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A few reflections after almost 30 years in central banking*

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Dear participants of the jubilee seminar. Let me begin by congratulating Narodowy Bank Polski on this day of celebrating the 100th anniversary of service to Poles and the Polish economy. A hundred years is a respectable age and, as you might expect, it encompasses a number of ups and downs in both central banking and Polish economic history. Others are much better predisposed than me to assess the last 100 years, but let me praise NBP for the monetary stability it has guaranteed to its country in recent times. I am also convinced that NBP has contributed to the impressive growth path on which the Polish economy has been for a long time. This is worth celebrating in itself!

It is an honor for me to address you here today. Growing up in Finland during the Cold War, this part of the world was close to us on the one hand, but because it was cut off, it was almost non-existent for us. However, the time of isolation imposed by force has come to an end and, as a result, centuries--old ties in our region have been rebuilt. It is hard to imagine greater joy! At the same time, given what is happening not far from here, one can get the impression that economic freedom and freedoms as such were not given to us once and for all. It is in our common interest to preserve the common heritage of Europe – a continent with such a difficult and complex history – that we have achieved together.

After 17 years as Governor, 5 years as Deputy Governor and 7 years at the IMF, a total of 29 years working in central banking and related fields, I will give you some very personal reflections that come to mind when I think about the past years, perhaps the views of a practitioner and a nerd in one, but it has been a privilege to be a practitioner for such a long time. My former scientific interests, profession and hobbies have merged into one whole. Taking into account my time limit, this is a sample of a reflection made almost in a telegraphic way.

The role of money

On a day like this, it is worth saying a few words about money as such. In central banking there is often a strong emphasis on monetary policy, and if we start from this macro point of view, the existence of money, much less the existence of a national currency, is taken for granted. Those of us who come from

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institutions with a hundred years or even more of pedigree know how difficult it was to get to where we are today. This difficulty is better understood especially when we take into account the legal definition of legal tender and the delicate balance between public and private sector money. The same applies when the value of one's own money has been or is being destroyed, as a result of which the broadly understood population of a given country decides to use another (someone else's) money.

In addition, before we get to monetary policy, we need a payment system and a financial sector through which monetary policy influences aggregate demand. The transmission mechanism is not fixed and can vary greatly depending on the level of development of the financial system in the economy. Currently, the inflation targeting strategy is very popular in many central banks, and it is easy to conclude that "this is the way to do it". The ultimate goal, direct or indirect, has long been monetary stability – seen as one of the elements and as a prerequisite for achieving beneficial economic development as such.

Other well-known options include the gold standard, often referred to as gold, a fixed exchange rate, a currency board, or simply using someone else's currency. Different countries come to different conclusions as to what is considered best for them at the national level, and conclusions vary over time.

The basic conclusion from my point of view in this context can be formulated as follows. One can choose any monetary formula, depending on what one likes, but once one has made a choice, one must understand and accept the economic consequences of the choice made. If the ruling elite is unable or unwilling to explain this to its voters, then regardless of the choice made, the whole project will end in failure. In other words, if you try to defy gravity, which in this particular case means creating a lot of money, then the monetary formula will collapse.

At the same time, different systems can produce good results. Let me introduce you to a sort of geographically regional list. Norway is not a member of the EU and refers to a floating exchange rate, just like Sweden, which is a member of the EU. Denmark is a member of the EU with a fixed exchange rate, but it is not part of the Eurozone. Finland, on the other hand, decided to use the euro, as did our neighbours from the Baltic countries, who started with different versions of the currency board, and then decided to introduce the euro. Of course, Poland can also be added to this list. Economically, all of these countries can be considered economically successful despite the differences in the monetary systems used. Thus, it is not only money itself that determines economic success, but stable money – in my opinion – certainly serves as a great help in achieving broadly understood economic success.

Monetary policy – what are we talking about?

