SPEECH

DATE:	18/05/2011
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PLACE:	Brussels Economic Forum, Brussels

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■ Coming stronger out of a crisis: Lessons from Sweden

"If in debt, you are not free." This expression was widely used by Göran Persson, Sweden's former prime minister, to explain the need for the extensive fiscal consolidation process that Sweden underwent after the crisis in the 1990s.[1] In 1997, a three-year nominal expenditure ceiling was introduced. This was an important step towards increasing budgetary discipline and strengthening the long-term perspective of the budget process. In addition, as part of this fiscal consolidation process, a new fiscal policy framework that included a budget surplus target of 1 per cent over the business cycle was introduced in the year 2000. With these instruments in place the debt to GDP ratio fell from 56 per cent in the year 2000 to 35 per cent today.

Recent developments in many European countries remind us of Göran Persson's words: small, open economies are vulnerable to crises of confidence when financial markets are in turmoil. They need to stand on very solid economic foundations and be supported by a credible and sound fiscal-policy framework. Sweden was lucky enough to be in this position when the recent crisis struck.

This was indeed fortunate as the crisis had a major impact on the Swedish economy. GDP fell by more than 5 per cent in 2009 – the largest fall since the 1930s. However, the fact that Sweden was relatively well equipped to confront the crisis, in combination with other factors, contributed to a rapid recovery of the Swedish economy. During 2010, GDP increased by more than 5 per cent. Thus the increase was as large as the decrease had been the year before. And some of the reasons behind the pronounced decline also explain the rapid recovery. I will cover this in the first part of the speech.

But Sweden was also lucky that the crisis did not have more severe consequences. As in many other countries, the crisis exposed vulnerabilities in the regulatory and supervisory framework for financial stability. The key

[1] For a more detailed discussion of the Swedish fiscal consolidation see Göran Persson (1996), "The Swedish Experience in Reducing Budget Deficits and Debt", Economic Review, First Quarter 1996, Federal Reserve Bank of Kansas.

conclusions we draw are not unique for Sweden and I will spend the rest of the speech outlining these issues and what we are doing to deal with them.

Why were both the recession and the recovery more pronounced in Sweden than in the rest of the world?

Sweden is indeed a small, open economy! Our exports and imports are approximately 50 and 40 per cent of GDP respectively. This is the main reason why the Swedish economy was hit so badly during the recent international recession, as global trade collapsed. While exports in the euro area and the United States fell by approximately the same amount as in Sweden, our higher export share meant a larger impact on the economy. Later this vulnerability became a boon for Sweden, as the strong upturn in global trade after the crisis benefited Sweden more than many other countries due to its high export share.

But the recovery was not only led by exports. As I said initially, Sweden was well prepared to confront the crisis as public finances were strong, unlike much of the euro area and the United States. In both these regions the budget deficit averaged 2 per cent of GDP in the 10 years leading up to the recent crisis, while Sweden had, on average, a surplus of over 1 per cent; in line with the surplus target I mentioned previously. Strong public finances limit the need for fiscal restraint during and after a crisis. While in other countries the fiscal stimulus needed during the crisis was widespread, in Sweden the fiscal stimulus was more targeted to the labour market and to those sectors that were more strongly hit. In addition to this, Sweden has had a high level of household saving and a relatively strong increase in disposable incomes in recent years. This combination has also enabled a high rate of growth in private consumption during and after the crisis. All these preconditions were weaker in the United States and the euro area.

Lastly, Sweden does not have the major structural problems that have arisen in the economies of those countries hit by a "boom-bust" cycle on the housing market – problems that have been reflected in a substantial weakening of public finances. House prices recovered after a slight turndown in connection with the crisis and are now at a higher level than before the crisis began. While we continue to follow developments in the Swedish housing market, structural factors, such as a low level of construction and traditionally low levels of credit losses on Swedish mortgages, reduce the likelihood of major price falls in the near future.

What have we learnt from the crisis?

It would be wrong to focus solely on the factors that explain Sweden's relatively strong recovery. There were also a number of vulnerabilities in the Swedish institutional set up and banking system which threatened to increase the severity and length of the downturn.

