SVERIGES
RIKSBANK

Sveriges Riksbank – a 350-year journey

S V E R I G E S   R I K S B A N K

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***Cover: The Riksbank's first own building** on Järntorget in Stockholm's Old Town. This was the Riksbank building 1680–1906.*

The unintentional central bank

The oldest central bank in the world was not really planned from the start. On the contrary, Sveriges Riksbank came into being as the result of one of Sweden's first financial scandals, and the founder of the bank was sentenced to death. But this is also where Europe's first banknotes were created and it laid the foundations for a new way of governing the economy.

On 15 September 2008 investment bank Lehman Brothers filed for bankruptcy. This was the starting point for one of the most severe financial crises the world has experienced in modern times. The trigger was that the financial institutions had issued bonds with impaired loans as collateral to finance mortgages, what were known as sub-prime-loans. When this was discovered, stock exchanges plummeted, companies went bankrupt and unemployment rose to historical highs.

One reason why Sweden managed the crisis so well was that the Riksbank had a sufficiently good reputation abroad to be able to mediate and support the banks with loans and guarantees. It is therefore ironic that its own birth was far from inspiring confidence.

Stockholms Banco – the precursor to the Riksbank

The Riksbank's history actually begins in 1656, when Johan Palmstruch was given permission to start Sweden's first bank, Stockholms Banco. When King Charles X Gustav issued the permit for Stockholms Banco he emphasised its importance in safeguarding the value of money[1].

The reason why Charles X Gustav included the value of money in the task given to Palmstruch and his new bank was that Sweden had become increasingly drawn into the European economy. The Swedish military consisted to a large extent of foreign mercenaries who demanded payment in acceptable coinage. Through the Peace of Westphalia, Sweden had received land around the Baltic Sea, where it was not certain that they would accept bad coins. It was therefore in the interests of the Swedish krona to defend the value of money in relation to the rest of the world.

The bank quickly became popular. This was partly because Sweden had introduced the copper standard in 1624. The standard meant that the metal in the coin should be worth as much as the actual coin. Silver coins were the

1) Although Charles XI expressed it like this: "Our own domestic copper coins shall probably thereby be able to come to their right and fair value, and will be able to fend off and prevent all unreasonable over-valuation of foreign coins."

The world's largest coin. *It weighed almost 20 kg and was produced when they began using copper in coins at the beginning of the 17th century. As copper was worth much less than silver, they needed to have large, cumbersome plates to correspond to the value of the silver coins.*

most common, but Sweden had problems at times selling all the copper the country produced. It was therefore decided in the mid-17th century to also use copper in the coins. But as the silver was worth many times more than the copper, large plates of copper were needed to correspond to one small silver coin. The largest coins weighed almost 20 kg. At Stockholms Banco the merchants could instead hand over their cumbersome copper plates and receive a deposit certificate, which they could use to trade with.

Sweden's first financial crisis and the first banknotes

But when in 1660 the state began to mint new coins with less metal in them, many depositors wanted their old, heavier coins back. There was thus a bank run. To counteract this, Palmstruch began to issue deposit certificates without the depositors having handed in any coins. The new certificates were instead handed out as loans from the bank. The certificates were

***Europe's first banknotes.** They were called credit notes and issued by Stockholms Banco. The notes were actually a form of proof of a loan that could be used as currency.*

called credit notes and could be used to buy anything at all. Palmstruch had thus invented the first banknotes in Europe.

The banknotes soon became popular as they were easier to handle than the coins. During following years, the bank printed more and more notes. In 1663, both the crown and the chancellor Magnus Gabriel De la Gardie took out large loans, which were given in the bank's notes. But the general public began to be suspicious and an increasing number demanded to redeem their banknotes for coins. In September 1663, the bank could no longer manage the exchange for copper plates.

The general public suspected mischief. *Chancellor* ***Magnus Gabriel De la Gardie*** *took on enormous loans so that Stockholms Banco could continue issuing more and more credit notes. But many people became suspicious and demanded to redeem the notes for coins.*

The rapid increase in the number of banknotes led to the notes losing value, what we now call inflation. When the customers demanded to redeem their notes, Stockholms Banco did not have enough plates to hand out. The bank began to demand that the loans it had given be repaid, which led to some of those who had taken loans suffering financial problems.

The Council of the Realm – which was the government of the time – decided in 1664 that the loan would be repaid and that the credit notes would be withdrawn. Palmstruch was ordered to appear before the Svea Court of Appeal and was found guilty of mismanagement of the bank in 1668. He was reprieved from the death sentence the following year, but remained in prison until 1670 and died the following year. But at the parliament in 1668 the nobles pushed through a proposal to establish a new bank from the ruins of Stockholm Banco, now with the nobles, the priests and the burghers as principals. The Bank of the Estates of the Realm – today Sveriges Riksbank – was established and this was the birth of the oldest central bank in the world[2].

2) It was called the Riksbank in public parlance quite early on, but it was not until 1867 that it was formally given the name Sveriges Riksbank. By then, the former Riksdag of the Estates had been phased out so the title Bank of the Estates of the Realm had had its day.

350 years of defending the value of money

The defence of the value of money has been one of the Riksbank's main tasks right from the start. In modern times the interest rate has varied widely from 500 per cent to below zero, all to defend price stability. Through history, inflation, war and kings have made money almost worthless – but there are also examples of how the value of money has increased substantially and how deflation has led to unemployment.

Inflation – a spectre for ordinary people and the retail trade

How much is money worth? What will a loaf of bread cost tomorrow? This has been the most important question from users since the first coins were minted. Many factors can affect the value of money. In today's economy, the value of money can increase if the banks push up lending or if governments increase their expenditure without having cover in the form of larger incomes. During the Middle Ages, the princes instead reduced the metal content in the coins, so that they no longer contained as much silver as was promised in the minting. When banknotes were introduced, one instead printed an excess of money, which pushed up prices of goods and other assets. At other times, there was a shortage of coins, which also complicated trade. It did not take long before severe fluctuations in the value of money became a spectre for the retail trade and ordinary people.

Right from the start, one of the Riksbank's tasks was to maintain price stability. If the value of money declines, then inflation occurs, and this creates uncertainty in the economy. Deflation, a general fall in prices, can be just as serious – then it becomes cheaper to wait than to buy and invest now. The uncertainty holds back investment and production grows more slowly than it would otherwise have done.

Some may be encouraged to speculate in a fall in the value of money. Those who buy for borrowed money and sell when prices rise earn money when they pay back their loan. This type of loan economy suffers major setbacks if inflation suddenly slows down. Many who have speculated will then find it difficult to pay their debts, and they in turn can cause problems for those who have lent money.

But not everyone loses from inflation. When kings and governments deliberately decrease the value of money, it may take a while before the general public understand what is happening. In the beginning, the government may therefore be able to get as much for its money as before the volume of money increased. An early example of this was when John III decreased the value of money during the second half of the 16th century. When Sweden had lost Älvsborg to Denmark in the 1570s, Sweden paid a large ransom. John got hold of the money by decreasing the value of the Swedish coin.

Emergency coins paid for the battles. *The wars during the reign of Charles XII cost a lot of money. To fund them, more than 40 million emergency coins were issued. The round coppers had different inscriptions such as "Jupiter", "Mars" and "Flink och färdig" (quick and ready).*

During the remainder of his reign, the lengthy war against Russia and the large-scale castle construction projects cost enormous amounts of money. The king acquired money by reducing the silver content even further. During the years 1590–1592, inflation is calculated to have been 800 per cent.

But the manipulation by John and other princes was seen through. Instead, the international currency "riksdaler" became the standard one used by merchants to protect themselves against individual prince's devaluations. It had its origins in the Holy Roman empire's thaler, which was first minted in 1518 in Joachimsthal in what is now the Czech Republic.

Charles XII's monetary experiment drove Sweden to bankruptcy

Back when the Riksbank was founded in 1668 the parliament had decided to forbid the issuing of banknotes. This worked as long as there was peace and order in the kingdom, but during Charles XI's Scania wars 1676–1679, there were thoughts of dealing with the shortage of money by printing banknotes again.

The money crisis became acute under the reign of Charles XII. After the Swedish army was defeated at Poltava in 1709, it became increasingly difficult for the autocratic king to finance the gigantic war effort. He introduced a wealth tax and forced loans, but above all a number of monetary instruments were put into circulation – coin substitutes, bonds, coin notes and pay notes. The coin substitutes were also known as emergency coins.

Every single coin collector usually has one or more of Charles XII's emergency coins in their possession: round copper pieces, stamped with one daler silver coin on one side and a Roman god or other symbol on the other side, known popularly as Görtz's gods, after the king's adviser Görtz.

