Speech

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What can Europe learn from other countries and former experiences?

Comments given at a conference arranged by BIS and Bundesbank

Let me begin by expressing my thanks for the invitation. I very much appreciate the opportunity of being here.

I should confess that it is not an easy task to be the last speaker in a conference as rich as this one. Perhaps I should also admit that I was not sure why I was asked to talk about what Europe can learn from others' experiences. Just for the record: Sweden belongs to Europe, though not yet to the euro area.

My guess was that the organisers wanted me to draw on my experience as a policy maker in a country which certainly did reap some experiences in the 1990s that are relevant for both monetary policy and financial stability. More, in fact, than any one of us Swedes would have wished. It is not surprising that my hair turned prematurely grey since I worked first in the finance ministry and then at the central bank during these turbulent years.

After the crisis in the early 1990's the Riksbank had to start more or less from scratch. The earlier policy was in tatters. In November 1992 the fixed exchange rate simply had to be abandoned, making it necessary to work out new ways of working in a credible way with a flexible rate. Meanwhile, the problems in the banking system had to be sorted out, while the Riksbank endeavoured to build up a future system for oversight and related matters.

Today I want to talk about two subjects. One is related to financial stability, the other to monetary policy. I shall be fairly practical and, as I mentioned, speak from the point of view of a decision-maker rather than an academic drawing on our own experiences. At the same time, the topics are ones that I know are currently being discussed a good deal in the European Community.

Financial stability

Let me first deal with the management of a banking crisis. Some of the previous speakers have touched briefly on this. Our experience demonstrates that an important element in crisis management is clear-cut rules and structures. Time is short and the risks are huge. I also believe that there is now an increased risk of future crises being triggered by mistakes within banks under increasing pressures. This kind of crisis can emerge very rapidly indeed, maybe more rapidly than a crisis related to macroeconomic problems.

It is sometimes argued that clear-cut rules are liable to create the problem of moral hazard. I do not deny that the risk exists and should be born in mind when rules and so on are constructed. But to my mind, the absence of a well thought-out position, with clear principles and rules, does not do away with moral hazard problems. They are still present under the surface. Ultimately it will be the tax-payer who stands to lose if actions are not well-prepared and policy is not coherent. This is our experience and I know it is also the view of, for instance, my Finnish and Thai colleagues.

The strategy adopted by the Swedish authorities almost a decade ago worked relatively well. But in the absence of clear examples from other crisis management, it was arrived at by improvisation without any rules to rely on. The fact that the result was so satisfactory and the crisis could be resolved so quickly was presumably in large measure a consequence of the profound economic crisis generating a willingness to co-operate, both among politicians and in society in general.

However, you cannot relay on that kind of spirit of co-operation, which means that a clear structure must have been established for managing acute problems. There has to be a clear division of labour between the competent authorities. The authorities concerned must have thought about the different situations than can arise and how to cope with them.

In a draft legislation that was presented recently, a specific procedure, called *public administration*, is proposed for the reconstruction and winding up of banks. This should provide a credible way of managing problem banks that could jeopardise the entire system. The general bankruptcy procedure is not considered credible, because it is not designed to handle systemic risk.[1]

The proposal envisages that a bank is to be put under public administration if it is unable, or is expected to become unable, to meet its commitments over a longer period. A bank under public administration is also to be able to obtain a government guarantee that covers all its commitments. All this is intended to

[1] Procedures to handle the same kind of problems exist in e.g. USA, England and Norway.

enable the bank to continue operations during a transitional period without a capital contribution from the government.

A guiding principle behind the proposed public administration is that, in the event of a crisis, there is no universal protection of creditors. Better risk management and decreased risk exposure are likely to result ex ante if shareholders are liable to be hit by a crisis and creditors may suffer losses. The government guarantee is accordingly proposed to apply only to commitments that are made after the guarantee has been issued. In this way, a bank's losses are to be carried in the first place by its shareholders and after them by the creditors whose claims pre-date the decision to impose public administration.

A basic principle in the management of the Swedish banking crisis was just that no compensation would be provided for shareholders if government funds were needed to cope with a bank's problems. This was important, of course, with a view to future moral hazard problems but it was also crucial politically. Otherwise it would hardly have been possible to obtain political support for the public funds needed. The unwillingness to adopt an equally strict approach in many Asian countries has presumably been a major factor behind the difficulties in dealing with the problems there.

The central bank's primary function in this context is to provide emergency lending for acute needs in order to avoid a systemic crisis and aid the work of the new authority. The experience from bank crises clearly demonstrates the importance of incorporating such emergency lending in the general structure for crisis management instead of treating it as a separate measure. This has to do with the great difficulty in practice of distinguishing between liquidity support and support motivated by problems with solvency. At the Riksbank we have made very concrete preparations in this field. We have, for example, produced manuals specifying who is to do what and how in various conceivable crisis situations.

Before turning to monetary policy, permit me finally to underscore that I am well aware of the difficulties of various kinds, not least of an institutional and political nature, that exist at the European level when it comes to composing a clear set of rules of this type. At the same time this conference has strengthened my belief that a development towards a more integrated European banking system can be swift. The least we can do is to prepare ourselves on the national level. It will probably help us managing a crisis at the European level if one would emerge.

