Olli Rehn: Monetary policy in low and high inflation environments

Speech by Mr Olli Rehn, Governor of the Bank of Finland and First Vice-Chair of the European Systemic Risk Board, at the Bank of Finland's 3rd International Monetary Policy Conference "Monetary Policy in Low and High Inflation Environments", Helsinki, 26 June 2024.

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Presentation accompanying the speech

Ladies and Gentlemen, Dear Friends,

It is my great pleasure to welcome all of you to the Bank of Finland's conference on monetary policy in low and high inflation environments, and especially those of you who have travelled from further afield to be here in Helsinki. I am more than delighted to welcome our distinguished speakers and participants from different continents, and very much looking forward to an inspiring exchange of views today.

In my opening remarks, I will first talk about the exceptional price dynamics over the past crisis years, and then provide some personal reflections on the ECB's upcoming monetary policy strategy review.

To set the stage, let me illustrate the brief history of inflation in the euro area by dividing the last quarter century of the euro into three periods.

SLIDE 2. Three periods of inflation in the euro era, 1999–2024

These are, on average: 1) at around 2% during the waning great moderation in 1999-2009; 2) slightly above 1% during the post-financial crisis below-target inflation in 2009–21; and 3) above 6% during the years of accelerating inflation since 2021. Each of these periods had a specific set of inflation (or deflation!) drivers and price stability anchors, and thus specific price dynamics and specific policy issues.

The common feature in the advanced economies is that inflation has been mostly due to supply disruptions and sharp increases in the prices of food and energy, as concluded by Ben Bernanke and Olivier Blanchard in their recent paper[i]. On the other hand, over time inflation became more broad-based and stickier, leading to higher wage inflation on a tight labour market. Fiscal policy also played a role in fuelling demand-side inflation, especially in the United States.

While we have seen some less convincing data on inflation recently, in a moving context, we must see the forest for the trees. Considerable progress has been made in bringing inflation down towards the ECB's symmetric 2% target, especially since September 2023. Monetary policy and financing conditions have been held tight to curb demand, which has helped keeping inflation expectations firmly anchored.

SLIDE 3. Monetary policy anchored inflation expectations at 2%

Overall, the dynamics of inflation continue to indicate that inflation will stabilise at the target in the medium term, even though its downward path has slowed somewhat in recent months. This will strengthen the real purchasing power of euro area households.

We always knew that it will be a bumpy road, but the ECB Governing Council is determined to ensure that inflation stabilizes to the 2% medium-term target in a timely manner. In the decision-making we will continue to focus on three factors: the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission.

SLIDE 4. Reflections on the ECB's next strategy review in 2025

In keeping with the title of this conference – Monetary Policy in Low and High Inflation Environments – as promised I will next provide some personal reflections on the ECB's upcoming monetary policy strategy review, having actively participated in the previous 2020–2021 review.

Prior to the 2021 review, we had had a long period – almost a decade – of exceptionally low inflation. But now, of course, the situation has changed considerably, as we have experienced exceptionally high inflation in the past couple of years or so.

In the 2021 strategy review, we reviewed the previous asymmetric target, "below but close to 2 percent", and replaced it with a symmetric 2% target. Symmetric in the sense that, as we stated, both negative and positive deviations from the target are regarded as equally undesirable. And we underlined the medium-term orientation for reaching the target.

In my view, the symmetric, medium-term 2% inflation target has served us well, so far: it has provided a clear and comprehensible anchor, and enough flexibility both in terms of the temporal definition and the instruments used. This has allowed us to avoid taking any excessively drastic measures that the old target might have implied.

The inflation **target** itself does not then, in my view, need re-consideration. But we need to analyze inflation **dynamics** in the exceptional years – and the functioning of the strategy – in more depth.

It is worth recalling that at the time we published our revised symmetric 2% inflation target in July 2021, the operating environment for monetary policy was in considerable flux.

First, the COVID-19 pandemic threatened to lead to a major depression and was countered by a quick and strong response of monetary and fiscal policies. Then we saw supply-side bottlenecks and accelerating inflation. And in February 2022, Russia launched its illegal war in Ukraine. The energy crisis caused by the war hit the European economy hard. The euro area's imported energy bill increased in 2022 by €400 billion, i.e. by around 3–4% of GDP. This meant a substantial and possibly long-lasting cut in the average European's standard of living.

At that point, the combination of stagnant growth and accelerating inflation was a completely credible prospect. On the one hand, the sharp rise in energy prices accelerated inflation. And on the other, the substantial increase in geopolitical uncertainty and the ending of energy imports and trade with Russia seemed destined to undermine Europe's economic recovery. Monetary policy was thus facing a major dilemma.

After a period of deliberation from March until June, the ECB began, in July 2022, a series of policy rate increases that was exceptionally rapid and consistent – due to the exceptionally high inflation rate. In line with our revised strategy, our goal was to tame inflation over the medium term by preventing a wage-price spiral and thus keeping inflation expectations anchored.

In my view, this goal has been, by and large, achieved (see graph). Our symmetric 2% inflation target and the medium-term orientation of monetary policy have made a soft landing possible: economic growth has been somewhat subdued as a result of the rise in interest rates, but the risk of a persistent economic crisis has been avoided, and inflation has been stabilized over a period of 2–3 years (knock on wood).

Some have argued that we did not hit the brakes early enough. Let me say that many of us policymakers would in fact have been ready to raise rates already in March 2022 in the face of soaring inflation, but Russia's invasion of Ukraine brought a return to the era of brutal geopolitics and created a massive cloud of uncertainty over Europe's economy.

