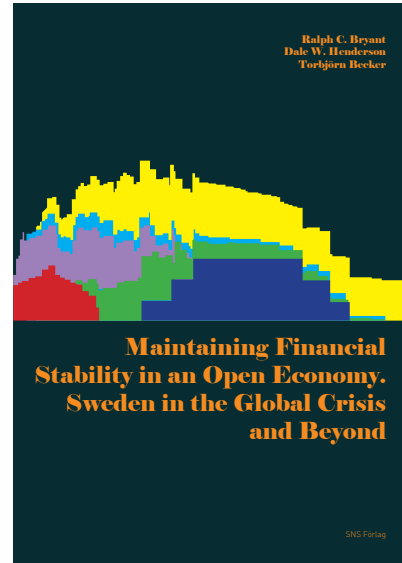


# Maintaining Financial Stability in an Open Economy. Sweden in the Global Crisis and Beyond

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## Executive summary

### Background

Sweden is highly open to the rest of the world, dependent on extensive cross-border transactions in goods, services, and financial assets and liabilities. While exports are now around half the size of GDP, cross-border financial assets and liabilities are 2½ times GDP and the banking system more than 4 times GDP. Swedish financial institutions and markets are now pervasively linked to the rest of the global financial system.

Sweden has been buffeted by financial instability twice in the last twenty years. In the recent global crisis, the underlying causes were predominantly “external” in origin, stemming from financial shocks emanating from financial markets and institutions outside Sweden.

A balanced perspective acknowledges that financial openness is essential to Sweden’s healthy economic growth. But it also supports a thoughtful analysis of the benefits and risks of openness. This report looks back at the Swedish authorities’ crisis responses and looks forward at how policies can be adjusted to reduce vulnerabilities and improve stability.



## Crisis actions

The Swedish authorities responded with alacrity after the eruption of the crisis. The broad range of collective-support activities taken included emergency lending, emergency market support, modification in government guarantees, facilitating the orderly recapitalization or resolution of institutions coping with possible insolvency, and traditional monetary policy.

Following the collapse of Lehman Brothers, assets that had been regarded as safe before the crisis suddenly became suspect. In response, the Swedish National Debt Office held “extra” auctions of Treasury bills where the proceeds were lent out using covered mortgage bonds as collateral to help stabilize financial markets. A few days later, the Riksbank sold “certificates” with interest rates and maturities similar to those of Treasury bills and just as safe and as liquid. Issuing Riksbank certificates is a new way to enhance liquidity.

Another significant crisis measure was the National Debt Office’s guarantee program. In contrast to Ireland’s program, only newly issued debt was guaranteed. The peak use of the program came to some SEK 325 billion, about 10 percent of GDP, with some two thirds related to borrowing in U.S. dollars and euros. Two notable aspects of the guarantee program are its selective importance for a few institutions and the importance of foreign currency funding.

The Riksbank also provided substantial liquidity to the banking system both in foreign currency and Swedish kronor at longer maturities and, at different times, at fixed and variable rates. In contrast, in non-crisis times regular fixed-rate, short-maturity liquidity is provided to support the repo rate. To ensure enough liquidity could be supplied, collateral requirements were relaxed and the list of counterparties extended. In making these longer-term loans, the Riksbank was doing something akin to the quantitative easing pursued by the Federal Reserve and the Bank of England.

Turning to the use of the more traditional monetary policy instrument, the Riksbank cut the repo rate from 4.25 to 0.25 in a nine-month period moving somewhat more slowly than the Federal Reserve and the ECB. It is an open question whether the repo rate should have been lowered more rapidly. There are (at least) two areas where we think there is room for some improvement with regard to the conduct of traditional monetary policy. First, we believe that most central banks have not focused sufficiently on the uncertainty aspects of forward guidance and how to incorporate their judgments about forward-looking uncertainty into their communications with the public. Second, we believe that it would be worthwhile to devote more resources to studying the issues associated with a zero lower bound for the repo rate, including whether innovative options might make central banks less hesitant to cut policy rates all the way to zero.

The exact effects of the various measures are hard to disentangle. Although Sweden experienced significant declines in output and stock prices, spreads on financial instruments were stabilized, credit to households was relatively stable while credit to companies rebounded quickly. Importantly, the financial system survived the crisis more or less intact. All things considered, we have the view that the Swedish crisis

actions were commendably prompt, typically appropriate, and augur well for the management of potential future crises.

