Olli Rehn: This time is different or back to basics? Reflections on monetary policy normalisation

Policy keynote speech by Mr Olli Rehn, Governor of the Bank of Finland, at the Bank of Finland and CEPR Joint Conference, Helsinki, 13 September 2024.

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Presentation accompanying the speech

Ladies and Gentlemen, Dear Friends,

May I warmly welcome you to Helsinki and to our annual research conference, which the Bank of Finland organizes jointly with the Centre for Economic Policy Research.

May I also say that taking inflation and monetary policy as the theme of the conference has proved to be a pertinent and productive tradition. But this was not always self-evident, as times have changed.

Just a few years ago, high inflation would have sounded like ancient history. However, as we know only too well, the COVID-19 pandemic and the subsequent geopolitical tragedies have proved that inflation can return, unexpectedly and significantly, and that central banks must stand ready to tackle it purposefully.

The surge in inflation and the robust disinflationary measures taken by the European Central Bank and other central banks remind us how important it is that central bankers and academics listen and talk to each other.

In fact, the timing of this dialogue opportunity today is particularly appropriate, as I returned home only yesterday evening from the Governing Council meeting in Frankfurt, where we took our latest interest rate decisions.

So let me devote the first part of my talk to the current economic outlook and our monetary policy decisions. I will then turn to a more bird's-eye view of the past few years regarding inflation. Finally, I shall say a few words about the ECB's assessment of its monetary policy strategy.

Slide 2: Disinflation in the euro area is on the right track

Inflation or, rather, disinflation in the euro area is on the right track. We've come down from the peak of 10.6% in October 2022 and are now in the vicinity of our 2% medium-term target. The latest Eurostat estimate, for August, shows an inflation rate of 2.2% in the euro area.

While the final stretch of the road to our 2% target may be bumpy, the ECB and other international institutions forecast that the 2% target will be achieved in a sustainable way in the course of next year.

Slide 3: Euro area GDP growth is projected to gradually pick up

Growth, however, remains slow in the euro area, and downside risks to growth have increased over the summer. Industrial production in the euro area is still stumbling after the energy price shock and is not expected to recover quickly. According to the ECB staff forecast published yesterday, growth in the euro area this year will be subdued, but will then accelerate to 1.3% in 2025 and to 1.5% in 2026. Geopolitics, including two wars and other political uncertainties, is strongly influencing the growth and inflation outlook for the euro area, both in the short and medium run.

It has become evident that the weakness in euro area growth is more structural than we had previously thought. Europe must, in my view, pursue stronger productivity growth, not least since its populations are ageing, green investments require massive funding, public debts and deficits are large and defence spending needs to be raised.

These developments call for a strong, unified response from the EU. This is the main message from former ECB President Mario **Draghi's** recent **report on EU competitiveness**. The report highlights three key areas for action: 1) closing the R&D and innovation gap with the United States; 2) balancing Europe's ambitious climate goals with competitiveness; and 3) enhancing security and reducing critical dependencies.

The report is a wakeup call to all Europeans and a deep diagnosis of our economic and industrial challenges. I do hope it catches the attention it deserves from both the new European Commission and the EU national governments.

Slide 4: The ECB's Governing Council lowered key interest rates at its September meeting

At the ECB's Governing Council meeting yesterday, we decided to lower our main policy rate by 0.25 percentage points, meaning that the deposit facility rate now stands at 3.5%.

There were good reasons for easing monetary policy: inflation has continued to slow down, and inflation expectations are close to the ECB's 2 percent target. In addition, economic activity is still subdued, and financing conditions remain restrictive.

Disinflation, together with robust wage growth, is supporting the growth of real disposable incomes in the euro area and paving the way for a consumption-led recovery. Our Achilles' heel, though, is the low level of productive investment.

