Olli Rehn: Challenges of monetary policy - past, present, future

Opening remarks by Mr Olli Rehn, Governor of the Bank of Finland, at the Bank of Finland Conference on Monetary Policy and Future of European Monetary Union, Helsinki, 1 July 2019.

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Accompanying slides of the speech.

Dear Colleagues and Friends, Ladies and Gentlemen,

It is my great pleasure to welcome all of you to Helsinki and the Bank of Finland, and to our Conference on Monetary Policy and the Future of European Monetary Union. I am delighted to welcome our distinguished speakers from different continents, many of them straight from Basel-BIS.

I would also like to welcome you to the Presidency of the European Union. Today, as we meet, Finland has just taken over the baton of EU Presidency for the next six months, now for the third time already. This fits well with today's theme, as monetary integration has been at the heart of Finland's relationship with Europe already for one and a half centuries.

The Bank of Finland, founded in 1811, is the fourth oldest existing central bank in the world. It is closely linked to the history of nation-building and independence of Finland: for instance, during the Winter War, the Finnish Government convened in the Bank and, during air raids, in its gold vault, partly because the then Governor Risto Ryti served as Prime Minister and later as President.

Since the mid-19th century, the Bank of Finland has striven for monetary stability through international integration, which was the way to attract foreign capital to boost investment and growth in our capital-poor country. One might even find historical parallels to the euro, as the Finnish markka was from the 1870s until the First World War pegged to the Gold Standard through the Latin Monetary Union and its key currency, the French franc.

For 36 years, the markka was equal to the gold franc, one to one. The monetary stability provided by this association was paramount to enable Finland to get the required capital, mainly through the financial markets in Frankfurt and Paris, for the large investments in the railroad network and rapid industrialisation in the last decades of the 19th century. This development was consequential for the economic catching-up by Finland and her joining the democratic, inclusive Nordic path of development.

Fast-forward to the late 20th century. Finland joined the European Union in the aftermath of the Cold War in 1995. Just prior to that we experienced a deep recession. The cumulative decline in real GDP from its peak in 1989 to the trough in 1993 was over 12%. The pre-crisis level of GDP was reached only in 1996. The unemployment rate peaked at close to 20%.

The crises was an amalgam of an overly leveraged banking sector, due to badly managed financial deregulation, and of overly loose and pro-cyclical fiscal and income policies. These domestic policy failures were amplified by the virtually overnight collapse of the Finnish-Soviet trade in 1991.[1]

Our lessons of the booming 1980s and busting early 1990s underline the capacity of a small open economy to adjust to both idiosyncratic and global shocks. They also underline the need for economic renewal. These years saw large swings on interest rates and the external value of the markka.

In her search for monetary stability, Finland joined the euro as of 1 January 1999, among the first eleven countries. Over the past two decades, the euro has brought us price stability and a stable currency. Its public support is very high. As many as 80% of the Finns support EMU and the euro.

After joining EMU, unfavourable demand and supply shocks have tested our ability to adjust, when the nominal exchange rate has no more been available to smooth out the ramifications to the real economy.

As a case in point on how a small open economy can adjust in a monetary union, a social pact was agreed in 2016 to correct the serious loss of cost-competitiveness. After concluding that the rise of Finland's labour costs had outpaced that of her peers, an agreement was reached with the social partners to narrow the gap of cost competitiveness to our main competitors. Mostly due to the Competitiveness Pact, relative unit labour costs were reduced by 6½% in the period of 2014–17. Supported by strong global demand and the ECB's monetary stimulus, the pact was essential for Finland's rebound from zero growth to 2½ % growth in 2017–18.

Ladies and Gentlemen,

Let me turn to the current and future challenges of monetary policy and the topics we will discuss in-depth today in our conference.

