

The role of the Riksbank in the Swedish economy

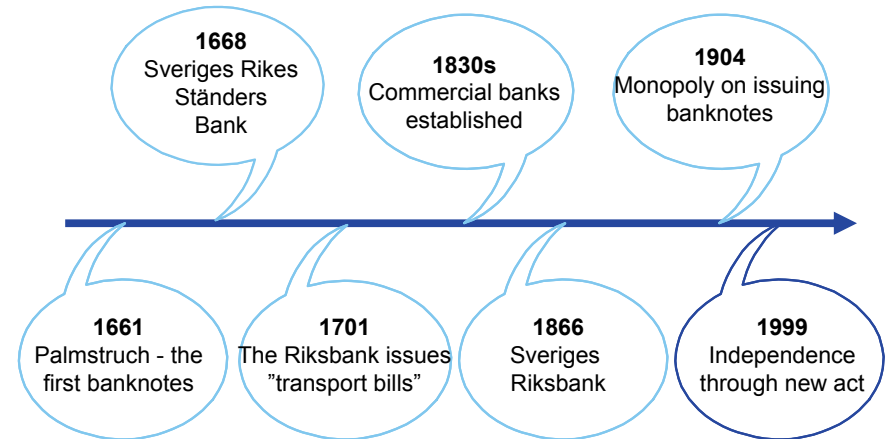
Stockholm School of Economics
9 May 2012

Lars E.O. Svensson



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The world's oldest central bank



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The Riksbank's tasks

- Sveriges Riksbank Act §2:
The objective of the Riksbank's activities shall be to maintain **price stability**. The Riksbank shall also **promote a safe and efficient payments system**.
- The Government bill 1997/98:40 p. 1:
As an authority under the Riksdag, without prejudice to the price stability goal, the Riksbank should furthermore support the goals of the general economic policy with a view to maintaining sustainable growth and **high employment**.

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The Riksbank's tasks

- Monetary policy:
Price stability
High employment (!)
- Financial stability:
Promote a safe and efficient payment system

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The Executive Board of the Riksbank



RB Governor, Stefan Ingves



1st deputy, Kerstin af Jochnick



Deputy, Karolina Ekholm



Deputy, Per Jansson



Deputy, Lars E.O. Svensson



Deputy, Barbro Wickman-Parak

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The governance of the Riksbank



- The Riksbank is an authority under the Riksdag, the Swedish parliament
- The Riksdag's General Council of the Riksbank appoints the Executive Board
- The Executive Board makes decisions at the Riksbank
- The Governor of the Riksbank is the Chairman (not the head) of the Executive Board
- Executive Board members are individually accountable
- High transparency: Monetary policy decisions, votes, reservations, reports/updates, attributed minutes of meetings

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The Riksbank's responsibility



- Monetary policy – sole responsibility
- Financial stability – shared responsibility with Finansinspektionen (SFSA), the Swedish National Debt Office, and the Ministry of Finance

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Monetary policy



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The mandate of monetary policy

- Maintaining price stability
 - Inflation target, 2 per cent (per year) for the CPI
 - Stabilise inflation around 2 per cent (incomplete control)

Why 2 per cent?

- Gives scope for adjustments in prices and wages without deflation
- Less risk that the repo rate will approach the zero lower bound
- Common inflation target for industrial nations

The mandate of monetary policy

- "High employment"
 - Highest **sustainable** rate of employment
 - Each MPR: "...the Riksbank, in addition to stabilising inflation around the inflation target, [is] also striving to **stabilise** output and **employment around long-term sustainable paths**. The Riksbank therefore conducts what is generally referred to as flexible inflation targeting."

