Erkki Liikanen: Economic and Monetary Union – lessons from the recent crisis

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the European Economics and Financial Centre (EEFC), Distinguished Speakers Seminar, London, 16 June 2011.

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It is a special pleasure for me to speak here in London and I thank professor Scobie for the kind invitation.

The Bank of Finland has had close contacts with the City for a very long time. Actually, we should now be celebrating 150 years of that relationship, since it was in 1861 when the Bank of Finland first opened correspondent accounts with the London bank, N.M. Rothschild & Sons.

A very special relationship exists also between the national central banks of the two countries, the Bank of Finland and the Bank of England. This was recently highlighted by the Governor, Mervyn King, when he spoke at the 200th anniversary conference of the Bank of Finland in Helsinki last month (yes, the Bank of Finland turns 200 this year). I was impressed to hear that Governor King had actually gone through the Old Lady's archives and had found some interesting evidence of how close the relationship between the two central banks was already in the 1920's and 1930's. That was the time when Risto Ryti, a well known anglophile was Governor of the Bank of Finland. Governor Ryti travelled regularly to London and got to know well his British counterpart, the famous Montagu Norman.

A particularly vivid example of Governor King's findings is a letter from Governor Ryti to Cameron Cobbold, then a Bank official and later Governor, dated 18th June 1935, which discussed the forthcoming visit of Cobbold and another official, Humphrey Mynors, to Finland.

Ryti wrote: "I shall have great pleasure in receiving you and Mr Mynors at the Bank of Finland at which I shall arrive on 4 July at 11:00 a.m. from the countryside, where I will be spending my summer holidays at that time. Permit me to invite you and Mr Mynors to a luncheon at the Bank after your arrival. I propose that we, after having discussed matters of mutual interest, start for a little trip to some nice places in South Finland, where I shall arrange for fishing possibilities or other summer enjoyment in which you and Mr Mynors might be interested". On the letter is a handwritten comment by Mr Cobbold to Mr Mynors "this sounds like real central banking cooperation! What are your summer sports?" To which Mr Mynors responds by saying "Does this mean bringing a mosquito net?"

At the time of that innocent letter, the world was gradually recovering from the Great Depression, the worst financial disaster of the century. That recovery was undermined by a surge of global protectionism and growing political instability in Europe towards the end of the 1930's. The fledgling attempts at international economic policy cooperation under the League of Nations and the new Bank for International Settlements were not effective enough to solve those problems.

Much has changed since that letter was written 76 years ago. However, we are once again recovering from a global economic and financial crisis. This time, economic cooperation, especially between central banks, enabled us to prevent the crisis from developing into a spiral of deflation and depression. However, as all of you know, the situation continues to be difficult and even precarious. The foundation for a sustainable recovery is far from ready and much more needs to be done.

My topic today is the economy of the euro area. I propose to discuss the current state of the EMU and its challenges and prospects. I will approach my topic from the perspective of a central banker. Thus I will start with monetary policy – the very core of the central bank's responsibility – and move then on to broader issues of financial markets and budgetary and economic policy.

Monetary policy evaluation

By what measure should we judge the performance of the EMU? When the monetary union was designed, the most important concern was how to ensure the stability of the value of money. The stability of the Deutsche mark and the monetary policy of the Bundesbank were important role-models in the construction of the whole euro area, and even for central banks elsewhere.

There was a strong consensus that the common currency should be as stable as the Deutsche mark had been. At the time when the Maastricht Treaty was signed in February 1992, the signatories knew that the German inflation rate over the previous 10 years had been 2.4 % per annum on average. This admirable stability was desired for the whole monetary union.

How have we done in this respect? The ECB adopted a target for price stability: inflation should be less than but close to 2 % in the medium term. This objective has been achieved. As Mr. Trichet has been able to note, during the twelve years of EMU, the average inflation rate in the euro area has been 1.97 % per annum. So, judging by the primary objective, we can say that the common currency has not disappointed the expectations of 1992.

It must be emphasized that price stability has also been maintained relatively well during the recent financial crisis. In the early phase of the crisis, there was an imminent danger of a financial collapse and ensuing deflation.

