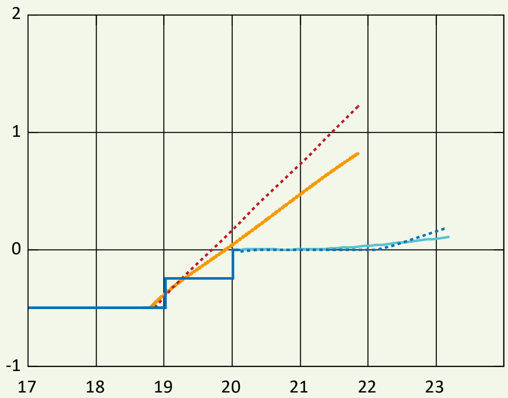
ARTICLE – What has happened to the financial conditions since the autumn of 2018?

Since the autumn of 2018, the Riksbank has raised the repo rate twice, from −0.50 per cent to zero per cent, but has cut the forecast for the repo rate, which is now expected to stay unchanged over the next few years. Over this period, yields with short maturities have risen in line with or slightly less than the repo rate, while yields for government and mortgage bonds with longer maturities have fallen. Interest rates for households and companies have remained largely unchanged. Equities have risen in value and the krona has depreciated. An index developed by the Riksbank indicates that the financial conditions in Sweden have become more expansionary since the autumn of 2018, even though the repo rate has been raised twice. Factors contributing to this include more expansionary financial conditions abroad and the Riksbank's downward adjustment of the forecast for the repo rate.

Monetary policy affects the financial conditions in Sweden

The target for monetary policy in Sweden is for inflation to be 2 per cent. The Riksbank adjusts monetary policy to fulfil the inflation target by influencing the financial conditions, which, in turn, has an effect on resource utilisation and inflation.[19] Since the autumn of 2018, the repo rate has been raised in two steps by a total of 0.5 percentage points to the present level of zero per cent. Over the same period, the forecast for the repo rate has also been adjusted down significantly and the current forecast means that the repo rate is expected to be largely unchanged over the next three years. At the same time, market participants' expectations for the repo rate, according to forward rates, have fallen (see Figure 2:12).

Figure 2:12. Repo rate and market repo rate expectations
Per cent



Note. The forward rate refers to 7 February 2020 and 19 October 2018 and is a measure of the expected repo rate.

Sources: Macrobond and the Riksbank

Development of financial variables since the autumn of 2018

Since October 2018, shorter market rates have risen. The three-month STIBOR rate has risen by just over 0.5 percentage points, which is approximately as much as the repo rate. The current level of the STIBOR rate is approximately 20 basis points above the repo rate, which is in line with the historical difference that could be observed before the negative policy rate period. Over the same period, the two-year mortgage bond yield and the two-year government bond yield have only risen marginally, even if the variation in these yields has been greater than the movements in the STIBOR rate (see Figure 2:13). The fact that two-year yields have not risen as much overall as the repo rate should be seen in the light of falling expectations since October 2018 among market participants of the repo rate's future level as well as the fact that the hike in 2018 was expected.

Unlike shorter yields, five-year government bond and mortgage bond yields have fallen since the autumn of 2018 (see Figure 2:14). Yields for bonds with even longer maturities have also fallen, for example the ten-year government bond yield (see Figure 2:2). Yields with long maturities are determined, to a greater extent than short-term yields, by expectations of the repo rate's future level. Falling expectations of the repo rate in the period ahead among market participants' may reasonably therefore provide part

