Monetary Policy in Sweden

by

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In the last few years the official attitude to monetary policy in Sweden has undergone a slow but significant change. The illusions of the earlier postwar years, when it was believed in official quarters that even a very strong inflationary pressure could be checked without recourse to monetary restrictions, have been shattered. Monetary policy is again given its logical rôle as a stabilizing influence in the economy. However, this change in the official attitude does not mean a simple return to orthodoxy in the monetary field. The kind of restrictive monetary policy that has developed in Sweden in the last few years is quite unorthodox in the sense that it does not operate through an increase in the *cost* of money but mainly through an increased *scarcity* of loanable funds. To prevent the scarcity of money from raising the level of interest rates recourse has had to be taken to a series of direct regulations of the lending activities of the credit institutions.

The object of this article is to discuss briefly the scope and methods of this new monetary policy, and to describe the background from which it developed.

Monetary Policy in the Earlier Postwar Period.

From the end of the war up to the summer of 1950 monetary policy in Sweden was almost completely passive, and the central bank, the Riksbank, did not play any decisive rôle in the shaping of economic policy. The conditions of cheap and easy money that existed at the end of the war were maintained unchanged in spite of very considerable changes in the general economic situation. The objective of monetary policy during this period, if one can talk of any objective at all, was to stabilize the interest rate rather than to stabilize economic developments. At the end of the war the official discount rate of the Riksbank was 2.5 per cent and the yield on long-term Government securities 3 per cent. These strategic money rates were maintained unchanged all through the period up to the autumn of 1950. Any market pressures tending to upset this pattern of interest rates were quickly and effectively counteracted by Riksbank operations.

This meant that the weapons of monetary policy were deliberately discarded, in spite of the fact that very severe strains on the economic situation of the country developed very early in the postwar period. These strains were first clearly seen in the development of the balance of payments situation. Sweden emerged from the war in a very strong international payments situation but as from the second half of 1946 the situation deteriorated very rapidly. There was a large degree of income inflation in the country and the excess purchasing power led to a very sharp increase in imports from abroad while for the same reasons Sweden's exports lagged behind. As a result of this pressure the combined reserves of gold and foreign exchange of the Riksbank dropped from nearly 3,000 million kronor in the beginning of 1946 to around 500 million kronor in the summer of 1948.

Traditionally such a development would very soon have created a severe shortage of money in the market. There would have been a strain on the liquid resources of the banks and the banks would have had to curtail their lendings very rigorously. The increased shortage of money and credit would in such a situation have served to curb the tendencies to increased imports and would thus sooner or later have afforded a certain corrective influence on the balance of payments crisis.

In actual fact, however, this corrective influence was not allowed to operate. As the shortage of liquid funds caused the banks to sell bonds on the market to strengthen their cash position, the Riksbank consistently counteracted the downward tendency of bond prices resulting from the sales pressure by substantial supporting purchases on the open market. This was done expressly to prevent the long-term interest rate from rising above the 3 per cent level. The proportion of these open-market purchases is shown by the increase in the bond portfolio of the Riksbank from around 1,000 million kronor in the summer of 1946 to around 3,000 million in 1948. As a matter of fact, in this very short period the Riksbank thus took over from the marked about 20 per cent of the entire outstanding debt of the Swedish Government.

Why, then, was the 3 per cent interest rate so stubbornly defended? Two main reasons can be offered as an explanation of this policy. First of all a higher interest rate was thought undesirable because of the difficulties it would have put in the way of the housing programme of the Government. This programme called for a substantial volume of new construction and a gradual lowering of the rent level relative to average incomes. Higher interest rates would clearly have restrained housing activities and would also have meant higher rents. Secondly, in Government and Riksbank circles higher interest rates were not regarded as an effective method to counteract the inflationary tendencies. It was generally supposed that the primary cause of the inflation was the very large volume of new investments in industrial enterprise and it was thought that an upward adjustment of interest rates within reasonable bounds would not be effective enough to ininfluence the volume of investments in a decisive way.

This attitude clearly disregarded the quantitative effect of monetary policy on the supply of credit. Obviously the volume of investments, even if it is not always very much influenced by a moderate change in the cost of money, is closely dependent upon the supply of money. A restrictive monetary policy would have meant not only dearer money but also an actual shortage of money for lending purposes. As the situation now developed, there were practically no restrictive limits to the lendings of the commercial banks. The banks had emerged from the war in an extremely liquid position, holding very substantial portfolios of Government securities which could now easily be « monetized » and thus serve as a basis for increased lendings. All through these years there was a substantial credit expansion in the commercial banking system and this credit expansion served to finance a substantial increase in real investments, which in turn overstrained the available real resources of the economy and led to a competitive bidding up of prices and wages. The total loans and discounts of the commercial banks increased from 5,800 million kronor in December 1945 to 8,000 million kronor at the end of 1947. During those two years the average wage level for industrial workers in Sweden rose by around 25 per cent. Had the credit expansion been effectively curtailed in its early stage there is no doubt that this would at least have moderated the force of the inflationary movements.

