Olli Rehn: The euro beyond 20 - monetary policy in the real economy

Keynote speech by Mr Olli Rehn, Governor of the Bank of Finland, at the Conference on financial market policy, at the Economic Council (CDU Wirtschaftsrat Deutschland), Berlin, 29 January 2019.

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Accompanying slides of the speech.

Meine sehr geehrten Damen und Herren, Liebe Freunde,

Berlin ist immer eine Reise wert!

Es ist schön, wieder einmal in der deutschen Hauptstadt zu sein. Ich danke dem CDU Wirtschaftsrat sehr herzlich für die Einladung. Es ist mir eine große Freude und Ehre, heute zu Ihnen sprechen zu dürfen. Als Sohn eines Kleinunternehmers liegt mir der Gedanke der sozialen Marktwirtschaft des Wirtschaftsrats sehr am Herzen.

Aber lassen Sie mich von der Muttersprache Goethes, Ludwig Erhards, sowie auch der von Gerd Müller und Franz Beckenbauer – übrigens den Helden meiner Jugend! – in die Muttersprache von Shakespeare, Adam Smith, Bobby Moore und Gary Lineker wechseln. Das ist etwas praktischer für meine Rede – und insbesondere für ihre Geduld!

Ladies and Gentlemen, Dear Friends,

As the euro turned twenty at the beginning of this year, it is logical to have a look at the two decades, and to prepare for the third decade of the monetary union that has now started. After all, it is our clarity of vision and sense of purpose, as Europeans, as citizens and decision-makers, which will determine how the future of the monetary union turns out.

In my remarks today, I will discuss the challenges the monetary policy makers face, with an eye on the future of the euro. I will not talk about monetary policy only in a narrow sense, as we need to discuss our monetary concerns in a broader context of economic and political developments.

In this context, let me quote Joseph Schumpeter, one of the greatest economists of all time, who wrote: “Der Zustand des Geldwesens eines Volkes ist ein Symptom aller seiner Zustände.” ["The condition of the monetary system of a nation is a symptom of all its conditions."] – What Schumpeter said about a nation, goes today as well for Europe as a whole, for our Economic and Monetary Union. What happens to our money, is a reflection of the state of our union and its economy. So we have to take a broad view.

Monetary policy has its own mandate in economic life, but it cannot solve all the world’s problems. However, monetary policy and economic success are interdependent: price stability is a necessary condition, although not a guarantee, for sound economic development. Simultaneously, the real economy together with political developments determines the preconditions for successful monetary policy. As Schumpeter understood, if the economic and political fundamentals are weak, that will be felt in the monetary developments as well.

The interaction of real and monetary factors brings me to the following point: Central bankers are often labelled as either hawks or doves. I don’t see this as a very useful classification. It is almost a caricature of one-eyed dogmatism, not fitting to any serious central banker that I know of.

Instead, a more relevant distinction was made by the philosopher Isaiah Berlin, who divided policymakers to foxes and hedgehogs: “the fox knows many things and the hedgehog knows one big thing”.

In monetary policy, pursuing the price stability objective with long-term consistency and resolve calls for the central banker to develop a personality of the hedgehog.

But monetary policy is not a mechanical exercise that can be done in a social vacuum. A strategic sense of the interplay between the economy and politics, the markets and the media is also essential – knowing when to play offensive, when to hold on to defence, and how to combine the two. By being aware of the big picture, and capable to navigate in uncertain seas, central bankers should be foxes, as well.

So, monetary policy must always take into account the analysis of the prevailing situation in the real economy, in enterprises and the society at large, recognizing its challenges and how they relate to the commitment and responsibility that central banks have for monetary stability.

Ladies and Gentlemen,

Our present starting point has both positive and negative features.

On the positive side, the recovery of the euro area after the financial crisis has lasted for almost six years now. We should appreciate the achievements: the number of jobs in the euro area has now passed the pre-crisis peak of 2008, and the unemployment rate is continuing to fall. Over 9 million jobs have been created since 2013. There has also been a significant improvement in public finances of the euro area as a whole, and also the bank balance sheets are now stronger than before.

