Olli Rehn: Monetary policy in the emerging post-pandemic context

Opening remarks by Mr Olli Rehn, Governor of the Bank of Finland, at the Bank of Finland-SUERF Joint Conference "Monetary policy approaches: a comparative appraisal", 19 October 2021.

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Ladies & Gentlemen, Dear Friends,

Good afternoon and welcome to this conference on *Monetary Policy Approaches: A Comparative Appraisal*, which is jointly organized by the Bank of Finland and the European Money and Finance Forum SUERF.

Our collaboration with SUERF in organizing biennial conferences has a long and successful history, for which we are very grateful. I wish to extend my thanks to all those colleagues and friends who have contributed to making today's conference possible.

We are honoured to have some of the leading experts in the field to address us at this conference, including the panellists Philip Lane, Andrew Levin, and Patricia C. Mosser. The organizing committee have done an excellent job in putting together a high-quality programme for today.

In my opening remarks, I will discuss monetary policy in the emerging post-pandemic context as seen from the perspective of the euro area. Let me first make a few remarks on growth and inflation outlook, and then discuss the recent strategy review of the European Central Bank.

The euro area economy has rebounded significantly this year on the back of the re-opening of the economy and strengthened policy support. According to the ECB's September staff projections, real GDP is projected to grow by 5.0% this year, 4.6% next year and 2.1% in 2023.

Not surprisingly, we have seen some inflation peaks in the recent months. On both sides of the Atlantic and globally – and last week in the IMF annual meetings – one is bound to witness an intensive debate on "back to the 70s stagflation", and whether the recent rise in consumer price inflation is of transitory or permanent nature. Let me give you my take on this.

We have a saying in the European Union: "Nothing is more permanent than something called 'transitory'."

By experience, that is often true, but it is somewhat more complicated this time round. As you know, the debate is particularly heated in the US. However, there is still plenty of slack in Europe, which is in another phase of recovery and behind the cycle compared to the United States.

Yes, we have seen some inflation peaks in Europe, as well. Last month consumer price inflation rose to 3.4%. Annual inflation is forecast to reach an average of 2.2% this year, supported by temporary factors, such as the strong base effects caused by the rapid rises in energy prices, especially electricity and gas, and the cost pressures arising from more persistent shortages of materials and equipment than previously thought. In 2022, inflation is projected to moderate to 1.7%, as the factors now deemed temporary should start to fade away, and projected to stay at 1.5% in 2023.

In my view, euro area inflation is still mostly transitory, even if some of its components are partly more persistent than previously expected. However, we need to recognize that the *micro* experience of the ordinary people is quite different from the *macro* reading of the economists and central bankers. If this state of elevated inflation were to last much longer, it would likely have a more significant effect on inflation expectations.

Indeed, the selling price expectations (3 months forward) of both the industrial and retail sectors have started to rise amid these temporary price pressures. Moreover, the short-term inflation expectations derived from the market information (i.e. inflation swaps) has increased to 1.8 – 1.9%.

However, the counterevidence speaking for the transitory interpretation is quite convincing. When looking at the longer-term expectations, there is no upward trend: The probability distributions of market inflation expectations have strongly concentrated between the levels of 1.5 – 2.5% and the probability of inflation higher than 2.5% is very small. Core inflation in the euro area is still subdued, the latest reading being 1.9%, and it is projected to stay at 1.5% in the medium term. So far, there is no major evidence of second-round effects through wages. Wage growth is still below pre-Covid average, despite significant sectoral labor shortages.

So, we may ask: where does the euro area stand when facing the classical monetary policy dilemma of not overreacting to the supply-side shock, on one hand, and engineering a reduction of stimulus without de-anchoring inflation expectations, on the other hand?

When answering this question, we should do so against the backdrop of the ECB's new monetary policy strategy, which is built on a symmetric 2% inflation target and on a reaction function that tolerates temporary overshooting. As core inflation is at 1.5% in the medium term and the latest reading of long-term inflation expectations (5y/5y) was at 1.9%, we may conclude that the trend in euro area inflation is now in line with the ECB's strategy. Logically, on the basis of this data and in line with its revised strategy, the ECB leans on the side of not overreacting.

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Let me now turn more specifically to our strategy review, which was concluded in July. High-quality analysis and extensive dialogue between research and policymaking were crucial for reaching substantive, pertinent conclusions going forward. You may compare the strategy review exercise to a major research project with dozens of in-depth seminars, covering key issue areas relevant to the making of monetary policy.

We reviewed the definition of price stability, monetary policy instruments and their effectiveness, as well as our communication practices. We also assessed the importance of digitalization, financial stability, globalization, monetary and fiscal policy interactions, and climate change from the perspective of monetary policy.

The most important revision to our strategy is the new definition of price stability and how it will be applied in our future decision-making. According to the new strategy, price stability is best maintained by aiming at a 2% symmetric inflation target over the medium term.

The old aim of 'below, but close to 2%' was less precise and very much open to interpretation. In particular, the former definition had probably a certain feel of asymmetry, and its ambiguous wording appeared more of a ceiling than a symmetric central target.

The new 2% inflation target is genuinely symmetric, unambiguous, and easy to communicate. Symmetry means that the Governing Council considers both slower and faster inflation to be equally undesirable.