What is understood by monetary policy has constantly changed over time. The times of my youth, i.e. long before I started working at the central bank, coincided with an era characterized by a fixed exchange rate, control of capital flows and a central bank that was almost an extension of the Ministry of Finance, and far-reaching restrictions limiting the freedom of the financial sector to operate, combined with precise views on the allocation of credit. All these factors determined the shape of monetary policy at that time. For a young economist with his head in American textbooks, it was almost impossible to comprehend what was happening at that time. As in many other countries where there has been an increase in cross-border trade and capital flows, this limited imbalance has proved unsustainable, as might have been expected. In particular, in combination with other macroeconomic

imbalances. Due to the onset of the currency, banking and fiscal crisis, as well as high and volatile inflation, the currency system of that time had to undergo profound changes. However, this was not a top-down planned and step-by-step reform of this system. On the contrary. The changes often occurred spontaneously. It was most likely not the optimal way of acting, but the only one that fulfilled its role in those circumstances.

These were the circumstances in which, in my opinion, the inflation target saw the light of day. There was no manual, no complicated models telling us what to do. There was one simple idea – if the inflation rate is above the target, then raise the base interest rate and reduce aggregate demand until you reach the target or, if inflation is below the target, which seemed unimaginable at the time, lower the base interest rate and increase aggregate demand until you reach the target.

Once the monetary formula, in this case the inflation target, is established, it is easy to assume that the formula as such is well-known and static, but in most cases it is not. As always, the devil is in the details, knowledge is accumulated or lost, and it is human to err and then learn from the mistakes made and correct it. Today's inflation targeting formula is much more complicated, some would say more sophisticated, compared to when I looked at it thirty years ago. When it comes to the execution of monetary policy and the efficiency of the transmission mechanism on the one hand, one can argue about the need to control the money supply and that a positive reserve requirement ratio is absolutely necessary. On the other hand, it can also be argued that there is no need to keep an eye on the money supply and there is no need to enforce a positive reserve requirement. Just set the policy rate. It is said that many roads can lead to Rome, and each of us is in favour of the particular path he has chosen. Regardless of this maxim, what is meant by the optimal monetary formula is over time subject to far--reaching changes, even though the target remains the same.

Without going into any technical details, let me give you an example of this evolutionary process. At the beginning of the inflation targeting strategy, it became clear that it was necessary to explain to market participants and other people what was happening at that time. You had to make forecasts, you had to tell stories about the future, and in particular about what kind of monetary policy would get you to the bliss point of 2% inflation. This is a very different approach compared to the world of fixed exchange rates and the frequent currency interventions that are part of it.

Initially, we assumed that the key interest rate would remain unchanged throughout the projection period. This assumption led to an inconsistent projection, especially if the inflation rate at the end of the period deviated from the target. The public found this assumption unrealistic, according to which "you will never maintain a constant interest rate for three years". In light of the above conditions, we accepted the criticism and began to use the so-called implied market rates as a proxy for future interest rates. That didn't work either, and as a result, we could once again hear the following voice: "You're central bankers, you have all the experts, you need to know more about your own monetary policy than market participants, right?" Yes, there were cases when we did not agree with what market participants thought. Especially in such circumstances, silence was not an option. Therefore, the next stage in the evolution of our activities was the publication of our own interest rate path. It took me about ten years to get through this iterative process. Each time we felt that we had already figured it out, but at the end of the day it always turned out that something was still wrong.

Once we started publishing the interest rate path, the next challenge was how to present it and how to incorporate the element of uncertainty into it. This is a challenge characteristic of other areas of life: just think about the weather forecast or real uncertainty in the era of a pandemic. In an ideal

world of uncertainty and widespread knowledge of uncertainty, one could argue about the subjective probability distributions of the future interest rate. However, this approach is unrealistic in the real world. So we tried to square the circle by combining a fan chart of interest rates with verbal statements: "the path of interest rates is a projection, not a promise, if the world changes, we will change too."