The king had 42 million of these coins minted, of which 25 million were still in circulation when the king was shot. The bonds and coin notes brought in 18 million to the treasury and they entailed an extreme increase in the volume of money. At first people were satisfied with a deduction of 4–5 per cent when they were paid in emergency coins or bonds, but the crown carried on pushing out large volumes of them. If anyone wanted to buy an ell of good cloth (almost 60 cm), which normally cost 4 daler silver coins, they must pay around 50 daler in "gods" or paper notes.

By forcing out the emergency coins and bonds as remuneration for salaries and goods, the crown was in practice taking out a huge loan from the citizens. The more inflation soared, the cheaper it became for the government to "pay back".

It ended at the brink of a state bankruptcy. After the king's death, the government decided in April 1719 that emergency coins should be gathered in and replaced with half of their nominal value, 16 öre for each daler. Two öre was paid in cash, 14 öre as an "insurance note" which the crown would redeem "in time".

The final insurance notes were redeemed in the 1760s – when the value of money had fallen again. The new inflation made it easier to pay for the old one.

Age of Liberty – alternating inflation and deflation

The years 1719–1772 were known as the age of liberty. This was because the power during this period lay with the estates of the realm: the nobles, burghers and farmers, and not as before with the king.

During the first decades the government and the Riksbank pursued a cautious economic policy, that aimed to restore the national finances and stabilise the value of money. But at the end of the 1730s, those who wanted to pursue a cautious line were overthrown. A new regime took over in Sweden – the so-called "Hats" became Sweden's first parliamentary party and took over both the council of the realm, the government of the time, and the Riksbank.

The Hats pushed for the Riksbank's lending to increase. They paid huge sums in support to the manufacturers (an early form of industry) and they invested enormous amounts on the failed wars against Russia 1741–1743 and Prussia 1757–1762. The Hats resolved the funding by by getting the Riksbank to being printing banknotes again. When the banknote printing presses started rolling, inflation began to soar again. At first, the banknotes could be redeemed for silver, but in 1745 the silver standard and the right to redeem were abolished. Then the value of the notes began to fall.

Bold speculators made use of the inflation. They bought property, ironworks and valuable goods for borrowed money. They held onto their purchases while inflation rose even further, then they sold them, paid off the undermined loans and made a tidy profit on the whole deal. The loans from the Riksbank fuelled inflation further.

The Hats lost power to the opposing party "the Caps" at the 1765–1766 parliament. The board of governors of the Riksbank was given the task of restoring the value of money to what it had been before the Hats took over. This meant that the exchange rate for Swedish banknotes against the international currency hamburger banco would be halved from 72 to 36 Swedish marks – one wanted to force an appreciation of the Swedish currency.

The idea was to proceed gradually. In February 1766, the exchange rate was set at 70 marks, according to a new announcement in November it was cut to 66 marks. Then the general public began to understand what was happening. There were far too many people involved in monetary policy for the plan to be kept secret. An increasing number began to hoard the Riksbank's notes. If they were going to be worth twice as much in a few years' time, why not wait until then to use them? Once so much money disappeared from circulation, the exchange rate against the hamburger banco fell much faster than the authorities had intended. In summer 1767 it fell to 42 marks.

The severe deflation led to many speculation companies going bankrupt. The manufacturers had to close down, properties were sold at a loss. Prices plummeted. One of the few who was happy was the poet Carl Michael Bellman[3]. In Fredman's epistle no. 24 he sings:

Usla tider!	Times are bad!
Vad det lider	People are sad
Bara kursen nederslås,	But with a lower nicker
Bättre pris på brännvin fås…	Comes cheaper liquor…

Bellman had understood how the economy worked. The times were bad for many companies, but the imported grain became cheaper when the exchange rate strengthened. Together with deflation, this pushed down the price of the grains used to make snaps.

Gustav III establishes the Swedish National Debt Office – the banknote printing presses roll again

In older times one saw the link to silver or gold as the most important means of protecting the value of money. By promising that it would be possible to exchange the banknotes for a particular amount of silver, their value was retained. Therefore the right to redeem, the silver standard, became the most important instrument for monetary policy. While research can conclude that prices changed when the amount of gold or silver in circulation increased or decreased, at the time the precious metals appeared to be an anchor.

Gustav III took power in 1772 to clean up the mess left by the Age of Liberty. He and his "finance minister" Johan Liljencrants therefore wanted to stabilise the value of money. To make the banknotes redeemable against silver, they implemented a "coin sale" in 1777. This meant that one determined a value for the right to redeem. The Riksbank's banknotes should be redeemable against silver to the rate of 72 marks to one daler.

3) Carl Michael Bellman had actually been employed at the Riksbank as clerk during the years 1757–1763.

Bad times provided cheap liquor. *The poet and former Riksbank employee* ***Carl Michael Bellman*** *saw advantages in the bad times in Sweden. Namely that the corn from which schnapps was made became cheaper. He wrote: Usla tider! Vad det lider Bara kursen nederslås, Bättre pris på brännvin fås…*

***The punishment was death. Gustav III** pushed through a law that loans taken out in banko notes should be repaid using the riksgäld notes, which were worth much less. This was a blow to the lenders. One of these was **Johan Jakob Anckarström**, who murdered the King. Anckarström was pilloried for three days and executed six days later on 27 April 1792.*

But the war then destroyed the silver standard. In summer 1788, Gustav III provoked a war against Russia with the hope of retaking the areas that had been lost under Charles XII. Once again, war funding was a key issue. The catch was that the king had promised to respect the Riksbank and the right to redeem. His staff took the initiative to start the National Debt Office in 1789, which was given the task of borrowing the money needed to fund the war. The Debt Office did this by issuing bonds with a yield on them, which were used as banknotes from the start.

Gustav III put pressure on them to produce more and more of these notes. "If you want to save Finland, you must send us money", he wrote in summer 1789 to Eric Ruuth, who had succeeded Liljencrants; the king assumed "that the paper factories in Sweden have not burnt up".

The yield on the bonds was abolished in 1791. Unlike the Riksbank's notes – which were called banknotes – it was not possible to redeem the Debt Office notes for silver. Nevertheless, they were generally used as a means of payment. In this way, Sweden in practice gained two types of coin: riksdaler banko (from the Riksbank) and riksdaler riksgälds (from the Debt Office).

Eventually, the banknotes were at a premium against the Debt Office notes. This meant that the crown received less in exchange for its Debt Office notes. To strengthen the exchange rate, Gustav III pushed a law through parliament that loans that were in banknotes should be repaid in Debt Office notes. This meant that the lenders' claims were devalued.

One of the lenders who suffered this was discharged captain Johan Jakob Anckarström, who two weeks after this parliamentary decision shot the king at the opera. At his trial at the Svea Court of Appeal Anckarström raised the manipulation of the currency as one of the reasons he had murdered Gustav III.

Interest rate becomes new weapon to steer the economy

The silver standard was subjected to strain at irregular intervals. When a lot of people wanted to redeem their banknotes it wan not certain that the Riksbank's silver depot would be enough. During the recurring international financial crises in the 18th and 19th centuries, the Swedish loans abroad were often withdrawn and had to be redeemed in international currency. Then the merchants exchanged their Swedish banknotes to get silver coins for their international payments, and the Riksbank's silver stocks dried up.

Another type of strain arose in 1840, when Emperor Nikolai I allowed the Grand Duchy of Finland to establish its own bank with a redeemable currency. The new bank then gathered together the many Swedish notes that were still circulating in Finland, even after the divorce in 1809. The Bank of Finland acquired a metal stock by giving the Swedish notes to the Riksbank and demanding silver in exchange.

The Swedish Riksbank had accepted the quantity theory, which was that there is a connection between the volume of money and the rate of inflation. The Riksbank endeavoured to have a silver store that was in a fixed proportion to the amount of banknotes. When the silver store then declined because banknotes were redeemed, the volume of banknotes must be reduced further, if the set proportion between silver and banknotes was to be retained.

In this way the so-called "strangulation system" was introduced. The Riksbank conducted extensive lending directly to individuals and companies. To reduce the volume of outstanding banknotes, the Riksbank quite simply gave notice of termination of outstanding loans when the silver stock fell and thus withdrew banknotes. The strangulation system created uncertainty and hampered investment in the economy. The risk of having loans terminated at short notice discouraged many.

The negative consequences of the strangulation system meant that people began to seek new ways of stabilising the value of money and the right of redemption. From the mid-19th century, an increasing number of economists began to argue in favour of the states using the interest rate to regulate the value of money. By raising the price of money, those who needed money the least would refrain from using it. Those who really needed money would be prepared to pay. In this way, the interest rate would not hit as indiscriminately as the strangulation system.

The international breakthrough for this new outlook came when the editor of The Economist, Walter Bagehot. published Lombard Street in 1873. In

Failed speculation. *Banking firm Barings Brothers in London suffered major problems and this led to an international financial crisis.*

this pamphlet on the role of the central banks, Walter Bagehot launched the modern view of rate-setting and action to take during a financial crisis. Bagehot argued that the central banks should ensure that there was always money available, even if this was expensive in a crisis. The editor of The Economist felt that all creditworthy companies would then survive, while the risk of being wiped out was much greater if credit to all was suddenly strangled.