Concerning productive investment – that we badly need – the distinction between structural and macro is never crystal-clear, black-and-white. Yes, the current clouds of geopolitics and intra-European uncertainty weigh on the European economy, in the form of damaging confidence effects. Nevertheless, and to paraphrase a certain giant on whose shoulders we all stand: "In the long run we are all retired. But in the meantime, we need more productive investment."

In other words, even though the euro area's longer term growth and competitiveness challenges cannot be solved using monetary policy, an easing in financial conditions will bring welcome relief to households and companies in the short term, and should support investment, which is needed to increase longer term productivity.

The prevailing uncertainties continue to underline the case for data dependency and a meeting-by-meeting approach in the Governing Council's decision-making going forward. We are not pre-committing to a particular rate path.

We thus maintain full freedom of action and flexibility in making interest rate decisions in future meetings. The next regular monetary policy meetings will be held in October and December.

The Governing Council will continue to base its monetary policy decisions on the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

Slide 5: Three periods of inflation in the euro era, 1999-2024

Let me now turn to the ECB's assessment of its monetary policy strategy by taking both a step back and a longer term perspective.

This graph shows that the quarter-century history of euro area inflation can be conveniently divided into three distinct periods: 1) 'normal times', during what later became largely known as the Great Moderation, from the 1980s until 2009 (inflation at 2.2% on average); 2) 'lowflation' in the aftermath of the Global Financial Crisis (inflation at 1.3% on average); and 3) 'highflation' since 2021 (inflation at 5.8% on average).

Each of these periods had a specific set of drivers, shocks and policy challenges. In spring 2020, the ECB launched its previous monetary policy strategy review, motivated by persistent sub-target price dynamics, the binding policy rate constraint and the need to evaluate the unconventional monetary policy toolkit. Estimates of the natural rate of interest were at that time pointing to a declining downward trend, and there was growing evidence of a flattening of the Phillips curve, although with apparent non-linearities.

All these factors together posed a risk that the central bank could have lost the necessary policy space and, equally worryingly, that inflation expectations could become de-anchored.

What cause inflation? Demand or supply shocks?

Given the commitment to reassess its actions regularly, the ECB decided this summer to launch an assessment of its monetary policy strategy, with the aim of completing it in mid-2025.

What has changed since the previous review in 2020? No sooner had the ink of the previous review dried in July 2021 than inflation started to rise rapidly. Clearly, understanding the nature of the inflation surge is of paramount importance – and a key lesson to be learnt.

Let me elaborate a bit.

One view holds that the surge in prices can be mainly attributed to factors that were constraining **supply**. For example, the pandemic-related lockdowns across the world heavily disrupted international production and transportation chains, resulting in multi-month delays in the supply of manufactured goods. The same lockdowns reduced or even temporarily eliminated the supply of many services, for instance in the leisure industry. The pandemic also led to a massive drop in average hours worked, creating labour shortages and further squeezing supply.

On top of that came a textbook **supply-side shock** or, rather, **a relative price shock**. When Russia invaded Ukraine in February 2022, global oil and gas prices shot up. Within a few months the euro area was largely cut off from Russian natural gas supplies and was instead increasing its natural gas imports from the US, Norway and Africa, which added to the energy bill and economic costs.

But **demand-shifting factors** could also have been at play, as acknowledged by Chair Powell at this year's Jackson Hole keynote speech. Research presented at this year's ECB Forum on Central Banking in Sintra also points in this direction. One potential factor was the strong level of pent-up demand following the pandemic lockdowns.

People not only consumed less and accumulated more savings during the pandemic, but demand also shifted from services to goods. Once the lockdown restrictions had been eased and lifted, the vaccines rollouts made and health security improved, there was a demand overhang and a surplus of savings that together boosted private consumption.

Secondly, advanced economies introduced both fiscal and monetary stimulus measures on an unprecedented scale, with the objective of boosting domestic demand. Expansionary fiscal policy was especially pronounced in the United States.