Monetary Policy in the Post-Korean Inflationary Crisis.

In the absence of any active monetary policy, a stabilization of Sweden's economic situation did not come about until the latter half of 1948, partly as a result of increasingly rigorous direct controls over building activities and imports, but partly also owing to the gradual slowing down of inflationary developments in the international sphere. The situation continued inherently unstable, however, and after the outbreak of war in Korea there was a new inflationary upsurge in Sweden, primarily caused by international influences. The increase in international prices led to new increases in the Swedish price level, which in turn gave rise to demands for higher wages. To finance the higher volume of payments, trade and industry needed more credits and a new credit expansion got under way in the banking system.

To this situation the authorities responded very quickly. Economic policy generally was tightened up and in this connection for the first time in the postwar period efforts were also made to reactivate monetary policy. Various measures were taken to this end:

(a) Interest rates were raised. In the summer of 1950 the Riksbank temporarily discontinued its open-market purchases of bonds and let the yield on long-term Government securities rise above 3 per cent. Thus bond rates later in the atumn settled down at a level about ½ per cent above the previous one. As a consequence, in December 1950 the Riksbank's official discount rate was raised from 2 ½ per cent to 3 per cent, with consequent changes in the money rates all through the credit system. Earlier in the autumn the special rediscount rate — ½ of one per cent below the official discount rate — applied to the rediscounting of commercial bank bills, had been abolished.

(b) Quantitative restrictions were placed on commercial bank lendings through a new system of cash reserve requirements. These requirements were fairly moderate, however, and in the case of most banks were actually below the liquidity holdings maintained before the new requirements were imposed.

(c) A system of voluntary credit restrictions was introduced in the banking system. Through these « qualitative » restrictions the Riksbank endeavoured to steer bank lendings into certain channels deemed to be of particular importance in the then existing situation.

In principle, these measures involved entirely new signals for monetary policy, and there is no doubt that this programme could have been used effectively to counteract the inflationary pressures. In actual fact, however, the new policy proved very largely ineffective. An arsenal of weapons had been built up, but the Riksbank was disinclined to use these weapons as forcefully as the situation demanded. This became obvious fairly early in 1951 when the Riksbank resumed its open-market purchases of bonds to prevent a further rise in interest rates from the newly established 3 ½ per cent level. It became still more obvious in the second half of 1951, when the exceptional export boom in the Swedish forest industries brought a substantial inflow of foreign exchange into the country. As the foreign exchange earned by exporters was offered for sale to the Riksbank, this caused a substantial increase in the supply of money. If the Riksbank had really been intent on pursuing a policy of monetary restrictions, these sales should of course, have been offset, either by sales of bonds out of the Riksbank portfolio on the open market or by raising the cash reserve requirements imposed upon the commercial banking system. In actual fact, however, for fear of disturbing the stability of interest rates the Riksbank refrained from taking such restrictive measures. Thus, the bond and foreign exchange purchases of the Riksbank in 1951 increased the total volume of central bank credit by around 600 million kronor and this was reflected in a continued credit expansion in the banking system. During 1951 deposits in the commercial banks increased by 1,600 million kronor and their lendings by over 900 million kronor. The effect of this failure to check the credit expansion is shown very clearly in the price and wages developments. Thus, from the summer of 1950 to the end of 1951, wholesale prices in Sweden rose by 43 per cent, the cost of living index by 22 per cent and average wage rates for industrial workers by 26 per cent. Of course, some inflationary effect on prices and wages would in any case have been inevitable as a result of international influences, but there is no doubt that this effect could have been moderated substantially had sufficiently restrictive monetary limits been imposed on this development.

The New Monetary Policy of 1952.

The situation prevailing in 1951 — which from a monetary point of view meant that the Riksbank continued to create the liquid resources necessary to finance the inflationary rise in prices and wage rates — was, of course, untenable in the long run. It soon became obvious that a truly restrictive monetary policy would have to be introduced in order to get the inflationary forces under control. Consequently, towards the close of 1951 and in the first months of 1952 more decisive efforts were made to curtail effectively the supply of credit. A programme of severe credit restrictions, qualitative *and* quantitative, was introduced, which has been in force since February 1952.