It was not until 1890 that the Riksbank adopted the new methods. This took place in connection with the international Baring Crisis[4] and it was an important milestone for the Swedish economy. That year the Riksbank used the

4) The Barings Brothers banking firm in London had speculated in Argentinian bonds and got into severe difficulties when Argentina defaulted on the payments on its national debt in 1890.

policy rate of the time, the discount rate, for the first time. Its purpose was the same as today, to influence the demand for money in the Swedish economy. The discount rate, the policy rate of the time, affected the interest rate the commercial banks were charged when redeeming bills of exchange at the Riksbank and thus the new interest rate was conveyed through the economy in the same way as when the Riksbank nowadays raises and lowers the repo rate.

The collapse of the gold standard

As long as the metal standard remained, it functioned as an anchor for the value of money, but once the First World War broke out, almost all countries abandoned their connection to it. This meant that they could increase the volume of money without being limited by the central banks' metal holdings.

In neutral Sweden, the war led to a large increase in the volume of money. The state increased defence expenditure at the same time as export income soared when Germany and other warring nationals bought foodstuffs, fuel and other necessities. The modern Swedish export companies took over market shares from competitors who were no longer allowed to sell to the opposing side.

The effect was that inflation rocketed sky high. The problem was that the Riksbank was unwilling to raise the interest rate to the high levels needed to dampen inflation, but they were concerned that capital would become too expensive if the interest rate was raised and this were to dampen the economy.

The consequence was that money became cheaper and cheaper. Once again, it was profitable to buy and sell when prices had risen so much that they both paid the loans and gave a good profit. The increased credit volumes fuelled inflation further. Sweden entered a speculation-driven economic boom.

The US economist Irving Fisher had actually launched the concept that could have helped the Riksbank to better understand what was happening back in 1896. Fisher explained that it was the real interest rate that mattered, the nominal interest rate minus inflation, but this insight had not yet had an impact. Monetary policy decision-makers considered the interest rate that would have been needed to dampen inflation to be too high, although in real terms it was not so bad.

Many speculators made large profits from this “profiteer economy” as it was called. After the war, these profits on the inflation economy contributed to the opinion in favour of a return to the gold standard. By returning to the exchange rate that applied prior to the war, even insightful economists such as Knut Wicksell hoped that some of the inflation gains could be repaired. But this also meant that they deliberately triggered a sharp deflation process in the economy.

The results were essentially a reminder of the sudden slowdown during the Age of Liberty in the 1760s when the “Caps” won a majority in parliament and tightened by halving the exchange rate. During the early years of the 1920s many companies went bankrupt and also brought down with them some of the banks. This led to major strains on the financial system, investment came to a halt and unemployment soared.

Sweden first in the world to have price stability as a goal

Several countries returned to the gold standard after the First World War in an attempt to stabilise their currencies, but it did not function as well as it had previously. One important reason for this was that important actors such as the United States were not prepared to release capital flows to allow surpluses and deficits in trade even each other out. When German and Austrian banks entered into difficulties at the start of the 1930s, this had consequences for the exchange rate system – in autumn 1931, the United Kingdom left the gold standard and, in September, Sweden followed.

The question was how Sweden should steer its monetary policy when the value of its currency was no longer determined by the value of gold. The value of money was in focus and, above all, there were concerns over a general fall in prices or deflation. If prices started to fall, important actors would defer their investments in the hope that they would get even lower. This would exacerbate the depression that also impacted Sweden in the wake of the crash of the 1920s.

For Sweden's part, after breaking from gold, Minister for Finance Felix Hamrin explained that monetary policy would focus on "using all available instruments to maintain the Swedish krona's domestic purchasing power".

Consequently, in 1932, the Riksdag adopted a monetary policy programme with price stability as a goal. The Riksbank became the first central bank in the world to have domestic price stability as a target. Both inflation and deflation would be combated.

Interest rates fell to lower and lower levels over the 1930s. This contributed towards domestic markets such as construction picking up and counteracted the downturn of the economy. Sweden coped with the strains of the 1920s and 1930s better than most other countries.

The 1970s and 1980s – high inflation and constant devaluation

After the Second World War, the Bretton Woods system was introduced, with the aim of facilitating world trade and eventually making currencies convertible with each other. The system regulated and restricted international capital flows to reduce the risk of financial crises. The dollar became a reserve currency and was pegged to gold.

In the 1960s, inflationary pressures increased in the international economy, among other reasons because the United States exploited the dollar's position to fund the Vietnam War by pushing more dollars out into the global economy. Most central banks neutralised the effects by expanding their foreign currency reserves and putting the newly-printed dollars in their vaults, but eventually the amount of dollars – the 'dollar glut' – became so large that, in August 1971, the United States abandoned the peg to gold. In March 1973, the worldwide system of fixed exchange rates was dropped and currencies started to float against each other.

At the same time, capital flows outside the central banks' control started to increase. Multinational corporations were able to go round the regulations by using internal accounting transactions and oil-producing countries had access to more money to invest on the unregulated eurodollar markets after the oil price increase of 1973.

***Criticism of interest-rate policy. Gunnar Sträng**, Finance Minister and later Chairman of the General Council of the Riksbank, received negative reactions from the business sector when he wanted to introduce a strict interest-rate policy to hold down inflation.*

The inflationary pressures were managed in different ways in different countries. The West German central bank, the Bundesbank, conducted a tight interest-rate policy to hold inflation down, even if it meant that the Deutsche Mark appreciated against other currencies and unemployment increased. In Sweden, both the Riksbank and Minister of Finance Gunnar Sträng proposed a similar policy, but met with negative reactions from the business sector, economists, the centre-right opposition and, finally, also Mr. Olof Palme, the Prime Minister. After oil prices went up, the Government instead chose to attempt a 'bridging policy', which is to say to keep interest rates low and increase public expenditure so as to mitigate the effects of the international economic slowdown following the oil price increase.

Inflation accelerated in the 1970s. On the labour market, employers and trade unions signed agreements on occasionally two-figure wage increases, at the same time as wage drift outside of central agreements was significant. The budget deficit and national debt increased heavily. The competitiveness of the Swedish export industry was weakened.

For two decades, Sweden continued to be characterised by strong and increasing inflation. One reason was that the leading economic politicians long believed that there was a positive correlation between inflation and employment. They wished to encourage consumption and investment by allowing interest rates to be low or negative, with the fundamental idea being that unemployment would thereby decrease. However, during the 1970s, increasing numbers of economists started to question this idea. The theory of rational expectations suggested that more and more people would get used to inflation and take account of it in their actions, leading to the desired positive effect failing to materialise. This also seems to have been what happened.

The effect was devastating for the value of money: the krona constantly weakened against other currencies. Sweden attempted to peg the krona to the various exchange rate systems existing in Europe, but was forced repeatedly to write down the value of the krona to maintain competitiveness. The greatest devaluation was in 1982, when the value of the krona was cut by 16 per cent in an attempt to set the groundwork for a more growth-oriented economic policy.

The krona was subjected to speculation and the repo rate was raised to 500 per cent

The reunification of Germany in 1990 created imbalances in the European economy. The East German currency, the East German mark, was redeemed for Deutsche Mark at a rate of 1:1 – which meant that relatively poor East Germans were suddenly able to buy as much for their weak currency as their western neighbours, with their strong purchasing power. Of course, this involved a heavy injection of purchasing power into the entire, now-unified German economy. In addition, major investments were made to reunify

The sky is the limit. *This was said by Riksbank Governor* ***Bengt Dennis*** *when the repo rate was raised to 500 per cent on 16 September 1992, shocking many people.*

the country, and this led to overheating in the German economy. The German central bank, the Bundesbank, did what it could to cool things down by raising its interest rate, but in the rest of Europe, in contrast, economic activity was slowing down. The Bundesbank's importance to the other countries' interest rate policies meant a clear cooling-down in the rest of Europe.

The imbalances in Europe led to strong capital flows ahead of expected devaluations. The krona was one of the currencies exposed to speculation. Sweden attempted to meet the pressure by implementing a number of crisis packages to strengthen the economy and by pegging the krona to the European Currency Unit. At the same time, the Riksbank raised its interest rate to deter the speculators. One of the most spectacular elements was on 16 September 1992, when the Riksbank raised the marginal rate for lending to the banks to 500 per cent. But even this was not enough to prevent speculation. On 19 November 1992, the Riksbank abandoned the defence of the fixed exchange rate and allowed the krona to float. Since then, the value of the krona has been determined by the market.

Inflation target introduced to keep the value of money stable

By the start of the crisis of the 1990s, the fruitless attempt at slowing down inflation in the 1970s and 1980s had already led the Government to explain that the fight against inflation would be a primary consideration. This was a decisive break from the previous policy.