The mandate of monetary policy

- Stabilise employment around a long-run sustainable path
- Implies stabilise unemployment around a long-run sustainable rate (if necessary adjusted with the labour force gap, the gap between the actual and potential labour force)

Flexible (not strict) inflation targeting



- Stabilise inflation around the inflation target
- Stabilise unemployment around a long-term sustainable rate
- More generally (different views): Stabilise the real economy (resource utilisation) around a (long-run) sustainable level
- Other measures of resource utilisation (different views):
Gaps: hours worked, output
- Qualitative assessment instead of quantitative?
- But in practice measurable targets are required in economic policy to produce results:
"What is measured gets done"

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Flexible inflation targeting

(not strict)



- Monetary policy impacts the real economy and inflation with a lag
- Forecast targeting
- Choose a repo-rate path so that the resulting forecasts for inflation and unemployment "look good"
 - Best stabilise inflation and unemployment
 - Represent "a well-balanced monetary policy"

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Flexible (not strict) inflation targeting

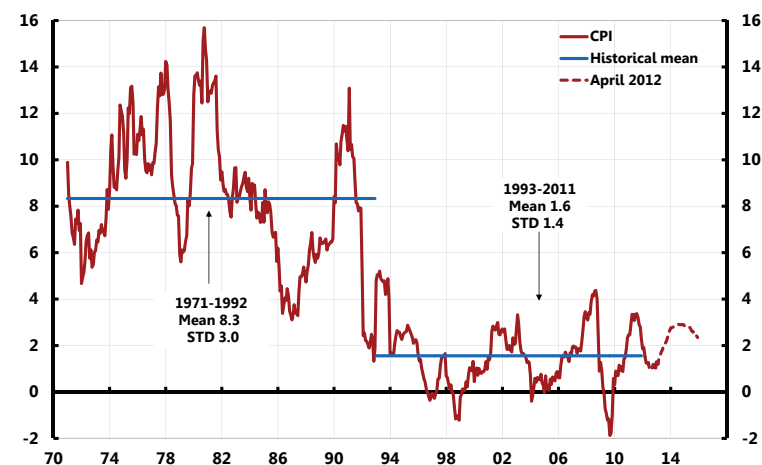


- **Higher** repo-rate path (tighter monetary policy)
 - Higher unemployment forecast
 - Lower inflation forecast
 - Transmission mechanism
 - Less aggregate demand: More attractive to save, more expensive to finance investment; stronger krona, less demand for export
 - Less aggregate demand implies lower domestic inflation
 - Also lower imported-goods inflation from stronger krona
- **Lower** repo-rate path (easier monetary policy)
 - Higher inflation forecast
 - Lower unemployment forecast