On the negative side, the convergence of the euro area price developments to our price stability objective is incomplete. For that reason, we still face the challenge of monetary policy normalization after a decade with non-standard measures. Hence, we continue to aim at stabilizing inflation back to the target of “below but close to 2 per cent in the medium term”, so that we would be able to ensure ourselves with “policy space”, and thus be able to react to deflationary as well as inflationary shocks, by moving our interest rates as needed.

Such policy space would require higher interest rates on average than today, which will be possible when the European economy can sustain a clearly higher real interest rate than now, or when we see sustained convergence of inflation to the ECB’s definition of price stability, or both.

The context has become more difficult recently. As you know, uncertainty about the future of the European recovery has increased in the last months – the risks to the growth outlook have moved to the downside. This is largely because of the weakening of the global economic cycle, which is felt in European exports, also in Germany. The shadow of global trade conflicts and protectionism is hanging over the European recovery.

Not all risks are external, however: political uncertainties within Europe have increased. A messy Brexit, the worries about Italian fiscal policy, and the recent French unrest, are among the sources of this uncertainty.

All in all, my analysis is that the current situation requires patience and persistence in removing the monetary policy accommodation. Perhaps paradoxically, this is necessary precisely in order to reach higher interest rates in the future in a durable way. If we were to tighten monetary policy too soon, the interest rate increases might turn out to be unsustainable, and we might end up being stuck back in the ultra-low interest rate situation for even longer time than otherwise.

Of course, we should not wait for too long either: an unnecessarily long period of inaction could trigger financial stability issues that the low interest rate environment may bring about, such over-indebtedness in some sectors; increases in real estate prices or other market segments; and the squeeze on banks’ interest rate margins.

And, of course, if we were to wait for too long, inflation might eventually accelerate too much, which would require applying the monetary policy brakes harder than otherwise would be necessary.

This patient approach is reflected in the current forward guidance of the ECB monetary policy, by which the interest rates will remain at the present levels as long as necessary to ensure the sustained convergence of inflation to levels consistent with our definition of price stability; and the reinvestment phase of our bond purchase programme will continue for an extended period beyond the first increases of the ECB policy rates.

Forward guidance has been a very important instrument in the ECB policy toolbox in the recent years. A key reason for having a clearly communicated strategy for monetary policy is the management of expectations of general price developments among economic actors. This is so on many grounds, not least because inflation expectations are the most important immediate determinant of actual inflation. The effect is so strong that it is often said that inflation expectations tend to be “self-fulfilling”.

Over the last five years, however, the connection between the ECB’s price stability objective and the expectations has been weaker than it should be. I have elsewhere previously expressed my view that it would be wise to make a thorough analytical review of the monetary policy strategy of the ECB, in order to strengthen our ability to stabilize the expectations, and to improve our accountability and transparency even further. I would like to reiterate this view also here.

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As I pointed out at the beginning, monetary policy is not made in isolation from the rest of the economy. In particular, successful monetary policy needs financial stability and healthy economic fundamentals.

The most fundamental challenge has to do with the real economy – to revitalize investment and productivity in the euro area countries. The economic potential of our enterprises and workers must be unleashed and developed.

This is of paramount importance for the well-being of our citizens, but it is also absolutely crucial for solving the monetary and financial problems that we still have, even ten years after the financial crisis. The real interest rate that is sustainable in the long run is determined by the growth of productivity and the demand for investment in the European economy.

I would like to stress that the entrepreneurial drive and long-term orientation of the German Mittelstand sets an important example for the business life all across Europe, an example that could help to strengthen the foundations of European productivity and competitiveness.

Climate change is not only an existential threat to our planet but also reinforces the urgency of Europe’s economic renewal. The transition of our economies to sustainability calls for both right incentives and plenty of investment. And turning big time to renewable energy – which is going on in Finland, in Germany and all over Europe – is also a major opportunity for businesses, which has to be enabled by consistent public policy. The central banks in the Eurosystem are committed to climate policy and support the ongoing work for removing the obstacles holding back sustainable finance and the disclosure of climate-related risks.

Another structural challenge is to improve financial stability in the monetary union. The most critical lesson of the two past decades was how important financial stability is for real economy and employment. It has become clear that financial stability was grossly disregarded when the Economic and Monetary Union was created – it was the ”neglected stepchild” of Maastricht, as the economist Daniel Gros has put it.

