Searching for a macroprudential regime. The case of Sweden

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SWEDISH FISCAL POLICY COUNCIL

Every major financial crisis starts a learning process

Which are the lessons from the recent crisis concerning crisis preventition and financial regulation?

Macroprudential regulation

Macroprudential or macrofinancial supervision – the new approach: Focus on the entire financial system

Microsupervision – the old approach: Focus on individual financial institutions, individual markets and individual assets

The historical pattern

- All major crises in the past have impacted on

  a) economic theories

  b) economic policies (”regulation” or ”control” of the economy)

  c) economic institutions

- Three ”great” crises (depressions) and macroeconomics:

  1. The Great Depression of the 1930s

  (UK and US: Keynes – macroeconomics – keynesianism. In Sweden: the Stockholm School – Ohlin, Myrdal, Lundberg, Lindahl)

  2. The stagflation of the 1970s

  (Friedman and Lucas, monetarism I and II, RET, DSGE)

  3. The Great Recession of today

  (Who is the new Keynes?)

The global financial crisis of 2008-2012

Critique of mainstream macroeconomics

1. Paul Krugman ”the dark age of macroeconomics”
2. Joseph Stiglitz ”needed: a new economic paradigm”
3. Galbraith jr ”leading active members of today’s economic profession … have formed themselves into a kind of Politburo for correct thinking”
4. Andrew Rose ”the crisis theory is in crisis”
5. Soros and INET

But a new macrotheory is not emerging … yet

The historical pattern

Economic crises have impacted on prevailing views of financial markets and financial institutions:

1. The Great Depression of the 1930s

(banking and financial markets were regarded as sources of instability and depression, financial markets were strongly regulated, Glass-Stegal act, after World War II the Bretton Woods system)

2. The stagflation of the 1970s

(Friedman and Lucas, financial deregulation, efficient market hypothesis, RET, finance or financial economics a major new subject in economics, financial deregulation)

3. The Great Recession of today

(Backlash against deregulation. IMF now proposing capital controls. Strong critique of ”finance”)

The global financial crisis of 2008-2012

Critique of ”finance”

1. Financial deregulation caused the crisis
2. Finance as a subject is based on misleading assumptions/models
3. Financial economists were not able to predict the coming of the crisis
4. New types of regulation of financial markets are needed
5. Financial innovations have proved dangerous to society

Macroprudential regulation

The arguments for macroprudential regulation in Sweden as summarized in Chapter 5 of the report of 2011 of the Swedish Fiscal Policy Council