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CPI inflation, outcome

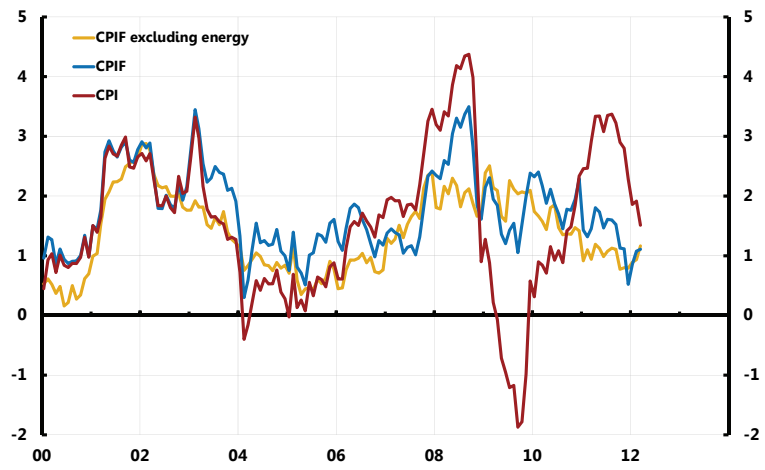
Annual percentage change



Sources: Statistics Sweden and the Riksbank 16

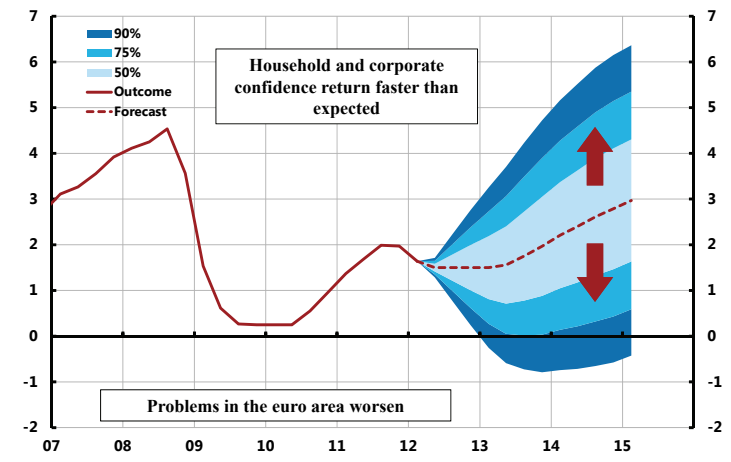
CPI, CPIF, and CPIF excluding energy

Annual percentage change



Note: CPIF is CPI with fixed interest rate. Source: Statistics Sweden 17

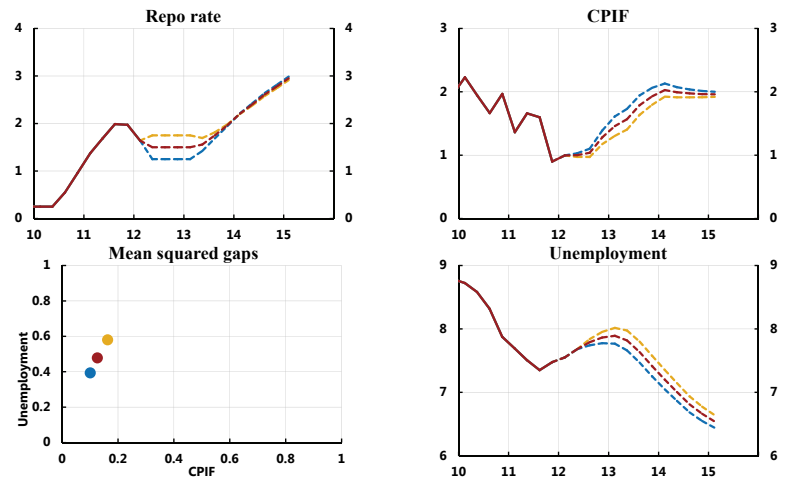
A forecast, not a promise



Repo rate, per cent, quarterly mean values Source: The Riksbank

Monetary policy alternatives, April 2012

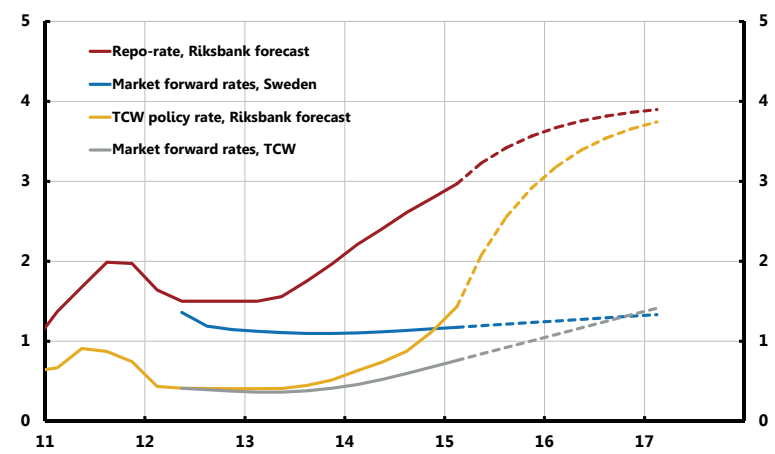
Foreign interest rates according to the main scenario. Sustainable unemployment 6.5%



Main scenario Lower repo rate Higher repo rate Sources: Statistics Sweden and the Riksbank

Repo-rate path, forward rates, and forecast for TCW-weighted policy rate, April 2012