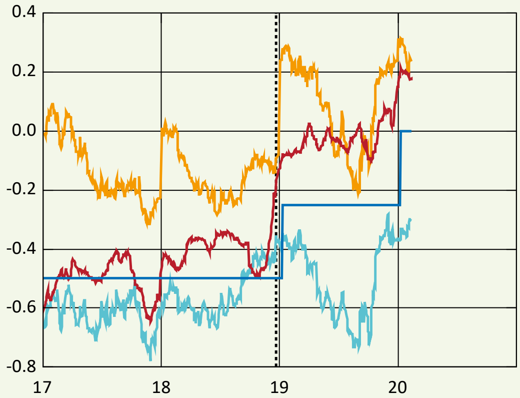
[19] The financial conditions are a summary of the state of the financial markets and the interest rates and conditions met by households and companies when they need to borrow or invest capital. For a more in-depth discussion of how monetary policy affects demand and inflation via the financial conditions, see J. Alsterlind, M. Lindskog, and T. von Brömsen, "An index for financial conditions", *Staff Memo*, February 2020, Sveriges Riksbank.

of the explanation for why longer-term yields have fallen while shorter-term yields have risen.[20]

However, to understand the development of the level of interest rates and financial conditions in Sweden more generally, it is not enough to consider only Swedish monetary policy without taking note of international developments, which have a strong effect on long-term interest rates. The period since the autumn of 2018 has been characterised by significant uncertainty over matters such as the United Kingdom's withdrawal from the EU, the trade conflict between the United States and China, the ongoing slowdown of the global economy and low inflation in many countries. These circumstances have contributed to both the ECB and Federal Reserve making monetary policy more expansionary in 2019, which, in turn, is also a factor behind the low interest rates in Sweden. Greater global uncertainty has also contributed to increased demand for risk-free assets, which has further fuelled the fall in long-term interest rates.

Figure 2:13. Repo rate, money market rate, government and mortgage bonds

Percentage points



Note. The vertical line indicates the Monetary Policy Meeting in December 2018.

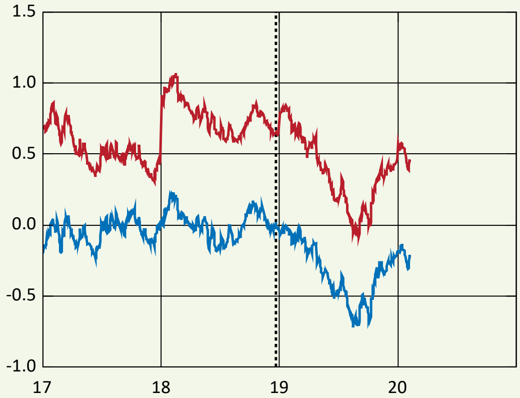
Sources: Macrobond and the Riksbank

On the foreign exchange market, the krona, measured in terms of the krona index (KIX), has depreciated by about 4 per cent since October 2018. Part of the reason for this depreciation is that the krona usually depreciates in times of turbulence in the global economy. At the same time, the lower forecast for the repo rate can also be assumed to have had an effect. Supported by clear signals of continued expansionary monetary policy and low global interest rates, equities have continued to increase in value. The Swedish OMX stock exchange index is now about 20 per cent above its level from the autumn of 2018 (see Figure 2:3).

Mortgage rates rose in conjunction with the repo rate increase in December 2018, before then falling back to the same level as previously (see Figure 2:8). As statistics for actual lending rates to households and companies are published with a time lag, the full effects of the rate hike in December 2019 cannot yet be seen in the available data. One of the reasons that mortgage rates have remained more or less unchanged since the autumn of 2018 is the establishment of mortgage credit companies in recent years, which has increased the competition for mortgage customers. This may have contributed to the reduction of margins among banks.[21]

Figure 2:14. Government and mortgage bonds, 5 years

Per cent



Note. The vertical line indicates the Monetary Policy Meeting in December 2018.

Source: Macrobond

Measuring the financial conditions

The development of the financial conditions since the autumn of 2018 is thus not uniform. Some variables, such as yields with short maturities, have risen, indicating less expansionary financial conditions. Other variables indicate more expansionary conditions: yields with longer maturities have fallen, equity prices have risen and the krona exchange rate has weakened. Consequently, to understand how the financial conditions have changed overall, a summarised measure or index may be used. Such a Financial Conditions Index (FCI) was documented in a recently published staff memo.[22] The index is a further development of the FCI that the Riksbank published previously and summarises five

[20] Longer-term yields fell up until the summer of 2019 due to increased international risks, but rose over the autumn as the situation between China and the United States improved and the risk of a no-deal British withdrawal from the EU decreased.

