Olli Rehn: Monetary policy and bank supervision in Europe after the last financial and sovereign debt crisis and challenges for the future

Remarks by Mr Olli Rehn, Governor of the Bank of Finland, in the governors' panel discussion at the Bank of Greece Economic History Conference "The birth of inter-war central banks: building a new monetary order", Athens, 2 November 2018.

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Dear colleagues, Ladies and Gentlemen:

I want to thank the organizers and particularly Governor Yannis Stournaras for the invitation to this conference. I also want to congratulate the Bank of Greece for its 90th anniversary. The Hellenic central bank has always been a highly professional and reliable European partner, renowned for its expertise in economics and economic policy.

The theme of this conference – focused as it is on lessons from economic history – is indeed quite timely. As some of the more intricate macroeconomic theorizing of the last decades is currently subject to a lot of criticism and even reconsideration, the voice of historians is now listened much more closely than some years ago – and rightly so. History may not repeat itself, but it certainly rhymes, as the saying goes.

In this vein, a comparison of the latest international financial crisis with the Great Depression of the 1930's yields some important lessons.

The first is the paramount importance of international policy cooperation for sustainable growth and employment. In the 1920s and 1930s, this cooperation failed, which paved the way for the rise of totalitarian regimes and global economic depression with large human and societal damage. Since the Second World War we have had international institutions that are – more or less – capable of facilitating policy coordination in economic and monetary affairs, to manage financial crises and, in effect, to protect growth and jobs. I refer to the IMF and GATT, now the WTO, in particular. These institutions and their capacity to act should be protected and developed even today. As I see it, the EU now has a heightened responsibility as a leading guardian of the multilateral economic order.

A second lesson from the comparison of the economic crises is how important is the central banks' responsibility for maintaining price stability, to prevent deflation in crises and inflation in boom periods. In the 1930's, the prevention of deflation was not taken seriously enough, which led to a fatal deflation spiral and mass unemployment on a world scale. Without denying the many problems at all, the performance of monetary policy was much better this time around.

It terms of discharging this task, European monetary policy still has some way to go. The European economy continues to need a degree of monetary policy support in order to converge sustainably to a state of price stability. The task is complicated by uncertainties regarding, in particular, the current level of the neutral rate of interest, and the strange behaviour of the Phillips curve, which seems to have flattened in a way that makes it hard to gauge the appropriate duration of our monetary support. In my judgement, these uncertainties speak for a patient, persistent and prudent approach to monetary policy normalization, as President Draghi has expressed our tactics.

This is a balancing act, where we must ensure the sustainable converge of inflation to our definition of price stability and simultaneously protecting the on-going recovery of employment and the repair of balance sheets. Because of the nature of this balancing act, I would emphasize the data dependency of the appropriate "normalization" strategy of monetary policy, without compromising our forward guidance which is a necessary commitment as long as the current situation prevails.

The third lesson is that the financial industry, banks and the other financial institutions are special and have a huge impact on macroeconomic stability in the broad sense. Failures of banks can be extremely disruptive for the economy as a whole. Therefore, authorities have a particular obligation to preserve financial stability – both in a preventive way by regulation, and by taking their crisis management responsibility seriously. It must be ensured that banks and other financial institutions are well managed so that under stress they will not destabilize the real economy.

The severity of the euro crisis galvanized the EU into action and, under pressure, some very important achievements were made. I think that the unification of banking supervision under the auspices of the ECB and the creation of the single resolution mechanism are enormous steps forward.

But three essential things are still lacking from a well-balanced reconstruction of the euro area financial system. They are, firstly, a common deposit insurance scheme, which would make deposits equally safe across the euro area and would prevent the very dangerous cross-border runs. Secondly, the promise of the EU council to create a credible liquidity backstop for the single resolution fund; this needs to be followed through. Thirdly and finally, the legacy problems in the form of non-performing assets in European banks must be treated more effectively than now. This is a package which I believe could benefit not only the EMU as a whole but each member state as well.

I will conclude by stating the obvious: the reinforcing of the euro area is still work in progress. While institutional reforms in banking and finance are important, they are only a means to an end. Europe needs to work towards sustainable growth and job creation on many fronts. Putting the real economy and reforms truly center-stage means that we should build the kind of Europe that opens up our citizens' opportunities to innovate and create new businesses and therefore jobs.

The reform of the euro area is closely linked to the overall future of Europe and its Union. The enlightenment values, which underpin the European social and political model, are now challenged both politically and socially, both from inside and outside. Politically, a populist and nationalist agenda is tempting to many. Socially, the values of tolerance, civil liberties and inclusion are increasingly under threat. In defending these values, the monetary union is not irrelevant. It is the core of the EU – and if the euro does not work, the EU is weakened.

Consequently, in this context, the task of reinforcing the EMU can be seen as a part of a broader endeavour to strengthen Europe, not only in the financial but also in the economic and political sphere. As Europeans, we should recognize the urgency of this effort, especially now as the role of Europe as the standard-bearer for liberal democracy has become even more critical than it may have been some years ago.