Olli Rehn: On conventional and unconventional monetary policies

Opening remarks by Mr Olli Rehn, Governor of the Bank of Finland, at the 70th Economic Policy Panel Meeting at the Bank of Finland, Helsinki, 10 October 2019.

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Ladies and Gentlemen, Dear Colleagues and Friends,

It is my great honour and pleasure to welcome you to the 70th Economic Policy Panel Meeting.

Economic Policy – the journal, that is – has had an invaluable impact on economists and policymakers in Europe since its establishment by Georges De Menil, Richard Portes, David Begg and Charles Wyplosz in 1985. So many thanks to the current managing editors (Thorsten Beck, Andrea Ichino, Beata Javorcik and Tommaso Monacelli) as well as senior editors (Pierre Cahuc, Kevin Hjortshøj and Klaus Schmidt) for continuing this great tradition. For a frequent reader of Economic Policy like myself it is indeed a great pleasure and honour to open this panel.

In my opening remarks I would like to maintain that the current global economic situation calls for interaction between different policy areas. Many of the challenges that we are facing are beyond the mandates of central banks and should be addressed through fiscal and structural policies. Better policy coordination – or policy mix – is key for better economic outcomes, especially since the monetary policy space is limited.

In the euro area, growth has decelerated to about 1% and is not forecast to meaningfully pick up in the immediate years ahead. Although a recession has been so far avoided, the balance of risks is tilted to the downside.

There is a long list of short- and long-term factors that contribute to this weak economic outlook, like the expanding trade wars and a possible hard Brexit, as well as vulnerabilities in the emerging markets and geopolitical turbulences in the Middle East. Europe faces its own structural problems, such as population ageing, declining productivity growth, as well as populism and indebtedness. Last but not least, there is the overwhelming challenge of mitigation of and adjustment to global warming.

Similarly, inflation in the euro area has continued to fall short with respect to the ECB's target, and the inflation outlook is projected to remain subdued well into the future. In response to that, the Governing Council of the ECB substantially increased monetary accommodation at its meeting on September 12th. With this decision, financing conditions will remain accommodative for an extended period and will contribute to the euro area's growth outlook, both short-term and long-term.

It has been recently argued that there has not been danger of a deflationary spiral in the euro area. I for one have to say that I don't remember or see it that way in light of the empirical evidence. For instance, the European Commission in 2013–14 was very concerned about the spectre of deflation, and expressed that also publicly.

On its part, in January 2015, the ECB launched an expanded asset purchase programme, since the degree of monetary accommodation prevailing at the time was insufficient to adequately address the heightened risks of a prolonged period of low inflation. HICP inflation had indeed been below 1 % since October 2013, and the reasons for low inflation, which were long seen only as temporary, started to indicate second round effects with a deflationary impact.

In January 2015, the overall HICP inflation rate was only at 0.6%. Moreover, the markets were pricing negative inflation in the time horizon of 2-3 years with the probability of about 50%. The degree of monetary policy accommodation was examined and reinforced many times since then.

Only in June 2018 was the Governing Council able to conclude that progress towards a sustained adjustment in inflation had been substantial.

The threat of a deflationary spiral was subsequently avoided. A key lesson of monetary policy of the last 10 years is that timely action is essential to avoid the zero lower bound and an extended period of too low inflation. We don't want to be in the midst of a deflationary spiral until we take action. This is also one of the key lessons of the Japanese experience.

Fast-forward to early 2019. Due to the rapidly worsening outlook, the normalisation of monetary policy that started in June 2018 had to be put on hold. The decisions to restart the easing phase in March this year and to resume the net asset purchases in September were timely and taken in response to the continued shortfall of inflation with respect to our aim.

Ladies and Gentlemen,

While I have focused on monetary policy, many factors that weaken the economic outlook originate beyond its realm. Yet the connection between seemingly non-monetary challenges and risk factors on the one hand, and monetary policy on the other, is actually much stronger than initially appears. This is because many of these challenges, if more permanent, have the potential of affecting the natural level of real interest rates. A good example is the ageing of the societies with persistently declining shares of youngest cohorts. Moreover, there are frictions in education and labour mobility that can further diminish the productivity potential of younger generations. All these factors lower aggregate investment and demand for capital. If they don't reduce aggregate income and savings at the same time, they can ultimately lower the natural rate of interest.

Why do these mechanisms matter for monetary policy? Because the lower the natural interest-rate level is, the higher is the probability that nominal interest rates are near the effective lower bound – "hitting the floor", if you like. A prolonged period of zero interest rates combined with low inflation could in turn trap the economy in a profoundly harmful equilibrium, which would undermine the effectiveness of monetary policy, constrain economic growth below its potential and hinder efforts to boost employment.

Let me be clear. We all, I assume, would like to get rid of negative interest rates. However, as long as the synchronized slowdown continues, there is no economically meaningful alternative to unconventional monetary policies – and it is better to be safe than sorry before shifting the policy gear back to normalization. At the same time, all countries and jurisdictions would do well by applying effective macroprudential policies to counter any negative side effects of accommodative monetary policy.

Furthermore, there are also new uncertainties and possibly fundamental changes in the functioning of the economy. Low interest rates, low inflation and persistently low growth put our economic theories and past empirical relationships into a real test.

Facing these challenges, many central banks, including the Federal Reserve and the Bank of Canada, are currently reviewing their monetary policy strategies. The Bank of Finland has been making the case for a strategy review for the ECB. Central banks in the European System of Central Banks have also invested in active research departments to analyse the implications of the new economic environment and new policy instruments, both for the conduct of monetary policy and its modelling.

A strategy review referred to by Christine Lagarde would provide us with an opportunity to conduct a thorough scientific assessment of our monetary policy framework and evaluate its effectiveness in light of the new economic landscape and new monetary policy instruments.

Fiscal policies remain more fragmented, uncoordinated and reacting at a much slower pace.

This is especially the case in the euro area, which consists of 19 member states, all having separate fiscal and political cycles.

The challenges in the domain of governments and fiscal authorities are both long- and short-run in nature. Good examples of long-run structural issues are competitiveness and global warming. Structural reforms can boost productivity and growth potential, and reduce structural unemployment, especially in times of ageing population.

However, fiscal policy has also the potential of affecting economic activity in the short run to stabilize the business cycle. As stressed by President Mario Draghi, automatic stabilizers should be able to play their full role. Clearly, euro area economies are heterogeneous in terms of their indebtedness and fiscal constraints. However, in countries where fiscal space is available, fiscal measures should be actively pursued, particularly towards the financing of public investment.

What are the tasks of central banks in this division of labour? Recent studies, such as those on the experiences of Japan over the past decades, demonstrate that declining inflation expectations can become permanently stuck at low levels. This can lead the economy into a prolonged period of low inflation, where monetary policy has little room for manoeuvre. To prevent the anchoring of expectations at a level below target, central banks need to respond early enough and powerfully enough to bring about convergence to the price stability target, in situations where inflation expectations have become depressed for a protracted period.

Dear Colleagues and Friends,

I was very excited to see the list of papers chosen for this panel. The selection covers most of the issues that I have mentioned before: structural reforms, expanding trade wars and the optimal policy mix.

This simply confirms the role of Economic Policy as the pivotal journal for policy-relevant research in Europe and beyond.

So, without further ado, let me pass the ball to the chair of the first session. But before that, let me wish you a substantive and productive conference!

Many thanks for your attention.