can develop despite stable prices and balanced government finances. As we know, demand and growth have been high there for many years without inflation accelerating. Demand has been stimulated by high share prices and the private sector's financial balance has decreased markedly.

The strong credit expansion that preceded the bank crises in Sweden at the beginning of the 1990s took place at the same time as a strong increase in private consumption and investments, which led to an increasing deficit in the balance of trade, considerable overheating and high inflation in the Swedish economy. It is reasonable to assume that a large expansion in credit would create inflationary pressure now as well that would motivate restrictions in monetary policy. In this way, the credit expansion should be dampened and the risk for problems in the bank system reduced. On the other hand, it cannot be excluded that situations will arise with strong credit expansion, for instance based on increasing asset prices without an increase in inflation being anticipated. Strong international competition combined with low, stable inflation expectations could possibly mean that inflation would not accelerate despite increased use of resources. It is also possible to conceive of situations with a credit expansion driven by high turnover on the asset markets. It is thus far from self-evident that a monetary policy based on stable prices would automatically be a guarantee against financial crises.

These are questions to which there are no certain answers although they are discussed and investigated internationally as well as in Sweden. Purely hypothetically it is conceivable that the Riksbank would increase interest rates even if we regard it as most probable that the inflation target would not be threatened. In this case, the motivation would be that we make the assessment that the credit expansion in the bank system risks threatening the stability of the system, for instance in the event of a large fall in asset prices. An interest rate decision of this kind could probably also be motivated by the risk of strongly falling inflation if the risk scenario is realised. In practice, it is probably only in retrospect that it can be noted that financial assets and liabilities that have been built up have been an expression for serious financial imbalances. It is therefore normal that the interest rate weapon is only used if the inflation target is threatened.

### **The pressure for change creates challenges for banks and authorities**

It is evident from everything that I have said that there are no sharp boundaries between the various areas of responsibility of the Riksbank. The Riksbank's analysis of the

development of the banks also serves as a basis for our assessments of stable prices and financial stability. For instance, structural changes in the financial markets probably affect the impact of interest rates on the economy, at the same time as they change the risks banking activities are associated with.

As this meeting has been arranged by the National Association of Independent Savings Banks, I think it is appropriate to highlight some development tendencies that entail major challenges for the banks and the Riksbank.

Globalisation, deregulation and technical development have changed and will change the conditions for traditional bank activities. The role of the banks has primarily been to act as an intermediary between savers and borrowers and to make available payment services linked to liquid deposit accounts. Characteristic for a traditional bank portfolio is that lending is long or medium-term while the bank's deposits are quite liquid. This has, of course, meant that the banks have assumed a credit and term risk.

Developments in recent decades have meant that competing alternatives have arisen to banks both for lenders and depositors. The base that has made up the foundation for the growth in profits of the banks has therefore tended to shrink. There have, for instance, been increased opportunities for big companies with credit risks that can easily be valued to use the security market to finance their investments. At the same time, households have obtained considerably more alternatives to invest their savings in and during recent years an increasing number of Swedish households have opted to invest their saving in shares and share funds.

Deregulated financial markets have also entailed that price fluctuations on various financial assets and also on properties seem to have increased. At the same time, an increasing proportion of lending by the banks is to smaller enterprises and households where the possibility of evaluating the credit risk in a traditional way is poorer than for large companies. Altogether therefore considerably higher demands are made on the banks' risk management systems than previously. Major investments in knowledge on modern financial economy and IT-based risk systems are required for instance. This development takes place at the same time as increased competition tends to squeeze profits and information technology is changing the conditions for provision of payment services.

When traditional bank activities shrink and change, the direction of activities has to be reviewed. The banks can for instance opt to take part in the provision of capital in the securities market and generate profits by charging fees for this activity. One strategy may be to offer businesses and private persons all financial services such as advice, insurance and payment services. In order to be competitive, larger banks are then often required, which is a driving force behind the increased frequency of bank mergers and mergers between banks and insurance companies that are taking place.

Another alternative is of course to concentrate activities and become competitive within a particular niche. Small and medium-sized enterprises need for instance to have access to capital via banks which are able to obtain knowledge on the risks associated with lending to these. The possibility of turning to the securities market to have their need of capital satisfied should above all be confined to large businesses. The savings banks with their

strong local implantation and closeness to and knowledge of customers should be able to play an important role here. Detailed personal knowledge is an unbeatable weapon in the competition.

### **In conclusion**

With my speech, I have wished to contribute to increasing understanding of and support for the objectives and tasks delegated to we who have been appointed to manage the Riksbank. I believe it is particularly important to create clarity in the sometimes exaggerated view of the import of the Riksbank's independent position. It is my definite view, given the control the government authorities have over the Riksbank and the openness that characterises our activity, that the demands made in a democracy on an authority responsible for a branch of economic policy are well satisfied.