After the krona exchange rate was floated in 1992, the question of the direction of monetary policy was raised anew. In 1993, the General Council of the Riksbank decided that policy would be directed on limiting inflationary impulses, with an inflation target of 2 per cent as guideline as of 1995 – which is to say that if inflation a few years ahead looked like exceeding the target, the interest rate would be raised and vice versa. The Government expressed support for this inflation target in 1996. Since then, the Riksbank has primarily used the interest rate to achieve the inflation target.

For twenty years, it seemed to be working relatively well. In the first years of the 2000s, the development of the international economy was calm. Inflation fell and no financial crises took place. But after the serious global financial crisis of 2008, something seems to have happened.

To stimulate consumption and investment in the wake of the financial crisis, the Riksbank has cut its repo rate in stages, occasionally down to negative levels. The low repo rate level has been aimed at bringing inflation back to the inflation target of 2 per cent and to ensuring that expectations of future inflation stay firmly anchored around the same level. This has also been a way of preventing the krona exchange rate from appreciating too much and to rapidly against other countries, with the negative consequences this could have for the value of money and also for the competitiveness of Swedish exports.

The problem has been that the low repo rate has also contributed towards a heavy increase in prices for various assets, not least for private housing. One consequence of this has been that household indebtedness has increased at a rapid rate.

Similar tendencies in other countries have led to a discussion of what inflation actually measures and how much responsibility central banks should actually have for financial stability. The thinking behind the inflation target is that inflation reflects activity in the economy, but a number of economists argue that this is not always the case. The low inflation of recent years has not had the same significance as the last such period, during the depression of the 1930s.

Then, it was an indicator of low activity in the economy; now, in contrast, the business sector in many countries has pushed for high pressure. On the other hand, one reason could be that new export countries have entered the world market. They have both increased the supply and been able to compete with lower prices. Despite high economic activity, inflation has thus been low. This is reminiscent of developments at the end of the 1800s, when international communications drastically improved and new countries pushed prices down with their exports. The large surplus caused by this high economic activity moved into the markets for assets such as equities and property, which paved the way for the major financial crisis a few years before the First World War. Again, the increased supply may be part of the explanation for the low rate of inflation in recent decades. The heavily increased participation in world trade of China, the former Soviet states and India has contributed towards restraining inflation.

Another important explanation for interest rates being so low today is that more individuals and companies are saving than investing. This has pushed real interest rates down across the world. A third explanation may be that some central banks have used low interest rates to prevent their currencies from becoming too strong.

Regardless of which, the debate on this issue is lively and highly relevant. There are economists who believe that the real level of interest rates has shifted to a lower level for several years to come and others who consider that the economic cycle usually repeats itself. The Riksbank is continuing its work of understanding and explaining what governs the value of money.

The Riksbank as manager of financial crises

The Riksbank's other main task is safe-guarding financial stability – ensuring that the banks are secure and that financial crises can be avoided. The Riksbank has had a central role in building Sweden into a modern trading nation. But, on several occasions in its 350-year history, the Swedish financial system has been exposed to severe strains.

From fragmented credit market to organised banking system

In 1609, the Bank of Amsterdam (Amsterdamsche Wisselbank) was formed to facilitate trade in Northern Europe. As early as 1619, Chancellor of Sweden Axel Oxenstierna argued that Sweden should also form banks. Oxenstierna wished to promote the free flow of trade, but he went beyond the Dutch prototype. Oxenstierna also emphasised the importance of collecting savers' money so that it could be lent to investors. He raised the idea of paying savers for making their money available, which is to say paying interest. The fragmented and labyrinthine credit market should be consolidated and organised by the banks, he considered. He was far ahead of his time but the vision he had is what we today call the payment system, or, slightly simplified, the banking system and its services.

Over the years, this issue gained a further dimension – how were payments to and from other countries to take place? In the 1700s, trading houses in Stockholm and Göteborg started funding Sweden's exports and imports. Loans started to be granted across borders, which had the effect of drawing Sweden into the international financial economy and its fluctuations. In addition, foreign trade meant that the valuation of the Swedish krona became increasingly important.

The Riksbank became crucial for both the credit system and the payment system. Both lending and measures to influence the exchange rate became important parts of the Riksbank's operations at an early stage.

Loans instead of tax

Lending was exactly what the nobility was safeguarding when it convinced the priesthood and burghers to help form the Riksbank, or Bank of the Estates of the Realm as it was then known, in 1668. This was because its predecessor, Palmstruch's Stockholm Banco, had taken care of one of the nobility's most important financial worries. The Swedish nobility often had substantial financial assets, but nevertheless a shortage of cash for their day-to-day expenses. It was therefore convenient for them to have a bank where they could pledge their property or valuables in exchange for cash. It was also cheaper than going to a moneylender.

For Charles XII, lending to the government became the Riksbank's most important task. Borrowing small-scale savers' money allowed him to partly fund the war. This was a easier way of bringing in money than increasing taxes. Government borrowing, as opposed to increasing taxes even more, meant that financial strains could be spread over a longer period. In this way, the Riksbank was able to mitigate the effects of the Great Northern War, 1700–1721.

The private banks become the first commercial banks

By the end of the 1700s and start of the 1800s, the government had formed discount houses, the first primitive commercial banks. However, after the Napoleonic Wars, the discount house in Malmö was rocked to its foundations and all of the discount houses were wound up. Instead, the Riksbank expanded its lending operations, but these were not able to meet the growing demand for loans and credits. Trading houses, money brokers and moneylenders therefore provided a large part of loans taken by the general public. In rural areas, informal lending between neighbours occurred, with 'parish bankers' who occasionally handled large sums.

Uncertainty over the value of money also slowed down the growth of the banking system. In the 1820s, the first savings banks were founded, but these were almost philanthropic in purpose – they provided a means of saving for the poor, helping them to help themselves.

After the Government and Riksdag decided to peg the krona to silver, the first private banks were founded, Skånska Privat-Banken in Ystad in 1831 and Wermlands Provincial-Bank in Karlstad the following year. These were eventually renamed Skånes Enskilda Bank and Wermlands Enskilda Bank, respectively.

It was significant that these banks were located in the provinces of Skåne and Värmland, far from Stockholm. Starting in Skåne, enskiftet was initiated in 1803. Enskiftet was a land reform involving the aggregation of the many small plots of land owned by farmers into a larger, connected piece of land for each farm, the dissolution of villages and the construction of new buildings on the new farms. This required major investments. In Värmland, the forestry industry started to gather pace. This meant that more capital was needed in rural areas than the Riksbank could lend.

Sweden's first private bank. *Skånska Privatbanken in Ystad issued its own banknotes to finance its operations. The medal shows* ***Fredrik Bogislaus von Schwerin****, the leading figure of the Riksbank's Governing Council in the 1820s and early 1830s.*

The first private banks based their lending on issuing their own banknotes as their own capital did not go far enough. It was difficult to fund lending with deposits, as the law – the Book of Commerce of the Civil Code of 1734 – set an interest rate cap of six per cent. This meant that the banks could not offer the same interest rates to depositors as unregulated private money brokers could. Instead, banknotes were the solution. Borrowers were thus able to receive their loans in the form of the lending bank's banknotes. As long as the banknotes remained in circulation, they acted, in practice, as a loan from the general public to the bank. Eventually, about fifteen banks issued their own banknotes.

The problem was that the banks were quite cautious. These banks were 'private' in the sense that their equity was funded by 'lots'. Everybody owning a lot, which is to say a share in the bank, was jointly liable for the bank's commitments. If a person visited the bank with that bank's own banknotes, the bank was obliged to redeem them for coins or the Riksbank's banknotes. If the bank was unable to do this, the banknote holder could, in principle, get a court decision allowing him or her to go to any one of the lot holders and take that person's property instead. This regulation was such a deterrent that it was never tested – none of the private banks every entered into insolvency in the period private banknotes were issued. The drawback was that there then continued to be a shortage of credits, as the banks did not wish to risk lending more banknotes than they could redeem.

The bank run of 1857 – the Riksbank is forced to intervene

For a large part of the 1800s, the payment system was the centre of a political struggle. The owners of the private banks were getting a good return on their capital. This did not escape the attention of their opponents, who argued that it was the ordinary people who had laid the groundwork for these profits by using the private banks' banknotes. Strong forces, not least among farmers and priests in the Riksdag, wished to use the Riksbank as a weapon against the private commercial banks. Different groups in the Riksdag pushed through special lending programmes aimed at benefiting good causes. These various forms of government lending were often handled by the Riksbank.

To benefit the Riksbank's banknotes and lending operations, the bank's friends in the Riksdag pushed through a system of 'filial banks' for the Riksbank. These were actually independent banks, but they were not allowed to issue their own banknotes, but were only expected to spread Riksbank banknotes.

