

## Erkki Liikanen: Economic research and economic policy

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Yrjö Jahnsson Foundation's 60th Anniversary Gala. Helsinki, 16 December 2014.

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The esteemed Honorary Chairmen of the Foundation, Mr Chairman, ladies and gentlemen,

The work of the Yrjö Jahnsson Foundation in promoting economic research and in educating economists in Finland is truly invaluable. The inauguration of the Foundation, and its activities, have been guided by the belief that economic education and research can make a valuable contribution to society.

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The importance of research as an aid to political decision-making is a subject that is always interesting and controversial. But there are times when it seems to be particularly topical. One such time was around the founding of the Yrjö Jahnsson Foundation. During the late 1950s and early 1960s, there was a strong positivistic current in Finnish economics. At the centre of this movement was the so-called O group, which was made up of young economists who set out to modernise Finnish economics, that is, to free it from the remnants of the historical school of thought and to adopt the Western analytical tradition.

The aim of the group was to put economics on a more scientific footing and make it a tool for rational policy-making. The Bank of Finland's Research Institute and the Yrjö Jahnsson Foundation both supported the group's activities.

The role model for the economists of the time was **Jan Tinbergen** who later received the first Nobel Prize in economics. According to his economic-policy philosophy, the politician determines the objectives and the limits within which the various tools can be used. The role of the economist, on the other hand, is to show how the tools, as allowed, can be used to achieve the objectives set by the politician. Policy analysis and quantitative planning were the lingo of the day. To this end, economics as a science had to become objective and quantitative.

Many of the young researchers of the time were quite fixed on their mission. One of the hard-liners of the O group, **Olavi Niitamo**, wrote in the Finnish Economic Journal in 1960 that "there does not appear to exist a fundamental difference between economic models and, for example, models used in physics. Both are models based on probabilities and the difference is merely in the accuracy of model."<sup>1</sup>

For many of us, Niitamo was later to become a conversational companion and teacher with original ideas. His areas of expertise were wide and varied, from economics and statistics to boxing.

Niitamo's view was disputed by **Jouko Paunio**, a leading expert used by the Yrjö Jahnsson Foundation over many years. Paunio said he saw economics essentially as part of the humanities even though he was himself a member of the O group. An economist should strive for objectivity in his research but economic science is not a natural science. Paunio wrote that, as representatives of a science that studies human behaviour, economists need to be highly tolerant as regards different approaches.<sup>2</sup>

Jouko Paunio had wide-ranging interests. He was also an important figure as the Foundation initiated its far-sighted emphasis on the economics of health. This was launched with fanfare

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<sup>1</sup> Niitamo, O.: Selitysmalleista ja todellisuudesta. Kansantaloudellinen Aikakauskirja, 1960:2.

<sup>2</sup> Paunio, J. Kansantaloustieteen näköaloista. Kansantaloudellinen Aikakauskirja, 1961:3.

at the international conference in Helsinki in the summer of 1975, where Paunio was the first speaker.

Paunio's presentation, which dealt with the efficiency of health services and their allocation mechanisms, made a profound impression on the thinking of many.<sup>3</sup> I was one of them. As we know, this subject is even more topical today, four decades later, and the longstanding work of the Foundation, also in this regard, deserves our gratitude.

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Many things have happened in the field of economic policy since those times and there have been recurrent disappointments in the most idealistic breeds of economics.

Losing its credibility already in the 1970s was the planning optimism that assumed that economists as the "engineers of the economy" could provide politicians with the means to rapid and stable economic growth.

The current that has most recently suffered such a loss of credibility is one according to which "*government is not the solution to our problems, government is the problem*", to paraphrase **Ronald Reagan**. The debate again is about the value of economic science in political decision-making. Since the financial crisis, economic science has become the target of growing criticism. The most common criticism condemns mainstream economics for economic policies that led to the crisis; for its inability to predict the crisis, and also for advocating economic policies which would only worsen the effects of the economic crisis.

Particular criticism has been directed at the content of economic science education, which has been accused of being ahistorical, even dogmatic.

Some of this criticism has been to the point, some of it unwarranted. There is pertinence in the concern about the overly narrow focus of economics education. Economic policy-making needs high quality economists, capable of trustworthy analysis. This is why the question is important.

But what makes a good economist? **Keynes** wrote in 1924:

*"...the master-economist must possess a rare combination of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher – in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in the light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician."*<sup>4</sup>

That is quite a list of requirements. This passage is from **Alfred Marshall's** obituary. It is well known that Keynes was not the most humble of men. He might have even been describing himself here. But he was right in saying that an economist should have wide-ranging competences, especially if he is working outside of basic research.

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In the light of Keynes's characterisation, it is interesting to read the manifesto published last spring by students at Manchester University, which garnered a lot of attention. In the manifesto, the students complain about the narrowness of contemporary economics education.

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<sup>3</sup> Paunio, J.: Alustavia näkökohtia terveydenhuollon taloudesta. Kansantaloudellinen Aikakauskirja, 1975:4.

<sup>4</sup> Keynes, J.M.: Alfred Marshall. Collected Works of John Maynard Keynes, Vol. II, p. 26. Macmillan, 1971.

