

Swedbank's Chief Economist, Cecilia Hermansson, and Ylva Yngveson, Director of the Personal Finances Institute at Swedbank, discuss...

what is happening to our money

... in the aftermath of the financial crisis

Ylva: Over the last ten years, wage earners have seen their financial situation improve significantly. In Sweden, a two-child family has about SEK 10 000 more every month to spend in real prices compared with a similar family in 1998.

Cecilia: In the last decade, the financial sector has taken on a much greater role in our lives. The economy is complex. It can be especially complex to save, when you consider all the confusing alternatives that are available.

Ylva: Interest rates have gone from very low to painfully high – and then the pendulum quickly swung back in the other direction. Now everyone is wondering, of course, how low rates will go. Just like everyone was wondering in the spring of 2008 how high they would get, now we are all wondering how low they can fall and how long they will stay there.

Cecilia: In the U.S. and Japan, key interest rates are near zero, while European central banks still have room for further rate cuts.

Ylva: Many people are naturally wondering why there is such a big difference between the Riksbank's repo rate and the interest rate on their loan. The gap increased in connection with the financial crisis because risks have increased and the price of risk, i.e., the bank's funding costs, has risen.

Cecilia: Banks set interest rates based on a risk-free portion, which is expressed as the price of government bonds, a risk portion and, lastly, inflation. Recession and falling inflation would seem to point to low interest rates, but on the other hand increased government borrowing needs to entail higher long-term rates.

Ylva: Interest rates, the stockmarket and housing prices – that is what many customers are worried about. Right now they all seem to be going in the same direction: down. The fact that loan fees are dropping is positive, of course, but for many people the diminished value of their assets certainly has a major impact on what they can and will do.

Cecilia: The financial crisis is contributing to weaker demand around the world, but at the same time central banks and governments are taking measures to significantly ease the situation. The crystal ball is a little cloudy right now, to put it mildly.





**Ten years of high growth and low inflation
– why did the good times end?**

Cecilia: American households have taken on huge amounts of debt aided by low interest rates and rising housing prices. The U.S. current account deficit was allowed to grow and was financed in part by China and Japan, which in turn boosted their currency reserves. The imbalances, along with low inflation resulting from slumping import prices and strong competition from emerging economies, pushed bond yields lower. In the end, things spiralled out of control. Commodity prices began to rise. The U.S. dollar fell and this led to more expensive oil and higher inflation. The debt burden became too heavy to bear, house prices fell and the financial crisis became a reality after the collapse of subprime lending.

Ylva: The problem is that we are not putting enough money away in good times. On the contrary, that is when we are borrowing to spend. This is a paradox or contradiction. When times are bad, when we are short of money, that is when we hold back and try to save. Instead, that is when we should be spending as usual, so that the situation does not get any worse than necessary.

Cecilia: If anything, the financial sector's development, tax laws as well as low interest rates and rising asset prices encouraged people to borrow rather than save.

Ylva: We have a fairly weak savings tradition in Sweden. In Finland, they are more inclined to save their extra earnings, from summer jobs, for example. Swedes do not seem to have the same attitude. No less than 20 percent of adult Swedes do not have one single krona in savings, and 15 percent have between SEK 1 and SEK 10 000. Saving is not a goal in itself; it is a question of creating financial freedom.

Now there is a new threat on the horizon – deflation.

Cecilia: Yes, deflation has grown as a threat due to the financial crisis and falling demand. When money grows in value, debts increase in real terms and people tend to reduce and postpone their purchases, since most things will be cheaper tomorrow. This leads to lower demand and eventually the economy seizes up.

Ylva: Deflation would naturally put borrowers in a totally different situation. Their total debt burden would increase, in contrast to times of inflation when the value of loans automatically shrinks.



Ylva Yngveson

Cecilia: The threat of deflation was overblown earlier in the decade. Economic policies had become too expansive after the IT bubble burst. Now the threat is more serious, since the recession is global and debts are going to have to be rescheduled in the aftermath of the financial crisis. At the same time, the central banks' one-sided focus on consumer prices means a greater risk of financial crises. It is time to seriously reassess our inflation targets and the reasons for them. Reality has changed since these targets were introduced nearly 20 years ago. The targets are based on consumer prices, but they should also take asset prices and credit growth into account.

What is the outlook in the short term?

Cecilia: In our economic report, we estimate that global GDP growth in 2009 will fall to -0.4 percent, the weakest level since the early 1980s. The Swedish economy will shrink by just over 2 percent in 2009. Sweden's finances are relatively strong, which means that when the economy picks up, we will have an inside track.

Ylva: At the moment, variable interest rates are expected to continue falling. And real incomes will continue to rise – for those who have jobs. Low inflation, tax cuts and other measures to ease pressure will put most wage earners in a relatively good position. However, many have lost their jobs. It can be hard on them, especially families with children, who usually have high expenses and find it harder to move to a new location.

Cecilia: In our main scenario, we anticipate a weak recovery in the global economy in 2010, driven by low inflation, low interest rates and fiscal stimulus measures. We do not expect a more normally driven economic recovery until 2011, but even then not with the high growth rate we had in 2007, driven by an undesirable debt

build-up. With so many uncertainties, we see relatively little likelihood, 45 percent, of the main scenario taking place. The likelihood of a worse outcome, similar to Japan's deflationary problems in the 1990s, is as high as 30 percent. We give the third scenario, where economic stimulus measures have a quicker effect and lead to a faster recovery, a likelihood of 25 percent. That shows how much uncertainty there is.