To keep the monetary situation under control, the ECB complemented its interest rate policy with a variety of unconventional or non-standard measures. These improved the liquidity of the banking system and the bond markets. The measures included, among other things, the much discussed bond purchases under the so-called Securities Market Programme.

These actions should be judged by the results. The euro has remained strong, the financial meltdown has been avoided, and inflation expectations have remained consistent with the ECB's price stability objective.

So, the crisis of the last years has not been a crisis of the euro as a currency. The currency has remained stable, and also strong in the international context. This achievement is remarkable, but it does not mean that there is cause for complacency.

Present challenges to monetary policy

In the area of monetary policy, our fundamental task is to ensure that euro area citizens and the economy can put their trust in the euro, also in the future. In this task, there are two major challenges.

The first challenge is the worldwide rapid increase in prices of raw materials and energy. This is quickly reflected in the inflation statistics, and monetary policy cannot do very much to stop it. But what monetary policy must do is to ensure that the cost impulses from the raw materials prices do not trigger second-round effects in domestic costs.

In order to avoid second-round effects, it is crucial to keep inflation expectations well anchored to the ECB's price stability objective. This is all about trust. ECB policy and the supporting communications must inspire public trust in price stability.

The more firmly the inflation expectations can be stabilized, the better monetary policy can support recovery of the euro area economy.

Communications are really effective only if monetary policy lives up to its commitment to price stability. And this is why the independence of the ECB is important. Central bank independence was the key to the success of the Bundesbank, it has been the key to the success of the ECB, and it must be the key to future success.

The second and more acute challenge to the EMU is economic divergence across the euro area. Some countries are now growing well and moving towards a satisfactory economic equilibrium. In others, the economic situation is still very fragile and shows little, if any, signs of improvement.

In this respect, the situation is clearly more difficult now than it was during the first ten years of the euro.

In a sense of course, economic divergence among the euro area countries is beyond the reach of the ECB. Monetary policy is formulated for the whole area of 331 million people. And they all equally deserve price stability, which it is the task of the ECB.

However, the problem of growing economic divergence is very serious for the EMU as a whole and therefore, it is a matter of concern also for the ECB. The monetary union can work well only if there is sufficient convergence in economic policy and economic performance across the euro area countries.

The financial system

Let me now turn from monetary policy to the financial system: that is, to banks and financial markets.

The good health of the banking system is an important condition for sustainable economic recovery. This is the case throughout the world, also for the euro area. Perhaps this task is especially urgent for the euro area, because uncertainty regarding the health of banks aggravates the negative effects of economic imbalances and divergence in the area.

A clear strengthening of the banks' capital base is long overdue. This should be the task primarily of the shareholders of the weaker banks, who should refrain from taking dividends or should inject more capital if needed. In some cases, government investment in bank equity may also be necessary.

Coming from Finland, I understand very well the political problems involved in cleaning up the banking system. In the 1990's, after the Finnish banking crisis, the Finnish government had to support an asset management company that handled the banks' problem assets, in amounts that at one point reached about 10 per cent of GDP. Most of this money was later recovered, but in the meantime taxpayers were furious. The public frustration with the costs of the banking crisis has not been forgotten in my country.

Despite the short-term discomfort it entails, the resolution of banking problems is necessary for us to move forward to a lasting recovery. On the one hand, the recapitalization of the weaker but viable banks is necessary to restore confidence. On the other hand, the well-managed closure of unprofitable banks is necessary, so that they do not distort the market for the viable banks.

Another challenge is to improve banking practices and banking culture. Reform of banking regulation is part of this change. Apart from stricter capital requirements, the new regulatory framework will also gradually develop stricter standards for bank liquidity. The risks of making long-term commitments with excessively volatile funding have been amply revealed during the recent crisis.

I regard improved regulation as an absolute necessity after the experiences of the last four years. At the same time, we must acknowledge that regulation alone is not enough.