Regardless of the level of uncertainty and how to deal with it, inflation expectations are a key variable in the world of inflation targeting strategies, and this is where survey data plays a key role. An interesting topic in itself is what the survey data shows and whether the respondents fully understand what they are being asked. The key factor in the functioning of the formula in question are inflation expectations, in addition to achieving the target in a systematic manner, of course. By understanding how to communicate, you can actually influence expectations. To put it simply – if no one understands what you say, then no matter what you say, it will not be very convincing. Over the years, I've been struck many times by how many very intelligent and educated economists have found it both difficult and sometimes unpleasant to accept that you need to understand who your audience is and then tailor your message to that specific audience. In a complicated media landscape, communication has become a profession in itself. I suspect that the term "curse of knowledge" played a role here. Part of this work is convincing others. For years, part of my job was to be something of a chief translator. People don't listen to the complicated talk of economists. So part of the job was to be an economic meteorologist, a seer looking into a crystal ball, and a storyteller, telling economic stories about the future in such a way that most people would be able to understand you. Becoming a TV and radio personality is not what most economists, including myself, are trained to do, but it takes some getting used to. This is how you influence people's expectations!

Prerequisites

Monetary policy and all the other things that the central bank does do not happen in a vacuum. The central bank exists for a reason and is an integral part of society. Therefore, our surroundings must be understood. In Sweden, most mortgages are adjustable-rate mortgages, unlike the United States, with 30-year fixed-rate mortgages. These are two very different environments: in the case of Sweden, monetary policy affects households' wallets in a very direct, almost immediate way. That is, unlike the USA. Two different countries and two different transmission mechanisms that have different consequences for aggregate demand when the interest rate level changes. These differences become even more pronounced when comparing countries with different income levels and very different financial sectors. In some cases, the inflation targeting strategy becomes a distant aspiration because there are simply no prerequisites for its implementation. Today, controlling the money supply is out of fashion, but after years at the IMF and a long-standing interest in technical assistance, I have come to the conclusion that there are cases in which controlling the money supply (mainly through monetary aggregates) is the only viable option. There is no one-size-fits-all solution when it comes to the implementation of monetary policy. As I said before – there are many roads that lead to Rome. So, do everything you can to understand the local geography. In this respect, Poland is also a good example. Today's monetary policy environment is different from, say, 30 years ago.

Two prerequisites are particularly troublesome. The first of them, discussed in detail, is fiscal dominance. If public debt runs amok and, depending on the governance structure, then either it becomes impossible to control the balance sheet of the central bank, or the banks and bond markets

cease to function and the exchange rate collapses. It's all a matter of proportion. Fiscal dominance can gradually build up over time. The second is what I would call the dominance of the financial sector. Let me explain. After the Swedish banking sector was fixed in the early 1990s, interest rates in the US began to rise in the mid-1990s. Due to the newly introduced inflation target and the lack of credibility, Swedish interest rates had to follow suit. Coming out of a major banking crisis, it was impossible to predict what the maximum interest rate that banks and others would be able to endure without getting into trouble again. In other words, there was an upper limit, an upper ceiling, below which we had to act. Then we succeeded, inflation went down and we did not have to choose between the inflation target and financial stability, or rather financial instability. The latter (i.e. financial instability) took place in the years leading up to the introduction of the inflation target, when inflation accelerated sharply and, as a result, the base interest rate had to rise. More recently, with a very large mortgage market and mostly adjustable-rate mortgages, the consequences could be dramatic if inflation did not fall in the way it did. In the 1990s and now, we were saved by the gong, since both global inflation and interest rates started to fall! My conclusion is that no matter how much you focus on the inflation target, including all its technical details, you should never forget about financial stability. If you do, you risk losing a well-functioning transmission mechanism when you need it most.

