Erkki Liikanen: Economics and economic policy

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, Helsinki, 10 April 2018.

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The central bank is an organisation of public servants. Public service bodies obtain their essential mandate from elected bodies.

Within the Eurosystem, the central banks and their governing bodies have been given a definite mandate, including independence in monetary policy issues. In recent years, central banks have also been assigned new responsibilities in the field of macroprudential policy.

As part of the Eurosystem, the Bank of Finland participates in monetary policy decision-making and implementation. The Bank also has a role to play as part of the Banking Union.

How then should the central bank participate in domestic discourse on economics and economic policy formation? The Bank of Finland's statements relating to domestic economic policy are based on objectives set for the Bank and the Eurosystem. According to the Act on the Bank of Finland and the EU Treaties ***the primary objective is price stability***. Without prejudice to this objective, the Bank also supports the achievement of other EU economic policy objectives, such as ***balanced economic growth.***

The Bank of Finland participates in economic discourse in Finland primarily at those stages of preparation and decision-making that are consistent with the Bank's expertise derived from research, international experience, or other publicly justified economic analysis.

There are two such stages: ***first,*** identification of the problems related to the current state of the economy; ***second,*** assessment of the potential effects of the alternatives for action.

At the same time, we should bear in mind that decisions on individual items of public spending or revenue often involve such value judgements as a central bank should refrain from making.

In the past decade, there was a lively debate in the United States on whether Federal Reserve Chairman Alan Greenspan went too far in supporting President George W. Bush's tax reforms. At the Central Bank Symposium in **Jackson Hole** in Wyoming in 2005, professors **Alan Blinder** and **Ricardo Reis** emphasised that it is highly questionable whether central banks should voice opinions on issues of economic policy outside of the realm of monetary policy. The general opinion of the meeting was that central banks should refrain from making value-based statements, in particular. But it is an entirely different matter if economic policy jeopardises the conditions for price stability or causes disruption on the financial markets.

Example from recent years: the structural problems of the Finnish economy

A role that comes naturally to the central bank in domestic economic discourse is to paint a picture of the state of the economy. A balanced picture of the state of macroeconomic developments based on careful analysis serves as an important basis for successful economic policy.

In step with the escalation of the global financial crisis in 2008, economic performance deteriorated across the advanced economies, including Finland. A few years after the onset of the crisis, economic growth had already gotten underway in many countries. However, in Finland, the weak performance of the economy turned out to be more protracted, despite the expansionary fiscal measures adopted to support the economy.

Realising this took some time in Finland. We had to acknowledge that Finland's economic difficulties were not short-term and transient problems of the global economic cycle but were of a longer-lasting nature. This debate was launched in spring 2013, largely at the initiative of the Bank of Finland.

Finland did not encounter a domestic financial crisis during the global financial crisis; the Finnish financial system remained fully operational. The cost and availability of bank loans did not constitute an obstacle to economic growth, nor did the costs of Finnish government borrowing rise.

Finland's economic hardship was caused by a number of setbacks. Mobile phone manufacture and the related huge inflows of revenue were exhausted. Demand for printing paper decreased in Europe, the forest industry was subject to restructuring and export volumes declined. Although largely unrelated to the global financial crisis, these problems hitting Finnish exports coincided with the crisis.

Export conditions were also subdued by the increase in the level of costs, which was faster than for Finland's trading partners. Just before the outbreak of the global financial crisis, collective bargaining agreements spanning over two years and providing for sizeable wage rises had been concluded in Finland. These were introduced at the same time as many other countries started to adopt cost moderation in response to the economic recession. Finland suffered a major loss of cost-competitiveness.

An additional factor behind the deteriorating conditions for economic growth in Finland was the reduction in the size of the working-age population. The turnaround occurred in 2010, when the members of the baby-boom generation, in large numbers, began to reach retirement age.

The established methods for capturing fluctuations in macroeconomic developments could partly have led policymakers astray, as the cyclical fluctuations witnessed were not of a standard nature; they also reflected profound structural changes. The global economic debate, as such, did also not deliver any comprehensive tools for understanding economic developments in Finland, as Finland's economic hardship was different in character to the problems encountered by many other countries in the wake of the financial crisis. In fact, the Finnish financial sector and the Finnish government's credit rating were not exposed to any disruptions or downgrades.

The most common indicators employed to analyse cost-competitiveness were no longer adequate due to the developments in the terms of trade. The deterioration in Finland's terms of trade was exceptionally strong due to the fall in export prices.

As regards the means available to improve cost-competitiveness, it was necessary to recognize that the usual measures of wage moderation did not bring about any improvements in the situation, given that the increase in wages and prices was exceptionally slow elsewhere, too. Despite the very subdued increase in wages witnessed in Finland after 2009 compared with previous years, this did not differ much from wage developments in other advanced economies.

As the slowdown in economic activity was not cyclical and short-term in nature, it resulted in a deterioration in the long-term fiscal outlook. Not only had the fiscal deficit begun to grow immediately upon the onset of the global financial crisis; a large fiscal sustainability gap had also emerged.