But the political implications of the banking question made it difficult for the Riksbank to play the role of central bank. Consequently, when the international banking crisis of 1857–1858 led to a run on Skånes Enskilda Bank, there was no system to support vulnerable banks. Finally, after great hesitation, the Government finally organised a loan to Skånes Enskilda Bank from the Swedish Agency for Public Management to prevent the bank from failing.

This rescue action forms a milestone in the development of the Swedish financial system. Minister for Finance Gripenstedt – who had organised the rescue action – noted, several years later, that "a banking institution stands unquestionably in a completely different relationship to the public than other industrial enterprises such as, for example, a cotton mill or a bath-house". He was the first Minister for Finance to be forced to realise that central government could not leave the banks to their fate.

The catch was that the government did not point out anyone to be responsible for the payment system and to help important banks that were experiencing difficulties. It would be some time before the Riksbank was given the task of acting as lender of last resort to the commercial banks. Indeed, even the Riksbank's own lending operations were shaken by the financial crisis. This underlined the problems inherent in the lack of separation of the Riksbank's different roles as central bank and commercial bank with lending operations.

The modern banking system emerges – but new rescue action is needed

In the second half of the 1800s, the private banks started to develop into modern commercial banks. The driving force behind this development was naval officer A. O. Wallenberg. He had founded filial banks in Sundsvall and Hudiksvall before receiving permission, in 1856, to start Stockholms Enskilda Bank. Wallenberg introduced a series of innovations leading to the smoother

Pushed for financial transformation. *When the private banks began to develop into modern commercial banks during the second half of the 19th century,* ***A.O. Wallenberg*** *was at the forefront.*

***Crisis for the railways.** The Bergslag railway was one of the companies that suffered major funding problems. This affected the financial crisis 1878–1879.*

functioning of the banking system. By introducing accounts with long periods of notice, Stockholms Enskilda Bank could offer depositors higher interest rates than previously, as it became safer for the bank to use this money. It became the first bank to base a large part of its lending on deposits. Right from the start, large parts of the business sector chose to engage the new bank.

The statutory interest rate ceiling started to be dissolved in 1864, which gave the banking system a more stable base. As interest in depositing money for a higher interest rate grew, the commercial banks became able to increase their lending. Small-scale savers deposited so much money in Stockholms Enskilda Bank that Wallenberg found it difficult to pay their interest. The bank purchased large numbers of railway bonds, one of savers' favourite securities in the 1860s and 1870s. But when the international downturn reached Sweden in 1878–1879, the railway companies were badly hit and Stockholms Enskilda Bank found it difficult to cope with the flood of savers wishing to withdraw their money.

Minister for Finance Hans Forssell initially wished to do as little as possible to support the banks, but other considerations came to play a part. The most vulnerable railway company was the Bergslagen Line, which was a prestige project for the then United Kingdoms of Sweden and Norway. The Government therefore took out foreign loans to set up a fund[5], which accepted railway bonds from Stockholms Enskilda Bank and others as collateral for the loans.

This rescue action meant that the business sector's most important bank, Stockholms Enskilda Bank, could continue its operations. In contrast, the trading houses and bankers impacted by the crisis had to manage as best they could. The Government had chosen to use the commercial banks as a basis for the development of the Swedish payment and credit system.

The Riksbank becomes central bank and gains a monopoly on banknotes

When financial crises shook the banks, the Government and Riksdag had to improvise. When the Swedish financial system needed capital from abroad, solutions had to be thrown together, often by the Swedish National Debt Office or Allmänna Hypoteksbanken having to raise loans on behalf of the country. It became clear that a different order was necessary. A smoothly-functioning banking system was an important precondition for industrialisation and the modernisation of the entire economy. But the commercial banks also needed a central bank with clear responsibility when problems arose in the payment and credit system.

It took a long time for the banks and Riksdag to agree on a new system. The political deadlock was unbending. The private banks wished to retain the private issuance of banknotes, while the members of the Riksdag critical to

5) This was called the Järnvägshypotekslånefonden (the 'railway mortgage loan fund').

the banks wished to retain the Riksbank's lending operations as a counterbalance to the commercial banks.

The Riksdag was unable to adopt the new Sveriges Riksbank Act until 1897. This act made a clear distinction between the commercial banks and the Riksbank. The Riksbank essentially abandoned commercial lending, while the commercial banks lost the right to issue banknotes. The law gave the Riksbank the sole right, a monopoly, to issue banknotes in Sweden, a monopoly that formally came into force at the turn of the year 1903/1904. The private banks wanted the Riksbank to refrain entirely from paying interest on deposits, but the Riksdag did not go so far. The Riksbank would still be able to accept deposits from the business sector. In addition, the Riksbank was also given more explicit responsibility for ensuring the stability of the payment and credit system. In this way, the Riksbank became a modern central bank with a professional management.

Furthermore, a special bank office had been established as part of the Ministry of Finance in 1876, and this became an independent civil service department, the Bank Inspection Board, in 1907. The Bank Inspection Board was given an important role overseeing the commercial banks and is the forerunner of today's Finansinspektionen (the Swedish financial supervisory authority).

The Swedo-Finnish economist Karl Langenskiöld became Governor of the Riksbank in 1901 and came to play a leading role when the international financial crisis of 1907–1908 reached Sweden. Several Swedish banks had significant credits abroad that were now cancelled. To pay their debts, companies and their bank contacts turned to the Riksbank to obtain foreign currency. To meet

Managed the financial crisis. *As Governor of the Riksbank, the Finnish-Swedish economist* ***Karl Langenskiöld*** *played an important role when the international financial crisis reached Sweden in 1907–1908.*

this requirement, the Riksbank took over part of a foreign loan from the Swedish National Debt Office. The Riksbank then sold parts of its foreign bond holdings and part of its gold reserve. In addition, at the start of 1908, the City of Stockholm took a foreign loan that the Riksbank was given access to. The bank's foreign reserves thereby increased heavily. For the first time, the Riksbank acted as a modern central bank and crisis manager. Due to Langenskiöld's intervention, Sweden was able to ride out this financial crisis.

The Kreuger Crash rocks the financial world

The crash of the Wall Street stock exchange in the autumn of 1929 led to great unease across the entire financial system. It led to the United Kingdom, Sweden and many other countries leaving the gold standard in the autumn of 1931. This turbulence had far-reaching consequences for the entire Swedish financial system.

During the 1920s, the financier Ivar Kreuger had purchased matchstick factories across the entire world and secured monopolies on matchsticks in many countries. Governments had granted monopolies in exchange for the investment, by Kreuger, of their government bonds on the international capital market. In this way, Kreuger organised massive capital transfers from countries with saving surpluses – not least the United States – to central and eastern Europe. But after the Wall Street Crash, Kreuger was no longer able to mobilise US small-scale savers' capital. The crisis of 1931 meant that the government bonds he had invested fell in value.

Kreuger then turned to the Swedish commercial banks to obtain funding. Although they lent him capital, they were unable to lend him enough. After this, he was instead granted a loan from the Riksbank. Despite this, Kreuger was unable to put his affairs in order and, on 1 March 1932, he committed suicide in Paris. It was revealed that his company was heavily indebted in relation to the value of its assets – a fact that shook the entire Swedish stock market and financial world to their roots. In particular, Skandinaviska Banken was so deeply involved in Kreuger's dealings that collapse threatened. To prevent this, the Government allowed the Swedish National Debt Office to give a loan to Skandinaviska Banken, which limited the damage within the banking system.

Economic collapse. Ivar Kreuger *got capital by large issues of bonds and shares. But after the Wall Street crash their value plummeted. He was not able to get his affairs in order and committed suicide in 1932.*

The low interest rates and weak krona of the 1930s benefited Sweden

The krona exchange rate was allowed to float in the autumn of 1931, after which it weakened against other currencies. Following Ivar Kreuger's death, it fell even more. By June 1933, when the krona was pegged to sterling at the rate of 19.40, it had fallen by 15 per cent. But this depreciation benefited Swedish exports, at the same time as the low interest rates facilitated domestic construction. Sweden therefore came through the 1920s and 1930s better than most other countries. On 28 August 1939 – just a few days before the outbreak of the Second World War – the krona was pegged to the dollar, instead of sterling, at the rate of 4.20.

On the other hand, the low interest rates throughout the 1930s caused difficulties for the life insurance companies, which had counted on a higher interest rate when they made their commitments to their policyholders. The Private Insurance Supervisory Service forced the companies to use lower and lower interest rates, which made it increasingly difficult to meet their commitments to their policyholders. But before the situation came to a head, the Second World War broke out and interest rates returned to higher levels.

Interest rate and exchange rate in the service of economic policy

The relatively favourable economic policy during the Second World War paved the way for a new view of how the payment system and the credit markets should be managed. The economist Gunnar Myrdal argued, in 1944, that the interest rate was an altogether too blunt instrument. It would be more effective, he considered, to steer the flows in the economy with targeted tax policies.