Therefore, what the ongoing reforms really aim for is a change in the culture of banking. Banking must renounce the excessive adventurism of the last decade and develop a stability culture of its own, so that citizens will once more see banking as an engine of solid economic progress rather than a conduit for short-term speculation.

Macroprudential policy

One of the key lessons of the latest global financial crisis is that central banks – and other authorities – need to pay much more attention to financial stability and macroprudential oversight. New institutions in which central banks play a key role have been created to identify systemic risks and to take appropriate action. Examples of such institutes include the European Systemic Risk Board (ESRB) in the EU, the Financial Policy Committee (FPC) within the Bank of England and the Financial Stability Oversight Council (FSOC) in the United States.

Macroprudential policy is still in its formative phase. But it is clear that new tools need to be developed in order to complement the more traditional instruments of monetary policy. These tools will pertain to capital standards, lending practices, and liquidity management of credit institutions. And the tools must work in relation to the changing financial market situation, preventing the development of excessive systemic risks and contagion.

The recent financial crisis painfully showed how quickly financial crises can spread over national borders in a world of integrated financial markets and systems. Because of the ever-deepening financial integration, financial cycles are likely to be highly correlated across countries also in the future.

In such a world, a successful macroprudential policy in any country entails positive externalities in the form of reduced financial risks in other countries. Conversely, erring on the side of inaction produces negative externalities to other countries, as financial problems will spread across national and currency borders.

I argue that in the absence of effective international coordination, national policymakers are likely to fail to internalize these positive externalities. This could lead to national macroprudential policies that are overly passive and dangerously weak at preventing the future global financial crises.

Let me elaborate a bit on this idea.

Consider a strong upturn of an international financial cycle, during which asset prices climb rapidly, leverage increases excessively and prices of risk decline simultaneously in many countries with interconnected financial markets. This scenario of course resembles the developments in the years preceding the latest global financial crisis. To prevent these risks from materializing into a systemic crisis, national authorities should tighten their macroprudential policies and possibly other economic policies.

Now, consider the decision-making problem of a macroprudential authority or body in an individual country. This authority may find it difficult to tighten the national macroprudential policy for two reasons.

First, there is the well known problem of “taking the punch bowl away in the middle of the party”. It has been pointed out that this political difficulty is likely to be even worse in the macroprudential context than in terms of monetary policy: there is at least some constituency that dislikes inflation, but probably none that dislikes the intoxicating feeling of getting richer as asset prices climb higher.

Second, as I mentioned earlier, a country that tightens its macroprudential policies in isolation would internalize only a part of the financial stability benefits of macroprudential tightening while bearing all the perceived costs in terms of a loss of competitiveness for its financial industry. This may lead to a first-mover disadvantage problem, where no country is willing to be the first to tighten its macroprudential policy unless it knows that other countries are committed to doing the same.

Unless properly addressed, these disincentives to pursuance of active national macroprudential policies may lead to a bad equilibrium, where global macroprudential policies become stuck in an overly passive stance. This implies that the identification of effective macroprudential instruments – which in itself is a formidable task – does not guarantee that these instruments will be used efficiently.

What can we do to avoid this bad equilibrium? I have three suggestions.

First, to relieve the extensive political pressure not to take action, we should try our best to develop and improve rules-based macroprudential policy. Instruments such as dynamic loan loss provisions used in Spain and the capital conservation buffer of the Basel III framework, could work as automatic stabilisers that do not require continuous discretionary policy decisions. The countercyclical capital buffer requirement included in the Basel III framework also includes a rules-based element, as national authorities are advised to use an indicator developed by the Basel Committee as a benchmark in their national buffer decisions.

Economists at the Bank of Finland have done some preliminary analysis on the feasibility of rules-based loan-to-value requirements. I urge the research community to intensify its efforts to develop simple and robust rules-based macroprudential instruments.

Second, national macroprudential authorities need sufficiently robust mandates, independence and legitimacy to make their discretionary macroprudential policy decisions. Efficient macroprudential actions will be highly unpopular. The costs of these actions are immediate whereas their benefits become visible only over periods of years. The weaker the macroprudential authorities, the more likely they are to bow to intense political pressure not to intervene when systemic risks are mounting.