Macroprudential regulation

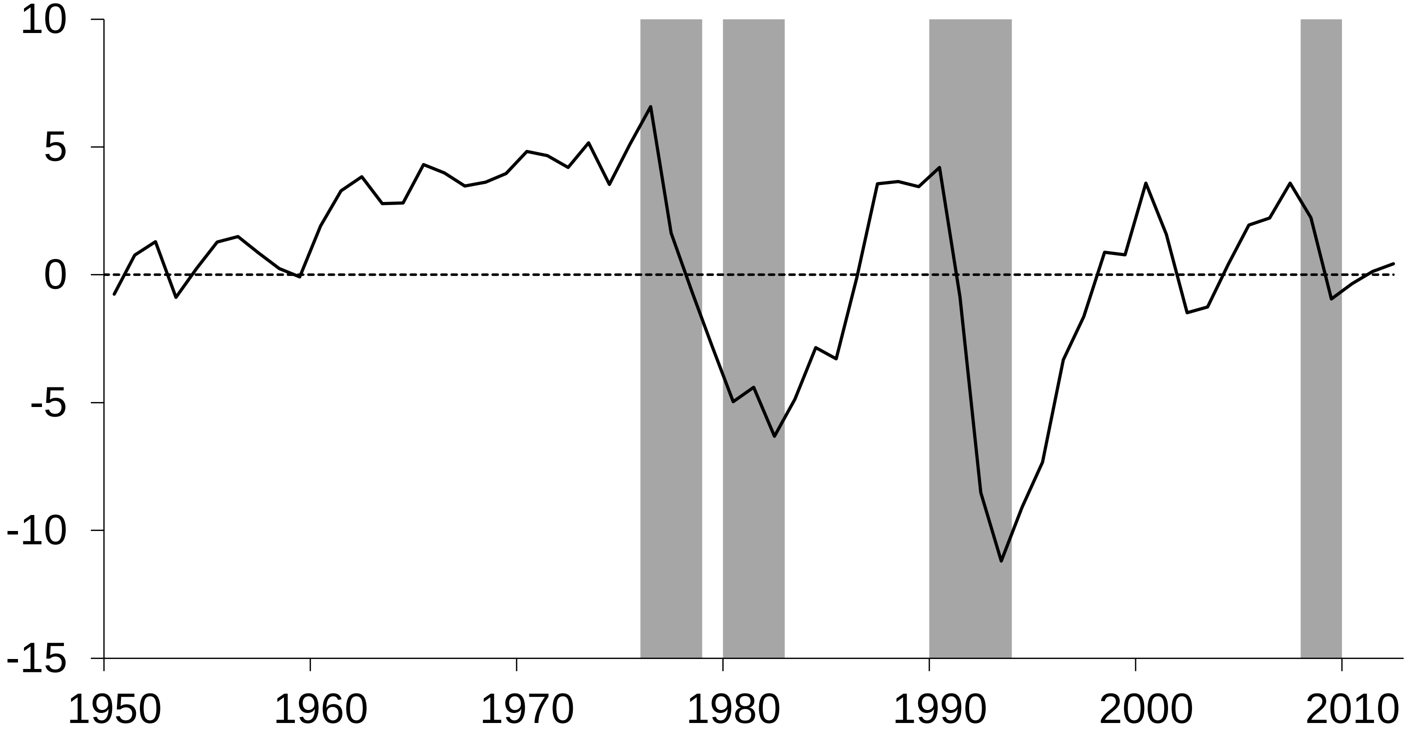
Question: Why should the Swedish Fiscal Policy Council focus on the regulation of the financial system?

The Council has the Swedish fiscal framework as its benchmark when evaluating the economic policies of the government. Focus on sound fiscal policy

Macroprudential regulation

Answer: History shows that financial crises are the major threat to stable public finances.

General government net lending in Sweden, 1950-2011, percent of GDP



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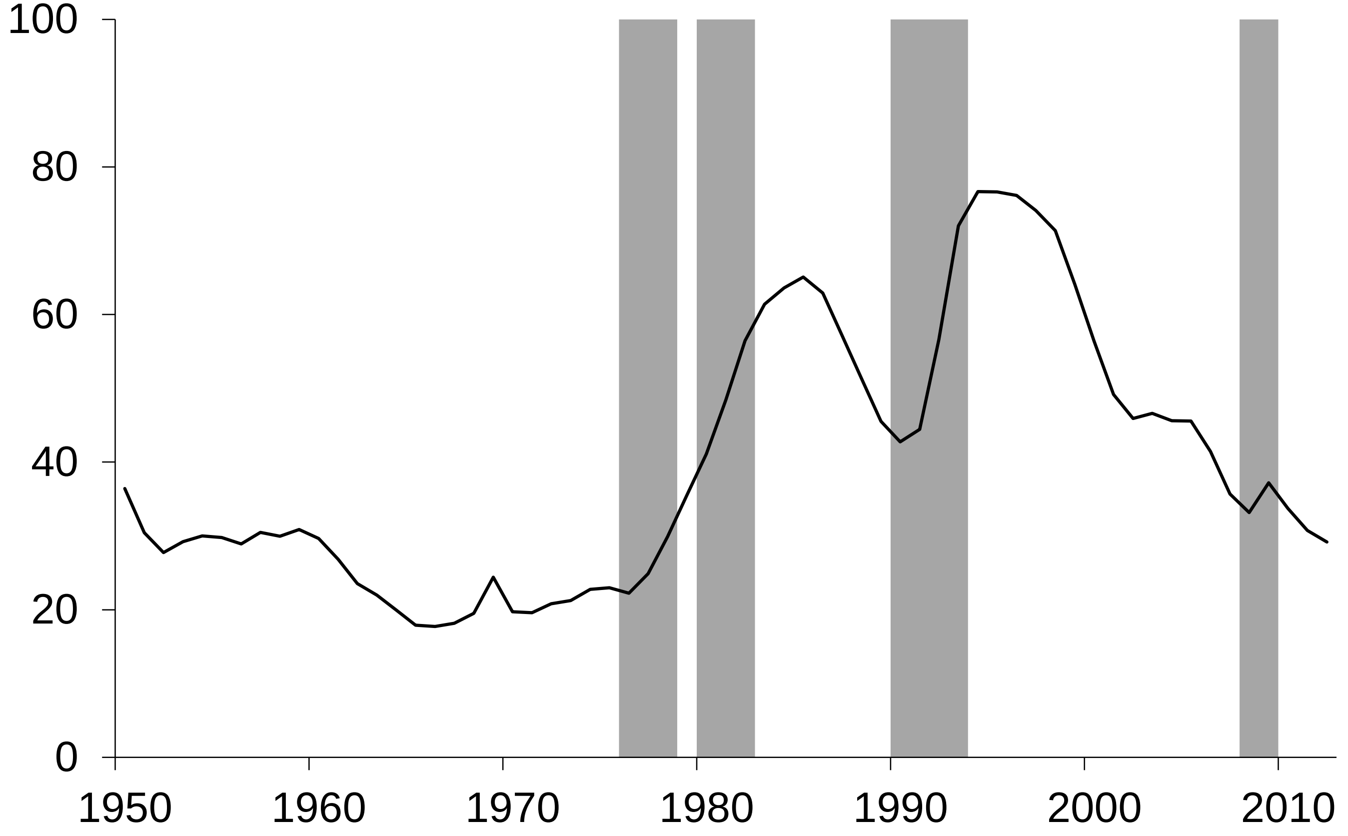
Central government debt, per cent of GDP