The symmetric 2% inflation target under the new strategy thus serves as a buffer against deflationary risks and provides monetary policy with more space to react to a sharp decline in inflation. Obviously, we also want to rein in the costs to the economy from a too high rate of inflation. And we have the tools to do it effectively, if and when needed.

This change in the price stability definition is clearly reflected in our forward guidance. As decided at our monetary policy meeting in September, the Governing Council expects the key ECB

interest rates to remain at their present or lower levels until it sees inflation reaching 2% durably, and it judges that the progress realized in underlying inflation is consistent with inflation stabilizing at 2% over the medium term.

Commitment to a symmetric inflation target requires particularly strong or long-term monetary policy measures when interest rates are close to the zero effective lower bound. This commitment, which is buttressed by the new forward guidance, is crucial to support the anchoring of long-term inflation expectations to 2%, but as said it may also imply a transitory period in which inflation is moderately above target.

A medium-term orientation for the inflation target is baked in into the new strategy, which also makes it possible, where necessary, to smooth out other economic shocks, such as shocks related to employment or financial stability. If actual inflation is slower or faster than targeted, monetary policy will respond to deviations gradually, considering the nature of the economic disruption. Deviations estimated to be temporary may not be responded to at all, but seen through.

The symmetric inflation target should help to ensure a stable and predictable price outlook, which is a key prerequisite for sustainable economic growth and a high level of employment. Price stability, balanced growth and a high employment rate are mutually consistent goals, and successful monetary policy improves the well-being of citizens by focusing on price stability. To this end, targeted monetary policy communication can improve people's understanding of how monetary policy responds to current and projected economic conditions.

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The strategy review also examined how monetary and fiscal policy can work together during and after times of crisis. The conventional thinking gives a clear division of labour between the monetary and fiscal authorities: monetary policy should promote price stability, and fiscal policy should keep sovereign debt on a sustainable path.

However, in a period of low interest rates, the scope for monetary-fiscal policy interactions is possibly wider. Counter-cyclical fiscal measures complement monetary policy when key policy interest rates cannot fall any further. Similarly, low interest rates can keep financing conditions favourable during and after crisis, thus creating space for fiscal authorities to respond to an economic downturn and hence stabilize the economy.

Fiscal policy also matters for the transmission of monetary policy in low interest rate environments. A recent study by Bank of Finland staff, ”The Power of Forward Guidance and the Fiscal Theory of the Price Level”[1], argues that fiscal support is essential for forward guidance announcements to have the right kind of effect on inflation and output. Fiscal support remains important at the effective lower bound and before inflation robustly converges to the 2% target. Moreover, in that context structural reforms are needed to support labour supply and productivity growth.

Then there is the "Voldemort" or the threat of "fiscal dominance", a scenario in which monetary policy is linked to the sustainability of public debt. Fiscal dominance scenarios are associated with high inflation and volatile macroeconomic conditions that could ultimately lead to loss of central bank independence. Such scenarios are certainly not desirable. It is clear that the ECB Governing Council has the mandate, the will and the tools to counter and prevent such scenario.

Moreover, the fiscal framework should be such that it first of all ensures debt sustainability in the long-run, while being sufficiently flexible to allow macro stabilization especially when the economy is at the effective lower bound.

That is why fiscal rules are of major relevance for monetary policy. Even though the existing EU

fiscal rules have been criticized, and the criticism is to some extent justified, discarding the rules without a clear alternative would obviously be a major mistake.

Once the rules are reformed, what should the reform look like? They should be made simple and transparent, like our new definition of price stability. Clarity supports the effectiveness of rules and enhances accountability.

One good starting point is the proposal by the European Fiscal Board. It includes an expenditure rule, which could be defined so that it effectively limits expenditure growth also during economic upswings. There is evidence that broadly these kind of expenditure rules, when complemented with other fiscal rules, have been successfully applied in many countries.[2]

Regarding the design of the rules in general, it is important that they are based as much as possible on observables, and not on un-observables such as output gap and potential output.

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Last but not least, there is the issue of climate change. While governments and parliaments have the primary responsibility for climate policy, the ECB, within its mandate, also needs to support these goals. Among other things, the ECB will expand its analytical capacity to incorporate climate issues in its economic models and to promote the measurement and disclosure of risks related to climate change. By thus expanding its analytical capacity, the ECB can effectively account for climate issues in its risk management analysis, investment activities and monetary policy operations.

Ladies and Gentlemen,

A warm welcome once more on behalf of the Bank of Finland. I wish you all a productive and enlightening conference. But before we get going with the first session, let me open the floor for possible questions.

Thank you.

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[1] McClung, Nigel, “The Power of Forward Guidance and the Fiscal Theory of the Price Level,” *International Journal of Central Banking,* (2021, forthcoming)

[2] See e.g. Belu Manescu, C and E Bova (2020), “National expenditure rules in the EU: an analysis of effectiveness and compliance”, Discussion Paper 124, European Commission. Till Cordes, Kinda, T., P. Muthoora, and A. Weber (2015): “Expenditure Rules: Effective Tools for Sound Fiscal Policy?”. IMF Working Paper 15/29.