Third, we need adequate international coordination of national macroprudential policies. In the EU, the European Systemic Risk Board should take this coordinating role. We must remember that all EU countries are part of it; Governors are voting members and supervisors are present at the meetings.

Without doubt, this is a difficult task. The ESRB has to strike the right balance between directing its recommendations on macroprudential policies to individual authorities or making collective recommendations to a larger group of authorities. Individual recommendations may be more effective in alleviating the first-mover coordination problem but may, at worst, be regarded by national authorities as accusations that they have failed to do their job properly. In such a case, their response may be defensive rather than constructive. Collective recommendations, in turn, would largely remove the stigma related to individually targeted recommendations but may be blunter and hence less appropriate to deal with more localized problems.

Finding a workable solution to this trade-off will be one the key challenges for the ESRB in the coming years.

Government finances and economic policy

Finally, let me turn to an even broader category of the current challenges, the challenges to economic policy.

When the monetary union was planned in Europe, there was much debate about the degree of economic convergence between countries that is necessary for forming a monetary union. Some people thought that a high degree of economic convergence was a necessary precondition, whereas others argued that membership in a monetary union and the necessity to hold on to it would perforce bring about the necessary adjustments and convergence.

Because of the insistence of Germany and others, emphasis was placed on economic convergence when the monetary union was established: reasonable entry criteria were set for membership in the union, and members' behaviour was regulated by the Stability and Growth Pact.

Now we know that this emphasis on convergence did not carry enough force. Shaken by the steep recession of 2008, several countries got unexpectedly to the danger zone. Now, we need even tighter economic convergence, and we need better economic governance within the EMU. The "Euro Plus" pact recently signed by the European Council is a step in the right direction.

The challenges which the economic crisis poses to economic policy in the EMU are twofold. First, the government finances of the problem countries must be stabilized. This takes tough measures, – expenditure control, tax increases, and sales of government assets – and it takes some time.

Second, we need a tighter convergence of competitiveness of the member countries of the EMU. The convergence of competitiveness is needed to get the problem countries to grow again, and to return their finances to a clearly sustainable trajectory.

As regards stabilization of the problem countries, it has been necessary to support their stabilization programmes via temporary financing from the other partner countries, and from the IMF. I believe this support has been necessary in order to buy time for adjustment, and to avoid a very risky illiquidity situation, with the possibility of contagion.

At the same time, it is important to understand that this financing is only temporary. Moreover, these loans can only be made under strict conditionality, most importantly in the context of an adjustment programme which will restore market confidence in the medium term.

We must strengthen economic governance mechanisms in the euro area to minimize the risk of additional crises in government finances in the future. I especially welcome the initiative on fiscal norms. These nationally implemented norms could help "internalize" the fiscal discipline in each country and render the matter less of an issue of EU policing of the countries' current fiscal actions.

In the Finnish case, for example, we have good experiences with medium-term budgetary frameworks. This system has made it easier to follow a planned fiscal policy and resist one-off pressures for increasing government spending. And even the Finnish system of budgetary frameworks can and should be developed further, of course.

I should add at this point that I do not see the financial support arrangements for Greece, Ireland, of Portugal as steps leading to a "transfer union". Transfer union would mean one-way subsidies from some governments to cover other governemts' deficits. This would not be consistent with the underlying principles of the EU.

As Mr. Trichet has put it, "it is fully recognised that this economic union must be one where countries that wisely follow a virtuous economic path are rewarded, and those that pursue unsustainable policies have to internalize the costs of their actions." I fully endorse this view.

Politics

We have now moved well into the area of politics. Let me say a few more words about my own country in this context. Finland was in the political spotlight recently. This happened because the financial support to Portugal became a focus of the electoral campaign during the parliamentary elections in April. Parties sensed – or feared – that voters would not easily accept continued support operations to stabilize the finances of the weaker euro area countries, and the issue became heated. There were even worries that Finland would prevent EU support for Portugal.