Central banks also stepped in with various stimulus programmes. For instance, the ECB launched the PEPP asset purchase programme worth 1,850 billion euro in total. The Federal Reserve, apart from dropping the policy rate to zero, embarked on a wide range of asset purchase and loan programmes.

On top of that, both the Fed and the ECB made fresh changes to their respective monetary policy strategies. In both cases, the original goal had been to lift inflation from the deflationary mire where we had been for too long, with the aim of achieving a slight upward shift in inflation expectations.

It therefore transpired that many of the potential factors contributing to high inflation, including demand shifts, fiscal and monetary policy measures, energy shocks and supply chain disruptions, all happened around the same time.

This concurrence of various economic forces apparently makes life more difficult for researchers who try to analyse the causes of the inflation surge, because it amplifies the perennial identification problem. So, the jury is still out, and researchers are busy trying to disentangle these factors and develop new tools for identification and analysis.

These demand-supply interactions are rightly a part of this year's Bank of Finland and CEPR joint conference, for example the papers and discussions from yesterday's fascinating session on large shocks. They are also likely to be among the issues considered in **the next ECB strategy assessment in 2025**.

Slide 6. Reflections on the ECB's next strategy review in 2025

The most important decision of the ECB's previous strategy review, in 2021, was to set a symmetric inflation target of 2% over the medium term. This means that both negative and positive deviations from the target are now treated as equally undesirable. We also underlined the medium-term orientation for reaching the target.

This redefined inflation target, in place since 2021, 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.

Thus, the target itself does not, in my view, need re-consideration. But in the strategy assessment we need a better understanding of the inflation dynamics of the past few years and of the secular trends affecting monetary policy going forward. These include geopolitics and other drivers of the natural rate of interest.

Geopolitical challenges and geoeconomic fragmentation, in particular, will continue to shape the operating environment of monetary policy in the years ahead. Complex value chains are no longer seen only as a sign of economic progress, efficiency and peaceful cooperation, but also as a potential source of risk and economic disruptions.

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. They will also importantly shape the new equilibrium of the euro area economy that emerges after the current interest rate cycle.

Turning to the natural rate of interest, there are arguments supporting the view that it is rising – as a result of the huge investment needs due to the green transition, artificial intelligence and defence spending – but there are also arguments for the view that it is declining – due to weakening productivity growth arising from population ageing and geoeconomic fragmentation. The true picture is still largely unknown and requires considerable further research.

Another focus area in the strategy assessment should, in my view, be **labour markets**. We need a more concrete understanding of how demographics affect the participation rate and labour force trends.

In recent years we have seen a sharp decrease in average hours worked during the pandemic and increased immigration, which has enlarged the labour supply and helped to constrain wage pressures.

We need to ask ourselves whether these trends are likely to continue and such shocks likely to reoccur. And what is their impact on labour productivity in the short and longer term?

Conclusions

Ladies and Gentlemen,

Let me finish with a few conclusions.

The latest inflationary episode was the largest in 40 years. This, and the subsequent disinflation, offer us a wealth of new empirical raw material to learn from and for re-examining the analytical and historical knowledge we gained from Volcker's disinflation in the early 1980s.

Nevertheless, the paths of real and nominal interest rates and the ultimate dynamics of prices have this time been, to some extent, different. Obviously, the world has also undergone profound structural changes in the meantime, which makes simple analogies tricky. Even so, careful comparison and analysis of these two inflation episodes and their differences may improve our understanding of economics.

Let me add that there are many reasons to assume that the supply side of the economy is and will likely continue to be a source of shocks with inflationary implications. Climate and weather, energy and geopolitics, production chains, labour market and new technologies can all be sources of major disruptions and accelerate structural change.

This is of paramount importance for another reason too, namely that our traditional analytical tools, such as the New Keynesian framework, are typically better suited to the study of demand disruptions. Thinking more about the supply side may be tougher but is no less important.

Thank you.