At Manchester, the history of economics was taught in an elective course that was avoided by students – because it required essay-writing skills, skills that were not developed in the rest of the programme. The teaching of economic history was equally inadequate. According to the manifesto, students graduated with an economics degree without knowing anything about such upheavals as the 1930s Great Depression or the breakdown of Bretton Woods in the 1970s.<sup>5</sup>

This type of narrow focus sounds alarming, especially from the point of view of practical work assignments. The chief economist at the Bank of England, **Andy Haldane**, read the manifesto and commented that employers of economists, such as the Bank of England, would benefit from a diversification of the course requirements for economics majors. In order to give workable answers to the future questions of economic policy, one must understand the past. It would also be helpful to have a knowledge of political economy, to take into account the institutions and to understand money and banking. Haldane stated that the kind of reform of education that would achieve these objectives, would also well serve the requirements of economic policy.<sup>6</sup>

There might also be room for improvement in the contents of Finnish university degrees as well. Fortunately, it seems that there has been an upswing of interest in applied macroeconomics in recent years, compared to the low point reached before the crisis. This rise in interest is also reflected in the fact that student activists have recently sought to revive some traditions of economic science that seem to have been pushed aside from the study programmes.

When discussing alternative approaches to economics, one should keep in mind that the aim of learning cannot be the compartmentalisation into “-isms”. Instead, it is the comparison and competition between theories and approaches, which will lead to synthesis and progress. From the point of view of a practical economic policy-maker, the worst outcome would be a polarisation of economic research and debate into camps unable or unwilling to talk to each other.

Some criticism has suggested that economic policy is slave to some abstract theory that blindly believes in perfect markets. Fortunately, this is not the case. Economic science, as it is best used in support of decision-making, is a controversial and developing science that has few absolute certainties. For this very reason, careful research and debate are of paramount importance.

If we look at the very active monetary policies of recent years in particular, and the thorough reform of financial regulation, it cannot be claimed that decision-making has been characterised by a blind faith in the infallibility of the markets. Monetary and economic policy has, on the contrary, centred on real world problems and taken a pragmatic approach. At the same time, it has tried to make extensive use of research-based knowledge.

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Current monetary policy leans heavily on economic research in at least in two respects.

Firstly, the current objective of price stability, and a monetary policy system based on an independent central bank that implements it, is the result of monetary policy research of the 1980s and 1990s. This research emphasised the importance of expectations, policy credibility and price stability. This research is also the basis of the status of the Eurosystem, its structure and its monetary policy, although another highly influential factor here was the example provided by the successful monetary policy of Germany.

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<sup>5</sup> Economics, Education and Unlearning. Post-Crash Economics Society, University of Manchester, 2014.

<sup>6</sup> Haldane, A: Foreword. Economics, Education and Unlearning. Post-Crash Economics Society, University of Manchester, 2014.

Secondly, the monetary policy pursued during the crisis and after it, which even globally has had to adopt many brave and unconventional methods, is also based on research.

It is interesting that, from the viewpoint of economic policy during the crisis, research into economic history has had a particularly profound influence. Of note, the research on the causes of the Great Depression of the 1930s has in recent years come to be held in high regard, and it has played a crucial role in monetary-policy decisions.

The Chairman of the United States Federal Reserve at the time the crisis came to a head, **Ben Bernanke**, has been a key figure here. He is known specifically as an expert on the Great Depression of the 1930s. It has been Bernanke's view that the protraction of that depression was caused by misguided monetary policy.

This, in itself, was not a new discovery. **Milton Friedman and Anna Schwartz** had already blamed the Federal Reserve for turning the crisis into a depression by allowing the quantity of money to decline. In Finland, **Yrjö Jahnsson** expressed similar views in his own time.

Bernanke's contribution to the debate was his emphasis on the importance of the banking system. According to Bernanke, the drying up of bank liquidity and the collapse of their lending capacity were the factors that turned a recession into the Great Depression. He further argued that the global monetary system based on the gold standard transformed the depression into a global one that spread even to countries that were not suffering from their own banking crises.<sup>7</sup>

The Parliamentary Supervisory Council of the Bank of Finland met Ben Bernanke during the last week of his term of office in Washington last January. We asked him what lessons we might take from the research on the depression of the 1930s in the current crisis, and if there had been any new developments in the field.

He emphasised that the essential lessons learned from the 1930s depression were the securing of banks' liquidity during the crisis and aggressive reductions in interest rates, so as to avert a deepening of the crisis and a slide into deflation.

But one thing about the current crisis had surprised Bernanke: the complexity of international financial institutions and their multi-level connections within the global financial system. The demand for international cooperation was thus even more important now than it had been during the Great Depression.

The influence of these lessons of the 1930s can be clearly seen in the monetary policy of recent years. The escalation of the financial crisis in September 2008 as the Lehman Brothers investment bank fell, and the severe disruption to the financial markets that followed, compelled central banks to act swiftly. The dry-up of liquidity in the banking system and onset of a general banking crisis had to be prevented.