[21] It is possible that the differential between lending rates to households and the Riksbank's repo rate will decrease slightly in the period ahead. The reason for this is that new players on the mortgage market have taken market shares, which has increased the competition for mortgage customers. New players on the mortgage market include Stabelo AB, Svensk Hypotekspension AB and Hypoteket Bolån Sverige AB. See N. Engström, 2020, "New challengers on the mortgage market – Increased competition and possible pressure on interest rates", *Economic Commentaries* No. 1, Sveriges Riksbank, for further discussion.

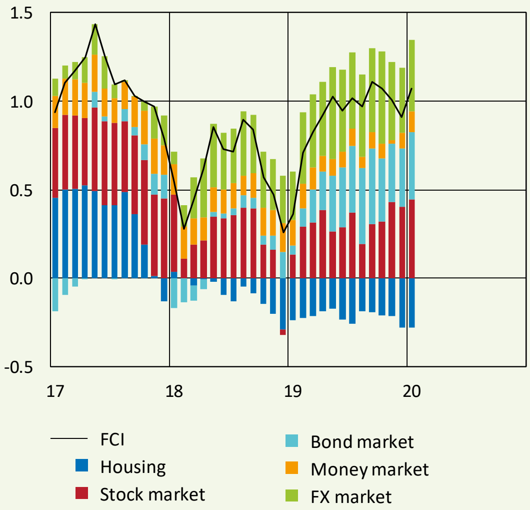
[22] J. Alsterlind, M. Lindskog, and T. von Brömsen, "An index for financial conditions" *Staff Memo* February 2020, Sveriges Riksbank,

different markets: the housing market, equity market, bond market, money market and foreign exchange market. The index attaches the same weight to the different markets and thereby has the advantage of being relatively transparent and easy to interpret.

Development of financial conditions since the autumn of 2018

Since the autumn of 2018, most of the markets included in the FCI have moved in an expansionary direction; the index as a whole has also moved in a more expansionary direction (see Figure 2:15).

Figure 2:15. Financial conditions index, FCI
Standard deviations



Note. A higher value indicates more expansionary financial conditions.
Source: The Riksbank

The change in the FCI is most clearly linked to increased contributions from the bond market, equity market and foreign exchange market, which can be explained by the falling yields for bonds with longer maturities, the depreciation of the krona and the upturn on the stock market. The money market makes a slightly lower contribution than in the autumn of 2018, primarily because STIBOR has risen. At the same time, the contribution from the housing market has been relatively stable since the autumn of 2018. The contribution made by the housing market fell at the end of 2017 and start of 2018 and has been negative since then. The more positive development of the housing market seen recently, with increased optimism and rising prices, has still not affected the FCI significantly. One reason for this is the time lag in the statistics, but also that debt has continued to increase faster than housing prices.

Overall, the financial conditions are deemed to have become more expansionary in Sweden since the autumn of 2018, even though the repo rate has been raised twice. Important reasons for this include the Riksbank's downward adjustment of the forecast for the repo rate and the accompanying fall in forward rates, as well as the more expansionary financial conditions abroad.

It is not clear-cut how more expansionary conditions in turn affect demand and inflation. The reason for this is that the financial conditions sometimes reflect the development of the macroeconomy and are sometimes affected by factors that are more specific to the financial markets. Occasionally, the financial conditions can thus become more expansionary due to expectations of a more expansionary monetary policy, which, in turn, may be caused by worsened macroeconomic prospects. For example, the fall in bond yields since the autumn of 2018 has made a positive contribution to the financial conditions according to the FCI (see Figure 2:15). As has already been pointed out, important reasons for the fall are increased global uncertainty, the slowdown in global economic activity and more expansionary monetary policies abroad. Consequently, even if expansionary financial conditions themselves are contributing to a more favourable economic development, the underlying driving forces must be taken into account to understand how they ultimately affect demand and inflation.