The major Swedish banks are heavily reliant on international funding and liquidity in these markets fell sharply following the collapse of Lehman Brothers. To protect the banking system, the Riksbank provided general liquidity assistance in the form of loans in SEK and USD at long maturities. This liquidity assistance was substantial: it peaked at around 15 per cent of GDP and lasted for over two years. Some Swedish banks were also exposed to significant risks through their operations in the Baltic countries. When the financial crisis hit Europe, GDP in the Baltic region fell sharply as foreign investors withdrew and demand for exports fell. And even if the global financial crisis had not arrived when it did, a combination of lax fiscal policies and rapid growth in wages and lending in the Baltics meant that the economies were overheating and were not on a sustainable path.

In addition, global financial inter-linkages produced serious negative externalities for Sweden and many other countries. This was a situation we had not encountered before.

To some extent, the reliance on international funding markets and exposure to the rapidly-expanding Baltic region were vulnerabilities that could have been identified before the crisis. It is now clear that in the past financial regulation and supervision did not function satisfactorily in Sweden and in many other countries.

Macro-prudential policy is needed

Prior to the crisis, financial regulation focused excessively on individual institutions under the erroneous assumption that the system would remain stable as long as the individual institutions were stable. Consequently, processes that create risks on the system-wide level were ignored. One important lesson from the global crisis is that we need to include more explicit systemic-risk preventive regulations, or macro-prudential regulation, in the regulatory framework. The European Systemic Risk Board (ESRB) and the Financial Stability Oversight Council in the United States are leading the development of formalized macro-prudential policy arrangements. Many other countries, Sweden included, are thinking seriously about how to implement and conduct macro-prudential policy in their jurisdictions. Macro-prudential policy needs to be operational soon, but some difficult hurdles remain to be overcome.

An important challenge for the design of a new regulatory framework will lie in finding an appropriate balance: on the one hand, the regulations will need to be sufficient to effectively reduce the risk of financial crisis; on the other hand they should not be so stringent as to impose unnecessary costs on the financial sector. It is a matter of finding just the right level of regulation.

Handling the interactions between monetary policy and macro-prudential policy poses further challenges. During the recent financial crisis, we observed the difficulties of conducting monetary policy in a non-stable financial environment. Interest rate signals from the central banks were sometimes dwarfed by contradictory events in the markets. Conversely, financial stability is dependent on smooth and predictable monetary policy. Thus, policy makers must always keep in mind that the increased use of regulatory tools will inevitably affect monetary policy in different ways. Regulations will affect the interest rates that firms and households meet and this is something that the central bank needs to take into consideration when setting the policy rate – in much the same way as monetary policy has to take into account changes in interest-rate spreads due to changes in financial conditions.

A key element in handling the interactions between monetary policy and macro-prudential policy will be putting an appropriate governance structure in place. How should we structure the decision-making process in order to take account of the nexus between monetary policy and financial stability? It seems clear that the central bank should have some role in setting macro-prudential policy but that precise role may differ depending on the regulatory structure preferred by different countries. For example, responsibility for macro-prudential policy could be given to a committee in which a representative from the central bank would sit (like in the United States) or it could be given to the central bank (like in the UK). And central banks can adopt different internal governance approaches: some have a separate board for monetary policy; others also have a separate board for financial stability. Most central banks have the same board for both, but may have separate Deputy Governors responsible for each of the two strands.

What matters, as I see it, is that 'the buck stops somewhere'. There must be a decision at some high managerial level which balances the interests of monetary policy and financial stability as well as other central bank responsibilities. The organisation and processes of the central bank must also be structured so that there are analytical tools and resources available to help policy makers take a balanced view in their decisions concerning both monetary and financial stability policy objectives. For instance, there should be inter-departmental working groups.

It is also important to remember that systemic risks can quickly spread between countries and reducing the build-up or impact of such risks will require coordinated international actions. Therefore, international governance arrangements also matter because they influence how macro-prudential policies interact across national borders. This matters a lot, not least in the Baltic region. In Europe, the ESRB will play an important role in identifying European system-wide risks and recommending policy responses, which will help manage cross-border issues.

Sound crisis resolution systems also needed

Effective macro-prudential policy would provide a line of defence against the build-up of systemic risks but it is unrealistic to expect it to prevent all serious financial disruptions in the future. It is therefore important to supplement macro-prudential policy with other measures to lessen the impact of financial instability when it occurs. This includes special resolution regimes for financial institutions which alter normal insolvency rules so that priority is given to reducing the negative externalities created when financial institutions fail. In many countries these regimes were completely absent or insufficient to deal with the magnitude and nature of institutions that failed in this crisis.

