Living without the euro in times of crisis

Deputy Governor Karolina Ekholm
Costs and benefits of currency unions

- Long term benefits related to improved efficiency versus...

- ...short run costs related to loss of monetary policy for dealing with asymmetric shocks
  - Was the shock symmetric?
  - Was the policy response different from that of the ECB?

- Strong currency costly in a deflationary environment?
External shock with asymmetric consequences

Riksbank’s forecasts of GDP levels. Index, Q4 2007 = 100

Sources: Bureau of Economic Analysis, Eurostat, Statistics Sweden and the Riksbank
Difference between interbank rates and expected monetary policy (Basis spread)

Basis points

Note. The differential is calculated as the difference between the three month interbank rate and the three month overnight index swap rate.

Sources: Reuters EcoWin and the Riksbank
Policy rates in Sweden and the euro area

Source: Reuters Ecowin
Measures when policy rates are close to lower bound

- Reducing spreads
  - Measures to secure banks’ funding
  - Outright purchase of covered bonds (ECB)

- Lowering expected future policy rates
  - Fixed rate loans
  - Announcement of low expected policy rates during long period (the Riksbank)

- Raising inflation expectations
  - Credible inflation target helps
  - Exchange rate movements matter
The balance sheets of the Riksbank and the ECB

Share of GDP

Source: ECB and the Riksbank
**Repo rate path**  A forecast - not a promise

Per cent, quarterly averages

Note. The uncertainty band does not take into account the fact that there may be a lower bound for the repo rate. The uncertainty band shows the band within which inflation is expected to be with a 50%, 75% and 90% probability.

Source: The Riksbank
Exchanges rates

Index, 02.01.06 = 100

Source: Reuters Ecowin

Source: Reuters Ecowin
Volatility

SEK, implied option volatility 6 months

Source: The Riksbank
The SEK during the crisis

- Weakening with bad news...
  - ...keeping up inflation expectations while reducing purchasing power of Swedish households.

- Increased volatility
  - But no clear evidence that it harms trade or foreign investment.
  - Increases forecasting errors...
    - ...leading to poorer forecasts and more uncertainty regarding appropriate policy response.
Liquidity support and the foreign exchange reserve

- Large part of bank funding is in foreign currency.
- The Riksbank has supplied banks with USD.
  - Swap agreements with the Fed and ECB
- Concern about how a local crisis would affect the foreign exchange reserve.
  - Swap agreements might be more difficult to obtain.
Conclusions

- Crisis should be the time when having your own currency is beneficial.
  - External shock had asymmetric consequences.
- The Riksbank and the ECB have pursued relatively similar policies...
  - ...but the SEK has weakened vis à vis the euro.
- Increased exchange rate volatility has led to larger forecasting errors and more uncertainty about appropriate policy.