Tuomas Välimäki: Drivers of inflation in a small open economy within a monetary union - experiences from Finland

Remarks by Mr Tuomas Välimäki, Board Member of the Bank of Finland, at The SNB and Its Watchers 2024 Conference, Zurich, 22 November 2024.

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Presentation accompanying the speech

Dear colleagues,

Thank you for inviting me to speak at this distinguished panel here in Zurich. It is an honor to be here today. I will discuss the drivers of inflation in a small open economy within a monetary union, drawing on the experiences of the country I know best, Finland. I will first present the main factors influencing Finnish inflation over the past 20 years and then explore the implications of being part of the euro area.

Inflation Dynamics: Finland vs. euro area

As a small open economy, Finland's inflation is heavily influenced by global factors and tends to follow global trends. Our experience as part of the euro area can be divided into three distinct periods, each with its own characteristics and lessons.

1. The Great Moderation (1999–2008):

During the first decade of the euro area, inflation was stable, averaging 2.2% across the euro area. Finnish inflation was slightly lower, averaging 1.8%. This divergence can be attributed to two main factors:

- The catching-up effect: Finland's general price level was-and remains-higher than in many euro area countries. While tradable goods prices have partially converged, non-tradables have showed more subdued adjustment.

- Nokia's impact: The rapid growth of Finland's ICT sector, led by Nokia, drove productivity gains. This allowed firms to absorb slightly higher wage increases without passing them on as higher prices. Furthermore, the booming ICT sector supported tighter public finances, which in turn reduced inflationary pressures.

2. The Lowflation Era (2009–2021):

The global financial crisis marked the start of a prolonged period of low inflation. However, from 2008 to 2014, Finnish inflation at 2.2% exceeded the euro area average at 1.5%, driven by several factors:

- Finland's robust banking sector and sound public finances helped to insulate the economy from both the banking crisis and the European debt crisis, maintaining stronger domestic demand.

- While Finnish economy faced several idiosyncratic shocks, the wages had not reacted to the new realities. Simultaneously, the decline in ICT sector began to weigh on productivity, which further increase unit labor costs.

3. The High-Inflation Period (2021–Present):

The post-pandemic recovery brought a sharp return of inflation, driven by global supply chain disruptions, shifts in demand, and energy price surges following Russia's brutal invasion of Ukraine. While euro area inflation has averaged 5.3% in this period, Finland's inflation has been slightly lower at 4.1%. Key contributors to this divergence include Finland's milder energy price increases and smaller labor cost pressures.

Inflation Drivers in the Euro Area and Finland

The overall picture during COVID and the subsequent inflation spike was quite similar for Finland and the entire euro area. Initially, inflation declined due to falling energy and service prices, driven by reduced demand and lockdowns. However, as global supply chains were disrupted, some prices began to rise. The shift in demand from services to goods and then back to services also had a noticeable impact on inflation. A mix of supply and demand effects interacted, causing inflation to exceed the target for the first time in over a decade.

Additionally, energy and other raw material prices surged sharply due to Russia's brutal invasion of Ukraine, which also led to rising food prices. On the demand side, prices were pushed up by increased consumption, fueled by household savings accumulated during the lockdowns and the strong fiscal and monetary stimulus measures implemented in response to the pandemic.

Recently, persistent service inflation has been the main factor sustaining inflation.

Now, lower increases in labor costs and differences in the energy mix are the two main reasons for the Finnish inflation deviating from the common trend. Let me next dive a bit deeper into the drivers of these inflation differences.

Mortgage rates in Finland vs. euro area

I am an old-school central banker. To me, inflation is always and everywhere a monetary phenomenon. Therefore, when analyzing inflation dynamics, one should not overlook the role of monetary policy. As Finland is part of the euro area, we share the same single monetary policy with the rest of the euro area. However, even though we share the risk-free rate, the transmission of monetary policy can vary from one country to another, impacting monetary conditions in each jurisdiction.

One significant difference between Finland and many other euro area member states lies in the housing market. In Finland, almost all housing loans are floating-rate mortgages, typically using the 12-month Euribor as a reference rate. In contrast, in Germany, for example, the most common fixing period is 10 years.

This affects housing loans through two channels. Normally, short-term rates fluctuate more than long-term rates over a business cycle. In the chart, we see interest rates on new housing loans. When we hiked the ECB policy rate by 450 basis points to address the sharply rising inflation in 2022-2023, the rates on new housing loans increased by 2.7 percentage points on average in the euro area, whereas in Finland, they went up by 3.7 percentage points, one percentage point more. Thus, monetary policy tightening had a larger impact on Finnish housing loans.

Moreover, the effect is even more pronounced when considering the rate on the outstanding stock of loans. The right-hand side chart illustrates this clearly. While the rate on the stock of housing loans increased by about 3.3 percentage points in Finland during this rate cycle, it rose by only 90 basis points on average in the euro area. This means the pass-through of rate hikes to the stock of loans was almost four times stronger in Finland.

It is worth noting that for the first 20 years in the euro area, Finnish households enjoyed the lowest mortgage rates in the region. This was partly due to the soundness of the Finnish banking sector throughout the crisis, underscoring the importance of a stable and resilient financial sector.

