Pentti Hakkarainen: Monetary policy - which road ahead

Notes by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, for the session "Monetary Policy: Which Road Ahead?", Frankfurt European Banking Congress, Frankfurt am Main, 18 November 2016.

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Let me start by pointing out my own perspective on the issues we are discussing. I approach these problems from the point of view of someone who is mainly preoccupied with financial stability and banking supervision. This may color my remarks to some extent.

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Recent monetary policy has been characterized by historically record low interest rates. It has been often pointed out that the low interest rate environment poses significant challenges to the banking system. It also supports some asset prices. The impact of low interest rates on asset prices has drawn some criticism from those who are worried by the possible reversal of the price increases.

It is a little misleading to interpret the possible problems generated by low interest rates as negative “side effects” of expansionary monetary policy. Let me explain why.

Monetary policy is not the ultimate reason why interest rates are so low. Low rates are a symptom of the underlying economic situation. They reflect weak long-term growth trends and the long macroeconomic slump that we have experienced after the last financial crisis.

The most important reason for the present situation can be found in the condition of the nonfinancial business sector. Years of low growth expectations and the continued low business confidence have depressed real productive investment. This lack of investment demand in turn has led to a situation where the natural rate of interest is very low.

Monetary policy has had to adapt itself to this situation. This has been necessary in order to pursue price stability. If monetary policy had not reacted to the decline of the natural rate of interest, price stability would have been at risk, and the situation in the financial sector could be worse than it is now.

So, while I would not deny that the low interest rates pose some challenges for financial markets and financial institutions, these challenges are not the result of monetary policy, but they are the result of structural problems in our economies. The present stance of monetary policy is actually also a side effect of the prevailing business conditions.

Although accommodative monetary policy has been necessary, monetary policy can hardly generate sustained recovery on its own. It is not enough. A recovery will require better business conditions, especially in the countries and regions where the investment activity has recently been the lowest.

In other words, structural reforms are required which open new frontiers for productive investment and improve profitability. That opens up the way to a higher natural rate of interest, and generally more normal monetary and financial conditions.

The title of the previous session was “How to reform Europe”. In the same way as the whole EU, we in the small euro area countries face the need to reform our economies. Monetary policy is common for the whole area. In other policy areas we must adjust accordingly, while improving incentives for sustainable growth in our countries.

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We must be realists and admit that we do not know much yet about the effectiveness of macro-prudential instruments. This is no reason to neglect macro-prudential policy, however. It is just one more reason to be very vigilant with regard to what is happening in the asset markets, especially in the real estate market.

The title of a recent IMF seminar on rethinking macro policy is to the point: "progress or confusion?". The present common macro-prudential toolbox in the euro area is quite limited but there is more diversity at the national level. I for one would prefer a simple and more unified set of macro-prudential instruments to confusing heterogeneity. In integrated banking markets, the available macro-prudential instruments should be identical or similar across countries.

The practical problems are not trivial. The implementation of the instruments in practice is complicated, and especially the timing of their use is subject to a lot of uncertainty.

The purpose of the macro-prudential policy should be to prevent fragilities from building up in the financial system during periods of low interest rates. In the present situation, the most important place where this might be happening is in the housing market.

One thing to look at would be the risk weights on housing loans. Banks using the internal modelling approach have, in some cases, been able to posit very low risk weights for their housing loan portfolio. This may be distortionary from the macro-prudential point of view: It may direct too large a share of the credit supply on the housing market, and reduce the interest of banks to new business lending.

The present situation is very different in different countries, also within the euro area. In some countries and regions, we are seeing significant increases in household indebtedness. But in some other parts of Europe, increases in new indebtedness are not the main concern, but more the backlog of old debts. Different situations require different policy responses.

In the longer run, I hope and believe that a more unified approach to macro-prudential policy will evolve for the euro area at least.

The Nordic countries and especially Sweden provide a very interesting case with some useful lessons. I would like to mention just two.

First, low interest rates in an environment of reasonable growth may lead to a quite large increase in household indebtedness. Much of new credit will be directed to the housing market, perhaps even disproportionately so.

Second, good cooperation between monetary policy makers and macro-prudential authorities would be beneficial for designing the appropriate policy response.

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Central banks in different countries have broadly similar responsibilities. They aim at price stability in the medium run, and support economic activity in a way that is consistent with medium term price stability.

While the objectives of the different central banks are not too different, the cyclical position of different countries and regions can be more different. This is unavoidable.

It is well understood that in this kind of situation the main responsibility of each central bank relates to the stability of its home currency and the stability of its home economy. To think otherwise would be unrealistic. Any financial repercussions that result from this fact are part of the normal course of events and the market participants should be well aware of that.

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Talking point on fiscal policy as a complement or alternative to monetary policy:

As the Governing Council of the ECB has indicated, there are three points which are relevant to the use for fiscal policy today:

- Fiscal policy must comply with the fiscal rules of the European Union. Full and consistent implementation of the Stability and Growth Pact over time and across countries remains crucial to ensure confidence in the fiscal framework.
- Second, having said that, fiscal policies should support the economic recovery where possible. However, it is difficult to give generalized prescriptions for this, because the starting position of different countries is not the same. Much depends on the local starting position and local conditions.
- Third, all countries should strive for a more growth-friendly composition of fiscal policies. This applies to tax policies, but also the expenditure side, where high-quality investment should be prioritized.

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Especially here at the European Banking Congress I would like to highlight the responsibility of the banking industry itself for shaping our future. Decisions made in banks play an important role both in monetary policy transmission and in ensuring the necessary financial stability.

Two main issues in particular should be borne in mind, not just by the authorities, but also by the banks themselves:

- With some banks performing well and some less so, restructuring and consolidation of the sector should continue, restoring a better functioning banking system for Europe.
- At the same time, competition must be enhanced. In particular, I am thinking about banks' cross-border activities. We would benefit in many ways from having area-wide banking groups, reflecting the spirit of the Banking Union. Banks should compete across borders in the full range of their activities, not just in "easier", more standardized products such as housing loans.