For several decades, this also became the focus of economic policy. The Board of Governors of the Riksbank was strongly influenced by the Government via the Ministry of Finance and was expected to maintain a low interest rate. When the Board of Governors continued to insist on a low interest rate policy, Governor of the Riksbank Ivar Rooth[6] finally decided to resign in 1948.

***Dramatic events. Ivar Rooth** headed up the Riksbank 1929–1948. He was involved in revolutionary changes, such as Sweden abandoning the gold standard in 1931 and the Kreuger crash in 1932.*

6) Rooth later became Managing Director of the International Monetary Fund (IMF).

The interest rate and the exchange rate were seen as tools in the service of economic policy. After the War, in 1946, the krona was written up against the dollar by 17 per cent, before being devalued by 30.5 per cent in 1949. The low interest rate led to tensions in the economy, which were managed via the increasingly complex regulation of banks and insurance companies. The Government steered the Riksbank and the Riksbank steered the banks. Central government thus had a strong influence on investments. The Government thereby steered significant capital flows into housing construction, while newly-started companies often found it difficult to obtain the loans they needed.

During the first decades after the Second World War, the Riksbank was given much of the practical responsibility for the regulation of the capital markets. The Riksbank signed far-reaching agreements with the Swedish Bankers' Association and individual commercial banks on the terms and conditions that would apply for deposits and loans and what should be prioritised in lending. The Riksbank also administered currency controls, which were highly significant for the banks' ability to support their corporate customers in their international operations. In addition, the Riksbank was also responsible for regulating the banks' overall credit volume so that this would follow growth in the economy as a whole.

The Riksbank thus attempted to secure the stability of the payment system by steering it in detail and the managing directors of the commercial banks were summoned to the Governor of the Riksbank to be reprimanded when he was dissatisfied with how they had managed lending.

Regulations are being eroded

In the 1970s, the Government tried to ease the economic strain by tightening the controls of capital flows even more. But the controls proved difficult to uphold in the long run. The increasingly internationalised economy demanded more flexible financial solutions.

On the international level, there were Eurobanks, commercial banks that did not come under the auspices of Bretton Woods regulations. They accepted increasingly large amounts, not least in US dollars, and invested them on capital markets that were out of the reach of government supervision and regulation. Developing countries in particular borrowed large sums on this Eurodollar market in the 1970s and 1980s. In some cases, the loan amounts were so large that they were considered a threat to the stability of the international payment system. Hence when countries like the United States and the United Kingdom started to deregulate, it was partly in order to entice these capital flows back so that the governments could gain control of what was happening.

Within Sweden, a “grey” credit market gradually emerged. “Grey” financial corporations operated alongside the conventional regulations. They approved direct loans, but they were also behind different types of credit card. Some of the funding came from large export companies with bulging cash balances, but a few of the companies were associated with the banks themselves.

In other words, both international and domestic developments were sending strong signals that the regulation was unsustainable in the long run. From 1985 onwards, the Government and the Riksbank began to phase out the regulations that had applied during the previous decades. It became easier to borrow and the previously clear boundaries between commercial banks. savings banks and insurance companies were erased. Large financial corporations with offshoots in several different areas emerged as a result of mergers and acquisitions.

Abolished regulations behind the 1990s banking crisis

The problem was that the financial system had become used to the regulation. Banks were therefore not equipped to make the risk assessments required by the new conditions. Companies and households were tasking on more and more debt which heightened the dangers in the financial system, but the companies involved did not realise the risks until it was too late. Neither did the Ministry of Finance, the Riksbank or Finansinspektionen understand the magnitude of the risks that had been built up.

The greatest risks were those in commercial property. The overheating on the asset markets meant that property increased substantially in value and

Property branch crisis. *After 1985 the financial markets were deregulated. But the banks were not equipped to make the risk assessments required by the new conditions. The property market, and in particular the commercial sector, was very overvalued.*

those who bought property were not only expecting to gain a return in the form of rents and similar. They were also expecting that the properties would increase in value. Therefore a chain-letter effect arose, whereby one over-valuation led to another.

The first sign of a crisis came in autumn 1989. At the end of the year, there were rumours that a number of financial companies were suffering problems as some property companies were in trouble. Foreign purchases in particular caused concern. Swedish investors had been carried along by developments in Sweden and bought expensive properties abroad. Financial company Nyckeln's losses on property in London were the most obvious example. The rental market showed a negative development, turnover on the property market fell, interest rates rose and during the period July-November 1990 equity prices on the Stockholm Stock Exchange fell by a good 35 per cent.

At the end of the 1980s, financial companies had lent a total of SEK 134 billion, largely to the property sector. At the end of September 1990, the crisis broke out. Some banks then notified the Bank Inspection Board that they had scruples about funding Nyckeln, which had just given an earnings warning. On 3 October, the financial company defaulted on its payments. After Nyckeln collapsed, property prices began to fall, first commercial property and then detached houses and tenant-owned apartments.

The crisis spread from the financial companies to the banks. The banks had valued each property loan separately, and had not calculated the overall effect of having lent an increasing share of their money to the property market. With hindsight, the people involved have explained that they look at the credit rating of each individual property, without considering the risk entailed in the increasing overall exposure to the property sector.

The Riksbank is forced to give support to the banks again

This was the start of the deepest recession in Sweden in modern times. The economic slowdown and property crisis hit the banks hard. Första Sparbanken, Sparbanken Väst, Gota Bank and Nordbanken were the banks that suffered the most. According to an estimate, the banks lost a total of SEK 200 billion between 1990 and 1995. Gota Bank's losses in the period 1990–1993 corresponded to a good 37 per cent of their total lending. For Nordbanken the figure was 21 per cent and for Sparbanken Sverige it was 17 per cent.

The government was forced to go in and support the banking system. The Riksbank safeguarded the banks' access to foreign currency by investing some of its foreign currency reserve in some of the larger banks. In 1993, the government established the Swedish Bank Support Authority, which managed the government's commitments in the banking sector. However, the condition for the state going in and providing support to a bank was that the Swedish Bank Support Authority would take over ownership of the bank. The major banks who wanted to continue on their own instead took in fresh capital through new issues.

With regard to the banks that were taken over, the Bank Support Authority sought new solutions to ensure as far as possible that tax-payers would not be affected. One method used was to invest the banks' impaired loans in special companies that managed them and eventually tried to sell them. The Authority was wound up in 1996.

Impaired mortgages – the start of the global financial crisis

The first decade or so after the banking crisis of the 1990s, the payment system was relatively stable. But the unease that arose regarding the US mortgage market in summer 2007 led to a new international financial crisis, the deepest and longest since the Wall Street crash in 1929 and the ensuing depression.

The impaired US mortgages had been converted into financial instruments that were so complicated that not even all of the financial institutions were able to realise what risks they entailed. The US banking firm Lehman Brothers had been one of the most important in this market. When Lehman Brothers faced such problems that they were forced to default on payments, this had major effects for other banks as well. International banks are strongly dependent on their links with one another and when they became uncertain over what exposures others had, the situation led to a

Bankruptcy that resounded. *In autumn 2008, the Lehman Brothers investment bank collapsed. This led to a global financial crisis, the worst in several decades.*

total stop on the credit market, with no one daring to lend money. This in turn affected companies, which were unable to invest. The problems then spread further through national economies and became the starting point for a severe economic slump.

During the second phase of the recession, individual countries' ability to pay was questioned. The consequences of the recession became to severe that the financial markets lost confidence in several countries' government securities. This in turn entailed an increased risk within the international banking system, as several banks had invested in these securities in the belief that government securities are particularly safe. The problems in these countries led to speculation that one or more of them might be forced to leave the European Monetary Union. This led to fears for the stability of the entire international financial system. Even before the crisis, growth in large parts of Europe had slowed down. Now the problems in both the countries and the banks contributed to both prolonging and deepening the downturn in Europe.

This lead to drastic measures in the EU. The European Central Bank (ECB) made vigorous attempts to stimulate the economy via monetary policy. They also negotiated a bank union to improve oversight of the banks and to manage banks in distress. The basic idea behind the union is the same one that guided Sweden's actions during the crisis in the 1990s: that the banks shall first and foremost solve their own problems. The support measures assume that the owners hand over the bank to the bank union and that the responsibility for overseeing and controlling the banks in the euro area countries lies with the European Central Bank.

A couple of Swedish banks were also affected by the crisis within the EU, not least because of their overly liberal lending to the Baltic countries. However, the problems were not as serious as they had been in the 1990s, as they were now in better condition. Nevertheless, in a long-term perspective international integration has increased. An increasing number of financial corporations have operations in several different countries. Nordea is classified as a global systemically important bank, and the other three major commercial banks in Sweden, Swedbank, SEB and Handelsbanken also have operations abroad. This means that problems that arise on the financial markets in one of these countries can affect the stability of the entire banking group's activities.

