

Erkki Liikanen: Some observations on today's international financial situation on the occasion of the 150th anniversary of the Bank of Russia

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, on the occasion of the 150th anniversary of the Bank of Russia, Moscow, 18 June 2010.

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It is a great pleasure for me to bring the greetings of the Bank of Finland to the 150th anniversary of the Bank of Russia. Our central banks are actually kind of relatives. Emperor Alexander II founded the Central Bank of the Russian Empire exactly 150 years ago.

The Bank of Finland, for its part, was established by his uncle, Alexander I, in 1811. So it is clear that we have many common roots. I will return to these common roots in a moment, but let me first make some observations on today's international financial situation.

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No country has escaped the effects of the current economic crisis. In many ways this was to be expected: The past decade witnessed unprecedented rise in the volumes of both international trade and financial flows. Not even during the first golden age of globalization, in the last decades of the 19th century and the first decade of the 20th, were so many countries trading so much with each other. During the present, second era of globalization, many countries previously largely outside the international division of labour, have been able to enjoy the benefits of international trade and specialization.

The other side of the largely beneficial coin of globalization and interdependence is of course the higher vulnerability to other countries' economic misfortunes. If a negative shock decreases demand in any large economy, the negative effects ripple through the world economy. In the current crisis, the sudden and very large disruption in the functioning of the global banking system made the problems even worse. After the collapse of Lehman Brothers in September 2008, one third of the volume of the world trade disappeared almost overnight. The increased integration of the world's financial systems allowed the negative liquidity shock to spread extremely fast. Very few countries were immune.

While the global scope of the recent crisis is unique, in many ways this crisis has been very similar to the ones before it. It was preceded by an economic boom, accompanied by higher indebtedness, which increased vulnerabilities. Asset prices rose, including housing prices. When negative shocks occurred, expectations were revised downwards, and this caused asset prices to drop. Banks' loan losses increased, and economic recession made the banks' situation even more difficult. Loan losses reduced bank capital, which led to banking crises in many countries. Problems in the banking sector led to further problems in the real sector of the economy. Crises in the financial and real sectors have had adverse effects on public finances, as tax revenues have plummeted and public expenditures have risen. This means that in many cases financial and economic crises have been followed by crises of the public finances, as we are now seeing in Europe.

The nature of the crisis has reminded us of a basic fact, perhaps overlooked in the previous years. Liquidity is extremely important. This means that the tasks of the central banks as liquidity creators and providers have come into focus. This has happened everywhere, Russia included. For its part, the Bank of Russia acted quickly to ensure the liquidity of Russian banking sector, as did other central banks in their own economies. In fact, we have been reminded of some very old lessons in economic policy-making. Already in 1873 Walter Bagehot told us that central banks should lend freely to illiquid but solvent banks if they have adequate collateral to offer.

What are then the broader lessons for policy-makers? How should economic policy be designed in the new era of globalization? It is clear that even if countries have become dependent on each other, economic policies still matter. Moreover, national economic policies have international dimensions and international repercussions.

During the current, very difficult crisis, central banks have been able to ensure the functioning of the banking systems. For sure, there have been problems in many private financial institutions, and some of them have failed, but functioning of the whole financial systems has been preserved. Actually, successful liquidity policies have only been possible through broad international cooperation. If there is anything positive about this crisis, it is the proven capacity of central banks to act in cooperation with each other.

Fiscal policies have been loosened significantly, globally, and this has supported the level of overall demand although the private sector has turned to consolidating its balance sheets. The countries which entered the crisis with sound public finances have been in much better position. I am glad to note that during the upswing years, Russia was able to save for the rainy day through its Stabilization Fund and by paying off its debts. This has made reacting to the crisis much easier. Also in Finland, the pre-crisis years witnessed large public surpluses, which allowed the fiscal policy to be loosened when the crisis hit. However, in the coming years there is even greater need for responsible fiscal policies. And the benefits from fiscal responsibility are not limited to each country separately, but they are shared globally.

In designing future economic policies, we need to remember at least three things. First, we need mechanisms to prevent over-borrowing, both in the private and public sector. Second, risks need to be priced correctly. Too low risk premia will lead to over-borrowing. Last, resolving modern financial and economic crises demands international and regional cooperation. Achieving all this will require new approaches and new attitudes both in the public and private sector, and this will – of course – be hard. However, failure to achieve these goals would increase the risks of more crises in the future, and this is unacceptable.

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We are celebrating now the anniversary of one of the world's great central banks, a bank with long traditions and a turbulent past. I think that this jubilee is especially significant for us Finns. This is so because the Russian and Finnish monetary systems share a lot of common history, in particular from the 19th century, when the Grand Duchy of Finland was established as a part of the Russian Empire.

1860, the birth-year of the Central Bank of Russia, was an important turning point also in the monetary history of Finland. In March 23, 1860 (old style), Emperor Alexander II issued a decree which gave Finland a monetary unit of its own, the Finnish markka. Before that, the Bank of Finland had issued banknotes denominated in rubles and kopecks. In June, at about the same time when the Central Bank of the Russian Empire was established, the first markka banknotes were circulated.

Both the Bank of Russia and the national monetary system of Finland were born as a result of a crisis which hit the rouble in the latter half of the 1850's. In 1860, the Imperial Government of Finland sought ways to stabilize the currency with the aim of linking it with silver, even ahead of Russia, if necessary. This was the background to the creation of a national monetary unit for Finland. At the same time, the Russian government carried out a more comprehensive institutional reform by founding a new central bank to replace the old state banks. This was also made as a step towards a stable and market-based financial system.

Circumstances are completely different now, of course, but one thing remains at least: financial and monetary stability are still the main objectives of today's central bank policies, just as they were during the reforms of the 1860's. We face challenges and even setbacks from time to time, but must still fulfil our responsibility in crisis management and work towards an even stronger and more resilient financial system in the future. This is not only a

national task, it is a global effort where good cooperation is a necessary condition for success. As circumstances change, the necessary tools may also change, but the ultimate goal remains the same.

I congratulate the Central Bank of the Russian Federation on its anniversary and wish all success in its important tasks, in the service of this country, and as a partner in the international central banking community.