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Losses in real income, industrial output and employment in severe crises in Sweden, per cent

Crisis year	1877-78	1907	1920-21	1931-33	1976-78 (OPEC I)	1980-82 (OPEC II)	1990-93	2008-09
1. Real income loss	11.3	11.2	9.6	17.7	9.9	1.9	13.0	13.4
Time below trend	1877-78	1908-09	1921	1931-33	1976-78	1980-82	1990-93	2008-09
Loss per year of crisis	5.7	5.6	9.6	5.9	3.3	0.6	3.3	6.7
2. Industrial output loss	14.7	17.3	19.8	30.9	13.5	5.3	17.0	29.7
Time below trend	1877-78	1908-09	1921	1930-33	1976-78	1980-82	1990-93	2008-09
Loss per year of crisis	7.4	8.7	19.8	7.7	4.5	1.8	4.3	14.9
3. Employment loss	3.1	1.2	8.4	10.9	2.1	1.9	16.6	3.0
Time below trend	1877-79	1908-09	1921-22	1931-33	1976-78	1981-83	1990-94	2009
Loss per year of crisis	1.0	0.6	4.8	3.6	0.7	0.6	3.3	3.0

What caused the financial crisis of 2008-2011?

More than 30 hypotheses about the causes of the crisis

A key reason for the crisis: Failures in financial regulation

The *financial systemic risks* were underestimated by

- Central banks
- Regulatory authorities (financial supervisory authorities)
- Ministries of Finance
- The IMF, OECD, G20 (all except the BIS in Basel)
- Macroeconomists and financial economists at universities

The financial crisis and stabilisation policy

The mainstream prescription *before* the financial crisis:

Monetary policy:

The goal of the central bank: monetary stability (low and stable inflation)

The means (instruments): an independent and rule-based central bank, targeting a low and stable inflation rate using a short-term rate of interest