My initial feeling – even in retrospect, a completely rational one – was that it would probably have serious stagflationary consequences, hitting growth and generating inflation, a kind of "back to the 70s". In that context, it made complete sense to pause for a minute and wait for the clouds to clear before choosing the policy stance. This is something worth remembering in all *post-mortems* of the recent polycrisis years.

This links very much to the ECB's upcoming strategy review. Given our primary mandate, the focus of the review should, in my view, be on achieving a better understanding of the inflation dynamics of the past few years, and of the secular trends that keep changing the operating environment of monetary policy going forward.

To begin with, it is essential to analyze the large and persistent **supply** shocks that the euro area has encountered in recent years. But we must also have an open debate on the role of **demand** shocks, including monetary and fiscal policies. The jury is still out concerning the relative importance of their contribution to the period of high inflation.

By the way, the same goes for the period of **low** inflation: did we come out of the liquidity trap as a result of our own policy actions, or was it due to the pandemic-related supply shocks and strong fiscal stimulus?

A further key question is whether we should react to supply shocks in a different way than in the past few years. To what extent can we, as a central bank, even influence supply-side issues? I think a good approach is to follow the established wisdom of monitoring the extent to which supply shocks cause second round effects.

Turning to secular trends, one thing that has fundamentally changed since our last strategy review is the geopolitical landscape.

Geopolitics will continue to shape the operating environment of monetary policy in the years ahead. The changes that are taking place in the world economy, from trade wars to supply chain diversions, are likely to increase the probability of supply shocks and inflation volatility. But geopolitics, and especially the ongoing geo-economic fragmentation, may also have a strong impact on the new equilibrium that emerges once the current interest rate cycle is completed.

And this brings us to the question of the level of the long-term real natural rate of interest, r* or the equilibrium interest rate. This has been much discussed among central bankers, including at the BIS and IMF.

SLIDE 5. Natural interest rate is a necessary analytical framework

The chart shows various estimates of the natural rate for the euro area. According to recent studies, it is typically estimated to be somewhere between 0% and 1% in real terms in the euro area.[ii]

I, for one, don't think of the natural interest rate as a certain exact number, nor as a viable concrete tool for **devising** monetary policy, but instead as an illustrative and even necessary analytical framework for **thinking about** monetary policy.

And I venture to say that it matters to policy outcomes what frameworks policymakers use: whether it is, say, the quantity theory of money, the monetarist explanation of inflation, the linear versus non-linear Phillips curve, or animal spirits and inflation expectations – just to name a few. My own view, as I implied, is that the natural rate has to be at the heart of modern monetary policy analysis.

In recent years, some have argued that r* has risen. Spurring this rise, it is argued, are the increase in investment needs due to the green energy transition, and also artificial intelligence and growing defence spending. On the other hand, population ageing and the deterioration in the global division of labour caused by geopolitics could weaken the dynamics of the economy and productivity growth, and thus also negatively affect the pace of investment. This would contribute to keeping real interest rates down. So, the trajectory of r* remains unclear for now – that's why we need to continue and dig deeper.

SLIDE 6. Hours worked and persons in employment

Another focus of analysis should be the labour market, not least since it is closely linked to the apparent slowdown in productivity growth.

In recent years, euro area employment growth has been robust, and the unemployment rate is at a historical low of 6.4%. However, the number of hours worked has increased at a significantly lower rate than the number of people in employment. This means that the euro area labour market – when measured as hours worked – has not developed particularly favourably, and correspondingly, productivity growth looks somewhat better when measured per hour.

We also need to gain a better understanding of how demographics affect the labour force participation rate and the development of the labour force in the future.

During the past few years, we have seen large and exceptional shocks originating from the labour market. In addition to the sharp decrease in average hours that led to an increase in the demand for labour, **immigration** has increased labour supply and helped to constrain wage pressure. Taking these shocks into account makes the developments in the labour market of the past few years look much less mysterious than is often claimed. Understanding what happens in the labour market is crucial for understanding wage and inflation dynamics in the future.

Currently wage increases in the euro area are driven by both compensation for past inflation surprises and still relatively strong labour demand (from the services sector). At the same time, inflation expectations have remained well anchored, and we see little or no wage impact from inflation expectations.

Ladies and Gentlemen,

This brings me to the end of my opening remarks.

Uncertainties and the exceptional price dynamics have challenged our policymaking in the past few years. The silver lining is that we have gained a lot of understanding about the appropriate policy responses in these circumstances. This understanding should be pooled and deepened in the upcoming ECB strategy review.

For me, the experiences of recent years have, above all, highlighted the crucial role of inflation expectations in the making of monetary policy. Likewise, they have underscored the importance of a firm commitment to a medium-term inflation target in line with our strategy.

Going forward, the monetary policy strategy should be designed in a way that is robust in the face of uncertainty about the future state of the world. It should be flexible enough to work well in different environments and react to new and unknown shocks. Thus, while we have made major advances in the science of economics relevant for monetary policy, there still is room for judgement; that is, for the art of monetary policy.

Last but not least, let me wish you an enjoyable and analytically rewarding conference! Thank you.

List of links in the text

[i] Bernanke and Blanchard 2024: An analysis of postpandemic inflation in 11 economies. PIIE Working Paper 24-11

[ii] See e.g. Claus Brand, Noëmie Lisack and Falk Mazelis (2024), 'Estimates of the natural interest rate for the euro area: an update', ECB Bulletin 1/2024.