This programme is still based on the assumption that it will be possible to maintain the long-term interest rate pegged at 3 ½ per cent. It differs, however, from the earlier attempts at a restrictive monetary policy in the sense that the accent has now been put on *quantitative* restrictions of credit. The experience in 1950 and 1951 showed very clearly that qualitative restrictions on bank credits could not be made effective unless supported by a truly restrictive policy in a quantitative sense. In other words, an effort to steer bank credits into certain channels cannot be effective unless steps are also taken to curtail the supply of funds available in the commercial banks for new lendings.

The various elements of the new policy are mainly the following.

(a) Through a system of reserve requirements the available supply of loanable funds in the banks has been curtailed. This has been achieved on a voluntary basis through an agreement between the Riksbank and the commercial banks (1). The previous cash reserve requirements have been abolished and instead the commercial banks have undertaken to keep a certain proportion of their deposits invested in liquid assets, *i.e.* mainly cash and short-term Government securities. The « liquidity » ratios fixed under this agreement are differentiated among the banks, being higher for the larger banks and lower for the smaller ones. From the outset, these ratios were fixed at a fairly high level, being for most banks much above the actual liquidity maintained before the agreement went into force. The understanding was that in the course of the subsequent months the banks should use any increase in funds deposited with them to build up their liquidity position until they had reached the ratios fixed in the agreement.

(b) The system of qualitative credit restrictions introduced in 1950 is maintained. This means that in their lending activities the banks have mainly to supply credit for such purposes as are given a high priority from the viewpoint of economic policy, *i.e.* they are to support essential production and exports and refrain from giving credit for speculative purposes and for consumer financing. Special importance is attached to credits for housing purposes, and the banks have undertaken at least not to reduce the proportion of their total lendings used for housing credits.

(c) The agreement with the commercial banks is supplemented by a system of agreements between the Riksbank and other types of credit institutions, such as savings bank, insurance companies, mortgage associations, agricultural credit associations, etc. In these agreements guiding rules are laid down for the lendings of these institutions primarily with a view to establishing a certain priority for housing credits. Thus, in the case of the insurance companies, the agreement involves an undertaking not to reduce the proportion of their total lendings and investments directed to housing finance and to the financing of local authorities (a large proportion of which indirectly serves to finance housing). Conversely, the insurance companies have undertaken not to increase, in proportion to their total loans and investments, their lendings to industrial firms. The latter proviso has been necessary in order to prevent such applicants as have been refused credit by the banks from getting their demands satisfied by the insurance companies.

(d) Interest rates for certain privileged credits are stabilized by agreement with the credit institutions. These have undertaken not to raise the rates for Government bonds, loans to local authorities and housing loans above the 3.5 level. For other credits, a certain flexibility in interest rates is tolerated. However, as the programme does not foresee any change in the Riksbank's official discount rate, no general upward adjustments in the loan rates charged by the banks have been possible.

(1) The « voluntary » aspect should perhaps not be overstressed. The commercial banks obviously had not really any other choice but to accept this agreement rather than a legal regulation, which would have been the alternative. It was voluntary, however, in the sense that the banks recognized the need for a more restrictive policy and the « voluntary » form also made it possible for the banks to get their special viewpoints heeded in the elaboration of the various details of the policy.

(e) The Riksbank controls the capital issue activities on the market through a system of informal regulation. All banks desiring to float a bond issue for account of a customer have to queue up at the Riksbank and await permission to go ahead. Such permits are given very sparingly and in a way that allows a certain measure of priority for bond issues for account of the Government and local authorities.

(f) Preparatory to implementing the programme of credit restrictions, a law was enacted in the autumn of 1951 giving the Goverment certain emergency powers to control interest rates by decree, including the power to fix maximum rates for loans and minimum rates for deposits applied by all credit institutions and other lenders in the market. This law has not yet been put into force but remains as « a club behind the door » in case the credit institutions should not behave in the way expected by the authorities.

The Effect of the New Credit Policy.

To judge from the banking statistics, the new credit policy introduced in February 1952 has seemingly had a very decisive effect. The previous trend of monetary inflation seems to have been broken in a definite manner and to have given way to a markedly deflationary development. Thus, between November 1951 and November 1952, the loans and discounts of the commercial banks were reduced by over 300 million kronor or by roughly 3 per cent and deposits in the commercial banks fell by 45 million kronor or 4.5 per cent.

It is necessary, however, to warn against drawing too hasty conclusions on this point. The deflationary effect has coincided with the very pronounced setback that has occurred in the international field during this period and which has affected Sweden's main exporting industries very severely. It also coincides with a pronounced slump in the textile industry and other home-market industries that had already started in the latter half of 1951 before the introduction of the new credit restrictions. It is somewhat difficult, therefore, to tell what is the cause and what is the effect in monetary developments during 1952.