Ylva: What happens to house prices will probably depend a lot on the job market and housing construction. To date, average house prices in Sweden have remained unchanged and condominium prices have dropped 10 percent in the last year after having increased by nearly 11 and 19 percent respectively in the previous year. Most people can handle a price decline, since they are going to remain in their homes. Some households may have problems if they got a mortgage when house prices were at their peak. In the case of a job loss or divorce, there is a risk that the loan becomes a burden, tying people down financially for many years. For the majority of households, however, I do not believe that things will be that drastic.

Cecilia: The increase in asset prices, particularly housing, facilitated the credit expansion. Now the opposite is true. If all assets drop in value and the entire financial sector shrinks, the scope of lending will decrease as well.

Ylva: Normally, you have to have saved some money in order to borrow. Your down payment has to be at least 10–15 percent when you buy a house and it must be 20 percent when you buy a car. The housing down payment has always been a principle, and now it is probably even more difficult to deviate from this.

Cecilia: Today's crisis did not begin with businesses. The problem lies with household balance sheets (i.e., the relationship between household assets and liabilities) and government finances, with many countries facing large, growing deficits. Most companies have maintained good profitability and have strong balance sheets. But the effects of the crisis are naturally affecting them as well.

“Low inflation, tax cuts and other measures to ease pressure will put most wage earners in a relatively good position. However, many have lost their jobs.”

Ylva Yngveson

The main scenario implies a tough job market with rising unemployment, low interest rates, falling house prices and higher public deficits. The big question is how to generate sustainable growth without creating new problems. With all the debt-burdened government securities in circulation, there is already a risk of a bond bubble. It is also a question of which instruments to use. Monetary policy takes time to reach full effect. Fiscal policy works fairly quickly, except infrastructure investments, which take a long time to implement and bear fruit. Still, they are important, of course, since they also create jobs.

What can we learn from the financial crisis?

Cecilia: A lot – that economic policy plays an important role, for example. We need sound regulation and monitoring. Rules that make the market more cyclical are not good. The capital adequacy rules designed to reduce risk in the banking system did not do their job. Instead, they contributed to the crisis by encouraging banks to 'hide' their off-balance sheet commitments in special entities. Incentive structures mean a great deal – in every area and on every level. It had practically been forgotten that access to liquidity is critical to a functioning economy. We got a brutal reminder of that.

Ylva: Households have learnt that asset values do not keep rising forever. We have to have realistic expectations of the returns we can expect from various investments, and we have to understand that risk and potential are closely linked. But it is also important to set goals for our investments – clear criteria regarding how we will monitor and exit them. Exiting an equity investment in time is essential in order to avoid unnecessary risk. The bank could probably be even better in its advice. Hopefully, households can learn in the future not to take on too much risk based on their needs and wishes.

Cecilia: Economic psychology – how people think and act when faced with economic issues – is becoming an increasingly important area of research. It is people who create bubbles and create crises of various types. We have to learn more about how macro affects micro, and vice versa. We also have to learn more about the connection between the financial sector and the real economy.

What role do the banks play and what responsibilities do they have?

Cecilia: We can play a part in designing rules that are functional, and we can design better products that are easy to understand. These are important roles and a major responsibility.

Ylva: Naturally, banks have a role to play in providing information in connection with lending and encouraging a sound approach to borrowing. When providing advice on buying a home, it is especially important to look at the big picture, not only whether people have sufficient incomes and enough margins, but also how borrowers can find a good balance between assets and liabilities and how their financial situation in general is affected.

What will happen in the slightly longer term in our economy?

Cecilia: Various structural changes are being accelerated by the financial crisis and recession. At the same time, the upper end of the population pyramid continues to increasingly expand; fewer people are going to have to support increasingly more people. China and India continue to grow. An important issue going forward will be how the U.S. and China strike a balance. China cannot continue to live off the U.S. current account deficit and has to find a new growth model.

Ylva: Younger generations have different values than their parents. Sweden, for example, has a strong automotive tradition and an auto industry that, when you include all its suppliers, produces a lot of jobs. But something appears to have happened here. For young people in metropolitan areas, cars no longer seem as important to their identity. They take taxis and use public transport instead of buying a car or even getting a driver's licence. Their identities are tied to other things.

Cecilia: Debt-financed growth is also bad for the climate. For this reason as well, we have to try to find a new 'normal level', not the old one with the same level of indebtedness. The huge stimulus packages we are now seeing will hopefully help the economy back on its feet, but the resulting large budget deficits will have to be paid back eventually.



Cecilia Hermansson

Ylva: Yes, sustainability is becoming more of a day-to-day issue and affecting the choices we must make. Households that feel financially secure can do something for both the environment and their own wallets by taking advantage of the new household deductions ("ROT-avdrag") in Sweden to make their homes more energy efficient. They receive help with the investment today, and will reduce their energy costs in the future. At the same time, we are pushing Sweden's economic development in a positive direction.