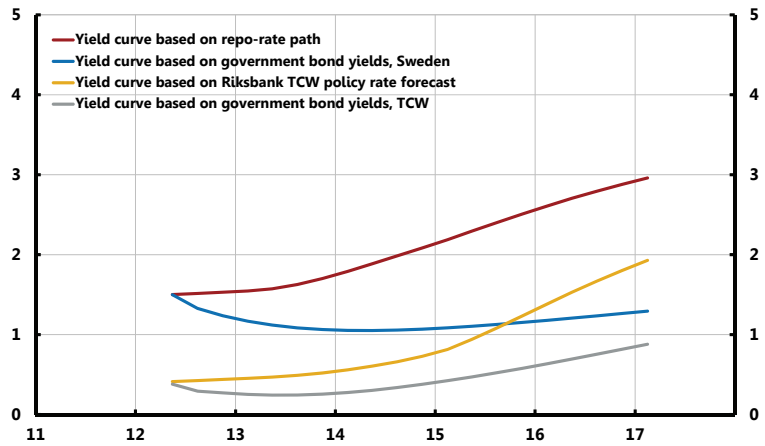
Per cent. Forward rates from 12 April



Sources: National sources, Reuters EcoWin, the Riksbank and own calculations

Yield curves, April 2012

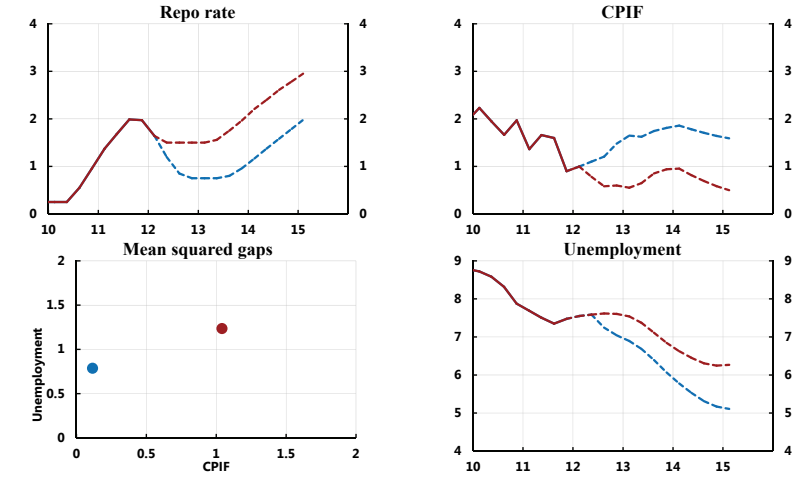
Per cent. Government bond rates from 12 April



Sources: National sources, Reuters EcoWin, the Riksbank and own calculations

Monetary policy alternatives, April 2012

Foreign interest rates according to implied forward rates. Sustainable unemployment 5.5%

