Editorial

Editorial: Accommodative monetary policy to continue until a sustained adjustment in the path of inflation is reached

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The amount of underutilized domestic capacity is expected to gradually be taken up, and the global economy's generally favourable outlook will support growth in the euro area. Together these factors support expectations that the inflation rate will slowly return to the policy objective.



The economic expansion accelerated in the euro area more than expected in the first half of 2017 and continues to be solid across a range of countries and sectors. The amount of underutilized capacity within the economy is expected to gradually be taken up, and the global economy's generally favourable outlook will support recovery in the euro area. Together these factors support expectations that the inflation rate will slowly return to the policy objective, even if inflation has so far remained relatively subdued. A substantial degree of monetary accommodation is still needed for underlying inflationary pressures to gradually build up and support headline inflation developments in the medium term.

The ECB Governing Council will this autumn decide on the calibration of its policy instruments beyond the end of the year, taking into account the expected path of inflation and the financial conditions needed for a sustained return of inflation rates towards levels that are below, but close to, 2%.

Forward guidance on interest rates is a constant feature of the ECB's non-standard monetary policy measures. Forward guidance is effective if it influences market expectations of future interest rates. An analysis conducted at the Bank of Finland indicates that the prevailing time-contingent forward guidance, which links the first ECB interest rate hike explicitly to the duration of the APP, has influenced market expectations on the timing of interest rate hikes.[1] Even as economic recovery in the euro area has gained momentum, market expectations on the timing of the first interest rate hike have not shortened excessively. Indeed, they have persisted consistent with the ECB's forward guidance linked to the duration of the net purchases. *Forward guidance has become a constant feature of monetary policy, enhancing its transparency. Forward guidance will also in the future help economic agents interpret the monetary policy measures of the central bank.*

Why has the ECB Governing Council adopted a quantitative price stability objective of 'below, but close to, 2%' for the Eurosystem? Firstly, adoption of the definition serves to anchor inflation expectations and improve the transparency of monetary policy. Secondly, the implementation of monetary policy calls for flexibility, which explains the adoption of a medium-term objective for the euro area as a whole. And finally, price stability is an important primary objective of monetary policy in that it supports economic growth in the long term.

The quantitative definition of price stability does not imply that monetary policy would, in all conditions, be persistently geared towards keeping the average rate of inflation in the euro area below 2%. This would tighten monetary policy more than intended and cause inflation expectations to drop well below 2%.[2] It is therefore possible that inflation will, at times, be above 2% – as, indeed, has been seen in the past – which increases the symmetry of the inflation objective.

The euro area's accommodative monetary policy has also bolstered the recovery of the Finnish economy. Lending rates remain low, and the euro area has seen continued economic growth, which is important for Finland's export sector. Furthermore, Finnish exports are receiving support both from the outlook for the global economy and from the Competitiveness Pact, which came into force at the turn of the year.

With a revival in both exports and corporate investment in machinery and equipment, the recovery of the Finnish economy is more broadly based and solid than earlier. The economic

recovery, together with the fiscal consolidation measures adopted in recent years, has reduced the general government deficit, and this trend is expected to continue. That said, the long-term sustainability of general public finances is not ensured, given that population ageing will, in the coming years, increase pension and care expenditure and reduce the size of the working-age population.

Hence, it is of key importance that the consolidation measures designed to strengthen Finland's economy continue to be implemented. The losses in competitiveness of the previous decade have been partly offset, but the work is not yet complete, and this progress must be sustained. Most urgent are measures to foster growth in employment and productivity, with a special focus on youth unemployment. It is also essential to strengthen the public finances and improve their long-term outlook.

Consolidation of Economic and Monetary Union (EMU) is a key priority. Finland would also benefit from continued discussion on the enhancement of the institutional arrangements of EMU. The Single Supervisory and Resolution Mechanisms of the Banking Union are already in place, but completion of Banking Union also requires establishment of a common deposit insurance scheme. This issue has been under preparation for a long time.[3] However, before a changeover to a common deposit insurance scheme can occur, we must ensure that a phased solution has been found to the problem of non-performing loans and that sufficiently uniform criteria have been employed in assessing the risk position of banks joining the scheme, to ensure appropriate capital adequacy. A common insurance-type deposit guarantee is in the interests of both individual countries and EMU.

A Capital Markets Union (CMU) will pave the way for increasingly effective risk sharing on the financial markets. The CMU will provide for more efficient financial intermediation and diversification of funding sources. However, to ensure progress of the initiative as a whole, priority must be given to the objectives of the broad action plan. Similarly, openness and initiative on the part of Member States in advancing the projects will also play a key role.

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Notes

1. Eskelinen, Maria – Kortela, Tomi (2017) Are market expectations in line with the forward ↑

guidance of the ECB? Bank of Finland Bulletin 4/2017.

2. Łyziak, Tomasz – Paloviita, Maritta (2016) Anchoring of inflation expectations in the euro area: recent evidence based on survey data. ECB Working Paper Series No 1945. See https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1945.en.pdf. ↑
3. Improving the resilience of Europe's Economic and Monetary Union (2015) Ministry of Finance publications – 37b/2015. See http://vm.fi/en/publication?pubid=7801. ↑

Keywords

competitiveness, EMU, monetary policy, price stability