SLIDE 2. Agenda of the BoF 2019 monetary policy conference

Right now, central banks must pay attention on the short term due to the current headwinds. The Governing Council of the ECB recently responded to the prolonged uncertainty by amplifying the accommodative monetary policy stance. With the symmetric approach underlined by President Mario Draghi in Sintra, inflation may vary around 2% in the short-term, to reach our target in the medium term. Looking ahead, the Governing Council stands ready to adjust all of its instruments, as appropriate, so that inflation continues to converge towards our inflation aim in a sustained manner.[2]

But we must also take a longer perspective. The ECB – much like other central banks – operates in a new environment where long-run trends, such as population aging, lower long-term interest rates and climate change have become key policy issues. The central banking community needs to better understand their implications for growth, employment and inflation dynamics, so that we can deliver more effectively within our mandates. Several central banks, including the Federal Reserve, are currently reviewing their monetary policy frameworks.

Would it be useful for the ECB to do a strategy review as well? We may find pertinent arguments for that. Firstly, monetary policy is done in an economic environment that looks very different from that of 16 years ago, when the ECB last reviewed its strategy. Secondly, monetary policy is done with very different tools from those of 16 years ago. And thirdly, it is a good practice to periodically bring the brightest minds in the academic community together with practical policymakers to evaluate our monetary policy strategies. This process can, once successful, enhance our common understanding of the goals and tools of monetary policy.

Some of these questions revolve around the Phillips curve, which describes the relationship between inflation and economic slack. It seems that during and after the crisis, the behaviour of the Phillips curve has diverged from its past. The rate of inflation has not picked up significantly despite higher economic growth and employment.

SLIDE 3. Euro area Phillips curve in three periods in 1999–2017, as a correlation between core inflation and unemployment

In other words, the Phillips curve may have 'flattened' – a possibility, which has haunted economists and central bankers throughout the post-crisis years. But we may also consider nonlinearity of the Phillips curve. Below, this is illustrated through the relationship between wage growth and the broad measure of unemployment (= U6).

SLIDE 4. Euro area Phillips curve 2005–17, as a correlation between the wage growth and broad unemployment

In the graph a possibility of a non-linear empirical relationship between wage inflation and broad unemployment is illustrated.[3]

So, this is an example of the puzzles that merit to be analysed further. I am delighted we have professor and Fed Vice-Chair Richard Clarida with us today, to share the Federal Reserve System's insights of their strategy review. I am likewise delighted to have my close colleague and now ECB chief economist Philip Lane to discuss the ECB's various instruments of monetary policy, and Governor Yi Gang to provide his take on the global economy and China's monetary policy.

Ladies and Gentlemen,

Let me conclude my opening remarks with a few words on the future of Economic and Monetary Union, the other subject of today's conference.

The sovereign debt crisis revealed serious design problems in EMU. Substantial reforms were enacted to reinforce economic governance and thus resilience of the Eurozone, and its ability to secure financial stability, sustainable growth and opportunities for employment. The European Stability Mechanism was established. The Banking Union was launched, and the euro area banking system is already much more resilient. During the economic recovery since 2013, over 11 million new jobs have been created, and the unemployment rate is down from 12% to around 8%.

But our Economic and Monetary Union is still very much unfinished business. Many questions remain. How to complete the Banking Union? What kind of fiscal capacity will best serve strong, sustained growth? How to make the fiscal rules more counter-cyclical? What kind of safe assets could fly in decision-making, to have liquid financial markets and pave the way for the euro's global role? – We will devote much of the afternoon, including the panel, to discuss these and other challenges of EMU.

With these words, Ladies and Gentlemen, let me welcome you again to Helsinki and the Bank of Finland – and wish you a very intensive and productive day, by discussing the often complicated, but at the same time fascinating issues related to the challenges of monetary policy and the future of European Monetary Union. – Thank you!

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[1] Gulan, A., Haavio, M. and Kilponen, J. (2019): *Can large trade shocks cause crises? The case of the Finnish-Soviet trade collapse,* Bank of Finland Research Discussion Papers 9/2019

[2] An empirical analysis of the ECB's past reaction function can be found in Maritta Paloviita – Markus Haavio – Pirkka Jalasjoki – Juha Kilponen, *What does "below, but close to, two percent mean? Assessing the ECB's reaction function with real-time data,* Bank of Finland Research Discussion Papers, 29/2017.

[3] For further discussion on the state of the Phillips curve, slack in the economy and inflation expectations, see e.g: www.bofbulletin.fi/en/2018/1/reports-of-the-phillips-curve-s-death-are-greatly-exaggerated/