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■ **Lars E.O. Svensson's Félix Neubergh lecture: Central-banking challenges for the Riksbank – monetary policy, financial-stability policy and asset management**

Deputy Governor Lars E.O. Svensson is today giving the Félix Neubergh lecture at the School of Business, Economics and Law at the University of Gothenburg. The lecture is titled "Central banking challenges for the Riksbank: Monetary policy, financial-stability policy and asset management".

Three challenges for the Riksbank

In his lecture Mr Svensson discusses challenges faced by the Riksbank with regard to each of its three core functions, namely to conduct monetary policy with the objective of stabilising inflation around the inflation target and resource utilisation around a sustainable level, to promote a safe and efficient payment system and thereby to conduct a policy for financial stability, and to manage its financial assets to attain a good risk-adjusted rate of return without prejudice to the first two core functions.

Monetary policy should focus on stabilising inflation and resource utilisation – and nothing else

A major challenge for the Riksbank's monetary policy is to make sure that it becomes transparent, consistent and clearly focused on stabilising inflation and resource utilisation and nothing else. Otherwise there is a risk that target attainment for inflation and resource utilisation will be poorer and that lack of clarity makes it more difficult to evaluate monetary policy and hold the Riksbank accountable for its policy.

More specifically, Lars Svensson maintains that the policy rate should not be treated as an independent target variable with an explicit or implicit objective to "normalise" the policy rate, at the cost of worse target attainment for inflation and/or resource utilisation. Attempts to justify such a normalisation policy

are frequently made with references to unspecified “imbalances” that may threaten financial stability if policy rates are low over a long period of time. However, Mr Svensson maintains that there is no theoretical or empirical support for the idea that low policy rates in themselves would lead for instance, to excessive leverage in the Swedish financial system, since it is dominated by a few major banks and has no shadow-banking sector to speak of. The policy rate is moreover a blunt and ineffective instrument for achieving financial stability, and any “imbalances” can be much better handled with micro- and macroprudential instruments within financial-stability policy, such as capital and liquidity requirements.

Nor should housing prices and household debt be treated as explicit or implicit target variables for monetary policy, according to Mr Svensson. The level of housing prices and household debt should not be considered problematic without thorough analysis. If their levels would be considered problematic, the policy rate is a blunt and ineffective instrument to influence them and will have negative consequences for inflation and resource utilisation. There are other instruments, such as the mortgage ceiling and stricter loan terms, that are more effective.

Financial-stability policy should not be confused with monetary policy

A related challenge for the Riksbank is the risk of conceptual and practical confusion between monetary policy and financial-stability policy. For instance, it is sometimes stated that the objectives of monetary policy should be expanded to include financial stability and that monetary policy and financial-stability policy should be integrated and conducted together. According to Mr Svensson, such suggestions are inappropriate, since they do not take into account the fact that monetary policy and financial-stability policies are distinct and separate policies.

Monetary policy and financial-stability policy are distinct policies, with different objectives, different instruments and different public authorities having responsibility for them; in the same way as monetary policy and fiscal policy are different policies, with different objectives, instruments and authorities responsible. Fiscal policy has its objectives – such as economic stability, efficiency and an even income distribution – and its instruments – primarily taxation and spending – with the Ministry of Finance and the Riksdag (the Swedish parliament) as the authorities responsible. Monetary policy has its objectives – stable inflation and resource utilisation – its instruments – primarily the policy rate and communication – with the Riksbank as the sole authority responsible. Financial-stability policy has its objective – financial stability – and its instruments – primarily micro- and macroprudential supervision and regulation – with the responsibility for this policy divided between the Swedish Financial Supervisory Authority, the Riksbank, the Swedish National Debt Office (SNDO) and the Ministry of Finance. Monetary policy should be conducted taking the conduct of fiscal policy into account, and vice versa. In the same way, monetary policy should be conducted taking the conduct of financial-stability policy into account, and vice versa. But they should not be confused with one another. Confusion risks leading to a poorer outcome for both policies and makes it more difficult to hold the policymakers accountable.

■ *Asset management should be efficient and eliminate unnecessary risk – including currency risk*

The third challenge Mr Svensson discusses in his lecture concerns asset management. The Riksbank's asset management does not get the same attention in the media or in evaluations of its performance as monetary policy and financial-stability policy. The lack of attention makes it all the more important that the Riksbank internally develops the understanding and methods for the efficient management of these assets. Otherwise there is a risk that the Riksbank's financial assets are managed in a routine fashion, with lower returns or higher risks than necessary when the Riksbank's first two core functions, conducting monetary policy and promoting financial stability, are taken into account.

The Riksbank's net foreign-currency assets at present amount to around SEK 185 billion, the size of an average Swedish public pension fund. This foreign currency reserve makes it possible for the Riksbank to promote financial stability by providing liquidity support in foreign currencies to Swedish banks when necessary. This represents a substantial amount of taxpayers' money, around SEK 40 thousand per household. Without prejudice to the Riksbank's possibilities to carry out its first two core functions, these assets should be managed with the same care and efficiency as any pension-fund.

However, traditionally the Riksbank's assets and thereby the taxpayers' money have been managed in a way that subjects them to a large currency risk and thereby a risk of large losses due to exchange-rate fluctuations. The currency risk is larger than the sum of all other financial risks to the Riksbank's assets. This currency risk is unnecessary, in the sense that it does not contribute to increasing the return or improving the Riksbank's possibilities to conduct monetary policy or promote financial stability. The Riksbank's Asset Management Department has now worked out a method by which the Riksbank would be able to eliminate the currency risk through an agreement with the SNDO that the latter takes over the currency risk. This method leaves the Riksbank's foreign currency reserve assets untouched, so that they can still be used, if necessary, to provide liquidity support in foreign currencies. The Riksbank's independence is not affected. As the SNDO has a foreign currency debt to start with, the method also implies that the SNDO's currency risk also declines. The SNDO will then take responsibility for the total currency risk for the government as a whole, which allows the currency risk to be dealt with more efficiently.

Eliminating the currency risk would reduce the financial risk in the Riksbank's balance sheet by more than half, and it would more than double the risk-adjusted rate of return. Reducing financial risk this much without eliminating the currency risk would reduce the expected return by around SEK 2.8 billion a year. This amount is thus a measure of the opportunity cost of not eliminating the currency risk. It is four times the cost of conducting the Riksbank's operations, which is around SEK 700 million a year. Another measure of the opportunity cost of not eliminating the currency risk is the extra capital requirement arising from the risk of currency losses. This is currently around SEK 43 billion, which is almost a quarter of the Riksbank's net assets in foreign currencies and almost SEK 10,000 per household.

Several central banks have managed to reduce or eliminate the currency risk by various means. Eliminating the currency risk for the Riksbank's assets and the taxpayers' money has long been an urgently needed improvement to the Riksbank's asset management, Mr Svensson maintains.