In addition, there is the question of how the Swedish banks choose to fund their operations, They are borrowing money on the international markets to an increasing extent, and then lending this money to companies and households. The fact that banks are so dependent on external funding is also an element of risk with regard to future international crises. The significance of the payment system and its risks are the background to a discussion even today on how the supervision shall be organised and how the responsibility for taking action in a crisis shall be allocated between the parliamentary authority the Riksbank on the one hand and the government's authorities Finansinspektionen and the Swedish National Debt Office on the other hand.

Who shall decide over the Riksbank?

A central bank issues the country's money, determines the price of this money and stands as guarantor in times of trouble. Both money and credit require confidence and trust. The Riksbank's history concerns to a large extent the efforts to safeguard the confidence of the general public – and the danger of losing it. Even now, the Riksbank's tasks and governance are the subject of lively debate and political discussion.

The start in 1668 – the king lost his power over the bank to the governing council

The key to the Riksbank being able to carry out its tasks is the confidence the general public has in the bank. Right from the start, one has sought constructions that make it possible to build up and retain the trust of the Swedish citizens. The Riksbank's principals have therefore emphasised time and time again the need for the bank to first of all focus on its main tasks, without spending too much time on other interests – but this has been an endeavour with varying success.

The origin of today's Riksbank, Johan Palmstruch's bank Stockholm Banco, was completely in the lap of the country's highest governing powers. It was the king who gave the bank permission to conduct its operations and the parliament of the time that closely monitored the operations of Stockholms Banco. Several leading parliamentarians also had owner shares in the bank and received dividends on them.

When the bank was reconstructed as the Bank of the Estates of the Realm in 1668, however, the estates chose a different system. Despite the fact that the government of the time had intended to play a strong role in the governance of the bank, the estates of the realm decided that the king and the government – the royal power – should be held outside. The bank would instead be governed by a governing council appointed by the estates. The bank would in this way be independent with regard to the royal powers.

It is reasonable to interpret this as an attempt to create confidence in the bank. For one thing, the leader of the government, the chancellor Magnus Gabriel De la Gardie's own business was not in very good order. There was concern that the royal powers might use the bank's funds when the state coffers were drained. Although the Bank of the Estates of the Realm was established during a time of peace, the founders were well aware of the financial strains of warfare.

By instead putting the bank under parliament, the etates of the realm were trying to convince the depositors that the bank's governing council would take their best interests into account. Independence of the royal powers would make depositors feel more secure.

Charles XI marked his power over the Riksbank

The Riksbank's independence was soon put to the test under Charles XI and Charles XII. When Charles XI introduced autocracy he explained that the royal powers had the final word on all questions: The government would thereafter be known as the king's council and the bank would be renamed the Royal Majesty's State Bank.

The question came to a head with regard to how interest should be calculated on the bank's loans to the king. The Riksbank required interest on the interest, but the king only wanted to pay a single interest rate. The Riksbank then referred to Karl XI's royal assurance in 1675, in which he promised to observe the decisions of the estates of the realm. The king promised that all of his promises to the Riksbank would be kept – but then he made a very large reservation: If the governing council at any point took a decision the king did not like and which also contravened other regulations and ordinances, "that we have found to be good," then the king could not allow either the estates of the realm or anyone else to take such decisions.

Charles XI understood nevertheless the reason why the estates had in 1668 wanted the Riksbank to be free from royal power and he did not make use of the right he had taken upon himself, but in the question of principle he had put the Riksbank in its place.

Charles XII borrowed from the Riksbank to finance the wars

Under the reign of Charles XII the situation become more critical. He put pressure on the governing council of the Riksbank to grant him large loans to finance his wars. On the other hand, he avoided as far as possible getting involved in the Riksbank's decisions. The king and his advisers realised that confidence in the Riksbank was important for savers to want to put their money into it. Without deposits, the Riksbank would have no money to lend out, as parliament had forbidden it to print new banknotes.

In January 1700 the rumours of an impending war became increasingly intensive. Then many of the depositors turned to the Riksbank to withdraw their money. This worried Charles XII. Once war had broken out, he urged his subjects that it was each man's duty support the bank and not to withdraw

Wanted more power. *King* ***Charles XIV Johan*** *tried to acquire greater influence over the Riksbank, but did not succeed.*

their money unnecessarily. He promised and ensured them that all of the depositors' rights would be maintained. When they had success in the field, savers were happy to deposit their money. With the king's approval, the Riksbank paid a good interest rate on the money deposited. But when the rumour of the great defeat at Poltava reached Stockholm at the end of August 1709, savers rushed to the bank to withdraw their money. After a week or so, the Riksbank was forced to close for withdrawals and froze all of the money deposited into the accounts.

After the Riksbank closed, its management nonetheless strove to pay interest on deposited money, so that the certificates of deposit would still retain some value. It was necessary to preserve as much confidence in the bank as was possible. The problem was that the King was becoming increasingly desperate. He forced the Riksbank to grant several loans and applied his new wealth tax to savings accounts in the bank, even though both he and his father had promised that savings in the Riksbank would be exempt from taxes and charges.

The Riksbank maintained its independence despite attacks from Charles XIV John

When Charles XIV John became King in 1818, he reacted against all the power over the Riksbank lying entirely in the hands of the Riksdag. He raised the matter of the Riksbank's independence during the negotiations on restoring the silver standard, the right for depositors to redeem their banknotes for silver.

This right and the value of the various currencies would be decided in a new currency law that the King and Riksdag passed together. In exchange, Charles XIV John requested the Riksdag to amend paragraph 72 of the Instrument of Government of 1809. In this, the Riksdag had confirmed the Riksbank's status: "The Bank of the Estates of the Realm will remain hereafter, as it has heretofore done, under the guarantee and care of the Riksdag of the Estates, so that it may be administered undisturbed by its Governing Council".

As a first step, the King requested the right to appoint a representative in the management of the Riksbank. The King's representative would be involved and have influence in decisions by the Riksbank, even though he would have no vote.

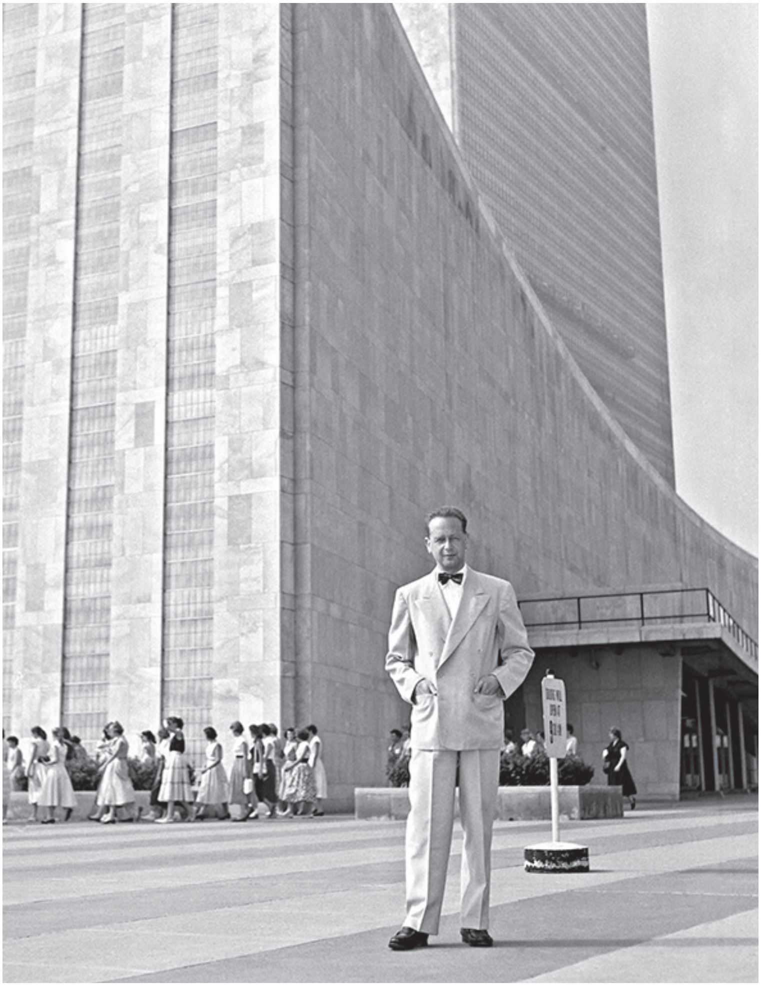
In 1830, the Riksdag adopted the new currency law and a new paragraph 72, but the new paragraph in the Instrument of Government was left dormant. This needed to be confirmed by a new Riksdag to enter into force. In February 1834, the King wrote to the Riksdag about the currency law and reminded it of the dormant amendment to the Constitution. The currency reform was implemented, but, when a decision was to be taken on the new paragraph, only the nobles and priests voted for the amendment – the burghers and peasants voted against it. As the decision required the support of three of the estates of the realm, the amendment fell. The King had lost, the Riksdag's absolute power remained, and the Riksbank's independence was thus secured.