In any case, it seems to be beyond doubt that the severe credit restrictions have been at least an important contributory factor in the economic stabilization brought about in Sweden in 1952. The banks have tried very hard to increase their liquidity ratios to the prescribed level and have, consequently, had to be very restrictive in their lending policies. Thus, an acute shortage of funds has developed in the credit market and many business firms have had to cope with very serious liquidity problems. This, in turn, has led to efforts throughout the economy to reduce commodity stocks and to trim down investment projects. There is, in fact, every reason to believe that the change-over from the inflationary business mentality prevailing in 1951 to the present attitude of caution and moderation has been strongly influenced by the psychological effect of the credit restraint.

The effects of the credit restrictions on investment activities have been particularly manifest, as is clearly indicated by available data on prospective investment activities. A forecast of industrial investments for the coming year, based on a questionnaire sent out to major industrial firms, is made in the autumn every year by the Swedish Business Research Institute. The projects thus recorded for 1953 indicate a planned reduction in building investments by 20 per cent and in machinery and equipment investments by 30 per cent compared to 1952. This is the first time in the postwar period that this annual survey shows a reduction in planned investments. This swing-over is no doubt explained in part at least by the increasing difficulties in the way of financing investment activities.

While the influence of the new credit policy on economic activities generally has thus obviously been in accordance with the original intentions and motives, this does not mean that the policy has been successful in all respects. There have been certain undesirable effects which seem to be inevitable so long as one tries to pursue the dual objective of making credit scarce *and* of preventing the interest rate from rising. In the short run, both these objectives may perhaps be attained by means of a detailed regulation of the activities of the credit institutions, but in the long run such an effort is bound to give rise to disturbances and dislocations on the credit market.

This is clearly illustrated by developments on the Swedish credit market in the course of 1952. One such disturbing effect has been a splitting up of the previous pattern of interest rates. The « priority » rates for the obligations of the Government and local authorities and for housing finance have been maintained at the 3.5 per cent level, but in the « free » section of the market rates have tended to rise. Thus, for instance, for fixed loans to industrial borrowers granted by insurance companies the rate has risen from 3 ¾ to 4 ¼-4 ½ per cent. For insurance companies and other institutional investors this increasing spread has made it more tempting to invest in such loans and in industrial bonds, to the detriment of investments for the « priority » purposes for which the interest rate has remained frozen. In spite of the agreement between the Riksbank and the insurance companies it has been impossible to prevent such a market influence from operating on investment decisions, all the more so since a great many institutional investors remain outside the official control. As a result it has become increasingly difficult to satisfy precisely those credit demands which the authorities have tried to favour through its policy of cheap interest rates, *i.e.* mainly housing finance.

Another undesirable effect is a certain splitting up of the credit market as a result of the official credit restrictions imposed upon the banks. As the lending policies of the banks have been tightened up, there has been a tendency for private lending operations at higher interest rates to increase. This private credit market has, of course, been fed by withdrawals from the deposit accounts in the banks, and has thus increased the difficulties of the banks in meeting the legitimate credit needs of their regular customers. It is true that this disorganisation of the credit market has not yet reached any alarming proportions, but it may eventually give rise to concern should the present system of credit restraint combined with artificially cheap money rates be continued over a lengthy period.

Conclusion.

It is perhaps too early as yet to judge the effects of the policy of credit restrictions introduced in Sweden in the beginning of 1952. Developments during the year do seem, however, to permit of certain preliminary conclusions.

One such conclusion is that the restrictive monetary policy has been an important contributory factor in bringing about a greater measure of stability in the economy. The fact that the strong and persistent inflationary tendencies that characterized the Swedish economy in the first postwar years and in the period 1950-1951 could not be effectively kept under control must be largely ascribed to the failure of the monetary authorities during these periods to restrain the creation of new money.

A second conclusion is that a qualitative regulation of credit either by voluntary agreement or by selective controls cannot work effectively by itself but has to be combined with a sufficiently rigorous quantitative regulation of the supply of loanable funds in the banking system. The failure of monetary policy in Sweden to cope with the post-Korean inflationary upsurge can largely be explained by a lack of coordination between these two elements of credit control.

A third conclusion is that a policy of credit restraint cannot in the long run, without causing serious dislocations on the credit market, be carried through if the rate of interest is not allowed to rise to a level that equates demand and supply in the market for loanable funds. In this sense the monetary authorities in Sweden are at present faced with a difficult dilemma. As long as certain purposes of credit are to be given a favoured position in the distribution of credit the authorities will have either to accept the market pressure for higher rates for these « priority » purposes also, or they will have to increase the supply of funds through expansive central bank operations. Which way out of this dilemma will ultimately be chosen is not yet clear, but obviously the latter course would mean a retreat from monetary policy which would be hazardous so long as the risks of a new inflationary upsurge are not yet definitely overcome.