The securing of the banks' liquidity was carried out in broad international cooperation. For instance, European banks at that point needed large amounts of short-term dollar credit, which the ECB was able to arrange with the help of the US central bank. International cooperation was achieved with unprecedented speed and scope.

As economic growth stalled in 2009 after the money-market crisis, inflation also came to a halt and turned negative for a while in all of the key currency areas. Monetary policy was eased around the world, to support activity and prevent a destructive spiral of deflation. Policy rates were pushed to record lows, to 1 per cent in the euro area, and already then close to zero in many countries.

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<sup>7</sup> Bernanke, B: Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression. *American Economic Review*, vol.73, no. 3 (1983).

Since that time, interest rates have remained exceptionally low everywhere and the spiral of deflation has been avoided. In the current circumstances, the securing of price stability and the supporting of economic growth have not been in conflict; rather, monetary policy has been able to pursue both of these goals.

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In assessing the success of monetary policy, it should be kept in mind that, for example, in the euro area and in Finland, many of the problems of the real economy are structural and could not be solved by monetary policy, which can only buy time for solving them.

In terms of price stability, monetary policy has not met our expectations in recent months. The inflation rate in the euro area is currently clearly below the ECB's target rate of close to, but below, 2 percent.

The decline of interest rates to their theoretical minimum, or close to it, has raised new questions. How can monetary policy sustain price stability if the situation requires new actions to get back to price stability when the main instrument of traditional monetary policy, the interest rate, is already at its minimum?

Different central banks have had to confront this question at different points in time. In the case of the ECB this happened last summer when the policy rate was lowered to the minimum and still the rate of inflation has remained well below the target.

In this situation, the ECB has adopted some new monetary policy programmes based on securities purchases: a covered bond purchase programme and an asset backed securities purchase programme. At the same time, banks have been offered collateralised long-term credit in order to speed up lending to businesses.

The intention is that the balance sheet of the Eurosystem should grow to the level where it was at the start of 2012. The ECB's Governing Council has unanimously stated that should the need arise, even new monetary-policy instruments will be utilised if the period of low inflation threatens to last too long.

As the modes of operation of monetary policy are changing, at least temporarily, research has much to offer to decision-makers. I will just mention here the three most central areas of research connected with the current situation:

The use of anticipatory communication of monetary policy, the so-called forward guidance, as a stabiliser of inflation expectations; the effect on inflation and growth of securities purchases by central banks; and the question of a neutral interest rate level in the post-financial-crisis world.

All of these areas have been subject to much useful research, which is monitored by central banks and in which they also take part.<sup>8</sup>

The seriousness and determination with which central banks have in recent years acted to secure banks' liquidity, support economic growth and prevent a deflationary spiral, is indicative of the influence of economic research.

The third problem mentioned by Bernanke as having been brought to light by the crisis, the complexity of financial institutions and the connections between them, has also been the focus of wide-ranging work. The regulation of banks has been reformed with the intention of making the banking system "safer, simpler and fairer". I will mention some of the most significant actions in this regard.

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<sup>8</sup> Ks. esimerkiksi Reifschneider, D. and Williams, J.: Three lessons for monetary policy in a low-inflation era. *Journal of Money, Credit, and Banking*, Vol. 32, No.4 (2000): Gambacorta, L., Hofmann, B. ja Peersman, G.: *Journal of Money, Credit and Banking*, Vol. 46, No. 4 (2014) Barsky, R., Justiniano, A. ja Melosi, L.: The Natural Rate of Interest and Its Usefulness for Monetary Policy. *American Economic Review*, vol. 104, no. 5 (2014).

The international solvency criteria required by the so-called Basel Accords have been strengthened.<sup>9</sup> The supervision of banks has been made more efficient, and in the euro area it has been centralised as a task of the ECB. The mechanisms for crisis resolution have been updated in a way that should avoid the taxpayer having to bear the burden of banks' risk-taking.

The structures of banks have come under regulation both in the United States and in many EU countries, with the aim of reducing speculative securities trading by deposit banks. I myself led the working group set up by the Commission to prepare the pan-European norms for this. The support we received from researchers – as well as their criticisms – are proof of the close links between research and decision-making in the development of regulation also. A Commission proposal for regulation has been made on this matter, and it is currently being deliberated in the Council of the European Union and the European Parliament.

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Science and research are of course global phenomena in today's world, but they also have a national dimension. It cannot be in the interest of any country to free-ride on the research front and rely only on foreign research. This is clear especially in a field such as economics, which has such strong links to policy. The influence of Finns in the Eurosystem, the EU, the IMF or the BIS can only be based on our capability to offer our own and unique contribution.

Having experts with skills that measure up to international standards has been a prerequisite to ensuring that Finland is not a passive participant in the European community but is instead capable of interacting on an equal basis with the other EU countries.

The work of the Yrjö Jahnsson Foundation in raising the level of Finnish economics education and research up to international standards has helped to ensure that Finland can be an influential and constructive participant in any forum where we have earned our status.

I would like to extend my warmest congratulations to the Foundation for its most commendable work over these 60 years.

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<sup>9</sup> Carney, M.: The Future of Financial Reform. Monetary Authority of Singapore Lecture, Singapore, 17.11.2014.