While I just pointed out the role of differences in interest rate fixings, it is important to note that differences in the economic structure are probably more significant factors in the varying transmission of monetary policy across euro area countries. For instance, construction and manufacturing constitute a considerable larger share of the Finnish economy compared to the euro area average. It is well known that monetary policy tightening impacts construction and manufacturing more quickly and strongly than services. Hence, Finland is especially prone to changes in monetary policy. On one hand, this increases the effectiveness of monetary policy, but on the other hand, if the pass-through in your country differs significantly from the euro area average, the single policy may temporarily seem suboptimal.

Energy Prices in the Euro Area and Finland

Let me quickly go through some other substantial factors behind the inflation differentials we've seen between Finland and the rest of the euro area.

The recent inflation spike was largely driven by the cost of energy. Energy prices almost tripled in the euro area on average compared to pre-pandemic levels. However, in Finland, energy prices increased less than the euro area average during the post-pandemic period. Even now, with the peak crises (hopefully) behind us, producer prices for energy in the euro area are more than 50% higher than they used to be, while in Finland, they have almost returned to pre-pandemic levels. This difference largely stems from Finland's better energy mix.

Here, we were actually quite fortunate for several reasons. First, the consumption of natural gas is extremely low in Finland. Second, before 2022, we were importing 10-15% of our electricity consumption from Russia, but a new, gigantic nuclear power plant started producing similar volumes that we lost from Russian imports just when energy prices were peaking. This was indeed lucky, as the construction of the plant had previously been delayed by more than a decade.

Third, thanks to ambitious policies aiming to bring Finnish net emissions to zero by 2035, we've been building a lot of renewable energy in the past couple of years. As a result, the share of renewable energy production in Finland is relatively high (close to 50%), and our dependency on energy imports is low by euro area standards (41% in 2022 compared to 68% in the euro area).

Wage Increases Broadly in Line with the Euro Area

More recently, wages have replaced energy as the main driver of inflation in the euro area. Growth in overall wages, measured by compensation per employee (CPE), has been elevated since 2022, peaking at 5.2% in 2023. This was initially driven by wage drift, such as bonus payments and changes in compensation for overtime. Since last summer, wage drift has largely receded and negotiated wage growth has become the main driver of overall euro area wage growth, remaining steady at 4.5-4.7% until recent months.

In Finland, negotiated wage growth has broadly aligned with the euro area in recent years. However, compensation per employee, which measures the cost of labor from the employer's perspective, has been slightly lower in Finland than in the euro area, reaching 3.5% growth in 2023. Hence, also service inflation has been lower in Finland than in the euro area since late 2021.

Next, I would like to highlight some conclusions that I find relevant for a small open economy within a monetary union.

Key Focus Areas for Open Economies in a Monetary Union

The main reason why Finnish inflation dynamics have been relatively similar to the euro area aggregate is that recent inflation volatility was largely caused by global shocks affecting all member states. Supply-side disruptions impacted prices and trade worldwide. This emphasizes the importance for a small open economy like Finland to be resilient and synchronized with the rest of the euro area. This also highlights my first point. For small open economies like Finland well-functioning economic structures, synchronized business cycles, and the trade linkages within the common market are vital for stability.

My second point considers the role of currency movements. Exchange rate changes are often considered an important economic adjustment mechanism, but this mechanism is abandoned within a monetary union. The ECB's monetary policy is set based purely on the euro area inflation outlook.

Being part of the monetary union has eliminated exchange rate fluctuations with euro area trading partners, who account for almost 40% of Finland's exports. This has added significant stability to the economy and inflation.

However, Finland remains exposed to exchange rate risks with key non-euro area trading partners like Sweden, US and China. From this perspective, one could argue that Finland is still exposed to typical small open economy risks. But this, of course, does not mean that joining the Economic and Monetary Union would have been a mistake. On the contrary, all small open economies have benefited considerably from joining the single market. Being a small open economy in a highly globalized world brings along vulnerabilities and risks that can be better managed within the European Union and the common market. This is more important when we are facing major geopolitical risks like we currently are.

When monetary policy is being set at the euro area level and we still occasionally face asymmetric economic shocks, the role of domestic economic policies becomes even more important. So, as my third point, I would like to stress the roles of fiscal and structural policies.

Fiscal policy is in practice the main tool for reacting to asymmetric shocks in the monetary union. Therefore, fiscal policies should be stability-oriented and countercyclical. Fiscal indebtedness should be kept on a sustainable track to facilitate policymakers to react to idiosyncratic shocks. In this respect, there is an urgent need in Finland, like in many other euro area countries, to stabilize and eventually reduce the fiscal deficit and improve resilience.

Furthermore, especially in a monetary union, economic structures should be kept flexible to address asymmetric external shocks in particular. Relative cost competitiveness, including wage developments, has an important impact on our economy. Thus, it's important that wage-setting procedures are flexible and avoid too long and rigid wage contracts.

Finally, one cannot overestimate the significance of having a resilient and sound banking sector to support monetary transmission and facilitate the funding of the real economy under all circumstances. Well-functioning banking sector facilitates financial stability and support economic growth. Hence, each member country should have adequate macroprudential policy tools at hand as well as be ready to adjust them also to complement single monetary policy.

Finally to conclude, I believe that the common monetary union-wide policy has served the Finnish economy well. We have avoided excessive fluctuations stemming from currency volatility and risk premia. At the same time, our inflation rate has closely followed the euro area average inflation. However, it is true that small economies in currency unions need to pay careful attention to public indebtedness, the accumulation of financial risks, and the competitiveness of their economy. But sound policies are called for no matter what kind of a monetary policy regime you have opted for.

Thank you for your attention.