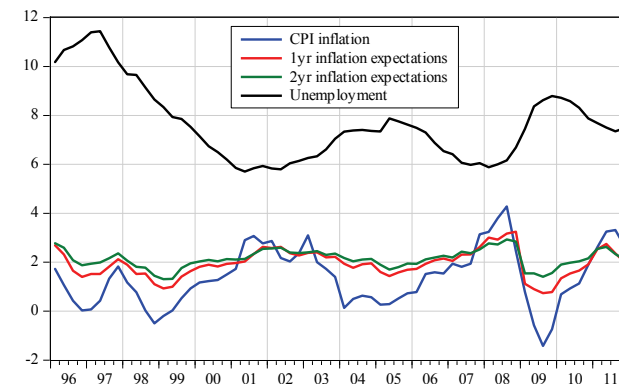


Repo rate as in main scenario Lower repo rate

Sources: Statistics Sweden and the Riksbank

Monetary policy: A longer perspective

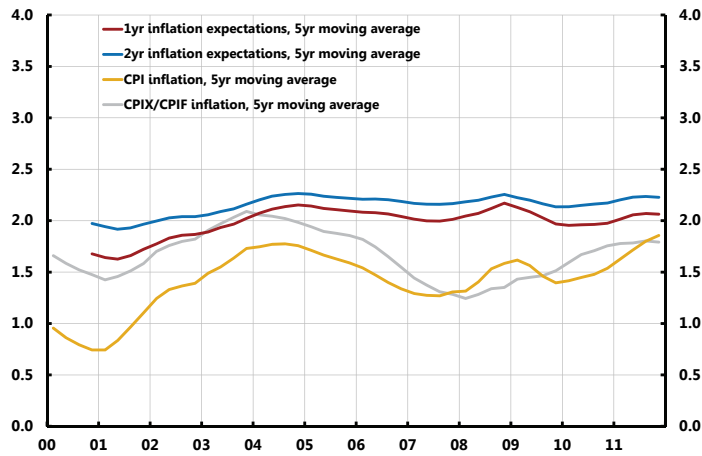
Inflation, inflation expectations and unemployment 1996-2011



Sources: Statistics Sweden and TNS SIFO Prospera

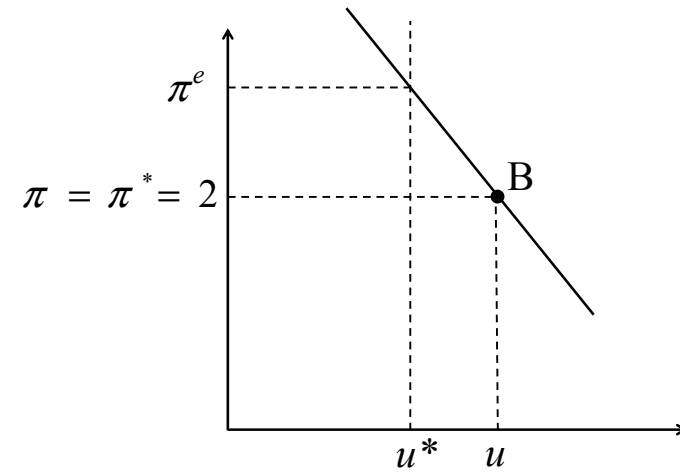
Inflation and inflation expectations 1996-2011: 5 year moving average

Annual percentage change, 5-year moving averages



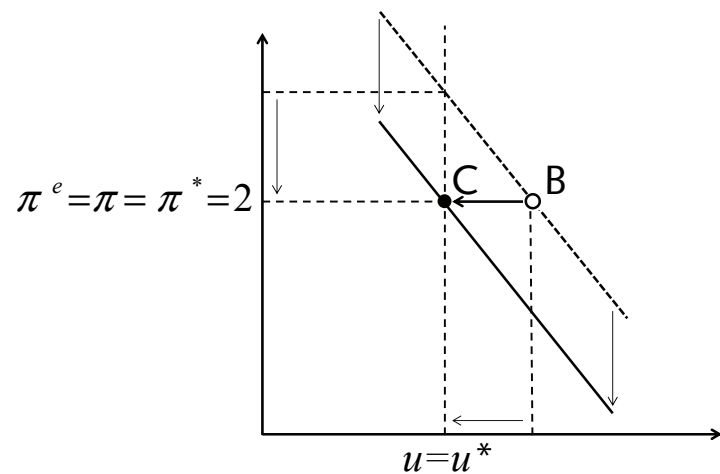
Sources: Statistics Sweden and TNS SIFO Prospera

In the beginning, inflation target not credible, tight monetary policy, and high unemployment



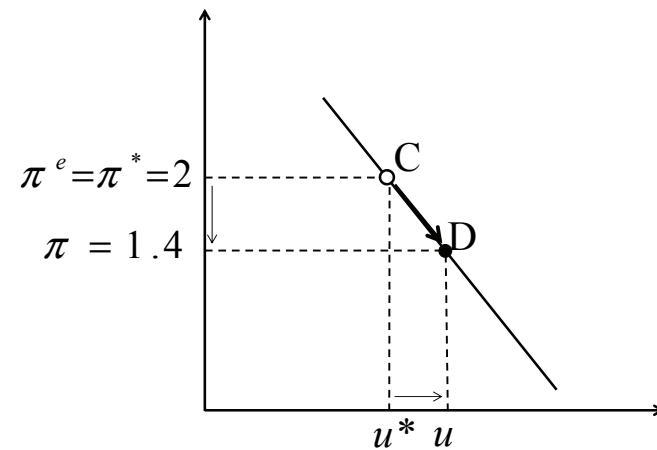
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Inflation target gradually becoming credible



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But monetary policy still tight, inflation too low and unemployment too high



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Real cost of average inflation under credible target?

