Erkki Liikanen: Monetary policy under resource mobility

Opening remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Bank of Finland 200th Anniversary Conference on "Monetary Policy Under Resource Mobility", Helsinki, 5 May 2011.

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It is a great pleasure for me to welcome you all to this conference on Monetary Policy Under Resource Mobility.

The conference has been arranged to celebrate the 200th anniversary of the establishment of the Bank of Finland in 1811.

The Bank of Finland is the fourth oldest central bank still in operation; the Swedish Riksbank, the Bank of England and Banque de France are our seniors, in that order.

It comes as a surprise to many that Finland's central bank is much older than the country's political independence. The explanation for this is that, once Finland had been conquered from Sweden by the Russian Empire, the Tsar granted the newly constituted Grand Duchy of Finland real autonomy from the start. The Bank of Finland was established as part of this national administration.

In the 1860s, the Bank of Finland was transferred under the auspices and control of the Finnish Parliament, where it remains to this day.

When Finland obtained her independence in 1917, the country had already had its national bank of issue for over a century. We had already had a national currency unit for more than fifty years. Still, I do think that the story of the Finnish currency is above all the story of integration, and the story of a quest for stability. Finland's currency was born out of the desire for stability in the aftermath of the great commercial crisis of 1857. This global crisis destabilized the Russian rouble. In Finland, the depreciation of the rouble raised demands for the re-establishment of the silver standard, even by unilateral action in Finland, if necessary.

In 1860, a national monetary unit, the markka, was granted to Finland. The markka was originally defined as a quarter of the paper rouble, but five years later it was made convertible to silver. Thus, the Finnish currency was linked to the north European silver area, which consisted of the currencies of the Scandinavian countries and Germany.

The goals of stability and international integration were seen as two sides of the same coin. So, when the gold standard emerged as the international monetary system in the 1870s, Finland joined it in 1878.

The gold markka was defined as the exact equivalent of the gold franc. Finland became a member of the franc zone, which included the Latin Monetary Union and some other countries which had adopted a monetary system identical to France.

The early European integration of Finland came as a surprise to many. One of them was the famous German musician and conductor, Hans von Bülow. He travelled to Helsinki from St Petersburg in 1883 and wrote to his wife:

> *"How are you? We are terribly well despite a severe cough and restless sleep – I have received the Russian New Year with great strength. But am I still in Russia? Here they follow the European calendar, speak so much German, Finnish and Swedish, and also no longer count in roubles, but in markkaa and penniä, which have just the value of the French francs and centimes – also the postage stamps are different, as you see..."*

The link to the franc proved very durable. The exchange rate of the markka vis-à-vis the franc remained stable until the First World War, 36 years later. This period was the time of

the great industrial takeoff in Finland. The country began to catch up with the wealthier countries of Europe. Capital imports were a crucial ingredient in this takeoff. Railroad construction, in particular, was financed with bonds floated in Germany and France.

The same drive for integration and search for stability also characterizes the later development of Finnish monetary policy. The arrangements varied – the interwar gold standard, the sterling bloc in the 1930s, the Bretton Woods system – but monetary and exchange policy was always seen as a way to promote the country's participation in the international division of labour, and so to overcome the very limited range of natural resources in Finland.

The other side of the same coin was that the export-oriented growth policy of Finland relied much on devaluations and financial repression, especially after the Second World War. In terms of economic growth, the results were good, but the structure of the economy, and especially the financial sector, remained weak.

Finland successfully caught up with the world's most advanced economies. But it also experienced a traumatic financial crisis in the early 1990s.

When money markets and capital movements were deregulated in Finland in the 1980s, the country was not ready. There was a backlog of demand for credit, inflation was too high and the banks were undercapitalized. A credit bubble emerged, fuelled by short-term capital imports and rather reckless risk-taking in the banking sector. The result is familiar from many other countries today: a large current account deficit, a heavily indebted and uncompetitive economy and an overextended banking sector.

Then, the Soviet economy collapsed at the start of the 1990s. This had a significant impact on Finnish export industry and triggered a severe economic and banking crisis, which was at that time the most severe in the OECD countries since the Second World War.

Dear colleagues, friends,

The choice of title for this conference – "Monetary policy under resource mobility" – reflects the central theme in the history of the Bank of Finland. It is also a central theme for all other central banks.

