Olli Rehn: Bretton Woods @ 75 – What Is New with the International Monetary System?

Remarks by Mr Olli Rehn, Governor of the Bank of Finland, at the Panel Discussion on "Bretton Woods @ 75 – What Is New with the International Monetary System?" in the context of the IMF Spring Meetings, Washington DC, 12 April 2019.

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Accompanying slides of the speech.

Your Excellencies, Ladies and Gentlemen,

1. As we are celebrating the 75-year anniversary of the Bretton Woods system, let me start by noting that fostering economic and financial stability has been and will continue to be the key objective in developing the International Monetary System – as reflected in the establishment of the Bretton Woods system in 1944, and, more recently, underlying the adoption of Europe's single currency, euro.

My home country, Finland, is a case in point of a small, open economy in search of a stable monetary regime. Throughout the 20th century, Finland had just one currency, markka, but several changes in its monetary regime – ranging from frequent devaluations to literally cutting large value banknotes in halves. Eventually, we decided to join the European single currency, euro, 20 years ago. This has greatly enhanced stability, but also brought challenging adjustment needs.

Learning by doing, in 2016, after realising that Finland's labour cost growth had significantly outpaced that of our peers, an agreement was reached with the social partners that helped to narrow the gap of price competitiveness to our main competitors. The Competitiveness Pact reduced unit labour costs by 6½ % in the period of 2014-17. Assisted by strong global demand, the pact was an important factor underlying Finland's rebound from zero growth to 2-3 % growth in 2017-18. One might say, it's small-country open-economy macroeconomics in action!

2. In the international monetary system, the US dollar has been the most important international currency since the birth of the Bretton Woods system. While we have moved to a more multipolar currency system, with the euro gaining ground since 2000 in international trade and currency markets, and the renmimbi making headway as well, the central scenario is still that the US dollar continues to play the dominant role, and retain its exorbitant privilege as the global reserve currency. When the financial crisis hit with full force, the dollar swap-lines of the Fed with e.g. the ECB were crucial in rapidly restoring confidence in the money markets and in the financial system.

Looking ahead, the outlook for continued growth in emerging Asia in the 21st century will probably promote the role of the renminbi. On the other hand, the still limited degree of openness in China's financial markets works for now to the opposite direction.

The euro's international role looks set to remain relatively strong. Let me underline that the ECB does not take a policy view on the global role of the euro, but we see it as a market-driven process. The euro's role will essentially depend on the strength and dynamics of the euro area economy, as well as on developments in international trade.

As this year, 2019, is the first centennial of his sacking from the post of Austrian finance minister, it is probably appropriate to quote Joseph Schumpeter, one of the greatest economists of all time, who once wrote: "The condition of the monetary system of a nation is a symptom of all its conditions."[1]

What Schumpeter said about a nation, goes today as well for Europe and for our Economic and Monetary Union. What happens to our money, is a reflection of the state of our union and its economy.

In line with Schumpeter's unbeatable logic, such policies that make the euro area more robust and its growth stronger will strengthen the euro's global role. The most pressing institutional reform is the completion of the Banking Union and creating a single capital market for investment, not least for sustainable finance. This should be supported by economic reforms in the EU member states. I also think there is a need to strengthen the external representation of the euro, as evidenced by the developments in the wake of the global financial crisis. These are, of course, issues to be solved between the European capitals, but there is a sense of urgency to make progress.

3. When posing the question "What is new in the international monetary system?", we must dig deeper. During the past decade, the operating environment of central banks has changed in profound ways.

The key lesson of the financial crisis is how vital financial resilience is for the real economy. Financial stability, including macroprudential policy, has become the other key pillar of central banking, alongside monetary policy. The main policy implication is to develop financial regulation consistently at the global level. Given the remarkable progress so far, a comprehensive impact assessment is appropriate before taking big new steps forward. However, it is imperative that we safeguard the progress achieved and avoid rollbacks.

4. Equally important, the operating environment of monetary policy proper has been substantially transformed. In a way, monetary policy has to live in two different timelines. In the immediate and short-term, it has to deal with the economic slowdown. In the medium-to-long term, it has to deal with many analytical puzzles to stay effective.

First, the short-term. After two years of robust expansion, global growth is waning. As a result, (almost) all major central banks have had to put monetary policy normalisation on hold and instead to maintain an accommodative policy stance. This holds true for the ECB as well.

On Wednesday, the ECB Governing Council concluded that an ample degree of monetary accommodation remains necessary to support the economic expansion. Significant monetary policy stimulus is indeed being provided by our forward guidance on the key ECB interest rates, reinvestments by a sizable stock of acquired assets, and the new series of targeted long-term refinancing operations.

As President Draghi said, the Governing Council stands ready to adjust all of its instruments, as appropriate, so that inflation converges to our aim, which is below but close to 2% in a sustained manner. It is worth noting that our inflation aim does not imply a ceiling at 2%, since inflation can deviate from our target in both directions.

5. Second, the long-term. There are major economics-related analytical puzzles in the operating environment of monetary policy.

It is clear from the economics research that **the natural rate of interest**, or the equilibrium interest rate, has declined to a historically low level. If this turns out to be long-lasting, the room for manoeuvre for traditional interest rate policies, especially in the accommodative direction, remains limited. Equally problematic, **the interdependence of economic activity and inflationary pressures** seems to have weakened, causing a flattening of the Phillips curve and implying a weaker impact of monetary policy on inflation via aggregate demand. Moreover, **inflation expectations** have remained low in recent years, thus deviating from central banks' definition of price stability.

Because of these developments, it is reasonable to assume that the unconventional monetary policy instruments will stay permanently in the central banks' toolbox, at least in reserve.

In my view, a review of monetary policy strategy is a sound way to prepare for these longer-term challenges. Last November, the Federal Reserve announced it would launch such a review. The latest update of the ECB's monetary policy strategy took place in 2003 – before the global financial crisis and its ramifications and policy changes. I am glad this option is now discussed and assume that the ECB will conduct a review at an opportune time, in the relatively near future.

6. On a final note, let me just say one thing. As the international monetary system is built on trust, current policy uncertainty and the erosion of international cooperation are damaging to everyone. We need bolder joint efforts to steer the global economy towards a more sustainable future, be it ecological, economic or social sustainability.

On Europe's part, I can only say that we keep the flame of global multilateralism alive. I hope others will stay, or join, on board.

Thank you so much for your attention!

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1 "Der Zustand des Geldwesens eines Volkes ist ein Symptom aller seiner Zustände."