Parliamentarianism reduced the Riksbank's independence

The breakthrough of parliamentarianism at the start of the 1900s meant, in practice, that the Riksbank's independence came to decrease. Governments relied on a majority in the Riksdag and the same power relation was repeated in the General Council of the Riksbank.

This meant that Governments could influence the bank through their party members in the General Council. When Ivar Kreuger encountered difficulties in funding his operations via the Swedish commercial banks, he turned, on two occasions, to the Riksbank with applications for credit. The Riksbank rejected them on both occasions, but Prime Minister Carl Gustaf Ekman pushed for a reassessment and succeeded, on both occasions, in getting the General Council of the Riksbank to change its mind. When it was later revealed that, a couple of weeks before both applications, Kreuger had signed cheques for significant amounts payable to the Prime Minister, Ekman resigned.

In the 1930s, a comprehensive reappraisal of economic policy and its forms was carried out. One part of this reappraisal was that economic policy started to be seen as a whole, in which the interplay of the Government's fiscal policy measures and the Riksbank's monetary policy was emphasised. One important, fundamental stage of this was taken in 1941, when the Government appointed State Secretary of the Ministry of Finance Dag Hammarskjöld to Chairperson of the Riksbank. This facilitated the coordination of the policies



***Made a difference. Dag Hammarskjöld** played an important role in the coordination of fiscal and monetary policy. He was state secretary at the Ministry of Finance and Chairman of the Riksbank's General Council. In 1953 he was elected Secretary General of the United Nations.*

of the Government and the Riksbank, but it also affected the Riksbank's independence.

The Riksbank under the Government's thumb

The new order remained in place for several decades to come. The Riksbank had formal independence under law, but the Government, on the other hand, relied on the same majority in the Riksdag that appointed members to the Riksbank. State Secretaries in the Ministry of Finance, previous Ministers of Finance and other persons close to the Government were appointed Chairperson of the Riksbank. In particular during the 1950s and 1960s, the Riksbank came to act more or less as a department in the Ministry of Finance.

When the Riksbank occasionally made use of its right to make decisions by itself on sensitive monetary policy issues, this led to strong reactions from the Government. The best known case is the 'interest rate coup' of 1957. This was when the Governor of the Riksbank Per Åsbrink convinced the General Council to raise the interest rate from 4 to 5 per cent without informing the Government in advance. This violated the low interest rate policy that the Social Democratic Party and the Farmers' League had agreed on, and led to sharp criticism from Prime Minister Tage Erlander and Minister of Finance Gunnar Sträng. County Governor Per Eckerberg was forced to resign as Chairperson of the General Council and the Government had once again made clear that, in practice, it had the final word with regard to the Riksbank.

Took own decisions. *Riksbank Governor* ***Per Åsbrink*** *received criticism for what was called an interest-rate coup. He convinced the General Council to raise the interest rate from 4 to 5 per cent without informing the Government in advance.*

New forms of independence

Only a few lone voices questioned the Riksbank's actual subordination. One of them was economist Erik Lindahl, who argued for a more independent role for the Riksbank in the mid-1950s. Lindahl considered that the Riksbank's independence from the Government had been weakened by the gold standard and the political pressure to keep interest rates low. He said that the constitutional basis was sufficient, but that it should be complemented by new rules for appointing the General Council, a stronger position for the Governor of the Riksbank and a paragraph on objectives that emphasised the importance of safeguarding the value of money.

Lindahl's words initially fell on deaf ears and understanding of the need for an independent central bank remained low into the 1970s. On the contrary: the then Danish Minister of Economic and Budgetary Affairs Per Hækkerup held up Sveriges Riksbank as a good example when he wanted "parliament and government to fully influence the dispositions taken".

However, in the 1980s, the close links between monetary policy and the rest of economic policy were increasingly questioned. Once Governments had the interest rate in their hands, they were easily overcome by the temptation to use inflation to boost employment. Economic agents predicted this and, in turn, attempted to anticipate the price increases they realised would result. The consequences were a constant roundabout of rising prices and wages, the value of which was constantly undermined by inflation.

Some economists observed that the rate of inflation was lower in those countries where the central bank had a more independent status. The German Bundesbank was the most frequent example, but also the US central bank was comparatively independent. This independent status made it possible for the Chairman of the Fed, Paul Volcker, to conduct an interest rate policy that contributed towards breaking the high inflation expectations as the 1970s turned into the 1980s.

This observation was transformed into a hypothesis and a rule: if monetary policy lies in the hands of an independent, cautious central bank with price stability as its only goal, the chances of actually fulfilling this objective will

Not an independent central bank. *Iron Lady* ***Margaret Thatcher*** *was not keen on giving the Bank of England greater influence.*

increase. This, in turn, will create better conditions for the development of the entire economy by removing the disruptive effects of inflation. Consequently, economic policy would be better served by an independent central bank than by a subordinate one.

This point of view was not self-evident from the start. The Prime Minister of the United Kingdom, Margaret Thatcher, was directly dismissive of the proposal of her Chancellor of the Exchequer in 1988 to grant the Bank of England a more independent status. There were also dissenting voices among economists. The relationship could also be the reverse – maybe it was countries with low inflation that had accepted independent central banks.

But the new opinion spread to more and more countries. It became an important element of the new agreement on an economic and monetary union that the Member States of the European Community (EC) agreed upon in 1992. The Maastricht Treaty also entailed the EC being reformed as the European Union (EU).

As part of the preparations for the economic and monetary union, the Member States committed to granting their central banks an independent status. The central banks should stand above political influence and central government would not be permitted to borrow from them. Central banks in other countries have also been granted greater independence, even if the institutional arrangements and degree of independence vary.

The Riksbank became more independent

Independence was developed gradually. In Sweden, the Riksdag decided on a new Sveriges Riksbank Act in 1987, and this entered into force in 1989. On a couple of points, this meant that the Riksbank's independence increased. For example, the Government lost its right to appoint the Chairperson of the General Council, which had been one of the decisive issues of the reform of 1897. Instead, the seven members appointed by the Riksdag would select a Chairperson from among themselves. In addition, these seven would appoint an eight member, the Governor of the Riksbank, whose mandate was extended from three to five years. This extended mandate period also gave the Governor a stronger position.

As Sweden had decided to apply for membership of the EC, these changed were insufficient. The entry into force of the Maastricht Treaty would have repercussions for all of the Riksbank's operations.

On the way towards independence. *The Treaty of Maastricht meant that the Riksbank became much more independent than before.*

This meant that it was necessary to determine exactly what was meant by the word ‘independence’. The commission of inquiry on the Riksbank in 1991 had determined that the most important aspects of the Riksbank’s independence were control of monetary policy, the operational objective, the power of appointment, accountability, rules for central government borrowing from the Riksbank and the bank’s budget. The commission of inquiry presented its proposals in 1993, but it took time to reach a political consensus. It was not until 1996 that a five-party agreement was reached on a new Sveriges Riksbank Act that corresponded with the EU’s regulations, but, as these issues concerned the Instrument of Government, a newly-elected Riksdag was also required to confirm the decision. The new arrangement started to apply from 1 January 1999 and has applied ever since.

Independence investigated anew

Today, the Riksbank is led neither by kings, ministers of finance nor even the General Council of the Riksbank. The present arrangement is that the Riksdag appoints the General Council and it is their responsibility to appoint a Governor and five further Deputy Governors to form the Executive Board. According to the law, the Executive Board may not allow itself to be influenced by political or economic interests. To guarantee economic insight, the Chairperson and Vice Chairperson of the General Council have the right to participate in meetings of the Executive Board, and the Executive Board attends hearings by its principal, the Riksdag Committee on Finance, at least twice a year.

However, in the wake of the global financial crisis of 2008, the governance of central banks is being debated anew around the world. In Sweden, the Government, on behalf of the Riksdag Committee on Finance, has appointed an inquiry into the framework for monetary policy and the Sveriges Riksbank Act.

PHOTO: CHRISTINE OLSSON

Gunnar Wetterberg

Historian and author. His books include Money and Power, a history of Sveriges Riksbank, a major autobiography of Axel Oxenstierna, a book about the Wallenberg family "empire" and a history of the province of Skåne In three parts. The most recent was published in 2017.

Gunnar Wetterberg has worked at the Swedish Ministry for Foreign Affairs, the Swedish National Audit Office, the Ministry of Finance and the Swedish Association of Local Authorities. 1999-2013 he was Head of the Policy Department at the Swedish Confederation of Professional Associations. The common denominator in his career has been economic and structural issues. He describes familiarising himself with a problem and gradually finding A solution as an amazing experience.

Ann-Leena Mikiver

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PHOTO: PETTER KARLBERG

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