The financial crisis and stabilisation policy

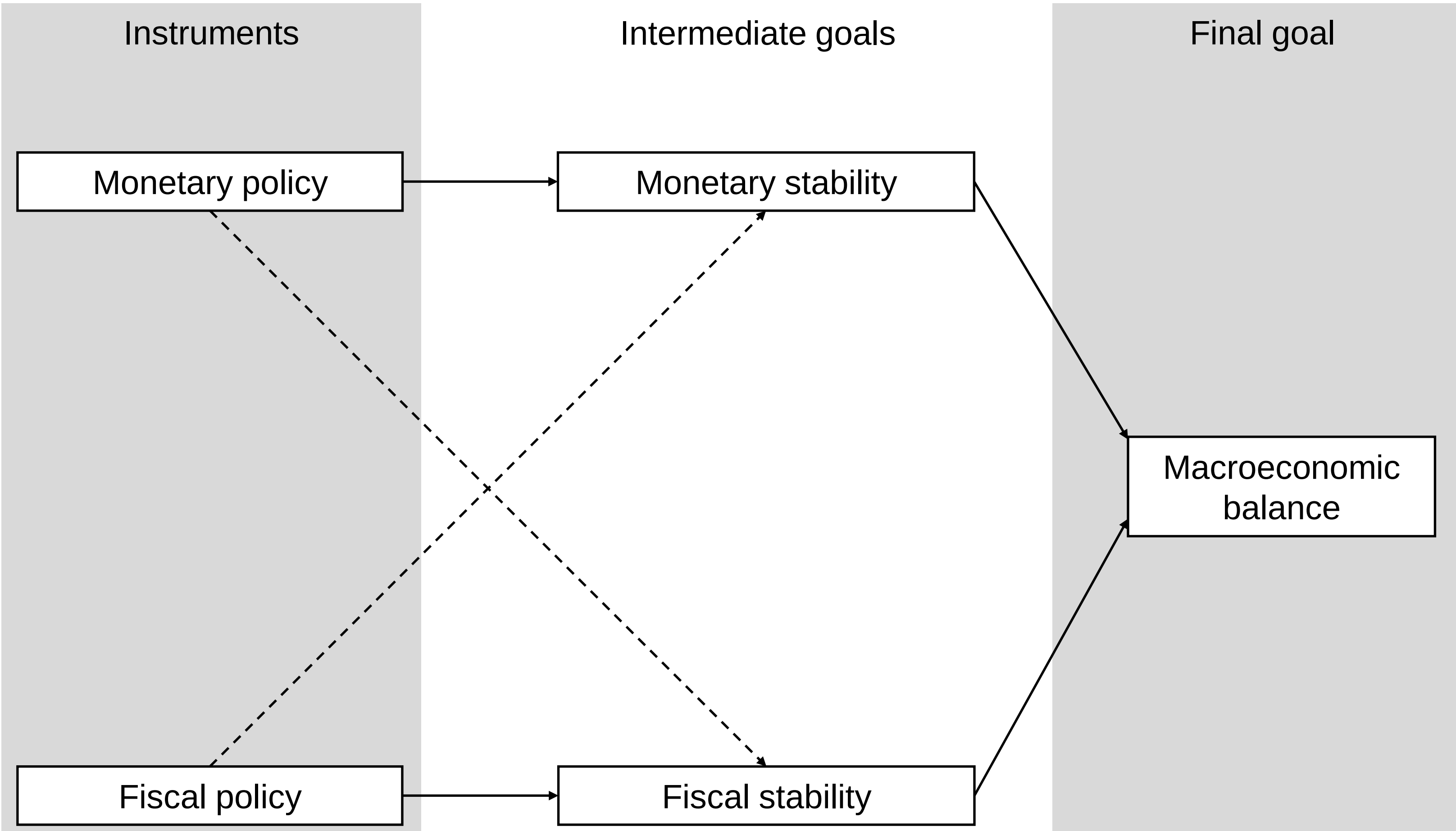
The prescription *before* the financial crisis:

Fiscal policy:

The goal: fiscal sustainability (balanced budget over the business cycle)

Means (instruments): reliance on automatic stabilisers, no discretionary policy, rule-based fiscal policy

Relationships between monetary policy and fiscal policy. A schematic description of the pre-crisis view.



The financial crisis and stabilisation policy

The prescription *during* the financial crisis:

Monetary and fiscal policies:

Focus on rescue operations, discretionary measures, QE, TARP, support to financial institutions, subsidies etc.