Hence, Finland faced a need to consolidate the public finances, improve the long-term outlook for both economic growth and the public finances, and to adopt swift measures to enhance cost-competitiveness. Awareness of the crucial importance of these economic policy objectives called for an understanding of the current state of the economy. The Bank of Finland presented its assessments based on these considerations to the social partners in early summer 2013.

In recent years, important decisions have been taken in Finland to enhance cost-competitiveness and improve long-term fiscal sustainability, and to adopt fiscal consolidation measures. Decisions have been taken on a competitiveness pact and pension reform and on fiscal consolidation measures. This has called for a broad consensus on the current state of the economy among the political parties and the social partners. The Bank of Finland also later made its analyses available to decision-makers, for use as a basis of decisions. The analysis conducted in 2015 on cost competitiveness played a crucial role for the decisions taken in recent years.

What is the input of economics in economic policy in general?

In autumn 2017, a significant contribution was brought to the discussion by Nobel laureate **Jean Tirole.**

When Tirole won the Nobel Prize in Economics in 2014, he became a well-known figure. Tirole has told how he suddenly found himself being stopped in the street by people who wanted to know what economic research is and how it can foster well-being. People were asking whether economics could resolve the great challenges of our times.

The questions presented to Tirole present an important challenge to the economist community as a whole. Economists need to produce a comprehensive and thorough analysis of the key economic policy problems, but they also need to share the results of their analysis in an easily readable form for the intelligent reader who lacks an education in economics.

Jean Tirole turned his reflections into a non-technical book entitled ‘Economics for the Common Good’. In his book, Tirole emphasises that economics is a science of the means, not of the aims.

Political objectives incorporate values, and setting these objectives is the task of those mandated to do so by democratic elections. Economics, in turn, can provide an input when the goal is to find tools for meeting the objectives at the lowest possible cost.

The market and the state

One of the key issues of economics is the role of the market. As Tirole emphasises in his book, the market is an instrument for economists, not an end itself. The market cannot always function without failures. This happens, for example, when buyers have insufficient information about products or when consumers only think about their immediate gratification or make decisions which, over time, involve higher costs than their payment capacity. Market failures also occur if an economic actor has too much market power.

If the market functions properly it can improve efficiency, but there is no reason to assume that it will deliver equity. This is why both the state and the market are needed. They are complementary – not substitutes for one another. The state cannot ensure a decent life for its citizens without a market. The market, in turn, needs the state to guarantee that the legal system operates smoothly and that market flaws and failures are addressed.

Increasing competition through regulatory decisions has brought considerable advantages to consumers. One example: during my term in the European Commission, we drew on Jean Tirole’s research and expertise when we proposed the unbundling of the local loop in 2000, thus opening up broadband services to competition. Broadband prices declined rapidly and most households gained access to broadband. This was an important step in the development of the information society.

Tirole writes a lot about incentives. Incentives affect the behaviour of firms and individuals. However, a financial incentive does not always lead to the intended results. As an example, Tirole refers to blood donation: when people started to get a financial reward from donating blood, the number of donors plummeted. Donors were not motivated by money but by the possibility to contribute to the common good.

As the example shows, policy measures can have unintended consequences. This poses a challenge, because economic models used as an aid in analysis are always simplifications – otherwise they would not be usable. And analyses may not always reveal all the side effects.

In academic literature, peer reviewers often ask researchers to expand their models by changing the underlying assumptions and testing the robustness of the analysis under different conditions. This is time-consuming and prolongs the publication process. And yet it is necessary for quality control when the purpose is to find as universal regularities as possible. In empirical research, the corresponding requirement means, for example, the use of alternative data or estimation methods.

Alternative analyses can remain without the attention and impact they deserve if views on the benefits of the prevailing course of action are too cemented.

Example: predicting the financial crisis

A famous example of this is the discussion held at the Jackson Hole symposium in 2005 when I had just begun my second year as governor of the Bank of Finland. That year's theme at Jackson Hole was the appraisal of Alan Greenspan's era as chairman of the Federal Reserve.

At the conference, Professor **Raghuram Rajan**, then director of research at the IMF, spoke on the topic 'Has financial development made the world riskier?'[1] Contrary to the accepted wisdom of the day, Rajan answered three times in the positive: yes, it has made it riskier.

Rajan noted how securitisation, markets for transferring risk and bad incentives were leading to a dangerous accumulation of risks in the global financial system. He was also worried about liquidity. There follows a quote from Rajan's speech and I have also cited it on some previous occasions, as it truly is worth reiterating:

'If banks also face credit losses and there is uncertainty about where those losses are located, only the very few unimpeachable banks will receive the supply of liquidity fleeing other markets. If these banks also lose confidence in their liquidity-short brethren, the inter-bank market could freeze up, and one could well have a full-blown financial crisis.'

Now this is exactly what happened three years later after the failure of Lehman Brothers. Next autumn will mark the passing of 10 years since that event.

The response from many in the audience was very hostile. Rajan was seen as a spoiler at the party and an opponent of innovation and progress. His proposals for reform were called 'non-starters'.

At that time, the policy community was not in a mood to change course just because of one conference presentation, even if it was a balanced and well thought-out contribution. It took a major international disaster for the policy community and the majority of academic opinion to adjust its view.