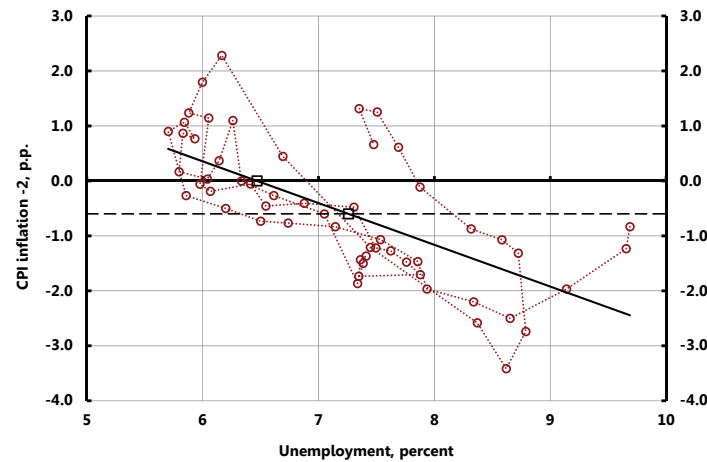
- 1997-2011 Average CPI inflation 1.4 %
- Average inflation expectations about 2 %
- Downward-sloping long-run Phillips curve

$$\text{Inflation} - 2 = 4.92 - 0.76 \text{ Unemployment}$$

- 0.6 p.e. lower inflation gives $0.6/0.76 = 0.8$ p.e. higher unemployment on average during 1997-2011
- Details, robustness test, etc.: www.larseosvensson.net

Downward-sloping long-run Phillips curve

Sample 1998Q1-2011Q4



Sources: Statistics Sweden and own calculations

Conclusions for the future?

- Inflation expectations not rational
- Stable inflation expectations of 2 per cent good:
Make it easier to stabilise unemployment without too much variation in inflation
- Important to hold average inflation close to 2 per cent
- Too low average inflation can entail large real economic costs

Financial stability

The Riksbank's role with regard to financial stability



- Financial stability: The financial system can maintain its essential functions (allowing separation of spending and income and optimal spending and income planning by households and firms, allowing risk management and sharing, and submitting payments) and is resilient to shocks that threaten these functions.

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The Riksbank's role with regard to financial stability



- The work covers several different areas:
 - Banknotes and coins
 - The RIX system
 - Overview of the financial system
 - Monitor the major banks
 - Avoid banking crises
 - Manage crises if they arise
- Cooperate with other authorities
 - Finansinspektionen (the Swedish financial supervisory authority), the Swedish National Debt Office, the Ministry of Finance

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Communication in normal times ...



- Financial Stability Report twice a year
 - Overview
 - Stress tests
 - Recommendations (Nov 2011)
 - Capital adequacy ratio at least 10 per cent Jan 2013, 12 per cent Jan 2015
 - Basel III liquidity coverage ratio 100 per cent, plus separate ratios for EUR and USD 100 per cent
 - Reduce structural liquidity risk, Net Stable Funding Ratio towards 100 per cent
 - Cooperation council on macroprudential policy between Riksbank and Finansinspektionen

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In times of crisis...



- Liquidity support, by the Riksbank
 - Lending of last resort against good collateral in kronor and foreign currency
 - Loans up to 12 month
- Bank resolution, by SNDO

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Monetary policy and financial stability

- "Leaning against the wind", tighter monetary policy to reduce increasing risks in the financial system
- OK, if no macroprudential tools and policy, but collateral damage
- Macroprudential policy (capital requirements, LCR, NSFR, LTVs, ...) much more direct and much more effective w/o collateral damage
- Swedish financial sector special: 4 commercial banks in oligopoly, no investment banking
- Riksbank and Finansinspektionen have excellent info, hardly any hidden vulnerabilities

Use the policy rate to affect housing prices and mortgage growth?