The pre-crisis paradigm was rejected by central banks and ministers of finance - a return to lessons learned from the 1930s.

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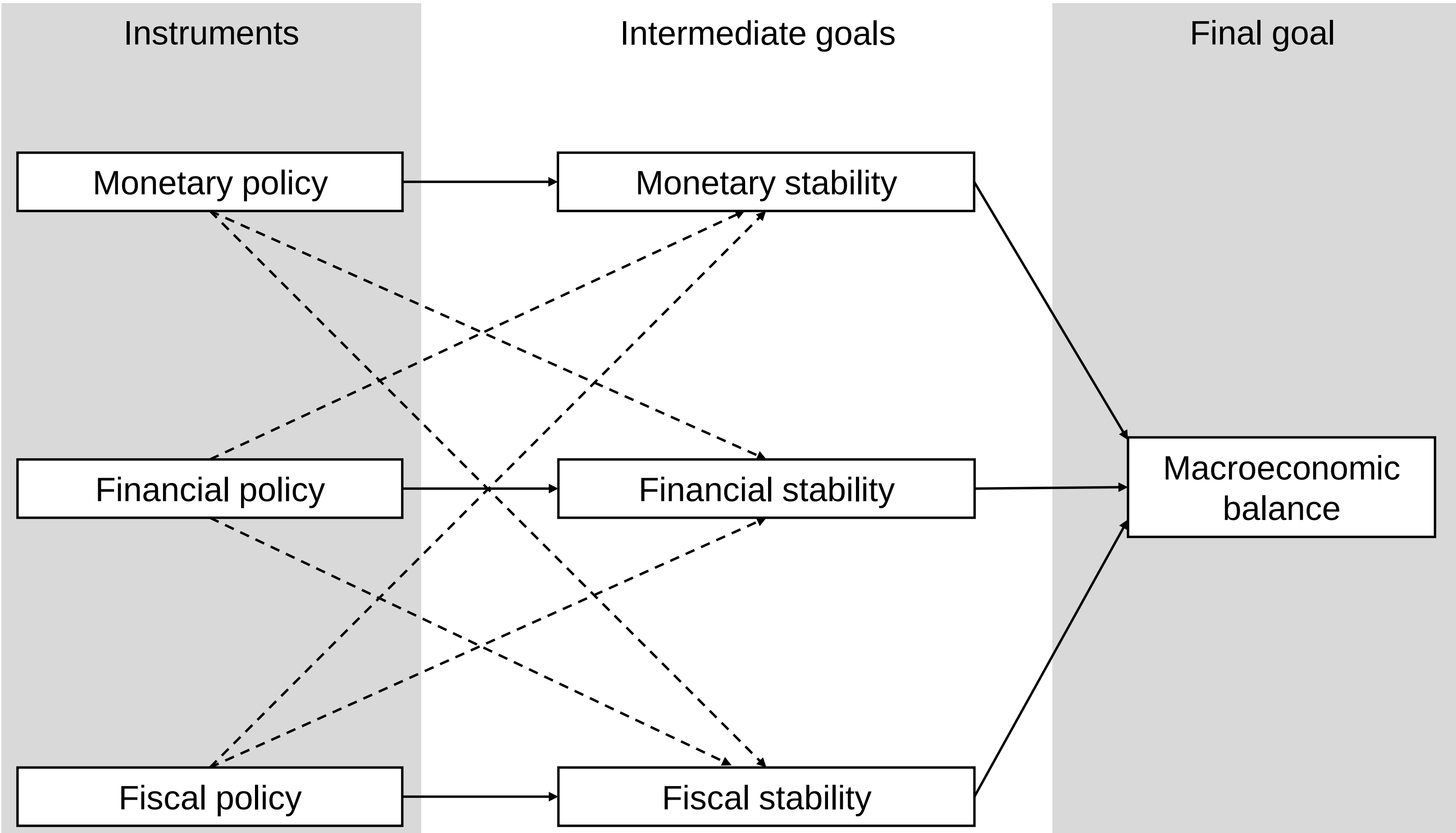
The financial crisis and stabilisation policy

The prescription *after* the financial crisis:

Monetary and fiscal stability are *necessary* but not *sufficient* conditions for macroeconomic balance.

