Olli Rehn: Impact of structural economic changes on monetary and macroprudential policies

Keynote speech by Mr Olli Rehn, Governor of the Bank of Finland, at the 2019 RiskLab/BoF/ESRB Conference on Systemic Risk Analytics, Helsinki, 24 May 2019.

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Ladies and Gentlemen,

Welcome to the Bank of Finland. I want to thank the co-organisers, the European Systemic Risk Board and RiskLab, for the opportunity to share my thoughts at this Conference on Systemic Risk Analytics – not least because in the aftermath of the Global Financial Crisis, the maintenance of financial stability has regained its original position as the second key pillar of central banking policy.

This comeback stems from certain permanent features of our economies and their development. Modern economies are in constant change. Some changes are cyclical. Economic variables like GDP, housing prices and the volume of lending often increase strongly in upturns and decrease equally strongly in downturns. At times, economies are hit by booms. At other times, they are hit by downturns and recessions.

Economies are also subject to more fundamental, longer-term changes. In economic history, major changes in technology, population growth and economic systems have had sweeping effects on economic growth, the welfare of citizens and the birth and death of occupations and industries.

It is our task – as economists, social scientists and other scholars – to try to identify the key short-term and long-term economic changes and to weigh their consequences, benefits and risks. The policymakers´ challenge, in turn, is to make proper adjustments in their economic and other policies when old policies become outdated for the new world.

In this keynote, I try to identify some major ongoing economic changes that in my view require a rethinking of current monetary policy strategies and macroprudential policies.

Structural economic changes and monetary policy

Let us start from the monetary policy, in general and in the euro area.

Before addressing the longer-term issues, it may be worthwhile to remind ourselves of the major economic recovery that has taken place in the euro area since 2013. In five years, more than 10 million new jobs have been created. Unemployment – although still too high – has declined by 4 percentage points to below 8 per cent.

The accommodative monetary policy of the European Central Bank has substantially contributed to the recovery. Recently, the global growth outlook has been shadowed by significant uncertainty. The trade tensions between the US and China have escalated, China´s growth has been decelerating and Europe has its own problems. As a consequence, most of the major central banks have had to put on hold their long-awaited monetary policy normalisation. This is the case for the ECB as well.

Against the backdrop of the current economic outlook, the ECB Governing Council is maintaining an ample degree of monetary accommodation through our forward guidance on the key ECB interest rates, reinvestments of a sizable stock of acquired assets, and the new series of targeted long-term refinancing operations.

Moreover, the Governing Council stands ready to adjust all of its instruments, as appropriate, so that inflation converges with our aim of below but close to 2% in a sustained manner. And as President Draghi has said, the ECB´s inflation target is symmetrical: our inflation goal does not imply a ceiling at 2%, since inflation can deviate from our target in both directions. The measures taken by the Governing Council reflect the Council´s position that it is equally important to act effectively on inflation levels that are above or below the price stability objective.

In addition to current cyclical headwinds, monetary policy-makers are faced with at least three longer-term developments that challenge their current monetary policy strategies.

First, despite years of highly expansionary monetary policies, inflation has got stuck at a low level. The long-lasting low inflation may have reduced inflationary expectations on a longer-term basis. Alternatively, market participants may have in general lost their faith in central banks´ ability to raise inflation closer to the target.

Second, related to low inflation, the equilibrium interest rate – or the so-called natural rate of interest – has declined to a historically low level. In the current low interest rate environment, the scope for conventional monetary policy easing is limited. The probability of hitting the zero lower bound might be elevated also in the longer term.

Third, the trade-off between economic activity and inflationary pressures seems to have loosened. In economic parlance, the Phillips curve seems to have become flatter. If this is the case, the effect of monetary policy on inflation is now weaker than it used to be.

And, needless to say, the forthcoming ecological and societal transformations caused by climate change, population aging and concerns about inequality need to be taken into account in all economic policy fronts, including monetary policy.

I am convinced that central banks should thoroughly explore the potential impacts of these deep structural changes on monetary policy. For this reason, I have been advocating a review of the ECB´s monetary policy strategy, without prejudice as to where it should lead. If such a review were undertaken, the ECB would be in the good company of the Federal Reserve Board, the Bank of Canada and Riksbanken, among other central banks, who also are currently reviewing their monetary policy strategies.

Structural economic changes and macroprudential policy

Turning to financial stability and macroprudential analysis and policy, let me congratulate the organisers of this conference for compiling such a topical and wide-ranging programme for this event. The selection of topics reflects very well the substantial progress that is taking place in analysis regarding financial stability and macroprudential policies.

As mentioned, I regard financial stability as the second key pillar of central banking today. Meanwhile, I find the debate on whether it should be formally part of our mandate as mostly theological – it is *de facto* the second pillar now, and *de jure* this fact has been anchored in the EU's secondary legislation. "Form follows function", as we functionalists tend to say.

However, the broadening range of macroprudential analysis has not yet been fully mirrored in actual macroprudential *policies*. These policies have focused relatively narrowly on strengthening the resilience of systemically important banks and setting caps on new housing loans to contain excesses in mortgage lending and household indebtedness.

For a new and evolving policy field, this rather focused approach has been justified. It has been sensible to first address the most imminent systemic risks and vulnerabilities. To my mind, is clear that the various macroprudential measures taken in different countries have overall been necessary for preventing serious imbalances building up once again in banking systems and

housing markets. I am thinking of my fellow Nordics, for instance, where macroprudential tools are at work.