This happened although the euro has enjoyed relatively strong support in Finland. According to the Eurobarometer survey conducted last November, 78% of Finns supported the common currency and less than 20% were negative about it. And of course, Finns have been much more positive about the euro than the other Scandinavian nations, for instance.

For Finland, joining the monetary union meant two things: a seat at the table where decisions are made, and the promise of more stable money. We wanted to avoid a repetition of the traumatic currency and banking crisis of the 1990's. We put our trust in the euro as a guarantor of monetary stability.

After the fiscal crisis erupted a year ago in Greece, when support had to be provided to that country and to other countries in difficulty, there was a sense of disillusionment in Finland.

People remembered how Finland exerted a huge effort to put its own house in order after the economic crisis of the early 1990's, and then qualified for monetary union. Having gone through that, many people ask, why should we now support others who apparently have not followed the commonly agreed rules? And what was the responsibility of banks and other investors who had carelessly underestimated the risks involved in lending to these countries?

We may understand the reasons for such frustration. But I for one do not accept any narrowly nationalistic or anti-EU undertones which sometimes accompany the expressions of that frustration. Responsible politicians in every European country should use their leadership to ensure that the idea of constructive participation prevails over the temptations of the nationalistic approach. Political fragmentation would weaken the prospects of recovery and would make it considerably more difficult to solve the challenges to the economic and monetary union.

Concluding comments

I want to conclude with some remarks about the outlook for the euro area. The beginning of this year was encouraging in terms of the average growth. The year-on-year growth rate, 2.5 per cent, was the highest we have seen since the onset of the last recession. However, this positive early phase of the year was dimmed by the fact that growth differentials between countries continued to be large and that inflation exceeded our expectations.

Looking ahead, I expect the recovery to continue. Still, there are many reasons why uncertainties to the economic outlook are larger than usual. According to the eurosystem staff projections published a week ago, GDP growth in 2011 should be in the range 1.5 to 2.3 per cent. That is a wide range. Next year's forecast range is even wider, between 0.6 and 2.8 per cent.

Part of the uncertainty regarding growth prospects emanates from the global economic situation. The growth of the world economy shows continuing momentum and appears increasingly self-sustained. This helps euro area exports and is of course a positive factor. On the other hand, the global expansion of demand is largely based in the emerging economies, many of which are running at full capacity and facing the risk of overheating. This fact makes the situation somewhat precarious, and a more balanced growth pattern in the world economy would clearly be better for stability.

The very rapid growth in the emerging economies is also one of the causes of high energy prices. The high cost of energy and raw materials hurts euro area recovery by eating into real incomes and thus weighs down private consumption. In that way, the energy-intensive nature of present global growth is a risk for the euro area.

Mostly because of energy, inflation in the euro area is projected to stay above the 2 per cent threshold in 2011. The range in the Eurosystem staff projections was 2.5 to 2.7 per cent. For 2012, inflationary pressures are projected to weaken. Ultimately, it is the responsibility of monetary policy to ensure that this moderation will take place.

The higher-than-expected consumer price inflation poses further risks to growth as well. One of them relates to the danger of wage inflation. Presently, the euro area recovery is driven mainly by exports and private investment. However, if energy prices are transmitted into higher wage demands, then profitability and competitiveness of the euro area economy will weaken, and this would hurt both exports and investment.

In addition to the global factors, internal tensions within the euro area economy continue to be a major source of uncertainty for growth. In the current situation, disruptions to the workings of financial markets might easily spill over to the real economy, depressing the demand for goods and services, and so damaging banks and hurting government budgets.

Even more than usually, growth in the euro area cannot now be taken for granted. It is highly conditional on the success of economic policy, in bringing about a more balanced economic landscape within the EMU. The policy agenda which I have reviewed in this talk is a large one. It is also a difficult agenda, not least because it must be realized in a cooperative effort by the EU and euro area governments.

While policy makers and market observers are well aware of the difficulties, I think that they are also aware of what is at stake. Therefore, I am confident that the challenges now facing the EMU will be successfully tackled and a foundation will be gradually laid for sustainable growth in Europe.

Thank you for your attention.