Another set of preconditions that I don't think is talked about very often is the openness of the economy (measured both in terms of goods and services and capital flows), the relative size of the country's financial sector relative to the rest of the world, and in some cases the degree of dollarization/euroization. At the national level, monetary policy is often discussed as if we had full control and could set our independent agendas. The preconditions that I have briefly mentioned here point in a different direction. The inflation targeting strategy guarantees a large degree of freedom, but at the same time you cannot abstract from the rest of the world.

Financial stability

I have just noted that financial stability matters. At the same time, throughout my professional career, it has been very difficult for me to both discuss and address the interplay between monetary policy and financial stability. If you create money, and you create too much of that money, then the situation gets out of control, and you will be blamed. You can often hear the statement that financial stability is the responsibility of others, but in my opinion this is not the right point of view. Central banks are lenders of last resort and now from time to time market makers (due to their purchase of various assets) of last resort. This is not surprising, because the supervisors have no money, and in the case of Sweden, it was understood as early as 1668 that this is where the money is in the Riksbank, and if history gives us any indications, we know that the financial sector is inherently unstable. My personal reflection is that it takes three to five years to destroy a well-functioning bank and another three to five years to put the pieces back together. At the same time, in the world of inflation targeting, the time frame for the impact of decisions taken by the central bank is, say, a maximum of three years, and in the case of economic discourse, its time frame is often much shorter. Time perspectives are different and we have not yet found a good way to square the circle. This is both unsatisfactory and sad, because often the economic consequences of a financial crisis mean irreparable losses for society.

When I consider the role of the central bank, its ability to create external money, its ability to increase (or decrease) its balance sheet size, and its role when things go wrong, I conclude that supervision is best exercised by the central bank. You have a balance sheet total that you need to protect, because it sets the right motivational structure. From a very practical managerial point of view, especially in small economies, human capital in this area is scarce, and the central bank is often the only institution that can quietly build the human capital needed to avoid future problems in the financial sector. I am well aware that the political economy of supervision often pulls in the opposite direction, locating supervision outside the central bank, but this does not change the strength of my argument.

One of the fairly recent lines of work in this area is what we now call macroprudential policy. Views on these tools can be the basis for a separate speech. Macroprudential policy is one possible way to bridge the gap between monetary policy and financial stability. The use of macroprudential tools is, in fact, one of the ways to change the interest rate indirectly and partially without the need to refer to the change in the interest rate itself! From a coordination point of view, these tools also belong to the central bank.

What's next – new money on the way?

On the one hand, it is impossible to predict what the future will bring. On the other hand, the basic characteristics of money, money as a convention in our societies, do not change. This statement also applies to situations where payment technologies change. We come from a world where money was first based on precious metals and then took the form of fiat paper money, to a world where almost everything will be digital. In this new world, old truths about money will be challenged and old experiments will be re-conducted with new technologies. There are now many versions of bitcoin and similar varieties that are private sector projects claiming to be money. Central banks will face this challenge and, as a result, will have to prepare for the arrival of a new era. I have the impression that many people find this point of view very uncomfortable and instinctively prefer to maintain the current structures of the financial sector. However, time cannot be stopped and that is why the current debate and work on the creation of CBDC is so important. And in my opinion, it is much more important than many realize. The cornerstone of a functioning fiat money system is to ensure that the exchange rate between central bank money and private sector money is one-to-one. Without this feature, monetary stability is lost. In a world where paper money has lost its usefulness and there is no CBDC money yet, it becomes impossible for the general public to hold central bank money. It has been tried in the past and the result was not good. To sum up, if we want to preserve money as we know it, in the digital world, many central banks will have to return to old, long-standing problems such as: what is fiat money, how to anchor the money supply, what is the role of the central bank when technologies change.

A lot has changed in the last 100 years, and a lot will change in the next 100 years. The stability of money, regardless of what we call the regime or what technologies are available, is a public good. In the past, NBP successfully "produced" this public good. Now let's set ourselves a goal for the next 100 years. Congratulations and good luck for the next 100 years as well!

Thank you