Comments on “Monetary policy in Finland: experiences since 1992”

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Overall economic developments

The Finnish recession of the early 1990s left a heavy burden: the unemployment rate rose dramatically; public debt and net external debt increased rapidly, a banking crisis developed.

The authorities’ strategy for overcoming the problems was centred on the growth of the export sector. The markka was devalued and then floated in 1992. This export-led orientation was successful. The fall in the markka did not lead to inflation, owing to the weakness of the labour market and a prudent monetary policy.

The recovery at first masked what the OECD called a “persisting dualism” in the economy, with weak activity in domestically oriented sectors.[1] In the meantime, domestic demand has recovered, however. Economic growth is largely without tension and above the west European average. If it continues unabated, we might expect consequences concerning interest rates or the exchange rate.

Finland has made headway in fiscal consolidation, too. It is a good example of a country in which a policy of fiscal policy consolidation is in the country’s own best interests and does not primarily serve to meet the convergence criteria of the Maastricht Treaty. Without the consolidation of public finance, government debt would have run out of control. Furthermore, consolidation has helped to maintain a comfortable external position, which is important given the country’s high foreign debt.

Unemployment has remained high, however. Finland is certainly not the only country facing difficulties on the labour market; the unsatisfactory situation in Germany is a case in point. In Germany, as in Finland, the expected rate of economic growth is not sufficient to bring about a substantial reduction in unemployment. Structural factors, such as over-

[1] See OECD (1996), p. 3.

regulation, the high burden of taxes and levies, high wages and insufficient wage flexibility obviously play a crucial role in this context.

Progress in these areas is proving to be particularly difficult within the framework of the European consensus model. Significantly enough, in its latest Annual Report, the European Commission rejected the so-called US model of sharp wage differentiation since the model of the working poor is not acceptable in Europe.[2] In Finland it seems, if anything, to be even more difficult to overcome structural difficulties. As in other Scandinavian countries, the Finnish society tends towards a more uniform income distribution.

In the past, recourse was often taken to incomes policy. The policy package adopted in September 1995 suggests that the use of incomes policy in the form of social contracts is still considered an appropriate means of bringing the challenges of global economic change into line with social conditions.[3] However, the package seems to provide only limited cause for hope: owing to tax cuts agreed at the same time and the reduction in the contributions to unemployment insurance, the moderate nominal wage increases were accompanied by a much higher rise in real net wages. In addition, the task to be tackled is not only general wage restraint, but also greater nominal wage flexibility and wage differentiation between the export sector and the domestic sector.

In other countries people tend to rely on the emergence of changing attitudes and approaches among wage negotiators. Even though it must be admitted that Germany is undoubtedly lagging behind in the structural adjustment process, there are encouraging signs that this is now happening in Germany, too. The latest wage settlements, which will be effective well into 1998, have been quite moderate. Flexibility and realism are increasing in the field of wage policy, and the erosion of industry-wide wage bargaining is making headway.

It will be interesting to see which course the European countries will choose to pursue in wage and labour market policy in the European monetary union. Generally speaking, owing to the growing common nature of European labour markets, it will no longer be possible to prevent pay policy from becoming more flexible and decentralised. Even more than before, wage policy will become locational in nature, and its implications for employment will be felt more directly than hitherto.

2 See European Commission (1996), p. 60.
3 For a more detailed discussion of the Finnish experience see, for example, Kuntze (1997).

However, in view of the social environment in some countries, incomes policy, too, might remain a subject of debate, especially if the use of a compensatory monetary or fiscal policy is limited by European monetary union and the stability pact.

Monetary policy

In 1993, Finland introduced inflation targeting; as in other countries, this measure was a matter of necessity. It was adopted because monetary policy needed a new nominal anchor and a new credibility after the fixed exchange rate had been abandoned. Following the loss of exchange rate stability, inflation targeting seemed to be more appropriate for a relatively small country than monetary targeting. Analyses of the stability of the Finnish demand for money likewise argued in favour of that decision.[4]

In the general view, the inflation targeting regime has served Finland well. The transparency of monetary policy and the credibility of the Bank of Finland (BoF) have increased, especially after the publication of the BoF's inflation forecast. Inflation has been brought down substantially. Risk premia on interest rates have fallen, too.

However, the Finnish experience also seems to indicate that "the introduction of explicit inflation targets does not provide an expressway to high policy credibility".[5] That may have something to do with the uncertainties of inflation forecasts. Credibility can be brought about only by establishing a track record. In that respect, the BoF was certainly helped by international developments, fiscal consolidation and the slack in the labour market. This raises the question for the future – and not only in Finland – about the price trend to be expected if unemployment declines again. The precise effect of inflation targeting is thus somewhat difficult to disentangle from the impact of positive economic and political developments. Nevertheless, the tightening of Finnish monetary policy in 1994–5 undoubtedly made its contribution to the subsequent decline in inflationary expectations.

Whether or not a strategy of inflation targeting is to be preferred to an intermediate targeting strategy depends on whether the linkage

[4] See, for example, Ripatti (1996).
[5] Åkerholm and Brunila (1995), p. 104.

between the instruments of monetary policy and the inflation rate is stronger than the linkage via any intermediate target which displays a stable relationship with the path of inflation.