The central bank works right at the nexus between the domestic economy, on the one hand, and global markets and policies, on the other. Central banks have their responsibilities at both national and international level. When the world changes, the central banks are among the first to feel the changes; they work inside the changes as it were, and they may even be able to manage them.

At this time, the world economy is undergoing profound changes that pose formidable challenges for both central banks and economic researchers. We are witnessing a process of great convergence. In a few years' time the combined output of the emerging economies will surpass the output of the advanced economies when measured in purchasing power parities.

It is not only about production of goods and services.

It is also about capital. The emerging economies have become major sources of savings, and the equilibrium – or lack of it – of global supply and demand hinges on how the surpluses of some countries are channelled to other countries and used there.

It is also about technology, which now spreads from country to country faster than before, narrowing productivity differentials and eroding the competitive position of many traditional centres of know-how.

It is also about labour, as evidenced by migration flows and migration pressures across many borders in the world.

I am very proud to note that our programme for tonight and tomorrow is filled with the world's most distinguished academics and central bankers.

We will start tonight with a session devoted to what we can learn from the economic history of globalization and global shifts.

The topic will be introduced by professor ***Barry Eichengreen*** of the University of California at Berkeley, and we are also very lucky to have three very special discussants, each of whom has an excellent vantage point over the global shifts that we are talking about: **Masaaki Shirakawa** (Bank of Japan), ***Sergey Ignatiev*** (Bank of Russia) and ***Miguel Fernández Ordóñez*** (Bank of Spain).

When the recent financial crises erupted in 2008, there was an emerging consensus in the world on the good strategies for central banks. This consensus emphasized the objective of price stability, which could be pursued by a suitably informed interest rate policy and the careful management of inflation expectations. Now, in the current situation, some new (or old) questions have been raised: for instance, how should central banks relate to the objective of financial stability without compromising their commitment to price stability?

Tomorrow, we will start with a monetary policy session presided over by the new president of the Bundesbank, ***Jens Weidmann***. Professor ***Carl Walsh*** of the University of California at Santa Cruz will be the main speaker in that session, and three central bank governors – ***Athanasios Orphanides***, from Cyprus, ***Mark Carney*** from Canada and ***Agustín Carstens*** from Mexico – will comment.

The globalization of financial markets is not a new thing in itself, but during the most recent wave of globalization the volume of finance channelled through international financial markets has grown tremendously. At the same time, the stability of national economies has become absolutely dependent on the stability of the international financial markets.

It is clear, then, that the world needs a global approach to financial stability. We are seeking a new balance between market discipline, transparency and stricter regulation of the conduct of financial institutions and market participants.

In our second session tomorrow a panel will deal with some of the financial market issues. Three well known governors will participate in the panel: ***Stefan Ingves*** from Sweden, ***Yves Mersch*** from Luxembourg and ***Nout Wellink*** from the Netherlands, as well as a renowned researcher, Professor ***Bengt Holmström*** of MIT.

The luncheon address will be given by Governor ***Mervyn King*** of the Bank of England, who, among his other distinctions, holds an honorary degree from the University of Helsinki.

The world still faces tremendous gaps in living standards between countries, and opportunities gaps between generations in many countries. Even in the advanced countries, the economic adjustment seems to be leaving large parts of the population, especially the young, with disappointingly few opportunities to realize their human potential.

The narrowing of these gaps in living standards and opportunities requires economic growth. But it has to be growth which is consistent with the new divisions of labour in the world economy, and which is sustainable in the context of scarce natural resources.

In a market economy, economic transformation and reallocation is the business of the financial markets. But what kind of financial markets can support and promote such growth? How can it be regulated in the global context? What kind of international monetary system can provide the infrastructure for it? And what does it require of the central banking community?

Tomorrow afternoon is dedicated to the issues of Finance and Economic Growth. The Keynote speech will be delivered by ***Janet Yellen***, vice chairman of the Federal Reserve Board.

The final panel will include Governor ***Stanley Fischer*** from the Bank of Israel and professors ***Philippe Aghion*** from Harvard and ***Martin Hellwig*** from the Max Planck Institute in Bonn.

I am thrilled by the prospect of learning from this set of the world's foremost minds, gathered here today, and am looking forward to many stimulating and fruitful exchanges.

Once more, let me extend to you all a very warm welcome. Let the conference begin!