- Claussen, Jonsson och Lagerwall (2011), "A macroeconomic analysis of house prices"
 - No housing bubble. Increasing prices explained by higher disposable income, lower long real mortgage rate, higher preferences, little construction
 - Small effect of policy rate on housing prices (1 pp policy-rate increase leads to 3% fall in housing prices)
 - Keeping housing prices on trend 2004-2010 would have required 5 pp higher policy rate some years and lead to 12 percent accumulated GDP loss and 3 pp lower average inflation 2004-2010
- CJL confirm similar results in international studies (Assenmacher-Wesche and Gerlach 2010, for instance)

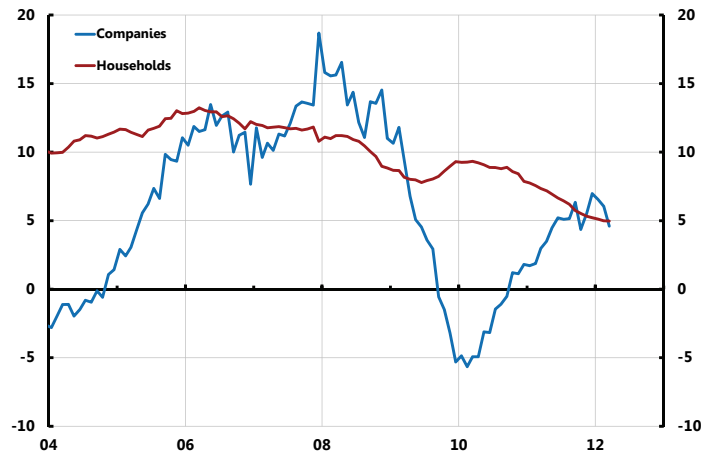
Use the policy rate to affect housing prices and mortgage growth?

- Claussen, Jonsson och Lagerwall (2011), "A macroeconomic analysis of house prices"
 - Macroeconomic consequences of fall in house prices (deleveraging, fall in consumption) are modest and can be mitigated by more expansionary policy
 - July 2010 minutes: Fall in GDP-growth or inflation or both can be more or less completely neutralized with more expansionary policy, also with the zero lower bound in the policy rate

Use the policy rate to affect housing prices and mortgage growth?

- FI (2012) "The Swedish Mortgage Market"
 - LTVs fell during 2011
 - The LTV ceiling of 85% is effective
 - Borrowers have strong repayment capacity (Note: Swedish mortgages are "full recourse")
 - Credit reviews are thorough and assume high mortgage rates (7.7% on average)
 - New borrowers pass stringent stress tests. For a house price fall of 40% and an unemployment increase to 20%, only 6% of new borrowers have negative equity and no surplus in a "left to live on" calculation
 - Mortgages are not threat to financial stability in Sweden

Bank lending to households and firms



Annual percentage change

Source: Statistics Sweden 41

Low policy rates during long period problematic?

- Evergreening of loans (zombi firms)? In Sweden?
- Steep yield curve, too much maturity transformation?
In Sweden, LCR, NSFR
- Flat yield curve, too little net interest income?
In Sweden: 4 banks in oligopoly, "cozy profit"
- Too risky new loans?
In Sweden, too little lending. Lenders evaluated in RB stability report
- Inefficient capital allocation? In Sweden, too little construction
- All these potential risks can be monitored
- Any theoretical or empirical evidence at all that is relevant for Sweden?
- Confusion nominal policy rate and general level of real rates determined by other factors (global imbalances)