Financial stability - a new goal for stabilisation policy.

Relationships between financial policy, monetary policy and fiscal policy. A schematic description of the post-crisis view.



What is financial stability?

Difficult to define

The objective of financial supervision and regulation:

minimize the risks of future financial imbalances and crises, and at the same time give the financial system opportunities to fulfill its traditional functions and develop over time in response to new challenges.

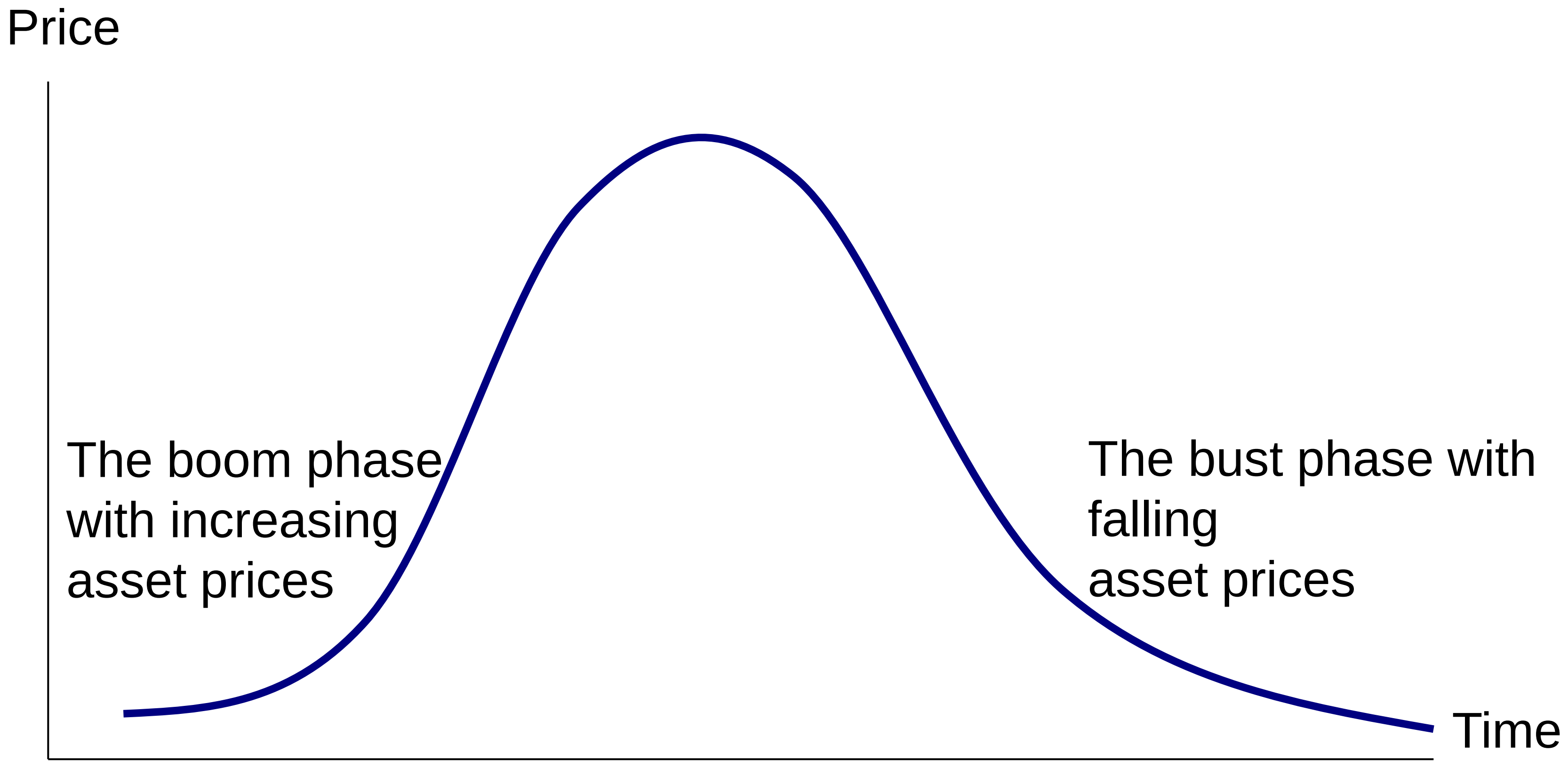
The theory of financial crises

There is no theory

There is a consensus regarding the evidence:

The volume of credit is a the central variable in all financial crises

The anatomy of financial crises



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Macrofinancial regulation: Focus on the systemic risk

Three arguments for macro regulation:

- The credit cycle (the financial cycle), (boom-bust)

- Banking crises - network effects

- Important institutions for the financial system

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Macrofinancial regulation

Dynamic regulation:

1. Cyclically adjusted bank capital requirements

2. Bonuses are calculated over a longer period of time

3. Other proposals, improved accounting, audit, etc. Double liability for bank share holders

Comparison of macroprudential and microprudential policies

	Macroprudential perspective	Microprudential perspective
Intermediary objective	Limit risks of imbalances in the entire financial system (general equilibrium approach)	Limit risks of imbalances in individual financial institutions, instruments or markets (partial equilibrium approach)
Final objective	Prevent financial crises that undermine the macroecono-mic balance	Protect consumers/depositors/ investors/other financial institu-tions
Sources of shocks	Shocks are primarily seen as created endogenously in the financial system	Shocks are primarily seen as exogenous
Co-variation of risks and interdependence among financial institutions	Important	Less important or unimportant
The design of regulatory measures	Regulation addressing the entire financial system	Regulation addressing individual financial institutions, instruments or markets

Macrofinancial supervision - not regulation

European Systemic Risk Board (ESRB)

Financial Stability Oversight Council (FSOC) in the U.S.

Financial Stability Committee at the Bank of England in the UK

Problems with macroprudential regulation

- There is no theory for when the threats are too large (where is the threshold?)

- Heavy demands on the regulatory authorities concerning the dating of the financial cycle.

- Micro-management of banks and financial institutions. Back to the credit regulation policies prior to the financial deregulation.

Macrofinancial regulation
(The Swedish Case)

Who should be in charge?

- The Riksbank (the central bank)?
- The Financial Supervisory Authority?
- A new financial stability council (assessing the systemic risks)?

Macrofinancial supervision and regulation Two ways forward:

- Greater responsibility for the Riksbank
- A new Financial Stability Council

Pros and cons of the Riksbank in charge of macroprudential supervision and regulation

Advantages:

- The Riksbank has most resources (Financial Stability Report twice a year)
- The Riksbank has close ties to financial markets

Disadvantages:

• The Riksbank has (presently) only one instrument, the repo rate

• Possibly conflicting objectives, unclear fulfillment of the mandate of the Riksbank (IT vs financial stability)

• Too close ties to the “market”

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Pros and cons of a Financial Stability Council

Advantages of an FSC

- Focus on only one goal - systemic risk
- More independence as a new and small organisation.
- A new voice in the economic policy debate
- More of an alarmist approach

Disadvantages of an FSC

- Analytical capacity is duplicated
- The Riksbank may feel less responsible for stability
- FSC advice can be ignored - FSC has no leverage