Despite the lessons from the crisis of the early 1990s, Sweden failed to create permanent resolution powers and so was unprepared in this respect when the recent crisis hit.[2] The lack of a legal framework meant that the authorities lacked the legal power and useful guidance on how to deal with failing banks. As a result, the Swedish government quickly passed the Government Support to Credit Institutions Act in October 2008, which gives the Swedish National Debt Office powers to intervene if a failing bank poses a serious threat to

[2] For a more detailed discussion of the lessons of the Swedish crisis, see Stefan Ingves and Göran Lind (2008), "Stockholm's solutions", Finance & Development, IMF, December 2008.

financial stability. We were fortunate that we could draw on people with experience from the 1990's crisis to help draft the legislation so quickly.

However, the increasing globalization of the financial system means that crisis management is more difficult today than it was at the beginning of the 1990s. As financial institutions and groups have become more internationally active, they are increasingly difficult to resolve as authorities from multiple countries must cooperate on tricky issues like burden sharing and national insolvency / resolution laws can clash.

Fortunately, there is currently a considerable push by international bodies such as the Financial Stability Board and the European Commission to design resolution tools (such as bail-in tools) and to develop guidelines or principles for national resolution regimes and for handling the failure of cross-border financial institutions. This work should help reduce the cross-border issues by making national resolution regimes more compatible. It is important that these regimes are well designed and properly implemented as we should not remain in a situation in which certain financial institutions or banking sectors are reliant on taxpayer bail-outs to survive. Removing (or reducing) the implicit government guarantee for these institutions reduces the impact and probability of financial crises and avoids an unwanted transfer of funds from taxpayers to bank creditors. In addition, this will help reduce the feed-back loops between the banking sector and the public sector. These loops arise when risks in the financial sector are resolved using public funds, weakening the fiscal budget which can, in turn, increase risks in the financial sector.

The way forward

As I said, these are key lessons for Sweden and the international community more generally and, as a result, there has been a significant amount of work by authorities and academics on the issues since the crisis began. The Riksbank is involved in this work through its engagement in the national and international debates and proposals on possible reforms to the financial system and through its own work on possible measures. For example, the Riksbank recently published an inquiry into risks on the Swedish housing market, including the risks associated with rising house prices and increasing household indebtedness and possible measures to address these risks.

The new capital adequacy and liquidity rules included in Basel III form a major element of the international response to the crisis. The new regulations are welcomed by the Riksbank. Basel III will introduce a counter-cyclical capital buffer which will form a part of the macro-prudential toolkit and entail higher minimum capital requirements which will improve the ability of authorities to resolve failing banks effectively. Finansinspektionen (Swedish FSA) recently announced that the major Swedish banks should prepare for their capital requirements to rise to the levels proposed in Basel III within the next few years, ahead of the international schedule for implementing Basel III. And I think that we should consider going further than Basel III in other ways in order to reflect the specific vulnerabilities and risks that exist in Sweden, for example by introducing liquidity requirements with specific rules for matching maturities per currency. This also seems to be the Swedish Government's view. According to the Fiscal Spring Policy Bill of 2011, the government's intention is – while the transition rules for Basel II still applies - to try different ways of

- strengthening the capital adequacy rules for systemically important banks beyond what will be required when Basel III is implemented.

In addition, the Swedish government recently established a Financial Crisis Committee to review the current regulatory framework and the handling of the recent crisis. It will also propose changes that would reduce the likelihood of future financial crises, by using preventive measures, and allow them to be resolved in an efficient manner. This will be a wide-ranging review that will consider the issues I have briefly mentioned in this speech, as well as many other issues. It is an important step towards ensuring that we have the appropriate institutional set-up in place to handle internal and external threats to financial stability in the future.

Concluding remarks

The Riksbank was formed in 1668 and in the nearly 350 years since then has seen many crises of many different shapes and sizes. I have experienced some (but not all!) of them. And in its time the Riksbank will have seen many different reforms and changes in response to the various crises. It seems extremely unlikely that we will be able to achieve what has eluded my predecessors in the Riksbank; namely, introducing changes that will eradicate all crises from our future. But it is still worth remembering the words of George Santayana, that "those who cannot remember the past are condemned to repeat it".

Ultimately, in the long-run, we may be condemned to repeat the past, but we can put structures in place that make the repetition less frequent and less costly. Institutions have a longer memory than individuals, so an important element of the current reforms to the regulatory structure and financial system is to create frameworks to ensure that the mistakes made in the run-up to this crisis are not forgotten and repeated once the key actors in this crisis are gone. In this context, three factors are key: fiscal sustainability, stable prices and sound financial stability policies.