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Read more at www.riksbank.se

www.larseosvensson.net

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Extra



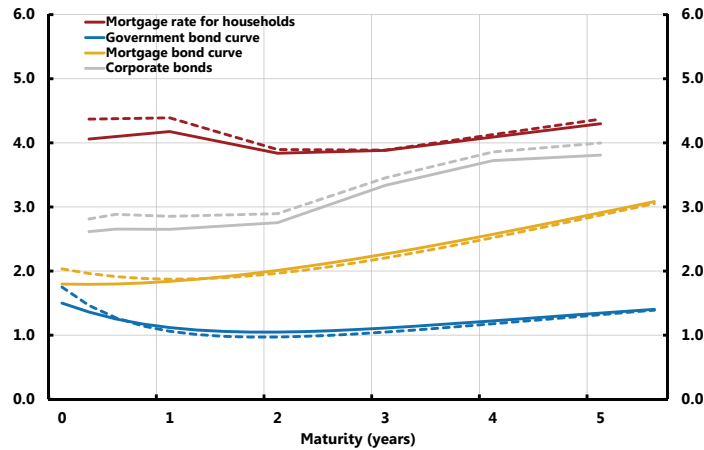
What is the problem with high inflation?



- Tendency to become entrenched and even increase
- High inflation fluctuates more than low inflation
- Undermines the value of money
- Increases uncertainty
- Gives a redistribution of incomes and wealth
- Easier to hold inflation down than to push it down – don't let it rise too far!

Yield curves

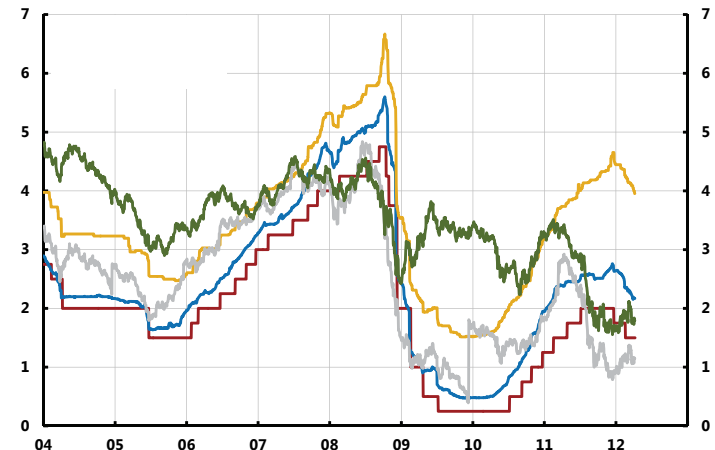
Per cent



Note. Broken line refers to 15 February and unbroken line to 16 April.

How does the repo rate affect other interest rates?

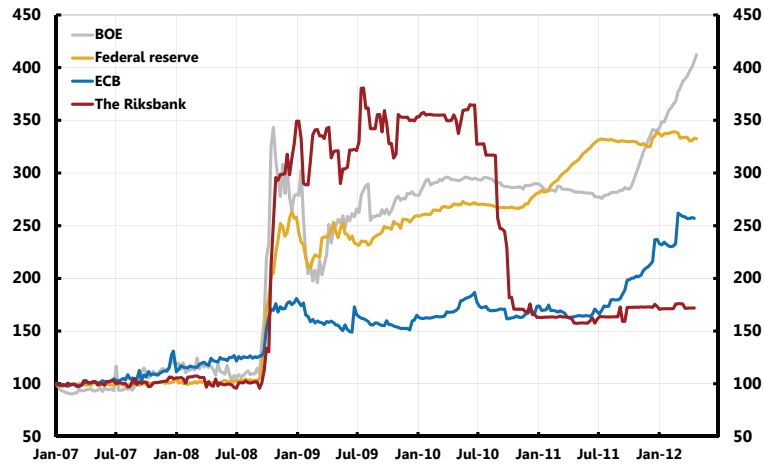
Per cent



Sources: The Riksbank, Reuters EcoWin and Statistics Sweden

The Riksbank's and other central banks' support during the crisis

Total balance sheets, percentage of GDP



Sources: Bureau of Economic Analysis, Eurostat, Office for National Statistics, Statistics Sweden and respective central bank 49