Going forward, there are several initiatives already on the table, including those by Germany, France, and the European Commission. In my view the manifesto of 14 German and French economists, published last year, is a particularly substantive and important contribution.

The manifesto proposed a synthesis uniting the core principles of ”German” economic philosophy, which calls for a stability union with sound incentives and firm rules, and those of ”French” economic thinking, which emphasizes economic governance with insurance and stabilization.

In essence, such genuinely European synthesis could pave the way for a solid stability union, where the main responsibility for economic policies should rest with the member states. This responsibility can and should be balanced with the insurance provided by stronger common structures, designed especially to safeguard financial stability.

For example, the European Council of last December decided to create a credible liquidity backstop for the Single Resolution Fund, to ensure that bank resolutions could be effectively managed without recourse to the politically damaging bail-outs at taxpayers' expense.

Finalizing the banking union also calls for a common European Deposit Insurance Scheme to prevent cross-border bank runs that could be dangerously destabilizing for the banking systems.

These remaining elements require convincing measures of risk reduction and possibly some co-insurance features to be feasible politically. In particular, legacy problems in the banking sector should be worked out in the member states, without shifting the risks to the euro area level.

A further area where work is needed is in the governance of the fiscal policy of the member states. There has been tension between reliance on market discipline and budgetary rules. However, the dichotomy between rules and market discipline is overstated. Both are needed. At best, rules and market discipline support and complement each other.

The obvious lesson is that the institutions and incentives have to be designed so that they help orientate the market forces to meaningful directions – you may call it 'market discipline by design' – an idea that immediately brings to mind the economic thinking of Ludwig Erhard, the architect of the German social market economy.

So we need fiscal rules, and they should be well designed. The European Union fiscal framework can be amended to emphasise national ownership of fiscal rules and to avoid forced pro-cyclical fiscal policy.

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This analysis of the institutional challenges brings us into the realm of democratic politics and the development of the EU as an organization.

The EU is a union of democratic states. It is the citizens' preferences and trust that count when the future of the monetary union is decided.

Today, the Enlightenment values, which underpin the European societal model, are challenged, both politically and socially, both from the inside and the outside. Politically, a populist and nationalist agenda is tempting to many. Socially, the values of tolerance, social market economy and inclusivity are increasingly under threat.

On the other hand, let us recall that the Europeans value their single currency. According to a fresh Eurobarometer survey[1], as many as 77 % of euro area citizens support the Monetary Union and the euro. This is the highest figure since 2004. Only 18 % of the citizens of the area say they are against. In Finland, the percentage of those “for” was even higher, altogether 80 per cent; in Germany as high as 83 %.

This support for the common currency is of course conditional. It depends on the stability of the euro and its performance. Moreover, in any member state, the support for the euro also depends on how successful the economic policy in that particular country is in adjusting the economy to the requirements of life within the monetary union.

There is a reason why eurozone reform is anything but a technical matter. It is linked to the overall future of the EU.

First and foremost, we need a monetary union that is capable of delivering on the promises made to our citizens — promises of financial stability, sustainable growth, and opportunity for employment.

As Joseph Schumpeter said, money is a reflection of the condition of our economy and our polity. Looking from that angle, reinforcing the monetary union is an integral part of a broader endeavour to strengthen Europe.

Ladies and Gentlemen,

This is of paramount importance especially today, when the international role of Europe as a key standard-bearer of democracy and the rules-based international order has become even more essential than it may have been some years ago.

For politicians, my message is: instead of using political energy for drawing red lines to agitate the home audience, we'd do better by pursuing positive goals of reform and focusing on building bridges across Europe.

A stronger Europe and a more stable monetary union are essential for both internal and external reasons. And these goals can, as in the football field, only be achieved in unity and by teamwork. This is a vision we can only achieve in dialogue and with support of the citizens of Europe.

Meine Damen und Herren,

Europa wird nur auf einer starken Vision, durch Brückenbauen und im engen Dialog mit den Bürgern erfolgreich aufgebaut.

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[1] The "Parlemeter" of October 2018.