Rajan's speech was a great example of not only professional competence, but also of professional integrity and even courage.

Economics and climate change

When we examine the major societal issues of our time that also have a strong impact on the economy, we cannot ignore climate change.

Climate change has been described as the largest global market failure, which is due to the fact that a price has not been established for greenhouse gas emissions. The future of our climate is subject to a considerable degree of uncertainty, but in the scientific community there is broad consensus on the basic issues: climate change is a fact, it is accelerating and it is a human-induced phenomenon.

There are many unresolved and difficult issues in the area of climate policy, but in economics there is a fairly broad consensus on the principles for solving the problem. These principles are discussed also by Jean Tirole in his book 'Economics for the Common Good'. Climate policy should be effective and equitable. The system should be constructed so that all countries have an incentive to participate in the combat against climate change.

First, I will discuss the issue of effectiveness. Climate change is a global problem that requires global solutions. One global price should be established for greenhouse gas emissions because the impact of greenhouse gas emissions on global warming is the same irrespective of where in the world or in which field of production they are created.

Various country-, region- or industry-specific unilateral solutions may have unwanted effects. For example, if a country introduces a stricter climate policy, it may provide companies an incentive for relocating greenhouse gas-emitting production to countries with a laxer climate policy. Due to this phenomenon – known as carbon leakage – global greenhouse gas emissions would not necessarily decrease.

On the other hand, as a result of subsidies on renewable energy, for example, other forms of low-emission power generation may be replaced. If the price of energy declines due to subsidies, companies may shut down low-emission power generation plants, and in addition to renewable forms of energy, we may be left with power generation that is low-cost but high-emissions. Professor **Matti Liski** has presented interesting views from this perspective.

A common global climate policy would create effective incentives for developing low-emission technology.

Another key issue in the combat against climate change is equity. The reduction of greenhouse emissions involves costs, and poor countries do not necessarily have sufficient resources or interest to participate. Moreover, advanced economies are responsible for the majority of historical greenhouse gas emissions. If one global price is established for emissions, we would probably need some type of a global system of compensation for poorer countries.

The key is not to try to resolve the issue of effectiveness and equity of climate policy with a single tool, i.e. country-specific emission targets or country-specific pricing mechanisms. This would easily lead to unwanted effects, such as carbon leakage.

Another key question is how to create incentives for governments to participate in the combat against climate change. The problem is due to the fact that the benefits of climate policy are global, while the costs of reducing greenhouse emissions are usually country-specific or local. The incentives for free-riding are obvious. To support climate policy, we need global supervision with sufficiently strong powers. Climate policy-related compensation systems could be part of the incentives.

On the need to develop economics competence and teaching in Finland

The examples that I have discussed today show that economics, together with other sciences, can play an important role in resolving key social issues. It is therefore essential that economic research and education have at their disposal sufficient resources, in terms of both quality and quantity.

The University of Helsinki, Aalto University and Hanken School of Economics have established the Helsinki Graduate School of Economics, a graduate school and research unit for economics. The objective is to meet the growing demand for economics competence and teaching in Finland. The Bank of Finland, together with the Ministry of Finance and the Ministry of Education and Culture, support the establishment of the unit and have expressed their preparedness to provide resources for its operation.

The aim of this project is to create in Finland a globally significant research and teaching unit for economics. The doctoral programmes of the Helsinki Graduate School of Economics will cover all the key areas of economics. The unit is also responsible for providing a setting for Master's degree programmes for students at the Aalto University, the University of Helsinki and Hanken School of Economics. The new unit will also be responsible for coordinating the establishment of professorships in the field of economics and the recruitment of economics professors in the universities that are part of the Graduate School.

The unit will be a centre for economics and other quantitative social sciences. It will also cooperate with external stakeholder groups, for example economics researchers and students, as well as researchers and students of the other social sciences at universities located outside the Greater Helsinki area. The various branches of social sciences have many joint interests, and therefore we may witness an increase in research interaction in future.

The sub-disciplines of economics that are in need of reinforcement are macroeconomics, public economics, applied micro-economics and data-based decision-making. These produce competence and research-based knowledge in key policy areas, such as monetary, financial and EU policies, social and health-care policy, competition policy and pension-related issues.

The input of researchers is also needed in the planning of markets and the impact assessment of policy measures in various fields. Industrial organisation and structural models can provide the necessary tools for analysis. A deep understanding of economic growth – ultimately productivity growth – is also of key importance.

We must also consider what constitutes the optimal amount of resources to be allocated, on one hand, to research communities that produce the critical mass and that have already been established in Finland in some sub-disciplines of economics, and, on the other hand, to ensure a sufficient degree of multidisciplinary research.

In conclusion

Economics has produced a number of tools for finding the best solutions. Economists play an important role in societal debate by contributing to the discussion the results of economics research and also by informing on the disagreements and interpretational differences in the field of research. This is not only their right but also their responsibility.

[1] Rajan, R. (2005): Has financial development made the world riskier? *Proceedings – Economic Policy Symposium – Jackson Hole*, Federal Reserve Bank of Kansas City.