Monetary policy

As I mentioned, the work of constructing a new policy with a flexible exchange rate had to start from scratch in the fall of 1992. But in a matter of months the Riksbank had prepared a new target for monetary policy. The annual rate of CPI inflation was to be held at 2 per cent, with a tolerance interval of one percentage point up or down. The 2 per cent target roughly matched the prevailing rate and was also considered to be well in line with the ambitions in other countries in Europe.

Since 1993 the way the Riksbank works has been developed quite a bit. This applies to our internal procedures, the intellectual policy framework and our external communication. Since this has been my primary task during the last five years, I could go on speaking about it for ages but I shall confine myself to a set of issues related to the *role of the inflation forecasts and policy rules.*

In my opinion, the focus on the combination a specific, symmetric target and published forecasts set by the policymakers has been important for monetary policy's credibility. By consistently presenting our forecasts and acting accordingly, we have created greater freedom of action than would otherwise have been feasible. It has been a short-cut to credibility. My favourite example is the autumn of 1998. At that time, in the midst of a fairly lively discussion of interest rate policy, similar to that in the rest of Europe, we managed to cut our rate in several rapid steps without being accused of political bias. We could make our point by referring to a very concrete picture of our view on inflation.

It is sometimes said that you need a firm foundation before venturing to publish forecasts. I don't subscribe to that. Admittedly the Riksbank began by just compiling inflation indicators. It was not until 1996 that we published really comprehensive accounts of economic tendencies and inflation, followed in 1997 by the first projections of inflation. However, I personally believe that an understanding of how the Riksbank acts could have been achieved sooner if we had started earlier with fuller accounts of inflation and stuck to them in policy. In this context the recent Brasilian experience is interesting.

In time the policy framework was augmented with what could be called a rule of action or a policy rule. We made it clear that if inflation is expected to exceed the 2 per cent target in the coming one to two years, then we will normally raise the interest rate and vice versa. This formulation reflects our judgement that policy's effects mainly occur after a time lag of twelve to twenty-four months. The rule of action has made policy even clearer. In principle, by relating new information to our most recent forecast, market players are in a good position to form a picture of policy's direction and we can see that when we compare their forecasts of the repo rate with our own.

However, one should be aware that there is a risk that an unduly simple rule or decision-making model will oblige the central bank itself to disregard other relevant information. Monetary policy is not mechanics. For this reason we have elaborated our view in various respects. We have underscored that there are also grounds for considering the periods before as well as beyond the 1–2 year horizon on which we focus. Strictly speaking, it is a matter of optimising over all future time, including both inflation and output. For a long time now we have also declared that there are transitory factors we should disregard; more recently we noted that there can be grounds for weighing a prompt return to inflation's targeted rate against the risk of avoidable fluctuations in output. Finally, we have said that departures from our simple rule may be warranted by problems with financial stability.

What is important, however, is our ambition to provide a clear explanation and motivation for such departures. Given our ambitions in this field we would risk severe criticism if we were to departure without good arguments. I should also say that if our application of the rule would continuously be modified and altered, much of its communicative and educational value would be lost.

The Riksbank do get suggestions that we should change to an inflation target similar to the one the ECB uses and aim for 0–2 per cent in a medium-term perspective. In practice, this could very well lead to the same decisions concerning the repo rate as the model we have chosen and the difference should therefore not be exaggerated. That I personally prefer our approach has to do with at least four different aspects. Besides Goodharts argument that it helps us staying on track, doing what we should to keep inflation at 2 per cent, there are three more arguments.

1. The more precise policy formulation has been beneficial for our thinking and the way it has developed, an aspect that does not usually get a mention in the literature. A clear framework kicks. Good and clear arguments that can be presented openly are needed for departing from adopted principles.
2. Aspects of communication also favour our approach, with published forecasts and a simple policy rule. When explaining on television to the general public or to the audience at a labour conference in the north of Sweden, I can rely on exactly the same arguments as when I face Professor Lars Svensson at Stockholm University.
3. The clearer the policy, the easier it is to assess or evaluate. These assessments are an important part of the efforts to generate broader respect for what we do and healthy for our accountability.

Before rounding off this discussion about monetary policy, let me also touch on the question of *publication of minutes*, which was brought up in the discussions earlier today. I think this is an issue that has been given too much prominence in recent discussions about clarity and transparency in monetary policy. Clearly, there are positive and negative aspects of publishing minutes. It can influence the internal discussions in both a positive and negative way. It can also have positive and negative effects on the way in which a central bank is perceived. I believe that the publication of minutes has been less important for the acceptance and credibility of monetary policy in Sweden during recent years than the policy framework with published forecasts and a policy rule. Nevertheless, I do think it was right of us to start publish ours.

Concluding remarks

Let me conclude by underscoring that there clearly are major differences between the problems we were confronted with in Sweden after our crisis and those confronting European decision-makers today. We started from scratch without any credibility, while the euro was launched in a relatively good setting drawing on the credibility of the Bundesbank. But on the other hand, we had the advantage of having to manage only one country. After five years in European policy circles, I think I understand what Ottmar Issing means when he says that every single language reflects the unique circumstances in the country where it is spoken.

Along the way of trying to solve different policy problems transparency and openness have been important features to us and helped us to increase credibility for our actions. The clearer the principles and rules are that guide policy, also in the financial stability area, the better.

Given the complexity of European policymaking and the many different national aspects involved I think that the arguments for this clear framework and for rules are even stronger on a European level although perhaps more difficult to obtain.

Thank you.