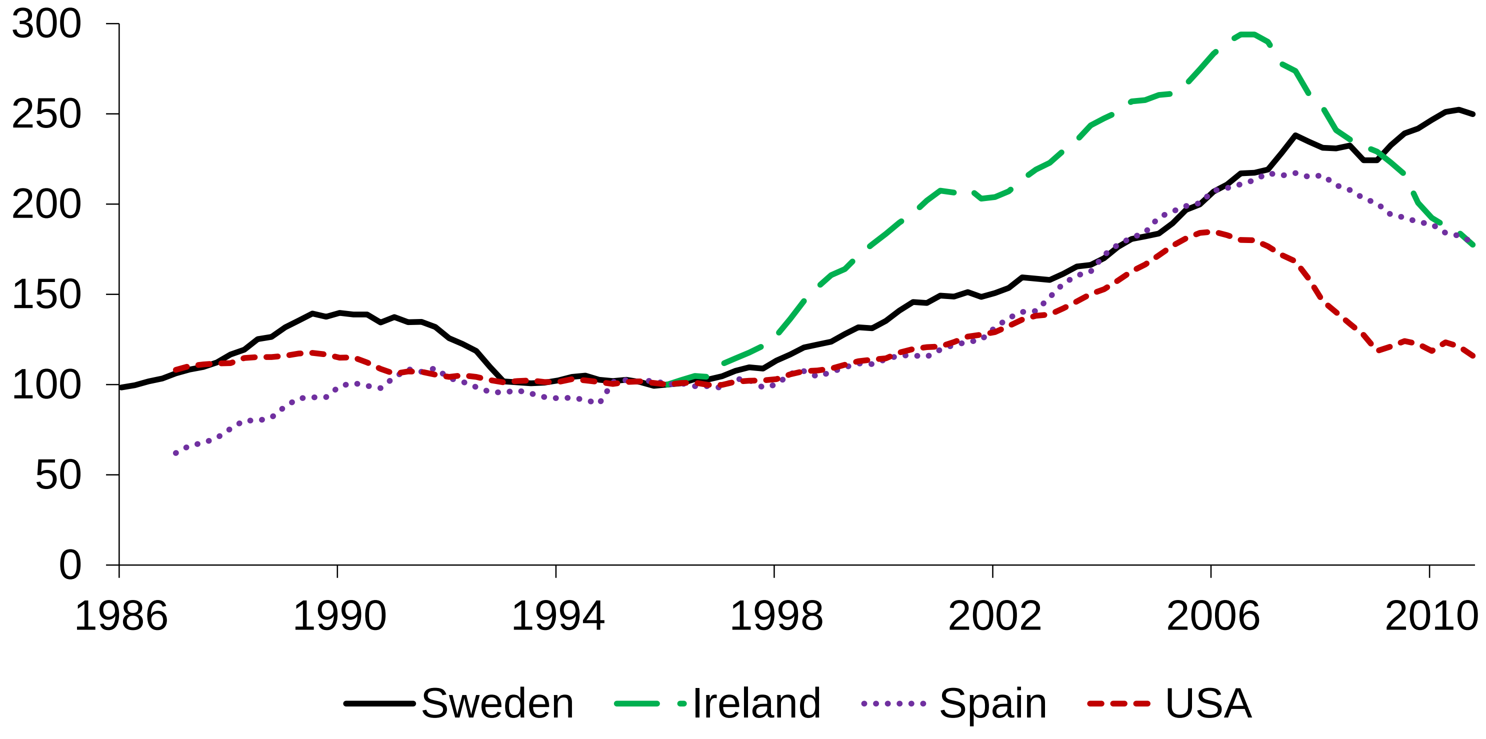
Something is going on …

1. The Swedish Fiscal Policy Council in May 2011
2. "Evaluation of the Riksbank's monetary policy and work with financial stability“ (Goodhart and Rochet) in August 2011, published by the finance and budget committee of the Riksbank
3. Financial Crisis Committee appointed in February 2011 by the Government, to publish its final report in August 2012
4. The budget (“Finansplanen”) in September 2011
5. Becker, Bryant and Hendersson, December 2012

Frequency of words associated with financial markets, financial imbalances and financial crises in the Budget Statements of 2003-2011

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Financial markets	3	2	1	4	5	29	54	63	32
Bank lending	0	0	0	0	0	0	5	8	6
The supply of credit	0	0	0	0	0	0	0	1	1
Financial stability	1	0	0	0	3	2	9	27	24
Financial instability	0	0	0	0	0	0	0	0	7
Risk taking	0	0	0	0	0	0	4	2	3
Financial regulation	0	0	0	0	0	0	1	13	1
Total	**4**	**2**	**1**	**4**	**8**	**31**	**73**	**114**	**74**

Real house prices in Sweden, Ireland, Spain and the United States, index 1996 = 100



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Finally,

Question: Will macro-financial regulation rescue Sweden from the next financial crisis?

Answer 1: No, but it will reduce the risk of large imbalances and thus a major crisis

Answer 2: No, the future can not be crisis-free

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