There has been considerable debate in the Riksbank Executive Board about how monetary policy should exit from the crisis period. The differences of view among Board members during 2009-2011 about the substance of forward guidance are a first-order issue. Modestly different projected levels for the repo-rate forward-guidance path are associated with probably significant differences in possible outcomes for the economy. The difficult tasks are to determine how best to combine model-based and judgmental analysis and how best to explain the process and associated uncertainties to the public.

## **Lessons for the future**

The global financial crisis has altered the debate about how to conduct financial policies in at least four important ways. First, central banks, market participants, and analysts in general are taking much more seriously the view that traditional monetary policy should give higher priority to financial stability. Second, they are according new urgency to making improvements in prudential policies. Third, they are recognizing that traditional monetary policy and prudential policies have important implications for one another so that they probably should be coordinated if they are to be used to best advantage. Fourth, given these new preoccupations, government authorities and outside observers are focusing anew on the institutional allocation of the responsibilities for the various financial policies – within national governments, but also among international institutions.

Prudential policies encompass both micro and macroprudential policies that aim at reducing the risk of financial instability. Although consultations at the BIS play a key role in developing international guidelines under the Basel III accord, domestic authorities implement the policies. In addition to more general increases in capital requirement for banks, measures to moderate credit fluctuations for stabilization purposes are being proposed. These countercyclical capital requirements (CCRs) can potentially also be used to deal with “bubbles”. The BIS and others have analyzed how CCRs can be implemented in practice and in particular the conditioning variables that can be used to determine when to build up and when to draw down buffers. Some progress has been made but more is needed in order to implement this type of requirement in a systematic way. A prudential tool now in use in Sweden is a loan to value ratio. Its effects are being debated and further study is both warranted and promised. Potentially important for Sweden given its banks operations in foreign currency are liquidity ratios designed to reduce maturity mismatches currency by currency. Many of these measures are promising but it is too early to tell how effective they will be in reducing vulnerabilities.

Buffers to deal with financial shocks can also be built at the national (rather than bank) level. During the crisis, the Financial Stability Fund, which can extend support to troubled financial institutions, was set up with a target size of 2.5 percent of GDP. Also

in response to the external vulnerabilities in the financial system, the Riksbank decided to increase foreign currency reserves in order to be able to support the financial system with liquidity not only in Swedish kronor but also in foreign currency. The size and funding of these buffers have been somewhat contentious.

The potential for instability in financial activity cannot be attributed primarily to cross-border finance. The causes are deeply rooted in the information asymmetries, the expectational and informational cascades, and the adverse-selection and moral-hazard problems that pervade all aspects of financial behavior, domestic as well as cross-border. Yet the cross-border features unquestionably magnify the potential for instability. How to allocate resolution responsibilities and associated costs among Swedish authorities and foreign authorities for complicated cross-border cases is very much an open question, now under active international consideration.

The distinction between the conduct of central-bank monetary policy and the implementation of prudential policies directed at “financial stability” has become blurred. Belatedly, more attention is being given to their interconnectedness. The perennial problem for Sweden is how to catalyze integration and coordination among the different authorities’ decisions regarding monetary policy and financial stability while still preserving the perceived advantages of decentralization. Despite discussions and a memorandum between the involved authorities this issue has not yet been decisively resolved.

The global financial crisis has forced analysts and policymakers alike into a much sharper awareness of the deficiencies of existing models used to guide monetary policy. Models of the transmission of monetary policy through the financial system to the real economy have been shown to be more inadequate than was realized before the crisis. Thankfully, one can now discern an intensification of research efforts to improve the modeling of financial behavior, including at the Riksbank. Eventually, modeling of the macroprudential instruments and their effects will need to be integrated into the larger, general-equilibrium analytical frameworks underpinning all types of macroeconomic and prudential policy actions.

For Sweden, a small open economy with extensive financial links to the rest of the world, the development of macroprudential tools aimed at external vulnerability of the financial system seems a logical priority. Many practical aspects of these efforts remain to be worked out. If macroprudential financial policies have a promising future at all in Sweden, the prospects ought to be bright for those aimed at external-sector vulnerability. In any case, that is where the challenge may be greatest, and perhaps the payoff greatest, for successful measures and procedures.

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