That raises the following questions:

- To what extent is the inflation rate controllable by the instruments of monetary policy in Finland, given external and social constraints?
- How reliable is the inflation forecast given the changes in the economy and the monetary policy regime?
- What role is assigned to the exchange rate and the monetary conditions index as an indicator of monetary conditions and a predictor of inflation?

If I read the situation correctly, the BoF relies in its inflation forecast more on real variables, whereas monetary variables are looked upon with scepticism. Our situation is different. We still think that money demand is reasonably stable in the longer term. In addition, we believe that monetary targeting has political advantages (transparency, self-constraint, accountability). That explains to some extent the different approaches.

The importance of price stability in the framework of inflation targeting implies that other goals can only be pursued to the extent that they do not conflict with the inflation target. That raises the question of whether inflation targeting may run into problems if the banking system still turns out to be rather fragile.

In addition, one may discuss the role of inflation targeting after Finland's entry into the ERM. The wide margin in the ERM offers some leeway. However, if this step is interpreted to mean that the markka should fluctuate only a little around its central rate in view of the planned entry into European monetary union, this exchange rate orientation might lead to conflicts with inflation targeting or, in fact, replace it.

In contrast to the majority of central banks which pursue inflation targets, the BoF focuses on a point target for the inflation rate rather than on a target range.[6] In keeping with the target, inflation was to be kept at about 2% from 1995 onwards. The point target was motivated by the argument that "it would provide a better guide for the formation of inflation expectations, given the country's history and high inflation expectations …".[7] It was feared that the public would construe the upper

[6] For an international comparison of practical issues concerning the inflation targeting framework see, for example, Debelle (1997).

[7] Brunila and Lohdenperä (1995), p. 129.

margin of a band as the factual target rate.[8] However, one might ask whether a single figure, together with the use of an underlying measure of inflation, provides the right balance between credibility and flexibility.

Other central banks have taken the opposite route in monetary and inflation targeting. The Bundesbank, for instance, has defined its monetary targets virtually exclusively as ranges ever since 1979. Ranges provide more room for manoeuvre, but are also a better guide to expectations than a single figure because everybody knows that you cannot reach a single figure anyway. In the case of Finland, the problem is mitigated by the fact that deviations from the target have so far been downwards.

This, however, raises the question of the rationale for an inflation target of 2%. From a theoretical point of view, zero inflation would be consistent with price stability. In practice, however, the concept of price stability is often affected by additional considerations. First, possible measuring errors in the price statistics suggest that price stability is likely to be associated with a low positive rate of inflation. Secondly, the downward rigidity in prices and wages is given as a reason for an optimal inflation rate higher than zero.

The Bundesbank has flatly rejected the concept of an optimal inflation rate. For us, zero inflation is desirable from a theoretical point of view. In our eyes, there is no reason to belittle the adverse effects of low inflation.[9] The Bundesbank sees its medium-term inflation target of 0 to 2%, which is included when deriving the annual monetary targets, as putting the concept of price stability into operation in practical policy. The toleration of an undershooting of the inflation target by the BoF is not *a priori* incompatible with such ideas. On the other hand, this may be due to the fact that decisive stimuli were generated by declining agricultural prices associated with entry into the EU. This decline is rated by the BoF as a one-off effect that is to be accepted, irrespective of its direction.

As regards the implementation of monetary policy, the Finnish paper mentions two innovations in Finland which are rather interesting from the German perspective as well.[10]

One is the introduction of a minimum reserve system with the aim of smoothing interbank overnight rates and facilitating banks' liquidity management. Against the background of liberalised and globalised financial

[8] See Åkerholm and Brunila (1995), p. 93.
[9] For a more detailed discussion see Deutsche Bundesbank (1996).
[10] See Pikkarainen et al. (1997), pp. 9–11.

markets, this step is rather surprising. It also runs counter to the trend towards reducing reserve requirements discerned by the BIS in the Nordic countries.[11] However, it tends to support our perceptions. As is well known, the Bundesbank has always had a minimum reserve system. Among the different goals which such a system may serve, the emphasis has recently clearly shifted to the money market aspect. Minimum reserve requirements which are to be met on a monthly average work as a buffer in the money market, they limit interest rate fluctuations and permit central bank action with little intervention; these are advantages which should be particularly felt in the decentralised implementation of monetary policy in EMU.

The second innovation in Finland is the transition to the fixed-rate tender in open market policy. Here, too, there are certain parallels with the Bundesbank's policy. Whereas the Bundesbank preferred the variable-rate tender in the past because it provided more scope for market forces and was more flexible, the fixed-rate tender and a steady-as-she-goes approach in interest rate policy have clearly predominated in the past few years. Much the same as in Finland, the fact that fixed-rate tenders have reduced uncertainty as to the policy stance played a part in this. Given the periodic increase in financial market volatilities associated with the liberalisation and globalisation of the financial sector, setting clear interest rate signals appeared to be a greater requirement than before, as opposed to the danger of exacerbating interest rate uncertainty.

Regardless of the tender form, the Bundesbank has always geared the allotment of repo transactions to its own liquidity forecast and not to the assessments of the market. This ensures that the liquidity supply of the market is in line with monetary policy requirements. Volatilities of bank liquidity and the overnight interbank rate could therefore be kept very low. I am not quite sure about the extent to which the greater volatility of the market for day-to-day money in Finland is connected with the structure of that market or the Band of Finland's allotment policy, which allows allotments to be determined mainly by the banks' bids.

[11] See BIS (this volume), pp. 230–263.

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