However, in the pursuit of preventing financial crises, there is always a risk of fighting the past war. Financial systems change, and the changes bring new risks.

Let me point out some ongoing structural changes to which macroprudential policy-makers should pay increasing attention.

First, the role of banks as providers of finance has started to erode in Europe and some other parts of the world. In continental Europe and Scandinavia, financial systems have traditionally been much more bank-based than in Anglo-Saxon countries, where securities markets have played a larger role. Now, the different systems may finally have started to converge.

The growth of the non-bank finance sector has taken different speeds and forms in different countries and regions. A notable example is of course China, where the size of the non-bank finance sector was about 10% relative to annual GDP a decade ago. Now the figure is over 100%.

In Europe, an increasing share of lending is provided by investment funds, insurance companies and the providers of consumer loans. For example, the total assets of the euro area investment fund sector grew by about 170% between 2008 and 2017.

An expanding investment fund sector enhances cross-border risk sharing and deepens the bond and equity markets in Europe. However, according to different metrics, investment funds have started to take more credit risk and invest in less liquid assets. Although the developments in the investment fund sector may not pose immediate financial stability concerns, they require close monitoring.

Second, in parallel with the increasing importance of non-banks, the relative importance of traditional loan products has decreased, at least in some countries. Let me take Finland as an example. In Finland, the composition of the household loan stock is rapidly changing as a result of the slow growth in traditional housing loans and a much quicker increase in consumer loans and especially housing company loans.

Without going into details, housing company loans are, in essence, housing loans in disguise with less transparent risks for the borrower. Consumer loans, in turn, are easily available and aggressively marketed to vulnerable customers with poor credit records.

Despite the strong increase in non-bank lending and non-traditional loan products, macroprudential tools in Finland can currently only be targeted at traditional housing loans and credit institutions´ capital buffers. Macroprudential toolkits are insufficient in many other countries as well.

The Bank of Finland has strongly advocated – latest very recently in the ongoing coalition talks to form a new government – the introduction of new macroprudential tools in Finland for containing household debt accumulation. The new instruments should ideally cover all loans and all lenders. For example, a cap on the loan applicant´s debt-to-income ratio at loan origination – the DTI-cap – would be a welcome addition to the Finnish macroprudential toolbox.

Every country has its own macroprudential risks and needs to find a policy mix that is suitable for its own specific circumstances. However, many macroprudential policymakers share the Finnish view that their macroprudential toolkits should be more comprehensive than today.

Finally, we should not neglect the effects of some global megatrends on macroprudential risks. For example, rapidly expanding urbanisation is already widening the regional differences in local housing markets and creating house price bubbles in some of the fastest growing cities. And one

of the even too “hot” topics also in the macroprudential field is the long-term impact of global warming on financial stability.

Strengthening the financial architecture of the euro area

According to a recent speech by the Governor of Bank of England, Mark Carney, in 800 years of financial history, financial crises have occurred roughly once in a decade. Given this history, we cannot realistically expect to fully eliminate the risk of financial crises, despite our best efforts in developing monetary and macroeconomic analyses and policies.

Therefore, to prepare for crises, we should try to make our economies and financial systems sufficiently “anti-fragile”, using a term made familiar by the author Nassim Nicholas Taleb. One task is to strengthen the resilience of financial institutions, markets and infrastructures, which is, as you are well aware, one of the key objectives of macroprudential policy.

In the EU, a critical reform in improving the resilience of the financial system has been the creation of the Banking Union, with its single banking supervision and crisis resolution. The Banking Union is up and running, but needs to be finalized to fully reap its benefits.

Creating a common European Deposit Insurance Scheme would reduce the risk of bank runs and their cross-border contagion. A credible back-stop for the Single Resolution Fund would, in turn, ensure that even large bank resolutions might be financed without resorting to bail-outs at the taxpayers´ expense.

Ultimately, both financial stability and the welfare of European citizens depend on Europe´s ability to create sustainable economic growth. To speed up growth, the EU should aim at becoming a true “Investment and Financing Union” with deep and liquid capital markets, where the availability and cost of funding for firms would depend more on their inherent qualities and less on their size, nationality and location.

To mobilise cross-border financing, it is critical that the EU´s Capital Markets Union initiatives are accelerated and the barriers to the integration of European capital markets dismantled in a more determined way. This is ever more paramount in the Europe of today and tomorrow, as we are in the middle of the climate- and energy-related economic transformation, with very substantial needs of sustainable finance and investment.

All in all, the enhancement of financial stability and economic growth should continue to be key priorities in developing the Economic and Monetary Union. The future of EMU is too broad a subject to be covered here in depth, but I see a lot of merit in the manifesto of 14 German and French economists, published last year. The manifesto is essentially a synthesis of “German” and “French” economic thinking, aiming at creating a genuine stability union by uniting sound incentives and rules with a sufficient dose of insurance and stabilization.

To wrap up, modern economies are indeed in perpetual change. Economics, as a science, provides tools for understanding these changes. Policymakers, in turn, need to have the wisdom to adapt their strategies and policies if and when their old ways turn out be inadequate.

And – as always in economic history – economic changes will bring new, unforeseen systemic risks. We should make our economic systems and architectures resilient enough to withstand the realisation of such risks. And as central banks, we need to keep our powder dry, just in case if some known or unknown risks nevertheless start to materialise.

With these thoughts, I thank you for your attention.